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- *Variable interest entities (2013)*
- *Utilities and power companies (2013)*

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Preface

PwC is pleased to offer the first edition of our *Financial Statement Presentation* guide. This guide serves as a compendium of the many presentation and disclosure requirements included in today's accounting and SEC literature. Appropriate financial statement presentation and disclosure is key to achieving the objectives of financial reporting, including providing decision-useful information to investors, lenders, creditors, and other stakeholders. This guide has been prepared to support practitioners in the preparation of their financial statements.

How to use this guide

We highlight below certain conventions used throughout the guide and other information regarding the guide's contents and organization.

- Throughout the guide, we have used shortened versions of certain terminology, such as "net income" when referring to net income or loss, or "retained earnings" when referring to retained earnings or deficit.

- Most chapters in this guide focus solely on the presentation and disclosure requirements applicable to the respective accounting topics. PwC's recognition and measurement guidance is contained in other PwC publications. Certain topics, however, relate only to presentation and disclosure. As such, the chapters are comprehensive. These chapters are *Statement of cash flows, Earnings per share, Segments, Discontinued operations*, and *Accounting changes*.

- Statement of cash flows requirements related to all topics are compiled within Chapter 6, *Statement of cash flows*.

- In general, the content refers to consolidated financial statements, with the exception of Chapter 31, *Parent company financial statements*.

- Presentation and disclosure requirements unique to interim reporting are discussed in Chapter 29, *Interim financial reporting*. Where interim and annual presentation and disclosure requirements are the same, the content is included within the chapter on the given topical area (for example, derivatives and hedging).

- Questions and examples are used throughout the guide for illustrative purposes; however, practitioners should still evaluate the relevant facts and circumstances in their situations.

This guide addresses financial statement presentation and disclosure related to the core financial statements only. As a result, the following are not included within this guide:

- Management Discussion and Analysis (MD&A) requirements

- Regulation S-K reporting requirements

- Bankruptcies and liquidations

  The presentation and disclosure guidance in this guide is applicable to reporting entities that are going concerns. PwC's *Bankruptcies and liquidations* guide addresses the presentation and disclosure requirements applicable to those reporting entities.

- Industry-specific guidance

  This guide discusses the requirements in SEC Regulation S-X, Article 5, for commercial and industrial companies. In most cases, the content does not include the requirements of other Articles within S-X or other industry-specific guidance. However, some chapters address topics relevant to reporting entities in other industries, such as investments and derivatives.

As of the content cutoff date of this publication (August 31, 2014), the FASB has several active projects that may affect current presentation and disclosure requirements. Financial statement preparers and other users of this publication are therefore encouraged to monitor the status of these projects, and if finalized, evaluate the effective date of the new guidance and the implications on presentation and disclosure. In addition, those using this publication are cautioned to stay abreast of and carefully evaluate subsequent authoritative and interpretative guidance that is issued after this guide.

Furthermore, the requirements of the new converged revenue recognition standard (ASC 606) are covered in PwC's global accounting and financial reporting guide for *Revenue from contracts with customers,* and therefore, the impact on current presentation and disclosure requirements is not addressed in this guide.

Locating guidance on particular topics

Guidance on particular topics can be located as follows:

- Table of contents—The table of contents provides a detailed listing of the various sections in each chapter. The titles of each section are intentionally descriptive to enable users to easily find a particular topic.

- Table of questions—The table of questions includes a listing of questions and PwC responses in numerical order, by chapter.

- Table of examples—The table of examples includes a listing of examples in numerical order, by chapter.

The guide also includes a detailed index of key topics.

References to U.S. GAAP and SEC guidance

Full paragraphs and excerpts from the FASB's Accounting Standards Codification or SEC guidance are clearly designated, either within quotes in the regular text or enclosed within a shaded box. In some instances, guidance was cited with minor editorial modification to flow in the context of the PwC Guide. The remaining text is PwC's original content.

In this guide, we may refer to SEC guidance generically, or specifically identify the guidance underlying the requirement. SEC guidance comes in a variety of forms. Regulation S-X prescribes the form and content of and requirements for financial statements filed with the SEC. SEC's codification of Financial Reporting Policies contains extracts of Accounting Series Releases (ASRs) and Financial Reporting Releases (FRRs) expressing the interpretive views on accounting and disclosure matters. Certain SEC views on accounting and auditing are also expressed in the enforcement-related ASRs and the Accounting and Auditing Enforcement Releases (AAERs). Also, Staff Accounting Bulletins (SAB topics) express the SEC staff's views on certain accounting and disclosure matters. Finally, the SEC has adopted numerous accounting and reporting positions, which are outlined in the Financial Reporting Manual, prepared by the Division of Corporation Finance.

References to other chapters and sections in this guide

Where relevant, the discussion includes general and specific references to other chapters of the guide that provide additional information. References to another chapter or particular section within a chapter are indicated by the abbreviation "FSP" followed by the specific section number, the first digit of which refers to the chapter number (e.g., FSP 2.2.2 refers to a section in chapter 2 of this guide).

References to other PwC guidance

This guide provides references to other PwC guides to assist users in finding other relevant information. References to other guides are indicated by the applicable guide abbreviation followed by the specific chapter number. The other PwC guides referred to in this guide, including their abbreviations, are:

- *Bankruptcies and liquidations (BLG)*
- *Business combinations and noncontrolling interests, global edition (BCG)*
- *Derivative instruments and hedging activities (DH)*
- *Fair value measurements, global edition (FV)*
- *Financing transactions: debt, equity and the instruments in between (FG)*
- *Income taxes (TX)*
- *Revenue from contracts with customers, global edition (RR)*
- *Stock-based compensation (SC)*

- *Transfers and servicing of financial assets (TS)*
- *Variable interest entities (VIE)*
- *Utilities and power companies (UP)*

All references to the guides are to the latest editions noted in the PwC Guide Library. In addition, PwC's *Accounting and reporting manual* (ARM) provides information about various accounting matters in U.S. GAAP, and PwC's *SEC Volume* (SEC) provides guidance on SEC registration and reporting requirements.

Copies of the other PwC guides may be obtained through CFOdirect, PwC's comprehensive online resource for financial executives (www.cfodirect.com), a subscription to Comperio, PwC's online accounting and financial reporting reference tool (www.pwccomperio.com), or by contacting a PwC representative.

Additionally, it is sometimes helpful to locate examples of actual published reports that may contain similar situations to assist in identifying appropriate wording for footnote disclosures.

SEC filings may be accessed on the SEC's website at www.sec.gov/edgar/searchedgar/webusers.htm. To search across SEC filings, use the full text search feature on the SEC's website at http://searchwww.sec.gov/EDGARFSClient/jsp/EDGAR_MainAccess.jsp. The "Advanced Search" feature can be used to perform searches within specific companies, form types, or industry SIC codes.

Accounting Trends & Techniques, published annually by the AICPA (and available on Comperio), is another source of information regarding financial reporting practices.

As they craft their disclosures, reporting entities may find it helpful to locate examples of a particular accounting treatment or footnote disclosure used by other entities in practice. However, reporting entities should recognize that other entities may have applied materiality judgments that influenced the necessity or extent of footnote disclosure that may not be apparent from reading the financial statements. Searching financial statement databases for examples should not replace detailed technical research and appropriate professional advice on accounting matters.

Guidance date

As the environment continues to change, so will the content in this guide. This guide considers existing guidance as of August 31, 2014. Future editions will be released to keep pace with significant developments. In addition, this guide supersedes all previously issued PwC guidance on financial statement presentation and disclosure.

Certain events, such as the issuance of a new pronouncement by the FASB, a consensus (and ensuing endorsement by the FASB) of the Emerging Issues Task Force or Private Company Council, or new SEC rules or guidance may necessitate an update or supplement to the guide. Updates, or supplements that may be in the form of other

PwC communications, can be found on CFOdirect (www.cfodirect.com) or Comperio (www.pwccomperio.com).

Other information

The appendices to this guide include guidance on professional literature, a listing of technical references and abbreviations, and definitions of key terms.

* * * * *

Financial statement presentation and disclosure is an area garnering much attention by the standard setting bodies, as evidenced by active projects on the FASB's current agenda. Presentation and disclosure is paramount to effective financial reporting. Our guide is designed to help you navigate the rules and regulations, understand the requirements, and prepare financial statements and effective footnote disclosures for your company. It should be used in combination with a thorough analysis of the relevant facts and circumstances, review of the authoritative accounting literature, and appropriate professional advice. We hope you find the information and insights in this guide useful. We will continue to share with you additional perspectives and interpretations as they develop.

Paul Kepple
U.S. Chief Accountant

2014

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Chapter 1: General presentation and disclosure requirements

1.1 Chapter overview

This chapter provides an introduction to the general concepts of presentation and disclosure that underlie the detailed guidance that is covered in the remaining chapters of this guide.

1.2 General presentation and disclosure requirements for all reporting entities

ASC 205, *Presentation of Financial Statements,* provides the baseline authoritative guidance for presentation of financial statements for all U.S. GAAP reporting entities. ASC 205-10-45-1A lists the required financial statements under U.S. GAAP.

ASC 205-10-45-1A

A full set of financial statements for a period shall show all of the following:

a. Financial position at the end of the period

b. Earnings (net income) for the period, (which may be presented as a separate statement or within a continuous statement of comprehensive income [see paragraph 220-10-45-1A])

c. Comprehensive income (total nonowner changes in equity) for the period in one statement or two separate but consecutive statements (if the reporting entity is required to report comprehensive income, see paragraph 220-10-15-3)

d. Cash flows during the period

e. Investments by and distributions to owners during the period.

The presentation rules in ASC 205 closely align with SEC regulations, except for certain circumstances in which the SEC may prescribe incremental requirements.

The presentation and disclosure requirements discussed in this guide presume that the related accounting topics are considered to be material and applicable to the reporting entity. That assumption applies throughout the guide and will not be restated in every instance. Accounting topics or transactions that are not material or not applicable to a reporting entity generally do not require separate presentation or disclosure, unless otherwise indicated.

This guide details the required presentation and disclosures for each topical area. However, S-X 4-01 requires that financial statements not be misleading. As a result, reporting entities may need to supplement required disclosures with additional information in some situations to provide context or further clarification that they believe would be meaningful to users.

1.2.1 *Basis of presentation*

S-X 4-01(a)(1) requires financial statements filed with the SEC to be presented in accordance with U.S. GAAP, unless the SEC has otherwise provided (e.g., the use of IFRS as issued by the IASB by foreign private issuers). S-K Item 10(e) prohibits the inclusion of non-GAAP information in financial statements filed with the SEC.

In practice, some reporting entities choose to provide a “Basis of Presentation,” or similarly titled footnote to disclose that the financial statements are presented in accordance with U.S. GAAP. Other reporting entities choose to include this information in a “Significant Accounting Policies” footnote, as described in FSP 1.2.4.

1.2.2 *Reporting periods*

Comparative financial statements provide historical context for reporting entities’ financial performance. Having more than one year of financial statements presented together enables users to identify trends or other relationships.

For public companies, S-X 3-01(a) mandates that financial statements include audited balance sheets as of the end of each of the two most recent fiscal years. S-X 3-02(a) mandates audited statements of income statements and cash flows for the three most recent fiscal years. SEC FRM 1110.1, Footnote 2, indicates that income statement requirements also extend to the statement of comprehensive income. Finally, S-X 3-04 requires information about changes in each caption of stockholders’ equity to be presented in a separate statement or in the footnotes for each period an income statement is presented. Qualifying Emerging Growth Companies and Smaller Reporting Companies are permitted to present only two years of audited financial statements.

Information presented for the comparative periods should be on a consistent basis or otherwise disclosed as a reclassification, an accounting change, or correction of an error (see FSP 30).

Although not required for private companies, ASC 205-10-45-2 encourages comparative statements for all entities.

ASC 205-10-45-2

In any one year, it is ordinarily desirable that the statement of financial position, the income statement, and the statement of changes in equity be presented for one or more preceding years, as well as for the current year.

ASC 205-10-45-4 indicates that footnote disclosures should be repeated in the next period’s comparative statements if they continue to be of significance.

1.2.3 *Chronological ordering of data*

The SEC staff has indicated no preference as to the order in which data is presented in the financial statements (e.g., whether the most current fiscal period should be displayed as the first or last column in the income statement). However, it has stated that data presented in tabular form should read consistently from left to right in the same chronological order throughout the filing. Numerical data included in the footnotes should also follow the same ordering pattern.

1.2.4 *Disclosure of accounting policies*

A reporting entity's accounting policies are critical to facilitate a user's ability to understand and compare operating results with other reporting entities. Reporting entities are therefore required to describe all significant accounting policies in the financial statements.

Determining which accounting policies are considered "significant" is a matter of management judgment. Management might consider materiality of the related account, as well as the requirements of users, such as investors, analysts, financial institutions, and other constituents.

ASC 235, *Notes to Financial Statements,* states the following regarding accounting policy disclosures:

ASC 235-10-50-3

Disclosure of accounting policies shall identify and describe the accounting principles followed by the entity and the methods of applying those principles that materially affect the determination of financial position, cash flows, or results of operations. In general, the disclosure shall encompass important judgments as to appropriateness of principles relating to recognition of revenue and allocation of asset costs to current and future periods; in particular, it shall encompass those accounting principles and methods that involve any of the following:

a. A selection from existing acceptable alternatives

b. Principles and methods peculiar to the industry in which the entity operates, even if such principles and methods are predominantly followed in that industry

c. Unusual or innovative applications of U.S. GAAP.

ASC 235 permits flexibility in matters of format (including the location) of the policy footnote, as long as it is an integral part of the financial statements.

1.2.5 *Use of estimates*

Reporting entities are required to disclose that the preparation of financial statements in accordance with U.S. GAAP requires the use of management's estimates.

1.3 Enhancing disclosure effectiveness

In preparing footnote disclosures, reporting entities should consider their intended purpose. A primary objective of financial reporting is to provide information to investors, lenders, creditors, and others for use in making decisions about whether to commit resources to the reporting entity. Disclosures should assist users in assessing both a reporting entity's historical performance and cash flow prospects. They should amplify information reported on the face of the financial statements, and focus users' attention on matters that are most relevant to understanding those financial statement areas.

We recognize that extensive footnote disclosure requirements impose costs on both reporting entities and investors. The costs to reporting entities include preparing and analyzing information, maintaining internal controls, and audit costs. In addition to indirectly bearing such costs, investors' costs include the time needed to assess the large amount of data presented in the footnotes to determine whether it is relevant for their decision-making.

Within established rules and legal requirements, we encourage reporting entities to exercise well-reasoned judgment to determine which disclosures are most relevant to financial statement users.

Reporting entities can enhance the format and organization of the footnotes to help focus users. Hallmarks of appropriate footnote disclosures include (1) clarity about relevant policies and significant transactions, and (2) organization that eases navigation. Reporting entities should consider employing best practices such as: using plain English to describe industry and entity-specific policies, eliminating overly technical references, grouping related data together and avoiding duplication, using tabular formats, and cross referencing information from the face of the primary statements to the related footnote or between footnotes.

Chapter 2: Balance sheet

2.1 Chapter overview

The balance sheet is one of the basic financial statements in a complete set of financial statements by public and private companies alike. Although the balance sheet is more formally referred to as the statement of financial position, the term "balance sheet" will be used throughout this chapter.

This chapter details general balance sheet presentation requirements. It includes an example of a balance sheet of a commercial company and an industrial company that illustrates the requirements of SEC Regulation S-X, Article 5, Rule 5-02, which calls for presentation of a classified balance sheet. It also covers balance sheet offsetting and the presentation of a noncontrolling interest ("NCI") in unconsolidated subsidiaries.

2.2 Scope

ASC 205, *Presentation of Financial Statements,* and ASC 210, *Balance Sheet*, provide the baseline authoritative guidance for presentation of the balance sheet for all U.S. GAAP reporting companies. These rules closely align with the SEC regulations, except for certain circumstances in which the SEC may prescribe incremental requirements.

SEC registrants subject to Article 5 for commercial and industrial companies should also comply with SAB Topic 11.E and the following Articles within S-X.

- *Article 3*

  Provides general instructions applicable to all registrants

  In particular, S-X 3-01 stipulates that the registrant and its subsidiaries should file a consolidated balance sheet as of the end of each of the two most recent fiscal years.

- *Article 4 (S-X 4-01 through 4-03)*

  Provides general application rules regarding the form and order of the balance sheet and other statements

Reporting entities subject to other SEC regulations include Registered Investment Companies (Article 6), Employee Stock Purchase, Savings and Similar Plans (Article 6A), Insurance Companies (Article 7), Smaller Reporting Companies (Article 8), and Bank Holding Companies (Article 9). While Article 5 requires a classified balance sheet, no other Articles within S-X contain this requirement. Reporting entities should refer to the applicable S-X guidance to determine their requirements.

2.2.1 Example balance sheet

The captions included on a balance sheet will often vary for each reporting entity based on the applicability of each account to its financial statements. Further, certain required captions may not be applicable to all reporting entities. Figure 2-1 is an illustrative balance sheet with the following conventions:

- Captions required by S-X 5-02 are in **bold** font and other common captions are in regular font.
- Captions not specifically required by SEC rules, but either required by U.S. GAAP or often included in a typical presentation are in regular font
- If S-X 5-02 specifically provides an option to include information in a footnote rather than on the face of the balance sheet, the caption is in regular font.
- Detailed presentation and disclosure requirements are addressed in FSP 2.3.3 and the relevant Guide chapters noted in the last column of the figure.

Figure 2-1
Example consolidated balance sheets under S-X 5-02

FSP Corp

Consolidated Balance Sheets

December 31, 20x4 and 20x3

Assets	**December 31, 20X4**	**December 31, 20X3**	**FSP Guide Chapter Reference**
	(in millions $, except per share data)	(in millions $, except per share data)	
Current assets			
Cash and cash items[1]	$ xxx	$ xxx	FSP 6
Restricted cash	xxx	xxx	FSP 6
Marketable securities (includes $xxx and $xxx measured at fair value)	xxx	xxx	FSP 9
Accounts receivable[2], net of **allowance for doubtful accounts** of $xx and $xx[3]	xxx	xxx	FSP 8
Notes receivable[2], **net of allowance for doubtful accounts** of $xx and $xx[3]	xxx	xxx	FSP 8
Net investment in leased property, net of **unearned income**[4]	xxx	xxx	FSP 14
Inventories	xxx	xxx	FSP 8
Prepaid expenses	xxx	xxx	FSP 8
Deferred income tax assets[5]	xxx	xxx	FSP 16
Other current assets	xxx	xxx	FSP 8
Total current assets	xxx	xxx	
Debt and equity securities	xxx	xxx	FSP 9
Securities of related parties	xxx	xxx	FSP 26
Indebtedness of related parties, noncurrent	xxx	xxx	FSP 26
Other investments	xxx	xxx	FSP 9
Investments in unconsolidated subsidiaries	xxx	xxx	FSP 10
Derivative assets	xxx	xxx	FSP 19

Assets	December 31, 20X4	December 31, 20X3	FSP Guide Chapter Reference
Deferred income tax assets, noncurrent[5]	xxx	xxx	FSP 16
Property, plant and equipment, net of **accumulated depreciation, depletion, and amortization** of $xx and $xx	xxx	xxx	FSP 8
Intangible assets, net of **accumulated amortization** of $xx and $xx	xxx	xxx	FSP 8
Goodwill[6]	xxx	xxx	FSP 8
Other assets	xxx	xxx	FSP 8
Total assets	$ xxx	$ xxx	

	December 31, 20X4	December 31, 20X3	FSP Guide Chapter Reference
	(in millions $, except per share data)	(in millions $, except per share data)	
Liabilities, redeemable preferred stock, and stockholders' equity			
Current liabilities			
Accounts and notes payable[7]	$ xxx	$ xxx	FSP 11
Current portion of long-term debt	xxx	xxx	FSP 12
Current portion of obligations under capital leases	xxx	xxx	FSP 14
Income taxes	xxx	xxx	FSP 16
Derivative liabilities	xxx	xxx	FSP 19
Deferred credits[5], current	xxx	xxx	FSP 16
Deferred tax liabilities, current[5]	xxx	xxx	FSP 16
Dividends payable	xxx	xxx	FSP 5
Other current liabilities	xxx	xxx	FSP 11
Total current liabilities	xxx	xxx	
Bonds, mortgages and other long-term debt, including capitalized leases	xxx	xxx	FSP 12 FSP 14
Indebtedness to related parties – noncurrent	xxx	xxx	FSP 12
Notes payable, noncurrent[7]	xxx	xxx	FSP 11
Employee benefit plan obligation	xxx	xxx	FSP 13
Deferred credits, noncurrent[5]	xxx	xxx	FSP 16
Deferred tax liabilities, noncurrent[5]	xxx	xxx	FSP 16
Other liabilities	xxx	xxx	FSP 11
Total liabilities	xxx	xxx	
Commitments and contingent liabilities[8]			FSP 23
Redeemable preferred stock[9] Class D - subject to redemption ($0.01 par value; authorized – xxxx shares; issued and outstanding – xxx and xxx shares)	xxx	xxx	FSP 5
Stockholders' equity			
Non-redeemable preferred stock Class C ($0.01 par value; authorized – xxxx shares; issued and outstanding – xxx and xxx shares)	xxx	xxx	FSP 5

	December 31, 20X4	December 31, 20X3	FSP Guide Chapter Reference
Common stock – Class A ($0.01 par value; authorized – xxxx shares; issued and outstanding – xxx and xxx shares)	xxx	xxx	FSP 5
Treasury stock, at cost (xxx and xxx shares held)	(xxx)	(xxx)	FSP 5
Additional paid-in capital[10]	xxx	xxx	FSP 5
Accumulated other comprehensive income[11]	xxx	xxx	FSP 4
Retained earnings[12]	xxx	xxx	FSP 5
Total stockholders' equity attributable to FSP Corp stockholders	xxx	xxx	
Noncontrolling interests in consolidated subsidiaries	xxx	xxx	FSP 5/ FSP 18
Total stockholders' equity	xxx	xxx	
Total liabilities, redeemable preferred stock, and equity	$ xxx	$ xxx	

See Notes to the Consolidated Financial Statements

1 For balance sheet presentation, cash includes cash and cash equivalents. The amount and caption presented on the balance sheet should align with the balance and caption on the statement of cash flows. See FSP 6.

2 S-X 5-02 requires separate captions for amounts receivable from (1) customers (trade), (2) related parties, (3) underwriters, promoters, and employees (other than related parties) that arose in other than the ordinary course of business, and (4) others.

3 S-X 5-02 permits allowances to be set forth separately in the balance sheet or in a note. ASC 210-10-45-13 requires allowances to be deducted from the asset group to which it relates.

4 In practice, reporting entities typically show the contra-asset, unearned income, in the footnotes.

5 S-X 5-02 requires separate captions for (1) deferred income taxes, (2) deferred tax credits, and (3) material items of deferred income. ASC 740 requires an entity to net all of the deferred tax assets and liabilities classified as current and, separately, to net all of the deferred tax assets and liabilities classified as noncurrent, when eligible unless facts and circumstances would prevent such netting. An example would be current assets and current liabilities in different jurisdictions where right of offset is not permitted.

6 Caption required by ASC 350-20-45-1.

7 S-X 5-02 requires separate captions for amounts payable to (1) banks for borrowings; (2) factors or other financial institutions for borrowings; (3) holders of commercial paper; (4) trade creditors; (5) related parties; (6) underwriters, promoters, and employees (other than related parties); and (7)others. Amounts applicable to (1), (2) and (3) may be stated separately in the balance sheet or in a footnote.

8 Required to be a separate caption, even without a dollar amount, if the reporting entity includes a footnote describing commitments and contingencies. See FSP 23.

9 This is "mezzanine equity" or temporary equity and is only required for SEC registrants. Determining whether certain instruments are required to be classified as mezzanine equity is discussed in PwC's accounting and financial reporting guide for *Financing transactions: debt, equity and the instruments in between* (FG) and presentation and disclosure of mezzanine equity is in FSP 5.6.3.

10 If applicable, S-X 5-02 requires that other additional capital be shown separately.

11 Caption required by ASC 220-10-45-14.

12 S-X 5-02 requires separate captions for (1) appropriated and (2) unappropriated retained earnings.

2.3 General presentation requirements

The rules that govern the presentation of the balance sheet components are intended to aid comparability between reporting entities. Reporting entities should consider chronology, individually significant account balances that may warrant further disaggregation, classified balance sheet requirements, and how the operating cycle impacts classification. While most reporting entities present the balance sheet in order of liquidity (i.e., starting with the most liquid asset, cash), there is no specific requirement within U.S. GAAP. Certain industries, such as public utility companies, may present prominent assets such as property, plant and equipment as the first line on the balance sheet.

2.3.1 Reporting periods

Comparative information provides a more comprehensive view of a reporting entity's financial position as compared to information that presents a single period of results. A U.S. GAAP balance sheet is typically presented for two fiscal years in a comparative format, as described in ASC 205-10-45. However, presenting a single fiscal year would also be in compliance with U.S. GAAP as comparative balance sheets are not required for private companies. However, ASC 205-10-45-2 states that comparative statements are "desirable."

The guidance for SEC registrants is more explicit regarding the required reporting periods for balance sheets. S-X 3-01(a) requires that SEC registrants file the most recent two fiscal years of audited balance sheets.

Prior-year figures presented in a comparative format are expected to be comparable to those shown in the most recent fiscal year. There may be instances when changes to prior year figures are necessary to achieve comparability, such as changes in accounting principles or corrections of errors. See FSP 30 for further discussion of such changes.

2.3.2 Chronology

SAB Topic 11.E indicates that the chronology of the periods presented in the balance sheet and tables within the financial statements do not require a particular sequence (e.g., earliest period to latest period). However, the reporting entity should consistently use the order chosen throughout the filing (i.e., same chronological order from left to right). While this is specific to SEC registrants, we encourage consistent ordering of financial statement presentation for all reporting entities.

2.3.3 Individually significant account balances

S-X 5-02 requires SEC reporting entities to separately present individual balance sheet amounts that exceed certain quantitative thresholds. The following are the criteria for determining whether separate presentation is required on the face of an SEC registrant's balance sheet or in its footnotes:

- Current assets with amounts that are greater than five percent of total current assets

- Any other assets with amounts that are in excess of five percent of total assets that are not properly classified in one of the existing asset captions

- The aggregate amount of notes receivable, if it exceeds ten percent of total receivables

- Each class of intangible assets with amounts in excess of five percent of total assets (required to be on the face of the balance sheet per S-X 5-02)

- Current liabilities with amounts greater than five percent of total current liabilities

  Reporting entities frequently separately present items such as accrued interest under this criterion when those balances are individually significant. The current portion of long-term debt is often required to be presented separately as a result of this threshold.

- Any other liabilities with amounts in excess of five percent of total liabilities that are not properly classified in one of the existing liability captions

2.3.4 Classified balance sheet

S-X 5-02 requires a classified balance sheet and ASC 210-10-05-4 notes that most reporting entities present a classified balance sheet. A classified balance sheet provides useful information regarding a reporting entity's level of working capital, a metric used in analyzing liquidity and near-term financial condition.

The ASC Master Glossary defines current assets and current liabilities.

Definitions from ASC Master Glossary

Current assets is used to designate cash and other assets or resources commonly identified as those that are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business.

Current liabilities is used principally to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities.

ASC 210-10-45 provides guidance on what is included in current assets and current liabilities that comprise working capital. The FASB guidance and the SEC guidance are aligned on what is considered current. It is based on the reporting entity's operating cycle.

2.3.4.1 Operating cycle

Reporting entities generally use a twelve month cycle when determining whether classification should be current or noncurrent. However, the classification should align with the business' operating cycle, which could be more, but not less, than twelve months. The ASC Master Glossary defines operating cycle.

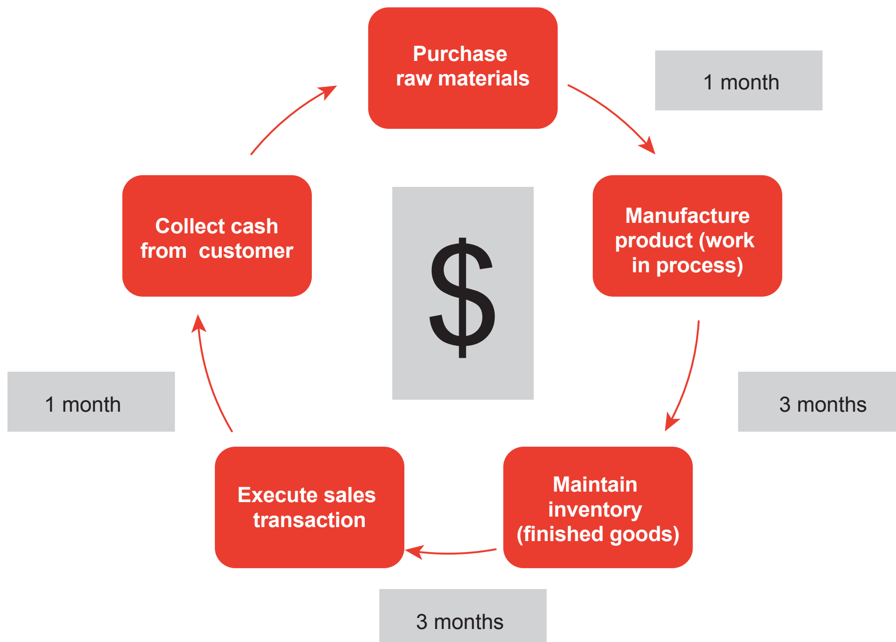
Definition from ASC Master Glossary

Operating Cycle: The average time intervening between the acquisition of materials or services and the final cash realization constitutes an operating cycle.

Figure 2-2 illustrates an operating cycle.

Figure 2-2

Example operating cycle for a commercial and industrial products company



ASC 210-10-45-3 provides guidance on the operating cycle that reporting entities should use in various situations. Figure 2-3 summarizes those requirements.

Figure 2-3

How to determine time period for current classification

Operating cycle of the business	Operating cycle for determining current classification
Less than one year (such as in Figure 2-2)	One year
Longer than one year (such as a tobacco, distillery, or lumber business)	Same as the business' operating cycle (i.e., the longer time period)
Not clearly-defined	One year

Once the reporting entity determines its operating cycle, it should analyze each asset and liability to determine if it should be classified as current or noncurrent or if it should be separated into both a current and noncurrent classification.

Certain financial statement captions or account balances may have specific guidance with respect to classification as current or noncurrent that do not depend on the operating cycle determination. Common examples of accounts with prescriptive guidance include debt (FSP 12) and deferred income taxes (FSP 16).

Example 2-1 demonstrates the application of this principle.

EXAMPLE 2-1

Classification of accrued rent obligation as current and noncurrent

FSP Corp is the lessee of an office building for a lease term of five years beginning on January 1, 20X4. The lease is classified as an operating lease and payments increase by a stated amount in each of the five years to approximate inflation. The expense is recognized on a straight-line basis over the lease term. The rent payments by year and corresponding expense and accrued rent are as indicated below:

Year ending	Rental payment	Rent expense	Accrued rent
December 31, 20X4	$100	$110	($10)
December 31, 20X5	$105	$110	($15)
December 31, 20X6	$110	$110	($15)
December 31, 20X7	$115	$110	($10)
December 31, 20X8	$120	$110	($ 0)

How should FSP Corp classify the accrued rent obligation at December 31, 20X6?

Analysis

On December 31, 20X6, FSP Corp should record a portion of the accrued rent, $5, as a current liability. This is based on the definition of a current liability, which is an obligation that will be liquidated by existing resources that are classified as current. In this example, cash will be used to liquidate the $5 obligation during FSP Corp's next operating cycle and therefore that obligation meets the definition of a current liability. In 20X7, FSP Corp will be paying cash in excess of the expense recorded which will have the effect of liquidating the $5 accrued rent liability.

Not all assets and liabilities will have a current and noncurrent allocation. For example, debt issue costs incurred when obtaining long term debt financing are typically deferred and amortized over the term of the debt and recognized as a part of interest expense. Because such deferred costs will not be directly realized in cash or otherwise consumed in operations, no portion of the asset is classified as current even though a portion of it will be amortized in the next operating cycle. Similarly, although a portion of property, plant and equipment and intangible assets will typically be depreciated or amortized during a reporting entity's operating cycle, the amount represents an allocation of the asset cost to operating expenses rather than an amount that is directly realized in cash or through consumption of the asset during the operating cycle; therefore, the entire asset should be classified as noncurrent.

2.4 Balance sheet offsetting

Balance sheet offsetting is permitted when a right of setoff exists and certain criteria are met.

ASC 210-20-45-1 provides guidance on the right of setoff. It lists four criteria that determine whether a right of setoff exists. If all four criteria are met, the reporting entity may present the asset and liability as a net amount on the balance sheet.

ASC 210-20-45-1

A right of setoff exists when all of the following conditions are met:

a. Each of two parties owes the other determinable amounts.

b. The reporting party has the right to set off the amount owed with the amount owed by the other party.

c. The reporting party intends to set off.

d. The right of setoff is enforceable at law.

Three of these criteria are objectively determinable; however, determining the intent of the reporting party may require judgment. ASC 210-10-45-5 notes that historical precedent is an indicator to consider in evaluating intent of the reporting entity. If the reporting entity has executed a settlement by offsetting balances with the other party in prior transactions, it may be appropriate to expect a similar offset in the future, provided the reporting entity asserts its intention to offset the balances. Generally, a reporting entity cannot present an asset and liability with another party net if the reporting entity does not intend to offset, even if all other criteria are met, except for derivatives, repurchase/reverse repurchase and stock lending agreements, which are subject to additional offsetting requirements as discussed in FSP 19 and 22.

The offsetting guidance relates to presentation only; its scope does not extend to derecognition of assets and liabilities. For example, presenting an asset and liability of equal value net on the balance sheet does not result in the derecognition of the contractual right and obligation. Therefore, reporting entities should include the gross amounts in disclosure, despite the amounts being all or partially eliminated from presentation on the balance sheet. Further, the offsetting guidance does not permit a reporting entity to record or disclose that debt or a note payable has been extinguished through the presence of a debt service fund or similar collateral arrangement.

The following questions address basic scenarios. In practice, contracts may not be as transparent as demonstrated in these scenarios when determining the ability to offset. Reporting entities should consider discussion with legal counsel to evaluate legal enforceability of set off rights.

Question 2-1

A reporting entity issued industrial revenue bonds ("IRBs") to construct pollution control facilities. The bond proceeds are in a trust to be drawn down for construction purposes based upon approved invoices. Can the reporting entity offset the funds held in a trust against the IRB liability?

PwC response

No. The funds held in a trust are intended to be used for asset construction, not debt repayment; therefore, not all of the criteria in ASC 210-20-45-1 are met. Specifically, there is no intent to set off. This question does not address whether the other three criteria are met.

Question 2-2

Sub Co borrows money from a third-party lender and lends the funds to a partnership, which uses the funds to pay existing debt of the partnership. The partnership is 50 percent-owned by Sub Co's parent company. Parent Co accounts for its investment in the partnership using the equity method. Parent Co intends to have Sub Co pledge its receivable from the partnership as collateral for the bank loan.

In preparing its consolidated balance sheet, should Parent Co offset Sub Co's note receivable from the partnership against Sub Co's note payable to the bank?

PwC response

No. It is only appropriate to offset an asset and liability under a legal right of set off when they represent amounts due to and from the same party. This question does not address whether the other three criteria are met.

2.5 *Noncontrolling interests*

Reporting entities should present any noncontrolling interest as a separate component of stockholders' equity, distinct from the equity attributable to the controlling shareholders. If there are noncontrolling interests (NCI) in multiple subsidiaries, the reporting entity may elect to aggregate them.

In some circumstances, reporting entities will classify NCI outside of stockholders' equity, either as a mezzanine instrument or as a liability. See BCG 2.6.5 and ASC 480-10-S99-3A for a discussion of circumstances that may require these alternative classifications. There are additional disclosure requirements in these circumstances, similar to those for redeemable preferred stock. Refer to FSP 5.6.3 for presentation and disclosure requirements for redeemable preferred stock.

2.6 Considerations for private companies

The balance sheet presentation requirements for private companies are largely the same as those for SEC registrants. One notable difference is the SEC rules on mezzanine equity in ASR 268, which requires presentation of certain instruments subject to redemption in mezzanine equity. While this is only applicable for SEC registrants, we strongly encourage such presentation for all reporting entities. See further discussion in FSP 5.6.3.

Other notable differences are:

- *The SEC requirement in S-X 3-01(a) that comparative statements be presented*

  Although not required for private companies, ASC 205-10-45-2 states that comparative financial statements are "desirable."

- *S-X 5-02 quantitative thresholds for determining which balances should be separately presented on the face of the balance sheet*

Chapter 3: Income statement

3.1 Chapter overview

This chapter provides an overview of the income statement, including its format, organization, and contents. The example statement presented in this chapter (1) provides presentation requirements for certain line items that are required to be identified separately, and (2) includes references to other sections of this chapter or other chapters of this guide for detailed presentation and disclosure considerations. This chapter focuses solely on the income statement and does not include discussion of the statement of comprehensive income, which is discussed in FSP 4.

3.2 Scope

The statement of income is referred to by various names, such as the income statement, statement of operations, statement of earnings, or others. Whatever name is used, its purpose is the same: to provide users of the financial statements with a measurement of a reporting entity's results of operations over a period of time. This allows users to make important investing, lending, and other decisions by understanding trends of key measures such as sales and profitability. The income statement contrasts with the balance sheet, which provides a measure of financial position at a point in time. It also contrasts with the statement of comprehensive income, which shows the change in a reporting entity's equity from all sources (net income, as well as revenues, expenses, gains, and losses included in comprehensive income but excluded from net income).

Authoritative guidance

Various accounting standards include guidance on the income statement presentation and related disclosure of certain transactions. The other chapters of this guide provide such requirements for specific topics. This chapter covers requirements that are more general in nature, or that are not covered by other chapters. The list below includes some of the authoritative guidance that is more pervasive for purposes of income statement presentation, but it is not a comprehensive list.

Presentation

- ASC 205, *Presentation of Financial Statements*
- ASC 225, *Income Statement*
- ASC 225-20, *Income Statement-Extraordinary and Unusual Items*
- ASC 235, *Notes to Financial Statements*

Revenues

- ASC 605, *Revenue*[1]

[1] The requirements of the newly-issued revenue recognition standard (ASC 606) are covered in PwC's accounting and financial reporting guide, *Revenue from contracts with customers, global edition*, and are not discussed in this guide.

<u>Expenses</u>

- ASC 720, *Other Expenses*

<u>SEC</u>

- Regulation S-X Articles 3, 4, and 5
- SAB Topic 1.B, *Allocation Of Expenses And Related Disclosure In Financial Statements Of Subsidiaries, Divisions Or Lesser Business Components Of Another Entity*
- SAB Topic 5.P*, Restructuring Charges*
- SAB Topic 13.A, *Selected Revenue Recognition Issues*

3.3 Format of the income statement

The income statement can be presented in a “one-step” or “two-step” format. In a “one-step” format, revenues and gains are grouped together, and expenses and losses are grouped together. These amounts are then totaled to show net income or loss. In a “two-step” format, subtotals are used to show decision-useful line items such as gross margin and operating income separately from non-operating income and net income or loss. Many commercial and industrial reporting entities use a “two-step” format.

Although income statements are generally presented in the formats noted above, reporting entities can also present an income statement by function (e.g., cost of sales, selling expense, administrative expense) or by nature (e.g., payroll expense, advertising expense, rent expense). The latter approach may be easier to prepare in some cases, but it does not present cost of sales, so no gross margin information can be determined.

S-X 5-03 indicates the various line items that, if applicable, should appear on the face of income statements filed with the SEC. Figure 3-1 illustrates the format of a typical “two-step” income statement.

3.3.1 Example income statement

The captions included in an income statement will vary across reporting entities based on their applicability to each entity’s business. Figure 3-1 is an example income statement that includes the line items required by S-X 5-03 (in **bold** font) and other commonly used captions. All required line items may not be applicable to all reporting entities.

Certain captions are permitted to be presented separately in the income statement by U.S. GAAP. Those are indicated in regular font and footnoted. Reporting entities should present these line items separately when material. Other presentation requirements may be satisfied in the footnotes. If S-X 5-03 indicates the placement of the detailed information is optional, the caption is in regular font.

Detailed presentation and disclosure requirements are addressed in the relevant sections of this chapter and other chapters of this guide (where applicable), as noted in the last column of the figure.

Figure 3-1

Example consolidated "two-step" income statement

FSP Corp
Consolidated Statements of Operations
For the years ended December 31, 20X4, 20X3, and 20X2

	20X4	**20X3**	**20X2**	**FSP chapter or section reference**
	In millions $, except per share data	In millions $, except per share data	In millions $, except per share data	
Net sales	**$xxx**	**$xxx**	**$xxx**	**3.5**
Cost of sales	**(xxx)**	**(xxx)**	**(xxx)**	**3.6**
Gross profit	xxx	xxx	xxx	N/A
Other operating expenses	**xxx**	**xxx**	**xxx**	**3.7**
Selling, general, & administrative expenses	**(xxx)**	**xxx**	**(xxx)**	**3.7**
Provision for doubtful accounts and notes	**(xxx)**	**(xxx)**	**(xxx)**	**3.7.2**
Depreciation expense[1]	(xxx)	(xxx)	(xxx)	3.7.3
Impairment loss[2]	—	(xxx)	—	3.7.4
Restructuring expense[3]	(xxx)	(xxx)	—	3.7.6
Other general expenses	**(xxx)**	**(xxx)**	**(xxx)**	**3.7.10**
Non-operating income	**xxx**	**xxx**	**xxx**	**3.8**
Interest and amortization of debt discount and expense	**(xxx)**	**(xxx)**	**(xxx)**	**FSP 12**
Non-operating expenses	**(xxx)**	**(xxx)**	**(xxx)**	**3.8**

[1] Reporting entities may choose to present depreciation expense separately in the income statement to fulfill the requirements of ASC 360-10.
[2] Reporting entities may choose to present impairment loss separately in the income statement to fulfill the requirements of ASC 360-10.
[3] Reporting entities may choose to present exit or disposal activities covered by ASC 420-10 separately within continuing operations as long as those activities do not involve a discontinued operation.

	20X4	20X3	20X2	FSP chapter or section reference
Income (loss) from continuing operations before income tax expense	**Xxx**	**xxx**	**(xxx)**	**3.9.1**
Income tax expense	**(xxx)**	**(xxx)**	**(xxx)**	**3.9.2/ FSP 16**
Equity in earnings of unconsolidated entities	**Xxx**	**xxx**	**(xxx)**	**3.9.3/ FSP 10**
Income (loss) from continuing operations	**Xxx**	**xxx**	**(xxx)**	**3.9.4**
Discontinued operations	**—**	**xxx**	**—**	**3.9.5/ FSP 27**
Income (loss) before extraordinary items and cumulative effects of changes in accounting principles	**Xxx**	**xxx**	**(xxx)**	**3.9.6**
Extraordinary item, net of $xx tax	**Xxx**	**—**	**—**	**3.9.7**
Cumulative effects of changes in accounting principles	**—**	**xxx**	**—**	**3.9.8/ FSP 30**
Net income (loss)	**Xxx**	**xxx**	**(xxx)**	**3.9.9**
Less: Net income (loss) attributable to noncontrolling interests	**Xxx**	**(xxx)**	**(xxx)**	**3.9.10/ FSP 18**
Net income (loss) attributable to parent	**$xxx**	**$(xxx)**	**$(xxx)**	**FSP 18**
Net income (loss) attributable to entity per common share—basic				**3.9.11/ FSP 7**
Continuing operations	x.xx	x.xx	x.xx	3.9.11/ FSP 7
Discontinued operations	N/A	x.xx	N/A	3.9.11/ FSP 7

	20X4	20X3	20X2	FSP chapter or section reference
Net income (loss)	x.xx	x.xx	x.xx	3.9.11/ FSP 7
Net income (loss) attributable to entity per common share – diluted				**3.9.11/ FSP 7**
Continuing operations	x.xx	x.xx	x.xx	3.9.11/ FSP 7
Discontinued operations	N/A	x.xx	N/A	3.9.11/ FSP 7
Net income (loss)	x.xx	x.xx	x.xx	3.9.11/ FSP 7

See Notes to the Consolidated Financial Statements

3.4 General presentation and disclosure requirements

ASC 225 is the primary guidance that provides the requirements for information included in the income statement. This includes ASC 225-10-S45 and 10-S99, which capture the guidance also included in Articles 3, 4, and 5 of SEC Regulation S-X. For purposes of this guide, we have focused on commercial and industrial companies, which are subject to Article 5. Other types of reporting entities (i.e., registered investment companies, employee stock purchase and similar plans, insurance companies, smaller reporting companies, banks and bank holding companies, and brokers and dealers that file Form X-17A-5) are subject to other SEC regulations not addressed in this guide.

3.4.1 Reporting periods

An income statement is typically presented for at least two fiscal years in a comparative format, as described in ASC 205-10-45. Presenting a single fiscal year would also be in compliance with U.S. GAAP. However, ASC 205-10-45-2 states that comparative statements are "desirable."

The guidance for SEC registrants is more explicit regarding the required reporting periods for income statements. S-X 3-02 requires that SEC registrants present the most recent three fiscal years of audited income statements, except for qualifying emerging growth companies and smaller reporting companies, which are permitted to present only two years of audited financial statements.

Prior year amounts presented in a comparative format are expected to be comparable to those shown in the most recent fiscal year. There may be instances where changes to prior year amounts are necessary to achieve comparability, such as changes in accounting principles. See FSP 30 for further discussion of such changes.

3.4.2 Thresholds for presenting separate revenue categories and related costs

S-X 5-03(1) requires separate presentation in the income statement for any of the following revenue categories that exceed 10 percent of total revenues:

- Net sales of tangible products (gross sales less discounts, returns, and allowances)
- Service revenues
- Income from rentals
- Operating revenues of public utilities
- Other revenues

The cost and expenses related to each revenue category must also be reflected separately in the income statement.

Any revenue categories that are individually 10 percent or less of total revenues for all periods presented may be combined into one line item in the income statement. The related costs and expenses should also be combined to be consistent with the revenue categories presented. These threshold rules align with the principle described in S-X 4-02, which indicates that items that are not material do not need to be shown separately.

The following figure illustrates how revenue and cost of sales may be presented in the income statement.

Figure 3-2
Presentation of revenue and related cost categories

Revenue:	
Product	$100
Service	$80
Total revenue	$180
Cost:	
Product	$40
Service	$60
Total cost	$100
Gross margin	$80

This threshold requirement does not apply to interim financial statements, though it is often followed in practice. Interim-specific requirements are discussed in FSP 29.

3.5 Sales and revenues

SAB Topic 13.A, *Selected Revenue Recognition Issues,* requires an SEC registrant to disclose its revenue recognition accounting policy, primarily because of the level of judgment generally involved in revenue recognition.

If a reporting entity has different policies for different types of revenue transactions, it should disclose the policy for each material type of transaction. The same is true for sales transactions that have multiple units of account (e.g., product and service). Additionally, the reporting entity should disclose how units of account are determined and measured.

Reporting entities use various descriptions for the categories of revenue presented on the face of the income statement. Such descriptions are based on facts and circumstances of each reporting entity and may include industry considerations. Some examples of these descriptions include:

- Net revenues
- Net sales
- Product revenue
- Service revenue
- Software revenue
- Hardware revenue
- Subscription revenue
- Advertising revenue

Question 3-1

In situations where the revenue recognition guidance does not allow for separation of multiple deliverables into different units of accounting specifically due to a lack of evidence of fair value, how should a reporting entity separate the total revenue into separate classes of revenues (e.g., software revenues and services revenues) for income statement presentation purposes in order to comply with the requirements of S-X 5-03(1)?

PwC response

Reporting entities should allocate revenue recognized into separate income statement classes of revenue using a reasonable and systematic method that is consistently applied. A reporting entity may not simply default to the contractual value in the arrangement or to a subjective allocation. This is true even if that model is consistently applied.

A reasonable basis generally consists of estimates based on objectively verifiable inputs. For example, third party evidence of fair value would be a reasonable basis for separately displaying software deliverables that require vendor specific objective evidence (VSOE) of fair value for revenue recognition purposes.

If material to the financial statements, the reporting entity should also provide transparent disclosures regarding the methodology and basis for separating the elements for disclosure purposes.

If a reporting entity is not able to identify a reasonable basis for separately displaying revenues from multiple deliverable transactions, presentation of a single line item (i.e., combining service and product revenue in the same line item for these types of arrangements) would be acceptable. We expect this situation to arise in limited instances, such as those involving multiple-element software arrangements. This is because the multiple-element arrangement guidance allows for the use of the best estimated selling price (BESP) to separate deliverables, except in certain circumstances (i.e., software revenue recognition).

EXAMPLE 3-1

Separately displaying revenues in a multiple-element arrangement

FSP Corp, a software company, has a multiple-element arrangement for $100 that includes products and services. The entire arrangement is accounted for pursuant to revenue recognition guidance within ASC 985, *Software*. The stated contractual values are $60 for the software and $40 for the services. FSP Corp does not have VSOE of fair value for any of the deliverables. Accordingly, the arrangement will be accounted for as a single accounting unit for recognition purposes. FSP Corp determines that the appropriate revenue recognition model is to recognize the $100 ratably over the period the services are delivered. Although FSP Corp does not have VSOE for all of the deliverables, management believes that separately presenting product and service revenues and the related costs in the income statement provides more useful information to investors than a single line item presentation.

Is it appropriate for FSP Corp to separately present product and service revenues even though the reporting entity does not have VSOE for all the deliverables?

Analysis

Yes. Such presentation is acceptable as long as the allocation methodology is consistently applied and clearly disclosed. In this case, FSP Corp determines an allocation methodology based on its internal price list and allocates $45 to software and $55 to services. FSP Corp will therefore present $45 as product revenue and $55 as service revenue ratably in its income statement for this arrangement over the service period. For example, if the service period is five months, one-fifth, or $9 of product revenue and $11 of service revenue, will be recognized after the first month of service delivery. The related product and service costs will also be presented separately in the income statement, utilizing the actual costs of the products and services.

3.5.1 *Revenues versus gains*

The ASC Master Glossary includes certain industry and topic-specific definitions of revenues and gains, but does not provide broad definitions of these terms.

However, CON 6, *Elements of Financial Statements*, provides some insight into the types of activities that should be presented as revenues and those that should be presented as gains.

Excerpts from CON 6, paragraphs 78 and 82

Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.

Gains are increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from revenues or investments by owners.

Certain transactions clearly result in revenues as compared to gains, while the distinction for other transactions may not be as clear.

EXAMPLE 3-2

Sale of revenue-generating equipment

FSP Corp, an equipment rental entity, purchases equipment to be used to generate rental revenue. The costs to acquire the equipment are capitalized as revenue-generating equipment and depreciated over their useful lives. In 20X4, several vehicles are sold to a third party at the end of their useful lives after being fully depreciated, resulting in an amount being recovered that exceeds the residual value.

Should FSP Corp present some amount (i.e., either the total sale amount or the excess over the residual value) as revenue?

Analysis

Based on the fact pattern, FSP Corp should not recognize any amount as revenue. If the company's "ongoing major or central operations" consist of renting equipment, then the amounts resulting from the sale of revenue-generating equipment should generally not be characterized as revenue. Rather, the activity constitutes the disposal of an asset for which an operating gain (in this case) should be recorded. If a significant portion of the company's "ongoing major or central operations" consisted of selling equipment that was previously used for rental activities, it may be appropriate to characterize the sales as revenue-generating activities. Judgment may be required in this assessment.

EXAMPLE 3-3

Sale of patent

FSP Corp is a pharmaceutical company that is in the business of licensing and selling patents in its patent portfolio. FSP Corp enters into an agreement with a third party to sell a recently approved patent for cash.

How should FSP Corp present the consideration received for the sale of the patent?

Analysis

As FSP Corp is in the business of routinely licensing and selling patents in its patent portfolio, it would be appropriate to present the consideration received as revenue. If FSP Corp was not in the business of routinely licensing and selling its patents, but nonetheless sold one of its patents to a third party, it would likely be more appropriate to present a gain on sale of the patent.

3.5.2 Income from litigation settlements

Determining the appropriate presentation of amounts received from litigation settlements can be particularly challenging. There are situations where the receipt of litigation settlements represent revenue, and others where the settlement receipts represent gains. When litigation settlements involve multiple elements, a reporting entity must identify each item given and received and determine how those items should be recognized and classified.

3.5.3 Gross versus net revenue presentation

Arrangements often involve two or more unrelated parties that contribute to providing a good or service to a customer. ASC 605-45 provides guidance to determine whether a reporting entity should present revenue based on the gross amount billed to a customer or the net amount retained (that is, the amount billed to a customer less the amount paid to a supplier). The decision to record revenue on a gross versus net basis is often a matter of significant judgment that is dependent upon the relevant facts and circumstances. Once the accounting determination is made, the presentation on the income statement should be clear as to which method is being applied. Footnote disclosure should describe the accounting policy and the basis for such determination.

Question 3-2

A reporting entity reports revenues on a net basis in accordance with ASC 605-45. For those transactions reported net, the reporting entity considers gross transaction volumes to be a useful statistic, and believes the best presentation for such amounts is on the face of the income statement.

What forms of gross presentation on the income statement are considered acceptable in this fact pattern?

PwC response

ASC 605-45 allows for the voluntary disclosure of gross transaction volumes for revenues reported on a net basis. The following factors should be considered if gross transaction volumes are disclosed on the face of the income statement:

- Gross transaction volumes should not be characterized as revenues (e.g., a description such as "gross billings" may be appropriate), nor should they be reported in a column that sums to net income or loss.

- While alternative formats may be permitted, the key is to ensure that the income statement does not give the impression that it begins before the line item that represents revenues reported on a net basis.

- Gross transaction volumes should not be presented in a manner where the gross transactions sum to the revenues reported on a net basis per ASC 605-45.

3.5.4 Shipping and handling fees and costs

Any amounts billed to a customer in a sale transaction related to shipping and handling represent revenues earned for the goods provided and should be classified as revenue in accordance with ASC 605-45.

The definition of what is included in shipping and handling costs and their classification on the income statement is an accounting policy decision. However, deducting these handling costs from revenues (i.e., netting any such costs against shipping and handling revenues) is not permitted. If the reporting entity does not record shipping and handling costs in cost of sales, the reporting entity must disclose the line item that includes the shipping and handling costs and the related amount, if significant. Note that significance is measured with respect to both absolute dollars and the effect on reported gross margin.

3.5.5 Out-of-pocket reimbursements

Expenses are often incurred by service providers while performing work for their customers. These can include costs for travel, meals, accommodations, and miscellaneous supplies. It is common for the parties to agree that the customer will reimburse the service provider for some or all of these out-of-pocket expenses. ASC 605-45 indicates that reimbursements received by a reporting entity for its out-of-pocket expenses should be characterized as revenue.

3.5.6 Taxes collected from customers and remitted to governmental authorities

ASC 605-45 also provides guidance on the income statement classification of taxes collected from customers on behalf of a governmental authority. Taxes within the scope of this guidance include any tax assessed by a governmental authority that is imposed on a specific revenue-producing transaction, and may include sales, use, value added (VAT), some excise, or other taxes. Tax schemes that are based on gross receipts and taxes that are imposed during the inventory procurement process are not within the scope of ASC 605-45.

Taxes within the scope of ASC 605-45 may be reported on either a gross basis (included in revenues and costs) or on a net basis (excluded from revenues) as an accounting policy election. A reporting entity should disclose its accounting policy applied to each type of tax collected on behalf of governmental authorities. Reporting entities should also disclose the amounts of any taxes reported on a gross basis for each period for which an income statement is presented, if those amounts are significant. This information can be disclosed on an aggregate basis.

S-X 5-03(1) requires that excise taxes amounting to one percent or more of total sales and revenues be disclosed on the face of the income statement, parenthetically or otherwise.

Question 3-3

A reporting entity collects sales taxes from customers in one jurisdiction and VAT in another jurisdiction. Could the reporting entity elect to report the sales taxes on a gross basis and the VAT on a net basis?

PwC response

Yes. We believe the accounting policy election may be applied to each type of tax within the scope of ASC 605-45 (e.g., sales taxes may be presented on a gross basis while VAT may be presented on a net basis).

3.5.7 Sales incentives

A sales incentive is any consideration given by a vendor to a customer to induce current or future sales. Sales incentives can take many forms, and include consideration given by vendors to either distributors or end users (customers). Examples of sales incentives include, but are not limited to, credits, coupons, rebates, customer loyalty programs, price protection, and product placement fees.

Reporting entities should carefully consider classification, timing, and measurement of the consideration provided when recording sales incentives, which can be a matter of significant judgment. ASC 605-50 provides guidance on the accounting for consideration given by a vendor to a customer, including whether such amounts should be presented as contra-revenue or an expense. Footnote disclosure should describe the accounting policy and the basis for such determination.

3.5.8 Negative revenue and upfront payments to customers

Negative revenue may arise from transactions or changes in estimates that are required to be characterized as a reduction of revenue.

ASC 605-50-45-7

If amounts are required to be characterized as a reduction of revenue under this or any other Topic, a presumption exists that no portion of those amounts shall be recharacterized as an expense. However, if a vendor demonstrates that characterization of those amounts as a reduction of revenue results in negative

revenue for a specific customer on a cumulative basis (that is, since the inception of the overall relationship between the vendor and the customer), then the amount of the cumulative shortfall may be recharacterized as an expense.

The illustrations in ASC 605-50-55 discuss some of the guidance and underlying circumstances that could result in negative revenue.

With respect to vendor upfront cash consideration tendered at the start of a customer relationship, ASC 605-50 includes the following guidance.

ASC 605-50-45-9

A vendor may remit or be obligated to remit cash consideration at the inception of the overall relationship with a customer before the customer orders, commits to order, or purchases any vendor products or services. Under the guidance in the preceding two paragraphs, any resulting negative revenue may be recharacterized as an expense if, at the time the consideration is recognized in the income statement, it exceeds cumulative revenue from the customer. However, recharacterization as an expense would not be appropriate if a supply arrangement exists and either of the following circumstances also exists:

a. The arrangement provides the vendor with the right to be the provider of a certain type or class of products or services for a specified period of time and it is probable that the customer will order the vendor's products or services.

b. The arrangement requires the customer to order a minimum amount of vendor products or services in the future, except to the extent that the consideration given exceeds probable future revenue from the customer under the arrangement.

When considering whether cumulative negative revenue exists for a specific customer, a reporting entity should consider all transactions with the customer that take place within the consolidated group.

3.5.9 Multiple-deliverable arrangements

Reporting entities with multiple-deliverable arrangements in the scope of ASC 605-25 are required to disclose all of the following information by similar type of arrangement:

- The nature of such arrangements

- The significant deliverables within the arrangements
- The general timing of delivery or performance of service for the deliverables
- Performance, cancellation, termination, and refund-type provisions
- A discussion of the significant factors, inputs, assumptions, and methods used to determine selling prices for the significant deliverables
- Whether the significant deliverables in the arrangements qualify as separate units of accounting and, if not, the reasons that they do not qualify
- The general timing of revenue recognition for significant units of accounting
- The effect of changes in either the selling price or the method or assumptions used to determine selling price for a specific unit of accounting if either one of those changes has a significant effect on the allocation of arrangement consideration

The objective of the disclosure requirements is to provide both qualitative and quantitative information necessary for a user of the financial statements to understand the nature of the judgments made and any changes in those judgments in recording arrangements with multiple deliverables, as they may significantly affect the timing or amount of revenue recognition. Therefore, in addition to the required disclosures above, reporting entities should disclose other qualitative and quantitative information in order to satisfy this objective.

Question 3-4

ASC 605-25 requires that a reporting entity disclose information by similar type of arrangement. What is meant by similar type of arrangement?

PwC response

We believe reporting entities should consider the following aspects of its multiple-deliverable arrangements when determining what constitutes similar arrangements:

- The products and services sold in the arrangements
- The customers and markets to which the arrangements are sold
- The terms of the arrangements

EXAMPLE 3-4

Presenting revenue in a multiple-deliverable arrangement

FSP Corp enters into an arrangement to sell Product A for $200 and Service B for $200. It has concluded that the BESP for Product A is $300 and the BESP for

Service B is $200. Product A is delivered immediately following the signing of the agreement. Service B will be delivered over a one-year period. Product A and Service B qualify as separate units of accounting. All consideration is received upfront, and there are no refund provisions or extended payment terms.

A relative allocation of the total contract consideration allocates the $400 of total consideration in the following manner:

Deliverable	**Contract Amount**	**BESP**	**Relative Allocation**
Product A	$200	$300 (60%)	$240 (60% of $400)
Service B	$200	$200 (40%)	$160 (40% of $400)
Total	$400	$500 (100%)	$400

However, the amount allocable to a delivered unit is limited to that amount that is not contingent upon the delivery of additional units or meeting other specified performance conditions (the non-contingent amount). Thus, the amount of revenue recognized upon delivery of Product A is limited to $200.

How much revenue should FSP Corp present as product revenue and service revenue from this arrangement?

Analysis

FSP Corp can select between two approaches to record the amounts allocated in this example, which impact the classification, but not the timing, of amounts recognized.

Approach 1

In this approach, $200 is recognized upon the delivery of Product A. Two hundred dollars is the maximum amount allocable to Product A, since the contractual consideration for Product A is $200. The remaining $40 is allocated to Service B and recognized as the service is performed. At the completion of this contract, a total of $200 is recognized as product revenue and $200 recognized as service revenue.

Approach 2

In this approach, $200 is recognized upon the delivery of Product A. The remaining $40 allocated to Product A based on the relative allocation is recognized pro rata as product revenue as Service B is performed, since that amount of the contractual consideration is contingent upon the delivery of Service B. At the completion of the contract under this approach, a total of $240 is recognized as product revenue and $160 recognized as service revenue.

3.5.10 *Sales returns and exchanges*

Although there are no explicit disclosure requirements for the sales returns reserve, reporting entities may consider disclosing certain information about the reserve if it is material or has changed significantly from prior periods. SEC staff comment letters have focused on footnote disclosures related to reporting entities' right of return allowances (ASC 605-15), as well as disclosure of the returns reserve activity (which is typically included in SEC filings as part of the "valuation and qualifying accounts" schedule (Schedule II)). Additional disclosure requests have included the method of determining the estimated reserves, the amounts of returns and related reserves, and a discussion of the impact of returns on a reporting period (including changes in estimated returns).

3.5.11 *Milestone method of revenue recognition*

Reporting entities that elect to apply the milestone method of revenue recognition will need to comply with the disclosure requirements in ASC 605-28-50-2. Specifically, a reporting entity is required to disclose:

- A description of the overall arrangement
- A description of each milestone and related contingent consideration
- A determination as to whether each milestone is substantive
- The factors considered in determining whether the milestone is substantive
- The amount of consideration recognized during the period for milestones

Question 3-5

Does each milestone within an arrangement need to be disclosed, or can milestones be combined for disclosure purposes?

PwC response

Reporting entities should avoid aggregating milestones for disclosure purposes, whenever practicable. However, in certain circumstances, a reasonable level of aggregation may be necessary for reporting entities with a substantial number of milestones. In such cases, instead of disclosing each individual milestone and related contingent consideration, a reporting entity might provide disclosure for each category of milestone within a given arrangement (e.g., clinical, regulatory, or commercial), if that level of disclosure provides meaningful information to allow users of the financial statements to understand the arrangement.

3.5.12 *Advertising barter transactions*

ASC 605-20 provides guidance on accounting for advertising-for-advertising barter arrangements. These arrangements have specific disclosure requirements, as follows.

ASC 605-20-50-1

Entities shall disclose the amount of revenue and expense recognized from advertising barter transactions for each income statement period presented. In

addition, if an entity engages in advertising barter transactions for which the fair value is not determinable within the limits of paragraphs 605-20-25-15 through 25-18, information regarding the volume and type of advertising surrendered and received (such as the number of equivalent pages, the number of minutes, or the overall percentage of advertising volume) shall be disclosed for each income statement period presented.

3.5.13 Other nonmonetary transactions

Reporting entities that engage in nonmonetary transactions are required by ASC 845 to disclose the nature of the transaction, the basis of accounting for the assets transferred, and any gain or loss recognized on the transfer. For each period in which a nonmonetary transaction occurred, reporting entities should also disclose the amount of gross operating revenue recognized as a result of the transaction. Finally, reporting entities must disclose the amount of revenue and costs (or gains and losses) associated with inventory exchanges recognized at fair value.

We believe that recording revenue on a gross basis is appropriate when the nonmonetary asset exchanged is an asset that is held for sale in the normal course of business (i.e., inventory). For transactions in which the asset or service surrendered is not the reporting entity's normal product or service, recording the transaction as other income is appropriate. For example, a gain in an exchange of fixed assets for barter credits should be reported as other operating income.

3.5.14 Construction and production-type contracts

When accounting for contracts in accordance with ASC 605-35, a reporting entity is required to disclose its accounting policy regarding revenue recognition and cost accrual — specifically, whether the percentage-of-completion or the completed-contract method is generally followed. The disclosure requirement also applies when following guidance within ASC 910-605, *Contractors-Construction – Revenue Recognition*.

A reporting entity that typically follows the percentage-of-completion method is required to disclose the method or methods (for example, cost-to-cost, labor hours) of measuring the extent of progress toward completion. If this same reporting entity uses the completed-contract method for certain contracts, as allowed by ASC 605-35, disclosure of this departure from its basic accounting policy is needed. Similarly, if the reporting entity typically follows the completed-contract method but then applies the percentage-of-completion method as allowed, disclosure is again needed. The specific criteria a reporting entity uses to determine when a contract is substantially completed should be followed consistently and disclosed in its accounting policy.

Reporting entities are required to disclose in annual and quarterly filings material changes in estimates and the related impacts on income and earnings per share. Comment letters indicate that the SEC staff expects, at a minimum, disclosure of the aggregate net impact of changes in contract estimates on income and earnings per share for each period presented, when material. Reporting entities should also consider disclosure of the aggregate gross favorable and gross unfavorable profit adjustments if such disclosure would be meaningful to an investor. In addition to quantitative disclosures, a qualitative description of the circumstances leading to the adjustments should be provided.

Claims (in the context of contract accounting) are amounts a contractor seeks to collect from customers in excess of (or not included in) the agreed-upon contract price due to customer delays, changes in scope, or similar circumstances. Additional disclosure is required related to revenue from claims, including the policy for recognizing such revenue, the amounts recognized, and the amount of a resulting contingent asset. However, as with the disclosure of any contingent asset or gain, a reporting entity should avoid misleading financial statement users regarding the likelihood of realization.

Reporting entities that apply the contract accounting guidance in ASC 605-35 may be required to record a provision for the entire loss on a contract if estimated costs for the contract exceed estimated revenue. The provision for loss should be accounted for in the income statement as cost rather than as a reduction of contract revenue. Unless the provision is material in amount or unusual or infrequent in nature, reporting entities are not required to present the loss provision separately in the income statement. If it is shown separately, it should be shown as a component of the cost included in the computation of gross profit. In most instances, however, disclosure of significant losses in the footnotes is sufficient.

Regulation S-X also requires certain balance sheet-related disclosures for long-term contracts. These are discussed in FSP 8.

3.6 Cost of sales

Cost of sales represents the costs that are directly related to creating the products that a reporting entity sells, or providing the service that generates service revenue. Costs may include direct costs, such as labor and raw materials, or indirect costs, such as machinery depreciation, warehouse utilities, and stock-based compensation. Judgment is required to determine which costs should be allocated to cost of sales compared to other categories of expense. Reporting entities should be consistent in their allocation methodology to ensure all periods presented are comparable. The classification of warranty expense is specifically discussed in FSP 11.

Although cost of sales typically represents one of the more material income statement line items, there are minimal presentation and disclosure requirements associated with it. As previously discussed, the cost and expenses related to each revenue category must be reflected separately in the income statement.

Question 3-6

If a reporting entity defers both costs and revenue (in an amount equal to or greater than the costs), there is an expectation that the capitalized costs will be amortized over the same period and in proportion to the amount of deferred revenue recognized as revenue. How should the amortization of such capitalized costs be classified on the income statement?

PwC response

Although the deferred costs relate to a revenue-generating transaction, they do not necessarily represent cost of sales. Various types of costs are capitalizable (e.g., salaries, sales commissions, etc.); and therefore, the costs should be recognized in accordance with the nature of the benefit provided (e.g., cost of sales, sales & marketing, or general & administrative) as they are amortized.

3.7 Operating expenses

As indicated in Figure 3-1, S-X 5-03 requires registrants to separately identify certain operating expense line items if they are material. In practice, many reporting entities will separately identify selling, general, and administrative costs (SG&A) as one line item, but the remaining operating costs may be separately identified in a manner that differs from the named line items prescribed by S-X 5-03. As such, this section discusses many of the common operating expenses that reporting entities may or may not separately identify depending on materiality, and what is most useful to their financial statement users.

The selling, general, and administrative (SG&A) line item frequently includes the sum of all direct and indirect selling expenses, as well as all general and administrative expenses of the reporting entity. SG&A expenses include salaries of employees (excluding those related to product manufacturing or capitalized labor), depreciation (excluding those related to product manufacturing), bad debt expense, advertising expenses, rent expense (excluding those related to product manufacturing), and any other costs of selling product or administrating the business.

3.7.1 Advertising expense

Advertising costs are generally presented as part of selling, general, and administrative expenses in a reporting entity's income statement. Advertising costs can either be expensed as incurred or expensed the first time the advertising takes place. The accounting policy selected from these two alternatives must be applied consistently to similar kinds of advertising activities. ASC 720-35-50-1 requires that disclosures include, at a minimum:

- The accounting policy selected for reporting advertising, indicating whether such costs are expensed as incurred, or the first time the advertising takes place
- The total amount charged to advertising expense for each period an income statement is presented

3.7.2 Provision for doubtful accounts and notes

Provision for doubtful accounts and notes is the current period expense associated with losses from normal credit sales. These provisions are generally grouped within SG&A. However, if they are material, they should be presented separately on the face of the income statement as an operating expense. Although the SEC requires a rollforward of the doubtful accounts and notes to be included in the filing as part of the "valuation and qualifying accounts" schedule (Schedule II), some reporting entities include such disclosures as part of the footnotes to the financial statements.

Reporting entities may have flexibility as to how they present expense associated with changes in the provision for receivables.

Excerpt from ASC 310-10-45-5

The change in present value from one reporting period to the next may result not only from the passage of time but also from changes in estimates of the timing or amount of expected future cash flows. A creditor that measures impairment based on the present value of expected future cash flows is permitted to report the entire change in present value as bad-debt expense. Alternatively, a creditor may report the change in present value attributable to the passage of time as interest income.

ASC 310 requires reporting entities that choose the latter alternative to disclose the amount of interest income that represents the change in present value of cash flows attributable to the passage of time.

Additionally, ASC 310 provides guidance on how reporting entities should present changes in the market price of an impaired loan or in the fair value of the collateral of an impaired collateral-dependent loan.

ASC 310-10-45-6

The observable market price of an impaired loan or the fair value of the collateral of an impaired collateral-dependent loan may change from one reporting period to the next. Changes in observable market prices or the fair value of the collateral shall be reported as bad-debt expense or a reduction in bad-debt expense.

For balance sheet-related disclosure requirements for provisions for doubtful accounts and notes, refer to FSP 8.

3.7.3 *Depreciation and amortization of long-lived assets*

Total depreciation and amortization of long-lived assets is required to be disclosed in a reporting entity's financial statements. Many reporting entities choose to disclose this information as one or more lines in the statement of cash flows.

Some reporting entities exclude from the cost of sales line item some or all of the depreciation, depletion, and amortization related to the manufacturing of products or the services provided. In this instance, SAB Topic 11.B, *Depreciation And Depletion Excluded From Cost Of Sales,* precludes those reporting entities from presenting a gross margin subtotal in the income statement unless depreciation, depletion, and amortization is presented as a separate line item before gross margin. Further, SAB Topic 11.B indicates that if cost of sales excludes charges for depreciation, depletion, and amortization, the description of the line item should reflect this (e.g., "Cost of sales (exclusive of items shown separately below)" or "Cost of sales (exclusive of depreciation shown separately below)").

Reporting entities that present cost of sales excluding depreciation, depletion, and amortization must also consider the requirements of S-K 302(a). This guidance requires certain SEC registrants to disclose selected quarterly financial data, including gross profit (i.e., net sales less costs and expenses associated directly with, or allocated to, products sold or services rendered). Reporting entities that exclude all or some allocation of depreciation, depletion, and amortization from cost of sales must include these amounts in the gross profit disclosure required by S-K 302(a), with appropriate footnote explanation.

Figure 3-3 depicts the alternative income statement presentations that comply with the guidance in SAB Topic 11.B.

Figure 3-3
Alternative presentation of depreciation and amortization expense

Example A:

Net revenue	$xxx
Cost of sales (exclusive of depreciation and amortization shown separately below)	xxx
Selling, general, and administrative expense	xxx
Research and development expense	xxx
Depreciation and amortization	xxx
Other operating expenses	xxx
Operating income	xxx
Interest expense	xxx

Other expense (income)	xxx
Income before taxes	xxx
Tax expense	xxx
Net income	$xxx

Example B:

Net revenue	$xxx
Cost of sales (exclusive of depreciation shown separately below)	xxx
Depreciation expense	xxx
Gross margin	xxx
Selling, general, and administrative expense	xxx
Research and development expense	xxx
Other operating expenses	xxx
Operating income	xxx
Interest expense	xxx
Other expense (income)	xxx
Income before taxes	xxx
Tax expense	xxx
Net income	$xxx

Under Example A, although not required in the footnotes, reporting entities could present the quarterly information required by S-K 302(a) as follows:

Note X: Unaudited Quarterly Financial Information

Results of operations for each of the four quarters in the years ended December 31, 20X4 and 20X3 are as follows:

Net revenue

Gross Margin (defined as net revenue less cost of sales and depreciation and amortization)[1]

Net Income

[1] Alternatively, this parenthetical could be shown as a footnote to gross margin

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In addition to the items discussed above, it is also common for a reporting entity to disclose how it determines the useful lives of its depreciable or amortizable assets.

Refer to FSP 8 for disclosures required for property, plant, and equipment and other long-lived assets, including depreciation and amortization disclosure requirements.

3.7.4 Impairment of long-lived assets

Impairments of long-lived assets may be included in SG&A, or presented separately on the income statement. Refer to FSP 8 for presentation and disclosure requirements for impairments related to long-lived assets.

3.7.5 Research and development expense

Many reporting entities, especially those in certain industries (e.g., biotechnology), incur significant research and development expenses. ASC 730 requires reporting entities to expense research and development costs as they are incurred, and disclose the following.

ASC 730-10-50-1

Disclosure shall be made in the financial statements of the total research and development costs charged to expense in each period for which an income statement is presented. Such disclosure shall include research and development costs incurred for a computer software product to be sold, leased, or otherwise marketed.

Impairment of in-process research and development costs initially capitalized as part of a business combination should also be classified in the research and development expense line.

Reporting entities that receive reimbursements of R&D expenses from another party may question whether those reimbursements should be treated as revenue or an offset to R&D expense since the guidance on income statement geography is piecemeal and contained in several different areas of the accounting literature. The SEC staff has acknowledged that, in some cases, a reporting entity may be able to support more than one conclusion based on the existing accounting literature. Reporting entities should evaluate the facts and circumstances of each arrangement, apply reasonable judgment consistently, and disclose the method of accounting used, as well as disclose the reason(s) that the chosen method is appropriate.

3.7.5.1 Collaborative arrangements

Certain research and development transactions may be structured as collaborative arrangements subject to the guidance in ASC 808, *Collaborative Arrangements*.

Reporting entities should evaluate payments related to collaborative arrangements based on the nature of the arrangement, the nature of the reporting entity's business operations, and the contractual terms of the arrangement. If there is other guidance that is applicable to payments in collaborative arrangements, reporting entities should follow that guidance (e.g., guidance on customer payments in ASC 605-50) for determining the income statement classification. If the payments are not in the scope of other guidance, or if there is no appropriate analogy, reporting entities should make a consistently-applied accounting policy election, and should consider disclosure of that policy election.

Reporting entities are required to disclose the following information about collaborative agreements in the scope of ASC 808:

ASC 808-10-50-1

In the period in which a collaborative arrangement is entered into (which may be an interim period) and all annual periods thereafter, a participant to a collaborative arrangement shall disclose all of the following:

a. Information about the nature and purpose of its collaborative arrangements

b. Its rights and obligations under the collaborative arrangements

c. The accounting policy for collaborative arrangements in accordance with Topic 235

d. The income statement classification and amounts attributable to transactions arising from the collaborative arrangement between participants for each period an income statement is presented.

Information related to individually significant collaborative arrangements shall be disclosed separately.

3.7.6 Restructuring expense

SAB Topic 5.P, *Restructuring Charges,* requires reporting entities to present restructuring charges and related asset impairment charges as a component of income from continuing operations, separately disclosed if material. Reporting entities are also permitted to separately present, in income from continuing operations, exit or disposal activities covered by ASC 420, *Exit or Disposal Cost*

Obligations, that are not discontinued operations. However, because exit or disposal activities do not meet the definition of extraordinary items in ASC 225-20, they should not be presented in any manner that implies that they are similar to extraordinary items. The earnings per share effect should not be disclosed on the face of the income statement. For more detail on presentation and disclosure of restructuring expenses, refer to FSP 11.

3.7.7 Amortization of intangibles and impairment of goodwill

Amortization of intangibles and impairment of goodwill may be included in operating expenses and are frequently aggregated with other line items, unless material enough to necessitate separate disclosure. Refer to FSP 8 for presentation and disclosure requirements for intangibles and goodwill post-acquisition.

3.7.8 Gains or losses on involuntary conversions

Involuntary conversions of nonmonetary assets to monetary assets are considered monetary transactions. Examples of such conversions are total or partial destruction or theft of insured nonmonetary assets and the condemnation of property in eminent domain proceedings. Any gain or loss from the conversion should be recognized as a component of ordinary income unless determined to be an extraordinary item in accordance with ASC 225-20.

Any insurance recoveries (up to the amount of any loss recognized on the nonmonetary asset) are required by ASC 605-40 to be recorded in the same financial statement line item as the related loss (generally operating income unless the gain or loss meets ASC 225-20's requirement for extraordinary treatment, which is expected to be rare). As such, insurance recoveries would rarely, if ever, be presented as revenues because they do not reflect payments from customers. Insurance proceeds in excess of the related loss, such as replacement cost insurance, are typically included in non-operating income.

3.7.9 Foreign currency gains/losses

Foreign currency gains/losses are incurred through foreign currency translation of business transactions when reporting entities have transactions denominated in a foreign currency and/or have an additional functional currency other than the reporting currency. These foreign currency gains/losses are considered to be a normal component of operations, and are therefore generally included as part of operating expenses. Refer to FSP 21 for more detail on presentation and disclosure considerations related to foreign currency.

3.7.10 Other general expenses

S-X 5-03 requires reporting entities to include items not normally included under the caption "selling, general, and administrative expenses" under the caption "other general expenses." Any material items are required to be separately stated (e.g., transaction costs related to business combinations).

3.7.10.1 Gains or losses from sale of long-lived assets

S-X 5-03(6) requires gains or losses from the sale of long-lived assets accounted for under ASC 360-10-45-5 to be presented as "other general expenses." Refer to FSP 8 for further presentation and disclosure guidance on long-lived assets and FSP 3.8.4 for further information on gains or losses on the sale of a business.

3.7.11 Unusual or infrequently occurring items

ASC 225-20 provides guidance on the presentation of unusual or infrequently occurring items in the income statement. Specifically, the guidance describes an unusual or infrequently occurring item in the following manner.

ASC 225-20-45-16

A material event or transaction that is unusual in nature or occurs infrequently but not both, and therefore does not meet both criteria for classification as an extraordinary item, shall be reported as a separate component of income from continuing operations. The nature and financial effects of each event or transaction shall be disclosed on the face of the income statement or, alternatively, in notes to financial statements. Gains or losses of a similar nature that are not individually material shall be aggregated. Such items shall not be reported on the face of the income statement net of income taxes or in any other manner that may imply that they are extraordinary items. Similarly, the EPS effects of those items shall not be presented on the face of the income statement.

Disclosure of "unusual item" amounts, net of applicable income taxes, and their earnings per share effect, net of applicable income taxes, is permissible only in the footnotes. Such footnote disclosure may be desirable for items that affect the comparability of income statements between periods. Reporting entities should not separately disclose the earnings per share effect of inconsequential items and items clearly of an operating nature (e.g., weather-related events, strikes, or start-up expenses).

To be considered an extraordinary item, an event must be infrequent and unusual in nature. Many times, events do not meet the infrequent criteria, and therefore are precluded from being presented as an extraordinary item. For example, ASC 410-30 states that environmental remediation obligations should not be considered an event that is unusual in nature, meaning they cannot be treated as extraordinary. For more on presentation and disclosure related to environmental costs, refer to FSP 11.

3.8 Non-operating income and expenses

S-X 5-03(7) and (9) prescribe separate income statement line item captions for non-operating income and non-operating expense. Many SEC registrants prefer to show one line item for non-operating income and expense on a net basis. Generally, the combination of non-operating income and expense is permissible as long as the individual amounts are not significant. Note that it is not the net balance that determines materiality, but the offsetting gross amounts. However, it is not permissible to combine non-operating income and expense if interest income and interest expense are netted in such a combination. The SEC presumes that all interest expense is shown in the caption for interest expense prescribed by S-X 5-03(8).

3.8.1 Non-operating income

S-X 5-03 requires entities to present separately, in the income statement or in a footnote, amounts earned from (a) dividends, (b) interest on securities, (c) profits on securities (net of losses), and (d) miscellaneous other income. Amounts earned from transactions in securities of related parties must also be disclosed as required by S-X 4-08(k). Material amounts included under miscellaneous other income should be separately presented in the income statement or in a footnote, indicating clearly the nature of the transactions out of which the items arose.

3.8.2 Non-operating expenses

S-X 5-03 requires entities to present separately, in the income statement or in a footnote, amounts of losses on securities (net of profits) and miscellaneous income deductions. Material amounts included under miscellaneous income deductions should be separately presented in the income statement or in a footnote, indicating clearly the nature of the transactions out of which the items arose.

3.8.3 Interest expense and amortization of debt discount

S-X 5-03 requires interest expense and amortization of debt discount to be presented on the face of the income statement. Refer to FSP 12 for discussion of the presentation and disclosure requirements associated with debt discounts.

3.8.4 Gains or losses on the sale of a business

Some reporting entities present gains or losses resulting from the sale of a business (that does not qualify as a discontinued operation) within operating income in a "two-step" income statement. However, others report such items as non-operating gains or losses. The SEC has accepted both approaches. In a "one-step" income statement format, gains or losses from the sale of businesses (that do not qualify as discontinued operations) should be reported as "other general expenses."

The approach selected should be applied consistently. Any material items should be presented separately on the face of the income statement or in the footnotes, regardless of whether they are classified as operating or non-operating.

3.8.5 Government grants

A reporting entity may receive a government grant that provides financial assistance for certain eligible expenditures — for example, to build and operate a factory in a particular geographical location. There is currently no authoritative guidance in U.S. GAAP that indicates how reporting entities should account for these reimbursements. However, depending on the nature of the grant, other U.S. GAAP may be applicable. For example, if the grant actually takes the form of a tax credit, it may be subject to ASC 740, *Income Taxes*. Likewise, if a grant is reported as revenue, a public reporting entity should apply the guidance in SAB Topic 13.A.

If the grant is not subject to other U.S. GAAP, and no other U.S. GAAP guidance can be applied by analogy, reporting entities may look to international accounting standards. International accounting standards indicate that the grants may be reflected as a deferred credit or a reduction of the constructed asset's carrying amount, or as other income or a reduction of expense, depending on the nature of the grant.

Reporting entities should disclose their accounting policy for accounting for government grants, if material, so it is clear which financial statement line item reflects the grants.

3.9 Other presentation requirements

Regulation S-X prescribes certain line items and subtotals in the income statements of SEC registrants. Reporting entities that are not SEC registrants frequently follow this guidance as well.

3.9.1 Income or loss before income tax expense

Income or loss before income tax expense is required to be presented separately on the face of the income statement by S-X 5-03.

3.9.2 Income tax expense

S-X 5-03 requires only taxes based on income to be included under this caption. Refer to FSP 16 for presentation and disclosure considerations related to income taxes.

3.9.3 Equity in earnings of unconsolidated entities

Equity in the earnings of an unconsolidated entity accounted for using the equity method should be separately stated. Refer to FSP 10 for presentation and disclosure guidance for equity method investments.

3.9.4 Income or loss from continuing operations

S-X 5-03 requires income or loss from continuing operations to be presented separately on the face of the income statement.

3.9.5 Discontinued operations

A component of a reporting entity that meets the requirements under ASC 205-20 is reported as discontinued operations on the face of the income statements.

This is also consistent with the requirements of S-X 5-03. Refer to FSP 27 for further guidance on presentation and disclosure guidance for discontinued operations.

3.9.6 Income or loss before extraordinary items and cumulative effects of changes in accounting principles

Entities are required by S-X 5-03 to report income or loss before extraordinary items and cumulative effects of changes in accounting principles.

3.9.7 Extraordinary items, less applicable tax

ASC 225-20-45-1 notes that judgment is required to identify items that are extraordinary. Events are presumed to be ordinary and usual activities unless there is clear evidence otherwise. A transaction must be both unusual and infrequent in order to be classified as extraordinary.

ASC 225-20-45-11

The caption extraordinary items shall be used to identify separately the effects of events and transactions, other than the disposal of a component of an entity, that meet the criteria for classification as extraordinary as discussed in paragraphs 225-20-45-1 through 45-6. Descriptive captions and the amounts for individual extraordinary events or transactions shall be presented, preferably on the face of the income statement, if practicable; otherwise disclosure in related notes is acceptable. The nature of an extraordinary event or transaction and the principal items entering into the determination of an extraordinary gain or loss shall be described. The income taxes applicable to extraordinary items shall be disclosed on the face of the income statement; alternatively, disclosure in the related notes is acceptable. The caption net income shall replace the three captions shown in the preceding paragraph if the income statement includes no extraordinary items.

ASC 225-20-55 provides illustrations of events and transactions that qualify—and do not qualify—for treatment as extraordinary items. Common areas where the question of extraordinary treatment arises include:

- Debt forgiveness - Generally, a gain from debt forgiveness resulting from bankruptcy emergence is typically reported as a reorganization item within continuing operations rather than as an extraordinary item.

- Life insurance proceeds - Life insurance proceeds relating to key employees should not be presented as extraordinary.

- Losses from natural disasters - Losses from natural disasters in which there is a history of similar natural disasters are generally not presented as extraordinary.

In all instances, the rationale is that these scenarios are generally not both infrequent and unusual in nature.

EPS related to extraordinary items should be presented either on the face of the income statement or in the related footnotes. Refer to FSP 7 for further discussion on calculating EPS with extraordinary items.

Note about ongoing standard setting

As of the content cutoff date of this publication (August 31, 2014), the FASB has an active project on classifying items as extraordinary that may affect presentation and disclosure requirements. Financial statement preparers and other users of this publication are therefore encouraged to monitor the status of the project, and if finalized, evaluate the effective date of the new guidance and the implications on presentation and disclosure.

3.9.8 Cumulative effects of changes in accounting principles

ASC 250 includes guidance on presentation of the cumulative effect of a change in accounting principles. Refer to FSP 30 for further discussion of the requirements.

3.9.9 Net income or net loss

S-X 5-03 requires that net income or net loss be presented on the face of the financial statements. ASC 225 includes guidance on what comprises net income.

ASC 225-10-45-1

Net income shall reflect all items of profit and loss recognized during the period with the sole exception of error corrections as addressed in Topic 250. However, the requirement that net income be presented as one amount does not apply to the following entities that have developed income statements with formats different from those of the typical commercial entity:

a. Investment companies

b. Insurance entities

c. Certain not-for-profit entities (NFPs).

Net income includes earnings attributable to both the controlling and noncontrolling interests. ASC 810-10-45-18 through 21 indicate that reporting entities that report a noncontrolling interest are required to apportion net income for the period between controlling and noncontrolling interests on the face of the income statement.

3.9.10 Net income attributable to noncontrolling interests

A parent company that has control of a reporting entity should record revenues, expenses, gains, losses, net income (loss), and other comprehensive income (loss) at the consolidated amounts from the acquisition date until the date on which the parent ceases to control the subsidiary. For more on presentation and disclosure requirements associated with noncontrolling interests, refer to FSP 18.

3.9.11 Earnings per share data

Entities with simple capital structures (i.e., those entities with only class of common stock outstanding and no equity instruments outstanding, such as stock options) must present basic per-share amounts for income from continuing operations and for net income on the face of the income statement. All other entities must present basic and diluted per-share amounts on the face of the income statement for income from continuing operations and for net income with equal prominence. Refer to FSP 7 for further discussion of the EPS presentation requirements.

3.10 Allocation of expenses to subsidiaries or carve-out entities

There are often several operating units or divisions within a consolidated group of reporting entities or an individual reporting entity. These units or divisions often are not themselves separate legal entities but individually or collectively could qualify as a "business" as defined by S-X 11-01(d).

Circumstances may arise that require separate financial statements for these businesses (sometimes referred to as "carve-out" financial statements), or may require financial statements for subsidiaries of the reporting entity. Separate financial statements required by SEC regulations are generally required to be prepared in accordance with Regulation S-X. However, this section only covers certain aspects of preparing standalone subsidiary financial statements and is not intended to be comprehensive.

When separate financial statements are required, both U.S. GAAP and SEC regulations provide guidance on their presentation and disclosure requirements. Some circumstances that may require separate subsidiary/business financial statements include:

- Collateral pledge financial statements: If an affiliate securities constitute a substantial portion of the collateral for any class of an SEC-registered (or to be registered) reporting entity's securities, the reporting entity may need to include the affiliate financial statements in their financial statements. Refer to SEC 4540 for further discussion.

- Standalone subsidiary financial statements: Subsidiaries are sometimes required to prepare standalone financial statements (including footnotes) for bank debt, bonding, or other operations-related commitments. If the party requesting such financial statements requires that they are prepared in accordance with U.S. GAAP, the subsidiary will need to apply the concepts discussed in this section and may also consider applying the related SEC guidance as U.S. GAAP in this area is relatively limited.

Further, in the event reporting entities are required to provide subsidiary standalone financial statements where pushdown accounting has been applied due to a business combination, such entities will have to appropriately present predecessor and successor financial statements. Reporting entities should keep in mind that such presentation is generally not as simple as combining predecessor and successor periods together. For further information, refer to BCG 13.2.10.

3.10.1 Presentation considerations

SAB Topic 1.B, *Allocation of Expenses and Related Disclosure in Financial Statements of Subsidiaries, Divisions or Lesser Business Components of Another Entity*, provides guidance to registrants regarding the allocation of costs incurred by a parent on behalf of a carve-out entity in the carve-out financial statements. However, the guidance is also useful for any separate financial statement reporting of businesses/subsidiaries, not just carve-out financial statements.

SAB Topic 1.B emphasizes the importance of presenting operating results that reflect all of the "costs of doing business" despite the fact that some of the costs may not have been allocated historically to the carve-out entity. These expenses include, but are not necessarily limited to, the following:

- Officer and employee salaries
- Rent and/or depreciation
- Advertising
- Accounting and legal services
- Other selling, general, and administrative expenses
- Income taxes
- Interest

Often, a reasonable method of allocating common expenses to the subsidiary (e.g., incremental or proportional cost allocation) must be chosen because specific identification of expenses is not practicable. In these situations, SEC FRM 7410.2 states that reporting entities should include an explanation in the footnotes of the allocation method used, together with management's assertion that the method is reasonable and disclosures of what expenses would have been on a standalone basis, if materially different. Although SAB Topic 1.B requires a reasonable estimate of expenses incurred on behalf of a subsidiary to be reflected in the financial statements, changes to actual amounts on the basis of expected future results is prohibited in the historical financial statements.

Example 3-5 illustrates the allocation of costs and expenses to a subsidiary.

EXAMPLE 3-5

Allocation of costs and expenses to a subsidiary

FSP Corp manufactures a wide range of product lines. It acquires the rights to manufacture and sell a specific branded product ("Product A") from Company Y.

Company Y has previously sold and marketed Product A through its sales force and marketing department, which also sells other product brands not being acquired by FSP Corp. The acquisition includes manufacturing facilities and related employees, inventory, certain tangible assets, patents, manufacturing and marketing rights, customer relationships, supply agreements, trade names, and trademarks. FSP Corp does not acquire the sales force and marketing department. FSP Corp will manufacture Product A at the acquired manufacturing facilities and will market the product through its existing sales force.

FSP Corp is required to file with the SEC a full set of "carve-out" financial statements if the acquisition is determined to be "significant" under S-X 3-05. Should the carve-out financial statements reflect an allocation of Company Y's costs and expenses (e.g., marketing expenses) to Product A's business?

Analysis

FSP Corp will need to obtain carve-out financial statements from Company Y for historical financial information. These financial statements need to include all of the appropriate revenues, expenses, assets, and liabilities related to the acquired business, even though Company Y may not have maintained separate accounting records for Product A. This would include an appropriate allocation of selling and marketing expenses (even though Company Y's sales force and marketing department was not acquired by FSP Corp), together with other costs such as overhead expenses in accordance with SAB Topic 1.B.

3.10.2 Disclosure considerations

If a reporting entity's financial statements include separate financial statements (e.g., of a subsidiary or investee), ASC 850-10-50-4 indicates that the reporting entity does not need to repeat disclosures in the separate financial statements. This is permissible only if the separate financial statements also are consolidated or combined in a complete set of financial statements and both sets of financial statements are presented in the same financial report.

If separate financial statements are prepared for subsidiaries or investees of a reporting entity, S-X 4-08(k)(2) requires those financial statements to indicate the amount of related party transactions that are and are not eliminated in the separate financial statements. In addition, it requires the financial statements to include disclosure of any intercompany profits or losses resulting from transactions with related parties that are not eliminated.

SAB Topic 1.B also requires additional disclosures of expense allocations from parents to subsidiaries regarding income taxes as follows:

SAB Topic 1.B, Question 3

What are the staff's views with respect to the accounting for and disclosure of the subsidiary's income tax expense?

Interpretive Response: Recently, a number of parent companies have sold interests in subsidiaries, but have retained sufficient ownership interests to permit continued inclusion of the subsidiaries in their consolidated tax returns. The staff believes that it is material to investors to know what the effect on income would have been if the registrant had not been eligible to be included in a consolidated income tax return with its parent. Some of these subsidiaries have calculated their tax provision on the separate return basis, which the staff believes is the preferable method. Others, however, have used different allocation methods. When the historical income statements in the filing do not reflect the tax provision on the separate return basis, the staff has required a pro forma income statement for the most recent year and interim period reflecting a tax provision calculated on the separate return basis.

Virtually all standalone subsidiary income tax provisions are prepared on this basis, given the SEC staff's strong preference for the separate return method to be utilized, as well as the need to prepare proforma separate return basis information.

SAB Topic 1.B also requires specific disclosure related to financing arrangements between a parent and a subsidiary.

SAB Topic 1.B, Question 4

Should the historical income statements reflect a charge for interest on intercompany debt if no such charge had been previously provided?

Interpretive Response: The staff generally believes that financial statements are more useful to investors if they reflect all costs of doing business, including interest costs. Because of the inherent difficulty in distinguishing the elements of a subsidiary's capital structure, the staff has not insisted that the historical income statements include an interest charge on intercompany debt if such a charge was not provided in the past, except when debt specifically related to the operations of the subsidiary and previously carried on the parent's books will henceforth be recorded in the subsidiary's books. In any case, financing arrangements with the parent must be discussed in a note to the financial statements. In this connection, the staff has taken the position that, where an interest charge on intercompany debt has not been provided, appropriate disclosure would include an analysis of the intercompany accounts as well as the average balance due to or from related parties for each period for which an income statement is required. The analysis of the intercompany accounts has taken the form of a listing of transactions (e.g., the allocation of costs to the subsidiary, intercompany purchases, and cash transfers between entities) for each period for which an income statement was required, reconciled to the intercompany accounts reflected in the balance sheets.

3.11 Considerations for private companies

The majority of presentation and disclosure requirements discussed in this chapter are applicable to both public and private companies. Requirements included in Figure 3-4 apply only to SEC registrants.

Figure 3-4
Presentation and disclosure requirements applicable only to SEC registrants

Description	Reference	Section
The various line items that, if applicable, should appear on the face of the income statements	S-X 4-01(a); S-X 5-03	3.3
Requirement to present three-year comparative income statement	S-X 3-02(a)	3.4.1
General requirement to disclose a reporting entity's revenue recognition accounting policy	SAB Topic 13.A	3.5
Requirement to separately report, under the heading operating income/expense any material amounts not included in the caption "costs and expenses applicable to sales and revenues"	S-X 5-03(3)	3.7
Requirement to present separate financial statement line items based on thresholds – including sales/revenues and corresponding cost of sales	S-X 5-03(1); S-X 5-03(2); S-X 4-02	3.4.2
Precludes reporting entities from presenting a gross margin subtotal in the income statement unless depreciation, depletion, and amortization is included in cost of sales or presented as a separate line item before gross margin	SAB Topic 11.B	3.7.3
Requirement to disclose selected quarterly financial data for each full quarter within the two most recent fiscal years in the annual reports on Form 10-K	S-K 302(a)(1)	3.7.3
Requirement to report as "other general expenses" gains or losses from the sale of long-lived assets reported under ASC 360-10-45-5	S-X 5-03(6)	3.7.10.1

Description	Reference	Section
Requirement to include items not normally included under the caption "selling, general, and administrative expenses" under the caption "other general expenses"	S-X 5-03(6)	3.7.10
Requirement to present separate income statement line item captions for non-operating income and non-operating expense	S-X 5-03(7) and (9)	3.8
Requirement to present all interest expense in the caption for interest expense	S-X 5-03(8)	3.8
Requirement to state separately, in the income statement or in a footnote, amounts earned from (a) dividends, (b) interest on securities, (c) profits on securities (net of losses), and (d) miscellaneous other income	S-X 5-03(7)	3.8.1
Requirement to disclose the amounts earned from transactions in securities of related parties (if applicable)	S-X 4-08 (k)	3.8.1
Requirement to state separately, in the income statement or in a footnote, amounts of losses on securities (net of profits) and miscellaneous income deductions	S-X 5-03(9)	3.8.2
Requirement to present interest expense and amortization of debt discount on the face of the income statement	S-X 5-03(8)	3.8.3
Requirement to only include taxes based on income under the caption "income tax expense"	S-X 5-03(11)	3.9.2
Requirement to present specific earnings per share captions on the face of the income statement	S-X 5-03(b) 20	3.9.11

Chapter 4: Reporting comprehensive income

4.1 Chapter overview

Comprehensive income/loss represents the change in a reporting entity's equity from all sources other than investments by, or distributions to owners. It includes all components of net income/loss and other comprehensive income/loss ("OCI").

This chapter discusses the requirements for reporting comprehensive income/loss and its components and changes in the components of accumulated other comprehensive income ("AOCI"). It also discusses the presentation of OCI in spin-off transactions.

Reporting entities are not required to use the term "comprehensive income," and alternatives such as "total non-owner changes in equity" may be used in its place.

4.2 Scope

ASC 220, *Comprehensive Income,* establishes standards for the presentation and disclosure of comprehensive income and accumulated other comprehensive income. ASC 220 establishes presentation and disclosure requirements only. It generally does not address issues of recognition or measurement.

ASC 220 does not apply to not-for-profit organizations that follow ASC 958-205, *Not-for-profit Entities*. Investment companies, defined benefit plans, and other employee benefit plans that are exempt from the requirement to provide a statement of cash flows under ASC 230-10-15-4 are not exempt from the requirements of ASC 220. However, these entities typically do not have items of OCI.

A reporting entity that does not have items of OCI in any period presented does not need to present comprehensive income.

The disclosure guidance in this chapter applies to all annual reporting periods for which a balance sheet and income statement are presented. Interim disclosure requirements for comprehensive income are addressed in FSP 29.

4.3 Presenting comprehensive income

ASC 220 provides a definition of comprehensive income.

Definition from ASC 220-10-20

Comprehensive income: The change in equity (net assets) of a business entity during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners. Comprehensive income comprises both of the following:

a. All components of net income

b. All components of other comprehensive income.

Comprehensive income may be presented in a single statement or in two consecutive statements. Proponents of the single statement prefer its simplicity, while proponents of the two-statement format cite as a benefit that the "primary" performance measurements of net income and earnings per share are more prominent.

Total comprehensive income per share should not be disclosed on the face of the financial statements. Figure 4-1 illustrates the reporting requirements of each format.

Figure 4-1
Formats for the presentation of comprehensive income

Format	Presentation
Single statement	□ Report net income, other comprehensive income, and comprehensive income in a single financial statement of comprehensive income. □ Present total net income, other comprehensive income, and comprehensive income. □ Earnings per share is typically shown below net income and before comprehensive income. □ Refer to Figure 4-2 for an illustrative example.
Two consecutive statements	□ Report net income in one financial statement. □ Report other comprehensive income and comprehensive income in a second separate, but consecutive, financial statement. □ Present total other comprehensive income and comprehensive income. □ Start the statement of comprehensive income with net income. □ Refer to Figure 4-3 for an illustrative example.

Question 4-1

Is a change from a past format of a single statement of comprehensive income to the two-statement format (or vice versa) considered a change in accounting principle?

PwC response:

We do not believe a change in the format of presentation of comprehensive income would be considered a change in accounting principle as both formats present the same information and are permitted under ASC 220. As such, there would be no need to demonstrate the preferability of one format over the other.

4.3.1 Presenting comprehensive income attributable to noncontrolling interest

Reporting entities are required by ASC 220-10-45-5 to separately present net income and comprehensive income attributable to the parent and NCI on the face of the financial statements. This would include the statement of comprehensive income and statement of income (if presented as two separate statements).

4.3.2 Example — One statement presentation of comprehensive income

Figure 4-2 illustrates the presentation of comprehensive income in a single statement. It presents the “net changes” for each component of OCI, rather than presenting reclassifications from AOCI separately, as depicted in ASC 220-10-55-7 and 55-8, as most reporting entities elect to include this detail in the footnotes instead. Comparative statements are not shown for simplicity. Figure 4-3 illustrates the alternative approach of presenting comprehensive income in two separate, but consecutive statements.

Figure 4-2

Example consolidated single statement of comprehensive income

FSP Corp
Consolidated Statement of Comprehensive Income
Year ended December 31, 20X4
In millions $, except per share data

Revenues	$1,400
Costs of goods sold	(500)
Selling, general and administrative	(20)
Gain on sale of securities	340
Income before tax	1,220
Income tax expense	(320)
Equity in earnings of unconsolidated investee	100

FSP Corp
Consolidated Statement of Comprehensive Income
Year ended December 31, 20X4
In millions $, except per share data

Net income		$1,000
Less: net income attributable to the noncontrolling interest	(100)	
Net income attributable to FSP Corp stockholders	$900	
Earnings per share		
Basic and diluted	$1.25	
Other comprehensive loss, net of tax:		
Change in foreign currency translation adjustments		80
Changes in unrealized gains related to available-for-sale securities		11
Equity in unrealized losses on available-for-sale securities of unconsolidated investee		(8)
Change in unrealized gains on cash flow hedges		15
Change in prior service cost and unrecognized loss for defined benefit pension plans		(150)
Other comprehensive loss		(52)
Comprehensive income		$948[1]
Less: comprehensive income attributable to the noncontrolling interest[2]		(220)[3]
Comprehensive income attributable to FSP Corp stockholders		$728

[1] Represents net income of $1,000 less other comprehensive loss of $52.

[2] ASC 220-10-45-5 requires presentation of comprehensive income attributable to NCI on the face of the financial statements.

[3] Represents net income attributable to NCI of $100 plus OCI attributable to NCI of $120.

4.3.3 *Example — Separate statement of comprehensive income*

A separate statement of comprehensive income should begin with net income attributable to the consolidated reporting entity. If a reporting entity has NCI, it should present net income before NCI as the starting point.

Figure 4-3 illustrates the consolidated statement of comprehensive income, which would follow the consolidated statement of income. For simplicity, the statement of income is not included below, and comparative statements are not shown.

For purposes of illustration in this example, we have segregated the reclassifications out of AOCI from other changes relative to that component of

OCI; however, this is not required, as illustrated in Figure 4-2. This information could also be shown in a footnote, rather than on the face of the financial statements. In addition, this detail is not commensurate with the two statement approach, but presented in Figure 4-3 for purposes of illustrating the optionality in presentation. Refer to ASC 220-10-55-9 for an additional illustration.

Figure 4-3

Example consolidated statement of comprehensive income (that would follow the consolidated statement of income)

FSP Corp
Consolidated Statement of Comprehensive Income
Year ended December 31, 20X4
In millions $

Net income		$1,000
Other comprehensive loss, net of tax:		
Change in foreign currency translation adjustments		80
Net changes related to available-for-sale securities:		
Unrealized gains during period	13	
Reclassifications of losses to net income	(2)	11
Equity in unrealized losses on available-for-sale securities of unconsolidated investee		(8)
Change in unrealized gains / losses on cash flow hedges:		
Unrealized gains during period	43	
Reclassifications of losses to net income	(28)	15
Changes in defined benefit pension plans:		
Prior service cost arising during period	(160)	
Net loss arising during period	(10)	
Less: amortization of prior service cost included in net periodic pension cost	20	(150)
Other comprehensive loss		(52)
Comprehensive income		$948
Less: comprehensive income attributable to the noncontrolling interest		(220)[1]
Comprehensive income attributable to FSP Corp stockholders		$728

[1] Represents net income attributable to NCI of $100 plus OCI attributable to NCI of $120.

4.4 Components of comprehensive income

Comprehensive income includes net income and OCI. OCI consists of revenues, expenses, gains, and losses to be included in comprehensive income but excluded from net income under guidance in other U.S. GAAP.

Reporting entities should present each of the components of other comprehensive income separately, based on their nature, in the statement of comprehensive income.

ASC 220-10-45-10A lists the major components of OCI, along with references to the relevant accounting guidance and where the component is addressed in this guide.

ASC 220-10-45-10B contains a list of items that are *not* considered OCI. These include:

- Changes in equity resulting from investments by or distributions to owners
- Items required to be reported as direct adjustments to additional paid in capital (APIC), retained earnings, and certain other non-income equity accounts (e.g., reductions of stockholders' equity related to employee stock ownership plans, taxes not payable in cash, and net cash settlements of own share transactions).

4.4.1 Displaying the tax effects of OCI components

Each component of OCI should be reported either (1) net of related tax effects, or (2) before related tax effects with one amount shown for the aggregate income tax effect of all OCI items. A reporting entity should disclose the income tax effect of each component of OCI, including reclassification adjustments, either on the face of the statement in which those components are displayed, or in the footnotes. ASC 220-10-55-7 through 55-8B provides examples of the alternative formats for disclosing the tax effects of the components of OCI.

4.5 Accumulated other comprehensive income and reclassification adjustments

Reporting entities should display AOCI separately from retained earnings and additional paid-in-capital on the balance sheet. Changes in the components of AOCI should be presented separately in the statement of changes in stockholders' equity, or in the footnotes. If the changes in AOCI are presented in the footnotes, the reporting entity should provide the information for each period for which a statement of stockholders' equity is presented; that is, three years for public reporting entities.

Other U.S. GAAP dictates how amounts are recorded into AOCI and how amounts are subsequently included in net income. To avoid double counting in comprehensive income, OCI includes reclassification adjustments for those items coming out of AOCI. Sometimes this is referred to as "recycling" AOCI.

ASC 220 requires reporting entities to aggregate the information about amounts reclassified from AOCI into net income that is presented throughout the financial statements, and to provide a roadmap to the related disclosures.

Reporting entities have two distinct disclosure requirements with respect to reporting AOCI. ASC 220-10-45-14A requires reporting entities to present the changes in each component of AOCI, showing separately the amount due to current period OCI, and current period reclassifications out of AOCI. Separately, ASC 220-10-45-17 through 17B requires an entity to provide additional information about reclassification adjustments.

4.5.1 Types of reclassification adjustments

Figure 4-4 lists the types of reclassification adjustments, along with references to the relevant guidance within the Codification that address the accounting for the reclassification, and where in this Guide the presentation of the reclassification adjustments in the income statement is discussed.

Figure 4-4
Types of reclassification adjustments with Codification and Guide references

Reclassifications out of accumulated other comprehensive income	Codification reference where accounting for the reclassification is addressed	FSP Guide chapter reference
Release of cumulative translation adjustments	830-30-40-1 through 40-4	FSP 21.4.1.1
Realized gains and losses on derivative instruments that qualify as cash flow hedges	815-30-35-38 through 35-41	FSP 19.5.3.4
Realized gains and losses on available-for-sale investments	320-10-40-2	FSP 9.3
Pension and other postretirement benefits items amortized into net income	715-30-35-24 (pension) and 715-60-35-29 (OPEB)	FSP 13.3.3

4.5.2 Presenting reclassification adjustments

A reporting entity is required to present the amount reclassified from each component of AOCI based on its source (e.g., foreign currency, realized gains/losses and other-than-temporary impairment on available-for-sale securities, and realized gains/losses on cash flow hedges). This disclosure should also provide the income statement line item affected by the reclassification (e.g., interest income or interest expense), unless the component is not required to be reclassified in its entirety. Finally, the disclosure should include amounts attributable to NCI. See FSP 4.5.5 for further information.

If a component of AOCI is not required to be reclassified to net income in its entirety, the reporting entity should disclose that fact within the AOCI footnote. A cross-reference is required within the footnote to the related disclosure with additional details about the effect of the reclassification.

A reporting entity can present this information either (1) parenthetically on the face of the financial statements or (2) in a single footnote. Therefore, for all components of OCI, a reporting entity may either present a gross display on the face of the financial statements or a net display, with disclosure of the gross change in the footnotes. If displayed gross, reporting entities should present reclassification adjustments separately from other changes in the AOCI component balance. If displayed net, reporting entities should combine reclassification adjustments with other changes in AOCI. In both options, a reporting entity can either present these amounts before or net of tax; however, the presentation should be consistent in each reporting period.

Figure 4-5 illustrates the options for presenting reclassifications out of AOCI.

Figure 4-5

Options for presenting amounts reclassified out of each component of AOCI

Presentation of reclassifications out of AOCI	Requirements of presentation
Parenthetically on the face of the financial statement in which net income is presented This presentation election can only be made if the two requirements outlined in FSP 4.5.3 are met.	▫ Present parenthetically by component of AOCI the effect of significant reclassification amounts on the respective line items of net income ▫ Present parenthetically the aggregate tax effect of all "significant reclassifications" on the income tax benefit or expense line item in the statement presenting net income ▫ If applicable, present amounts of reclassifications attributable to NCI; see FSP 4.5.5

Presentation of reclassifications out of AOCI	Requirements of presentation
Within a single footnote A reporting entity can elect this option or may be required to follow this guidance if the requirements outlined in FSP 4.5.3 are not met.	□ Present significant amounts by component of AOCI □ Provide a subtotal of each component of comprehensive income that corresponds to the components presented on the face of the financial statement in which comprehensive income is presented □ Identify each income statement line item affected by each "significant reclassification amount" for reclassifications to net income in their entirety □ Cross-reference to the footnote for any significant reclassification amount not made to net income in its entirety □ Present amounts either before tax or net of tax, as long as the reporting entity complies with requirements of ASC 220-10-45-12 related to the presentation of the income tax effects on other comprehensive income □ If applicable, present amounts of reclassifications attributable to NCI; see FSP 4.5.5

4.5.2.1 Example – insurance industry

One example of an amount not reclassified to net income in its entirety relates to the accounting for deferred acquisition costs ("DAC") by life insurance entities. For certain products, the related DAC is amortized using the "estimated gross profit" method. For those products, the insurer is required to record, as an adjustment to OCI, the impact on DAC amortization of unrealized gains and losses as if those gains and losses had been realized. This adjustment is required for certain DAC and DAC in conjunction with purchase accounting balances, and is often referred to as a shadow adjustment. The calculation of this shadow adjustment can be complex, and the amounts reclassified from AOCI might be recorded through income or recapitalized on the balance sheet.

Similarly, traditional long-duration insurance contracts could also require a shadow adjustment. In performing a premium deficiency assessment, life insurance entities must consider unrealized gains and losses. If a premium deficiency would have resulted had the gain or loss been realized, the premium deficiency would be recorded as either a reduction to DAC or an additional reserve through OCI. These amounts may either be reclassified through income or be reclassified to the balance sheet. Therefore, for both of these insurance-related items, the FASB concluded in the basis of conclusions in ASU 2013-02 that a cross-reference to the relevant footnote would suffice. This is similar to the way pension reclassifications are addressed. See FSP 13 for further information on pension reclassifications.

4.5.3 *Presenting reclassifications parenthetically on the face of the financial statements*

A reporting entity may only elect to present the information parenthetically on the face of the financial statement in which net income is presented if the following requirements are met:

- All of the reclassification adjustments were reclassified to net income in their entirety.
- The reporting entity can identify the income statement line item impacted by the reclassification.

If a reporting entity elects to present the reclassification adjustments on the face of the financial statement in which net income is presented, it is also required to present parenthetically the aggregate tax effect of all of the reclassification adjustments on the income tax expense/benefit line item. Thus, under this approach, the reporting entity is also electing to present the reclassification adjustments on a before-tax basis.

4.5.3.1 *Example – reclassification adjustments in AOCI included in statement of income*

Figure 4-6 illustrates the disclosure requirements in ASC 220-10-45-14 through 17B when an entity elects to provide the required information for reclassification adjustments parenthetically on the face of the income statement. The example demonstrates how the entity complied with ASC 220-10-45-17 through 17B. To comply with the requirements of ASC 220-10-45-14A, the reporting entity provided a separate footnote. Comparative information is not shown for simplicity.

Figure 4-6

Example consolidated statement of income, with reclassification adjustments presented on the face and a footnote showing changes in AOCI

This is partially excerpted from ASC 220-10-55-15A and 55-17F.

FSP Corp
Consolidated Income Statement
For the year ended December 31, 20X4

Revenues (includes $4,000 accumulated other comprehensive income reclassifications for net gains on cash flow hedges)	$122,500
Expenses (includes ($1,000) accumulated other comprehensive income reclassifications for net losses on cash flow hedges)	(32,000)
Other gains and losses	5,000
Gain on sale of securities (includes $4,000 accumulated other comprehensive income reclassifications for unrealized net gains on available-for-sale securities)	4,000
Income from operations before tax	99,500
Income tax expense (includes ($1,750) income tax expense from reclassification items)	(24,875)
Net income	$74,625

Note X: Changes in accumulated other comprehensive income by component

The following table presents a rollforward of accumulated other comprehensive income. All amounts are net of tax.

	Gains and losses on cash flow hedges	Unrealized gains and losses on available-for-sale securities	Total
Beginning balance, January 1, 20X4	$(5,000)	$8,000	$3,000
Other comprehensive income before reclassifications	7,000	8,000	15,000
Amounts reclassified from accumulated other comprehensive income	(2,250)	(3,000)	(5,250)
Net current-period other comprehensive income	4,750	5,000	9,750
Ending balance, December 31, 20X4	$(250)	$13,000	$12,750

4.5.4 *Presenting reclassifications in a footnote*

Many reporting entities that have numerous reclassification adjustments have elected to present the amounts reclassified out of AOCI in a footnote rather than on the face of the financial statement in which net income is presented. Some believe that including multiple reclassification adjustments clutters the appearance of the income statement.

Other reporting entities may not meet the requirements to present reclassified amounts on the face of the financials. This could occur when a reporting entity has a reclassification adjustment that is initially capitalized, or when it is unable to identify the impacts on the income statement line items. Instead, the reporting entity will present the information in the footnotes and cross-reference to the other applicable notes.

One common example is a reporting entity that has a defined benefit pension plan and capitalizes a portion of the net periodic pension cost in inventory. In this instance, the amount reclassified from AOCI during a period is not recognized in net income until the inventory is sold. Therefore, the reporting entity is not able to present reclassification adjustments on the face of the financials. Instead, it should disclose all of its reclassification adjustments in a single footnote (see Figure 4-8). In that note, the income statement line item affected only needs to be shown for components reclassified to net income in their entirety. Other components, such as net periodic pension cost, should be cross-referenced to the related footnote (e.g., the pension footnote).

If a reporting entity elects, or is required, to present the information in a single footnote, the disclosure can be presented before tax or net of tax as long as the entity complies with the requirements of ASC 220-10-45-12 related to the presentation of the income tax effects on OCI. The reclassification adjustments should reconcile by component to the AOCI disclosure.

If a reporting entity presents the information in a single footnote, ASC 220-10-45-17B requires that the subtotals for each component of the disclosure agree to the AOCI rollforward required by ASC 220-10-45-14A.

4.5.4.1 *Example – Footnote displaying changes in AOCI*

Figure 4-7 illustrates the disclosure requirements in ASC 220-10-45-14 through 17B when an entity elects to provide the required information in a single footnote. The first table in the figure demonstrates how the reporting entity complied with ASC 220-10-45-14A, while the second table demonstrates how the reporting entity complied with ASC 220-10-45-17 through 17B. Comparative information is not shown for simplicity.

Figure 4-7
Reclassification adjustments in AOCI by component – single footnote presentation

This example was partially excerpted from ASC 220-10-55-15 and 55-17E.

Note X: Changes in accumulated other comprehensive income by component

The following table presents a rollforward of accumulated other comprehensive income. All amounts are net of tax and inclusive of noncontrolling interest.

	Gains and losses on cash flow hedges	Unrealized gains and losses on available-for-sale securities	Defined benefit pension items	Foreign currency items	Total
Beginning balance, January 1, 20X4	$(1,200)	$1,000	$(8,800)	$1,300	$(7,700)
Other comprehensive income before reclassifications	3,000	2,500	(3,000)	1,000	3,500
Amounts reclassified from accumulated other comprehensive income	(750)	(1,500)	4,500	-	2,250
Net current-period other comprehensive income	2,250	1,000	1,500	1,000	5,750
Ending balance, December 31, 20X4	$1,050	$2,000	$(7,300)	$2,300	$(1,950)

Reclassifications out of accumulated other comprehensive income[4]

For the period ended December 31, 20X4

The following table presents the income statement line items affected by the reclassifications out of accumulated other comprehensive income:

Details about accumulated other comprehensive income components	Reclassification amount from accumulated other comprehensive income	Affected line item in the income statement
Gains and losses on cash flow hedges		
Interest rate contracts	$1,000	Interest income (expense)
Credit derivatives	(500)	Other income (expense)
Foreign exchange contracts	2,500	Revenue[1]
Commodity contracts	(2,000)	Cost of sales
	1,000	Total before tax
	(250)	Tax (expense) or benefit
	$750[3]	Net of tax
Unrealized gains and losses on available-for-sale securities		
	$2,300	Realized gain (loss) on sale of securities
	(285)	Impairment expense
Insignificant items	(15)	
	2,000	Total before tax
	(500)	Tax (expense) or benefit
	$1,500[3]	Net of tax
Amortization of defined pension items		
Prior-service costs	$(2,000)[2]	
Transition obligation	(2,500)[2]	
Actuarial gains/(losses)	(1,500)[2]	
	(6,000)	Total before tax

Details about accumulated other comprehensive income components	Reclassification amount from accumulated other comprehensive income	Affected line item in the income statement
	1,500	Tax (expense) or benefit
	$(4,500)[3]	Refer to pension footnote
Total reclassification for the period	$(2,250)[3]	Net of tax

[1]This foreign exchange contract represents a cash flow hedge of a forecasted sales transaction, and therefore affects revenue as the reporting entity has elected to reflect the impact of the derivative on the same line item in the income statement as that of the hedged item. See FSP 19.4.2 for additional information.

[2] These accumulated other comprehensive income components are included in the computation of net periodic pension cost.

[3] These amounts reconcile to the "Amounts reclassified from accumulated other comprehensive income" in the first table in this figure.

[4]Amounts in parentheses indicate debits.

4.5.5 *Presenting reclassifications attributable to noncontrolling interest*

There is no explicit guidance in ASC 220 regarding how reporting entities should present amounts attributable to NCI when a reporting entity elects to disclose reclassifications from AOCI in a single footnote. Our view is that NCI should be included in each of the relevant components. In other words, amounts attributable to NCI would not be shown separately.

In practice, many reporting entities present the tax impact of NCI below the tax expense/benefit line for each component. Additionally, the total reclassifications in the rollforward of AOCI would be presented net of tax and inclusive of NCI, as shown in Figure 4-7.

4.5.6 *Income tax considerations for reporting reclassifications out of AOCI*

As noted in FSP 4.4.1, each component of OCI should be reported either (1) net of related tax effects or (2) before related tax effects with one amount shown for the aggregate income tax expense or benefit related to the total OCI items.

ASC 740, *Income Taxes,* prohibits allocating tax impacts of transactions involving AOCI based on past tax rates used in accumulating other comprehensive income transactions, sometimes called "backward tracing." Consistent with this principle, when amounts are reclassified into net income out of AOCI, we believe it would generally be appropriate to use the tax rate in effect at the time of the reclassification rather than using the tax rate in effect when the AOCI amount was initially recorded. This approach maintains consistency with the offsetting tax effect recognized in net income under the intraperiod allocation requirements of ASC 740.

Backward tracing could result in using different tax rates for different components of AOCI if the reclassified items relate to different tax jurisdictions. It could also result in items being reclassified using different tax rates than when the items were originally recorded in AOCI (for example, when there have been changes in the valuation allowance). This result is consistent with the FASB's desire to simplify AOCI accounting, although it may seem different from the objective of OCI reclassification to prevent double counting in comprehensive income. For further considerations surrounding presentation and disclosure of income taxes, see FSP 15 for further information on presentation and disclosure of income taxes.

ASC 220-10-55-7 through 55-8B provides examples of the alternative formats for disclosing the tax effects related to the components of OCI.

4.6 OCI in spin-off transactions

In a spin-off transaction, which is a carryover basis transaction, no realization occurs with respect to previously accumulated elements of OCI reported by the parent and subsidiary. Thus, the post-spin financial statements of a subsidiary should generally reflect the OCI previously accumulated in the parent's financial statements related to assets and liabilities of the subsidiary. Likewise, the post-spin financial statements of the spinnor should only reflect its AOCI after the spin. In the spinnor's financial statements, this would not be considered a reclassification adjustment. However, when the spinnor is disclosing its rollforward of AOCI, the spinnor will need to show the impact of the spin-off.

Question 4-2

Parent Co plans to spin-off Sub Co. Prior to the spin, the consolidated financial statements of Parent Co contain AOCI balances related to both Parent Co's and Sub Co's assets and liabilities. For example, unrealized gains and losses on available-for-sale securities, minimum pension liability adjustments on subsidiary-specific pension plans, and cumulative translation adjustments (CTA) have been accumulated in AOCI in the consolidated financial statements.

How would AOCI attributable to assets and liabilities of Sub Co be presented in post-spin financial statements of Sub Co?

PwC response

AOCI related to Sub Co's assets and liabilities existing at the date of the spin should be maintained in the opening equity accounts of the post-spin entity. That is, AOCI should not be collapsed into APIC as is typical for many other components of pre-spin equity.

Regarding CTA in AOCI of Parent Co, management should identify only the CTA related to SubCo's subsidiaries or foreign operations. For example, if Sub Co has a different functional currency from Parent Co, CTA arising from Parent Co's consolidation of Sub Co prior to the spin should not be reflected in Sub Co's post-spin financial statements.

4.7 Considerations for private companies

The requirements discussed in this chapter are applicable to both public and private reporting entities.

Chapter 5: Stockholders' equity

5.1 Chapter overview

This chapter discusses the specific annual presentation and disclosure requirements in the financial statements and footnotes for stockholders' equity and noncontrolling interest accounts. Interim presentation and disclosure requirements differ and are discussed in FSP 29.

Unlike the balance sheet and income statement, the statement of stockholders' equity is not a required financial statement. Both the FASB and the SEC allow changes in stockholders' equity accounts to be disclosed either in a statement or in the footnotes, although most reporting entities present changes in stockholders' equity in a statement.

The chapter begins with the disclosures required for all classes of equity, and then details the presentation and disclosure considerations by classes of equity.

The impact of various types of equity on earnings per share is addressed in FSP 7. Stockholders' equity presentation and disclosure considerations related to limited liability companies and partnerships are detailed in FSP 32.

5.2 Scope

ASC 505, *Equity*, S-X 3-04, and S-X 5-02 are the primary sources for the presentation and disclosure requirements related to stockholders' equity accounts. ASC 810-10 addresses the presentation and disclosure requirements of noncontrolling interests. FRP 211 (SEC Accounting Series Release No. 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks"* ("ASR 268")) requires certain securities to be presented outside of permanent equity on the balance sheet.

Other relevant guidance for SEC registrants includes:

SAB Topic 3.C	Redeemable Preferred Stock
SAB Topic 4.C	Change in Capital Structure
SAB Topic 4.E	Receivables from Sale of Stock
SAB Topic 4.G	Notes and Other Receivables from Affiliates
S-X 4-07	Discount on Shares
S-X 4-08	General Notes to Financial Statements
FRP 213	Separate Financial Statements

5.3 *Presentation of changes in stockholders' equity*

ASC 505-10-50-2 requires a reporting entity to disclose changes in each account that comprise the reporting entity's equity when both a balance sheet and income statement are presented. This disclosure may take the form of a separate statement or it may be in the footnotes.

While footnote disclosure is permitted, the most common presentation is as a separate statement of changes in stockholders equity. For SEC registrants, S-X 3-04 also calls for disclosure of dividends per share and in the aggregate for each class of shares.

Most commonly, reporting entities present the information about changes in stockholders' equity in a columnar format, but it is not required. Figure 5-1 shows an example statement of changes in stockholders' equity in columnar format.

Figure 5-1

Example consolidated statement of changes in stockholders' equity

FSP Corp
Consolidated statement of changes in stockholders' equity
For the year ended December 31, 20X4 (in millions $, except per share data)

	Common Shares	Amount	Pre-ferred Shares	Amount	Addi-tional Paid in Capital	Retained earnings	Accu-mulated Other Compre-hensive Income	Total FSP Corp Stock holders Equity	Noncon-trolling Interests	Total Equity
Balance at December 31, 20X3	xx	$xx	xx	$xx	$xx	$xx	$xx	$xx	$xx	$xx
Net income						xx		xx	xx	xx
Other comprehensive income, net							xx	xx	xx	xx
Stock-based compensation	xx	xx			xx			xx		xx
Tax benefit from stock plans					xx			xx		xx
Common stock issued	xx	xx			xx			xx		xx
Retirement of common shares	(xx)	(xx)			(xx)	(xx)		(xx)		(xx)
Cash dividends declared ($0.xx per share)						(xx)		(xx)		(xx)
Stock dividends declared	xx	xx			Xx	(xx)				
Conversion of preferred shares into common shares	xx	xx	(xx)	(xx)						
Purchase of shares from noncontrolling interests					(xx)		xx[1]	(xx)	(xx)	(xx)
Balance at December 31, 20X4	xx	$xx	xx	$xx	$xx	$xx	$xx	$xx	$xx	$xx

See Notes to Consolidated Financial Statements

[1]The purchase of additional subsidiary shares once control is obtained by the Parent Company is accounted for as an equity transaction, and no gain or loss is recognized. The components of accumulated other comprehensive income are proportionately reallocated from the noncontrolling interest to the Parent.

As illustrated in Figure 5-1, if there is more than one item that comprises other comprehensive income, the items may be presented net on the statement of stockholders' equity (the gross amounts of the items would be presented on the statement of comprehensive income). However, reporting entities are not prohibited from presenting the gross amounts of other comprehensive income in the statement of stockholders' equity as well. Refer to FSP 4 for presentation of comprehensive income.

5.3.1 Noncontrolling interest

The statement of changes in stockholders' equity should distinguish equity attributable to the parent from equity attributable to noncontrolling interests. It should present the noncontrolling interests' portion of each component of stockholders' equity.

Reporting entities are required by ASC 810-10-50-1A(c) to present in the statement of changes in equity, or disclose in the footnotes a reconciliation of the carrying amount at the beginning and end of the period each of the following categories of equity: (1) total equity, (2) equity attributable to the parent, and (3) equity attributable to the noncontrolling interest.

In this reconciliation, the reporting entity should present the following details separately when they have one or more less-than-wholly-owned subsidiaries:

- Net income
- Transactions with owners acting in their capacity as owners (contributions from, and distributions to, owners should be shown separately)
- Each component of other comprehensive income

There is also a requirement to disclose in the footnotes a separate schedule that shows the effects of any changes in a parent's ownership interest in a subsidiary on the equity attributable to the parent. The schedule is only required in periods when a parent's ownership interest in a subsidiary changes. ASC 810-10-55-4M also provides an illustration of this disclosure.

Question 5-1

Should redeemable noncontrolling interests classified outside of stockholders' equity be included in the equity reconciliation required by ASC 810-10-50-1A(c)?

PwC response

We believe a reporting entity should follow the SEC guidance for redeemable preferred stock when disclosing changes in redeemable noncontrolling interest. That is, an SEC registrant is required to include a rollforward of redeemable preferred stock in either the statement of changes in stockholders' equity, if presented, or in the footnotes. If the reporting entity includes the rollforward of redeemable preferred stock in the statement of changes in stockholders' equity, it should consider an appropriate title of the statement, since it will include amounts not included in stockholders' equity. S-X 5-02 (27) prohibits totaling preferred stocks subject to mandatory redemption requirements or whose redemption is outside the control of the issuer with equity-classified instruments.

Refer to FSP 5.6.3 for further information on presentation of redeemable preferred stock.

5.4 Disclosures for all classes of securities

A reporting entity is required to explain the pertinent rights and privileges of all outstanding classes of securities. ASC 505-10-50-3 includes the following examples of information that should be summarized within the financial statements (either on the balance sheet or in the statement of stockholders' equity):

- Dividend and liquidation preferences
- Participation rights
- Call prices and dates
- Sinking-fund requirements
- Unusual voting rights
- Significant terms of contracts to issue additional shares
- Conversion or exercise prices and pertinent dates
- Number of shares issued upon conversion, exercise, or satisfaction of required conditions during the most recent annual fiscal period and any subsequent interim period presented

Public companies should show any discount on shares (or any unamortized discount balance) separately as a deduction from the related shares' account, as required by S-X 4-07.

5.5 Common stock

Common stock represents the basic ownership interest in the reporting entity. It is the residual corporate interest that bears the ultimate risk of loss, as it is subordinate to all other stock. A reporting entity may have more than one class of common stock.

5.5.1 Balance sheet presentation

Public reporting entities are required by S-X 5-02 (29) to present the dollar amount and number of shares issued or outstanding, as appropriate, on the face of the balance sheet. If the common stock class is convertible, the reporting entity should label the common stock as such on the face of the balance sheet. When multiple classes of common stock exist, a reporting entity may aggregate them together on the balance sheet and present the required information for each class of common stock in a footnote.

The total number of outstanding shares disclosed on the face of the balance sheet is a legal determination. The legal shares outstanding may be different from the number of shares considered outstanding for accounting purposes and for earnings per share computations.

5.5.2 Disclosure

S-X 5-02 (29) also requires the following information to be disclosed in the footnotes, or on the face of the balance sheet, for each class of common stock:

- The title of the issuance
- The number of shares authorized
- If convertible, the basis of conversion
- Dollar amount of common shares subscribed but unissued, and the deduction of subscriptions receivable

5.6 Preferred stock

Preferred stock is an equity security with preferential rights generally not associated with common stock. Like common stock, reporting entities may have multiple classes of preferred stock.

The balance sheet presentation of preferred stock depends on whether it is (1) perpetual or non-redeemable (FSP 5.6.2.1), (2) mandatorily redeemable (FSP 5.6.3.1), or (3) contingently redeemable (FSP 5.6.3.1). The determination of how to classify redeemable preferred stock is addressed in FG 4.

5.6.1 Disclosure

Preferred stock often has a preference in liquidation in which the preferred stock has a claim on proceeds equal to its par value. However, there are situations when the preferred stock has a preference that is considerably in excess of the par or stated value of the stock. When such a preference exists, ASC 505-10-50-4 indicates that reporting entities should disclose this on the face of the balance sheet. Further, S-X 4-08(d)(1) requires public companies that have preferred stock with a liquidation preference other than par or the stated value to disclose the preference on the face of the balance sheet regardless of whether it is considerably in excess of the par or stated value of the stock.

In addition to the general requirements outlined in FSP 5.4, ASC 505-10-50-5 requires a reporting entity with preferred stock with preferences to disclose the following on the face of the balance sheet or in the footnotes:

- Aggregate or per-share amounts at which the preferred stock is called or is subject to redemption through sinking-fund operations or otherwise

- Aggregate and per-share amounts of cumulative preferred dividends in arrears

Further, S-X 4-08(d)(2) requires public companies to disclose any restrictions on retained earnings upon an involuntary liquidation that results from a preference that exceeds the par or stated value of the related shares.

5.6.2 Perpetual preferred stock (no redemption)

Perpetual, or non-redeemable, preferred stock, by its legal terms, has no contractual redemption provisions.

5.6.2.1 Balance sheet presentation

Absent any conversion or exchange provisions, preferred stock is generally classified in equity. However, reporting entities should consider whether substantive redemption features exist, in which case it may be classified outside of equity (e.g., mezzanine equity), or as a liability. See FG 4.3.2.

In addition to the general disclosure requirements outlined in FSP 5.4, a reporting entity with non-redeemable preferred stock should state on the face of the balance sheet (or if more than one issue is outstanding, in the footnotes) the following for each issue in accordance with S-X 5-02 (28):

- Title

- Dollar amount

- Dollar amount of any shares subscribed but unissued and the deduction of subscriptions receivable

On the face of the balance sheet or in the footnotes, disclose the number of shares authorized and the number of shares issued or outstanding for each issue. In the footnotes or in a separate statement, disclose the changes in each class of non-redeemable preferred stock for each period an income statement is presented.

5.6.3 Redeemable preferred stock

Preferred stock may have redemption features in which the preferred shares may be exchanged for cash. Preferred stock that is redeemable at the option of the issuer (i.e., the issuer has a call option) would follow the same presentation and disclosure requirements as perpetual preferred stock. Refer to FSP 5.6.2. Preferred stock may also have a mandatory redemption feature or a redemption feature outside of the control of the issuer.

5.6.3.1 *Balance sheet presentation*

A public reporting entity should state on the face of the balance sheet the following for each issue of redeemable preferred stock in accordance with S-X 5-02 (27). If a reporting entity has multiple issues of such instruments outstanding, it may combine the amounts on the face of the balance sheet if appropriate disclosure is included in the footnotes.

- Title
- Carrying amount
- Redemption amount
- Dollar amount of any shares subscribed but unissued and the deduction of subscriptions receivable
- The number of shares authorized and the number of shares issued or outstanding for each issue (either on the face of the balance sheet or in the footnotes)

Mandatorily redeemable

ASC 480-10-25-4 requires reporting entities to present mandatorily redeemable preferred stock as a liability on the balance sheet. Financial instruments in the scope of ASC 480 should be presented as liabilities in the balance sheet, and not as items in the mezzanine section (i.e., not between the liabilities section and the equity section in the balance sheet). There is a special presentation for entities that have all of their "equity" instruments classified as mandatorily redeemable liabilities under ASC 480. The issuer should describe those instruments as "shares subject to mandatory redemption" in the balance sheet to distinguish them from other liabilities.

Further, reporting entities should present payments to holders of such instruments (e.g., dividends on the "equity" shares) and related accruals as interest cost separate from amounts due to other creditors in the income statement and statement of cash flows.

Redeemable outside control of the issuer

Public companies are required to present contingently redeemable preferred stock (i.e., redeemable upon the occurrence of an event) and preferred stock that is redeemable (outside the control of the issuer), including those instruments that are redeemable at the option of the holder, in mezzanine equity. Mezzanine equity is presented after liabilities and before stockholders' equity on the balance sheet. The purpose of this classification is to convey to the reader that such a security may not be permanently part of equity and could result in a demand for cash or other assets of the entity in the future.

Reporting entities should present redeemable securities that are classified as mezzanine equity separate from all other stockholders' equity accounts that are classified as permanent equity (e.g., non-redeemable preferred, common stock, and retained earnings). ASR 268 specifically prohibits the use of the term "stockholders' equity" as a caption to present the combined total of all equity securities and redeemable preferred stock.

The SEC has stated that it will not accept liability classification for redeemable instruments that do not meet the requirements for liability classification in ASC 480. These instruments should be classified as mezzanine equity based on the guidance in ASC 480-10-S99.

Private companies are not required to present contingently redeemable preferred stock in mezzanine equity. However, mezzanine equity classification is strongly encouraged for private companies, especially in those circumstances when there is not a high likelihood that the capital is in fact permanent; for example, when preferred stock is redeemable at the option of the holder at any time. On the other hand, use of a mezzanine presentation may be considered less relevant in other circumstances, such as when preferred stock is redeemable by the holder only upon a remote event. If the private company does not elect mezzanine presentation, it should consider separate presentation from other items within equity. Regardless of whether a nonpublic entity adopts the mezzanine equity presentation, ASC 505-10-50-11 requires specific disclosures for redeemable securities. Refer to FSP 5.6.3.2 for further information.

5.6.3.2 Disclosure

For mandatorily and contingently redeemable securities where redemption is outside the control of the issuer, in addition the information in FSP 5.4, S-X 5-02 (27) requires disclosure of the following in a footnote labeled "Redeemable Preferred Stocks:"

- General description of each issue, including redemption features
- Rights, if any, of the holders in the event of default, and any impact on junior securities if a required dividend, sinking fund, or other redemption payment is not made
- Redemption requirements in the aggregate for all issues for each of the five years following the latest balance sheet presented
- Changes in each issue for each period an income statement is presented
- A description of the accounting treatment for any difference between the carrying value and redemption amount

ASC 505-10-50-11 requires a reporting entity to disclose the redemption requirements for each of the five years following the latest balance sheet only for stock redeemable at fixed or determinable prices and redeemable on fixed or determinable dates. In contrast, S-X 5-02 requires this disclosure for all redeemable preferred stock issued by SEC registrants.

ASR 268 requires the following presentation/disclosure for public companies with redeemable equity instruments that are classified outside of permanent equity:

FRP 211.04

ASR 268:

In the interest of clear and prominent disclosure of the future cash obligations attendant with these types of securities, the rules require disclosure of the terms of redemption, five-year maturity data, and changes in these securities in a separate note to the financial statements captioned "Redeemable Preferred Stocks." It should be noted that although in the past a registrant may have disclosed changes in redeemable preferred stocks in a statement of stockholders' equity, such changes are now required to be disclosed in a separate note as described above.

Excerpt from FRP 211.03

ASR 268:

Where redeemable preferred stocks are outstanding, the Commission will not prohibit the combining of non-redeemable preferred stocks, common stocks and other equity accounts under an appropriate designated caption (e. g., "Non-Redeemable Preferred Stocks, Common Stocks, and Other Stockholders' Equity") provided that any combinations be exclusive of redeemable preferred stocks.

As noted in the excerpt, FRP 211.04 indicates that changes in redeemable preferred stock are required to be disclosed in a separate note. However, we believe that presentation of redeemable securities within the statement of changes in stockholders' equity is permitted provided the statement is appropriately titled. We believe either alternative is appropriate.

Mandatorily redeemable

In addition to the disclosures in FSP 5.4, reporting entities that issue mandatorily redeemable securities classified as liabilities are required to provide the following disclosures in accordance with ASC 480-10-50:

- Nature and terms of the financial instrument
- Rights and obligations of the security, including any settlement alternatives in the contract, and the entity that controls the settlement alternatives

This guidance also requires the following disclosures for each settlement alternative:

- Amount that would be paid, or the number of shares that would be issued and their fair value, determined based on the conditions in the contract if the settlement were to occur at the balance sheet date
- How changes in the fair value of the issuer's equity shares would impact the settlement amounts (see ASC 480-10-50-2(b) for example disclosure)

- If applicable, the maximum amount that the issuer could be required to pay to redeem the instrument by physical settlement, the maximum number of shares that could be required to be issued, and that a contract does not limit the amount that the issuer could be required to pay or the number of shares that the issuer could be required to issue

- For a forward contract or an option indexed to an issuer's equity shares, disclose the forward price or option strike price, the number of issuer's shares that the contract is indexed to, and the settlement date or dates of the contract

5.6.4 Convertible preferred stock

Convertible preferred stock is convertible into common stock upon the occurrence of certain events. It may be contingently convertible (e.g., convertible at the option of the issuer, upon an initial public offering, or when reaching a target stock price) or mandatorily convertible. Refer to FG 9.3.2 to determine if convertible preferred stock should be classified in permanent or mezzanine equity.

5.6.4.1 Balance sheet presentation

Convertible preferred stock classified in permanent equity should follow the balance sheet presentation requirements for non-redeemable preferred stock outlined in FSP 5.6.2.1.

Convertible preferred stock classified in mezzanine equity should follow the guidance in terms of what information is to be included, but be presented in mezzanine equity. Refer to the "contingently redeemable outside control of the issuer" section of FSP 5.6.3.1 for presentation requirements of mezzanine equity.

5.6.4.2 Disclosure

Reporting entities are required to include the disclosures noted in FSP 5.4 for all convertible preferred stock. In addition, ASC 505-10-50-6 requires reporting entities to disclose all terms of contingently convertible securities to help financial statement users understand both the nature of the contingency and the potential impact to the ownership of the reporting entity upon conversion. These should include:

- What events or circumstances would cause the contingency to be met and other significant terms that will enable the user to understand the impact and potential timing of those rights

- The conversion price and the number of shares into which the contingently convertible securities will potentially convert

- If there are any events or circumstances that could change the contingency, the conversion price, or the number of shares into which they will ultimately convert, including the significant features of those circumstances

- How the shares will settle upon conversion and if there are alternative settlement methods (for example, cash, shares, or a combination)

ASC 505-10-50-7 includes an example disclosure that addresses the preceding requirements.

Excerpt from ASC 505-10-50-7

The Company is obligated to issue X shares and as the market price of the common stock decreases, the Company is obligated to issue an additional X shares for each $1 decrease in the stock price.

Additionally, ASC 505-10-50-9 requires a reporting entity to indicate in the footnotes if the convertible preferred stock is included in diluted EPS and the reasons why or why not.

5.6.4.3 Contingently convertible preferred stock — with related derivatives

A reporting entity may enter into derivative instruments in connection with the issuance of contingently convertible preferred stock. In that instance, ASC 505-10-50-10 requires the reporting entity to explain in the footnotes the terms of any derivatives and their potential impact on the contingently convertible securities. The information might include:

- The terms of the derivative instruments (including the terms of settlement)
- How the derivative instruments relate to the contingently convertible securities
- The number of shares underlying the derivative instruments

For additional information related to disclosures of derivative instruments, refer to FSP 19.

5.6.4.4 Discount on contingently convertible preferred stock

Preferred stock may be issued at a discount when the redemption value exceeds the proceeds received. ASC 505-10-50-8 requires a reporting entity that issues contingently convertible preferred stock at a discount to disclose in the footnotes the excess of (1) the aggregate fair value of the instruments the holder would receive at conversion, over (2) the proceeds received by the issuer, and the period over which the discount is accreted.

5.7 Retained earnings

Retained earnings represents the earned capital of the reporting entity. Earned capital is the capital that develops and builds up over time from profitable operations. It consists of all undistributed income that remains invested in the reporting entity. Retained earnings (or accumulated deficit) should be stated separately on the balance sheet.

5.7.1 *Restrictions on retained earnings*

When a reporting entity is materially restricted from paying dividends, they should describe the restriction in the footnotes.

S-X 4-08(e) requires footnote disclosure of the following:

- The most significant restrictions on the payment of dividends, including their sources, their pertinent provisions, and the amount of retained earnings or net income restricted or free of such restrictions
- The amount of consolidated retained earnings that represents undistributed earnings of 50 percent or less-owned entities accounted for by the equity method
- If restricted net assets of consolidated and unconsolidated subsidiaries plus the parent's equity in 50 percent or less-owned entities accounted for by the equity method exceed 25 percent of consolidated net assets, disclose the nature of any restrictions on the ability of consolidated and unconsolidated subsidiaries to transfer funds to the parent, and the amounts of such restricted net assets

The disclosure should not only include a description of the restriction, but also a statement indicating the amount of retained earnings restricted or not restricted. Reporting entities should not make any statement that a portion of retained earnings is "available" for dividends because this statement ignores the possibility that it may be unwise or impractical, for business reasons, to pay a dividend. If a reporting entity chooses to make such a statement, we recommend they discuss the decision with legal counsel.

Example 5-1 includes suggested language in the footnote to indicate a restriction on retained earnings.

EXAMPLE 5-1

Example disclosure – retained earnings restrictions

Note D - At December 31, 20X4, consolidated retained earnings was restricted in the amount of $3,500,000, representing the cost of 170,000 shares of common stock held in the treasury.

5.7.1.1 *Restrictions on retained earnings in loan agreements*

Loan agreements may contain restrictions on earnings. In these circumstances, it is usually not sufficient to describe only the provisions of loan or credit agreements that restrict the amount available for dividends; the reporting entity should also state the amount restricted.

Example 5-2 illustrates disclosure of restrictions on retained earnings in loan agreements.

EXAMPLE 5-2

Example disclosure – restrictions on retained earnings in a loan agreement

As stated more fully in such an agreement, the corporation has agreed, among other things, that it will not, without the consent of the banks, declare any dividend if immediately thereafter the consolidated working capital would be less than $9 million. This working capital provision effectively limits the amount that might be paid as cash dividends to $3 million, which represents the excess of consolidated working capital at December 31, 20X4 over the amount of $9 million.

5.7.1.2 Subsidiary restrictions on retained earnings

Reporting entities should consider material amounts of consolidated retained earnings that are restricted because of actions by subsidiaries. Restrictions on consolidated retained earnings could, for example, arise at the subsidiary level in the following situations:

- A domestic subsidiary with a noncontrolling interest that capitalizes retained earnings by declaring a stock dividend
- Subsidiaries that capitalize retained earnings by transfers to common stock in order to gain tax or other advantages
- A foreign subsidiary that is required by statute to establish a legal reserve for the protection of creditors
- Debt covenant requirements that restrict a subsidiary's ability to transfer funds to the parent
- Regulated subsidiaries, such as broker dealers and insurance companies, that need to keep capital levels at certain amounts or have regulators approve dividends

5.7.2 Appropriations on retained earnings

Retained earnings may be appropriated by:

- Action of the board of directors (such as an authorization for the acquisition of treasury stock)
- Arrearages of cumulative preferred stock dividends
- Preferences of preferred stock upon involuntary liquidation in excess of par or stated value
- Provisions in the corporate charter, loan agreements, and other contracts

ASC 505-10-45-3 permits an appropriation of retained earnings if it is shown within stockholders' equity on the balance sheet and is clearly identified as such. Reporting entities should not transfer any part of the appropriation to net income, nor should it charge costs or losses directly to an appropriation of retained earnings.

5.8 Treasury stock

Treasury stock is created when a reporting entity reacquires its own common stock.

5.8.1 Balance sheet presentation

Treasury stock may be legally issued and outstanding but not considered outstanding for accounting purposes; it is represented by a debit in the equity section for the purposes of financial reporting. If the treasury stock is not constructively or actually retired upon its reacquisition, the reporting entity may present it on the balance sheet as a reduction from common stock, additional paid-in capital (APIC), or retained earnings. Alternatively, reporting entities may follow the accounting requirements of ASC 505-30-30-7 to 30-10, which govern the retirement of treasury stock.

5.8.2 Disclosure

Reporting entities with treasury stock should disclose its terms, similar to the way they do for common stock. Reporting entities should consider disclosing the following:

- Basis at which it is carried
- Number of shares
- Commitments to repurchase capital stock
- Restrictions imposed by state law
- Reasons for acquisition

Shares may be repurchased at a price that is significantly in excess of the current market price. As indicated in ASC 505-30-50-3, when this occurs there is a presumption that the repurchase price includes amounts attributable to items other than the shares. As a result, a reporting entity may be required to allocate amounts of the repurchase price to other elements of the transaction as required by ASC 505-30-30-2. There is significant judgment involved in allocating amounts between treasury shares and other items. Disclosure is required in the footnotes of the allocation of the amounts paid and the accounting treatment for these amounts, in accordance with ASC 505-30-50-4.

See FG 6.3 for accounting considerations related to treasury stock.

5.9 Additional paid-in capital

Additional paid-in capital (sometimes referred to as capital in excess of par value) is the excess amount paid by an investor over the par value of a stock issue. In addition, non-stock-related contributions from an investor, such as cash or property, are normally reflected in APIC. APIC may be shown as a separate caption in the equity section of the balance sheet or combined with the related stock caption.

5.9.1 Notes received for common stock

A reporting entity may receive a note, rather than cash, as a contribution to its equity. The note may be for the sale of common stock or a contribution to paid-in capital. The question arises as to whether the note should be presented as a receivable or as contra-equity. ASC 505-10-45-2 indicates that reporting the note as an asset is generally not appropriate, except in very limited circumstances in which there is substantial evidence of intent and ability to pay in a reasonably short time period. SAB Topic 4-E indicates that the SEC would permit recording such notes as an asset if the note is collected prior to issuance of the financial statements. The predominant practice is to present the note receivable as contra-equity.

For nonpublic entities, evidence of intent and ability to pay in a reasonably short period, and therefore the ability to include the note as an asset, may include circumstances in which the notes are secured by irrevocable letters of credit or other liquid collateral, have a stated maturity in a short time period, or if the notes are collected prior to issuance of the financial statements.

5.10 Dividends

Dividends are distributions to owners or stockholders.

5.10.1 Cash dividends

Cash dividends declared are generally reported as a deduction from retained earnings until retained earnings is exhausted. In the absence of retained earnings, cash dividends should generally be charged to APIC. Dividends declared or paid are normally presented in the statement of stockholders' equity at the amount per share, and in total for each class of shares as required by S-X 3-04.

Figure 5-1 provides an example of this presentation. Whenever dividends are declared from other than parent company retained earnings (e.g., from APIC, or retained earnings resulting from parent's equity in undistributed earnings of a subsidiary), the reporting entity should consider obtaining an opinion of counsel as to the legality of the declaration. The declaration of a dividend implies that there have been profits that justify the dividend.

5.10.2 Dividends-in-kind

Dividends-in-kind are dividends paid other than in cash. Reporting entities record dividends of assets, property, or stock of another entity made pro rata to all stockholders at fair value (except for dividends of shares of investees consolidated or accounted for under the equity method). See ASC 845-10-30-10.

Example 5-3 illustrates a disclosure related to dividends-in-kind.

EXAMPLE 5-3

Example disclosure – dividend-in-kind

FSP Corp - 20X4	
Dividends paid -	
Regular cash dividends at $2.40 a share	$24,000,000
Special dividend	
500,000 shares in capital stock of RST Inc. at market value, equivalent to $0.67 per share of FSP Corp stock, together with equalizing cash payments in lieu of fractional shares	$6,702,000

5.10.3 Unpaid dividends

Reporting entities often declare dividends on common stock before the balance sheet date, and then pay the dividends after the balance sheet date. Unpaid declared dividends other than stock dividends should be presented as current liabilities. However, if the dividend is payable in kind from noncurrent assets, the reporting entity should present it as a noncurrent liability.

5.10.4 Stockholders' rights plans ("poison pill" takeover defenses)

To discourage unfriendly takeover attempts, reporting entities may adopt plans under which rights are granted to existing stockholders that convert to common stock upon the occurrence of certain events, such as the accumulation of a significant percentage of the reporting entity's outstanding shares by a single stockholder. These plans are sometimes referred to as "poison pill" takeover defenses and have the characteristics of a dividend. Reporting entities with poison pill takeover defenses should disclose in their footnotes the terms of the plans, including events that cause conversion, the potentially dilutive nature of the plan, and call provisions, if any. Accounting for these plans is addressed in FG 8.4.

5.10.5 Liquidating dividends

A distribution that represents a return of capital is a liquidating dividend. When a reporting entity pays such a dividend, usually on partial or complete dissolution, it should advise the shareholders and disclose the facts in the financial statements. The reporting entity may deduct "liquidating dividends" or "capital repayment" from APIC in the balance sheet or show only the balance of capital after partial liquidation. Example 5-4 illustrates the presentation and disclosure of liquidating dividends.

EXAMPLE 5-4

Example disclosure for a liquidating dividend – deducting from capital balance

Note X - Cash dividends paid during the year 20X4 equaled $1.00 per share on the $3.00 par value common stock, of which $0.30 represented a liquidating dividend paid from APIC.

5.10.6 Stock dividends

ASC 505-20-20 defines a stock dividend as a dividend paid in the reporting entity’s own shares. Like cash dividends, stock dividends declared are generally shown as a deduction from retained earnings and added to common stock and APIC (“permanent equity”). Unless this is done, the amount of earnings distributed will remain in retained earnings, leading stockholders to believe these distributions are available for further stock issuances or cash distributions. Therefore, the transfer from retained earnings should not be shown as an appropriation of retained earnings, but as a reduction of permanent equity.

Stock dividends declared or paid are normally presented in the statement of stockholders’ equity at the amount per share and in total for each class of shares as required by S-X 3-04. In the year declared, the reporting entity should disclose the amount of retained earnings transferred to permanent equity.

Further, as noted in FSP 5.4, S-X 5-02 requires disclosure of the number of shares issued and outstanding on the face of the balance sheet. When a stock dividend has been declared, but not issued at the balance sheet date, the sum of the number of shares declared as a stock dividend and the total number of shares outstanding should usually be disclosed on the face of the balance sheet. When there are multiple classes of shares, it may be appropriate to disclose this information in the footnotes. Example 5-5 illustrates two versions of this presentation on the balance sheet:

EXAMPLE 5-5

Example presentation – shares declared as a stock dividend and not issued

	December 31, 20X4
Common stock - $10 par; authorized 200,000 shares; issued and outstanding 105,000 shares (including 5,000 shares declared as a stock dividend on December 29, 20X3, and issued on January 15, 20X4)	$1,050,000

Or

	December 31, 20X4	
	Shares	Amount
Common stock - $10 par; authorized 200,000 shares		
Issued and outstanding	100,000 shares	$1,000,000
Issued on January 15, 20X4 as a stock dividend	5,000 shares	50,000
	105,000 shares	$1,050,000

5.10.6.1 *Stock dividend declared but not paid*

Reporting entities may elect not to record a declared stock dividend and related per share effects if there is a reasonable basis for concluding that the dividend may be rescinded. Such a situation might exist when stockholder approval is required and scheduled for a date subsequent to issuance of the financial statements, and there are reasonable grounds to believe that stockholders will not approve the dividend. The reporting entity should disclose such a situation in the footnotes.

If a balance sheet date falls between declaration and issuance of the stock dividend, the reporting entity should show the credit in stockholders' equity on the balance sheet. The account is not shown as a liability because no corporate obligation is created by the declaration of a stock dividend (and the future payment of the stock dividend would not meet the definition of a liability under ASC 480). As such, reporting entities should not use the caption "stock dividend payable" because it may cause the reader to think of the item as a liability.

We believe an appropriate way to present this is to charge retained earnings for the fair value of the stock dividend with an offsetting credit allocating the amount of the dividend between the capital stock account (at par or at stated value) and APIC in the same manner as would be done if the dividend were issued before the balance sheet date. This treatment eliminates any possible misinterpretation of the nature of the credit or its eventual disposition. We do not believe showing the credit as appropriated retained earnings or as a separate equity item, instead of being included in common stock and APIC, would adequately identify the amount as part of permanent equity.

5.10.6.2 Earnings capitalized in prior years

Some reporting entities disclose the amount of cumulative retained earnings that was capitalized in prior years as a result of stock dividends and other authorized transfers. However, if the transfers are fully disclosed as they occur, there is no requirement for a cumulative disclosure.

5.10.6.3 Fractional shares

Stock dividends almost always create fractional shares. Frequently, the reporting entity pays cash in lieu of issuing the fractional shares and reduces retained earnings for the cash payment. When the balance sheet date is between the date of declaration and the date of distribution, and the amount to be paid in cash is determinable, it is typically classified as dividends payable. The reporting entity may show the charge to retained earnings as a separate item or as part of the stock dividend caption in the statement of stockholders' equity. If the amount is not determinable, the reporting entity generally describes the transaction.

5.11 Stock splits

ASC 505-20-20 defines a stock split.

Definition from ASC 505-20-20

An issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to increase the number of outstanding shares for the purpose of effecting a reduction in their unit market price and, thereby, of obtaining wider distribution and improved marketability of the shares. Sometimes called a stock split-up.

ASC 505-20-30-6 indicates that in the event of a stock split, absent a legal requirement to do so, it is not necessary to transfer the amount from retained earnings to APIC and common stock (for the change in par value). Therefore, the only presentation requirements in the event of a stock split are to update:

- The shares outstanding
- The par amount of the stock on the face of the balance sheet

5.11.1 Differentiation between stock dividends and stock splits

There are situations in which a stock dividend may be in the form of a stock split, as described in ASC 505-20-25-2. When this occurs, to avoid confusion, a reporting entity should avoid solely using the word "dividend." Rather, one way to describe the transaction is as "a stock split effected in the form of a dividend."

Refer to FSP 7 for discussion of the impact of a stock dividend and stock split on earnings per share.

5.12 Balance sheet restatement – stock dividend and stock split

Refer to FSP 28.5.1.2 for guidance on the balance sheet presentation of capital structure changes due to a stock dividend, stock split, or reverse split after the balance sheet date. Since stock dividends and stock splits should be given retroactive recognition in computing earnings per share (ASC 260-10-55-12 and FSP 7.6), they are also given retroactive recognition in computing dividends per share. When dividends per share are presented on other than the historical basis, as a result of retroactive recognition, reporting entities should disclose the basis of presentation in the footnotes.

5.13 Change in capitalization at or prior to closing of an IPO

Often in an IPO, outstanding debt or preferred stock will automatically convert into common stock either upon the effective date or completion (i.e., closing) of the IPO. Such conversions typically have a significant impact on an entity's capital structure. The conversion of securities on either the effective date or closing date of an IPO cannot be reflected in the historical balance sheet. The security should be classified according to its nature in the historical balance sheet at such date. In the financial statements included in the IPO registration statement, the SEC staff generally expects the reporting entity to present an unaudited pro forma balance sheet next to the historical balance sheet to give effect to the assumed conversion of the security on either the effective date or closing date. This pro forma balance sheet should not give effect to the proceeds of the offering. See SEC 4220.76 for an example of a pro forma balance sheet.

5.14 Considerations for private companies

SEC guidance includes a number of specific requirements related to the presentation and disclosure of stockholders' equity for public reporting entities that are not required for private companies. However, the guidance in ASR 268 requiring that redeemable equity instruments be classified outside of permanent equity is strongly encouraged for all reporting entities. Refer to FSP 5.6.3.1 for additional guidance on mezzanine classification.

In addition, ASC 505-10-50-11 requires that all reporting entities disclose the amount of redemption requirements for all issues of stock that are redeemable at fixed or determinable prices on fixed or determinable dates in each of the five years following the date of the latest balance sheet presented. In contrast, S-X 5-02 requires this disclosure for all redeemable preferred stock issued by SEC registrants.

The following items discussed in this chapter are incremental requirements for SEC registrants that are not required for private companies.

- S-X 3-04 requires inclusion of dividends per share in the statement of changes in stockholders' equity.

- S-X 4-07 requires that any discount on shares (or any unamortized discount) be shown separately as a deduction from the related shares' account.

- While ASC 505-30-50-2 requires disclosure of restrictions on retained earnings related to repurchase of treasury shares, S-X 4-08 goes further. It requires disclosure of all restrictions, including any restrictions on retained earnings upon an involuntary liquidation that results from a preference that exceeds the par or stated value of the related shares.

  ASC 505-10-45-3 requires presentation of appropriations of retained earnings for all entities, and ASC 505-10-50-4 requires disclosure of the involuntary preference in liquidation.

- S-X 5-02 requires disclosure on the face of the balance sheet of the following for each issue of common and preferred stock, including redeemable preferred stock:

  - Title

  - Carrying amount

  - Redemption amount

  - Dollar amount of any shares subscribed but unissued, and the deduction of subscriptions receivable

  - The number of shares authorized, issued, or outstanding for each issue (either on the face of the balance sheet or in the footnotes)

  There is a general requirement in ASC 505-10-50-3 to disclose the "pertinent rights and privileges" of all classes of securities, so the above is likely to be required under that guidance.

- SAB Topic 4.C requires that a capital structure change due to a stock dividend, stock split, or reverse split that occurs after the date of the latest reported balance sheet, but before the release (issuance) of the financial statements or the effective date of the registration statement, whichever is later, be given retroactive effect in the balance sheet.

Chapter 6: Statement of cash flows

6.1 Chapter overview

This chapter discusses the concepts that guide classification within the statement of cash flows. Proper presentation begins with understanding what qualifies as cash and cash equivalents, and what does not. From there, classifying cash flows as operating, investing, or financing can often be a challenge, especially for cash flows related to non-recurring transactions. The following sections explore both of these topics and provide examples and considerations that will offer financial statement preparers and other users insight into appropriate presentation of the statement of cash flows in accordance with U.S. GAAP.

The principles of reporting cash flows are contained in ASC 230, *Statement of Cash Flows*; however, ASC 230 is not a comprehensive source of authoritative guidance. The following list contains some of the additional sources for authoritative guidance governing the statement of cash flows:

- FASB Concept Statement No. 5
- ASC 320, *Investments – Debt and Equity Securities*
- ASC 718, *Stock Compensation*
- ASC 815, *Derivatives and Hedging*
- ASC 830, *Foreign Currency Matters*

6.2 Scope

ASC 230, requires a statement of cash flows as part of a full set of financial statements for all reporting entities. The statement of cash flows is a primary financial statement and is required for each period for which an income statement (or statement of activities for not-for-profits) is presented. The statement of cash flows is required to be presented in guarantor condensed consolidated information and parent company-only financial statements that include a balance sheet and an income statement. There are no exclusions for specific industries or different types of reporting entities except for:

- An investment company that is subject to the registration and regulatory requirements of the Investment Company Act of 1940, or that has essentially the same characteristics, meeting the following conditions:
  - Substantially all of the assets of the reporting entity are carried at fair value and are classified as Level 1 or Level 2 under topic ASC 820, *Fair Value Measurement*
  - The reporting entity has little or no debt (based on the average debt outstanding during the period) in relation to average total assets
  - The reporting entity provides a statement of changes in net assets

- A common trust fund, variable annuity account, or similar fund maintained by a bank, insurance entity, or other entity in its capacity as a trustee, administrator, or guardian for the collective investment and reinvestment of moneys

- A defined benefit or defined contribution postretirement plan

Note about ongoing standard setting

As of the content cutoff date of this publication (August 31, 2014), the FASB has an active project intended to reduce diversity in practice in financial reporting by clarifying certain existing principles related to the statement of cash flows, including providing additional guidance on how and what an entity should consider in determining the classification of certain cash flows. As part of the project, the FASB staff will research potential additional disclosures that could result in increased relevance for users. Financial statement preparers and other users of this publication are therefore encouraged to monitor the status of the project, and if finalized, evaluate the effective date of the new guidance and the implications on presentation and disclosure.

6.3 Cash basis method of reporting

Reporting activity in the statement of cash flows is predicated on the cash method of accounting, rather than the accrual method reflected in other financial statements. Accordingly, all debits and credits to a bank account that have the general characteristics of an unrestricted demand deposit account should be reported as cash outflows of the payer and cash inflows of the payee. FASB CON 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, explains, “Reporting cash flows involves no estimates or allocations and few judgments except regarding classification in the statement of cash flows.” It further indicates that cash flows should be recognized when they occur. Accordingly, reporting entities should generally only report cash flows that actually affected cash and cash equivalents (see FSP 6.9.1 for a discussion of constructive receipts and disbursements). A statement of cash flows should not reflect cash flows that could have happened or are expected to happen. For example, when a reporting entity takes title to a long-lived asset on the last day of a reporting period in exchange for an account payable with normal 30-day trade terms, the reporting entity’s statement of cash flows should not include an investing cash outflow, but instead should disclose a noncash investing activity. The fact that the reporting entity had sufficient cash to settle the accounts payable on the balance sheet date, or expects to pay the accounts payable shortly after the balance sheet date, is irrelevant.

6.4 Format of the statement of cash flows

ASC 230 allows a reporting entity to prepare and present its statement of cash flows using either the direct or indirect method (discussed in detail in the next section), though the guidance encourages using the direct method.

6.4.1 *Example statement of cash flows*

The captions included on a statement of cash flows will vary across each reporting entity based on the applicability of each caption. Figure 6-1 is an illustrative cash flow statement prepared using the indirect method which reflects certain captions required by ASC 230 (bolded), and other common captions. All captions below may not be applicable to all reporting entities. In addition, some captions may be reflected in other classification categories depending on facts and circumstances. Note that line items labeled with an asterisk (*) generally should be presented gross; however, for ease of reference in Figure 6-1, the inflows and outflows are reflected in the example statement on one line.

Detailed presentation and disclosure requirements are addressed in the relevant sections of this chapter and noted in the last column of the figure. Not all items discussed within this chapter are presented in the figure below.

Figure 6-1

Example consolidated statement of cash flows

FSP Corp
Consolidated Statement of Cash Flows

	20X4	**20X3**	**20X2**	**Section reference**
	in millions $	in millions $	in millions $	
Cash flows from operating activities:				
Net income	$xxx	$xxx	$xxx	6.4.2
Adjustments to reconcile net income to net cash provided by (used in) operating activities:				
Accretion (amortization) of discount (premium) on investment in debt securities	xxx	xxx	xxx	6.7.1.3
Accretion (amortization) of discount (premium) on debt securities	xxx	xxx	xxx	6.7.2.1
Loss on extinguishment of debt	xxx	xxx	xxx	6.7.2.2 6.7.2.3
Depreciation and amortization	xxx	xxx	xxx	6.7.3
Amortization of debt issue costs	xxx	xxx	xxx	6.7.3
Share-based incentive compensation	xxx	xxx	xxx	6.7.3
Impairment of assets	xxx	xxx	xxx	6.7.3
Provision for bad debt expense	xxx	xxx	xxx	6.7.3

	20X4	20X3	20X2	Section reference
Inventory obsolescence impairment	xxx	xxx	xxx	6.7.3
Deferred taxes	xxx	xxx	xxx	6.7.3
Noncash provisions for exit costs	xxx	xxx	xxx	6.7.3
Loss (gain) on disposal of property and equipment	xxx	xxx	xxx	6.7.3
(Income) loss from equity-method investments, net of dividends received	xxx	xxx	xxx	6.7.3.2
Unrealized foreign currency transactions	xxx	xxx	xxx	6.8
Changes in operating assets and liabilities, net of effects of businesses acquired:				
Decrease (increase) in trade receivables	xxx	xxx	xxx	6.4.2
Decrease (increase) in accounts receivable securitization program	xxx	xxx	xxx	6.4.2
Decrease (increase) in inventories	xxx	xxx	xxx	6.4.2
Decrease (increase) in other assets, net	xxx	xxx	xxx	6.4.2
Increase (decrease) in accounts payable	xxx	xxx	xxx	6.4.2
Increase (decrease) in accrued liabilities	xxx	xxx	xxx	6.4.2
Increase (decrease) in income taxes payable	xxx	xxx	xxx	6.4.2
Increase (decrease) in other liabilities	xxx	xxx	xxx	6.4.2
Net cash provided by (used in) operating activities	xxx	xxx	xxx	6.7.3
Cash flows from investing activities:				
Restricted cash	xxx	xxx	xxx	6.5.7

	20X4	20X3	20X2	Section reference
Acquisition [sale] of equity securities*	xxx	xxx	xxx	6.7.1
Acquisition [proceeds from sale] of property, plant, and equipment*	xxx	xxx	xxx	6.7.1.1
Acquisition [sale] of a business, net of cash and cash equivalents acquired [or sold]*	xxx	xxx	xxx	6.7.1.2
Acquisition [sale] of debt securities or investments*	xxx	xxx	xxx	6.7.1.3
Acquisition of [sale of] unconsolidated entities*	xxx	xxx	xxx	6.7.1.5
Net cash provided by (used in) investing activities	xxx	xxx	xxx	6.7.1
Cash flows from financing activities:				
Bank overdrafts	xxx	xxx	xxx	6.5.3
Payment of contingent consideration	xxx	xxx	xxx	6.7.1.2
Proceeds from debt	xxx	xxx	xxx	6.7.2
Repayments of debt	xxx	xxx	xxx	6.7.2
Payments of debt issue costs	xxx	xxx	xxx	6.7.2
Dividends paid	xxx	xxx	xxx	6.7.2
Net payments of short-term borrowings	xxx	xxx	xxx	6.7.2
Repurchases of equity securities	xxx	xxx	xxx	6.7.2
Acquisition of common stock for tax withholding obligations	xxx	xxx	xxx	6.7.2.6
Distributions to noncontrolling interests	xxx	xxx	xxx	6.7.2.7
Derivative with an other-than-insignificant financing element	xxx	xxx	xxx	6.7.2.8

	20X4	20X3	20X2	Section reference
Net cash provided by (used in) financing activities	xxx	xxx	xxx	6.7.2
Effect of exchange rate changes on cash and cash equivalents	xxx	xxx	xxx	6.8
Cash and cash equivalents:				
Net change during the period	xxx	xxx	xxx	6.5
Balance, beginning of period	xxx	xxx	xxx	6.5
Balance, end of period	$xxx	$xxx	$xxx	6.5
Supplemental Cash Flow Information:				
Cash paid for interest, net of amounts capitalized	$xxx	$xxx	$xxx	6.4.2
Cash paid for income taxes	xxx	xxx	xxx	6.4.2
Noncash investing and financing activity	xxx	xxx	xxx	6.9

* Line items labeled with an asterisk (*) generally should be presented gross; however, for ease of reference in Figure 6-1, the inflows and outflows are reflected in the example statement on one line.

6.4.2 Direct versus indirect method

Cash flows related to operating activities may be determined and presented in one of two ways — the direct method or the indirect method. The determination and presentation of investing and financing activities are identical under the direct and indirect methods. Although the presentation of operating cash flows differs between the two methods, both methods should theoretically result in the same amount of net cash flows from operations. While the FASB encourages the use of the direct method, the large majority of reporting entities elect to use the indirect method. The concepts underlying classification within ASC 230 were conceived and explained solely from the perspective of the direct method. While the indirect method represents an alternative presentation model, it is not an alternative classification methodology. Accordingly, even when a reporting entity is using the indirect method, it should consider the direct method framework when evaluating the proper classification of a cash flow.

The direct method requires the presentation of major types of gross cash receipts and gross cash payments and their arithmetic sum, which represents the net cash flow from operating activities. At a minimum, the following types of operating receipts and disbursements are required in a direct method presentation:

- Cash collected from customers, including lessees, licensees, etc.
- Interest and dividends received (except for return of capital)
- Other operating cash receipts, if any
- Cash paid to employees and other suppliers of goods or services, including suppliers of insurance, advertising, etc.
- Interest paid
- Income taxes paid
- Other operating cash payments, if any

In order to illustrate how operating cash flows (prepared on the cash basis of accounting) relate to net income (prepared on the accrual method of accounting), the direct method also requires a reconciliation of net income to net cash flows from operating activities, which removes the effects of both of the following:

- All deferrals of past operating cash receipts and payments, and all accruals of expected future operating cash receipts and payments. For example, changes during the period in receivables and payables pertaining to operating activities
- All items included in net income that do not affect operating cash receipts and payments. For example, all items for which cash effects are related to investing or financing activities (e.g., depreciation, amortization, and gains or losses on dispositions of long-lived assets)

When the indirect method is used, a reporting entity does not report the gross cash receipts and gross payments required by the direct method. Instead, only the reconciliation of net income to net operating activities, as described above, is reported. In addition, when the indirect method is used, amounts of interest paid (net of amounts capitalized) and income taxes paid during the period must be disclosed, either on the face of the statement of cash flow or in the footnotes.

Reporting entities have latitude in how they present an indirect method reconciliation, as there is no prescribed format. As with most forms of practical expediency, the indirect method yields information that is less useful than the direct method. For example, because the individual line items within a reconciliation of net income to net operating cash flows do not represent cash flows, they by themselves provide no incremental information about a reporting entity's cash flows.

Question 6-1

Should a reporting entity reconcile net income or net income attributable to the reporting entity to cash flows from operating activities?

PwC response

The implementation of the noncontrolling interest guidance in ASC 810, *Consolidation*, did not change the statement of cash flow guidance. Therefore, net income is the starting point for the statement of cash flows even though the noncontrolling interest guidance changed the definition of net income to include earnings attributable to both the controlling and noncontrolling interests.

Whether reporting entities use the direct or indirect method to determine and present its operating cash flows, they are prohibited from disclosing cash flow per share or any component of cash flow per share. Once a method has been elected, a reporting entity may change the method from the direct to the indirect method, or vice versa. Although ASC 230 encourages the use of the direct method, a change in presentation from the indirect to direct method (or vice versa) is considered a change in presentation. This retroactive change in the presentation of the statement of cash flows would not be considered a discretionary accounting change and would not require the issuance of a preferability letter.

6.5 Cash and cash equivalents

The statement of cash flows must detail changes in cash and cash equivalents for the period. The beginning and ending balance of cash and cash equivalents shown on the statement of cash flows should agree to a similarly titled line item or subtotal on the balance sheet.

6.5.1 Definition of cash equivalents

While the definition of cash is generally understood, what constitutes a cash equivalent is not as straightforward. ASC 230 defines cash equivalents as follows:

ASC 230-10-20 Glossary - Cash Equivalents

Cash equivalents are short-term, highly liquid investments that have both of the following characteristics:

a. Readily convertible to known amounts of cash

b. So near their maturity that they present insignificant risk of changes in value because of changes in interest rates.

Generally, only investments with original maturities of three months or less qualify under that definition. Original maturity means original maturity to the entity holding the investment. For example, both a three-month U.S. Treasury bill and a three-year U.S. Treasury note purchased three months from maturity qualify as cash equivalents. However, a Treasury note purchased three years ago does not become a cash equivalent when its remaining maturity is three months. Examples of items commonly considered to be cash equivalents are Treasury bills, commercial paper, money market funds, and federal funds sold (for an entity with banking operations).

Note that the definition presumes that all cash equivalents have two attributes: they must be short-term and highly liquid. The definition then provides two characteristics that elaborate on the required attributes. In practice, reporting entities sometimes place undue focus on the maturity characteristic (short-term), while overlooking the readily convertible characteristic (highly liquid). While the FASB's definition seems to focus more on the maturity characteristic, this does not diminish the requirement for a cash equivalent to be readily convertible to known amounts of cash.

The definition of "readily convertible to cash" is included in the FASB Codification Master Glossary. To be considered "readily convertible to cash," an instrument must have both interchangeable units and quoted prices that are available in an active market. The active market must be able to handle a reporting entity's conversion of an instrument to cash quickly and without significantly affecting the quoted price. For example, in the SEC's recent rule making concerning money market funds (discussed in FSP 6.5.9), the existence of liquidity fees or redemption gates may cause reporting entities to assess if their money market fund investments should continue to be considered cash equivalents. Both characteristics included in the definition must be met for an investment to be considered a cash equivalent. Accordingly, an investment with a maturity of less than three months that is not readily convertible to known amounts of cash — received from the investment's issuer or provided by an active market mechanism — is not a cash equivalent. Similarly, an investment that is convertible into a known amount of cash, but that has a maturity greater than three months, is also not a cash equivalent.

6.5.2 Accounting policy defining cash equivalents

As discussed in ASC 230-10-45-6, not all investments that qualify as cash equivalents are required to be classified as such. A reporting entity with banking operations may choose to present certain cash equivalents within investments.

Pursuant to ASC 230-10-50-1, a reporting entity must disclose its definition of cash equivalents. Any subsequent change in the definition is a change in accounting principle, requiring retrospective presentation in prior years and a determination that such change is preferable.

6.5.3 Bank overdrafts

Bank overdrafts occur when a bank honors disbursements in excess of funds on deposit in a reporting entity's account. Accordingly, bank overdrafts represent short-term loans and should be classified as liabilities on the balance sheet and financing cash flows in the statement of cash flows.

Some reporting entities have executed contractual agreements that link numerous bank accounts within the same bank, or a group of banks. For example, multinational entities that maintain cash balances in numerous consolidated subsidiaries, in multiple currencies, in multiple countries sometimes enter into notional pooling arrangements to facilitate their worldwide treasury activities. Under a notional pooling arrangement, the balances of all bank accounts subject to the arrangement are combined for purposes of determining the balance on deposit under the terms of the agreement. Accordingly, the bank accounts of certain subsidiaries in the notional pooling arrangement are allowed to be in an overdraft position if the bank accounts of other subsidiaries in the notional arrangement have aggregated deposit positions in excess of the aggregated overdraft accounts.

ASC 210, *Balance Sheet*, indicates that a reporting entity's cash account at a bank is not considered an amount owed to the reporting entity for purposes of determining whether a right of offset exists. Accordingly, the ASC 210 offset model cannot be utilized to offset a bank account in a deposit position against another bank account with the same bank that is in an overdraft position. Notwithstanding the guidance in ASC 210, we are aware that some reporting entities have concluded that the contractual terms of their notional cash arrangements preclude individual bank accounts within the arrangement from being considered separate units of account. In such circumstances, we believe it would be acceptable for the reporting entity to aggregate all bank accounts that are subject to the notional pooling arrangement into a single balance on its balance sheet. However, when a subsidiary that participates in the notional pooling arrangement prepares its financial statements on a standalone basis, the presentation of the subsidiary's bank accounts should reflect the facts and circumstances of the individual subsidiary without consideration of its parent's conclusions regarding the notional pooling arrangement at the consolidated level.

6.5.4 Book overdrafts

Book overdrafts — representing outstanding checks related to a specific bank account in excess of funds on deposit for that bank account — should be classified as liabilities on the balance sheet. Book overdrafts should not be offset against other cash or cash equivalent accounts (including time deposits, certificates of deposit, money market funds, and similar temporary investments). Instead, these credit balances should be considered a reinstatement of the liabilities that were cleared in the bookkeeping process. Outstanding checks in excess of funds on deposit that are reclassified to accounts payable should be disclosed separately.

However, as discussed in FSP 6.5.3, a reporting entity may have a contractual banking arrangement whereby it determines that the unit of account is the contractual arrangement, not the individual bank accounts subject to the arrangement. In such circumstances, we believe it may be acceptable for the reporting entity to assess the combined balance on deposit for presentation within its balance sheet.

Question 6-2

How should changes in book overdrafts be reflected in the statement of cash flows using the indirect method?

PwC response

A book overdraft merely represents the reinstatement of accounts payable and does not result in cash changing hands or credit being extended by a financial institution. Accordingly, this noncash bookkeeping entry indicates a temporary excess of written promises to pay (e.g., checks) in excess of funds on deposit in a particular account. Thus, this activity does not represent "proceeds from short-term borrowings" per ASC 230-10-45-14 and is not a financing activity.

In contrast to the fact pattern above, if a zero balance account is linked to a bank overdraft credit facility and checks presented for payment are immediately payable under the credit facility, the "book" overdraft would be, in substance, a "bank" overdraft. This is because the bank can turn presented checks into legal liabilities without further action by the payor. In that case, changes in the overdraft would be classified as a financing activity in the statement of cash flows and as debt on the balance sheet.

Presenting all outstanding checks as liabilities (including those covered by funds on deposit in the bank account) is not acceptable. The generally accepted approach is to reduce the cash balance for checks issued but not yet paid by the bank. To the extent the outstanding checks exceed the funds on deposit (and there is no linkage to a credit facility as discussed above), the amount of outstanding checks in excess of funds on deposit should be reflected as a liability.

6.5.5 Checks written but not released

Checks that have not been released by the end of the accounting period (e.g., not mailed) should not be reflected in the financial statements (e.g., the related balances should still be reflected as accounts payable).

6.5.6 Compensating balances

Some borrowing arrangements contain compensating balance requirements. The terms of those arrangements may or may not prohibit the withdrawal of compensating balances. It is important to evaluate whether any compensating balance arrangements legally restrict the use of cash. Cash that is legally restricted from withdrawal is considered to be restricted cash, as discussed in FSP 6.5.7.

When compensating balance arrangements exist, but do not legally restrict the use of cash amounts shown on the balance sheet, such arrangements should be disclosed in the footnotes. Compensating balances related to future credit availability should be disclosed along with the amount and terms of such agreement.

Regardless of whether the reporting entity has met the compensating balance requirement, there should be disclosure of any sanctions for noncompliance under a compensating balance arrangement. An example of such disclosure may be as simple as stating, "Compensating balance deficiencies are subject to interest charges at the average rate for 91-day Treasury Bills."

As indicated in SEC FRP 203.02.b, when a reporting entity is not in compliance with a compensating balance requirement at the balance sheet date, that fact should be disclosed, together with stated or possible sanctions. SEC FRP 203 provides the following additional guidance regarding disclosure of compensating balances:

Excerpts from SEC FRP 203.02.b

An arrangement where the [compensating] balance required is expressed as an average over time would ordinarily lead to additional footnote disclosure of the average amount required to be maintained for arrangements in existence at the reporting date since the amount held at the close of the reporting period might vary significantly from the average balance held during the period and bear little relationship to the amount required to be maintained over time. If arrangements requiring maintenance of compensating balances during the year were materially greater than those at year end, that fact should be disclosed. Disclosure may also include a statement, if appropriate, that the amounts are legally subject to withdrawal with or without sanctions, as applicable. If many banks are involved, the disclosure should summarize the most common arrangements and aggregate the compensating balances involved.

When a company is not in compliance with a compensating balance requirement, that fact generally should be disclosed along with stated or possible sanctions whenever such possible sanctions may be immediate (not vague or unpredictable) and material.

In determining whether compensating balance arrangements are sufficiently material to require segregation or disclosure, various factors should be considered. Among these may be the relationship of the amount of the balances to total cash, total liquid assets and net working capital, and the impact of the balances on the effective cost of financing. In the usual case, reportable compensating balances which in the aggregate amount to more than 15 percent of liquid assets (current cash balances, restricted and unrestricted, plus marketable securities) would be considered to be material. Lesser amounts may be material if they have a significant impact on the cost of financing.

Some borrowing arrangements do not prohibit the withdrawal of compensating balances, but as a practical matter, future credit availability may be dependent on the maintenance of such balances. Accordingly, reporting entities should disclose this fact. Sample wording might be "the compensating balances may be withdrawn, but the availability of short-term lines of credit is dependent upon maintenance of such compensating balances." If the borrower is not prohibited from withdrawing the compensating balance and using such funds in current operations, it would be appropriate to include such amounts in the cash and cash equivalent caption.

Finally, compensating balances maintained by a reporting entity for the benefit of affiliates, officers, directors, principal stockholders, or other related parties may be of particular significance. Disclosure of those arrangements as related party transactions should occur. Similarly, compensating balances maintained by related parties for the reporting entity's benefit should be disclosed in the footnotes.

6.5.7 Restricted cash

ASC 230 contains no discussion about how to classify restricted cash in the statement of cash flows. However, ASC 210-10-45 contains some limited guidance related to items that are restricted as to withdrawal or usage. Further, the SEC has issued some limited guidance, discussed below, which is subject to interpretation. Given the lack of definitive guidance related to restricted cash, identifying restricted cash balances, and differentiating restricted cash balances from compensating balances (see FSP 6.5.6), reporting changes in restricted cash within the statement of cash flows can be very challenging.

Cash is sometimes not immediately available — for example, cash may be restricted to uses other than current operations, designated for acquisition or construction of noncurrent assets, held by trustees (such as sinking funds), segregated for the liquidation of long-term debt, or committed to compensating balance arrangements where the funds are legally restricted from withdrawal. Restrictions are considered effective if the reporting entity clearly intends to observe them, even though the funds are not actually set aside in special bank accounts. When a reporting entity maintains the physical ability to gain access to a cash balance, such accessibility does not by itself support a conclusion that the cash balance is not restricted. Instead, the reporting entity should evaluate if accessing the cash balance would create a legal or contractual consequence. If it would, then the cash balance is likely restricted.

S-X 5-02(1) requires SEC registrants to separately disclose funds legally restricted as to withdrawal. SEC FRP 203.02.b requires segregation of all compensating balances that are legally restricted on the face of the balance sheet. As such, restricted cash should not be included with cash and cash equivalents in the statement of cash flows, and any restrictions should be disclosed.

Cash that cannot be withdrawn due to compensating balance arrangements should be classified as a noncurrent asset to the extent such cash relates to the noncurrent portion of the debt which causes its restriction. Private companies may present cash and restricted cash together in one caption on the financial statements provided: (1) the legally restricted cash relates to short-term borrowings, and (2) there is disclosure of the restricted amounts in the footnotes. For example, "Cash and restricted cash (Note 3)" is an appropriate caption for a private company.

If a variable interest entity (VIE) that holds cash deposits available for its general operating purposes is consolidated by its primary beneficiary, such amounts should be included in the primary beneficiary's cash and cash equivalents. These amounts do not represent restricted cash, even if the primary beneficiary does not have voting control over the VIE (i.e., legal rights to control the VIE's assets).

6.5.7.1 *Changes in restricted cash*

Because most restricted cash balances result from a contractual requirement to invest cash balances as stipulated, changes in restricted cash balances should generally be classified as cash flows from investing activities. We note that the investment in a restricted cash vehicle is similar to an investment in marketable securities, for which cash flows are treated as investing activities.

6.5.8 *Auction rate securities and variable rate demand notes*

ASC 230-10-20 limits a cash equivalent's maturity (to the reporting entity holding the investment) to three months. The maturity is determined by reference to the stated term of the security or the timeframe for exercising any put features to the issuer, not by reference to the frequency with which liquidity may be available through an auction, a put feature to a third party, or otherwise. Accordingly, auction rate securities and variable rate demand notes that do not mature, or are not puttable to the issuer, within three months from the date of acquisition do not demonstrate the maturity characteristic of a cash equivalent. Instead, they should be classified as investments in accordance with ASC 320-10.

If a security is not deemed to be a cash equivalent, the cash flow statement classification should follow guidance applicable for securities subject to ASC 320-10.

When auction rate securities are subject to an auction, resetting the interest rate on the securities is not considered equivalent to a sale and a purchase of such securities when reporting cash flows. Therefore, cash flows should not be reflected when the interest rate is reset. An actual purchase and sale of a security through the auction process should be reflected as investing activities in the statement of cash flows.

6.5.9 *Money market funds*

Items commonly considered cash equivalents include treasury bills, commercial paper, and money market funds. Although what constitutes a money market fund is not defined in ASC 230, we believe it is appropriate for a fund to be classified as a cash equivalent if it meets all of the qualifying criteria for a money market fund under the 1940 Act.

Reporting entities must assess whether it is appropriate to classify funds as cash equivalents if they do not meet all of the qualifying criteria for a money market fund under the 1940 Act. We believe it would be appropriate for a reporting entity's investment in a fund to be classified as a cash equivalent if all of the following attributes are present:

(1) A fund's policies include a provision that requires the weighted average maturity of the fund's securities holdings not to exceed 90 days

(2) The investor has the ability to redeem the fund's shares daily in accordance with its cash-management policy

(3) The fund's investment attributes are consistent with the investment attributes of an SEC-registered money market fund and the definition of cash equivalents

If, however, there are increased credit and liquidity concerns associated with the fund — especially if there is a significant decline in net asset value, a money market fund may no longer have the attributes to be considered a cash equivalent. This analysis should be performed at each reporting period. If a money market fund no longer qualifies as a cash equivalent due to such analysis, we believe the corresponding outflow of cash equivalents within the statement of cash flows should be reflected as an investing activity.

In July 2014, the SEC issued a final rule that mandates the use of a floating net asset value (NAV) for institutional prime money market funds. While the rule is not focused on the financial reporting of entities that have investments in money market funds, the changes could impact whether investments in money market funds are considered cash equivalents. The SEC noted that under normal circumstances, qualifying money market funds with floating NAVs will continue to be reported as cash equivalents. However, in the event credit or liquidity issues arise, including the increased potential for enactment of liquidity fees or redemption rates, investors will need to assess the validity of continuing to account for such money market funds as cash equivalents.

Question 6-3

In the current year, classification of a money market fund was changed from a cash equivalent to a short-term investment as a result of a periodic evaluation. Should the prior period be reclassified to conform to this new classification?

PwC response

No, the prior period should not be reclassified. The evaluation of the classification is based upon the facts and circumstances at each individual reporting period.

6.5.10 Balances created at subsidiaries by centralized treasury functions

Many large entities use centralized treasury functions in which the parent reporting entity controls all cash transactions on behalf of its subsidiaries, and maintains all cash accounts. This kind of arrangement results in due-to-parent or due-from-parent balances on the subsidiaries' books at each reporting period since the parent makes all cash payments on behalf of the subsidiaries and sweeps all cash balances from the subsidiaries. In such circumstances, the intercompany net due-to-parent or net due-from-parent account is, in substance, the subsidiaries' checking account. When standalone financial statements are prepared for subsidiaries that participate in centralized treasury functions, the changes in the due-to-parent and due-from-parent are reflected as actual cash flows.

If a subsidiary's balance sheet shows a net due-from-parent, an appropriate classification in the subsidiary's statement of cash flows would be investing, as this balance is akin to making a loan, as contemplated by ASC 230-10-45-12a and 13a. If a subsidiary's balance sheet reflects a net due-to-parent, the appropriate classification in the subsidiary's statement of cash flows would be financing, as this balance is similar to issuing debt. Alternatively, both a parent and its subsidiaries could classify the cash flow activity associated with due-from-parent and due-to-parent accounts as financing activities based upon the consolidating statement of cash flows example included in ASC 830-230-55-2.

6.6 Gross and net cash flows

Generally, information about the gross amounts of cash receipts and cash payments during a period is more relevant than information about the net amounts of cash receipts and payments. Accordingly, ASC 230 emphasizes gross, rather than net, cash flows. However, netting cash flows in certain circumstances (e.g., receipts and repayments of certain short-term borrowings, certain hedges and items being hedged, and certain cash receipts and cash payments of banks, savings institutions, and credit unions) is permitted. Account balances and transactions should be thoroughly evaluated to determine whether the related cash flows should be presented on a gross or net basis. Items that qualify for net reporting must have quick turnover, occur in large volumes, and have short maturities (i.e., less than 90 days).

Examples that typically qualify for net reporting include:

- Cash receipts and payments pertaining to trading investments, classified within operating activities

- Balance sheet items in which a reporting entity is substantively holding or disbursing cash on behalf of its customers (e.g., customer demand deposits of a bank and customer accounts payable of a broker-dealer)

- Debt where the original maturity of the asset or liability is three months or less. Items that are due on demand are considered to have maturities of three months or less even though they may remain outstanding for longer periods.

- Net borrowings under a revolving line of credit if the credit arrangement requires the borrower to sign a series of notes having a maturity of 90 days or less. However, it would not be appropriate to present the net change if the borrower signs only a single note with a term of more than three months for the maximum amount of the line of credit.

Reporting entities that participate in securities lending arrangements may receive cash as collateral. When a reporting entity holds collateral for 90 days or less, net presentation may be appropriate, because the financing is considered short-term. In such instances, the overall change in all collateral balances during the reporting period may be shown on a net basis in financing activities. By analogy, ASC 230-10-45-9 provides additional support for presenting these types of short-term lending arrangements on a net basis. The cash flows must otherwise be shown on a gross basis (i.e., separate line items of “Repayments of securities lending program” and “Proceeds from securities lending program”).

ASC 942-230-45-1 permits banks, savings institutions, and credit unions to present the following cash flows on a net basis:

- Certain cash flows for deposits placed with other financial institutions and withdrawals of deposits
- Time deposits accepted and repayments of deposits
- Loans made to customers and principal collections

This provision is not available to finance companies, insurance companies, or other financial intermediaries.

6.7 Classification of cash flows

ASC 230 identifies three classes of cash flows — investing, financing, and operating — and requires a reporting entity to classify its cash receipts and cash payments in one of these three classes. The classification is based upon the nature of the cash flow, without regard to whether a cash flow stems from another item. Using a waterfall model, a cash flow is first evaluated to determine if it meets the definition of an investing activity. If the cash flow does not meet the definition of an investing activity, the cash flow is then evaluated to determine if it is a financing cash flow. If a cash flow does not meet the definition of an investing activity or a financing activity, the cash flow is classified as operating. Cash flows from operating activities are generally the cash effects of events that enter into the determination of net income. The definitions of the activity classes within ASC 230, combined with its waterfall model, results in a bias toward classifying cash flows as operating activities.

Certain cash receipts and payments may have aspects of more than one class of cash flow. ASC 230-10-45-22 recognizes that the most appropriate classification of an item may not always be clear. In these cases, the appropriate classification should be based on the nature of the activity most likely to be the predominant source of cash flows. Consider the following example:

EXAMPLE 6-1

Classification of equipment purchases that are rented to third parties and then sold

FSP Corp operates a chain of rent-to-own facilities offering household appliances. It purchases new equipment, rents the equipment to third parties for a period of time, and subsequently sells the used appliances.

What is the appropriate classification in the statement of cash flows for the purchase of the appliances, the receipt of rental income, and the sale proceeds of the used appliances?

Analysis

The cash inflows from renting the appliances should be classified as operating activities because such cash flows enter directly into the determination of net income. The classification of the cash flows related to purchasing the new appliances and later selling the used appliances could be classified as either operating activities or investing activities. Accordingly, the reporting entity would need to determine the nature of the activity that is likely to be the predominant source of cash flows.

For example, assume FSP Corp expects to rent the new appliances for only a short period of time before selling them. In such circumstances, the appliances would appear to have the nature of an inventory item, and accordingly the cash flows related to the purchase and sale of the appliances should be classified as operating activities.

If, however, FSP Corp determines the appliances have the nature of a long-lived asset, the cash flows related to the purchase and sale of the appliances should be classified as investing activities.

In its current form, ASC 230 does not overtly define a classification principle. However, it describes the principle as being based on the nature of the cash flow. Each cash receipt and payment should be classified as investing, financing, or operating according to its nature, without regard to whether it stems from another item.

Often, reporting entities instead employ a classification convention that is best described as "linkage theory," in which cash receipts and payments are classified based on the nature of other transactions commercially linked to the cash flow in question.

The following two examples illustrate how the linkage theory and the nature principle differ when applied to the same fact pattern.

EXAMPLE 6-2

Nature principle — Cash flows related to an economic hedge

FSP Corp, an oil and gas producing company, sells its daily oil production to third parties for cash based upon a floating spot price specific to the production's location. In order to fix the cash proceeds for its anticipated oil production over the next twelve months, FSP Corp enters into a financially settled derivative (a price swap) which requires the derivative counterparty to pay FSP Corp a stated fixed price for a fixed volume of oil, while FSP Corp must pay the counterparty a stated index price (that is variable) for the same fixed volume of oil. The price swap is settled net, in cash, on a quarterly basis. Based on common practice in the industry, FSP Corp does not employ hedge accounting and instead records changes in the derivative's fair value in net income. Thus, the derivative is commonly called an "economic hedge."

At the first settlement date, FSP Corp receives a cash payment from the derivative counterparty. How should the cash receipt be classified in the statement of cash flows?

Analysis

Using the nature principle, FSP Corp should classify the cash received as an investing cash inflow because a derivative has attributes similar to debt and equity instruments, both of which are included in the definition of investing activities in ASC 230-10-20. Further, ASC 230-10-45-27 indicates that the nature of a futures contract (which also is a derivative) is investing. It also indicates that a reporting entity may (not must) classify cash flows associated with a derivative designated in a qualifying hedging relationship in the same category as the cash flows associated with the hedged item. Because FSP Corp's derivative is not in a qualifying hedging relationship, the option to disregard the nature of the derivative when classifying its cash flows, and instead classify such cash flows consistent with the hedged item (which in this case would be operating), is not available.

If FSP Corp used the linkage theory in Example 6-2, FSP Corp would classify the cash received from the counterparty as an operating cash inflow because the derivative is commercially linked with the activity of producing and selling oil, which for FSP Corp are clearly operating activities. Further, the derivative facilitates FSP Corp's operational goal of reducing variability in its cash inflows. The fact that a derivative is fundamentally different from a barrel of oil, or that a derivative counterparty could never be considered a "customer," is irrelevant when using the linkage theory to classify the cash inflow.

We believe that a literal application of the nature principle, combined with other guidance in ASC 230 pertaining to classifying cash flows related to derivatives, should lead a reporting entity to classify the cash flows related to an economic hedge as investing. However, in practice we note that the predominant practice is to classify such cash flows as operating, and that this practice has been acknowledged by regulators. Accordingly, we do not object to classifying cash flows related to an economic hedge as operating assuming the practice is clearly disclosed.

EXAMPLE 6-3

Nature principle — Cash flows related to restricted cash

FSP Corp enters into a new term loan with a bank that requires FSP Corp to keep deposits at the lending bank in an interest-earning account upon the occurrence of certain defined events. The account would be considered restricted. Six months subsequent to the funding of the new loan, a defined event occurs and FSP Corp funds the restricted cash account.

How should the cash outflow be classified in the statement of cash flows?

Analysis

Using the nature principle, FSP Corp should classify the cash used to fund the restricted cash account as an investing cash outflow because when the interest-earning aspect of the restricted cash account is considered, the cash outflow is similar to making a loan or acquiring a debt instrument, both of which are included in the definition of investing activities in ASC 230-10-20. The fact that this outflow was contractually required by the term loan does not change its nature to financing for the same reason that the term loan's requirement to pay interest does not preclude those outflows from being classified as operating.

If FSP Corp used the linkage theory in Example 6-3, FSP Corp would classify the cash outflow as financing because the funding of the restricted cash account was precipitated by the terms of the term loan, which was a financing activity. The fact that the restricted cash account earns interest and is not eligible to be offset against the loan balance is irrelevant when using the linkage theory to classify the cash outflow.

We believe that a literal application of the nature principle should lead a reporting entity to classify the cash flows related to restricted cash as investing. In practice, we note mixed practice, including some that has been mandated by regulators.

Because all cash flows can ultimately be linked to a reporting entity's operations, we do not believe the linkage theory is capable of producing consistent cash flow classifications among reporting entities when applied to a broad spectrum of transactions. Accordingly, it should generally not be used.

The remainder of our discussion on classification of cash flows assumes the "nature principle" is being utilized, and only in rare occasions will we highlight alternative classifications. In these instances, we will indicate which classification we believe is more consistent with the nature principle, recognizing that applying a principle-based model like ASC 230 to specific facts and circumstances will sometimes yield different conclusions. Because the FASB acknowledged that in some situations a reasonable case can be made for alternative classifications, we believe that a change in classification of a cash flow item (assuming both the old and the new classifications are in accordance with U.S. GAAP) represents a reclassification of information and not a change in accounting principle. In such circumstances, all years presented must reflect the reclassification, and the reclassification should be disclosed in the footnotes.

6.7.1 Investing activities

Investing activities include making and collecting loans, purchasing and selling debt or equity instruments of other reporting entities, and acquiring and disposing of property, plant, and equipment and other productive assets used in the production of goods or services.

The following items should be classified as investing activities:

- Proceeds from the disposition of property, plant, and equipment, including those derived from sale-leaseback transactions

- Cash inflows and outflows from sales and purchases of productive assets, including the acquisition or sale of a business, net of cash acquired or sold

- Restricted cash – see Example 6-3 and FSP 6.5.7 for further discussion

- Insurance proceeds directly attributable to casualty losses related to productive assets

- Gross cash receipts or cash payments resulting from the acquisition or sale of debt or equity securities of other reporting entities (classified as available-for-sale or held-to-maturity). However, interest income or dividend income earned on such investment securities is an operating cash inflow. Investments accounted for as trading securities under ASC 320-10, where there is a stated intent to buy and sell securities with the objective of generating profits, should be classified as operating activities rather than investing activities.

- The impact on cash and cash equivalents of either consolidating or deconsolidating a variable interest entity

- Cash outflows and inflows associated with reverse repurchase agreements

- Cash flows resulting from acquisitions and sales of loans originally classified as loans held for long-term investment should be investing activities. Cash flows should continue to be classified as cash flows from investing activities, even if the reporting entity subsequently reclassifies the loans to be held for sale.

6.7.1.1 Property, plant and equipment

Payments made soon before, soon after, or at the time of purchase to acquire property, plant, and equipment and other productive assets should be classified as investing cash outflows. These amounts should include interest capitalized as part of the cost of those assets. Incurring debt to acquire a fixed asset from the seller or another party is often a financing transaction, and therefore would be a financing cash inflow. Subsequent payments of principal on that debt are financing cash outflows.

Purchases of property, plant, and equipment that have not been paid for during the period (i.e., liabilities exist in accounts payable or accrued liabilities to pay for the purchase) represent noncash activities. As such, they should generally be excluded from the relevant statement of cash flow line items (i.e., change in accounts payable or accrued liabilities line(s) in the operating category, and purchases of property, plant, and equipment in the investing category). However, the noncash activity should be separately disclosed. Refer to Example 6-11 for more information.

In a lease transaction, a lessor may agree to reimburse the cost of the leasehold improvements by making payments to either the lessee or directly to a third party. A reimbursement of expenditures for leasehold improvements by the lessor directly to a third party may not be a noncash transaction for the lessee. If the payment was made by the lessor on behalf of the lessee as a matter of convenience, we believe the lessee has acquired fixed assets for cash, which should be reflected as an investing activity. The lessee has also received a cash incentive from the lessor, which should be reflected as an operating activity. However, when a lessor makes a payment directly to a third party based on a contractual requirement, the lessee should reflect the payment as a noncash investing transaction. Determining whether the payment made by the lessor was a matter of convenience is judgmental and requires an evaluation of the specific facts and circumstances of the arrangement. See FSP 6.9.1 for a discussion of constructive receipt and constructive disbursement.

ASC 230-10-45-14 indicates that receipts from contributions and investment income that are stipulated by the donor for the purposes of acquiring, constructing, or improving property, plant, and equipment should be classified as financing activities.

As discussed in Question 6-4, not all payments to acquire or sell property are necessarily investing activities.

Question 6-4

What is the appropriate classification in the statement of cash flows for the payments made for real estate purchased by a developer to be subdivided, improved, and sold in individual lots?

PwC response

The cash payments to purchase the real estate and the related cash receipts from sale of the real estate should be classified as operating activities because the cash outflow to purchase the real estate is specifically for resale. Thus, the nature of the cash flows is similar to inventory in other businesses.

6.7.1.2 Business combinations

Business combinations may generate multiple types of cash flows. Their classification can vary depending on the nature and source of the cash flows.

- ***Business combinations:*** Cash flows from sales and for purchases of productive assets, including the acquisition or sale of a business, are presented as investing activities. In an acquisition, the unit of account is the acquired business, and therefore the individual changes in assets and liabilities that occur on the acquisition date in the consolidated financial statements are not reflected on the individual line items in the statement of cash flows. Rather, the statement of cash flows should reflect, as a single line item, cash paid to purchase a business (net of cash acquired). The noncash effects of a business combination, including any noncash consideration included in the purchase consideration and the significant assets and liabilities of the acquirer, are required to be disclosed. Subsequent to the acquisition of a business, cash flows of the newly acquired business are combined with those of the consolidated entity and presented within operating, investing, and financing activities as appropriate.

- ***Transaction costs:*** The cash paid by the buyer for transaction costs incurred in a business combination would be classified as operating activities in the statement of cash flows. ASC 805-10-25-23 requires transaction costs to be expensed as incurred, thus establishing that the nature of transaction costs is that of an operating activity.

- ***Contingent consideration:*** Contingent consideration arrangements will often be settled at an amount different than the amount initially included in the measurement of the consideration transferred. Contingent consideration classified as a liability is remeasured to fair value at each reporting date until the contingency is resolved. Changes in fair value that are not measurement period adjustments are recognized in earnings. These subsequent changes in the fair value of the contingent consideration arrangement should be an adjustment to reconcile net income to cash flows from operating activities.

  When a contingent consideration liability is settled at an amount equal to or less than the acquisition date fair value, the cash payment is akin to seller-provided financing and should therefore be classified as a financing outflow in the statement of cash flows. When a contingent consideration liability is settled at an amount greater than the acquisition date fair value, the portion of the payment in excess of the acquisition date fair value should be classified as an operating outflow because it has entered into the determination of net income. The portion of the payment related to the acquisition date fair value should be classified as a financing outflow as discussed above.

- ***Pushdown accounting:*** In situations where pushdown accounting is not applied to the financial statements of the subsidiary as a result of a business combination, cash flows should only be reported by the entity actually involved in the cash transactions. When pushdown accounting has been elected or is required to be applied as a result of a business combination, acceptable alternatives, other than reporting the transaction cash flows only by the entities actually involved in the cash flows, may exist in the financial statements of the subsidiary. In all cases, appropriate disclosure of the form of the transaction and the resulting cash flows should be made.

- ***Debt extinguished in conjunction with a business combination:*** Debt extinguished by the acquirer in connection with a business combination requires a careful evaluation of the facts and circumstances of the arrangement to determine how the cash flows should be presented. We believe the presentation of cash flows should be based upon whether the acquirer legally assumed the debt.

  When determining whether the acquirer legally assumed the debt, consideration should be given to all relevant factors, which may include the following:

- If repayment of an acquiree's debt is required by the terms of the acquisition agreement, it is important to understand the reasons for including this provision as well as the timing and method of settlement.

- If the lender provides a concession that allows the acquiree's debt to be assumed by the acquirer or settled after the acquisition date, such concession indicates that the acquirer has assumed the debt. Therefore, it is important to understand the specific terms of any change in control provisions, and whether the lender was required to grant consent to allow the acquirer to assume the debt.

- If the debt is settled after the acquisition date, it indicates the debt was assumed by the acquirer in the acquisition. Therefore, understanding the timing of extinguishment in relation to the acquisition date is also important.

If the acquirer legally assumed the debt, we believe it is appropriate to record the debt at fair value on the acquirer's balance sheet as a liability assumed in the acquisition. It would therefore be included net in the "acquisition of a business, net of cash acquired" line in investing activities, rather than a financing inflow. Any subsequent payments to extinguish the debt would be a financing cash outflow of the acquirer as the debt is the legal obligation of the acquirer.

If an acquirer does not legally assume debt as part of an acquisition and the debt is extinguished on the acquisition date, we believe any funds provided by the acquirer to extinguish the acquiree's debt should be reflected by the acquirer as consideration transferred in the acquisition and classified as an investing cash outflow.

In limited circumstances, it may be appropriate to consider debt that has been legally assumed and extinguished by the acquirer to be acquisition consideration transferred and an investing cash outflow. This should only occur when the acquirer extinguishes the assumed debt as an integrated part of closing the acquisition, and it is accomplished in close proximity to the acquisition date (i.e., approximately 1 day), such that it is clear that the acquirer did not substantively assume the risks inherent in the borrowing. In these circumstances, if a cash payment to extinguish acquiree debt is considered part of the acquisition consideration and therefore classified as an investing outflow, the extinguished debt should not be disclosed elsewhere as a liability assumed in the business combination.

6.7.1.3 Discounts and premiums on debt investment securities

The cash payment to acquire a debt security issued at a discount is classified as an investing outflow. If using the indirect method in the statement of cash flows, the discount accretion in subsequent periods should be included as a negative adjustment in the reconciliation of net income to operating cash flows. As a result, operating cash flows reflect the amount of the interest coupon actually received. At retirement, the portion of the proceeds equal to the discounted acquisition cost should be classified as an investing inflow, with the remainder of the proceeds classified as an operating inflow.

The cash flows related to a debt security purchased at a premium may be reflected using multiple methods. We believe that when a debt security is purchased at a premium, the statement of cash flows could reflect an investing outflow for the face value of the debt, with the premium reflected as an operating outflow. For an indirect method statement of cash flows, the premium amortization in subsequent periods is included as a positive adjustment in the reconciliation of net income to operating cash flows. As a result, operating cash flows reflect the amount of the interest coupon actually received.

Alternatively, upon acquisition, the entire cash outflow, including the premium, could be reflected as an investing outflow. Under this method (assuming an application of the indirect method), in lieu of reflecting a positive adjustment for the amortization of the premium in the operating section of the statement of cash flows, such amount (which effectively represents "above market interest") is classified as an investing inflow akin to a return of capital.

While these two methods of reflecting a debt investment purchased at a premium result in different outcomes in discrete years, their cumulative outcomes over the entire holding period are identical (i.e., there is symmetry in the investment category). Regardless which method is utilized, it should be consistently applied and appropriately disclosed. There may also be other acceptable approaches found in practice.

EXAMPLE 6-4

Debt security purchased at a premium

FSP Corp purchases a debt security with the following terms on January 1, 20X4:

Par value	$1,000
Coupon Rate	8%
Market Rate	5%
Cash Paid	$1,082
Premium	$82
Maturity	3 years

What are the ways in which FSP Corp could classify the cash flows related to the purchased debt security in its indirect method statement of cash flows?

Analysis

Upon acquisition, FSP Corp could reflect a cash outflow from investing activities of $1,000 and an operating cash outflow of $82. In each subsequent period, the amortization of the premium would be negated in the statement of cash flows by presenting the premium amortization as a positive adjustment in the reconciliation of net income to operating cash flows. Operating cash flows would then reflect the annual $80 interest coupon payment received. Upon maturity, the receipt of the principal amount of the bond of $1,000 would be an investing activity.

Alternatively, upon acquisition, FSP Corp could reflect an investing cash outflow of $1,082. In each subsequent period, in lieu of negating the impact to net income from the premium amortization by reflecting the amortization as a positive adjustment in the reconciliation of net income to operating cash flows, such amount (which effectively represents "above market interest") could be classified as an investing inflow akin to a return of investment when cash coupons are received. As a result, part of the cash inflow related to the above market interest coupon will be classified as operating, and the other part will be classified as investing.

6.7.1.4 Classification of securities measured at fair value

According to ASC 820 purchases of trading securities should be classified according to their nature and purpose. For example, if the reporting entity's investment strategy is not to actively buy and sell securities with the objective of generating profits on short-term differences in market prices, purchases and sales of trading securities should be classified as investing activities. Similarly, we believe cash flows associated with investments or debt securities accounted for using the fair value option under ASC 825, *Financial Instruments,* should be classified according to their nature and purpose.

6.7.1.5 Contributions and advances to joint ventures

Initial and subsequent cash contributions by a reporting entity to joint ventures meet the ASC 230 definition of investing activities and should be reflected as such in the investor's statement of cash flows. Contributions of other assets are noncash transactions, which require separate disclosure.

In many cases, a reporting entity will loan money to their joint ventures with the expectation of repayment. Such loans, and their subsequent repayment, should be reflected as investing activities in the reporting entity's statement of cash flows.

6.7.1.6 Classification of cash flows related to derivatives

Cash receipts and payments related to a derivative should be classified according to their nature (which ASC 230-10-45-27 indicates is investing) without regard to whether the cash flows stemmed from an item intended as a hedge of another item. As an alternative to classification as investing, a reporting entity may elect an accounting policy to classify the cash flows from derivative instruments designated in a qualifying hedging relationship in the same category as the cash flows from the hedged items, provided this treatment is disclosed. However, if for any reason, hedge accounting for an instrument that hedges an asset, liability, firm commitment, or forecasted transaction is discontinued, then any cash flows subsequent to the date of discontinuance should be classified consistent with the nature of the instrument which, as noted above, is investing.

See Example 6-2 for a discussion about classifying cash flows related to economic hedges.

All of the cash flows associated with derivative instruments that contain an other-than-insignificant financing element at inception, other than a financing element inherently included in an at-the-market derivative instrument with no prepayments, should be presented by the borrower as cash flows from financing activities. Refer to FSP 6.7.2.8 for further discussion.

Question 6-5

A reporting entity has a qualifying cash flow hedge related to the forecasted purchase of inventory. The forecasted purchase has occurred but the inventory is not yet sold at the reporting date. How should the reporting entity classify the cash flows related to the qualifying hedging instrument in the statement of cash flows?

PwC response

The reporting entity may present the cash flows from the hedging instrument as either an investing activity or an operating activity (as a change in working capital components because the hedged item in this example is the forecasted purchase of inventory). However, if the reporting entity presents the cash flows from the hedging instruments in the same category in the statement of cash flows as the category for the cash flows from the hedged items, it must disclose its accounting policy in the financial statements.

EXAMPLE 6-5

Classifying cash flows from settlement of a net investment hedge

FSP Corp, a U.S. parent company, enters into a foreign currency forward exchange contract to sell British Pounds and receive U.S. Dollars, and designates it as a net investment hedge of its British subsidiary whose functional currency is the British Pound. The effective portion of the changes in the fair value of the forward exchange contract are recorded in the cumulative translation adjustment (CTA) account, which is a component of OCI, and will remain there until the investment in the subsidiary is sold or substantially liquidated in accordance with ASC 830, *Foreign Currency Matters*. At the expiration of the forward exchange contract, FSP Corp receives $2 million from the counterparty.

How should the cash received from the settlement of the derivative accounted for as a net investment hedge be classified on the statement of cash flows?

Analysis

The cash received from settlement of the net investment hedge should be classified as an investing activity in the statement of cash flows. Investing classification is appropriate as the hedged item is the investment in a foreign subsidiary and the cash paid or received from acquiring or selling the subsidiary would typically be classified as investing under ASC 230-10-45. Additionally, the original basis for conclusions of ASC 230-10-45 further supports an investing classification as the FASB believed that the purchase or sale of a forward contract is an investing activity. Therefore, the $2 million received from the settlement of the net investment hedge should be classified as an investing inflow.

If the hedging instrument in a net investment hedge is a non-derivative financial instrument, such as foreign denominated debt, the cash flows related to the net investment hedge would be classified according to the nature of the non-derivative instrument. In the case of debt instruments, interest payments are operating activities and the principal repayments are financing activities.

6.7.2 *Financing activities*

Financing activities include borrowing money and repaying or settling the obligation, and obtaining equity from owners and providing owners with a return on, or return of, their investment.

The following items should be classified as financing activities:

- Payments for debt issue costs (i.e., third party costs)
- Proceeds from failed sale-leaseback transactions
- Proceeds received from issuing debt
- Payments on seller-financed debt related to the purchase of property, plant, and equipment and other productive assets. The incurrence of that debt is a noncash financing transaction.
- Stock issuance proceeds, net of stock issuance costs
- Cash dividends and purchases of treasury stock
- Cash activity related to stock subscriptions receivable
- If a reporting entity has a "bank overdraft" at year end, the change in bank overdrafts during the period. See discussion of bank overdrafts in FSP 6.5.3
- Cash proceeds received as collateral under a securities lending program and subsequent repayment of the cash, because the cash received is considered a borrowing
- Cash inflows and outflows associated with repurchase agreements, including transactions accounted for as a securitized borrowing. Net presentation for these cash flows may be permitted

6.7.2.1 *Discounts and premiums on debt securities*

The cash received when a debt security is issued at a discount (e.g., zero coupon debt) is classified as a financing inflow for the issuer. For an indirect method statement of cash flows, the discount accretion in subsequent periods is included as a positive adjustment in the reconciliation of net income to operating cash flows. As a result, operating cash flows reflect the amount of the interest coupon actually paid. At retirement, the portion of the payment equal to the original proceeds should be classified as a financing outflow, with the remainder of the payment classified as an operating outflow.

The cash flows related to a debt security issued at a premium may be reflected using multiple methods by the issuer. We believe that when a debt security is issued at a premium, the statement of cash flows could reflect a financing inflow for the face value of the debt, with the premium reflected as an operating inflow. For an indirect method statement of cash flows, the premium amortization in subsequent periods is included as a negative adjustment in the reconciliation of net income to operating cash flows. As a result, operating cash flows reflect the amount of the interest coupon actually paid.

Alternatively, upon issuance, the entire cash inflow, including the premium, could be reflected as a financing inflow. Under this method (assuming an application of the indirect method), in lieu of reflecting a negative adjustment for the amortization of the premium in the operating section of the statement of cash flows, such amount (which effectively represents "above market interest") is classified as financing outflow akin to a repayment of debt. As a result, part of the cash outflow related to the above market interest coupon will be classified as operating, and the other part will be classified as financing. While these two methods of reflecting debt issued at a premium result in different outcomes in discrete years, their cumulative outcomes over the entire issuance period are identical. Regardless of which method is utilized, it should be consistently applied and appropriately disclosed. There may also be other acceptable approaches found in practice.

6.7.2.2 *Debt extinguishment*

Debt prepayment penalties should usually be classified as operating activities in the statement of cash flows, since such amounts essentially represent an adjustment of the debt's effective interest rate and do not represent repayments of amounts borrowed.

EXAMPLE 6-6

Debt extinguishment

On January 1, 20X4, FSP Corp receives $95 when it issues debt with the following terms:

Par value	$100
Original issue discount	$5

Maturity	December 31, 20X9

On December 31, 20X7, FSP Corp extinguishes the debt early, and pays a $1 pre-payment penalty at the time of extinguishment. On the extinguishment date, there is an unamortized discount balance of $2. Therefore, there is an extinguishment loss of $3 consisting of the $1 pre-payment penalty and write off of the unamortized discount balance of $2.

How should FSP Corp reflect the payment of $101 in its statement of cash flows?

Analysis

Since the debt was issued at a discount, the financing outflow upon extinguishment is limited to the original $95, net of discount proceeds. The remaining $6 outflow is an operating activity comprised of the pre-payment penalty and the original issue discount. Under an indirect method of presentation, and assuming no other activity in the period, the transaction should be presented as follows:

Operating Activities:

Net loss	($3)
Noncash portion of extinguishment loss	2
Payment of original issue discount	(5)
Net cash used in operating activities	*($6)*

Financing activities:

Repayment of original proceeds	($95)

6.7.2.3 *Debt restructurings*

If a restructuring of debt is not a troubled debt restructuring, then term debt restructuring is accounted for as either a modification or as an extinguishment. Accounting for unamortized debt issue costs and new fees relating to modifications of line of credit and revolving-debt arrangements is based on a borrowing capacity analysis.

The following discussion addresses the cash flow classification for new fees incurred in connection with a term debt restructuring. See FG 3 for a detailed discussion of accounting for modifications and extinguishments, and accounting for modifications to line of credit and revolving debt arrangements. The treatment of unamortized fees or principal that remains outstanding is not addressed below, as there is no cash flow effect.

Term debt modifications

Fees paid to third parties associated with a term debt restructuring accounted for as a modification are expensed. The payment, which has entered into the determination of net income, would not be considered debt issuance costs since there is no new issuance of debt. Therefore, the payment should be classified as an operating cash flow.

Creditor fees incurred for a debt restructuring accounted for as a modification are capitalized and amortized as a yield adjustment. A yield adjustment payment associated with a debt restructuring is essentially prepaid interest expense, and therefore should be classified as an operating cash flow.

Term debt extinguishments

Third party fees incurred in connection with a debt restructuring accounted for as an extinguishment are capitalized because effectively the old debt has been extinguished and new debt has been issued. Accordingly, the cash payment related to third party fees should be classified as financing.

Fees paid to creditors associated with a term debt restructuring accounted for as an extinguishment are expensed as part of the gain or loss on extinguishment. These fees should be classified as operating activities since such amounts essentially represent interest payments that have entered into the determination of net income.

Modifications to line of credit and revolving debt arrangements

Third party and creditor fees incurred in connection with a modification to a line of credit or revolving debt arrangements are considered to be associated with the new arrangement and are therefore capitalized. Accordingly, the cash payment related to new third party should be classified as financing, while the creditor fees should be classified as operating. At the time of the modification, there is no cash flow associated with the unamortized debt issue costs. Thus, if unamortized debt issue costs are expensed, the noncash charge would be a reconciling adjustment to determine operating cash flows under the indirect method.

6.7.2.4 Floor plan financing programs

Reporting entities often finance the purchase of their inventory by engaging in floor plan financing arrangements with lenders that are not affiliated with the manufacturer of the inventory. In such an arrangement, the unaffiliated lender pays the manufacturer of the inventory directly, and is then repaid by the reporting entity according to the terms negotiated between the reporting entity and the lender, which are usually much longer than normal trade payables.

Application of the concepts of ASC 230 to such an arrangement results in the reporting entity disclosing a noncash financing transaction for the acquisition of the inventory, followed by a financing outflow when the reporting entity repays the lender. As a result, operating activities will be asymmetrical, in that operating cash flows will never include an outflow for the purchase of inventory that, when sold, will produce an operating inflow. Such an outcome would appear consistent with paragraph 54 of Concept Statement No. 5, which indicates that cash payments are recognized when they occur, and ASC 230-10-50-5, which indicates that only the cash portion of a transaction should be reported in the statement of cash flows.

However, the SEC staff has expressed the view that the lack of symmetry in such floor financing programs does not depict the substance of the transaction because the lender effectively acts as the reporting entity's agent. To remedy the asymmetry, the SEC staff believes that the reporting entity should report an operating cash outflow and a financing cash inflow upon receipt of the inventory, even though neither cash flow occurred. This view appears to be based on anti-abuse concerns. While we accept the SEC staff's view in regard to floor plan financing programs, we generally do not believe that noncash investing and financing activities should be included in the statement of cash flows.

6.7.2.5 Structured payables

Under structured payable programs, the bank pays vendors on behalf of a reporting entity in advance of a payable's due date so that the reporting entity can take advantage of normal trade discounts offered by the vendor as an incentive to settle the invoice sooner. The balance sheet classification of the reporting entity's payable depends on the economic substance of the arrangement. See FG 6.3 for additional discussion on balance sheet classification of structured payables arrangements.

If the economic substance of the trade payables has changed as a consequence of implementing a structured vendor payable program, an in-substance refinancing will be deemed to have occurred. As a result, the affected trade payable balances should be reclassified to debt on the reporting entity's balance sheet. In this circumstance, the SEC staff's position (which is consistent with the view expressed concerning floor plan financing programs discussed in FSP 6.7.2.4) is that a reporting entity's statement of cash flows should reflect an operating cash outflow and financing cash inflow related to the affected trade payable balances. A financing cash outflow should be reflected upon payment to the bank and settlement of the obligation.

6.7.2.6 Stock compensation

When gross windfall tax benefits from the exercise of stock-based compensation awards are realized, income taxes payable is reduced with a corresponding entry to additional paid-in capital. Even though realizing a windfall tax benefit does not result in a cash flow (nor was there a cash flow when the income taxes payable was established), ASC 230 indicates that when a windfall tax benefit is realized, the statement of cash flows should reflect a financing inflow with a corresponding operating outflow. Beyond this specific fact pattern, we generally do not believe that noncash investing and financing activities should be included in the statement of cash flows. For example, we do not believe that a transfer of assets to a reporting entity in exchange for an equity interest in the reporting entity should be reflected as a financing inflow and an investing outflow in the reporting entity's statement of cash flows.

Windfall tax benefits reported in the statement of cash flows may differ from the amount recognized in additional paid-in capital. This is because the statement of cash flows includes only the effects of awards that generate windfall tax benefits, while the entry to additional paid-in capital reflects awards with both windfall tax benefits and shortfalls. Shortfalls should not be netted against windfall tax benefits in the statement of cash flows.

When a reporting entity settles outstanding equity-classified stock options with cash, the classification of the outflow in the statement of cash flows is dependent upon the amount of cash paid. If the cash paid to settle a stock option is less than or equal to the fair value of the award on the settlement date, then the amount of cash paid is charged to equity in the balance sheet and classified as financing in the statement of cash flows. However, if the amount paid to settle a stock option exceeds the fair value of the award on the settlement date, the amount paid in excess of fair value would be charged to compensation cost. As such, the cash payment to settle the stock option should be bifurcated in the statement of cash flows — a financing outflow equal to the settlement date fair value and an operating outflow for the amount paid in excess of the settlement date fair value.

If cash is paid to settle a liability-classified stock option, the amount of cash paid to repurchase the award would settle the liability, which would have already been charged to compensation expense. As such, a cash settlement of a liability-classified stock option should be classified as an operating cash outflow in the statement of cash flows.

Reporting entities may grant awards to employees that are exercisable prior to vesting so that the employee's holding period for the underlying stock begins at an earlier date to achieve a more favorable tax position. These awards have an "early exercise" feature. When employees "early exercise" stock options, we believe that the cash received by the reporting entity should be presented as a cash inflow from financing activities. Although the underlying shares are not considered "issued" for accounting purposes when the cash is received (because the options are subject to vesting conditions), the cash represents proceeds in connection with awarding equity instruments that will not enter into the determination of net income.

Stock-based compensation plans may permit shares to be withheld by a reporting entity in exchange for agreeing to fund an employee's minimum statutory tax withholding requirements. When the reporting entity pays the withholding taxes to the appropriate taxing jurisdiction, we believe that the cash payment may be presented either as a financing outflow or an operating outflow in the statement of cash flows.

The presentation as a financing activity follows the view that while the reporting entity made a cash payment to a taxing authority and not the employee, in substance the reporting entity issued the gross number of shares to the employee, and then repurchased from the employee shares commensurate with the minimum statutory tax withholding requirement. As a result, it would be appropriate to account for the "in substance" repurchase of shares as a purchase of treasury shares, which is a financing outflow.

Alternatively, it would also be acceptable to classify the cash outflow related to paying the employee's minimum statutory tax withholding as operating. Under this view, it is assumed that only the net shares were issued and that the cash payment is viewed as the settlement of a tax obligation directly related to employee compensation, despite the fact that such payment never enters into the determination of net income.

6.7.2.7 Cash flows related to noncontrolling interests

Pursuant to ASC 810, noncontrolling interest holders are viewed as owners. ASC 230 indicates that financing activities include the provision of resources by owners and the return on, and return of, their investment. Therefore, dividends paid to noncontrolling interest holders should be classified as financing activities.

Cash paid to acquire a noncontrolling interest, or cash received from the sale of a noncontrolling interest, should be presented as a financing activity when the parent maintains control of the subsidiary. Cash received for the sale of an interest in a subsidiary should be classified as an investing activity in the consolidated statement of cash flows when the parent loses control of the subsidiary as a result of the transaction.

Because there is no guidance regarding transaction costs related to purchases and sales of noncontrolling interests, reporting entities may elect a policy to report such costs as either an expense in the income statement, or as a direct charge to equity. The classification of transaction costs in the cash flow statement should be consistent with that accounting. Therefore, if a reporting entity reflects transaction costs in its income statement, the related cash flows should be classified as an operating activity. If a reporting entity instead reflects the transaction costs as a direct charge to equity, the related cash flows should be classified as a financing activity.

6.7.2.8 Derivative transactions that contain a financing element

Per ASC 230-10-45-14d and 45-15d, all cash flows associated with an instrument accounted for as a derivative (i.e., the normal purchases and normal sales assertion has not been elected) that, at its inception, includes an "other-than-insignificant financing element," should be classified as financing activities by the borrower (i.e., the counterparty with a derivative liability on its books).

Derivatives with off-market terms and those that require upfront cash payments often contain a financing element. ASC 815-10-45 does not establish bright lines for determining when an inherent financing element should be considered other-than-insignificant. Determining if a derivative contains an other-than-insignificant financing element requires judgment based on the facts and circumstances. We have interpreted the term "insignificant" in this guidance as denoting an amount that is less than 10 percent of the present value of an at-the-market derivative's fully prepaid amount. The term "at inception" is generally interpreted within ASC 815 to mean when the reporting entity acquired the derivative position, not when the derivative instrument was originated. While the requirement to classify all cash flows related to a derivative with an other-than-insignificant financing element within the financing category was an attempt to add transparency to the practice of effectively creating a borrowing in the form of an off-market derivative, the interpretation of "at inception" combined with the lack of scoping attached to the guidance in ASC 230 potentially impacts derivative instruments that were not intended to provide the borrower counterparty any direct financing.

In instances when the financing element is considered to be other-than-insignificant at inception, all of the cash flows associated with the derivative (i.e., not just the cash flows associated with the portion that represents the financing element) should be included in financing activities by the borrower.

EXAMPLE 6-7

Classifying cash flows associated with acquired derivatives

FSP Corp uses its common stock to acquire another company in a transaction accounted for as a business combination under ASC 805. At the acquisition date, the acquired company held derivatives in the form of physically settled commodity forward contracts that the acquired company originated. Based on the difference between market prices at the date of the acquisition and the historical terms of the acquired forward contracts, all of the forward contracts are in a liability position, and they all are deemed to contain an "other-than-insignificant" financing element.

Upon acquisition, FSP Corp accounts for the acquired forward contracts as derivative instruments. Source documents obtained from the acquired company clearly indicate that the fair value of all the acquired forward contracts were zero when originated by the acquired company.

How should FSP Corp classify the cash flows associated with the acquired forward contracts in its statement of cash flows?

Analysis

The inception of the physically settled forward contracts for FSP Corp is the date of the business combination, not the date the acquired company originated the derivative contracts. Because all of the forward contracts contain an other-than-insignificant financing element, a literal read of ASC 230 would suggest that the cash flows associated with the physically settled forward contracts should be presented in the financing section of the statement of cash flows.

While FSP Corp did not receive an up-front payment related to the acquired forward contracts, one could argue that FSP Corp effectively received noncash "financing" from the forward contracts because their liability position effectively allowed FSP Corp to issue fewer shares to purchase the acquiree. Of course, FSP also acquired all the acquiree's accounts payable and accrued liabilities, and when FSP Corp settles those liabilities, ASC 230 requires those outflows to be classified as operating.

Given that facts like these appear inconsistent with the transactions that the other-than-insignificant financing element concept was intended to target (especially when the derivative results in the physical delivery of an item used for operating purposes), we rarely see the other-than-insignificant financing element guidance applied to derivatives acquired in a business combination.

6.7.3 Operating activities

Cash flows that are not investing or financing activities are operating cash flows. Typically, operating cash flows are receipts and payments that enter into the determination of net income.

Common examples of operating cash flows are:

- Receipts from customers for sales of goods and/or services, as well as receipts from short-term and long-term receivables under normal trade terms that arose from sales of goods and/or services

- Interest and dividend receipts related to investments in other reporting entities or deposits with financial institutions (i.e., returns on investment). Interest income is considered received when the bank posts the entry to a reporting entity's account.

- Payments to vendors for inventory or services (including cash expenditures for advertising). Similarly, payments on short-term or long-term credit extended by the supplier or its affiliate finance subsidiary for the purchase of inventory or other goods and services under normal trade terms would also qualify as operating. In contrast, payments on credit extended by an entity other than the supplier or its affiliate finance subsidiary is a financing activity.

- Payments to creditors for interest

- Insurance proceeds related to operating activities (e.g., inventory losses or business interruption)

- Cash receipts or cash payments resulting from the acquisition or sale of debt or equity securities of other reporting entities classified as trading securities pursuant to ASC 320-10 that are part of an investment strategy to actively buy and sell securities with the objective of generating profits on short-term differences in market prices

- Payments of all income taxes

- Payments made to settle an asset retirement obligation

- Cash receipts and cash payments resulting from acquisitions and sales of loans originally classified as loans held for sale. Cash flows should continue to be classified as operating activities, even if the reporting entity subsequently reclassifies the loans to be held for long-term investment.

- Restructuring payments, including severance

- Cash contributions made to employee benefit plans

When using the indirect method, adjustments for noncash items must be identified to reconcile net income to operating cash flows. Noncash adjustments to income (which do not represent noncash investing and financing activities as described in FSP 6.9) may include items such as:

- Depreciation and amortization relating to fixed assets, definite-lived intangible assets, debt financing fees, capital leases, premiums, or discounts on debt
- Provisions for bad debts and inventory
- Share-based incentive compensation
- Deferred income taxes
- Impairment losses
- Unrealized gains or losses
- Gains or losses from the sale of long-lived assets or a business
- Gains or losses from the extinguishment of debt

6.7.3.1 Planned major maintenance

The accounting for planned major maintenance allows two alternative methods: direct expensing and deferral. While these methods impact the income statement and balance sheet differently, we believe that the nature of expenditures related to planned major maintenance requires these cash flows to be classified as operating in the statement of cash flows, regardless of which accounting method the entity uses. This view is consistent with comments issued by the SEC staff.

6.7.3.2 Investor's share of equity in the earnings of an investee (accounted for using the equity method)

When using the indirect method to report operating cash flows, a reporting entity's equity in the earnings of an investee is presented as a reconciling item in the reconciliation of net income to net cash provided by operating activities. ASC 230 is clear that dividends received should be classified as operating. As such, there is a rebuttable presumption that distributions received from equity-method investees should be classified as cash inflows from operating activities. If, however, the distribution does not represent a return on the investment but rather a return of the investment, the cash inflow should be classified as investing. The cumulative earnings approach is commonly used to differentiate between returns on investment and returns of investment.

Under the cumulative earnings approach, a reporting entity compares distributions received to its share of equity earnings (as adjusted for basis differences), both on an inception-to-date basis. Examples of returns of investment might include a distribution from an investee in circumstances when losses have reduced the investment account below the amount originally invested, distributions soon after the purchase of the investment, or a distribution arising from significant sales of operating assets by the investee.

The following examples demonstrate the determination of a return of investment versus return on investment using the cumulative earnings approach:

EXAMPLE 6-8

Return of investment versus return on investment

FSP Corp is a calendar year-end SEC registrant with a 20% equity investment in a joint venture, EM Company. The initial cash investment by FSP Corp on January 1, 20X1 for the 20% interest is $25,000. The investment is accounted for as an equity-method investment, and there is no basis difference between FSP Corp's equity investment and the underlying equity of EM Company.

FSP Corp's share of EM Company's income/(loss) and the related share of dividend distributions for the last four years are as follows:

	Share of net income/(loss)	Share of dividend distributions
12/31/20X1	(2,000)	1,000
12/31/20X2	(1,000)	1,000
12/31/20X3	5,000	3,000
12/31/20X4	6,000	3,000

How should the distributions be classified in the statement of cash flows for each of these periods?

Analysis

The following table summarizes the impact to FSP Corp:

End of period	FSP Corp's 20% share of EM Company's annual net income/(loss)	FSP Corp's share of EM Company's cumulative earnings since investment inception	FSP Corp's 20% share of annual distribution	FSP Corp's cumulative distributions since investment inception	Statement of cash flows classification: Operating	Statement of cash flows classification: Investing
12/31/20X1	$(2,000)	$(2,000)	$1,000	$1,000		$1,000
12/31/20X2	$(1,000)	$(3,000)	$1,000	$2,000		$1,000
12/31/20X3	$ 5,000	$ 2,000	$3,000	$5,000	$2,000	$1,000
12/31/20X4	$ 6,000	$ 8,000	$3,000	$8,000	$3,000	

If the investor's inception-to-date distributions are greater than the investor's inception-to-date earnings, the presumption is that the equity-method investee utilized a portion of the funds initially invested to pay all, or a portion of, the cash distributions. As noted above, FSP Corp received distributions for the years ended 12/31/20X1 and 12/31/20X2 of $1,000 each year, when EM Company incurred net losses. As such, it is determined that EM Company paid the distributions from its capital balance, which would be considered a return of investment and classified as an investing inflow within FSP Corp's statement of cash flows. For the year ended 12/31/20X3, the distribution received by FSP Corp was allocated between return on investment and return of investment because, even though FSP's inception-to-date distribution exceeded its inception-to-date earnings, for the first time FSP Corp's inception-to-date earnings were positive and therefore eligible to be considered as a portion of the 20X3 distributions. For the year ended 12/31/20X4, FSP Corp's inception-to-date earnings equaled the inception-to-date distributions, and therefore the entire 20X4 distribution would be considered a return on investment and classified as an operating activity within FSP Corp's statement of cash flows.

EM Company's historical retained earnings balance prior to FSP Corp's investment of $25,000 is not relevant for purposes of determining the classification of the distribution in FSP Corp's statement of cash flows. EM Company's earnings should start accumulating for purposes of the cumulative earnings test beginning when FSP Corp made its investment in EM Company.

EXAMPLE 6-9

Return of investment versus return on investment during interim periods

FSP Corp receives a dividend from its equity-method investee during an interim period. Based upon an analysis of inception-to-date distributions compared to inception-to-date earnings, it would appear the dividend received in the interim period should be considered a return of investment and classified as an investing inflow by the reporting entity. However, when forecasted earnings for the entire fiscal year are considered, inception-to-date earnings are expected to be greater than inception-to-date distributions. Thus, the dividend exceeds the investee's current quarterly earnings (and the inception-to-date earnings), but does not exceed forecasted annual earnings.

How should the reporting entity classify the cash dividend received in its interim period statement of cash flows – return of investment or return on investment?

Analysis

We believe that it is acceptable for a reporting entity to consider the investee's forecasted annual earnings in classifying dividends as either a return on or return of investment under the cumulative earnings approach. We also believe it is acceptable to analyze dividends received on a quarter-by-quarter basis without consideration of the investee's forecasted earnings. In either case, the reporting entity should reassess its estimate throughout the year to reflect the nature of the dividends in the annual statement of cash flows. The approach followed should be disclosed and consistently applied in all periods for similar investments.

6.7.3.3 *Transfers of trade receivables with holdbacks or deferred purchase price structures*

Reporting entities sometimes sell trade receivables to banks or asset-backed commercial paper conduits, frequently under revolving financing arrangements, to accelerate cash inflows. Sellers may not receive the entire purchase price in cash at the transfer date. Rather, the seller may receive only a portion of the purchase price (which is classified as operating in the statement of cash flows), with the difference consisting of a receivable from the bank or conduit. The repayment of that receivable is contingent on the subsequent collections on the underlying trade receivables sold. This deferred payment arrangement, representing a beneficial interest in the transferred trade receivables, is commonly referred to as the "deferred purchase price," or "DPP."

Reporting entities must determine the appropriate classification of subsequent collections of DPP receivable in the statement of cash flows if the transfer of the receivables giving rise to the DPP qualifies for sale accounting under ASC 860, *Transfers and Servicing*. Typically this analysis would lead to an investing conclusion, based on the view that the DPP receivable has the characteristics of a collateral-dependent debt instrument issued by a securitization entity. As noted in FSP 6.7.1, cash flows associated with investments in debt securities are generally classified as investing activities.

However, in instances where the DPP is collateralized by short-term trade receivables, subsequent receipts may be reflected as an operating cash inflow, subject to the following conditions:

- All cash flows from the DPP should be stated on a separate line item within the operating category
- The reporting entity discloses its classification conclusion and the basis for its conclusion
- The DPP's exposure to interest-rate risk has been considered when evaluating the appropriate classification of the instrument's cash inflows. If the impact of the movements in interest rates is deemed to have a significant effect on the fair value of the DPP, reporting entities may need to further consider whether it is appropriate to present the DPP-related cash inflows as operating.

In our view, it would be difficult to support operating cash flow treatment in instances where the form of the DPP is a legal security or a "certificated" interest (i.e., a transferable certificate of ownership). We would expect these circumstances to be rare, as the DPP is typically a contractual undertaking that arises from the underlying receivables purchase agreement and does not involve the issuance of a security.

6.7.4 *Discontinued operations*

In April 2014, the FASB released ASU 2014-08, *Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity,* which requires reporting entities to present in the statement of cash flows or disclose in a footnote either (1) total operating and investing cash flows for discontinued operations, or (2) depreciation, amortization, capital expenditures, and significant operating and investing noncash items related to discontinued operations. This guidance is applicable for calendar year-end reporting entities in 2015, and can be early adopted.

Reporting entities may have historically reported information about cash flows from discontinued operations that are incremental to what is required by ASU 2014-08. For example, a reporting entity may have presented information about financing activities or additional details of operating and investing activities. While ASU 2014-08 does not require presentation or disclosure of cash flow information from discontinued operations related to financing activities, a reporting entity is not precluded from presenting or disclosing such information. Similarly, we do not believe a reporting entity would be precluded from providing information about operating or investing activities for discontinued operations that is incremental to the requirements of ASU 2014-08 (e.g., line item detail).

Before adopting ASU 2014-08, prior guidance did not require reporting entities to separately present or disclose cash flows from discontinued operations. However, if a reporting entity elects to disclose cash flows from a discontinued operation separately, it must disclose such cash flows consistently. This presentation should be continued until all material cash flows related to the discontinued operation have occurred. Therefore, a reporting entity should consider the length of time that may be required to "wrap up" the discontinued operations when determining whether to separately disclose cash flows from discontinued operations (e.g., if the enterprise has agreed to pay future postretirement health care benefits for retirees of the discontinued operations). A reporting entity's method of disclosure should follow one of the following five alternatives:

- Cash flows from a discontinued operation and the continuing business are presented together without separate identification within operating, investing, and financing activities

- Detailed line items of discontinued operation cash flows are separately reported within operating, investing, and financing activities

- A total of discontinued operation cash flows are separately reported within operating, investing, and financing activities

- Operating, investing, and financing activities of the continuing business are presented, and then discontinued operation cash flows are presented below financing activities of the continuing operation showing detailed line items comprising operating, investing, and financing cash flows of the discontinued operation

- Operating, investing, and financing activities of the continuing business are presented, and then discontinued operation cash flows are presented below financing activities of the continuing operation showing the total amount of activities from operating, investing, and financing cash flows of the discontinued operation

If a reporting entity separately discloses cash flows pertaining to discontinued operations, it should identify the respective categories (operating, investing, and financing). Including all cash flows from discontinued operations separate from the continuing operation cash flows, without breaking them out into their respective categories (e.g., reflecting the entire net change as part of operating cash flows), is unacceptable. Doing so violates the provisions of ASC 230-10-45-24, which states, in part, "A statement of cash flows for a period shall report net cash provided or used by operating, investing, and financing activities…"

Questions have arisen around the proper presentation of cash receipts from the sale of a discontinued operation when a reporting entity elects to break out its cash flows from discontinued operations separate from continuing operations. We believe it is acceptable to present the cash inflow as either continuing-investing or discontinued-investing as long as such presentation is applied consistently and is accompanied by transparent disclosure. However, we believe the more intuitive treatment is to classify such sales proceeds as discontinued-investing cash flows.

The cash and cash equivalents line item on the balance sheet may not include all of an entity's cash and cash equivalents if the entity has a discontinued operation (disposal group) with cash and cash equivalents included within the assets held for sale caption. In such cases (regardless of which alternative described above is used), the traditional format of the cash flow statement will need to be adjusted in order to reconcile to the cash and cash equivalents line item on the balance sheet. In this instance, we believe there are two acceptable presentation methods: (1) include a reconciling item after financing activities and before beginning cash balances to reflect the change in cash balances included in the held for sale caption, or (2) for purposes of the statement of cash flows, add the cash and cash equivalents included in assets held for sale at the beginning and end of the period to the respective balances in the cash line item from the balance sheet and include a reconciliation of the ending cash balance in the statement of cash flows to the cash reported in the balance sheet within a footnote.

6.8 Foreign currency cash flows

A reporting entity with operations in foreign countries or with foreign currency transactions must report the reporting currency equivalent of foreign currency cash flows using the exchange rates in effect at the time of the cash flows. If the pattern of cash flows and exchange rates are relatively consistent throughout the period, the reporting entity may use an average exchange rate for translation, as the cash flow results would not be significantly different from the result if actual exchange rates on the day of the cash flows were used. However, if the pattern of cash flows is not consistent or the exchange rates are volatile, a simple average of the rates at the beginning and end of the period may not yield an appropriately-weighted average exchange rate, especially for large and infrequent investing and financing transactions. In such circumstances the rate in effect at the time of the transaction should be disclosed.

Foreign currency activities require specific presentation on the statement of cash flows as follows:

- Unrealized foreign currency transaction gains and losses reported on the income statement should be reflected as a reconciling item from net income to cash flows from operating activities in an indirect presentation

- The effect of exchange rate changes on cash and cash equivalents denominated in currencies other than the reporting currency should be a separate line item as part of the reconciliation of the change in cash equivalents during the period

The effect of exchange rate changes on cash and cash equivalents reflected in the statement of cash flows is not a "plug." It is a balancing amount and may be proven using the following formula:

The net cash flow activity for the period measured in the functional currency *multiplied by* the difference between the exchange rates used in translating functional currency cash flows and the exchange rate at year end	+	The fluctuation in the exchange rates from the beginning of the year to the end of the year *multiplied by* the beginning cash balance denominated in currencies other than the reporting currency.

See Step 3 in Example 6-10 for further illustration of how to calculate this number.

6.8.1 *Preparing the statement of cash flows for a reporting entity with foreign operations*

When preparing the statement of cash flows for a reporting entity with foreign operations, the reporting entity should perform the following steps:

- Step 1: The statement of cash flows for each distinct and separable operation should be prepared on a standalone basis in its respective functional currency.

- Step 2: The statement of cash flows for each distinct and separable operation that is a foreign entity (as defined in ASC 830) should be translated into the reporting entity's reporting currency.

- Step 3: The reporting entity should prepare a consolidating statement of cash flows using the individually translated statements of cash flows for each distinct and separable operation. The effect of exchange rate changes on cash and cash equivalents denominated in currencies other than the reporting currency should be calculated for each distinct and separable operation.

See Example 6-10 for an illustrative example of preparing the statement of cash flows for a reporting entity with foreign operations. ASC 830-230-55 also includes an example of how to calculate "the effect of exchange rate changes on cash."

EXAMPLE 6-10

Statement of cash flows — foreign subsidiary

FSP Corp is located in the U.S. and has one wholly-owned subsidiary, Britain Limited (Britain).

Britain's integrated manufacturing facility is in Great Britain, with the sales market for its products mainly in Great Britain. Financing is primarily denominated in U.S. dollars. Financing from FSP Corp is in the form of a demand note, but settlement of the note is not planned for, or anticipated in, the foreseeable future.

The functional currency of Britain is the British Pound (GBP). The reporting currency for FSP Corp is the U.S. Dollar (USD). The year-end for FSP Corp is December 31, 20X4.

The British Pound to U.S. Dollar exchange rates are as follows:

Code	Description	GBP to USD
B	Current rate, beginning of year	GBP 1 = USD 1.45
E	Current rate, end of year	GBP 1 = USD 1.55
A	Average rate for the year	GBP 1 = USD 1.50
R	Rate in effect at time of transaction	GBP 1 = USD Varies

Britain sold a piece of equipment with a net book value of 20,000 GBP and received proceeds of 10,000 GBP. The exchange rate on the date of the transaction was GBP 1 = USD 1.46.

Britain made one property, plant, and equipment purchase for 155,000 GBP. The exchange rate on the date of purchase was GBP 1 = USD 1.47.

Britain paid cash dividends of 100,000 GBP. The exchange rate on the date of the dividend was GBP 1 = USD 1.54.

Britain has a bank note denominated in U.S. dollars. There were no payments or additional borrowings on the bank note. As a result of movements in the exchange rate, a transaction gain of 26,000 GBP was recorded at 12/31/X4.

Britain has an intercompany note denominated in U.S. dollars. There were no payments or additional borrowings on the intercompany note. As a result of movements in the exchange rate, a transaction gain of 9,000 GBP was recorded at 12/31/X4.

The GBP to USD exchange rate is deemed to not have significantly fluctuated throughout the period.

The balance sheet for Britain in GBP as of 12/31/20X3 and 12/31/20X4 is as follows:

	Functional currency (GBP)		
	12/31/20X3	12/31/20X4	Change
Assets			
Cash and cash equivalents	256,000	457,000	201,000
Accounts receivable	225,000	250,000	25,000
Inventory	478,000	500,000	22,000
Property, plant and equipment, net	1,000,000	1,050,000	50,000
Total assets	1,959,000	2,257,000	298,000
Liabilities			
Accounts payable	300,000	340,000	40,000
Accrued expenses	120,000	190,000	70,000
Debt, denominated in USD	413,000	387,000	(26,000)
Debt, denominated in GBP	50,000	50,000	–
Debt, intercompany	138,000	129,000	(9,000)
Deferred income taxes	100,000	80,000	(20,000)
Total liabilities	1,121,000	1,176,000	55,000
Stockholders' equity			
Common stock	500,000	500,000	–
Retained earnings	338,000	581,000	243,000
Total stockholders' equity	838,000	1,081,000	243,000
Total liabilities and stockholders' equity	1,959,000	2,257,000	298,000

The income statement and changes in retained earnings for Britain in GBP for the year ended 12/31/20x4 is as follows:

	Functional currency (GBP) 12/31/20X4
Revenue	2,000,000
Cost and expenses	
Cost of sales	1,000,000
Selling and administrative expenses	341,000
Interest expense	86,000
Depreciation	85,000
Loss on sale of equipment	10,000
Foreign currency transaction gain	(35,000)
Total costs and expenses	1,487,000
Income before income taxes	513,000
Current	190,000
Deferred	(20,000)
Total provision for income taxes	170,000
Net income	343,000
Retained earnings, beginning	338,000
Cash dividends	(100,000)
Retained earnings, ending	581,000

How should FSP Corp prepare Britain's statement of cash flows as of 12/31/20X4 in U.S. dollars?

Analysis

Step 1:

Prepare the statement of cash flows in Britain's functional currency (GBP) based on the changes in assets, liabilities, and stockholders' equity noted. Refer to the table contained in Step 2 for an illustration.

The unrealized transaction gain created by the USD denominated debt balances is reflected in the reconciliation of net income to operating cash flows.

Step 2:

Translate the functional currency statement of cash flows into the reporting currency, USD.

	Step 1			Step 2
	GBP 12/31/20X4	Code	Exchange Rate	USD 12/31/20X4
Cash flows from operating activities				
Net Income	343,000	A	GBP 1 = USD 1.50	514,500
Adjustments to reconcile net income to net cash provided by operating activities				
Depreciation	85,000	A	GBP 1 = USD 1.50	127,500
(Gain) loss on sale of equipment	10,000	R	GBP 1 = USD 1.46	14,600
(Gain) loss on foreign currency exchange rates	(35,000)	A	GBP 1 = USD 1.50	(52,500)
Deferred income taxes	(20,000)	A	GBP 1 = USD 1.50	(30,000)
Change in operating assets and liabilities				
Accounts receivable	(25,000)	A	GBP 1 = USD 1.50	(37,500)
Inventory	(22,000)	A	GBP 1 = USD 1.50	(33,000)
Accounts payable	40,000	A	GBP 1 = USD 1.50	60,000
Accrued expenses	70,000	A	GBP 1 = USD 1.50	105,000
Net cash provided by operating activities	446,000			668,600
Cash flows from investing activities				
Proceeds from sale of equipment	10,000	R	GBP 1 = USD 1.46	14,600
Purchases of property, plant and equipment	(155,000)	R	GBP 1 = USD 1.47	(227,850)
Net cash used in investing activities	(145,000)			(213,250)
Cash flows from financing activities				
Payment of dividends	(100,000)	R	GBP 1 = USD 1.54	(154,000)
Net cash used in financing activities	(100,000)			(154,000)
Effect of exchange rate changes on cash	—			35,800
Change in cash	201,000			337,150
Cash, beginning of the year	256,000	B	GBP 1 = USD 1.45	371,200
Cash, end of the year	457,000	E	GBP 1 = USD 1.55	708,350

Because the pattern of cash flows and the GBP to USD exchange rate has not significantly fluctuated throughout the year, an average exchange rate can be used to translate most of the cash flows from operating activities (Code "A" in the example above). For specific transactions such as dividends, significant purchases, and dispositions of equipment, the rate in effect at the time of transaction should be used (Code "R" in the example above).

Step 3:

Upon consolidating the statement of cash flows of each distinct and separable operation, the reporting entity should record elimination entries for the reporting currency equivalent of intercompany transactions. Since the information for FSP Corp's U.S. operations has not been provided in this example, the consolidating statement of cash flows for FSP Corp is not presented. However, the effect of exchange rate changes on cash held by Britain is presented below.

When a reporting entity records gains and losses relating to holding cash and cash equivalents in a currency other than its functional currency, these recorded gains and losses are not cash flows, but should instead be reported within the effect of foreign currency exchange rates on cash and cash equivalents.

Calculation of effect of exchange rate changes on cash

	Code	Calculation	Result
Effect on beginning cash balance			
Beginning cash balance in local currency		256,000	
Net change in exchange rate during the year	(E - B)	0.10	
Effect on beginning cash balance			25,600
Effect from operating activities during the year			
Cash provided by operating activities in local currency		446,000	
Year-end exchange rate	E	1.55	
Operating cash flows based on year-end exchange rate		691,300	
Operating cash flows reported in the statement of cash flows		668,600	
Effect from operating activities during the year			22,700
Effect from investing activities during the year			
Cash provided by investing activities in local currency		(145,000)	
Year-end exchange rate	E	1.55	
Investing cash flows based on year-end exchange rate		(224,750)	
Investing cash flows reported in the statement of cash flows		(213,250)	
Effect from investing activities during the year			(11,500)
Effect from financing activities during the year			
Cash provided by financing activities in local currency		(100,000)	
Year-end exchange rate	E	1.55	
Financing cash flows based on year-end exchange rate		(155,000)	
Financing cash flows reported in the statement of cash flows		(154,000)	
Effect from financing activities during the year			(1,000)
Effect of exchange rate changes on cash			35,800

6.9 *Noncash investing and financing activities*

ASC 230 requires separate disclosure of all investing or financing activities that do not result in cash flows. This disclosure may be in a narrative or tabular format. The noncash activities may be included on the same page as the statement of cash flows, in a separate footnote, or in other footnotes, as appropriate.

Examples of noncash investing and financing transactions are:

- Acquiring assets by assuming directly related liabilities
- Converting debt to equity
- Obtaining an asset by entering into a capital lease
- Exchanging noncash assets or liabilities for other noncash assets or liabilities
- Obtaining a building or investment asset as a gift
- Issuing stock in connection with a stock compensation plan where no cash payment is required
- Obtaining a residual interest in a securitization
- Acquiring a business through the issuance of stock

ASC 230-10-45-13c indicates that payments at the time of purchase *or soon before or after purchase* to acquire plant, property, or equipment and other productive assets are investing activities. While this phrase is unclear, it does not mean that cash flows can be reflected in a statement of cash flows before they occur. The words "or soon before or after purchase" are intended to highlight that some payments made subsequent to the acquisition of a long-lived asset should be classified as investing (i.e., payments made shortly after acquisition of the long-lived asset according to normal trade terms), while other payments made subsequent to the acquisition of a long-lived asset should be classified as financing (i.e., the timing of the payments are not consistent with normal trade terms and instead indicate that the long-lived asset was acquired with debt financing). Determining if the payment terms received by a reporting entity are consistent with the trade terms the seller normally makes available to its other customers is an important consideration when evaluating if seller financing was provided.

Separately, reporting entities may undertake transactions where cash is received or disbursed on its behalf by another entity. ASC 230 does not address these situations. In certain circumstances, we believe a reporting entity may be able to recognize those cash flows as if they had received or disbursed the cash from its bank account under a constructive receipt and disbursement concept.

6.9.1 *Constructive receipts and disbursements*

Numerous processes and protocols have developed in which financial institutions or other entities act as quasi-agents on behalf of reporting entities in regard to transfers of cash. Thus, a reporting entity may have certain transactions that do not result in an exchange of currency or an entry into its cash account, but for which the same economic results are obtained as if an exchange of currency or an entry into its cash account had occurred.

For example, assume a reporting entity engages a lender to service its customer cash receipts that are mailed to a lockbox. Per the lockbox servicing arrangement, at the end of each business day the lender is obligated to transfer all funds received to the reporting entity's account at another bank. While not addressed in the lockbox servicing arrangement, on the last day of every month the lender does not transfer that day's lockbox receipts to the reporting entity's bank account, and instead, the reporting entity wires the lender funds equal to the difference between the principal and interest payment on its loan from the lender, and that day's lockbox receipts.

In this situation, the question arises as to whether this netting should be reflected by the reporting entity as a noncash transaction, or if it should gross up its statement of cash flows to reflect that cash was constructively received from a customer (an operating inflow) and then cash constructively disbursed to the lender in the form of principal and interest (a financing outflow and operating outflow). While we generally do not believe that noncash investing and financing activities should be included in the statement of cash flows, it may be appropriate in certain situations for reporting entities to invoke constructive receipt and constructive disbursement.

Judgment is required when determining if constructive receipt and constructive disbursement is appropriate. Generally, we believe if the processes or protocols that allow a reporting entity not to be directly involved in a cash flow are predicated on convenience, then constructive receipt and disbursement may be considered. However, if a reporting entity's lack of direct involvement in a cash flow was by design such that the reporting entity was purposely excluded from the cash exchange, then constructive receipt and disbursement should not be considered.

6.9.2 *Examples of noncash investing and financing activities*

The following examples demonstrate the identification and presentation of noncash investing and financing activities.

EXAMPLE 6-11

Noncash investing or financing activity — purchased equipment not yet paid for

On December 20, 20X4, FSP Corp purchases and takes title to equipment costing $100, and accordingly debits property, plant, and equipment and credits accounts payable. As of December 31, 20X4, FSP Corp has not yet made cash payment to settle the accounts payable.

How should the equipment acquisition be reflected in FSP Corp's December 31, 20X4 statement of cash flows?

Analysis

Until FSP Corp has made a cash payment related to the equipment, the equipment acquisition is a noncash activity that should not be reflected in the statement of cash flows. Understanding if FSP Corp's equipment acquisition is either a noncash investing activity or a noncash financing activity requires an understanding of the words "or soon before or after purchase." Regardless, it would be incorrect to include a $100 investing outflow and a corresponding $100 operating inflow (created by the increase in accounts payable) in FSP Corp's December 31, 20X4 indirect method statement of cash flows, because neither of those cash flows occurred.

EXAMPLE 6-12

Noncash investing and financing activity — equipment partially financed by a note

FSP Corp acquires computer equipment for $100 cash and a $400 installment note payable to the seller. Providing installment notes payable to its customers is not a normal trade term for the seller.

How should the $100 cash payment be recorded in the statement of cash flows? How should the $400 installment note payable to the seller be reflected?

Analysis

The $100 cash payment should be reported as an investing activity outflow and included with purchases of property, plant, and equipment. The noncash investing and financing transaction of $400 should be disclosed.

The subsequent principal payments on the debt should be classified as financing cash outflows, whereas the payments of interest on the debt should be classified as operating cash flows.

Alternatively, if in the above example the $400 is borrowed from a third party lender who disbursed the funds to the buyer, the loan would be a financing cash inflow and the full purchase price of the equipment would be an investing cash outflow.

EXAMPLE 6-13

Noncash investing and financing activity — restricted use financing

FSP Corp issues debt in a $100 million bond offering, and, per the bond agreement, the proceeds are distributed to an escrow account that FSP Corp records as restricted cash. FSP Corp never received the funds from the bond offering in its general cash account, as the proceeds were directly transferred from the investor to the trustee-controlled escrow account. Per the bond agreement, the trustee is instructed to use $40 million of the proceeds to repay FSP Corp's existing debt, while the remaining $60 million will be held in the restricted escrow account until FSP Corp incurs qualifying construction expenditures. At that time, the trustee will make distributions to FSP Corp's general cash account for reimbursement of these incurred costs.

How should this arrangement be reflected in FSP Corp's statement of cash flows?

Analysis

The cash flow statement should reflect what actually happened, rather than what could have happened. In this scenario, FSP Corp did not actually receive the proceeds from the bond offering. Since the bond proceeds are sent to the escrow account by design and not for convenience sake, the cash from the $100 million bond offering, the $40 million payment of the existing debt, and the funding of the $60 million restricted cash account should be reflected as noncash activities.

When FSP Corp incurs construction expenditures, those cash flows should be classified as cash outflows from investing activities. When the qualifying construction expenditures are reimbursed by the trustee with the funds in the restricted cash account, the decreases in the restricted cash account should be classified as cash inflows from financing activities because the restricted cash account is a result of a noncash financing activity.

Alternatively, when the qualifying construction expenditures are reimbursed by the trustee with the funds in the restricted cash account, the decreases in the restricted cash account could be classified as cash inflows from investing activities. While this would be consistent with the general rule that changes in restricted cash are investing cash flows, there should be transparent disclosure and a gross presentation in the investing category of the statement of cash flows. A net presentation (i.e., single line item in the investing category of the statement of cash flows) would not be consistent with the fact that the cash expenditures actually occurred and as a result, capitalized costs on the balance sheet increased.

EXAMPLE 6-14

Noncash investing and financing activity — sinking fund requirements

FSP Corp obtains financing from a financial institution which requires FSP Corp to make monthly sinking fund deposits into an escrow account to service the semiannual debt service payments. The financial institution has the legal claim to all escrow balances to offset the loan in an event of default. At the semiannual payment due date, the financial institution withdraws funds directly from the escrow account and applies the funds against the outstanding principal balance and accrued interest. FSP Corp subsequently receives a confirmation that the escrow funds have been withdrawn and that FSP Corp's respective escrow account and loan payable balance, including accrued interest, have been reduced.

How should this arrangement be reflected in FSP Corp's statement of cash flows?

Analysis

FSP Corp reflects the original proceeds of the financing arrangement as a financing inflow. The escrow account represents restricted cash of FSP Corp.

Generally, we believe that changes in restricted cash balance should be classified as cash flows from investing activities.

Normally, at the debt service payment date, FSP Corp would withdraw funds from the escrow account (an investing inflow) and remit payment, to the financial institution (an operating outflow for the interest component of the payment and a financing outflow for the principal component). However, in this case, the financial institution physically withdraws funds from the escrow account by design, and no actual cash flow activity occurs for FSP Corp. Accordingly, the statement of cash flows would not reflect any cash flows related to using funds in the restricted account to service the loan, but instead would include a transparent disclosure that described the noncash activity.

Alternatively, we believe FSP Corp may reflect an appropriate portion of the monthly escrow sinking fund deposit as operating and financing activities, as if the payment was going directly to the financial institution. This presentation would reflect the substance of the activity — an operating outflow for the payment of interest and a financing outflow associated with the repayment of principal on the loan — even though the balance sheet would not reflect such offset.

6.10 Considerations for private companies

There are no significant differences for private companies regarding the presentation or disclosures of cash flows. The requirements of ASC 230 apply equally to SEC registrants and private companies. Figure 6-2 summarizes the presentation items discussed in this chapter that are only required for SEC registrants.

Figure 6-2
Presentation and disclosure requirements applicable only to SEC registrants

Description	Reference	Section
Compensating balances	SEC FRP 203.02.b	6.5.6
Restricted cash must be segregated	S-X 5-02(1)	6.5.7

Chapter 7: Earnings per share (EPS)

7.1 Chapter overview

The objective of earnings per share (EPS) is to measure the performance of an entity over a reporting period. This chapter highlights key provisions for the computation, presentation, and disclosure of EPS.

The chapter explains several methodologies used in computing EPS and highlights some of the key considerations in determining how to include particular instruments and transactions, including financing transactions and stock-based compensation awards, in EPS.

The chapter also includes sample computations of both basic and diluted EPS.

7.2 Scope

ASC 260, *Earnings Per Share*, requires the presentation of EPS for all entities that have publicly traded common stock or potential common stock, e.g., options or warrants. A public market includes a stock exchange (domestic or foreign) or over-the-counter markets, including circumstances where the securities are quoted only locally or regionally.

Presentation of EPS is also required for a reporting entity that has made a filing or is in the process of filing with a regulatory agency in preparation for the sale of securities in a public market.

Private companies may elect to report EPS provided they comply with the guidance in ASC 260.

ASC 260-10-15-3 states that the presentation of EPS is not required for investment companies that comply with the requirements of ASC 946, *Financial Services — Investment Companies*, or in the financial statements of wholly-owned subsidiaries.

SAB 98 includes information that should be considered that is incremental to ASC 260, including SAB Topics 1.B (carve-out entities), 3.A (convertible securities), 4.D (nominal issuances), 6.B (income or loss applicable to common stock), and 6.G (quarterly per share results).

Note on ongoing standard setting

ASC 260 includes guidance on EPS presentation when a reporting entity has an extraordinary item. As of the content cutoff date of this publication (August 31, 2014), the FASB has an active project to remove the concept of extraordinary items from U.S. GAAP altogether. Financial statement preparers and other users of this publication are therefore encouraged to monitor the status of the project, and if finalized, evaluate the effective date of the new guidance and the implications on presentation and disclosure.

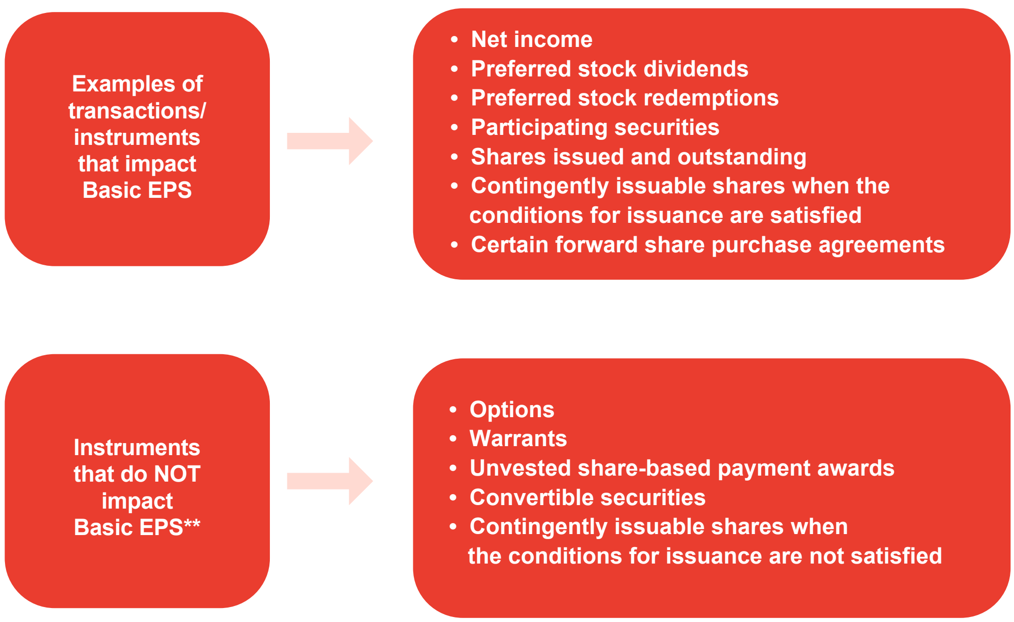
7.3 Types of EPS computations

ASC 260-10 requires the reporting of both basic and diluted EPS for each reporting period.

- *Basic EPS*

  Computed by dividing income available to common stockholders by the number of weighted average common shares outstanding

Figure 7-1
Summary of basic EPS



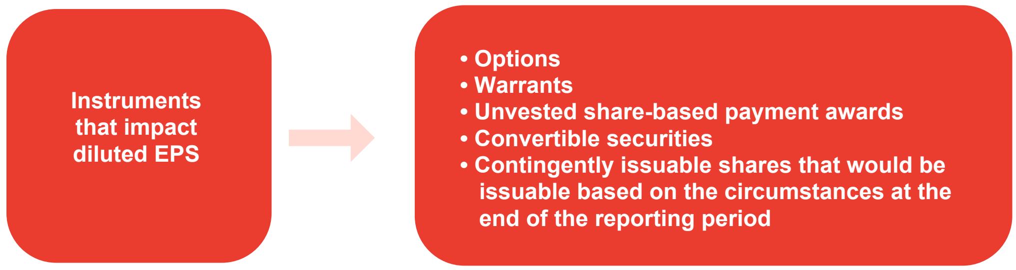
** Presumes the securities are not considered participating securities

- *Diluted EPS*

  Computed by dividing income available to common stockholders, adjusted for the effects of the presumed issuance of potential common shares, by (1) the number of weighted average common shares outstanding, *plus* (2) potentially issuable shares, such as those that result from the conversion of a convertible instrument or exercise of a warrant.

  In other words, diluted EPS is basic EPS adjusted for the hypothetical effect of potentially dilutive securities.

Figure 7-2
Summary of diluted EPS



7.3.1 Basic EPS

EPS should be presented for income from continuing operations, if applicable, and for net income on the income statement.

Definition from ASC 260-10-20

Basic Earnings Per Share: The amount of earnings for the period available to each share of common stock outstanding during the reporting period.

Basic EPS is detailed in FSP 7.4.

7.3.2 Diluted EPS

Reporting entities with outstanding potential common stock should present diluted EPS for income from continuing operations, if applicable, and net income with equal prominence on the face of the income statement.

Definition from ASC 260-10-20

Diluted Earnings Per Share: The amount of earnings for the period available to each share of common stock outstanding during the reporting period and to each share that would have been outstanding assuming the issuance of common shares for all dilutive potential common shares outstanding during the reporting period.

Diluted EPS is detailed in FSP 7.5.

7.3.3 Presentation of basic and diluted EPS

Reporting entities should present EPS for each class of common stock for all periods for which an income statement is presented. If the reporting entity reports diluted EPS data in one period, it should report it for all periods presented, even if the amounts are the same as basic EPS. If basic and diluted EPS are the same amount for all periods, dual presentation can be accomplished in one line. If the reporting entity elects to present a single statement of comprehensive income, EPS should be presented after net income and before OCI. Reporting entities are not required to present EPS for preferred stock, but can elect to do so.

In SAB Topic 6.B, the SEC staff requires that income or loss available to common stockholders be presented on the income statement when it is materially different from reported net income or loss. While the SAB acknowledges that a materiality assessment consists of quantitative and qualitative factors, it highlights that for differences of less than ten percent, the staff would generally not insist on disclosure on the income statement. Refer to Figure 7-3 for examples of adjustments which can create differences between net income and income available to common stockholders.

The terms "basic EPS" and "diluted EPS" are used in ASC 260 to identify EPS data to be presented. However, ASC 260-10-45-4 notes they are not required captions in the income statement; terms such as "earnings per common share" and "earnings per common share — assuming dilution," respectively, are acceptable alternatives.

A reporting entity that reports a discontinued operation or an extraordinary item should present basic and diluted EPS amounts for each of those line items either on the income statement or in the notes. However, if disclosure of these amounts in the notes is elected, basic and diluted EPS for continuing operations, if applicable, and for net income, must still be presented on the income statement. ASC 260-10-55-49 illustrates the presentation of the captions on the income statement.

7.3.3.1 Other per-share performance measures

ASC 225-20-45-16 precludes disclosure of the EPS effects of individual events or transactions that do not meet the definition of an extraordinary item on the face of the income statement. Therefore, the EPS impact of restructurings, charges subject to ASC 420, *Exit or Disposal Cost Obligations*, and impairments, may not be presented on the face of the income statement. Reporting entities may disclose such EPS effects in the footnotes.

ASC 230-10-45-3 prohibits presentation of cash flow per share. Similarly, SEC FRP 202.04 notes that per share data other than that relating to net income, net assets, and dividends should be avoided in reporting financial results.

If the reporting entity chooses to report per-share amounts not required by ASC 260, such amounts should be computed in accordance with ASC 260 and presented only in the notes (i.e., not on the face of the financial statements) and labelled as pretax or net-of-tax.

7.3.4 Disclosure related to EPS

ASC 260-10-50-1 requires a reporting entity to disclose the following for each period for which an income statement is presented:

- *For basic and diluted EPS, a reconciliation of the numerators and denominators for income from continuing operations*

  The reconciliation should include the individual income and share amount effects of all securities that affect EPS. ASC 260-10-55-51 provides an example of this presentation.

- *The effect of preferred dividends on income available to common stockholders in computing basic EPS*

- *Securities that were anti-dilutive for diluted EPS for the period(s) presented but which could potentially dilute EPS in the future (the concept of anti-dilution is addressed in FSP 7.5.1)*

A reporting entity should provide a description of any subsequent event that occurs after the end of the most recent balance sheet, but before issuance of the financial statements, that will materially change the number of common shares or potential common shares outstanding. Examples of those events may include:

- the issuance or acquisition of common shares

- the resolution of a contingency under a contingent stock agreement

- a stock dividend or stock split

In certain circumstances, pro forma EPS may be required as well. Refer to FSP 7.6.1 for details.

ASC 505, *Equity*, requires reporting entities to disclose participation rights on its outstanding securities (see ASC 505-10-50-3). Refer to FSP 7.4.2 for details.

Lastly, a reporting entity should also disclose its accounting policy election for the treatment of the accretion of capitalized interest in applying the if-converted method for diluted EPS. Refer to FSP 7.5.5.1 for details.

7.4 Basic EPS

Basic EPS is computed as:

$$\frac{\textit{Income available to parent company common stockholders (the “numerator”)}}{\textit{Weighted average number of common shares outstanding (the “denominator”)}}$$

The numerator may be impacted by transactions with preferred stockholders (dividends, accretion, repurchases, etc.) and by the required allocation of income to other classes of securities with participation rights.

The denominator may be impacted by share issuances and repurchases, as well as forward share purchase agreements, vested stock-based compensation awards, and contingent share arrangements.

7.4.1 Numerator

The starting point for the calculation of the numerator is income from continuing operations and net income (after allocation of income to noncontrolling interests under ASC 260-10-45-11A, if applicable). The reporting entity adjusts these amounts by deducting (1) dividends declared in the period on preferred stock (whether or not paid), and (2) cumulative dividends on preferred stock (whether or not declared), regardless of the form of payment of the dividends (e.g., cash, stock, or other assets).

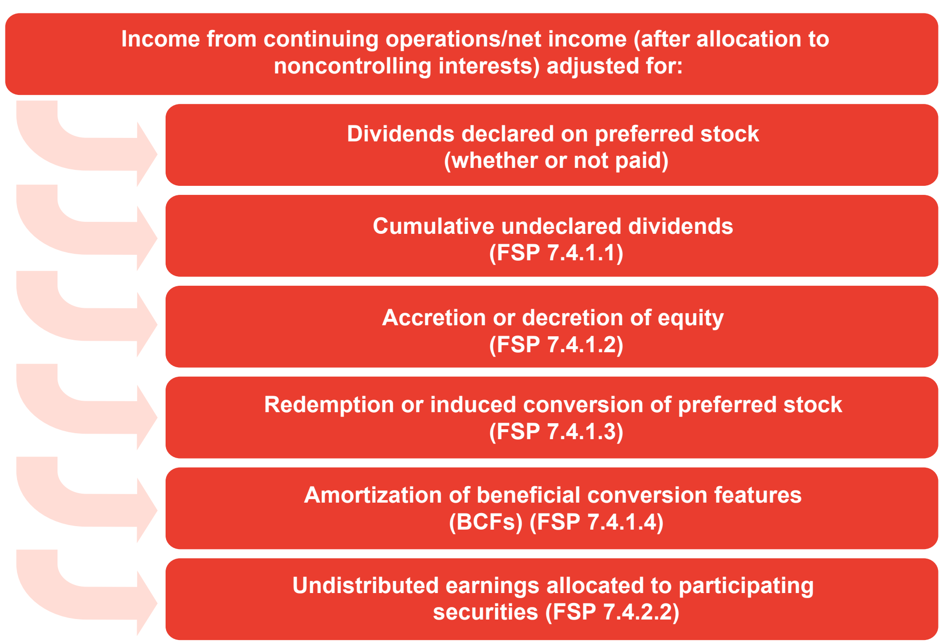
When a stock dividend on preferred stock is paid in another class of stock, the reporting entity should capitalize retained earnings to the extent of the fair value of the dividend. See FG 5.4.5.1 for further information. As discussed in ASC 260-10-45-12, dividends declared on preferred stock that are payable in the reporting entity's common shares should be deducted from earnings available to common shareholders when computing earnings per share. Accordingly, an adjustment to net income for preferred stock dividends is required regardless of the form of the payment (whether the dividend is paid in cash, common shares, or additional preferred shares of the same or another class).

When there is a loss from continuing operations or net income, the adjustment for preferred dividends will increase the loss. Preferred dividends that are cumulative only if earned should be deducted only to the extent they are earned.

In addition, the reporting entity should deduct any amount of undistributed earnings allocated to participating securities from the numerator. Refer to FSP 7.4.2.2 for details.

There are a number of other adjustments to arrive at the numerator, as illustrated in Figure 7-3.

Figure 7-3
Possible adjustments made in computing income available to common stockholders for basic EPS



7.4.1.1 *Adjustments for cumulative undeclared dividends*

A reporting entity may not be required to record undeclared dividends on cumulative preferred stock in its accounting records. However, the absence of accounting for undeclared dividends on cumulative preferred stock does not change the requirement to include the cumulative undeclared dividends in the EPS computation.

There are two common situations in which the accounting for the cumulative undeclared preferred dividends would differ from the EPS treatment. In these instances, the reporting entity is not required to record the accumulated undeclared dividends in its balance sheet, but should still deduct the cumulative undeclared dividends from the EPS numerator.

- *Perpetual cumulative preferred stock*

  Because there are no redemption features in perpetual preferred stock, the preferred stock is classified within permanent equity. As such, no dividend entry is recorded in the balance sheet or the statement of stockholders' equity for any undeclared dividends.

- *Cumulative preferred stock that is redeemable only upon a change of control of the reporting entity, the redemption price includes cumulative undeclared dividends, the reporting entity has not declared any preferred stock dividends, and the change in control is not probable at the reporting date*

  While the preferred stock would be classified as mezzanine equity on the balance sheet for reporting purposes, the redemption feature is contingent, and, therefore, accretion to the redemption price (including undeclared cumulative dividends) is not necessary until the redemption event is probable. In such cases, reporting entities should disclose why redemption of the security is not probable. When redemption becomes probable, the cumulative undeclared dividends would increase the mezzanine equity carrying value. Only dividends declared are reported as dividends payable.

If the reporting entity subsequently declares preferred dividends that had accumulated over prior periods, it should only reduce the numerator by the dividends related to the current period, as the amounts related to the prior periods would have already been included in the EPS computations of the prior periods.

7.4.1.2 *Adjustments for accretion/decretion of equity*

The accretion/decretion of equity, such as mezzanine equity, should be considered in the calculation of the numerator.

The impact of accretion/decretion on the computation of EPS varies, depending on whether the mezzanine equity is common stock, preferred stock, or a noncontrolling interest issued by a subsidiary.

Impact of mezzanine equity in the form of common stock

ASC 480-10-S99-3A requires common stock reported as mezzanine equity that is redeemable at an amount other than fair value to be treated as having a right to distributions that differs from other common stockholders. As such, changes in the mezzanine carrying amount generally impact income available to common stockholders.

ASC 480-10-S99-3A, paragraph 21 (FN 17), provides two acceptable approaches for allocating earnings to a common security that is redeemable at other than fair value. A reporting entity should make an accounting policy election to either:

- Treat the entire adjustment to the security's carrying amount as being akin to a dividend, or

- Treat the portion of the adjustment to the security's carrying amount that reflects the change during the period in the amount by which the redemption price exceeds fair value as being akin to a dividend.

The impact may result in either an increase or decrease in income available to common stockholders. However, under either approach, increases cannot exceed the cumulative amount previously reflected as a reduction of income available to common stockholders.

For common stock that is redeemable at fair value, no adjustment to the EPS numerator is required because redemption at fair value is not considered an economic distribution different from other common stockholders.

Paragraph 21 (FN 18) of ASC 480-10-S99-3A also states that common stock redeemable based on a specified formula is considered to be redeemable at fair value if the formula is designed to approximate fair value. However, a formula based on a fixed multiple of EBITDA does not approximate fair value, as the appropriate multiple for determining fair value may change over time.

Example 7-1 illustrates how to calculate income available to common stockholders when mezzanine equity in the form of common stock is redeemable for cash at an amount other than fair value.

EXAMPLE 7-1

Accretion of mezzanine common stock in the calculation of the numerator for basic EPS

FSP Corp has 200 outstanding shares of common stock. One hundred shares of the common stock are redeemable for cash at an amount other than fair value.

During the reporting period, there is a $100 increase in the redemption value of the stock ($20 of which is in excess of changes in the stock's fair value) and income of $500.

How should FSP Corp determine the numerator for basic EPS?

Analysis

The numerator depends on FSP Corp's accounting policy choice. If FSP Corp elects to treat the entire adjustment as being akin to an actual dividend, the numerator would be $400 ($500 less $100). If it elected to treat only the portion of the adjustment that is in excess of fair value as being akin to an actual dividend, the numerator would be $480 ($500 less $20).

Impact of mezzanine equity in the form of preferred stock

Any accretion/decretion of preferred stock classified as mezzanine equity should reduce/increase the numerator. Decretion can only be recorded to the extent of prior accretion on that instrument, until actual redemption occurs (see FSP 7.4.1.3).

Impact of mezzanine equity in the form of a noncontrolling interest in a consolidated subsidiary

The same EPS concepts for parent-issued common and preferred mezzanine equity apply to noncontrolling interests in the form of common and preferred equity.

For mezzanine equity-classified noncontrolling interests in the form of preferred stock, presentation of the impact to the numerator may vary, depending on the terms of the redemption feature. If the redemption feature in the preferred securities is issued or guaranteed by the parent, the resulting increases or decreases in the carrying amount of the redeemable noncontrolling interest are treated in the same manner as dividends on nonredeemable stock. Therefore, increases or decreases in the carrying amount of a redeemable preferred stock will reduce or increase the numerator in the computation of the parent's EPS.

If the subsidiary issued the preferred security (not guaranteed by the parent), the adjustment is attributed to the parent and the noncontrolling interest in accordance with ASC 260-10-55-20 and Example 7 in ASC 260-10-55-64 through 55-67. As explained in these references, the per-share earnings of the subsidiary are included in the consolidated EPS computations based on the consolidated group's holding of the subsidiary securities pursuant to the two-class method at the subsidiary level.

For mezzanine equity-classified noncontrolling interest in the form of common stock, no adjustment is needed if the common stock is redeemable at fair value, as redemption at fair value is not considered an economic distribution different from other common stockholders. For mezzanine equity-classified noncontrolling interest in the form of common stock that is redeemable at a value other than fair value, the manner in which the adjustments affect the numerator may differ, depending on how a reporting entity considers the terms of the redemption feature in its calculation of net income attributable to the parent.

If the terms of the redemption feature are fully considered in the attribution of net income to the parent, the reporting entity would not adjust the numerator, as it has already been included in the attribution of net income. However, if the terms of the redemption feature are not considered in the attribution of net income, then the parent adjusts its numerator for the impact of the redemption feature.

7.4.1.3 Adjustments for redemption or induced conversion of preferred stock

ASC 260-10-S99-2 notes that in a redemption of preferred stock where the fair value of consideration paid upon redemption exceeds the carrying amount, net of its issuance costs, the excess represents a return to preferred stockholders, and the difference should be deducted from the EPS numerator. Reporting entities should deduct the commitment date beneficial conversion feature (BCF) related to the preferred stock from the fair value of consideration paid. Refer to FG 9.7 for a more detailed discussion of beneficial conversion features.

The calculation is as follows:

Fair value of consideration transferred	***minus***	original BCF	***less***	Carrying value, net of issuance costs	***equals***	Adjustment to numerator

When the consideration is less than the carrying amount, for example, when a redemption is effected at a discount to the carrying amount of the preferred security, the reporting entity should add the difference between the carrying amount and the consideration to the EPS numerator.

This guidance applies to redemptions of convertible preferred stock regardless of whether the embedded conversion feature is "in-the-money" or "out-of-the-money" at the time of redemption. Example 7-2 illustrates the impact of a redemption of preferred stock on the computation of basic EPS.

EXAMPLE 7-2

Impact of redemption of preferred stock on the calculation of basic EPS

FSP Corp issued perpetual preferred stock on January 1, 20X4, that is convertible in four years. The par value (and issuance price) of the convertible preferred stock is $1,000,000.

The convertible preferred stock also contains a beneficial conversion feature with an intrinsic value of $200,000 on the commitment date. The BCF is recorded as a discount on the preferred stock, with a related credit to APIC, and is being amortized to the first date at which the preferred stock is convertible.

On December 31, 20X6, FSP Corp paid shareholders $1.2 million in cash to redeem the preferred stock.

What is the impact of the redemption of the convertible preferred stock on the calculation of basic EPS?

Analysis

The difference between the fair value of the consideration transferred to preferred stockholders less the original BCF, and the carrying value of the preferred stock, including any amortized discount related to the BCF, is treated as a "deemed dividend" to preferred shareholders and results in a reduction to the numerator in the computation of basic EPS.

In this example, the reduction to the numerator in the computation of basic EPS is determined as follows:

Fair value of consideration transferred	$1,200,000
Less: BCF (at original intrinsic value)	(200,000)
Less: Carrying value of preferred stock	(950,000)[1]
Reduction in numerator related to "deemed dividend"	$50,000

[1]$1,000,000 par value less $50,000 remaining discount associated with the BCF.

If a reporting entity issues preferred shares that are conditionally redeemable (e.g., at the holder's option, or upon the occurrence of an uncertain event not solely within the reporting entity's control) and the uncertain event occurs, the condition is resolved, or the event becomes certain to occur, then the shares become mandatorily redeemable under ASC 480, and would require reclassification from mezzanine equity to a liability. ASC 480-10-30-2 requires the issuer to measure the liability initially at fair value, and reduce equity by the amount of the initial measurement, recognizing no gain or loss in the income statement. This reclassification of shares to a liability is akin to the redemption of such shares by the issuance of debt.

Similar to the accounting for the redemption of preferred shares in ASC 260-10-S99-2, if the fair value of the liability differs from the carrying amount of the preferred shares upon reclassification, the reporting entity should deduct the difference from, or add to, the numerator (i.e., as a deemed dividend or as a return from preferred stockholders).

ASC 810-10-40-2 provides guidance that a redemption of a subsidiary's preferred stock, either directly by the subsidiary or by its parent, that is not classified as a liability in the parent's consolidated balance sheet, is treated in the parent's consolidated financial statements as an equity transaction and not recorded in the income statement. The related retained earnings charge or credit is reflected in EPS in the same manner described above.

While ASC 260-10-S99-2 states that the excess consideration requires an adjustment to the numerator, it does not address the treatment of the redemption of preferred stock of a subsidiary when that subsidiary's operations will be classified as a discontinued operation. We believe that, because the adjustment is directly associated with the subsidiary being discontinued, it should be attributed to discontinued operations in computing EPS.

Additionally, ASC 260-10-S99-2 indicates that in an induced conversion of preferred shares, the excess of the fair value of securities issued over the fair value of securities issuable pursuant to the original contractual conversion terms also represents a return to preferred stockholders and should reduce the numerator of EPS.

Question 7-1

A reporting entity issued warrants (which have been classified as equity) to certain common stockholders who are not also lenders, customers, vendors, or others who would have a commercial relationship with the company. During the exercise period, the reporting entity induces the warrant holders to early exercise by offering the warrant holders additional common shares if the warrants are exercised by a certain date.

Does the issuance of the additional shares offered as an inducement to early exercise impact earnings per share?

PwC response

Yes. Because there is incremental value being transferred to a group of equity holders, the fair value of the inducement provided to the warrant holders should be considered an allocation against income applicable to common stockholders in the computation of earnings per share based on the guidance in ASC 260-10-S99-3. Because the value is only transferred to a sub-group of common stockholders, it is akin to a preferential distribution to that group and is reflected in EPS even though there is no impact to net income in this fact pattern.

7.4.1.4 Adjustments related to beneficial conversion features

For convertible preferred securities, any amortization of the discount resulting from an allocation of proceeds to a BCF is analogous to a dividend. The reporting entity should recognize the amortization as a return to the preferred stockholders (a deemed dividend), following the guidance in ASC 470-20-30. The deemed dividend should be deducted from the numerator.

The reporting entity should also consider the deemed dividend when determining the dilutive impact of the convertible security in the computation of diluted EPS. That is, the adjustment to the numerator should be reversed if conversion is assumed.

For convertible debt securities, the discount created by recording the beneficial conversion feature represents an adjustment of the effective interest rate of the security, and the reporting entity should reflect it as a charge to interest cost.

For basic EPS, convertible debt instruments with BCFs would not result in an adjustment to the numerator, as the interest cost is already included in net income. However, the interest on the debt (inclusive of amortization of the discount), net of associated tax, is added back to the numerator if the security is assumed to be converted for purposes of calculating diluted EPS.

7.4.2 *Participating securities and the two-class method*

The capital structures of some reporting entities include:

- Securities that may participate in dividends with common stock according to a predetermined formula (for example, two for one) with, at times, an upper limit on the extent of participation (for example, up to, but not beyond, a specified amount per share).
- A class of common stock with different dividend rates from those of another class of common stock but without priority or senior rights.

These characteristics represent participation rights and should be considered in the computation of basic EPS.

Definition from ASC 260-10-20

Participating Security: A security that may participate in undistributed earnings with common stock, whether that participation is conditioned upon the occurrence of a specified event or not. The form of such participation does not have to be a dividend—that is, any form of participation in undistributed earnings would constitute participation by that security, regardless of whether the payment to the security holder was referred to as a dividend.

In accordance with ASC 260-10-45-60A, any securities meeting the definition of a participating security, irrespective of whether the securities are convertible, nonconvertible, or potential common stock securities, are included in the computation of basic EPS using the two-class method.

Excerpt from ASC 260-10-45-60

The two-class method is an earnings allocation formula that treats a participating security as having rights to earnings that otherwise would have been available to common shareholders…

7.4.2.1 *Overview of the two-class method*

The key to applying the two-class method is identifying the instruments that, in their current form (e.g., prior to exercise, settlement, conversion, or vesting), are entitled to receive dividends if and when declared on common stock.

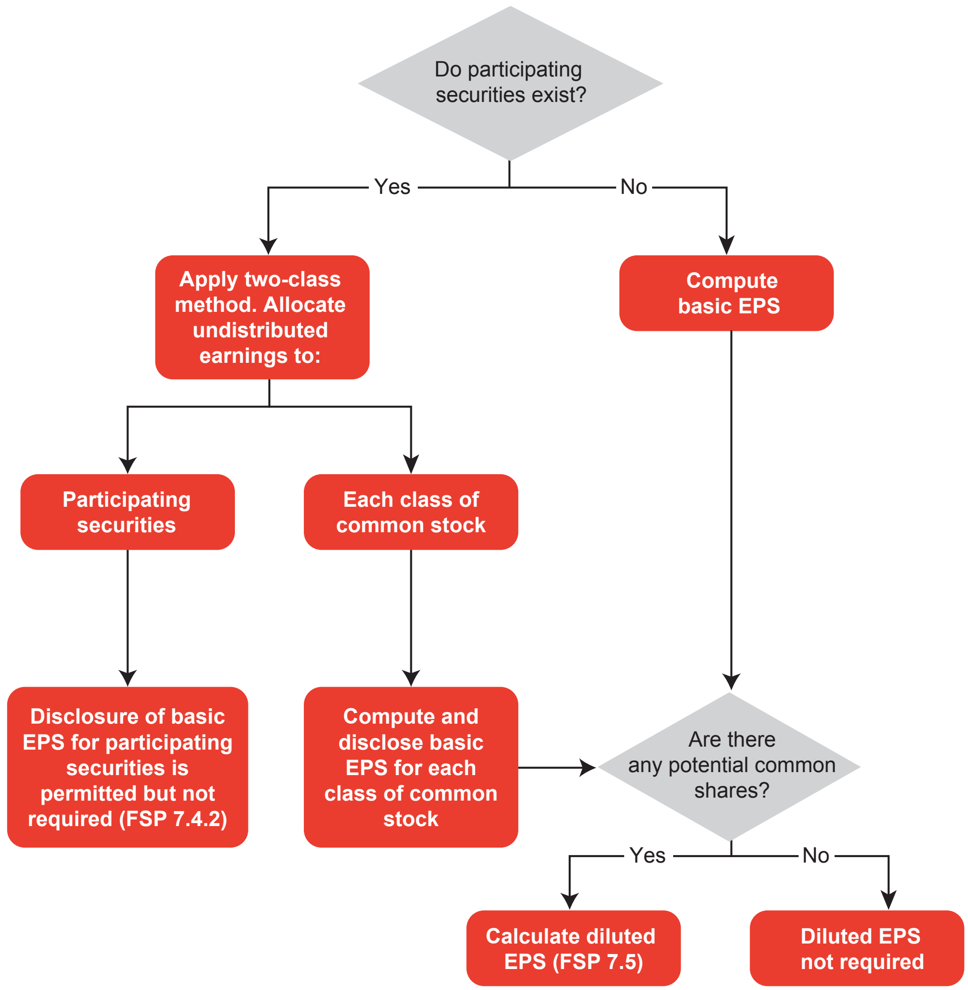
The reporting entity is required to allocate any undistributed earnings between the common stockholders and the participating security holders based on their respective rights to receive dividends, as if all undistributed earnings for the period were distributed.

A participating security, including those which are noncumulative, will reduce EPS regardless of whether dividends are actually paid, because the two-class method allocates earnings away from common stockholders to the participating security holders. This process is explained in FSP 7.4.2.2.

The reporting entity is not required to present basic and diluted EPS for participating securities, other than a second class of common stock, under the two-class method, but it is not precluded from doing so.

The following figure illustrates when and how to use the two-class method in computing basic EPS.

Figure 7-4
EPS decision tree



7.4.2.2 *Allocating undistributed earnings to participating securities*

Reporting entities need to allocate undistributed earnings for the period to a participating security based on the contractual participation rights of the security to share in those earnings, as if all of the earnings for the period had been distributed. However, if the terms of the participating security do not specify objectively-determinable, nondiscretionary participation rights, undistributed earnings would not be allocated based on arbitrary assumptions.

In addition, if a reporting entity can avoid a distribution of earnings to a participating security, even when all of the earnings for the period are distributed, the reporting entity would not allocate undistributed earnings to that participating security.

The use of the two-class method requires an assumption of the hypothetical distribution of all earnings each period to all common stock and participating security holders according to the terms of the securities. Reporting entities should consider whether there are preferential distribution rights between classes of common or other participating security holders, or whether the distributions are made without preference between classes of common stockholders and other participating securities' classes.

As required by ASC 260-10-45-60B, reporting entities should perform the hypothetical distribution of all earnings, regardless of whether those earnings would actually be distributed from an economic or practical perspective, and regardless of whether there are other legal or contractual limitations on its ability to pay dividends (e.g., debt covenants or state law considerations on the payment of dividends). The allocation of undistributed earnings is generally based on the weighted average number of common shares and participating securities outstanding for the period, not based on the shares or participating securities outstanding at the end of the period.

When an entire class of participating securities is created, sold, converted, or redeemed during the period, we believe a reporting entity has the option of performing the allocation of undistributed earnings for the pre- and post-transaction period. Under this method, net income for the pre- and post-transaction portions of the period are allocated to the securities outstanding during each respective portion of the period. While not required, this earnings allocation methodology may be used only if the underlying accounting systems and controls provide that the net income amount reflects all appropriate entries that a normal close process would include. The allocation methodology is an accounting policy choice and should be consistently applied.

Question 7-2

In some entities (especially those with noncorporate structures), all distributions may follow a stated "waterfall" that requires that any distributions be first paid to Class A preferred unitholders until those holders receive a compounded cumulative annual return (e.g., 10%), as well as the return of all of their invested capital. Subsequent distributions are then paid to other unitholders, including common units.

In such a situation, in calculating earnings per share under the two-class method, does the hypothetical distribution of earnings in each period to all security holders following the terms of the organizing documents mean that all book net income up to the amount of invested capital of Class A preferred units should be allocated to the Class A preferred units, as that is how cash would be distributed?

PwC response

No. When considering the allocation of earnings between classes of securities, the focus is generally on the return <u>on</u> capital of each security, not the return <u>of</u> capital. As described above, the two-class method is an allocation of <u>earnings</u> of the reporting entity. This reflects the change in the net assets of the entity, and how each security holder shares in those increases and decreases. It is often the case that a reporting entity may be prohibited from paying any dividends on common stock while a class of preferred stock is outstanding. This effectively operates in a similar economic fashion as the situation described in the question but, as noted above, contractual limitations on the ability to pay dividends are ignored in the application of the two-class method.

Accordingly, we believe that in the above situation, earnings should generally be allocated first to the Class A preferred unitholders for their 10% cumulative dividends, and then shared between the common and preferred unitholders based on their right to receive dividends once dividends are being paid to the different classes. To do otherwise would often allocate all earnings in all periods to the preferred unitholders (as each year is evaluated independently and if the principal is not actually paid, each year's allocation would assume that principal still needs to be paid), which we do not believe is consistent with the sharing of earnings (i.e., increases in net asset value) of the reporting entity between the classes of unitholders.

7.4.2.3 *Allocating losses to participating securities*

As noted in ASC 260-10-45-67 and 45-68, a reporting entity should only allocate losses to convertible and nonconvertible participating securities if, based on the contractual terms of the participating securities, the securities have a contractual obligation to share in the losses of the reporting entity and the basis on which losses are shared is objectively determinable.

ASC 260-10-45-67 provides criteria to determine whether the holder of a participating security has a contractual obligation to share in the losses.

Since this is often not the case, participating securities will generally be allocated earnings in periods of net income, but not allocated losses in periods of net loss. Although this treatment is not symmetrical, it is consistent with the notion that EPS should reflect the most dilutive results. The reporting entity should determine whether a participating security holder has an obligation to share in its losses in each period.

In computing year-to-date EPS, reporting entities should use year-to-date income (or loss) in determining whether undistributed earnings should be allocated to participating security holders. For example, if there is a quarter-to-date loss but year-to-date income for a given period, the year-to-date EPS computation should include an allocation to participating security holders even if the quarter-to-date computation did not.

We believe the discussion of allocating losses in ASC 260-10-45-67 and 68 was written in the context of preferential securities. If the participating security is a second class of common stock (such as a nonvoting class with different dividend rates) that shares equally in residual net assets, losses would generally be allocated equally to each class of common stock.

Allocating losses to restricted stock

Restricted stock may share in residual net assets after it vests because, once vested, the fair value of the restricted stock would reflect any losses that have been incurred. However, unvested restricted shares do not share in residual net assets and, therefore, do not economically absorb the loss. As such, reporting entities should not allocate losses to unvested restricted shares.

Example 7-3 illustrates how to apply the two-class method to participating securities.

EXAMPLE 7-3

Application of the two-class method of EPS

FSP Corp has 10 million shares of common stock and 2 million shares of convertible preferred stock (issued at $10 par value per share) outstanding.

FSP Corp's net income is $50 million.

Each share of preferred stock is convertible into 3 shares of common stock.

The preferred stock participates on a 1:1 basis in any common dividends that would have been payable had the preferred stock been converted immediately prior to the record date of any dividend declared on the common stock (i.e., as-converted basis).

At year-end, FSP Corp pays dividends of $2 per share to the common stockholders and $6 per share to the preferred stockholders, since each preferred share converts into 3 common shares.

How would FSP Corp compute basic EPS under the two-class method?

Analysis

Step 1: Calculate the undistributed earnings

Net income		$50,000,000
Less dividends declared:		
Common stock	($20,000,000)[1]	
Participating preferred stock	(12,000,000)[2]	(32,000,000)
Undistributed earnings		$18,000,000

[1] 10 million shares x $2 dividend/share

[2] 2 million preferred shares x $6 dividend per preferred share

Step 2: Allocate undistributed earnings to the two classes

To common:

[(Common shares outstanding) / (common shares outstanding + "as converted" shares of preferred)] x undistributed earnings

[(10,000,000) / (10,000,000 + 6,000,000)] x $18,000,000 = $11,250,000

To preferred:

[("As-converted" common shares) / (common shares outstanding + "as converted" shares of preferred)] x undistributed earnings

[(6,000,000) / (10,000,000 + 6,000,000)] x $18,000,000 = $6,750,000

Step 3: Compute basic EPS for common stockholders

Net income	$50,000,000
Less: Earnings attributable to preferred stockholders	(18,750,000)[1]
Income available to common stockholders	$31,250,000
Divided by common shares outstanding	10,000,000
Basic EPS	$3.13

[1] $12,000,000 dividend plus undistributed earnings of $6,750,000 allocated to preferred stockholders.

Applying master limited partnership guidance to other types of corporate entities when allocating excess distributions

ASC 260 has certain provisions that specifically address the application of the two-class method to master limited partnerships (as addressed in FSP 32) when cash distributions exceed earnings for the period. We believe this guidance can be applied by analogy to other types of corporate entities that have dividend distributions in excess of current period earnings. Therefore, in these situations, if the participating securities are contractually obligated to participate in the losses of the reporting entity, a portion of the excess distribution is allocated to these security holders based on their contractual participation in losses. If they do not participate in losses, all of the excess distribution is allocated to common stockholders.

Example 7-4 illustrates how to apply the master limited partnership guidance when a reporting entity has participating securities and dividend distributions in excess of earnings.

EXAMPLE 7-4

Allocating earnings to common shares when there are participating securities and dividends in excess of earnings

FSP Corp reports net income of $10 million in the quarter ended June 30, 20X4, and has 9.5 million shares of common stock outstanding.

FSP Corp has granted 1 million shares of unvested restricted stock to certain employees. The restricted stock is entitled to nonforfeitable dividends and, as such, is deemed to be a participating security. Requisite service is expected to be rendered for all shares of restricted stock.

During the quarter, FSP Corp pays dividends of $1/share, totaling $10.5 million ($9.5 million to the common stockholders and $1 million to the restricted stockholders).

How should FSP Corp allocate income to the common shares?

Analysis

By analogizing to the master limited partnership guidance, we believe it is appropriate in this case to allocate the excess of distributions over earnings to the common shares, as the restricted shares have no obligation to participate in losses. As such, the excess of distributions over earnings are allocated as follows.

	Common stock	Restricted stock	Total
Distributable earnings	$9,500,000	$1,000,000	$10,500,000
Excess distributions	(500,000)	—	(500,000)
Net income	$9,000,000	$1,000,000	$10,000,000

7.4.2.4 *Allocating earnings to participating securities when there is income from continuing operations and an overall net loss, or loss from continuing operations and overall net income*

In a reporting period when there are different combinations of income and loss on different line items, and the participating securities are not contractually obligated to share in losses, there is no clear guidance in ASC 260 as to how earnings should be allocated to participating securities. We believe an acceptable approach is to allocate earnings to participating securities based on the "control number," as discussed in ASC 260-10-45-18 and FSP 7.5.1.

The "control number" concept requires that income from continuing operations (adjusted for preferred dividends, as described in paragraph ASC 260-10-45-11) be used to determine whether potential common shares are dilutive or anti-dilutive. Using this concept by analogy, if a reporting entity has income from continuing operations but losses from discontinued operations or extraordinary items resulting in an overall net loss, it could allocate the loss using the two-class method. However, if there was a loss from continuing operations but income from discontinued operations or extraordinary items results in overall net income, nothing would be allocated to participating securities for any of the categories.

Another acceptable method is to treat each line item as an independent calculation and only allocate earnings to participating securities for those line items for which income is reported. There would be no allocation of losses to participating securities for those line items for which a loss is reported.

For example, in a reporting period in which there is a loss from continuing operations, gain from discontinued operations and overall net income, we believe an acceptable approach is to not allocate losses from continuing operations to the participating securities, as the participating securities do not have a contractual obligation to participate in losses. However, the gain from discontinued operations and net income would be allocated to participating securities. Under this method, the sum of the individual EPS income statement line items would not reconcile to the total net income per share.

Other allocation methods may also be appropriate. The reporting entity should make and disclose an accounting policy election related to the allocation methodology and consistently apply the policy elected.

7.4.2.5 Other securities which may be considered participating

Consistent with ASC 260-10-45-60A, potential common shares (securities or other contracts that may entitle their holders to obtain common stock such as options, warrants, forwards, or other contracts) may be participating securities if, in their current form, they are entitled to receive dividends when declared on common stock.

Stock options, warrants, and other contracts to issue common stock

ASC 260-10-45-61A notes that an unvested share-based payment award that includes nonforfeitable rights to dividends or dividend equivalents meets the definition of a participating security in its current form—that is, prior to the requisite service having been rendered for the award. Share-based payment awards that include forfeitable rights to dividends would not be considered participating securities.

ASC 260-10-45-68B discusses the computation of EPS when share-based payment awards with nonforfeitable rights to dividends or dividend equivalents are present. ASC 718, *Compensation — Stock Compensation*, requires that nonrefundable dividends or dividend equivalents paid on awards for which the requisite service is not (or is not expected to be) rendered be recognized as additional compensation cost, and that dividends or dividend equivalents paid on awards for which the requisite service is (or is expected to be) rendered be charged to retained earnings. As a result, a reporting entity should not include dividends or dividend equivalents that are already accounted for as compensation cost in the earnings allocation to participating securities because that amount has already reduced net income. However, when allocating the remaining undistributed earnings, all amounts attributable to the participating awards should be included, as these amounts are not reflected in compensation cost but will reduce what is available for common shareholders either way.

The estimate of the number of awards for which the requisite service is not expected to be rendered for determining EPS should be consistent with the estimate used for recognizing compensation cost under ASC 718.

A reporting entity should apply a change in the estimate of the number of awards for which the requisite service is not expected to be rendered in the period the change in estimate occurs. This change in estimate will affect net income in the current period; however, a current period change in an entity's expected forfeiture rate would not affect prior period EPS computations. The example in ASC 260-10-55-76A through 55-76D (Case D: Participating Share-Based Payment Awards) illustrates this.

Reporting entities should allocate undistributed earnings to all outstanding share-based payment awards that have nonforfeitable rights to dividends, including those for which the requisite service is not expected to be rendered.

Convertible securities and options

Participation may not always involve the right to receive dividends in cash. For certain securities, including share-based payment awards, dividends do not get paid to the holders when declared on common stock. Instead, the conversion or exercise price of the security may be adjusted for dividends to keep the holder whole. In some cases, those adjustments may constitute participation rights.

Dividends or dividend equivalents transferred to the holder of a convertible security in the form of an adjustment or reduction of the conversion price or an increase in the conversion ratio of the security do not represent participation rights if conversion is optional (i.e., at the election of either the holder or the reporting entity). This conclusion also applies to other securities that could be converted into a reporting entity's common stock (e.g., options or warrants), if those securities provide for an adjustment to the exercise price that is tied to the declaration of dividends by the issuer.

Since obtaining the benefit of an adjustment to the conversion or exercise price is dependent on the actual conversion or exercise of the security, which may or may not occur, these types of adjustments may not result in an actual transfer of value to the holder of the security (they are referred to as contingent transfers of value) and are, therefore, not a participation right. Accordingly, reporting entities need not allocate any undistributed earnings to these securities.

However, if a convertible security has a mandatory conversion date, and if dividends or dividend equivalents are transferred to the holder of the convertible security in the form of a reduction of the conversion price or an increase in the conversion ratio of the security, then such feature would represent a participation right, because the transfer of value is not contingent on a decision to exercise (similar to a forward contract). In such cases, the reporting entity would reflect the participating feature in EPS as a participation right.

Forward contracts

A provision in a forward contract to issue a reporting entity's own equity shares that reduces the contractual price per share when dividends are declared on the issuing entity's common stock is a participation right, because it results in a non-contingent transfer of value to the holder of the forward contract for dividends declared during the forward contract period.

Because a forward contract will be settled (i.e., it is not an option which could expire unexercised), the value transferred to the holder is not contingent. Thus, a forward contract in which the strike price is adjusted for dividends is a participating security, regardless of whether a dividend is declared during the period the contract is outstanding.

Variable share-settled instruments (such as FELINE PRIDES, ACES and DECS)

Certain equity-linked securities involve arrangements with variable settlement features, referred to as "variable share forwards," or "variable share forward delivery agreements." These instruments are marketed by financial institutions by different proprietary names (e.g., FELINE PRIDES, ACES, and DECS).

Variable share forward delivery arrangements differ from fixed-term forwards through which the holder will always receive the benefit of dividends if declared (i.e., the transfer of value is non-contingent). Under variable share forwards, the holder is required to pay a certain amount of money to the reporting entity at the settlement date, and either of the following will occur:

- If the reporting entity's stock price at settlement falls within the established range, commonly referred to as the "dead zone," there is no transfer of value, and the holder receives a variable number of shares of reporting entity stock with value equal to the contractual amount owed by the holder.

- If the reporting entity's stock price at settlement is above or below a certain range, the holder receives a fixed number of shares of reporting entity stock and realizes a benefit or loss.

The terms of these arrangements typically include a provision that, if the reporting entity declares a dividend on common stock while the arrangement is outstanding, the stock prices associated with the end points of the range, and the number of shares delivered when the stock price at settlement is outside of the range, are adjusted according to a formula. However, there is no adjustment to the number of shares delivered when the stock price at settlement is within the range.

Economically, these securities act as a combination of a written call option and a purchased put option, each with different strike prices. An adjustment to a potential common security, such as convertible debt or a warrant, is typically not considered a participation right because the value of the dividend is contingently received (i.e., only if the option is exercised). In contrast, an adjustment to a forward sale contract in which the holder will always receive the benefit of dividends if declared (i.e., there is always a transfer of value) is considered a participation right. The issuer of a variable share forward delivery agreement should determine whether any adjustment provisions included in its contract convey a contingent or a non-contingent transfer of value. Generally, a variable share forward delivery agreement is not considered a participating security provided:

- The agreement does not entitle the holder to participate in dividends if the final settlement is within the range; and

- At issuance, it is at least reasonably possible that the final settlement of the contract will be at a price within the range.

To determine whether it is reasonably possible for a particular variable share forward delivery agreement to settle at a price within the dead zone, the reporting entity may need to perform a quantitative evaluation that incorporates:

- The contractual terms of the agreement, including the method of adjusting for dividends and the maturity date,
- Volatility of the issuer's stock,
- Historical and expected dividends, and
- The width of the dead zone, and whether the issuer's stock price is inside or outside the dead zone at issuance.

We believe the assessment as to whether these variable share forward agreements constitute participating securities need only be performed at issuance of the instrument, or upon a subsequent modification.

Mandatorily redeemable common stock

Under ASC 480, *Distinguishing Liabilities from Equity*, mandatorily redeemable financial instruments are accounted for as a liability. If these instruments have a right to dividends declared on the common shares, they are considered a participating security. Therefore, in computing the numerator, reporting entities should deduct any amounts, including contractual (cumulative) dividends and participation rights (e.g., of senior securities) in undistributed earnings that are attributable to mandatorily redeemable financial instruments (regardless of form), unless those amounts have already been recognized as interest in the income statement.

7.4.2.6 Targeted stock

Some registrants issue classes of stock that they characterize as "targeted" or "tracking" stock. The dividend rates associated with these classes of stock differ and are based upon the earnings of a specific business unit, activity, or assets of the registrant. As such, they are subject to the two-class method of ASC 260.

Reporting entities with targeted stock should ensure they are compliant with the contractual terms of the arrangement as to how the reporting entity's overall earnings would be allocated to the different classes of stock, especially if there are inter-unit transactions that are eliminated in consolidation. The total amount of earnings attributable to all the classes of stock under the two-class method for EPS purposes should be equal to consolidated income. In addition, EPS with respect to any class of the reporting entity's securities should be presented only in the reporting entity's consolidated financial statements, or in its related consolidated information, as that is the entity that issued the stock, and not the targeted business.

7.4.3 Denominator

The denominator of the basic EPS computation starts with the weighted-average number of common shares outstanding.

Definition from ASC 260-10-20

Weighted-average number of common shares outstanding: The number of shares determined by relating the portion of time within a reporting period that common shares have been outstanding to the total time in that period. In computing diluted EPS, equivalent common shares are considered for all dilutive potential common shares.

The number of weighted-average common shares outstanding is the average of shares outstanding and assumed to be outstanding (e.g., contingently issuable shares when the contingency has been met). While a daily calculation would be the most precise, other averaging methods may be used as long as they produce reasonable results. As noted in ASC 260-10-55-2, methods that introduce artificial weighting are not acceptable. The reporting entity should weight shares issued and shares reacquired during the period for the portion of the period they were outstanding.

Figure 7-5

Impact of selected securities on the denominator of basic EPS

Contingent shares (FSP 7.4.3.1)	Not included in the basic EPS denominator until the contingency has been resolved
Restricted stock based compensation awards (FSP 7.4.3.2)	Not included in the basic EPS denominator until vested, unless vesting occurs upon retirement and the employee is retirement eligible
Employee stock options (FSP 7.4.3.3)	Not included in the basic EPS denominator
Mandatorily redeemable common stock (FSP 7.4.3.4)	Not included in the basic EPS denominator if the stock is liability classified under ASC 480
Forward contracts for a fixed number of shares (FSP 7.4.3.4)	Not included in the basic EPS denominator if the forward purchase contract requires physical settlement of a fixed number of shares in exchange for cash
Share lending arrangements (FSP 7.4.3.5)	Not included in the basic EPS denominator unless default of the share lending arrangement occurs
Employee stock purchase plans (ESPPs) (FSP 7.4.3.6)	Typically not included in the basic EPS denominator until the shares are actually purchased

7.4.3.1 *Contingent shares*

In accordance with ASC 260-10-45-12A, contingently issuable shares, including shares issuable for little or no consideration, are included in the denominator for basic EPS only when the contingent condition has been met and there is no longer a circumstance in which those shares would not be issued. For example, if the issuance of shares were subject to a shareholder vote, they would not be included in EPS until the vote occurs. The shares are included in the computation of basic EPS as of the date that all conditions have been satisfied (i.e., issuance of the shares is no longer contingent), even if the shares are not legally issued until a later date.

However, awards for which restrictions have lapsed, and shares to be issued to settle a deferred compensation obligation that may only be settled in shares (for example, Plan A in ASC 710-10-25-15), are included as outstanding shares for basic EPS. Outstanding common shares that are contingently returnable are treated in the same manner as contingently issuable shares.

7.4.3.2 *Restricted stock-based compensation awards*

Unvested restricted stock or restricted stock units are excluded from the denominator of basic EPS, because the employee has not yet earned the shares (i.e., there is still a further "payment" in the form of future employee services). While the shares may be considered legally issued and outstanding under the terms of the restricted stock agreement, they are not considered issued for accounting purposes. Once vested, the reporting entity includes the shares in basic EPS as of the vesting date, regardless of whether they have been legally issued.

Unvested restricted stock that immediately vests upon an employee's retirement is included in the denominator in the computation of basic EPS at the earlier of (1) the stated vesting date, or (2) the date the employee becomes eligible for retirement.

At the date the employee becomes eligible for retirement, any remaining stated vesting period is considered nonsubstantive because issuance of the shares is not dependent on any service after that date.

7.4.3.3 *Employee stock options*

Stock options are excluded from the basic EPS denominator because they are not considered outstanding shares. However, at the time the options are exercised, they are included in the denominator as outstanding shares.

Reporting entities should consider the substance, rather than the legal form, of all awards to determine the appropriate EPS treatment. For example, unvested stock options that allow the employee to "early exercise" but for which the reporting entity has the right to repurchase the shares at the exercise price (or the lesser of the current fair value or original exercise price) if the employee terminates employment prior to vesting should not be included in the basic EPS denominator prior to the stated vesting date. The shares issued upon early exercise are treated as contingently returnable pursuant to the guidance in ASC 260-10-45-13 and still subject to a substantive vesting period, and, therefore, should not be included in basic EPS.

Question 7-3

How should “penny warrants” be reflected in EPS?

PwC response

As noted in ASC 260-10-45-13, shares issuable for little to no consideration should be included in the number of outstanding shares used for basic EPS purposes. There is no guidance on what is considered “little to no” consideration, and whether this literature should be applied to unexercised warrants or options. In their proposed amendments to FAS 128 (the source of ASC 260) in 2008, the FASB proposed that warrants or options exercisable for nominal amounts be included in the denominator of basic EPS once there were no further vesting conditions or contingencies associated with them. The vesting conditions are relevant as future service is considered a form of “consideration.” Contingent shares are not included in basic EPS until the contingencies are resolved. While this guidance was never finalized, we believe that this is generally a reasonable approach to apply. Determination of what is considered a “nominal” exercise price would still require judgment, and would typically be assessed at the issuance (or grant) date of the instrument in relation to the stock price at that time.

7.4.3.4 Mandatorily redeemable common stock and common stock subject to forward purchase contracts requiring physical settlement

ASC 480-10-45-4 requires the following to be excluded from the denominator: (1) mandatorily redeemable shares of common stock requiring liability classification under ASC 480, and (2) shares of common stock subject to forward purchase contracts that require physical settlement of a fixed number of shares in exchange for cash.

With regard to forward purchase contracts that require settlement in a fixed number of shares, reporting entities should carefully assess the substance of the arrangement. In circumstances when two or more forward contracts, including one which is for a fixed number of shares, together act as a forward contract on a variable number of shares, the shares underlying the forward contract will be included in the denominator for basic EPS.

Forward contracts that do not meet the criteria above impact the computation of the diluted EPS denominator under the guidance in ASC 260-10-45-35. Refer to FSP 7.5.4.8 for details.

7.4.3.5 Share lending agreements

A reporting entity that is a convertible bond issuer may enter into a share lending agreement with an investment bank. A share lending agreement is intended to facilitate the ability of investors, primarily hedge funds, to borrow shares to hedge the conversion option in the convertible debt. They are often executed when the issuer’s stock is difficult or expensive to borrow in the conventional stock loan market.

Typically, share lending arrangements require the issuer to issue shares to the investment bank in exchange for a small fee, generally equal to the common stock’s par value and a promise by the investment bank to return the loaned shares to the issuer upon conversion or maturity of the convertible debt. The shares issued are legally outstanding, and are entitled to vote and receive dividends. However, under the terms of the arrangement, the investment bank may agree to reimburse the issuer for dividends received and may agree to not vote on any matters submitted to a vote of the reporting entity's stockholders.

ASC 470-20-45-2A states that loaned shares are excluded from EPS unless default of the share lending arrangement occurs, at which time the loaned shares would be included in the computation of basic EPS. If dividends on the loaned shares are not reimbursed to the reporting entity, the reporting entity would deduct any amounts, including contractual (accumulated) dividends and participation rights in undistributed earnings, attributable to the loaned shares from the numerator, in a manner consistent with the two-class method.

See FG 9.10.4 for a discussion of the recognition and measurement considerations of a share lending arrangement.

7.4.3.6 *Employee stock purchase plans (ESPPs)*

Many companies offer ESPPs in which employees have a specified amount of their pay withheld for purposes of purchasing the reporting entity's shares at a discount to the then current fair value. If employees can withdraw the amount of salary withheld during the offering period or must remain employed through the end of the offering period in order to purchase the shares, their continued participation in the plan is a contingency that can only be satisfied at the end of the offering period. Until then, the contingency has not been met, and shares calculated based on the employees' withholding and the ESPP's terms would not be included in the denominator of basic EPS. In such circumstances, the withholdings are a liability of the reporting entity that can be settled in cash or shares at the option of the employee. To be included in the basic EPS denominator, the shares have to be unequivocally issuable by the reporting entity.

If, however, the employee's participation is irrevocable (even if employment was to terminate), the employee has no ability to obtain a refund of the amounts withheld, and the number of shares is fixed, there is no contingency. The reporting entity has received cash and has an irrevocable obligation to issue the shares. Therefore, the reporting entity would include the shares in the computation of basic EPS based on the amounts withheld and the ESPP's purchase price formula.

In our experience, it is unusual for an ESPP to allow an employee to continue to participate in the plan after termination of employment; as a result, the employee is generally refunded any amounts withheld upon termination. Therefore, shares issuable under an ESPP are contingently issuable (i.e., based on continued employment) and will typically not be included in basic EPS until the shares are actually purchased.

7.5 *Diluted EPS*

Diluted EPS gives effect to all dilutive potential common shares outstanding during a period. The computation of diluted EPS is similar to the computation of basic EPS except that the denominator is increased to include the number of additional common shares that would have been outstanding if the dilutive potential common shares had been issued. The potential common shares are weighted for the period the instruments were outstanding (i.e., as of the beginning of the period or the date of issuance, if later).

In computing diluted EPS, reporting entities may have to adjust the numerator used in the basic EPS computation, subject to sequencing rules addressed in FSP 7.5.1, to make adjustments for any dividends and income or loss items associated with potentially dilutive securities that are assumed to have resulted in the issuance of common shares. ASC 260-10-55-32 indicates that these income or loss items should also include the fair value adjustments on instruments accounted for as liabilities, but which may be settled in shares that would result from the assumed issuance of potential common shares.

Because the numerator and denominator used for basic EPS are the starting point in computing diluted EPS, the concepts discussed in FSP 7.4 which address the computation of basic EPS remain relevant when computing diluted EPS.

Definition from ASC 260-10-20

Potential common stock: A security or other contract that may entitle its holder to obtain common stock during the reporting period or after the end of the reporting period.

This definition encompasses options, warrants, convertible securities, and contingent stock agreements.

Reporting entities should include dilutive instruments that are (1) issued, (2) expire unexercised, or (3) are cancelled during the period in the denominator of diluted EPS for the period they were outstanding.

Additionally, reporting entities should include dilutive instruments exercised during the period in the denominator of diluted EPS for the period prior to exercise. Thereafter, reporting entities include the actual shares issued in the denominator for both basic and diluted EPS.

7.5.1 Anti-dilution and sequencing – the control number concept

Computations of diluted EPS should generally not give effect to any individual class of potential common stock instrument for any period in which its inclusion would have the effect of increasing EPS (or decreasing the loss per share) otherwise computed (i.e., it is anti-dilutive).

Reporting entities use the control number concept to determine whether a potential common stock instrument is dilutive. The control number to be used is income/loss from continuing operations (adjusted for preferred dividends, as described in ASC 260-10-45-11). The control number concept requires that the same number of potentially dilutive securities applied in computing diluted EPS from continuing operations be applied to all other categories of income or loss, even if they would have an anti-dilutive effect on such categories.

For example, if a reporting entity were to report income from continuing operations, an extraordinary loss, and a net loss, the number of potential common shares used in the computation of diluted EPS from continuing operations would be used in determining diluted per share amounts of extraordinary loss and net loss, although this would result in reduced (or anti-dilutive) reported per share losses for those items.

In determining whether potential common shares are dilutive or anti-dilutive, the reporting entity should consider each issue or series of issues of potential common shares separately, rather than in the aggregate.

To reflect maximum potential dilution, the reporting entity should consider each issue or series of issues of potential common shares in sequence, from the most dilutive to the least dilutive (refer to Example 4 in ASC 260-10-55-57 through 55-59). That is, dilutive potential common shares with the lowest earnings per incremental share are included in diluted EPS before those with higher earnings per incremental share. It would not be appropriate to simply calculate the impact of all potential common shares in the aggregate to determine if the end result is dilutive to basic EPS (see Example 7-20).

7.5.2 Participating securities

Reporting entities should consider the effects of participating securities when computing diluted EPS. In some cases, the computation under the two-class method for basic EPS is more dilutive than the diluted EPS computation for these securities when the participating securities are convertible (e.g., many convertible participating preferred securities or unvested restricted stock entitled to non-forfeitable dividend rights).

In these cases, because of the "no anti-dilution" provision in ASC 260-10-45-17 through 45-20, conversion is not assumed. Rather, the allocation of earnings to participating security holders performed under the two-class method is followed. Therefore, the numerator is reduced for both basic and diluted EPS, and since the participating securities are not considered converted, the denominator is not adjusted.

The impact of participating securities on the calculation of diluted EPS for other types of potential common shares is discussed at FSP 7.5.7 and 7.5.8.

7.5.3 Contingently issuable shares

Shares (including those issued in connection with a business combination) whose issuance is contingent upon the satisfaction of certain conditions are considered outstanding and included in the computation of diluted EPS as follows:

- If all necessary conditions have been satisfied by the end of the period (the events have occurred), the shares are included as of the beginning of the period in which the conditions were satisfied (or as of the date of the contingent stock agreement, if later).

- If all necessary conditions have not been satisfied by the end of the period, the number of contingently issuable shares to be included in diluted EPS is based on the number of shares, if any, that would be issuable if the end of the reporting period were the end of the contingency period (e.g., the number of shares that would be issuable based on current period earnings or period-end market price), if the result is dilutive. These contingently-issuable shares are included in the denominator of diluted EPS as of the beginning of the period (or as of the date of the contingent stock agreement, if later).

General guidelines for the application of these principles for different types of contingencies are as follows:

- If attainment or maintenance of a specified amount of earnings is the condition, and if that amount has been attained, the additional shares are considered to be outstanding for the purpose of computing diluted EPS if their effect is dilutive. The diluted EPS computation should include those shares that would be issued under the conditions of the contract based on the assumption that the current amount of earnings will remain unchanged until the end of the agreement, but only if the effect would be dilutive. No projection of future results is made.

- The number of shares contingently issuable may depend on the market price of the stock at a future date. In that case, computations of diluted EPS should reflect the number of shares that would be issued based on the current market price at the end of the period being reported on, if their effect is dilutive. If the condition is based on an average of market prices over some period of time (e.g., a 10-day average of prices), the corresponding average for the period (i.e., the 10 days leading up to the period-end date) is used.

- If the number of shares contingently issuable depends on both future earnings and future prices of the shares, the determination of the number of shares included in diluted EPS must be based upon both conditions — that is, earnings to date and current market price — as they exist at the end of the reporting period. Unless both conditions are being met at the end of the reporting period, no contingently issuable shares are included in diluted EPS.

- If the contingency is based on a condition other than earnings or market price (for example, opening a certain number of retail stores), the contingent shares are included in the computation of diluted EPS based on the assumption that the current status of the condition will remain unchanged until the end of the contingency period.

- Each period is evaluated independently.

Outstanding common shares that are contingently returnable are treated in the same manner as contingently issuable shares.

Example 7-5 illustrates the treatment of a business combination earn-out provision in the computation of diluted EPS.

EXAMPLE 7-5

Impact of an earn-out based on earnings on diluted EPS when cumulative earnings fluctuate

An earn-out provision, payable in shares, for a 20X4 business combination, is based on cumulative earnings from the date of the business combination, January 1, 20X4, through December 31, 20X6.

The cumulative earnings target is first achieved in the 20X5 year-to-date fourth quarter results.

Because of a loss in the first quarter of 20X6, cumulative results do not meet the target at the end of that period.

What is the impact on the EPS computation?

Analysis

The shares are included in the denominator of diluted EPS from the beginning of the fourth quarter for 20X5. They are not included in diluted EPS before that time. However, because cumulative results do not meet the target at the end of the first quarter of 20X6, the shares are not included in that quarter's EPS computations and would not be included again until the earnings target is achieved. However, the prior year amounts are not revised.

For contingently issuable financial instruments other than shares, e.g., a contingently exercisable warrant, if the potential common shares may be assumed to be issuable based on the conditions specified for its issuance as described above, the impact on the computation of diluted EPS is determined by use of the treasury stock guidelines for options and warrants (see FSP 7.5.5.1), the if-converted method for convertible securities (see FSP 7.5.6), or the provisions for contracts that may be settled in stock or cash (see FSP 7.5.7.1), as appropriate.

Year-to-date computations for contingent shares

As noted in ASC 260-10-45-49, for year-to-date computations, contingent shares are included in diluted EPS on a weighted-average basis. That is, contingent shares are weighted for the interim periods in which they were included in the computation of diluted EPS. This methodology can result in a lack of comparability from quarter to quarter. Moreover, the sum of quarterly EPS data will not necessarily equal cumulative EPS data, and transactions considered dilutive or anti-dilutive in certain quarters may not be in other quarters. This is illustrated in ASC 260-10-55-50.

Example 7-6 illustrates the treatment of contingent shares in the year-to-date diluted EPS computation when the contingency is met during the year.

EXAMPLE 7-6

Impact of an earn-out on year-to-date diluted EPS

An earn-out provision, payable in shares, for a 20X4 business combination is based on cumulative earnings from the date of the business combination, January 1, 20X4, through December 31, 20X6.

The cumulative earnings target is first achieved in the 20X5 third quarter. There is no loss in a subsequent quarter.

What is the impact on the EPS computation?

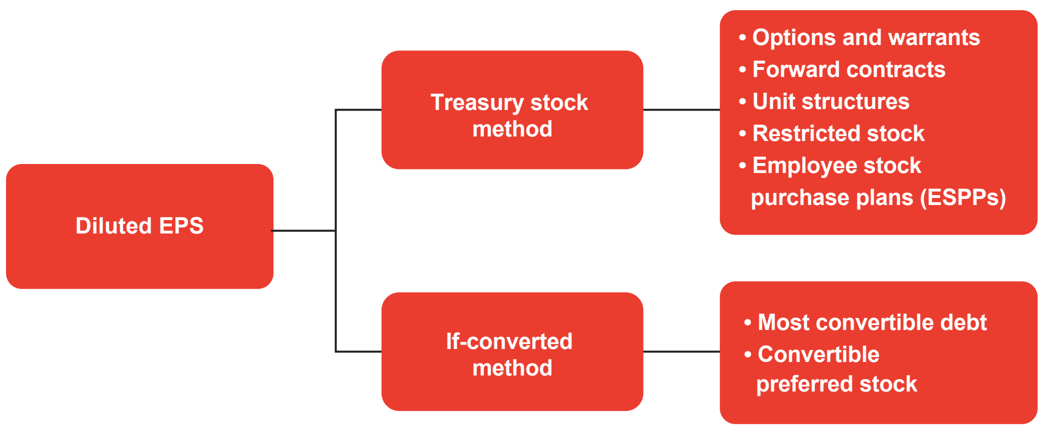
Analysis

In the year-to-date diluted EPS computation for 20X5, the shares associated with the earn-out are included as if issued on the first day of the third quarter (not the first day of the year) of 20X5 on a weighted-average basis. The shares are also included in the quarterly EPS computation for the third and fourth quarters of 20X5. As the earning target was not achieved at that time, the shares are not included in the quarterly or year-to-date EPS computations for either the first or second quarter of 20X5.

7.5.4 *Methods of incorporating potentially dilutive securities in diluted EPS*

The following figure summarizes which methods of including potentially dilutive securities in diluted EPS should be used for various securities.

Figure 7-6
Methods of incorporating potentially dilutive securities in diluted EPS



7.5.5 *Treasury stock method*

The treasury stock method considers the dilutive effect of issued, exercised, or expired options and warrants (and their equivalents) issued by a reporting entity in the computation of diluted EPS for the period they were outstanding. Equivalents include restricted stock, stock purchase contracts, and partially-paid stock subscriptions.

Definition from ASC 260-10-20

Treasury stock method: A method of recognizing the use of proceeds that could be obtained upon exercise of options and warrants in computing diluted EPS. It assumes that any proceeds would be used to purchase common stock at the average market price during the period.

Like other types of potential common stock, each issue or series of issues should be considered separately in determining whether potential common shares are dilutive or anti-dilutive.

7.5.5.1 Written options and warrants

Options and warrants that are equity-classified will be dilutive when the average market price of the common stock during the period exceeds the exercise price (i.e., they are "in-the-money"). Options and warrants that are liability-classified should be evaluated under the guidance in FSP 7.5.7.1 pertaining to instruments settleable in cash or shares when their presumed exercise would result in incremental common shares.

ASC 260-10-45-23 provides guidelines for applying the treasury stock method:

1. Assume exercise or settlement of the instrument at the later of the time of issuance or the beginning of the period

2. Assume the proceeds from exercise or settlement have been used to repurchase the reporting entity's common shares at their average market price during the period

3. Include the incremental shares (shares assumed to be issued less shares assumed to have been repurchased) in the denominator

Example 7-7 illustrates how to calculate the number of incremental shares that would result from the assumed exercise of options for purposes of computing diluted EPS.

EXAMPLE 7-7

Application of the treasury stock method for warrants on common stock

FSP Corp has outstanding warrants to issue 500,000 shares of its common stock with a strike price of $10 per share. These options are equity classified (i.e., derivative accounting under ASC 815 is not required) and can only be settled in shares.

The average market price of the common stock during the period is $20.

How should FSP Corp include the warrants in the diluted EPS computation for the period?

Analysis

FSP Corp should include the incremental shares in the denominator of diluted EPS using the treasury stock method. The incremental shares are calculated assuming the warrants are exercised at the beginning of the period, as follows:

Step 1: Calculate the assumed proceeds

Assumed proceeds = Number of options x strike price

$5,000,000 = 500,000 x $10/share

Step 2: Calculate the shares to be repurchased

Shares = Assumed proceeds / average market price

250,000 shares = $5,000,000 / $20/share

Step 3: Calculate the incremental shares assumed to be issued

Incremental shares = Common shares issued upon exercise of warrants – shares to be repurchased

250,000 shares = 500,000 shares – 250,000 shares

The assumed proceeds under the treasury stock method are calculated differently for stock-based compensation awards. See FSP 7.5.5.5.

If an option holder issues a nonrecourse note to the reporting entity to exercise the option, it is treated as if the option remains outstanding. Accordingly, the nonrecourse loan amount should be considered to be exercise proceeds in the application of the treasury stock method. If the option holder issues a recourse note to the reporting entity to exercise the option, the reporting entity should perform additional analysis to determine the substance of the arrangement. The relevant factors are more fully described in SC 1.7.9.

7.5.5.2 Purchased options

ASC 260-10-45-37 notes that purchased options (both purchased puts and calls) held by the reporting entity on its own stock should not be included in the denominator of diluted EPS because including them would be anti-dilutive. The put options would be exercised only when the exercise price is higher than the market price, and the call option would be exercised only when the exercise price is lower than the market price. In both instances, their effect would be anti-dilutive under the treasury stock method and the reverse treasury stock method, respectively. The reverse treasury stock method is addressed in FSP 7.5.5.8.

Reporting entities may enter into arrangements that include two contracts: (1) a separate purchased option, and (2) a written option. The changes in the value of the purchased option and written option may offset or hedge each other. We believe it would generally be inappropriate to combine the purchased option and the written option in the computation of EPS (this is consistent with pre-Codification FAS 128, paragraph 112 (*Basis for Conclusions*)), unless these transactions were otherwise combined for U.S. GAAP. Conversely, if the reporting entity entered into a single contract for a net purchased option (such as a "capped call option"), exclusion from the EPS computations would generally be appropriate.

See FSP 7.4.3.4 for a discussion of arrangements involving multiple legal contracts.

7.5.5.3 Options or warrants to purchase convertible securities

Written options or warrants to purchase convertible debt or preferred stock (that is classified as mezzanine equity) are liabilities under ASC 480-10-25-13.

Reporting entities should assume options or warrants to purchase convertible securities are exercised when the average prices of both the convertible security and the common stock obtainable upon its conversion are above the exercise price of the option or warrant.

However, reporting entities should not assume exercise unless they assume conversion of similar outstanding convertible securities, if any. After considering the anti-dilution sequencing rules, the reporting entity should determine the number of incremental shares of the convertible security (which will then be converted to common stock) using the treasury stock method similar to other options or warrants. There is no need to impute interest or dividends on the incremental shares, as these items would be reversed by the if-converted adjustments for the assumed conversions. See further discussion of conversion adjustments in FSP 7.5.6.

7.5.5.4 Unit structures

In a unit structure, a reporting entity issues debt to an investment bank, which will be remarketed to investors at a date in the future, and concurrently issues a forward sale contract on its own shares. A unit structure is economically similar to convertible debt; however, unlike convertible debt, the forward contract for the reporting entity's shares is legally detachable from the debt. Generally, the conversion option in convertible debt is not separable from the debt. Further, in the case of a unit structure, the debt often matures at a different (usually later) time than the forward contract does.

If the remarketing of the debt in the unit structure is successful, which is the expected outcome, the investor will use the cash received from the remarketing to settle the obligation under the forward. In the unlikely event of a failed remarketing of the debt, the debt is tendered by the holder as payment upon the exercise of the forward contract.

We believe the reporting entity should use the treasury stock method for the forward purchase contract to compute diluted EPS if the chances of a failed remarketing are remote. In applying the treasury stock method, the reporting entity should determine the number of shares to be issued based on the average stock price and the terms of the forward contract.

The reporting entity should review the assumptions leading to this conclusion at the end of each reporting period. If the chance of a failed remarketing of the debt is no longer remote, the unit structure is, in effect, convertible debt under ASC 260-10-55-9. In that case, the reporting entity should use the if-converted method to compute diluted EPS, because the debt will be tendered by the investor in satisfaction of the investor's obligation under the forward contract.

7.5.5.5 Stock-based compensation under the treasury stock method

The calculation of assumed proceeds under the treasury stock method for stock-based compensation awards requires additional considerations because the reporting entity can receive the benefit of future service and tax benefits upon exercise, which are considered additional proceeds.

The assumed proceeds under the treasury stock method include:

- The exercise price of the stock options, if any
- Average unrecognized compensation cost for future service
- Any windfall tax benefits that would be credited to APIC when the award generates a tax deduction

  Reporting entities should calculate the windfall tax benefit using the average stock price for the period. If there would be a charge to APIC (i.e., shortfall), such an amount would be a reduction of proceeds. Shortfalls that would be charged to income tax expense (i.e., because there is no pool of windfall tax benefits) should not be included as a reduction of proceeds.

Although compensation cost is recognized only for awards that are expected to vest (determined by applying the pre-vesting forfeiture rate assumption), all options and shares outstanding that have not been forfeited are included in diluted EPS. In other words, the amount of stock-based compensation cost in the numerator includes a forfeiture rate assumption, while the number of shares in the denominator does not.

See Example 7-8 for an illustration of the difference between the compensation cost recorded for share-based payment awards in the income statement and the amounts included in the assumed proceeds calculation.

When calculating the assumed proceeds under the treasury stock method, reporting entities should not include potential windfall tax benefits if the award does not ordinarily result in a tax deduction (e.g., an incentive stock option), or if the reporting entity does not believe it is more likely than not that such benefits will ultimately be realized.

This analysis should include consideration of the impact of ASC 718-740-25-10, which does not permit a reporting entity to record windfall tax benefits until the deduction reduces taxes payable (see SC 4.16 for further guidance) and consideration of future taxable income. Further, the reporting entity should elect the same approach for calculating the assumed proceeds as it does in evaluating the potential impact of ASC 718-740-25-10 (i.e., with-and-without or tax law ordering). Reporting entities should consider ASC 718-740-25-10 based on estimated annual taxable income.

ASC 718, *Compensation-Stock Compensation*, did not provide transition guidance (under the “long-form” and “short-cut” methods to calculate the historical pool of windfall tax benefits) for calculating the potential windfall tax benefit or shortfall under the treasury stock method for awards that were partially or fully vested as of the adoption date. If a reporting entity adopted ASC 718 under the modified prospective transition method, it would have made an accounting policy decision to calculate potential windfalls and shortfalls under the treasury stock method either: (1) including the impact of pro forma deferred tax assets (i.e., the “as if” windfall or shortfall), or (2) excluding the impact of pro forma deferred tax assets (i.e., the windfall or shortfall that would be recognized in the financial statements upon exercise of the award).

Applying the treasury stock method to in-the-money options could be anti-dilutive if the sum of the proceeds, including the unrecognized compensation and windfall tax benefits, exceeds the average stock price. In that case, those options would be excluded from the computation of diluted EPS. For example, if the average market price of the underlying stock was $12, an option with an exercise price of $10 (i.e., $2 in-the-money), average unrecognized compensation for the period of $4, and an estimated tax windfall of $1, would be anti-dilutive because the assumed proceeds of $15 ($10 +$4 + $1) is greater than the average market price of the underlying share of $12. As a result, these awards are excluded from the diluted EPS denominator.

Conversely, it is possible that applying the treasury stock method to out-of-the-money options could be dilutive as a result of including a potential tax shortfall in the calculation of assumed proceeds. However, the FAS 123(R) Resource Group reached a consensus that out-of-the-money options (i.e., based on a comparison of the strike price to the average stock price) should not be included in the computation of diluted EPS, even if the treasury stock method would result in the options having a dilutive effect. Because the dilutive effect of each award is determined individually rather than for all outstanding awards in the aggregate, reporting entities need to maintain detailed records of each award, including the amount of unrecognized compensation cost and tax attributes associated with each.

The conclusion that out-of-the-money options should not be included in the computation of diluted EPS should not be analogized to other instances. For example, the effects of potentially dilutive convertible debt would be included under the if-converted method, even if the conversion price is out-of-the-money.

It may also be possible to have “negative proceeds” when applying the treasury stock method (e.g., if the potential shortfall exceeds the sum of the exercise price and average unrecognized compensation expense). When the assumed proceeds are negative, the reporting entity cannot repurchase any common stock as a result of the exercise/vesting of the award. Therefore, all outstanding shares for the award would be included in diluted EPS. We do not believe it would be appropriate to assume a hypothetical “sale of common stock” equal to the negative value of the assumed proceeds for the award such that the number of shares included in diluted EPS exceeds the total number of shares issuable under the award.

Stock options

Stock options with service conditions are included in the computation of the denominator of diluted EPS using the treasury stock method if the option is dilutive. In computing diluted EPS, reporting entities should include all outstanding options that are dilutive, without considering the impact of a forfeiture-rate assumption applied for purposes of recognizing compensation cost under ASC 718.

Reporting entities should include stock options with performance or market conditions in the computation of diluted EPS if the options are dilutive and if their conditions (1) have been satisfied at the reporting date (the events have occurred), or (2) would have been satisfied if the reporting date was the end of the contingency period (for example, the number of shares that would be issuable based on current period earnings or period-end market price). When making the determination, a reporting entity should not use projections that look beyond the current reporting period. In essence, it should follow the contingently issuable share guidance described in FSP 7.5.3.

For example, assume that a stock option has a performance condition under which the option vests when earnings before interest, taxes, depreciation, and amortization (EBITDA) reaches $15 million. At the end of the third quarter, EBITDA is $13 million and the company believes that EBITDA will be $17 million at the end of the year. The option would be excluded from the third quarter diluted EPS computation because the performance condition had not been achieved as of the end of that period, as required by ASC 260-10-45-51.

If the performance or market condition was satisfied, or would have been satisfied if the performance or market metric was measured as of the reporting date, the stock options would be included in diluted EPS from the beginning of the period (or date of grant, if later) using the treasury stock method if the option is dilutive.

Stock options often contain both performance and market conditions. If the award vests if either the performance or market condition is met, then assuming the options are dilutive, the award would be included in the computation of diluted EPS if either condition has been satisfied at the reporting date or would have been satisfied if the reporting date was the end of the contingency period. If both conditions must be met in order to vest, the award would be included in the computation of diluted EPS if the options are dilutive and both conditions have been satisfied at the reporting date or would have been satisfied if the reporting date was the end of the contingency period.

The accounting treatment for options with performance conditions under ASC 718 requires a probability assessment as to whether the option will vest; the accounting treatment under ASC 260 does not call for an assessment of the probability of vesting. Therefore, the numerator in the EPS computations may include compensation cost related to the performance awards, but the performance awards themselves may be excluded from the denominator.

The following examples illustrate the impact of stock options granted to employees on the computation of diluted EPS.

EXAMPLE 7-8

Stock option with a service condition and windfall tax benefits

Ten thousand nonqualified stock options were granted on January 1, 20X4, with an exercise price of $10. Each stock option has a $4 fair value at the grant date. 25% of the shares vest each year over a four-year period. The employee must be employed by the reporting entity on each vesting date to become vested in each tranche.

The reporting entity has elected a policy of straight-line attribution of compensation cost. The assumed forfeiture rate is 5% each year. No options were forfeited during 20X4.

The market price of the common stock is: $10 on January 1, 20X4; $26 on December 31, 20X4; $18 average for 20X4.

Applicable tax rate is 40% for all periods. In each year, there is sufficient taxable income such that the company realizes any windfall tax benefits generated from the exercise of an award.

Treasury stock computation:

The treasury stock calculations use actual forfeitures rather than the forfeiture assumption used for compensation cost recognition purposes. The results of the calculations are hypothetical for EPS purposes and would not agree to the financial statement amounts. The calculations are only used to determine the number of options to include in the diluted EPS computation.

- Hypothetical total book compensation expense = $40,000

  $4 (fair value per option on grant date) multiplied by 10,000 (options outstanding)

- Hypothetical expense will be recognized ratably over four years ($10,000 per year)

- Hypothetical unrecognized compensation expense at December 31, 20X4 = $30,000

  $40,000 (hypothetical total book compensation cost) minus $10,000 (hypothetical book compensation cost recognized in 2014)

- Hypothetical future total deferred tax asset = $16,000

  $40,000 (total stock-based compensation expense for all outstanding options) multiplied by 40% applicable tax rate

How many potential common shares should be included in diluted EPS for the year ended December 31, 20X4 for these stock options, assuming the shares are dilutive at the end of 20X4?

Analysis

The options are included in the diluted EPS computation by applying the treasury stock method and assuming that the proceeds will be used to buy back shares. Proceeds equal the hypothetical average unrecognized compensation, plus exercise price and hypothetical windfall tax benefits (or a reduction for shortfalls that would be credited to APIC).

- Hypothetical average unrecognized compensation expense for 20X4 = $35,000

  Average of $40,000 (hypothetical unrecognized compensation expense at January 1, 20X4) and $30,000 (hypothetical unrecognized compensation at December 31, 20X4)

- Hypothetical tax benefit at December 31, 20X4 = $32,000

  10,000 shares (options assumed exercised) multiplied by ($18 (20X4 average stock price) less $10 (exercise price)) multiplied by 40% (applicable tax rate)

- Hypothetical windfall tax benefit = $16,000

  $32,000 (hypothetical tax benefit) less $16,000 (hypothetical deferred tax asset once all compensation expense has been recorded)

- Assumed proceeds = $151,000

  $100,000 (exercise price) plus $35,000 (hypothetical average unrecognized compensation) and $16,000 (hypothetical windfall tax benefit)

- Shares assumed repurchased = 8,389 shares

  $151,000 (assumed proceeds) divided by $18 (20X4 average stock price)

- Incremental shares to be included in the December 31, 20X4 diluted EPS computation = 1,611 shares

  10,000 (shares issuable upon exercise) minus 8,389 (shares assumed repurchased)

EXAMPLE 7-9

Stock option with a service condition and a tax shortfall

All of the assumptions are the same as in Example 7-8 except:

The market price of the reporting entity's common stock is: $10 on January 1, 20X4; $17 on December 31, 20X4; $13.50 average for 20X4.

The reporting entity's pool of windfall tax benefits as of December 31, 20X4, is $1,500.

How many potential common shares are included in diluted EPS for the year ended December 31, 20X4 for these stock options, assuming the shares are dilutive at the end of 20X4?

Analysis

The options are included in the diluted EPS computation by applying the treasury stock method and assuming that the proceeds will be used to buy back shares. Proceeds equal the hypothetical average unrecognized compensation plus exercise price and hypothetical windfall tax benefits (or a reduction for shortfalls that would be credited to APIC).

- Hypothetical average unrecognized compensation expense for 20X4 = $35,000

  Average of $40,000 (hypothetical unrecognized compensation expense at January 1, 20X4) and $30,000 (hypothetical unrecognized compensation at December 31, 20X4)

- Hypothetical tax benefit at December 31, 20X4 = $14,000

  10,000 shares (options assumed exercised) multiplied by ($13.50 (20X4 average stock price) less $10 (exercise price)) multiplied by 40% (applicable tax rate)

- Hypothetical shortfall charged to APIC = $1,500

  $14,000 (hypothetical tax benefit) less $16,000 (hypothetical deferred tax asset once all compensation expense has been recorded) = $2,000 total hypothetical shortfall

  The reporting entity should assess whether the shortfall would be recorded as a reduction of APIC based on the reporting entity's current pool of windfall tax benefits. Since the reporting entity's pool of windfall tax benefits is only $1,500, $500 of the hypothetical shortfall would be recognized in income tax expense. Therefore, only $1,500 of the hypothetical shortfall is included as a reduction of assumed proceeds.

- Assumed proceeds = $133,500

  $100,000 (exercise price) plus $35,000 (hypothetical average unrecognized compensation) less $1,500 (hypothetical shortfall charged to APIC)

- Shares assumed repurchased = 9,889 shares

  $133,500 (assumed proceeds) divided by $13.50 (20X4 average stock price)

- Incremental shares to be included in the December 31, 20X4, diluted EPS computation = 111 shares

  10,000 (shares issuable upon exercise) minus 9,889 (shares assumed repurchased)

Restricted stock

A reporting entity should include both of the following in its computation of diluted EPS using the treasury stock method:

- Unvested restricted stock with service conditions

- Unvested restricted stock with a performance or market condition that is considered contingently issuable shares pursuant to ASC 260-10-45-48

Assumed proceeds under the treasury stock method would include unamortized compensation cost and potential windfall tax benefits or shortfalls. If dilutive, the unvested restricted stock would be considered outstanding as of the later of the beginning of the period or the grant date for diluted EPS computation purposes. If anti-dilutive, the reporting entity would exclude it from the diluted EPS computation.

The following examples illustrate the impact of restricted stock granted to employees on the computation of diluted EPS.

EXAMPLE 7-10

Restricted stock with a service condition and an IRC Section 83(b) election

Ten thousand shares of restricted stock are granted on January 1, 20X4. The shares are legally issued and outstanding, and the employee is not required to pay for the restricted stock. Ten thousand shares are expected to and actually vest.

Twenty-five percent of the shares vest each year over a four-year period. The employee must be employed by the reporting entity on each vesting date to become vested in each tranche. The company has elected a policy of straight-line attribution.

The market price of the common stock is: $10 on January 1, 20X4; $20 on December 31, 20X4; $15 average for 20X4.

The tax deduction will equal book compensation cost because the employee made an IRC Section 83(b) election for tax purposes and thus will be taxed based on the grant-date fair value of the restricted stock (i.e., there will not be a windfall tax benefit upon settlement of the award).

Applicable tax rate is 40% for all periods.

In each year, there is sufficient taxable income so the reporting entity realizes any tax benefits generated.

Expense computation:

- Total book compensation cost = $100,000

  $10 (fair value per share on January 1, 20X4) multiplied by 10,000 shares

- Compensation cost will be expensed ratably over four years ($25,000 per year)

- Unrecognized compensation expense at December 31, 20X4, is $75,000

  ($100,000 minus $25,000)

How many shares are included in diluted EPS for the year ended December 31, 20X4, assuming the shares are dilutive at the end of 20X4?

Analysis

The unvested shares are included in the diluted EPS computation by applying the treasury stock method and assuming that the proceeds will be used to buy back shares. Proceeds equal the average unrecognized compensation plus any purchase price and windfall tax benefits.

- Average unrecognized compensation for 20X4 = $87,500

  Average of $100,000 (unrecognized compensation at January 1, 20X4) and $75,000 (unrecognized compensation at December 31, 20X4)

- There are no assumed proceeds from exercise (because the employee is not required to pay for the restricted stock) or windfall tax benefits (because of the IRC Section 83(b) election)

- Assumed repurchase = 5,833 shares

  $87,500 (assumed proceeds) divided by $15 (20X4 average stock price)

- Incremental shares to be included in the December 31, 20X4, diluted EPS computation = 4,167 shares

  10,000 (unvested shares outstanding) minus 5,833 shares (assumed repurchased)

EXAMPLE 7-11

Restricted stock with a service condition and windfall tax benefits

All of the assumptions are the same as in Example 7-10, except the employee did not make an IRC Section 83(b) election.

How many shares are included in diluted EPS for the year ended December 31, 20X4 assuming the shares are dilutive at the end of 20X4?

Analysis

- Average unrecognized compensation for 20X4 = $87,500

  Average of $100,000 (unrecognized compensation at January 1, 20X4) and $75,000 (unrecognized compensation at December 31, 20X4)

- There are no assumed proceeds from exercise price because the employee is not required to pay for the restricted stock

- Deferred tax asset once all compensation expense has been recorded = $40,000

  10,000 unvested shares outstanding multiplied by $10 grant date fair value multiplied by 40% applicable tax rate

- Potential windfall tax benefit = $20,000

  (10,000 unvested shares outstanding multiplied by $15 average stock price multiplied by 40% tax rate) less $40,000 (deferred tax asset once all compensation expense has been recorded)

- Assumed proceeds = $107,500

  $20,000 (potential windfall tax benefit) plus $87,500 (average unrecognized compensation)

- Assumed repurchase = 7,166 shares

  $107,500 (assumed proceeds) divided by $15 (20X4 average stock price)

- Incremental shares to be included in the December 31, 20X4 diluted EPS computation = 2,834 shares

  10,000 shares (unvested shares outstanding) minus 7,166 shares (assumed repurchased)

EXAMPLE 7-12

Restricted stock with a performance condition and an IRC Section 83(b) election

All of the assumptions are the same as in Example 7-10, except that the vesting provision now includes a performance condition that requires the reporting entity's revenues to exceed $100 million in 20X4; $115 million in 20X5; $130 million in 20X6; and $145 million in 20X7 for the respective year's award to vest.

The requirements for a grant date are met on January 1, 20X4, for all tranches.

Each tranche is based on performance within that year; therefore, each tranche is treated as a separate award with a service inception date of January 1 of each year and a one-year requisite service period.

The reporting entity recognizes compensation cost for each tranche over the respective one-year requisite service period if it is probable that the target established for that year will be met.

Revenues for the year ended December 31, 20X4 were $120 million.

How many shares are included in diluted EPS for the year ended December 31, 20X4, assuming the shares are dilutive at the end of 20X4?

Analysis

Using the treasury stock method, the diluted EPS computation would reflect the number of shares that would be issued based on the assumption that the current amount of revenue achieved will remain unchanged through the end of the performance period.

Revenues for 20X4 were $120 million. Therefore, the 20X4 performance condition for revenues exceeding $100 million has been satisfied at the reporting date, and the 20X5 performance condition for revenues exceeding $115 million would have been satisfied if the reporting date was the end of the contingency period.

The performance conditions for 20X6 and 20X7 would not have been satisfied by revenue of $120 million. Therefore, 5,000 shares (20X4 and 20X5 tranches) are included in the diluted EPS computation process. The 20X6 and 20X7 tranches are not included.

- Average unrecognized compensation for 20X4 = $37,500

  Average of $50,000 (unrecognized compensation at January 1, 20X4, related to shares for which achievement of the performance condition is assumed) and $25,000 (unrecognized compensation at December 31, 20X4, related to shares for which achievement of the performance condition is assumed)

The unrecognized compensation related to shares for which achievement of the performance condition is assumed includes unrecognized compensation for shares related to the 20X4 and 20X5 performance goals ($25,000 in compensation cost per tranche multiplied by 2 tranches for which achievement of the performance condition is assumed). The unrecognized compensation related to the 20X6 and 20X7 performance goals is excluded because it is assumed those performance goals will not be met.

- There are no assumed proceeds from exercise or windfall tax benefits (because of the IRC Section 83(b) election)

- Assumed repurchase = 2,500 shares

  $37,500 (assumed proceeds) divided by $15 (20X4 average stock price).

- Incremental shares to be included in the December 31, 20X4, diluted EPS computation = 2,500 shares

  5,000 (unvested shares outstanding for which achievement of the performance condition is assumed) minus 2,500 shares (assumed repurchased)

EXAMPLE 7-13

Restricted stock with a market condition and an IRC Section 83(b) election

All of the assumptions are the same as in Example 7-10, except that the vesting provision is a market condition that all of the restricted stock will cliff vest if the stock price is higher than $18 on December 31, 20X7, and the recipient is still employed at that date. Each share of restricted stock has an $8 fair value on the grant date; the effect of the market condition is reflected (i.e., discounted) in the award's fair value.

The market price of the underlying stock is $20 on December 31, 20X4.

Expense computations:

- Total book compensation cost = $80,000

  $8 (fair value per share on January 1, 20X4) multiplied by 10,000 shares

- Expense will be recognized ratably over four years ($20,000 per year)

- Unearned compensation at December 31, 20X4, is $60,000

  $80,000 minus $20,000

How many shares are included in diluted EPS for the year ended December 31, 20X4, assuming the shares are dilutive at the end of 20X4?

Analysis

Using the treasury stock method, the diluted EPS computation should reflect the number of shares that would be issued based on comparing the market price at the end of the period to the market condition metric. Because the stock price at the end of 20x4 is higher than the threshold price, all of the restricted shares are included in the calculation.

- Average unrecognized compensation for 20X4 = $70,000

  Average of $80,000 (unrecognized compensation at January 1, 20X4) and $60,000 (unrecognized compensation at December 31, 20X4)

- There are no assumed proceeds from exercise or windfall tax benefits (because of the IRC Section 83(b) election)

- Assumed repurchase = 4,666 shares

  $70,000 (assumed proceeds) divided by $15 (20X4 average stock price)

- Incremental shares to be included in December 31, 20X4, diluted EPS computation = 5,334 shares

  10,000 (unvested shares outstanding) minus 4,666 shares (assumed repurchased)

If the stock price were below $18 at the end of 20X4, which is less than the threshold price, then none of the restricted shares would be included in the diluted EPS computation.

Stock award modifications

In computing diluted EPS, a reporting entity should treat the modification of a share-based award as if there was a cancellation and new issuance of an award. This includes modifications that are made in conjunction with an equity restructuring, such as a spin-off or large cash dividend.

Consistent with the approach described in ASC 260-10-45-26, the reporting entity should treat the "before" and "after" awards (i.e., the original and the modified awards) separately and include each for the weighted average period that each was outstanding.

Therefore, the reporting entity will perform two treasury stock method calculations.

- Based on the terms of the award and the average stock price for the period prior to the modification (weighted for the appropriate period)

- Based on the terms of the award and the average stock price for the period after the modification (weighted for the appropriate period)

The sum of the two calculations will equal the number of incremental shares to be included in the diluted EPS computation. The reporting entity does the "as if" cancellation and reissuance for any share-based payment award whose terms have changed.

Employee stock purchase plans (ESPPs)

Under ASC 718, ESPPs are treated as options which are granted at the start of the offering period. Similarly, ESPPs are considered options to be included in diluted EPS using the treasury stock method because granting an employee the ability to purchase stock at a defined price through an ESPP is very similar to a conventional employee stock option with a vesting period. Both awards give the employee the ability to purchase reporting entity stock in the future at a potentially discounted price. Accordingly, an ESPP represents potential common shares that reporting entities should include in the denominator for the computation of diluted EPS. The same is true for non-compensatory ESPPs, except there would be no unrecognized compensation expense included in assumed proceeds under the treasury stock method.

Because the vesting of an ESPP is typically based on service, not performance, reporting entities should consider the plan in the denominator for EPS purposes from the start date of the offering period. The fact that employees have amounts withheld from their paychecks to pay for the shares over time is a funding mechanism for the ultimate payment of the exercise price; it does not change the nature of the potentially dilutive option arrangement.

At each reporting date during the offering period, reporting entities should apply the guidance in ASC 260-10-45-48 through 45-52 for contingently issuable shares, and ASC 260-10-45-22 through 45-26 for the treasury stock method. Under this guidance, the number of incremental potential common shares included in diluted EPS is based on the number of shares that would be issuable if the reporting date were the end of the contingency period, net of the hypothetical shares that could be repurchased under the treasury stock method.

The employees' withholding elections at period-end, the stock price at the beginning of the offering period and at the reporting date, and the purchase price formula for the ESPP will determine the number of shares issuable under the plan, consistent with ASC 260-10-45-52, for market price contingencies. Therefore, if the plan requires the purchase price to be the lesser of the beginning or ending stock price in the offering period, the reporting entity would compare the stock price at the beginning of the offering period to the stock price at the reporting date and use the lower of those two stock prices in the calculation of purchase price.

The reporting entity should calculate the assumed proceeds under the treasury stock method based on the sum of (1) the cash assumed to be received over the course of the offering period, and (2) the average unrecognized compensation expense related to the ESPP during the period.

There should typically be no income tax effects for the shares issued because ESPPs generally are qualified plans for tax purposes and are not expected to result in a tax deduction for the reporting entity. Disqualifying dispositions should not be recognized until they occur and, therefore, no deferred tax assets are recognized for qualified plans. The reporting entity would divide the total assumed proceeds by the average stock price for the reporting period to determine the hypothetical number of shares that can be repurchased under the treasury stock method.

In calculating the dilutive effect of an ESPP on EPS, reporting entities should base the number of shares issued on the aggregate expected amount of withholdings during the entire offering period, rather than only the withholding amount received up to the reporting date. Reporting entities should consider the entire offering period because the ESPP is treated as an option for both accounting and EPS purposes. Accordingly, reporting entities should consider all amounts to be withheld from employees to purchase shares under the plan, both current withholdings and expected withholdings, part of the assumed proceeds under the treasury stock method for EPS.

Because the amount withheld from employees is recorded by the reporting entity as a liability (as it belongs to the employees until the offering period has ended), it is not considered a prepayment of the purchase price of the shares for EPS purposes and therefore, continues to be included in the assumed proceeds for the treasury stock method calculation.

At the beginning of the ESPP offering period, management can determine, based on the employees' withholding elections and the current stock price, how many shares of stock will eventually be purchased, assuming that the employees continue their employment through the offering period. Changes to employee withholding elections are considered modifications for EPS purposes, and are reflected in EPS on a prospective basis.

Accordingly, in order to determine the ESPP's impact on EPS, the reporting entity should:

- Assess employment status and employee participation as of the reporting date to ensure that employees' elections are appropriately considered in the computation

- Determine the exercise price by utilizing the stock price as of the beginning of the offering period, the stock price at the reporting date, and the purchase price formula defined in the ESPP

- Project total withholdings over the course of the offering period

- Calculate the number of shares to be issued under the ESPP and hypothetical repurchases under the treasury stock method (considering total expected withholdings and average unrecognized compensation expense as assumed proceeds)

Example 7-14 illustrates the computation of diluted EPS for an ESPP.

EXAMPLE 7-14

Impact on EPS of an employee stock purchase plan

The ESPP begins its six-month offering period on September 1, 20X4, which ends on February 28, 20X5.

The ESPP allows employees to elect to withhold a certain amount of their salary (up to 15%) to purchase the reporting entity's stock at a discounted price.

The ESPP provides for shares to be purchased at 85% of the lesser of the stock price at the beginning or end of the offering period (i.e., a look-back option) and is considered compensatory. Since the plan is compensatory, the reporting entity recognizes compensation cost for the ESPP.

Employees are allowed to withdraw from the ESPP at any time during the offering period, are required to withdraw if terminated, and upon withdrawal will be reimbursed any amount withheld.

The ESPP is a qualified plan under Section 423 of the Internal Revenue Code. Therefore, no windfall tax benefits are assumed for purposes of applying the treasury stock method.

The stock price on September 1, 20X4, the beginning of the six-month offering period, is $25. After applying the ESPP's discount, the formula price would be $21.25 ($25 × 85% = $21.25).

The stock price on December 31, 20X4, the reporting date, is $20. After applying the ESPP's discount, the formula price would be $17 ($20 × 85% = $17).

Employee withholdings at December 31, 20X4, total $4,500,000. Expected withholdings for the remaining offering period, based on current employee elections, is $2,300,000. Therefore, the expected total withholdings are $6,800,000.

Average stock price during the period from September 1 to December 31, 20X4, is $22.

Average unrecognized compensation expense during the period from September 1 to December 31, 20X4 = $1,650,000.

How many shares are included in diluted EPS for the year ended December 31, 20X4, assuming the shares are dilutive at the end of 20X4?

Analysis

The number of shares projected to be issued at December 31, 20X4 under the ESPP = 400,000

$6,800,000 (expected total withholding amount) divided by $17 (purchase price per share determined by the ESPP purchase price formula).

The formula price of $17 per share on the reporting date is used because the ESPP contains a look-back option and this price is lower than the formula price at the beginning of the offering period. If the stock price on the reporting date was greater than the stock price at the beginning of the offering period, the reporting entity would have used the formula price at the beginning of the offering period to calculate the shares projected to be issued due to the look-back option.

Total assumed proceeds = $8,450,000

$6,800,000 (expected total withholding amount) plus $1,650,000 (average unrecognized compensation expense during the reporting period).

There are no assumed proceeds from windfall tax benefits because the ESPP is a qualified plan.

Shares assumed repurchased = 384,091 shares

$8,450,000 (assumed proceeds) divided by $22 (average stock price)

Incremental shares to be included in the December 31, 20X4 diluted EPS computation = 5,303 shares

[400,000 (gross number of shares to issue under the ESPP) minus 384,091 shares (assumed repurchased)] x 4 / 12 (ESPP is outstanding for 4 of 12 months in 20X4)

Because most ESPPs provide for the purchase of shares at a discount to the market price, there is typically a dilutive effect on EPS. However, the inclusion of unrecognized compensation expense in the calculation of assumed proceeds tends to mitigate the impact, particularly in the earlier portions of the offering period. Once there is an obligation to issue shares (on March 1 in the above example), the shares would be included in basic EPS on a prospective basis. During the quarter ending March 31, along with being included in basic EPS for the one month from March 1 to March 31, the ESPP would also affect diluted EPS on a weighted average basis for the period from January 1 to February 28.

Stock-appreciation rights

A stock-appreciation right (SAR) is a contract that gives the employee the right to receive an amount of stock that equals the appreciation in a company's stock from an award's grant date to the exercise date. SARs generally do not involve payment of an exercise price and may be settled in cash or in stock.

If a SAR will be settled in cash, the only effect the cash-settled SAR would have on the numerator is through the recognition of compensation cost in net income.

If a SAR will be settled in stock, it will be included in the computation of diluted EPS (if the award is dilutive) based on the net number of shares issuable using the average stock price for the period. Because an employee typically does not pay to exercise a stock-settled SAR, only unrecognized compensation expense and any windfall tax benefits or shortfalls are considered proceeds when calculating the dilutive effect under the treasury stock method.

If the reporting entity or the employee can decide whether a SAR will be settled in cash or in stock, refer to FSP 7.5.6.1 for the appropriate EPS treatment.

Some cash and share-settled SARs may be treated differently for determining the classification of an award and related compensation cost to be recorded, and for EPS purposes. For example, a SAR that provides the employee with the choice of settlement method is a liability-classified award; however, EPS will be computed on the assumption that the award will be settled in shares because it is more dilutive. In accordance with ASC 260-10-55-33, the reporting entity should not adjust the numerator in that situation.

7.5.5.6 Market prices used in the treasury stock method

In applying the treasury stock method, a simple average of market prices usually will be adequate. As noted in ASC 260-10-55-5, closing market prices are generally adequate for use in computing the average market price. When prices fluctuate widely, however, an average of the high and low price usually would be more representative. A reporting entity should consistently apply the method used to compute the average market price, unless it is no longer representative because of changed conditions.

When market prices are unavailable (e.g., the pre-IPO period for a reporting entity going public, or a reporting entity that has been delisted) for periods presented in the financial statements, management should use its best estimate of the fair value of the entity's shares during the period. Management's determination of fair value of its shares should be consistent with the fair values and assumptions used in the calculation of the reporting entity's stock compensation expense and disclosures.

7.5.5.7 Year-to-date computations in the treasury stock method

Earnings per share for a quarter should be based on the weighted average number of shares of common stock and dilutive potential common shares outstanding during that quarter, rather than calculated as the difference between year-to-date earnings per share and cumulative earnings per share for previous quarters of the fiscal year. When performing year-to-date computations for the treasury stock method, the reporting entity does not perform the year-to-date computation independently using the whole year as the averaging period; rather, it is an average of the quarters' weighted average incremental shares under the treasury stock method.

Excerpt from ASC 260-10-55-3

For the purpose of determining the weighted average number of shares in applying the treasury stock method to year-to-date computations:

The number of incremental shares to be included in the denominator shall be determined by computing a year-to-date weighted average of the number of incremental shares included in each quarterly diluted EPS computation.

However, in computing year-to-date diluted EPS, reporting entities should use year-to-date income (or loss) from continuing operations as the basis for determining whether or not dilutive potential common shares not included (or included) in one or more quarterly computations of diluted EPS are included in the year-to-date computation.

For example, if a reporting entity had a year-to-date loss from continuing operations that included quarters with income, any incremental shares included in the quarters with income would not be included in the denominator for the year-to-date diluted EPS computation, and vice versa.

Disclosure in the annual report of the quarterly per share data required by S-K 302 should reflect the average shares outstanding during each particular quarter. If the sum of such quarterly EPS amounts differs significantly from annual EPS, the reason for the difference should be explained in a note to the quarterly financial data included in the annual report.

See ASC 260-10-55-3A, Example 1 in ASC 260-10-55-38 through 50, and Example 12 in ASC 260-10-55-85 for an illustration of this concept.

7.5.5.8 Modifications to use of the treasury stock method

Options or warrants may permit or require the holder of the option to tender debt or other securities of the issuer (or its subsidiary or parent) in payment of all or a portion of the exercise price.

In computing diluted EPS, the reporting entity assumes (1) those options or warrants are exercised, and (2) the debt or other securities is tendered (this is, effectively, the if-converted method which is discussed in FSP 7.5.5). The reporting entity adds back interest (net of tax) on any debt assumed to be tendered to the numerator and also adjusts the numerator for any nondiscretionary adjustments based on income (net of tax), such as profit-sharing and royalty agreements.

If tendering cash, however, would be more advantageous to the option or warrant holder, and the contract permits tendering cash, the reporting entity should apply the treasury stock method.

The terms of certain options or warrants may require that proceeds received from their exercise be applied to retire debt or other securities of the issuer (or its parent or subsidiary). In computing diluted EPS, the reporting entity assumes those options or warrants are exercised and the proceeds applied to purchase the debt at its average market price rather than to purchase common stock under the treasury stock method. In doing so, it should add back interest, net of tax, on any debt assumed to be repurchased to income available to common stockholders. It also adjusts the numerator for any nondiscretionary adjustments based on income (net of tax). However, the reporting entity should apply the treasury stock method for excess proceeds received from the assumed exercise (i.e., proceeds received on exercise exceed the amount of debt retired).

Convertible securities that permit or require the payment of cash by their holder at conversion are deemed to be warrants. In computing diluted EPS, the reporting entity applies the proceeds assumed to be received to purchase common stock using the treasury stock method, and assumes the convertible security is converted under the if-converted method.

Written put options and use of reverse treasury stock method

Contracts that require the reporting entity to repurchase its own stock (such as written put options and forward purchase contracts) are reflected in the computation of diluted EPS if their effect is dilutive.

If, during the reporting period, the exercise price of these contracts is above the average market price for that period (i.e., they are "in-the-money"), reporting entities should compute their dilutive effect using the "reverse treasury stock" method. Under that method:

- Assume issuance of sufficient common shares at the beginning of the reporting period (at the average market price during the period) to raise enough proceeds to satisfy the contract.
- Assume the proceeds from issuance are used to satisfy the contract (i.e., "buy back" the shares).
- Include the incremental shares (the difference between the number of shares assumed to have been issued and the number of shares assumed to have been repurchased) in the denominator.

See FSP 7.4.3.4 for a discussion of physically-settled forward purchase contracts for a fixed number of shares under ASC 480. If the contract is required to be carried at fair value with changes recorded in net income under other U.S. GAAP (as is frequently the case for written put options), then reporting entities should also consider the guidance in FSP 7.5.7.1 regarding numerator adjustments when determining the EPS impact.

Example 7-15 illustrates the application of the reverse treasury stock method to written put options.

EXAMPLE 7-15

Reverse treasury stock method

FSP Corp sells a put option that allows the investor to sell 100 shares to FSP Corp at an exercise price of $25; the average market price for the period is $20.

How should FSP Corp compute EPS?

Analysis

The incremental number of shares to be included in diluted EPS is 25. This is computed as follows:

- Shares are issued at the beginning of the period to raise enough proceeds to satisfy the put option of $2,500 (100 shares at $25). 125 shares are assumed to have been issued ($2,500 in required proceeds divided by the average market price of $20 per share for the period).
- The $2,500 in proceeds from issuance of new shares is then used to satisfy the put on 100 options.
- Twenty-five incremental shares are included in the EPS computation—125 shares assumed to be issued less the 100 shares assumed to have been repurchased.

7.5.6 *If-converted method for convertible securities*

ASC 260 considers all convertible securities, including convertible debt and convertible preferred stock, which by their terms may be converted into common stock of the reporting entity, as potential common shares.

Share-settled convertible debt and convertible preferred stock are generally included in diluted EPS using the if-converted method described in ASC 260-10-45-40. However, convertible debt with a cash conversion feature, specifically Instrument C (as discussed in FG 9.6 and FSP 7.5.6.3), is typically included in diluted EPS using the net share settlement method described at ASC 260-10-55-84 through 84B.

Definition from ASC 260-10-20

If-converted method: A method of computing EPS data that assumes conversion of convertible securities at the beginning of the reporting period (or at time of issuance, if later).

Under the "if-converted" method:

- If a reporting entity has convertible preferred stock outstanding, it adds back the preferred dividends (declared or cumulative undeclared) applicable to the convertible preferred stock to the numerator. Such add-back would also include deemed dividends in the period from amortization of a BCF and any adjustments charged or credited to equity in the period to accrete preferred stock classified as mezzanine equity to its cash redemption price, or recorded upon a redemption or induced conversion.
- If a reporting entity has convertible debt outstanding, the reporting entity should:

  (1) Add back interest charges applicable to such convertible debt, including interest expense from the amortization of a BCF, to the numerator,

  (2) Adjust the numerator if nondiscretionary adjustments based on income made during the period would have been computed differently had the interest on convertible debt not been recognized, and

  (3) Adjust the numerator for the income tax effect of adjustments (1) and (2), computed on a "with or without" basis. See TX 3 for tax considerations related to BCF on convertible debt.

Nondiscretionary adjustments include any expenses or charges that are determined based on the income (loss) for the period, such as profit-sharing and royalty agreements, and allocation of participating dividends.

If a reporting entity enters into an interest rate swap as a hedge of the interest associated with convertible debt that automatically terminates upon settlement or conversion of the debt (i.e., nondiscretionary), the interest expense adjustment to the numerator is inclusive of the impact of the interest rate swap. If the swap arrangement does not automatically terminate upon conversion, the reporting entity should exclude the impact of the swap from the add-back, and add back only the contractual interest on the debt in the numerator.

Conversion is not assumed for purposes of computing diluted EPS if the effect would be anti-dilutive:

- Convertible debt is anti-dilutive when its interest and nondiscretionary adjustments, net of tax, per common share obtainable on conversion exceeds basic EPS.

- Convertible preferred stock is anti-dilutive when the amount of the dividend declared in, or accumulated for, the current period, including any deemed dividends or related accretion and participation in dividends, per common share obtainable on conversion exceeds basic EPS.

Similarly, in periods of net loss, the application of the if-converted method to convertible participating securities is generally anti-dilutive (see FSP 7.5.7.1 for a situation where it may not be).

The adjustments discussed above are not affected by the reporting entity's current stock price in relation to the conversion price. That is, a convertible security has the same effect on diluted EPS when the conversion option is far out of the money (i.e., the security has little chance of being converted), as it does when it is deep in the money (i.e., the security has a high likelihood of being converted).

Reporting entities should include convertible securities that have a dilutive effect on EPS in the denominator of diluted EPS from the beginning of the period or from the date of issuance, if later. They should also include dilutive convertible securities that are extinguished or redeemed, and securities in which the conversion options lapse, in the denominator for the period they were outstanding. Consistent with ASC 260-10-S99-2, in circumstances where dilutive convertible securities are extinguished or redeemed and there is a gain or loss on extinguishment or induced conversion, that gain or loss should be reversed in the numerator of diluted EPS because the shares are assumed converted.

Dilutive convertible securities converted during the period are included in the denominator of diluted EPS for the period prior to their conversion. Thereafter, the shares issued are included in the denominator of both basic and diluted EPS.

If the number of shares to be issued upon conversion varies based on (1) the stock price at the conversion date, (2) an average of stock prices around the conversion date, or (3) a formula based on stock prices, the reporting entity should determine the number of shares included in the diluted EPS denominator by applying the conversion formula to the corresponding stock prices at the end of the reporting period. For example, if the number of shares issued upon conversion is based on the average stock price for the 10 days prior to conversion, the stock price on the last 10 days of the reporting period should be used to calculate the number of shares included in the diluted EPS denominator for the period.

The following examples illustrate the application of the if-converted method for convertible debt.

EXAMPLE 7-16

Application of the if-converted method to convertible debt

On January 1, 20X4, FSP Corp issued $10 million of convertible bonds (10,000 bonds in $1,000 increments, at par). On the issuance date, FSP Corp's common stock price was $100 per share. The terms of the bonds include:

- A coupon rate of 2% per year, which results in after-tax interest expense of $30,000 per quarter ($10 million x 2% x 1/4 = $50,000 less income tax of $20,000 (40% tax rate x $50,000)).

- A requirement that FSP Corp deliver 8 shares per bond to bond holders upon conversion (which equates to a conversion price of $125), or 80,000 shares (10,000 bonds x 8 shares per bond) in total.

FSP Corp has 10 million weighted average common shares outstanding, and net income for the quarter ended March 31, 20X4 is $50 million.

How should FSP Corp include the convertible bonds in the diluted EPS computation for the period ended March 31, 20X4?

Analysis

FSP Corp should include the convertible bond in diluted EPS using the if-converted method, if it is dilutive.

	Basic EPS	Adjustments	Diluted EPS
Earnings	$50,000,000	$30,000	$50,030,000
Weighted average common shares and common share equivalents	10,000,000	80,000	10,080,000
EPS	$5.00		$4.96

EXAMPLE 7-17

Computing year-to-date diluted EPS when convertible debt is anti-dilutive in certain periods and dilutive in others

FSP Corp is profitable for the year but has net losses in the first and second quarters of 20X4. FSP Corp issued convertible debt in the prior year, which has been outstanding for all of 20X4.

When adding back interest expense on the convertible debt and adjusting the weighted average shares to reflect conversion at the beginning of those periods, the results are anti-dilutive for both the discrete quarters and for the year-to-date EPS computation for the first and second quarters. The result of assuming conversion in the third and fourth quarters is dilutive.

How would FSP Corp compute year-to-date EPS for the third and fourth quarters of 20x4?

Analysis

For the nine- and twelve-month period computations, the assessment of whether the convertible debt is anti-dilutive should consider the entire period for which the convertible debt was outstanding (the nine- or twelve-month periods). The fact that there are discrete quarters in which the conversion was anti-dilutive does not matter, and those periods would not be excluded from the nine- and twelve-month year-to-date assessments.

Example 1 (transaction e) in ASC 260-10-55 illustrates this point.

7.5.6.1 Treatment of capitalized interest on convertible debt

Capitalized interest from convertible debt could present a conceptual problem in applying the if-converted method. Application of the if-converted method requires the add-back of interest expense and certain other non-discretionary adjustments to net income when convertible securities are assumed to be converted. Accordingly, when any portion of convertible debt interest has been capitalized during a period, it is appropriate, in the EPS computations only, to assume that such interest was not incurred during the period and, therefore, neither capitalized nor expensed, and to make an "as-if" recomputation of interest that would have been capitalized based on interest on other debt.

In this situation, the reporting entity would adjust the numerator to eliminate any effect of the convertible debt interest that was expensed, and to eliminate any other interest expense that would have been capitalized on other debt instruments had the convertible debt not been in existence. As usual, the effect of the "if converted" method cannot be anti-dilutive.

To illustrate, assume a reporting entity has convertible debt that is included using the "if-converted" method for diluted EPS purposes. In general, the reporting entity should determine the amount of interest related to the convertible security included in interest expense and include only that amount (net of tax) in the "if-converted" method calculation. In other words, the reporting entity should not add back to the numerator of diluted EPS the interest attributable to convertible debt that has been capitalized based upon the requirements of ASC 835-20, which requires the capitalization of interest related to the initial investment in an asset.

The rationale is that capitalized interest is, by definition, not an expense of the current period and, therefore, assumed conversion of the debt at the beginning of the current period generally would not have affected net income if the interest was capitalized. However, the reporting entity should consider whether assumed conversion at the beginning of the period would have affected the overall amount of interest capitalized on other debt, and thus income. The reporting entity should perform a "with conversion" and "without conversion" calculation of capitalized interest to determine if assumed conversion at the beginning of the period would have affected income. If the capitalized interest would have been different if conversion had occurred at the beginning of the period, the reporting entity should treat that difference as a nondiscretionary amount, and include that amount as an adjustment in the diluted EPS computation in accordance with ASC 260-10-45-40.

As it relates to interest that has been capitalized in prior periods and is now included in depreciation expense of the fixed asset in the current period, neither ASC 260 nor ASC 835-20 specifically addresses this question. Reporting entities can elect to either reverse depreciation expense attributable to previously capitalized interest when applying the if-converted method, or elect not to. While both methods are acceptable, we believe it may be very difficult in practice to reverse depreciation expense due to the administrative difficulties in tracking the capitalized interest and related depreciation expense. Choosing which approach to follow is an accounting policy decision and, therefore, reporting entities should consistently apply it in all periods for all convertible securities and disclose it.

7.5.6.2 Impact of partial redemption or conversion on diluted EPS

As discussed in FSP 7.4.1.3 and 7.5.6, a reporting entity may offer an incentive to preferred stockholders to either redeem or convert their outstanding shares.

If a reporting entity effects a redemption or induced conversion of only a portion of the outstanding securities of a class of preferred stock, any excess consideration is attributed to only those shares that are redeemed or converted. ASC 260-10-S99-2 indicates that, in determining the dilutive effect of the preferred stock, each group — those remaining outstanding and those redeemed or converted — are considered separately, as they have different effective dividend yields resulting from the excess consideration.

Example 7-18 illustrates how to determine if conversion is dilutive.

EXAMPLE 7-18

Determining whether redemption of a portion of outstanding shares is dilutive

FSP Corp has shares of common stock and 100 shares of convertible preferred stock outstanding at the beginning of a period.

The convertible preferred stock was issued at fair value, which was equal to its par value of $10 per share, has a stated dividend of 5%, and each share of preferred stock is convertible into one share of common stock.

During the reporting period, 20 preferred shares were redeemed at a per share price of $12.

How should FSP Corp determine whether conversion is dilutive?

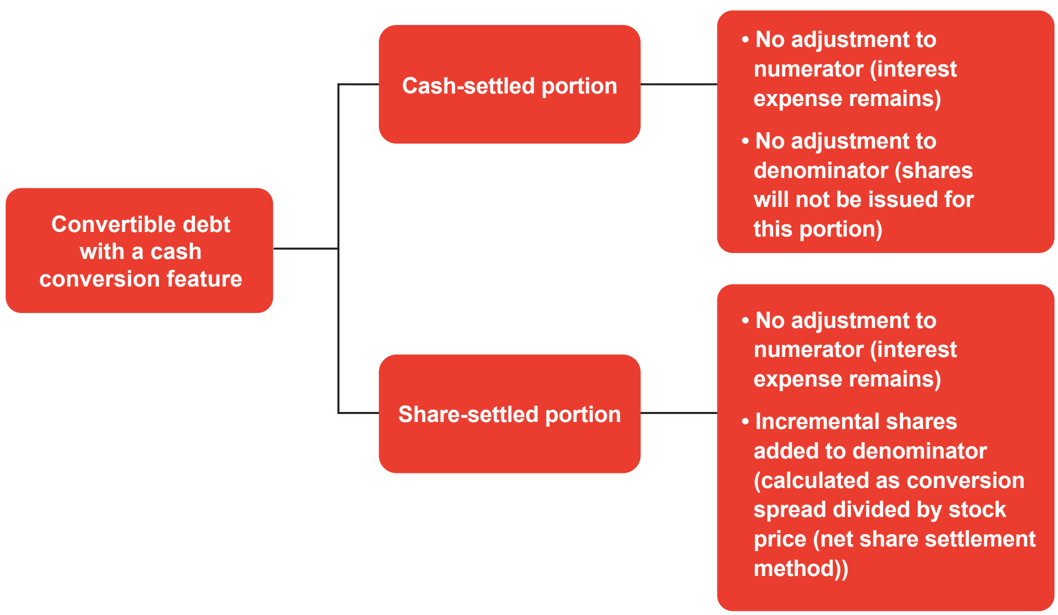
Analysis

In this example, FSP Corp should apply the guidance in ASC 260-10-S99-2 and determine whether conversion is dilutive for 80 of the preferred shares (the shares remaining outstanding) by applying the if-converted method from (1) the beginning of the period to the end of the period using the stated dividend of 5%, and (2) for the 20 shares redeemed by applying the if-converted method from the beginning of the period to the date of redemption, using both the stated dividend of 5% and the $2 per share redemption premium.

7.5.6.3 *Convertible debt with a cash conversion feature*

Traditional share-settled convertible debt provides the holder with the full number of shares underlying the bond upon conversion (i.e., no cash is received). However, a convertible bond with a cash conversion feature allows the issuer to settle its obligation upon conversion, either in whole or in part, in a combination of cash or stock, either mandatorily or at the issuer's option. Convertible debt with a cash conversion feature (FG 9.6) in which the principal amount must be settled in cash is not included in diluted EPS using the if-converted method. The treatment of these instruments, which is discussed further in ASC 260-10-55-84 through 55-84B, is illustrated in the following figure.

Figure 7-7
EPS treatment of convertible debt with a cash conversion feature



The number of shares included in the denominator of diluted EPS is determined by dividing the "conversion spread value" of the share-settled portion of the instrument by the share price. The "conversion spread value" is the value that would be delivered to investors in shares based on the terms of the bond upon an assumed conversion. An issuer should elect a policy of determining the share price to be used to calculate the number of shares included in diluted EPS. We believe it is permissible to use either (1) an average share price over the reporting period, or (2) the share price formula stated in the agreement, which would be applied to the corresponding stock prices at the end of the period.

However, the issuer of a debt instrument that may settle in any combination of cash or stock at the issuer's option (known in practice as an "Instrument X" bond) should consider the guidance on instruments settleable in cash or shares. Refer to FSP 7.5.7.1 for details.

7.5.6.4 Contingently convertible instruments

Some conversion options can only be exercised by the holder upon satisfaction of a contingency. There are two broad categories of conversion option contingencies:

- *Contingencies tied to the issuer's stock price*

  For example, the investor cannot exercise the conversion option until the issuer's stock price reaches a level of 120% of the conversion price.

- *Contingencies tied to an event or index other than the issuer's stock price*

  For example, the investor can only exercise the conversion option upon the issuer's successful completion of an IPO.

If the instrument's conversion is based on achieving a substantive contingency based on an event or index other than the issuer's stock price, the reporting entity would not include the instrument in diluted EPS until the non-market based contingency has been met or is being met based on circumstances at the end of the reporting period. For example, if the contingency was based on an IPO, and an IPO had not been completed by period end, the contingently convertible instruments would not be included in diluted EPS for the period.

However, based on the guidance in ASC 260-10-45-44, contingently convertible instruments that are tied to the reporting entity's stock price should be treated in the same manner as other convertible securities and included in diluted EPS, if the effect is dilutive, regardless of whether the stock price trigger has been met.

Further, delayed convertibility based solely on the passage of time does not avoid including the security immediately in the if-converted method based on the requirements above, even if the security is not convertible for many years.

Figure 7-8 illustrates the treatment of the two types of contingencies.

Figure 7-8
EPS treatment of contingently convertible securities in diluted EPS

ASC 260-10-45-44 applies to all issued securities that have embedded market-price-contingent conversion features, including contingently convertible debt, contingently convertible preferred stock, and convertible debt for which, upon conversion, the issuer must satisfy the principal amount of the debt in cash, and may satisfy the conversion premium in either cash or stock. ASC 260-10-45-44 does not cover freestanding instruments and contingent conversion features that are based on a contingency other than a market price trigger, nor does it apply to stock warrants or options that are only exercisable upon achieving a market condition (see FSP 7.5.3).

Depending on the terms of the security, it could be included in diluted EPS using either the if-converted method (convertible securities), or a method similar to the treasury stock method (convertible debt with a cash conversion feature, i.e., Instrument C).

- If upon conversion, the reporting entity could deliver the full number of shares, it should use the if-converted method.

- If upon conversion, the reporting entity is required to deliver cash for the par value of the security, and could deliver shares only for the differential between the stock price and the conversion price, it should use the net share settlement method described in ASC 260-10-55-84 through 55-84B.

7.5.7 *Other arrangements potentially impacting diluted EPS*

There are various other arrangements that could result in the issuance of additional shares of stock by the reporting entity and, therefore, impact the computation of diluted EPS. These include: financial instruments settleable in cash or shares, subsidiary share agreements, and escrow share arrangements.

7.5.7.1 *Instruments settleable in cash or shares*

Certain instruments may allow the issuer, at its election, to settle in cash or shares.

Under ASC 260-10-55-32 through 55-36A, when the reporting entity has the choice, and controls the settlement method, it should presume share settlement for EPS purposes. However, it may overcome this presumption, and assume cash settlement, when there is a past practice or substantive stated policy that provides a reasonable basis to believe that the contract will be paid partially or wholly in cash.

We understand the SEC staff looks to a number of factors in evaluating whether a reporting entity's stated policy to cash-settle a portion of its convertible debt instruments is substantive, including:

- *Settlement alternatives as a selling point*

  The extent to which the ability to share settle factored into senior management's decision to approve the issuance of the instrument rather than an instrument that only allowed for cash settlement

- *Intent and ability to cash settle*

  The extent to which the reporting entity has the positive intent and ability to cash settle the face value and interest components of the instrument upon conversion

  The reporting entity should consider both current and projected liquidity in determining whether positive intent and ability exists. Management's representation attesting to the positive intent and ability to cash settle is also a factor.

- *Disclosure commensurate with the reporting entity's intention*

  The extent to which the disclosures included in current period financial statements, and those included in the instrument's offering documents, acknowledge and support the reporting entity's positive intent and ability to adhere to its stated policy

- *Past practice*

  Whether the reporting entity has previously share-settled contracts that provided a choice of settlement alternatives

If the instrument provides the counterparty with the choice of settlement method, the reporting entity should use the more dilutive outcome each period (cash vs. shares); past experience or a stated policy is not determinative.

When computing the numerator in the diluted EPS computation, the reporting entity needs to make independent quarterly and year-to-date determinations of the most dilutive method of settlement, similar to the treatment of the convertible preferred stock in Example 1 of ASC 260-10-55-38 through 55-50.

The computation of EPS can be more complex if the presumption of share settlement changes to cash settlement or vice versa. In these situations, the computation of EPS should reflect the change in the settlement assumption on a prospective basis, and the change in presumption should be disclosed. If, subsequent to issuance, a reporting entity could overcome the share settlement presumption and assume cash settlement, the computation of EPS would reflect the contract as share-settled up until the date the assumption was changed. Thereafter, EPS would reflect the contract as cash-settled. The ability to overcome the presumption of share settlement will become difficult if a reporting entity has a past practice of changing its assumption from cash settlement to share settlement.

Question 7-4

A reporting entity issues a convertible debt instrument with a cash conversion feature that allows the reporting entity to settle the entire obligation, both the par value and the conversion spread value, in any combination of cash or stock upon conversion (i.e., Instrument X).

Can the reporting entity assert that the instrument will be fully settled in cash for purposes of its diluted EPS calculation?

PwC response

No. Generally, it would not be appropriate to assume that the entire instrument will be cash-settled for purposes of diluted EPS because the value of the conversion spread is limitless (i.e., there is no limit to how high the reporting entity's stock price may rise), which would make it difficult for a company to assert that it would have the intent and ability to always settle the arrangement in cash.

For a security that is accounted for as a liability, or in some cases an asset, with changes in fair value recorded in earnings, the calculation of assumed share settlement would include an adjustment of the diluted EPS numerator to eliminate the effects of the contract that have been recorded in net income and an adjustment of the denominator to include the impact of the share-settled contract, if dilutive in the aggregate. However, in accordance with ASC 260-10-55-33, this adjustment to the numerator would not be made for stock-based compensation awards with assumed share settlement.

If a reporting entity reports a net loss for the period, potential common shares are generally anti-dilutive. However, if the net loss includes a mark-to-market (MTM) gain on an instrument that is classified as an asset or liability, and share settlement is assumed, this could result in the instrument being dilutive because the reversal of a gain in the numerator creates a larger loss and potentially a larger loss per share. For the instrument to be dilutive, the mark-to-market gain that is reversed in the numerator (i.e., the increase to the net loss) must exceed the impact of the potential common shares that are added to the denominator as a result of presumed share settlement. When evaluating whether the instrument is dilutive, the collective impact of both the numerator and denominator adjustments on diluted EPS should be considered, versus evaluating the impact to the numerator and denominator separately. The reporting entity would not adjust the numerator of diluted EPS unless the application of the treasury stock method to the options and warrants in question would result in incremental potential common shares.

Reporting entities may treat such contracts differently for accounting recognition purposes and for EPS purposes. For example, certain contracts that provide the reporting entity with the choice of settlement method would be treated as equity instruments for accounting purposes. Regardless of the balance sheet classification, however, if the reporting entity has a past practice or stated policy of settling such contracts in cash, the EPS computations would assume cash settlement.

For contracts accounted for as equity that are treated as cash settled for EPS, the reporting entity should also adjust the numerator when computing diluted EPS to reflect the income or loss on the contract that would have resulted during the period if the contract had been reported as an asset or liability. These adjustments are only permitted to the extent that accounting for the instrument as equity versus an asset or liability has an effect on net income.

Example 7-19 illustrates the impact of a liability-classified warrant on the computation of diluted EPS.

EXAMPLE 7-19

Determining whether cash or share settlement is more dilutive for a liability-classified warrant

FSP Corp has net income of $10 million for 20X4 and 1 million shares of common stock outstanding for the period.

FSP Corp has outstanding warrants to issue 50,000 shares of its common stock with a strike price of $10 per share. These warrants are liability-classified and are MTM each reporting period. The after-tax MTM adjustment related to the warrants is a $0.5 million charge for the period (warrant fair value increased in the period, resulting in an income statement charge for FSP Corp). The warrants were outstanding for the entire period.

FSP Corp has no other potential common shares. The average market price of the common stock during the period is $15. The holder of the warrants has the choice of settlement in cash or shares. FSP Corp believes, based on past experiences, that the warrants will be share-settled.

How should FSP Corp include the warrants in the diluted EPS computation for the period?

Analysis

For warrants that may be cash- or share-settled at the holder's election, past experience or a stated policy for settlement is not relevant. Accordingly, EPS should be based on the more dilutive of the settlement alternatives. If the warrants are assumed to be cash-settled, diluted EPS for the period is $10 per share ($10 million net income / 1 million shares), as no adjustment is required to either the numerator or denominator.

If the warrants are assumed to be share-settled, diluted EPS for the period is $10.33 per share (calculated below), as both the numerator and the denominator should be adjusted for the assumed exercise.

Calculation of diluted EPS with assumed share settlement:

Net income	$10,000,000	
Add back of MTM loss	500,000	
Income available to common stockholders		$10,500,000
Common shares outstanding		1,000,000
Shares issued upon exercise of warrants	50,000	
Less: shares repurchased with proceeds[1]	(33,333)	
Incremental shares issued		16,667
Weighted average shares outstanding		1,016,667
Diluted EPS		$10.33

[1] Calculated as: [(50,000 warrants multiplied by the $10 strike price) / $15 average share price]

The warrants should be presumed to be cash-settled, as that is more dilutive.

7.5.7.2 *Securities of subsidiaries and of other investees*

The effect on consolidated EPS of options, warrants, and convertible securities issued by a subsidiary or investee depends on whether the securities issued by the subsidiary or investee enable their holders to obtain common stock of the subsidiary or investee, or the common stock of the parent. In computing consolidated diluted EPS, including for investments in common stock of corporate joint ventures and investee companies accounted for under the equity method, reporting entities should use the following general guidelines:

- Securities issued by the subsidiary that enable the holder to obtain the subsidiary's common stock should be included by the subsidiary in its computation of diluted EPS data. Those diluted per-share earnings should then be included in the parent's consolidated EPS computation based on the parent's share of the subsidiary's securities (diluted EPS of subsidiary times the number of shares owned by parent equals earnings included in the numerator of consolidated EPS). Therefore, a reduction of subsidiary diluted EPS due to increased potential common shares issued by the subsidiary results in a reduction in the numerator of consolidated diluted EPS.

- The parent reporting entity should consider securities of a subsidiary that are convertible into its common stock as potential common shares in computing consolidated diluted EPS.

A detailed example of the EPS computations for the parent and the subsidiary when the subsidiary's securities enable their holders to obtain subsidiary common stock is presented in Example 7 in ASC 260-10-55-64 through 55-67. The same approach should be used by an investor in an equity method investment.

The reporting entity should use the if-converted method in determining the EPS impact of securities issued by a parent that are convertible into common stock of a subsidiary or an investee reporting entity accounted for under the equity method. The securities are assumed to be converted, and the income available to parent company common stockholders is adjusted as necessary. That is, the numerator is adjusted appropriately for any change in the income reported by, or allocated to, the parent (such as dividend income or equity method income) due to the increase in the number of common shares of the subsidiary or equity method investee as a result of the assumed conversion. However, the denominator of the diluted EPS computation would not be affected, because the number of shares of parent company common stock outstanding would not change upon assumed conversion.

7.5.7.3 Escrow share arrangements

There are potential accounting implications when stockholders place a portion of their shares in escrow in connection with an initial public offering (IPO) or other financing transactions. In ASC 718-10-S99-2, the SEC staff expressed a view that escrow arrangements that involve the release of shares based on performance-related criteria are presumed to be equivalent to reverse stock splits that are followed by a grant of restricted stock awards under a performance-based plan. See further discussion in SC 3.5.1.

Escrowed shares are legally outstanding and reported as such on the face of the balance sheet. However, reporting entities should consider these arrangements share-based payment awards for EPS purposes and apply the guidance as to when contingently issuable shares are included in diluted EPS in ASC 260-10-45-48.

7.5.8 Illustrative computation of diluted EPS

ASC 260-10-55-57 through 55-59 (Example 4: Anti-dilution Sequencing) illustrates sequencing in the computation of diluted EPS. Example 7-20 also illustrates this concept.

EXAMPLE 7-20

Diluted EPS and the application of anti-dilution sequencing

FSP Corp has 10,000,000 shares of common stock and 2,000,000 shares of convertible preferred stock (issued at $10 par value per share) outstanding during 20X4 and has net income of $50,000,000.

Each share of preferred stock is convertible into two shares of common stock. The preferred stock is entitled to a cumulative annual dividend of $0.50 per preferred share (5% of the $10 par value), and then participates on a 1:1 basis in any common dividends that would have been payable had the preferred stock been converted immediately prior to the record date of any dividend declared on the common stock (i.e., on an "as-converted" basis).

For the year ended December 31, 20X4, dividends of $2 per share are paid to the common stockholders and, accordingly, participating dividends of $4 per preferred share are paid to the preferred stockholders, since each share of preferred converts into 2 common shares, in addition to the cumulative annual preferred dividend of $0.50. FSP Corp also has 1,200,000 stock options outstanding that were issued with an exercise price of $10 per share.

This example assumes that all compensation expense was recorded in prior years and the options are qualified incentive stock options (ISOs) and, therefore, have no tax effect upon exercise. The weighted average market price of FSP Corp's common stock for 20X4 is $15 per share.

How should diluted EPS be computed?

Analysis

Step 1: Allocate undistributed earnings under the two-class method

Net income		$50,000,000
Less: Dividends declared:		
Common stock	20,000,000	
Cumulative annual preferred stock dividend	1,000,000[1]	
Participating preferred stock dividend	8,000,000[2]	
Undistributed 20X4 earnings		$21,000,000

[1] 2 million shares multiplied by $0.50 per share dividend

[2] 4 million "as-converted" shares of common stock [2 million preferred shares multiplied by 2 shares of common stock per share of preferred] multiplied by $2 per share dividend paid on common stock

	Common stock	Preferred stock	Total
Distributed earnings	$20,000,000	$ 9,000,000	$29,000,000
Undistributed earnings	15,000,000[1]	6,000,000[2]	$21,000,000
	$35,000,000	$15,000,000	$50,000,000

[1] 10 million common shares / (10 million + 4 million as-converted) = 71% multiplied $21 million

[2] 4 million as-converted shares / (10 million + 4 million as-converted) = 29% multiplied by 21 million

Step 2: Calculate Basic EPS

	Common stock	Preferred stock
Distributed earnings	$2.00	$4.50
Undistributed earnings	1.50	3.00
Basic EPS	$3.50	$7.50

Step 3: Calculate the potential common shares related to options under the treasury stock method

Number of shares issued upon exercise		1,200,000
Less: shares repurchased with proceeds		
Cash proceeds (1,200,000 multiplied by $10)	$12,000,000	
Unamortized compensation cost[1]	—	
Windfall tax benefits upon exercise[1]	—	
Total proceeds	$12,000,000	
Divided by average stock price	$15	
Shares repurchased		(800,000)
Incremental shares issued		400,000

[1] None in this example as all compensation cost was previously recorded and the options are qualified ISOs (i.e., no tax impact upon exercise)

Step 4: Determine the earnings per incremental share for each class of security

	Add-back to income	Increase in number of common shares	Earnings add-back per incremental share
Options	0	400,000	—
Convertible preferred stock	$15,000,000	4,000,000	$3.75

The security with the lowest earnings per incremental share has the most dilutive impact on EPS. In this case, the options are most dilutive, followed by the convertible preferred, so this is the sequence that is followed for determining diluted EPS.

Further, because the EPS associated with the convertible preferred stock is greater than basic EPS, the convertible preferred stock is considered anti-dilutive, as illustrated below.

Step 5: Compute diluted EPS

	Income	Common shares	Diluted EPS
As reported for basic	$35,000,000	10,000,000	$3.50
Options	—	400,000	
	$35,000,000	10,400,000	$3.37 Dilutive
Convertible preferred stock	15,000,000	4,000,000	
	$50,000,000	14,400,000	$3.47 Anti-dilutive

Because diluted EPS increases from $3.37 to $3.47 when convertible preferred shares are included in the computation, the convertible preferred shares are anti-dilutive, and are excluded from the computation of diluted EPS. Therefore, diluted EPS is reported as $3.37.

This example illustrates the importance of following the proper sequencing when determining whether potential common shares are dilutive or anti-dilutive. If all potential common shares had been included in the diluted EPS computation without proper sequencing, it would have appeared that diluted EPS is $3.47, because $3.47 is dilutive versus the $3.50 computed for basic EPS. However, computing diluted EPS in the manner required by ASC 260 produces a more dilutive result, and the reporting entity reports $3.37.

7.5.9 *Diluted EPS under the two-class method (as proposed in FAS 128R)*

ASC 260 does not provide an example of computing diluted EPS under the two-class method. In the Exposure Draft of FAS 128R released in August 2008 but never finalized, the FASB included guidance on computing diluted EPS under the two-class method in paragraphs 61A-61D, as well as three example scenarios in Illustration 6A.

The three example scenarios are:

- Common stock with participating preferred security
- Two classes of common stock with different dividend rights, where one is convertible into the other
- Two classes of common stock with different dividend rights where one class is convertible into the other and there are convertible bonds outstanding

Although the computation methodology included in the exposure draft is not currently a required methodology, it does represent useful guidance that should be considered.

In computing diluted EPS under the FAS 128R two-class method, undistributed earnings allocated away from common stockholders in the basic EPS computation are reversed, and then re-allocated to each class of common or potential common shares and participating securities that are assumed to be outstanding for the period.

Continuing with the facts in Example 7-20, Example 7-21 illustrates computation of diluted EPS under the two-class method (as proposed in FAS 128R):

EXAMPLE 7-21

Diluted EPS under the two-class method proposed in FAS 128R

How does use of the two-class method for participating securities impact the computation of diluted EPS?

Analysis

Step 1: Re-allocate undistributed earnings to preferred stockholders after assumed exercise of options

4,000,000 if-converted shares / (10,000,000 + 4,000,000 if-converted + 400,000 incremental shares from options) = 28% multiplied by $21,000,000 = $5,833,333.33

Step 2: Re-compute diluted EPS after the reallocation of undistributed earnings to preferred stockholders

	Undistributed and distributed earnings to common stockholders	Common shares	Earnings per share
As reported-Basic	$35,000,000	10,000,000	$3.50
Add-back: Undistributed earnings allocated to preferred shares in basic computation	$6,000,000		
Options		400,000	
Less: Undistributed earnings reallocated to preferred shares	($5,833,333)	—	
Subtotal	$35,166,667	10,400,000	$3.38 Dilutive
Add-back: Undistributed earnings re-allocated to preferred shares	$5,833,333	—	
Add-back: Distributed earnings to preferred shares	$9,000,000	4,000,000	
Total	$50,000,000	14,400,000	$3.47 Anti-dilutive

Because diluted EPS increases when convertible preferred shares are included in the computation, the convertible preferred shares are anti-dilutive, and are ignored in the computation of diluted EPS. Therefore, diluted EPS is reported as $3.38.

Summary of total amount allocated:

	Common stock	Preferred stock	Total
Distributed earnings	$20,000,000	$ 9,000,000	$29,000,000
Undistributed earnings	$15,166,667	$5,833,333	$21,000,000
Total	$35,166,667	$14,833,333	$50,000,000

Summary of diluted earnings per share amounts:

	Common stock	Preferred stock
Distributed earnings	$1.92	$2.25
Undistributed earnings	$1.46	$1.46
Diluted EPS	$3.38	$3.71

As the example demonstrates, when using the reallocation method proposed in FAS 128R, diluted EPS is $3.38 per common share, as opposed to $3.37 per common share. This incremental $0.01 per common share results from the reallocation of undistributed earnings performed under this method. Assuming that the options have been outstanding as common shares from the beginning of the period, the reallocation method proposed in FAS 128R results in less undistributed earnings being allocated away from the common stock to the preferred stock, and, as a result, EPS per common share is higher.

Reporting entities using the two-class method for the first time may use the method of computing diluted EPS under the two-class method proposed in FAS 128R. However, reporting entities that have not historically used the two-class method proposed in FAS 128R for computing diluted EPS should continue to compute diluted EPS in the manner they have historically applied.

7.6 Change in capital structure

EPS is affected by various changes in capital structure. In this section, we address those relating generally to the financial statements. Other statements and schedules, such as registration statements, are addressed in PwC's SEC Volume. Changing from an LLC or partnership to a C-corp is addressed in FSP 32.

7.6.1 *Stock splits/reverse stock splits/stock dividends*

If the number of common shares outstanding increases as a result of a stock dividend or stock split, or decreases as a result of a reverse stock split, the reporting entity should adjust the computations of basic and diluted EPS retroactively for all periods presented to reflect that change in capital structure. If changes in common stock resulting from stock dividends, stock splits, or reverse stock splits occur after the close of the period but either (1) before issuance of the financial statements, or (2) before the effective date of the registration statement, whichever is later, as applicable, the per-share computations for those and any prior period financial statements presented should be based on the new number of shares. If per-share computations reflect such changes in the number of shares, ASC 260-10-55-12 requires disclosure of those changes, including the retroactive treatment, explanation of the change made, and the date the change became effective.

The effective date of a stock split (i.e., the distribution date, which is the date that the shares begin trading at their new split-adjusted price) may affect the form of disclosure in the financial statements. Figure 7-9 illustrates the appropriate financial statement presentation in various situations for a registrant that is already a public entity.

Figure 7-9
Presentation of EPS upon stock splits

The following assumptions are applicable in each case:

- The latest balance sheet date is December 31, 20X3.
- The accountant's report date and financial statement issuance date through filing of the Annual Report on Form 10-K is January 31, 20X4.
- The variable assumptions are the declaration dates and effective dates of the stock split.

	Split Date		
Case	**Declared**	**Effective**	**Financial statement presentation**
I	11/15/X3	12/16/X3 or 1/16/X4	Split would be reflected in 12/31/X3 balance sheet, 20X3 statement of changes in stockholders' equity, and in per share data for all periods presented.
II	1/16/X4	1/31/X4	Same as I.
III	1/20/X4	2/20/X4	Split would be disclosed in a footnote along with the pro forma effect (labeled unaudited) on the 12/31/X3 balance sheet. Historical per share data would remain on a pre-split basis, and pro forma per share data (labeled "unaudited") on a post-split basis would be disclosed in the notes to the financial statements.

Case III illustrates the appropriate presentation when, at the time financial statements are issued, a split has been declared, but is not effective. In this situation, historical EPS must be disclosed on a pre-split basis since the subsequent event "triggering" the split (i.e., its effectiveness) has not occurred as of the time the financial statements are issued. However, once the split is effective, the reported historical EPS becomes irrelevant in relation to post-split shares outstanding, as well as to post-split market price.

Consequently, if a split has been declared, but is not effective at the date the financial statements are issued, pro forma EPS (labeled "unaudited") on a post-split basis should be presented in the footnotes in addition to historical EPS, which is presented on a pre-split basis. If the financial statements are reissued after the effective date, the aforementioned pro forma amounts would become historical EPS and the previously-disclosed historical amounts would be deleted.

For financial reporting considerations related to the filing of a registration statement, refer to SEC 4220.25.

7.6.2 Stock rights plans

A rights issue whose exercise price at issuance is less than the fair value of the stock contains a bonus element that is similar to a stock dividend. If a rights issue contains such a bonus element and it is offered to all existing stockholders, the reporting entity should adjust basic and diluted EPS retroactively for the bonus element for all periods presented. If this occurs after the close of the period but before issuance of the financial statements, the per-share computations for those and any prior period financial statements presented are based on the new number of shares, reflecting the bonus element.

If the ability to exercise the rights issue is contingent on an event other than the passage of time (e.g., change in control), the reporting entity need not consider the bonus element in the denominator of either basic or diluted EPS until such time as the contingency is resolved. See further discussion in ASC 260-10-55-14.

7.6.3 Distributions to stockholders with components of stock and cash

ASC 260-10-55-12 provides guidance for real estate investment trusts (REITs) that declare a distribution that stockholders can elect to receive in cash or shares of equivalent value, with a potential limitation on the total amount of cash that stockholders can elect to receive in the aggregate.

The stock portion of a distribution to stockholders that allows them to elect to receive cash or shares with a potential limitation on the total amount of cash that all stockholders can elect to receive in the aggregate is considered a share issuance. Therefore, for EPS computation purposes, the stock portion of the distribution is reflected in EPS prospectively, consistent with the treatment of other new share issuances.

7.6.4 *IPO or spin-off of a subsidiary and recapitalizations*

When a reporting entity completes an IPO or a spin-off of either an existing subsidiary or a "carve-out" business, questions often arise as to how to compute EPS in the historical financial statements of the subsidiary or carve-out business.

In computing basic EPS for a carve-out business, the number of shares issued to the owner upon the legal formation of the entity that holds the business and contribution of that business to the entity is used as the denominator for all periods presented, akin to the treatment of a stock split. In this case, the number of shares issued simply reflects a recharacterization of the capital account previously held by the owner.

With respect to an existing subsidiary (i.e., an entity with a separate legal identity), the historical number of shares outstanding during each period is reflected in the denominator for all periods presented. However, issuance of shares to new investors in connection with the IPO/spin-off is treated prospectively from the issuance date. In connection with a stock split, EPS is restated for all periods presented. See FSP 7.6.1 for details.

In computing diluted EPS for a carve-out business or an existing subsidiary whereby parent options are exchanged for options in the affiliate at the date of the IPO/spin-off, the dilutive effect of the affiliate options exchanged for the parent options is included in the denominator on a prospective basis. Previous periods are not affected, as the exchange of parent options for affiliate options is considered a modification of the terms of the original award. However, if the affiliate issues options and warrants to the parent company as part of the initial capitalization of the carved-out business, then the options are treated as if they were outstanding for all periods presented. It is also common for reporting entities to recapitalize or reorganize their legal entity structure in preparation for an IPO. There is limited guidance on such transactions. However, ASC 260-10-55-17 provides guidance on computing EPS in reorganizations.

ASC 260-10-55-17

When common shares are issued to acquire a business in a business combination, the computations of EPS shall recognize the existence of the new shares only from the acquisition date. In reorganizations, EPS computations shall be based on analysis of the particular transaction and the provisions of this Subtopic.

The reporting entity should evaluate the facts and circumstances of each situation when concluding on the appropriate EPS treatment. For example, some transactions may result in an exchange of equity interests, but no change in relative shareholder rights, rank, or value before and after the transaction. Such reorganizations may be equivalent to a stock split (simply changing the form of legal ownership to a new structure) and require retrospective treatment for EPS purposes, even if effected after the latest balance sheet date. Any financial statements issued, or SEC filings made, after the effective date of such an event should reflect the transaction retrospectively (i.e., it should be pushed back to prior periods).

In other transactions, often involving more complex capital structures, the reorganization transaction may affect a value-for-value exchange of equity interests at the point of the recapitalization, which results in a change in relative shareholder rights or rank before and after the transaction. This transaction may be more akin to the repurchase of equity interests through the issuance of new equity interests, and be afforded prospective treatment in the EPS computation.

If, in conjunction with an IPO, a conversion of outstanding securities will occur subsequent to the latest balance sheet date and the conversion will result in a material reduction of earnings per share (excluding effects of offering proceeds), pro forma EPS for the latest year and interim period should be presented giving effect to the conversion (but not the offering proceeds).

Question 7-5

Under ASC 805, *Business Combinations*, a common control merger is recorded at carryover basis, and the receiving entity should reflect the acquired business for all prior periods (or since the date common control was obtained, if later), as if the entities had always been combined. How should the entity reflect the impact of the merger on EPS?

PwC response

If the receiving entity issued shares to the stockholders of the contributing entity, this should be reflected in EPS in a similar fashion as a stock split (i.e., recharacterization of the historical common ownership) and reflected retrospectively for all periods presented under common control. The ratio of exchange of receiving entity shares issued for each share of the transferred entity should be multiplied by the weighted average number of shares and potential shares of the transferred entity for each reporting period, and added to the number of shares and potential shares of the receiving entity.

If the receiving entity paid cash to the stockholders of the contributing entity, there should generally be no impact to EPS. However, if the receiving entity issued shares to new investors to raise that cash, consideration should be given as to the treatment of the shares in the historical or pro forma EPS computations.

7.6.5 Computing EPS when dividends are paid from the proceeds of an IPO

A private company or subsidiary may use the proceeds of an IPO to pay a dividend to its promoters/owners or parent company. In some situations, the dividend may exceed earnings in the most recent year. In such a case, the reporting entity should include unaudited pro forma per share data (for the latest year and interim period only) on the face of the income statement, giving effect to the number of shares whose proceeds would be necessary to pay the portion of the dividend that exceeds the current year's earnings.

The pro forma EPS requirement also applies to both of the following situations.

- A dividend that is declared after the date of the latest balance sheet included in the registration statement if the dividend exceeds earnings for the previous twelve months

- A planned (but not yet declared) dividend if the planned dividend exceeds earnings for the previous twelve months, even if the dividend will not be funded from the proceeds of the IPO (e.g., the dividends were/will be funded from the proceeds of a line of credit or cash on hand)

SEC FRM 3420.2 addresses the application of SAB Topic 1.B.3 when the dividend to be paid exceeds both the last twelve months' earnings and the proceeds from the equity offering. In that instance, the pro forma EPS computation should not reflect more shares than will be outstanding after the offering.

To present a transparent picture for the investor, reporting entities should also adjust the numerator of the pro forma EPS computation to reflect the incremental interest expense (net of tax) relating to the portion of the dividend that exceeds both the gross proceeds from the equity offering and the previous 12 months' earnings.

7.6.6 Partially paid shares and partially paid stock subscriptions

If a reporting entity has common shares issued in a partially paid form, and those shares are entitled to dividends in proportion to the amount paid, the common-share equivalent of those partially paid shares is included in the basic EPS computation if they were entitled to participate in dividends.

Partially paid stock subscriptions that do not share in dividends until fully paid are considered the equivalent of warrants, and are included in the diluted EPS computation using the treasury stock method. The unpaid balance is assumed to represent proceeds used to purchase stock, and the incremental number of shares to be included is the difference between the number of shares subscribed and the number of shares assumed to be purchased.

7.6.7 Bankruptcy

Under ASC 852-10-45-16, EPS is computed during the bankruptcy period following all of the provisions of ASC 260. This standard specifically notes that any potential changes in the capital structure as a result of the plan of bankruptcy are disclosed but not reflected in the computation of EPS.

7.7 EPS in prior period adjustments

In the event of a restatement of prior period earnings, retrospective application of a new accounting principle, or a discontinued operation, the reporting entity should restate prior EPS data and disclose the per-share effect of the restatement in the period of restatement.

The reporting entity should compute restated EPS as if the restated income or loss had been reported originally in the prior periods. It is possible that common stock assumed to be issued upon exercise, conversion, or issuance of potential common shares may not be included in the computation of restated EPS amounts. That is, retroactive restatement of income from continuing operations could cause potential common shares originally determined to be dilutive to become anti-dilutive or vice versa. Retroactive restatement may also cause the numerator of the EPS computation to change by an amount that differs from the amount of the retroactive adjustment.

7.8 Considerations for private companies

EPS is only required for entities with publicly-traded equity securities, including those that have filed a registration statement to sell equity securities. Entities that choose to present EPS are required to comply with the requirements of ASC 260.

Chapter 8: Other assets

8.1 Chapter overview

This chapter provides the presentation and disclosure requirements for assets that are not covered in other chapters of this guide. This includes:

- Receivables
- Inventory
- Prepaid assets and other current and noncurrent assets
- Property, plant, and equipment
- Assets held for sale
- Intangible assets subject to amortization
- Goodwill and intangible assets not subject to amortization
- Long-term contracts

Presentation and disclosure requirements for common assets that are not included in this chapter are covered elsewhere in this guide, as follows: cash and restricted cash are covered in FSP 6; investments are covered in FSP 9; equity method investments are covered in FSP 10; lease receivables are covered in FSP 14; recognition of intangible assets and goodwill in connection with a business combination are covered in FSP 17; securitized receivables and repurchase agreements are discussed in FSP 22; and receivables from related parties are covered in FSP 26.

8.2 Scope

The prevailing presentation and disclosure guidance comes from U.S. GAAP and is applicable to all reporting entities. The primary authoritative guidance is listed below for each type of asset. To the extent other guidance exists on specific points related to the asset type, it is noted in the respective asset section.

ASC 310, *Receivables*

ASC 330, *Inventory*

ASC 340, *Deferred Costs and Other Assets*

ASC 350, *Intangibles – Goodwill and Other*

ASC 360, *Property, Plant and Equipment*

ASC 910, *Contractors – Construction*

ASC 912, *Contractors – Federal Government*

S-X 5-02 applies only to SEC registrants, and provides guidance on certain assets that are required to be presented as individual balance sheet line items, if material.

8.3 Receivables

Receivables exist in virtually every reporting entity, though their nature varies depending on the characteristics of the business. Accordingly, the guidance governing the receivables will also vary. This section addresses presentation and disclosure considerations for the following topics:

- Accounts and notes receivable and financing receivables, including allowances for credit losses and impaired loans
- Shareholder and other receivables
- Discounts or premiums on note receivables
- Loan origination and other fees, including net fees and costs
- Hypothecation or other pledging of receivables

8.3.1 Accounts and notes receivable and financing receivables

The term "accounts and notes receivable" is used in S-X 5-02 and is generally consistent with the "financing receivable" terminology used in U.S. GAAP. Financing receivables are contractual rights to receive cash either on demand or on fixed or determinable dates, and are recognized as an asset on the balance sheet. Examples of financing receivables include trade accounts receivable, notes receivable, credit card receivables, loans, and certain receivables relating to a lessor's rights to payments from a lease.

8.3.1.1 Presentation requirements

ASC 310 permits loans or trade receivables to be presented as aggregate amounts. However, major categories of loans or trade receivables should be presented separately either on the balance sheet or in the footnotes. Receivables that are held for sale should be presented separately on the balance sheet from other receivables.

Receivables whose amounts include unearned discounts (other than cash or quantity discounts), finance charges, or prepaid interest should reflect those items as deductions from the related receivable. Allowance for doubtful accounts should be shown as a reduction of the related receivables.

Note and accounts receivable from officers, employees, or affiliated companies are required to be disclosed separately on the balance sheet. Additionally, ASC 310-10-45-14 requires notes received as equity contributions to be presented in equity. Reporting such a note as an asset is generally not appropriate.

SEC registrants are required to separately disclose major categories of accounts and notes receivable, including receivables from customers (trade); related parties; underwriters, promoters, and employees (other than related parties) which arose in a manner other than the ordinary course of business; and receivables held for sale (reported at lower of cost or fair value).

In addition, if the aggregate amount of notes receivable exceeds 10 percent of the aggregate amount of receivables, SEC registrants must separately disclose accounts receivable and notes receivable either on the balance sheet or in a footnote.

8.3.1.2 Disclosure requirements

ASC 310-10-50-2 specifies the information required to be addressed in an accounting policy footnote for all loans and trade receivables.

ASC 310-10-50-2

The summary of significant accounting policies shall include the following:

a. The basis for accounting for loans and trade receivables

b. The method used in determining the lower of cost or fair value of nonmortgage loans held for sale (that is, aggregate or individual asset basis)

c. The classification and method of accounting for interest-only strips, loans, other receivables, or retained interests in securitizations that can be contractually prepaid or otherwise settled in a way that the holder would not recover substantially all of its recorded investment

d. The method for recognizing interest income on loan and trade receivables, including a statement about the entity's policy for treatment of related fees and costs, including the method of amortizing net deferred fees or costs.

Reporting entities are also required to disclose the allowance for credit losses (i.e., allowance for doubtful accounts), unearned income, unamortized premiums and discounts, and net unamortized deferred fees and costs in its financial statements. In addition, reporting entities should disclose their policy for writing off uncollectible trade accounts receivable (excluding credit card receivables) that have a contractual maturity of one year or less, and arose from the sale of goods or services.

Receivables are generally considered to be financial assets, and as such, reporting entities are required to comply with the fair value disclosure requirements of ASC 825, *Financial Instruments*, discussed in FSP 20. However, reporting entities do not need to provide the fair value disclosures for trade receivables whose carrying value approximates fair value.

ASC 310-10-50-6 through 50-7A require accounting policy disclosures by class of financing receivables, except for the following types of financing receivables, as detailed in ASC 310-10-50-5A and 5B:

- Receivables measured at fair value through earnings (see FSP 20)
- Receivables measured at lower of cost or fair value (see ASC 948-310-50)
- Trade accounts receivable (other than credit card receivables) that have a contractual maturity of one year or less, and arose from the sale of goods or services
- Participant loans in defined contribution pension plans
- Loans acquired with deteriorated credit quality (see discussion under "troubled debt restructuring by a creditor" below)

The accounting policy disclosures should include the following:

Excerpt from ASC 310-10-50-6

a. The policy for placing financing receivables, if applicable, on nonaccrual status (or discontinuing accrual of interest)

b. The policy for recording payments received on nonaccrual financing receivables, if applicable

c. The policy for resuming accrual of interest

d. [not used]

e. The policy for determining past due or delinquency status.

As required by ASC 310-10-50-7 and 7A, reporting entities should also disclose the amount of financing receivables on nonaccrual status and the amounts that are 90 days or more past due and still accruing, as of each balance sheet date. They should also disclose the aging for financing receivables that are past due at the end of the reporting period.

Reporting entities may have credit exposure related to off-balance-sheet loan commitments, standby letters of credit, certain financial guarantees, and other similar instruments (other than those within the scope of ASC 815, *Derivatives and Hedging*). In addition to the disclosures required by ASC 450, *Contingencies* (discussed in FSP 23), reporting entities should also describe the accounting policies and methods used to estimate its liabilities related to off-balance-sheet credit exposures and related charges. The disclosure should discuss factors that influenced management's judgment and the risk elements relevant to their financial instruments.

In addition, reporting entities are required to disclose quantitative and qualitative information by class that indicates the credit quality of their financing receivables. This information should include all of the following:

- A description of the credit quality indicator
- The recorded investment in financing receivables by credit quality indicator
- The date/range of dates for which each credit quality indicator was updated

In addition, if the reporting entities disclose internal risk ratings, they should provide qualitative information on how those ratings relate to the risk of loss.

Allowance for credit losses related to financing receivables

The disclosure requirements discussed in this section apply to financing receivables, except for the receivables listed in ASC 310-10-50-7B (e.g., certain trade accounts receivable, receivables measured at fair value with changes in fair value reported in earnings, receivables measured at lower of cost or fair value, and participant loans in defined contribution pension plans), and a lessor's net investment in leveraged leases.

ASC 310 requires reporting entities to disclose information about financing receivables' allowance for credit losses at a portfolio segment level.

The following disclosures related to the allowance for credit losses are required by portfolio segment.

ASC 310-10-50-11B

a. A description of the entity's accounting policies and methodology used to estimate the allowance for credit losses, including all of the following:

    1. A description of the factors that influenced management's judgment, including both of the following:

        i. Historical losses

        ii. Existing economic conditions.

    2. A discussion of risk characteristics relevant to each portfolio segment

    3. Identification of any changes to the entity's accounting policies or methodology from the prior period and the entity's rationale for the change.

b. A description of the policy for charging off uncollectible financing receivables

c. The activity in the allowance for credit losses for each period, including all of the following:

   1. The balance in the allowance at the beginning and end of each period

   2. Current period provision

   3. Direct write-downs charged against the allowance

   4. Recoveries of amounts previously charged off.

d. The quantitative effect of changes identified in item (a)(3) on item (c)(2)

e. The amount of any significant purchases of financing receivables during each reporting period

f. The amount of any significant sales of financing receivables or reclassifications of financing receivables to held for sale during each reporting period

g. The balance in the allowance for credit losses at the end of each period disaggregated on the basis of the entity's impairment method

h. The recorded investment in financing receivables at the end of each period related to each balance in the allowance for credit losses, disaggregated on the basis of the entity's impairment methodology in the same manner as the disclosure in item (g).

In order to disaggregate the information required by items (g) and (h) above on the basis of the impairment methodology, ASC 310-10-50-11C requires reporting entities to separately disclose:

- Amounts collectively evaluated for impairment (determined under ASC 450-20)

- Amounts individually evaluated for impairment (determined under ASC 310-10-35)

- Amounts related to loans acquired with deteriorated credit quality (determined under ASC 310-30)

In addition, asset valuation allowances for losses should be deducted from the assets or group of assets to which the allowances relate and should have appropriate footnote disclosures.

Finally, if loan products have contractual terms that expose the reporting entities to risks and uncertainties, the disclosure requirements of ASC 275, *Risks and Uncertainties*, may be required. See FSP 24 for discussion of disclosure requirements associated with risks and uncertainties.

Impaired loans

ASC 310-10-35-16 through 35-17 define impaired loans. In general, loans are impaired when it is probable that a creditor will be unable to collect the contractual amount due under the loan agreement.

Measuring impairment of a loan requires estimates and the eventual outcomes may differ from those estimates. Impairment should be measured using the present value of expected future cash flow or, as a practical expedient, can use the fair value of collateral or a loan's observable market price. The measurement method could be applied on a loan-by-loan basis. Once the method is selected for an individual loan, it should be applied consistently to that loan.

When the loan amount, determined under either of the methods noted above, is less than the recorded investment in the loan, an impairment is recorded by adjusting (or creating) a valuation allowance account with a corresponding charge to bad-debt expense.

When either the loan pricing or fair value of collateral is used, changes in the observable market price of an impaired loan (or the fair value of the collateral that backs an impaired, collateral-dependent loan) should be reflected as an increase or decrease in bad debt expense.

For financing receivables that meet the definition of impaired loans, reporting entities are required to disclose both the accounting policy and the amounts of such loans. In addition, the following disclosures are required for partially charged off loans. These disclosures are not applicable to fully charged off loans since both the recovered investment and allowance for credit losses will equal zero.

Excerpt from ASC 310-10-50-15

An entity shall disclose all of the following information about loans that meet the definition of an impaired loan in paragraphs 310-10-35-16 through 35-17 by class of financing receivable:

a. As of the date of each statement of financial position presented:

    1. [not used]

    2. [not used]

    3. The recorded investment in the impaired loans and both of the following:

        i. The amount of that recorded investment for which there is a related allowance for credit losses determined in accordance with Section 310-10-35 and the amount of that allowance

        ii. The amount of that recorded investment for which there is no related allowance for credit losses determined in accordance with Section 310-10-35.

4. The total unpaid principal balance of the impaired loans.

b. The entity's policy for recognizing interest income on impaired loans, including how cash receipts are recorded

c. For each period for which results of operations are presented:

1. The average recorded investment in the impaired loans

2. The related amount of interest income recognized during the time within that period that the loans were impaired

3. The amount of interest income recognized using a cash-basis method of accounting during the time within that period that the loans were impaired, if practicable.

d. The entity's policy for determining which loans the entity assesses for impairment under Section 310-10-35

e. The factors considered in determining that the loan is impaired.

Reporting entities should disclose the activity in the total allowance for credit losses related to loans for each period presented, including the balance in the allowance at the beginning and end of each period, additions charged to operations, direct write-downs charged against the allowance, and recoveries of amounts previously charged off.

Finally, when a change in present value attributable to the passage of time is recorded as interest income, footnote disclosure is required.

Troubled debt restructurings by a creditor

ASC 310-40 requires creditors to disclose the amount of commitments, if any, the reporting entities have made to lend additional funds to debtors whose receivables to the creditor have been modified in a troubled debt restructuring.

However, the disclosures required by ASC 310-10-50-15(a) and 15(c) are not required for impaired loans that have been restructured in a troubled debt restructuring involving a modification of terms in years after the restructuring if both of the following conditions exist:

- The interest rate in the restructuring agreement is greater than or equal to the rate the creditor was willing to accept for a new loan with comparable risk at the time of the restructuring

- The loan is not impaired based on the terms of the restructuring agreement

This disclosure exception should be applied consistently for all restructured loans in a troubled debt restructuring.

ASC 310-10-50-31 through 50-34 also provide disclosure requirements for a creditor's troubled debt restructuring of financing receivables, including a creditor's modification of a lease receivable that meets the definition of a troubled debt restructuring. This guidance is not applicable to the receivables listed in ASC 310-10-50-7B detailed above (e.g., certain trade accounts receivable, receivables measured at fair value with changes in fair value reported in earnings, receivables measured at lower of cost or fair value, and participant loans in defined contribution pension plans), and loans acquired with deteriorated credit quality that are accounted for within a pool.

For all income statement periods presented, reporting entities must disclose the following for any troubled debt restructurings of financing receivables occurring during the period:

- Qualitative and quantitative information, by class, including how the receivable was modified and the modification's effects

- Qualitative information, by portfolio segment, discussing how such modifications factor into the determination of the allowance for credit losses

If there was a payment default on any financing receivables that were modified within the last twelve months, the reporting entities should also disclose the following for each income statement presented:

- Qualitative and quantitative information, by class, indicating the types of financing receivables that defaulted and the amount

- Qualitative information, by portfolio segment, discussing how such defaults factor into the determination of the allowance for credit losses

Loans acquired with deteriorated credit quality

Some reporting entities purchase loans that have deteriorated credit quality. ASC 310-30 provides specific disclosure requirements for these types of receivables.

Reporting entities must describe in their footnotes how prepayments are considered when determining contractual cash flows and cash flows expected to be collected. In addition, ASC 310-30-50-2 requires additional disclosures.

ASC 310-30-50-2

In addition to disclosures required by other generally accepted accounting principles (U.S. GAAP), for each balance sheet presented, an investor shall disclose the following information about loans within the scope of this Subtopic:

a. Separately for both those loans that are accounted for as debt securities and those loans that are not accounted for as debt securities, all of the following.

1. The outstanding balance (see paragraph 310-30-50-3) and related carrying amount at the beginning and end of the period

2. The amount of accretable yield at the beginning and end of the period, reconciled for additions, accretion, disposals of loans, and reclassifications to or from nonaccretable difference during the period

3. For loans acquired during the period, the contractually required payments receivable, cash flows expected to be collected, and fair value at the acquisition date

4. For those loans within the scope of this Subtopic for which the income recognition model in this Subtopic is not applied in accordance with paragraph 310-30-35-3, the carrying amount at the acquisition date for loans acquired during the period and the carrying amount of all loans at the end of the period.

b. Further, for those loans that are not accounted for as debt securities, both of the following:

1. The amount of both of the following:

    i. Any expense recognized pursuant to paragraph 310-30-35-10(a)

    ii. Any reductions of the allowance recognized pursuant to paragraph 310-30-35-10(b)(1) for each period for which an income statement is presented.

2. The amount of the allowance for uncollectible accounts at the beginning and end of the period.

8.3.2 Shareholder and other receivables

Generally, reporting entities should separately state on the balance sheet all amounts receivable from officers and directors resulting from sales of stock or from other transactions (other than expense advances or sales on normal trade terms). This is true regardless of whether such amounts are shown as assets or deductions from shareholders' equity. Refer to FSP 5 for further discussion on determining the appropriate presentation of these receivables.

In accordance with S-X 5-02(17), other receivables that are in excess of 5 percent of total assets should be presented separately on the face of the balance sheet or in a footnote.

8.3.3 *Discounts or premiums on note receivables*

Often, the face amount of a note receivable does not represent the present value of the consideration given or received in the exchange. In this situation, a discount or premium is recorded.

ASC 835-30 includes the presentation and disclosures required for discounts or premiums on note receivables.

ASC 835-30-45-1A through 45-3

45-1A. The discount or premium resulting from the determination of present value in cash or noncash transactions is not an asset or liability separable from the note that gives rise to it. Therefore, the discount or premium shall be reported in the balance sheet as a direct deduction from or addition to the face amount of the note. It shall not be classified as a deferred charge or deferred credit.

45-2. The description of the note shall include the effective interest rate. The face amount shall also be disclosed in the financial statements or in the notes to the statements.

45-3. Amortization of discount or premium shall be reported as interest expense. Issue costs shall be reported in the balance sheet as deferred charges.

Further discussion about discount and premium presentation and disclosure considerations from the debtor's perspective are discussed in FSP 12.

8.3.4 *Loan origination and other fees*

The unamortized balance of loan origination, commitment, or other fees or costs, and purchase premiums and discounts that are being recognized as an adjustment of yield, should be reported on the balance sheet as part of the loan balance to which it relates. Any commitment fee that meets the criteria of ASC 310-20-35-3 should be classified as deferred income in the financial statements.

Per ASC 310-20-45-3, loan origination, commitment, and other fees and costs recognized as an adjustment of yield should be reported as part of interest income. Amortization of other fees, such as commitment fees that are being amortized on a straight-line basis over the commitment period or included in income when the commitment expires, should be reported as service fee income.

8.3.4.1 *Net fees and costs*

Reporting entities may acquire a loan by initially lending money or by purchasing the loan from another party. Typically, nonrefundable fees and costs are associated with these lending activities and loan purchases.

Reporting entities are required to disclose the method for recognizing interest income on loans. As part of this disclosure, they should also include their accounting policy for related fees and costs and their method of amortizing net deferred fees or costs.

ASC 310-20-50 includes other required disclosures related to net fees and costs.

ASC 310-20-50-2 through 50-3

50-2. Entities that anticipate prepayments in applying the interest method shall disclose that policy and the significant assumptions underlying the prepayment estimates.

50-3. The unamortized net fees and costs shall be reported as a part of each loan category. Additional disclosures such as unamortized net fees and costs may be included in the footnotes if the lender believes that such information is useful to the users of financial statements.

ASC 310-20-50-4 requires reporting entities to disclose its accounting policy related to net amount capitalized at the balance sheet date, and the amortization periods related to credit card fees received and costs for both purchased and originated credit cards.

8.3.5 Hypothecation or other pledging of receivables

S-X 4-08(b) requires disclosure of the amount of receivables mortgaged, pledged, or otherwise subject to lien. Any obligations collateralized should also be identified.

8.4 Inventory

The presentation requirements for inventory are generally dictated by SEC guidance, while the disclosure requirements are found in both SEC and U.S. GAAP guidance. The extent of disclosure requirements varies depending on the method of accounting for inventory.

8.4.1 General presentation requirements

S-X 5-02(6)(a) requires an SEC registrant to state separately on the balance sheet or in a footnote the amounts of major classes of inventory, such as finished goods, inventoried costs relating to long-term contracts or programs, work in process, raw materials, and supplies.

Inventory markdowns attributed to an exit plan or other restructuring activity (not accounted for as discontinued activity) should be classified on the income statement as a component of cost of goods sold.

8.4.2 General disclosure requirements

The primary basis of accounting for inventories is cost, provided cost is not higher than the net amount realizable from the subsequent sale of the inventories. Reporting entities are required to disclose the basis of accounting for inventories (e.g., lower of cost or market). When a significant change in basis occurs, disclosures regarding the nature of the change and its effect on income are required.

S-X 5-02(6)(b)

The basis of determining the amounts shall be stated.

If "cost" is used to determine any portion of the inventory amounts, the description of this method shall include the nature of the cost elements included in inventory. Elements of "cost" include, among other items, retained costs representing the excess of manufacturing or production costs over the amounts charged to cost of sales or delivered or in-process units, initial tooling or other deferred startup costs, or general and administrative costs.

The method by which amounts are removed from inventory (e.g., "average cost," "first-in, first-out," "last-in, first-out," "estimated average cost per unit") shall be described. If the estimated average cost per unit is used as a basis to determine amounts removed from inventory under a total program or similar basis of accounting, the principal assumptions (including, where meaningful, the aggregate number of units expected to be delivered under the program, the number of units delivered to date and the number of units on order) shall be disclosed.

If any general and administrative costs are charged to inventory, state in a note to the financial statements the aggregate amount of the general and administrative costs incurred in each period and the actual or estimated amount remaining in inventory at the date of each balance sheet.

ASC 330-10-50-1 also requires disclosure of the measurement basis and the nature of any change therein as well as, if material, the effect on income. In the relatively rare instances that inventory is stated above cost or at sales price, this fact should be disclosed. If inventory is presented at standard cost, it should be titled appropriately.

ASC 330-10-30-12

Standard costs are acceptable if adjusted at reasonable intervals to reflect current conditions so that at the balance-sheet date standard costs reasonably approximate costs computed under one of the recognized bases. In such cases descriptive language shall be used which will express this relationship, as, for

> instance, "approximate costs determined on the first-in first-out basis," or, if it is desired to mention standard costs, "at standard costs, approximating average costs."

ASC 330-10-50-1 also requires disclosure of the method by which costs are removed from inventory (e.g., average cost, first-in, first-out (FIFO), last-in, first-out (LIFO), estimated average cost per unit). If LIFO or estimated average cost per unit is used, additional disclosures are required. LIFO disclosures are detailed in FSP 8.4.3. If the estimated cost per unit method is used, reporting entities should disclose the principal assumptions, including, where meaningful, the aggregate number of units expected to be delivered under the program, the number of units delivered to date, and the number of units on order.

For any inventory mortgaged, pledged, or otherwise subject to lien, the approximate amounts thereof and the related obligations collateralized by those assets should be disclosed. In addition, when substantial and unusual losses result from the application of the lower of cost or market rule to inventories or firm purchase commitments, disclosure of the amount of the loss generally should be identified separately from cost of goods sold on the income statement.

Some reporting entities maintain a stock of spare parts that is used in connection with maintenance agreements with customers for customer-owned equipment. Often, when the reporting entities replace a particular part, the removed part is repaired and maintained for future use. The refurbished parts should be classified as inventories, and a loss in the utility of such parts should be recorded in the period in which it occurs, in accordance with ASC 330-10-35-2.

8.4.3 Last-in, first-out (LIFO) inventories

Reporting entities that use LIFO for tax reporting purposes are required to also use LIFO for accounting reporting purposes under the LIFO conformity requirement (Internal Revenue Code 472-2(e)). Supplemental disclosure of non-LIFO information is allowed, as long as it accompanies the primary LIFO statement, and is clearly labeled as being supplemental.

When the LIFO inventory method is used, S-X 5-02(6)(c) requires reporting entities to disclose the excess of replacement or current cost over stated LIFO value. This disclosure can be made parenthetically on the face of the balance sheet or in a footnote. In addition, if the method of calculating LIFO inventory does not allow for the practical determination of amounts assigned to major classes of inventory, S-X 5-02(6)(a) requires the amounts of those classes to be stated under cost flow assumptions other than LIFO. However, the excess of such total amounts over the aggregate LIFO amount should be shown as a deduction to arrive at the amount of LIFO inventory.

SAB Topic 11.F, *LIFO Liquidations*, requires sufficient disclosure in the footnotes of the impact of LIFO liquidations on net income and earnings per share. Furthermore, these effects should not receive any special treatment on the income statement (e.g., they should be included in the same line item where inventory costs are expensed).

8.4.3.1 *LIFO used for a portion of inventories*

If LIFO is not used for all inventories, then disclosure is recommended regarding the extent to which LIFO is used, which generally means the nature and dollar amount of inventories priced at LIFO and under other methods.

8.4.4 *Change in inventory costing method*

A change in inventory costing method is a change in accounting principle. As such, reporting entities that change their method of inventory costing are required to justify and disclose the change and explain why the newly adopted principle is preferable.

The effect of the change on the income statement must be disclosed in subsequent years whenever the change has created an inconsistency among the years being presented. Refer to FSP 30 for further considerations related to accounting changes.

8.5 *Prepaid assets and other current and noncurrent assets*

Presentation and disclosure requirements for prepaid assets and other current and noncurrent assets vary depending on the nature of the asset and the underlying guidance.

8.5.1 *Prepaid and other current assets*

S-X 5-02(8) requires any amounts in excess of 5 percent of total current assets to be separately disclosed on the balance sheet or in a footnote.

8.5.2 *Foreclosed or repossessed assets*

ASC 310 requires foreclosed or repossessed assets to be identified either on the face of the balance sheet or in the footnotes unless such assets will be utilized by the reporting entities in operations (e.g., returned inventory that will be resold). In addition, reporting entities should disclose the carrying amount of foreclosed residential real estate properties held at the reporting date.

8.5.3 *Other assets – noncurrent*

S-X 5-02(17) requires any noncurrent asset that is in excess of 5 percent of total assets to be disclosed separately on the balance sheet or in a footnote. In addition, any significant increase or decrease in that asset should be explained in the footnotes. With respect to any significant deferred charges, the policy for deferral and amortization should also be provided in the footnotes.

8.5.4 *Deferred costs – capitalized advertising costs*

ASC 340-20-50 requires reporting entities to disclose information related to advertising costs.

ASC 340-20-50-1

The notes to the financial statements shall disclose all of the following:

a. The accounting policy selected from the two alternatives in paragraph 720-35-25-1 for reporting advertising, indicating whether such costs are expensed as incurred or the first time the advertising takes place

b. A description of the direct-response advertising reported as assets (if any), the accounting policy for it, and the amortization period

c. The total amount charged to advertising expense for each income statement presented, with separate disclosure of amounts, if any, representing a write-down to net realizable value

d. The total amount of advertising reported as assets in each balance sheet presented.

In addition, costs of direct-response advertising that meet the capitalization criteria under ASC 340-20-25-4 should be reported separately as assets net of accumulated amortization.

8.6 *Property, plant, and equipment*

The balances of major classes of depreciable assets, accumulated depreciation (either by major classes of depreciable assets or in total), depreciation expense for all income statement periods presented, and a general description of methods used to compute depreciation should be disclosed in the financial statements or in the footnotes. In disclosing the major classes of depreciable assets, reporting entities are required to disclose depreciable assets by nature (e.g., machinery and equipment, buildings) or by function (e.g., manufacturing, marketing, transportation). In addition, the SEC expects registrants to disclose the useful lives of major classes of assets.

The total amount of depreciation accumulated during a period, together with significant amounts charged to noncurrent asset accounts, should be disclosed. In addition, disclosures should be provided to enable financial statement users to reconcile depreciation expense reported for the period to the amount shown on the statement of cash flows.

S-x 4-08(b) requires disclosure of any assets mortgaged, pledged, or otherwise subject to lien, and the obligations collateralized should be identified briefly.

It is common for manufacturing companies to maintain “stores” items, which are spare maintenance materials and parts kept on hand as backup components of major production lines. These items are considered essential to the operations of the facility. It is appropriate to capitalize stores items because they have a service potential (when a part on a machine breaks down) and will provide future economic benefit to the reporting entities. These items are generally classified as current or noncurrent assets depending on a reporting entities' specific facts and the nature of the reporting entities' business.

8.6.1 *Long-lived assets classified as held and used*

ASC 360 requires certain disclosures for long-lived assets classified as held and used, which are discussed in the following subsections.

8.6.1.1 *Impairment*

ASC 360-10-45-4 requires an impairment loss recognized for a long-lived asset (asset group) to be held and used to be included in income from continuing operations before income taxes. If a subtotal such as "income from operations" is presented, that subtotal should include the impairment loss.

Related disclosures are detailed in ASC 360-10-50.

ASC 360-10-50-2

All of the following information shall be disclosed in the notes to the financial statements that include the period in which an impairment loss is recognized.

a. A description of the impaired long-lived asset (asset group) and the facts and circumstances leading to the impairment

b. If not separately presented on the face of the statement, the amount of the impairment loss and the caption in the income statement or the statement of activities that includes that loss

c. The method or methods for determining fair value (whether based on a quoted market price, prices for similar assets, or another valuation technique)

d. If applicable, the segment in which the impaired long-lived asset (asset group) is reported under Topic 280.

8.6.1.2 *Disposal gain or losses*

A gain or loss recognized on the sale of a long-lived asset (disposal group) that does not qualify as a discontinued operation should be included in an operating income (expense) line item on the income statement. If a subtotal such as income from operations is presented, that subtotal should include the amounts of those gains or losses. It is not appropriate to present such gains or losses as non-operating.

8.6.2 *Long-lived assets to be disposed of other than by sale*

A long-lived asset to be disposed of other than by sale (for example, by abandonment, in an exchange measured based on the recorded amount of the nonmonetary asset relinquished, or in a distribution to owners in a spinoff) should continue to be classified as held and used until it is disposed. It will be subject to the presentation and disclosure requirements discussed in FSP 8.6.1.

8.6.3 *Leases*

Refer to FSP 14 for presentation and disclosure considerations related to leased property, plant, and equipment.

8.7 *Held for sale*

ASC 360 provides guidance for when to classify long-lived assets as held for sale, how to present the assets, and the required disclosures.

Excerpt from ASC 360-10-45-9

A long-lived asset (disposal group) to be sold shall be classified as held for sale in the period in which all of the following criteria are met:

a. Management, having the authority to approve the action, commits to a plan to sell the asset (disposal group).

b. The asset (disposal group) is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (disposal groups).

c. An active program to locate a buyer and other actions required to complete the plan to sell the asset (disposal group) have been initiated.

d. The sale of the asset (disposal group) is probable, and transfer of the asset (disposal group) is expected to qualify for recognition as a completed sale, within one year, except as permitted by paragraph 360-10-45-11.

e. The asset (disposal group) is being actively marketed for sale at a price that is reasonable in relation to its current fair value. The price at which a long-lived asset (disposal group) is being marketed is indicative of whether the entity currently has the intent and ability to sell the asset (disposal group). A market price that is reasonable in relation to fair value indicates that the asset (disposal group) is available for immediate sale, whereas a market price in excess of fair value indicates that the asset (disposal group) is not available for immediate sale.

f. Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

Refer to BCG 10 for further details on how to apply the above requirements. Once a long-lived asset (disposal) group meets these requirements, it is subject to the presentation and disclosure requirements discussed in the following subsections.

8.7.1 *Assets (disposal group) sold or classified as held for sale*

Assets and liabilities (separate line items of current and noncurrent assets, and current and noncurrent liabilities, as applicable) of a disposal group classified as held for sale should be separately disclosed on the face of the balance sheet. Reporting entities may classify all assets and liabilities held for sale as current when 1) the disposal is expected to be consummated within one year of the balance sheet date, 2) the entity expects to receive cash or other current assets upon disposal and the sale proceeds will not be used to reduce long-term borrowings, and 3) the components (current and noncurrent) of the major classes of assets and liabilities held for sale are disclosed in the notes to the financial statements.

Reporting entities are not required to reclassify the disposal group as held for sale in periods prior to the period in which the disposal group becomes held for sale. Refer to FSP 27 for presentation and disclosure requirements associated with disposal groups classified as held for sale that qualify as discontinued operations.

If an asset (disposal group) classified as held for sale does not meet the definition of a component, or is a component but does not meet the criteria for discontinued operations, the gain or loss on disposal should be recognized in operating income before income taxes on the income statement.

Pursuant to S-X 5-03(6), gains or losses from the sale of long-lived assets or a business that does not qualify as a discontinued operation should be reported as "other general expenses." Gains or losses from the sale of long-lived assets must be included as a component of operating income. Gains or losses from the sale of business could be included as a component of operating or non-operating income. Any material item should be stated separately.

ASC 205, *Presentation of Financial Statements*, requires disclosures related to assets sold or held for sale.

Excerpt from ASC 205-20-50-1

a. A description of the facts and circumstances leading to the expected disposal, the expected manner and timing of that disposal, and, if not separately presented on the face of the statement, the carrying amount(s) of the major classes of assets and liabilities included as part of a disposal group

b. The gain or loss recognized in accordance with paragraphs 360-10-35-40 and 360-10-40-5 and if not separately presented on the face of the income statement, the caption in the income statement or the statement of activities that includes that gain or loss

c. If applicable, amounts of revenue and pretax profit or loss reported in discontinued operations

d. If applicable, the segment in which the long-lived asset (disposal group) is reported under Topic 280 [*Segment Reporting*].

The above disclosures are required in financial statements that cover the period in which a long-lived asset (disposal group) has either been sold or is classified as held for sale.

The FASB issued new guidance on discontinued operations in April 2014, which requires additional disclosures for individually significant disposals that do not qualify for discontinued operations. See FSP 27 for discussion of these requirements.

8.7.2 Change to a plan of sale

Reporting entities may change a plan to sell a long-lived asset (disposal group). In the period that decision is made, the reporting entities should describe the facts and circumstances leading to the decision to change the plan and its effect on the income statement for the period and any prior periods presented.

If the reporting entity decides not to sell a long-lived asset (disposal group) previously classified as held for sale, then such asset (disposal group) should be reclassified as held and used in the period when the decision is made. Any required adjustment to the carrying amount due to the reclassification should be included in income from continuing operations in the period of the subsequent decision not to sell. This adjustment should be reported in the same income statement caption used to report a loss, if any, recognized in accordance with ASC 360-10-45-5. The results of operations of a component previously reported in discontinued operations in accordance with ASC 205-20-45-3 should be reclassified and included in income from continuing operations for all periods presented.

8.7.3 Newly acquired asset classified as held for sale

ASC 360-10-45-12 provides specific criteria which, if met, require the acquirer to present newly-acquired assets as assets held for sale. The criteria requires a plan to dispose of the assets within a year, and that it be probable that the acquirer will meet the other held for sale criteria (discussed in FSP 8.7) within a short period of time after the acquisition date (usually within three months).

8.8 Intangible assets subject to amortization

The presentation and disclosure requirements discussed in this section are applicable to the post-acquisition periods for intangible assets subject to amortization. Presentation and disclosure requirements in the period of acquisition are discussed in FSP 17.

8.8.1 *Post-acquisition disclosures*

ASC 350-30-45-1 requires intangible assets to be presented separately on the balance sheet at an individual, class, or aggregate level.

S-X 5-02(15) requires separate presentation for each class of intangible assets that is in excess of 5 percent of total assets, along with the basis of determining the respective amounts. Any significant addition or deletion should be explained in a footnote. S-X 5-02(16) requires that the amount of accumulated depreciation and amortization related to intangible assets be stated separately on the balance sheet or in a footnote.

Information related to intangible assets should be disclosed in the financial statements or the footnotes for each period for which a balance sheet is presented.

Excerpt from ASC 350-30-50-2(a)

For intangible assets subject to amortization, [disclose] all of the following:

1. The gross carrying amount and accumulated amortization, in total and by major intangible asset class

2. The aggregate amortization expense for the period

3. The estimated aggregate amortization expense for each of the five succeeding fiscal years.

ASC 350-30-45-2 also requires amortization expense and impairment losses for intangible assets to be presented in income statement line items within continuing operations. Refer to FSP 3 for income statement presentation and disclosure requirements.

8.8.1.1 *Research and development assets*

ASC 350 requires disclosures for research and development assets.

Excerpt from ASC 350-30-50-1

c. The amount of research and development assets acquired in a transaction other than a business combination or an acquisition by a not-for-profit entity and written off in the period and the line item in the income statement in which the amounts written off are aggregated.

8.8.1.2 *Estimate of useful life*

ASC 275, *Risks and Uncertainties,* requires reporting entities to disclose the estimated useful life of an intangible asset when it is reasonably possible the estimate will change and have a material impact on the financial statements.

The materiality criterion may be met if a change in useful lives or a change in expected likelihood of renewal is material individually or in aggregate by major intangible asset class.

8.8.2 *Impairment losses*

ASC 350-30-50 requires disclosure for each impairment loss recognized related to an intangible asset.

Excerpt from ASC 350-30-50-3

a. A description of the impaired intangible asset and the facts and circumstances leading to the impairment

b. The amount of the impairment loss and the method for determining fair value

c. The caption in the income statement or the statement of activities in which the impairment loss is aggregated

d. If applicable, the segment in which the impaired intangible asset is reported under Topic 280 [Segment Reporting].

The above disclosures should continue to be included in the footnotes whenever the financial statements include the income statement for the year in which the impairment loss was recognized.

8.9 *Intangible assets not subject to amortization and goodwill*

Goodwill and intangible assets that are not subject to amortization have different presentation and disclosure requirements. The following subsections discuss the requirements for post-acquisition ("Day 2") accounting. Presentation and disclosure requirements for goodwill and intangible assets associated with an acquisition are discussed in FSP 17.

8.9.1 *Intangible assets not subject to amortization*

For each period for which a balance sheet is presented, all of the following information should be disclosed in the financial statements or footnotes.

Excerpt from ASC 350-30-50-2

b. For intangible assets not subject to amortization, the total carrying amount and the carrying amount for each major intangible asset class

c. The entity's accounting policy on the treatment of costs incurred to renew or extend the term of a recognized intangible asset

d. For intangible assets that have been renewed or extended in the period for which a statement of financial position is presented, both of the following:

   1. For entities that capitalize renewal or extension costs, the total amount of costs incurred in the period to renew or extend the term of a recognized intangible asset, by major intangible asset class

   2. The weighted-average period before the next renewal or extension (both explicit and implicit), by major intangible asset class.

In addition, SEC registrants are required to separately state each class of intangible asset that is in excess of 5 percent of total assets, along with the basis of determining the respective amounts. The amount of significant additions or deletions related to these assets should be stated separately on the balance sheet or in a footnote.

8.9.1.1 *Impairment of intangible assets not subject to amortization*

Disclosures for impairment losses for intangible assets not subject to amortization are similar to intangible assets subject to amortization. Refer to FSP 8.8.2.

8.9.1.2 *Renewal or extension of an intangible asset's legal or contractual life*

ASC 350-30-50-4 requires reporting entities to disclose information that enables financial statement users to assess the extent to which the expected future cash flows associated with the intangible asset are affected by the reporting entities' intent or ability (or both intent and ability) to renew or extend the arrangement.

8.9.2 *Goodwill*

Reporting entities are required to present the aggregate amount of goodwill as a separate line item in the balance sheet.

8.9.2.1 *Goodwill reconciliation*

A reconciliation of the carrying amount of goodwill at the beginning and end of the reporting period is required and should include the following:

Excerpt from ASC 350-20-50-1

The changes in the carrying amount of goodwill during the period shall be disclosed, showing separately:

a. The gross amount and accumulated impairment losses at the beginning of the period

b. Additional goodwill recognized during the period, except goodwill included in a disposal group that, on acquisition, meets the criteria to be classified as held for sale in accordance with paragraph 360-10-45-9

c. Adjustments resulting from the subsequent recognition of deferred tax assets during the period in accordance with paragraphs 805-740-25-2 through 25-4 and 805-740-45-2

d. Goodwill included in a disposal group classified as held for sale in accordance paragraph 360-10-45-9 and goodwill derecognized during the period without having previously been reported in a disposal group classified as held for sale

e. Impairment losses recognized during the period in accordance with this Subtopic

f. Net exchange differences arising during the period in accordance with Topic 830

g. Any other changes in the carrying amounts during the period

h. The gross amount and accumulated impairment losses at the end of the period.

ASC 350-20-50-1 also requires reporting entities that report segments under ASC 280, *Segment Reporting*, to disclose this information in total, and for each reportable segment. Significant changes in the allocation of goodwill should also be disclosed by segment. If any portion of goodwill has not yet been allocated to a reporting unit at the date the financial statements are issued, that unallocated amount and the reasons for not allocating that amount should be disclosed.

Reporting entities may change their internal organization structure such that the composition of reportable segments may change under ASC 280. This would result in the reporting entities restating all periods shown to reflect the new segments (see FSP 25.7.8 for further discussion). If the change in reporting structure does not change the composition of the entities' reporting units, the disclosures required for goodwill under ASC 350-20-50-1 could be revised without a reallocation of goodwill to reporting units.

If the composition of one or more of the reporting entities' reporting units is changed, the guidance in ASC 350-20-35-39 through 35-40 should be used to reassign assets and liabilities to the reporting units affected. Goodwill should be reassigned to the reporting units affected at the time the change to the structure is made and reported (in accordance with ASC 350-20-50-1(g)). This should be done using a relative fair value allocation approach similar to that used when a portion of a reporting unit is to be disposed of using the relative fair value approach discussed in ASC 350-20-35-51 through 35-57. Refer to BCG 11 for further details on this topic.

8.9.2.2 *Goodwill impairment*

The aggregate amount of goodwill impairment losses should be presented as a separate line item on the income statement within continuing operations unless a goodwill impairment is associated with a discontinued operation. For each goodwill impairment loss recognized, the following information should be disclosed in the footnotes that include the period in which the impairment loss is recognized:

Excerpt from ASC 350-20-50-2

a. A description of the facts and circumstances leading to the impairment

b. The amount of the impairment loss and the method of determining the fair value of the associated reporting unit (whether based on quoted market prices, prices of comparable businesses or nonprofit activities, a present value or other valuation technique, or a combination thereof)

c. If a recognized impairment loss is an estimate that has not yet been finalized (see paragraphs 350-20-35-18 through 35-19), that fact and the reasons therefore and, in subsequent periods, the nature and amount of any significant adjustments made to the initial estimate of the impairment loss.

This information should continue to be disclosed in the footnotes whenever the financial statements include the income statement for the period in which the impairment loss was recognized.

ASC 820-10-50-2(bbb) requires quantitative disclosures about significant unobservable inputs used in fair value measurements categorized within Level 3 of the fair value hierarchy. These disclosures are not required for fair value measurements related to the financial accounting and reporting for goodwill after its initial recognition in a business combination.

8.10 *Long-term contracts*

Reporting entities in certain industries enter into long-term revenue contracts. This may include construction contractors, but also manufacturers of large scale items (such as ships and airplanes) and professional service providers (such as consultants or architects). Although ASC 605-35, *Revenue—Construction-Type and Production-Type Contracts*, provides recognition and measurement guidance for such contracts, guidance on presentation and disclosure is limited. Therefore, many reporting entities look to ASC 910, *Contractors—Construction*, and ASC 912, *Contractors—Federal Government*, for guidance on what constitutes prudent presentation and disclosure for their long-term contracts.

Some of the ASC 910 and ASC 912 requirements are relevant primarily (or only) to the construction industry, and therefore are not covered in this chapter since this guide does not cover industry-specific guidance. However, because many different types of industries rely (either directly or by analogy) on certain aspects of ASC 910 or ASC 912 for presentation and disclosure guidance, select topics are discussed in this section. Due to the significant role that estimates play in accounting for long-term contracts, reporting entities should consider the disclosure requirements in ASC 275, *Risks and Uncertainties*. See FSP 24 for discussion of these requirements.

Note about new standard setting

In May 2014, the FASB issued Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers* (Topic 606). The new guidance will supersede ASC 605-35, and certain revenue-related requirements in ASC 910 and 912. This new guidance has not been reflected in this publication. Financial statement preparers and other users of this publication are therefore encouraged to evaluate the effective date of the new guidance and the implications on presentation and disclosure.

8.10.1 Contract receivables

Contract receivables are typically shown separate from other receivables on the balance sheet or otherwise disclosed in the footnotes. Receivables may include billed and unbilled amounts. Unbilled costs and fees are presented as receivables rather than advances or inventory. They should generally be shown separate from billed accounts receivable, net of unliquidated progress payments. Contract receivables from government agencies should be shown separately from other receivables either on the balance sheet or in the footnotes. This disaggregation provides a financial statement user with enhanced transparency since the risk profile of government receivables tends to differ from commercial enterprises.

In addition, the following disclosure requirements apply to contract receivables that are generated by unapproved change orders, claims, or similar items:

ASC 910-310-50-1

For billed or unbilled amounts under contracts representing unapproved change orders, claims, or similar items subject to uncertainty concerning their determination or ultimate realization, the balance sheet, or a note to the financial statements, shall disclose all of the following:

a. The amount
b. A description of the nature and status of the principal items comprising the amount
c. The portion, if any, expected to be collected after one year.

For amounts representing the recognized sales value of performance under contracts that have not been billed and were not billable at the date of the balance sheet, ASC 910-310-50-2 requires disclosures of the amounts and a general description of the prerequisites for billings. Reporting entities must also disclose the portion, if any, expected to be collected after one year.

For receivable amounts maturing after one year, reporting entities should disclose both:

- The amount maturing after one year and, if practicable, the amounts maturing in each year
- The interest rates on major receivables, or on classes of receivables, maturing after one year. Alternatively, the average interest rate or the range of rates on all receivables could be disclosed

Retainage provisions are common in long-term contracts. For retainage amounts billed but not paid by customers, the following items should be disclosed:

- The amount of retainage
- The portion expected to be collected after one year (if applicable)
- The years in which the amounts are expected to be collected (if practicable)

The portion of retainage not collectible within one year should be classified as noncurrent on the balance sheet.

S-X 5-02(3)(c) also requires separate disclosure requirements for receivables under long-term contracts. This guidance requires the following disclosures, either on the balance sheet or in a footnote:

Excerpt from S-X 5-02(3)(c)

1. Balances billed but not paid by customers under retainage provisions in contracts
2. Amounts representing the recognized sales value of performance and such amounts that had not been billed and were not billable to customers at the date of the balance sheet. Include a general description of the prerequisites for billing.
3. Billed or unbilled amounts representing claims or other similar items subject to uncertainty concerning their determination or ultimate realization. Include a description of the nature and status of the principal items comprising such amount.
4. With respect to (1) through (3) above, also state the amounts included in each item which are expected to be collected after one year. Also state, by year, if practicable, when the amounts of retainage (see (1) above) are expected to be collected.

8.10.2 Contract costs

Reporting entities' accounting practices with respect to costs included in inventory should be disclosed in a footnote. For costs deferred either in anticipation of future sales (precontract costs that are not within the scope of ASC 720-15), or as a result of an unapproved change order (where approval is anticipated), ASC 910-340-50-1 requires that the amount of deferred costs and the deferral policy also be disclosed in the footnotes.

In addition, the following disclosures should be made with regard to the nature of amounts included in contract costs:

Excerpt from ASC 910-20-50-1

a. The aggregate amount included in contract costs representing unapproved change orders, claims, or similar items subject to uncertainty concerning their determination or ultimate realization, plus a description of the nature and status of the principal items comprising such aggregate amounts and the basis on which such items are recorded (for example, cost or realizable value)

b. The amount of progress payments netted against contract costs at the date of the balance sheet.

In addition to the items discussed, S-X 5-02(6)(d) requires the following incremental disclosures relating to contract costs:

- The aggregate amount of manufacturing or production costs and any related deferred costs (e.g., initial tooling costs) that exceeds the total estimated cost of all units (whether in-process or delivered). This should be based on the estimated average cost of all units expected to be produced under long-term contracts and programs (even if not yet complete), as well as amounts that would not be absorbed in cost of sales based on existing firm orders at the latest balance sheet date. If practicable, also disclose the amount of deferred costs by type of cost (e.g., initial tooling, deferred production, etc.).

- The aggregate amount of contract claims or other similar items subject to uncertainty, including a description of the nature and status of the primary items comprising the amount.

- The amount of progress payments netted against inventory at the balance sheet date.

8.10.3 Other disclosures related to long-term contracts

Reporting entities are required to disclose the method of recognizing revenue (i.e., percentage of completion or completed contract method). If the percentage of completion is used, the method of measuring the extent of progress (e.g., cost-to-cost, direct labor) should be disclosed. If the completed contract method is used, the reason for selecting this method should also be disclosed.

Reporting entities that are engaged in long-term contracts may often be acting in a primary contractor role and have long-term contracts with its subcontractors related to the reporting entities' overall contract with its customer. In these instances, the reporting entities may have both a retainage asset from its customer, and a retainage payable to its subcontractors. Such amounts should not be netted on the balance sheet. Reporting entities are required to disclose information relating to retentions payable, including the amounts of retentions to be paid after one year and, if practicable, the year in which the amounts are expected to be paid.

8.11 Considerations for private companies

Certain presentation and disclosure requirements discussed in this chapter are only required for SEC registrants. In some instances, the difference in requirements is due to differences in U.S. GAAP. These differences are discussed in FSP 8.11.1 and 8.11.2.

The remaining differences are due to incremental presentation and disclosure requirements mandated by the SEC. These are summarized in Figure 8-1 at the end of this section.

8.11.1 Indefinite-lived intangible assets

When disclosing an indefinite-lived intangible asset after its initial recognition, a private company is not required to disclose the quantitative information about significant unobservable inputs used in fair value measurements categorized within Level 3 of the fair value hierarchy required by paragraph 820-10-50-2(bbb).

8.11.2 Goodwill

Private companies are permitted to early adopt goodwill accounting alternative ASU No. 2014-02, *Intangibles-Goodwill and Other* (Topic 350) (ASU 2014-02), which includes specific reporting and disclosure requirements for such companies. ASU 2014-02 allows eligible private companies to amortize goodwill and apply a one-step impairment model.

ASU 2014-02 requires the aggregate amount of goodwill net of accumulated amortization and impairment to be presented as a separate line item on the balance sheet. The amortization and aggregate amount of impairment of goodwill is required to be presented on the income statement line items within continuing operations (or similar caption) unless the amortization or a goodwill impairment loss is associated with a discontinued operation. In that case, the amortization and impairment should be included (on a net-of-tax basis) within the results of discontinued operations.

For each period for which a balance sheet is presented, private companies are required to disclose in the footnotes (1) the amount assigned to goodwill in total and by major business combination or by reorganization event resulting in fresh-start reporting, and (2) the weighted-average amortization period in total and the amortization period by major business combination or by reorganization event resulting in fresh-start reporting.

The following information should also be disclosed in the footnotes:

ASC 350-20-50-5

a. The gross carrying amounts of goodwill, accumulated amortization, and accumulated impairment loss

b. The aggregate amortization expense for the period

c. Goodwill included in a disposal group classified as held for sale in accordance with paragraph 360-10-45-9 and goodwill derecognized during the period without having previously been reported in a disposal group classified as held for sale.

The above disclosures are required in each period for which a balance sheet is presented.

ASC 820-10-50-2(bbb) requires quantitative disclosures about significant unobservable inputs used in fair value measurements categorized within Level 3 of the fair value hierarchy. These disclosures are not required for fair value measurements related to the financial accounting and reporting for goodwill after its initial recognition in a business combination.

8.11.2.1 Impairment loss

For each goodwill impairment loss recognized, the following information should be disclosed in the footnotes that include the period in which the impairment loss is recognized:

Excerpt from ASC 350-20-50-6

a. A description of the facts and circumstances leading to the impairment

b. The amount of the impairment loss and the method of determining the fair value of the entity or the reporting unit (whether based on prices of comparable businesses, a present value or other valuation technique, or a combination of those methods)

c. The caption in the income statement in which the impairment loss is included

e. The method of allocating the impairment loss to the individual amortizable units of goodwill.

This information should continue to be disclosed in the footnotes whenever the financial statements include the income statement for the year the impairment loss was recognized.

8.11.3 SEC requirements not applicable to private companies

The following presentation and disclosure requirements are only required for SEC registrants.

Figure 8-1
Presentation and disclosure requirements applicable only to SEC registrants

Description	Reference	Section of this chapter
Separate disclosure of receivables that exceed 10 percent of aggregate receivables	S-X 5-02 3(b),6-04 6(b)	8.3.1
Disclosure of receivables mortgaged, pledged, or otherwise subject to lien	S-X 4-08 (b)	8.3.5
Separate disclosure of major classes of inventory	S-X 5-02 6(a)	8.4.1
Disclosure of the excess of replacement or current cost over stated LIFO value	S-X 5-02 6(c)	8.4.3
Separate disclosure of prepaid and other current assets that exceed 5 percent of total current assets	S-X 5-02(8)	8.5.1
Separate disclosure of other noncurrent assets that exceed 5 percent of total assets	S-X 5-02(17)	8.5.3
Separate presentation for each class of intangible assets that exceed 5 percent of total assets	S-X 5-02 (15),(16)	8.8.1

Chapter 9: Investments — debt and equity securities

9.1 Chapter overview

Investments held in debt or equity securities of other entities (other than subsidiaries) are usually accounted for by one of three methods: the cost method, the equity method, or the fair value method. This chapter outlines the presentation and disclosure of investments in debt and equity securities and includes examples of the required disclosures.

This chapter does not address the following: investments in consolidated entities (FSP 18), investments accounted for under the equity method (FSP 10), investments in certain limited partnerships and limited liability companies (FSP 32), and hedging of investments (DH).

9.2 Scope

ASC 320, *Investments—Debt and Equity Securities,* establishes requirements for the presentation and disclosure of investments in debt and equity securities. As described in ASC 320-10-15-2 through 15-3, the guidance applies to all reporting entities, other than reporting entities in specialized industries that account for substantially all investments in debt and equity securities at fair value, with changes in fair value recognized through net income. These include broker-dealers, investment companies, and defined benefit pension and other postretirement plans.

ASC 325, *Investments—Other*, provides guidance for the presentation and disclosure of investments not within the scope of other authoritative guidance, including cost method investments.

Other relevant guidance for SEC registrants in this chapter includes S-X 5-02. S-X also includes industry-specific guidance, which is not addressed in this chapter.

Note about ongoing standard setting

This chapter includes guidance on classification and measurement of investments and presentation of impairments, including other-than-temporary impairments. As of the content cutoff date of this publication (August 31, 2014), the FASB has an active project that may affect presentation and disclosure requirements. Financial statement preparers and other users of this publication are therefore encouraged to monitor the status of the project, and if finalized, evaluate the effective date of the new guidance and the implications on presentation and disclosure.

9.3 Overview of classification guidance

The classification of investment securities per ASC 320-10-25 as trading, available-for-sale (“AFS”), or held-to-maturity (“HTM”) determines the balance sheet recognition as either a fair value or non-fair value measure.

ASC 325 provides guidance for investments in equity securities accounted for at cost because they do not have readily determinable fair values. The cost method should be applied if the equity investment does not qualify for consolidation, for the equity method of accounting, or as an ASC 320 security, and the reporting entity has not elected the fair value option under ASC 825, *Financial Instruments*.

Figure 9-1 summarizes the presentation of investments within the scope of ASC 320 or ASC 325.

Figure 9-1

Balance sheet and income statement presentation of investments

Classification of debt or equity security	Valuation	Treatment of unrealized gain/loss	Other income statement effects
Trading	Fair value	Recognized in net income	Interest and dividends as earned Gains and losses from sale
Held-to-maturity (debt securities only)	Amortized cost	Not recognized	Interest as earned Credit component of other-than-temporary impairment losses through income and remainder in OCI Gains and losses from sale
Available-for-sale	Fair value	Recognized in AOCI as a separate component of stockholders' equity	Interest and dividends as earned Other-than-temporary impairment losses through income (equity securities) Credit component of other-than-temporary impairment losses through income and remainder in OCI (debt securities) Gains and losses from sale
Cost method	Cost	Not recognized	Dividends as earned Other-than-temporary impairment losses through income Gains and losses from sale

9.4 Balance sheet presentation

ASC 320-10-45-1 and S-X 5-02 require a reporting entity to present AFS securities and trading securities that are measured at fair value separately from similar assets that are carried at amortized cost on the face of the balance sheet. To accomplish this, a reporting entity should present either of the following.

- The aggregate of the fair value and non-fair value amounts in the same line item in the balance sheet and parenthetically disclose the fair value amount included in the aggregate amount

- The fair value and non-fair value carrying amounts in two separate line items

S-X 5-02 states that reporting entities should have a separate caption for "marketable securities." The disclosure requirements for current marketable equity securities are specified by ASC 320. For marketable securities other than equity securities, S-X 5-02 requires reporting entities to state, parenthetically on the balance sheet or in the footnotes, the basis for determining the aggregate amount presented in the balance sheet, and the alternative measure (i.e., amortized cost if the securities are presented at fair value and fair value if the securities are presented at amortized cost).

We believe that complying with ASC 320 satisfies the requirements of S-X 5-02 in that investments in debt and equity securities will be presented separately from other assets, even if not termed "marketable securities" on the face of the balance sheet. Example 9-1 illustrates how a reporting entity may use this terminology in its balance sheet presentation for debt and equity securities, rather than using ASC 320 terminology.

EXAMPLE 9-1

Presentation of marketable securities

FSP Corp has marketable securities at December 31, 20X4, consisting of $150 of debt securities classified as HTM (with a fair value of $160) and AFS equity securities with a fair value of $100 (with an amortized cost basis of $90).

How should FSP Corp present these marketable securities on the balance sheet as of December 31, 20X4?

Analysis

FSP Corp should present these marketable securities on the balance sheet as follows:

Marketable securities at fair value (amortized cost is $90)	$100
Marketable securities at amortized cost (fair value is $160)	$150

Reporting entities subject to industry-specific guidance under S-X, such as bank holding companies and insurers, have different reporting requirements with regard to balance sheet captions. For example, insurers present fixed-maturity securities separately from equity securities on the face of the balance sheet. This chapter does not address all of the industry-specific guidance for balance sheet presentation.

9.4.1 Current and noncurrent classification

A reporting entity that presents a classified balance sheet (refer to FSP 2.3.4) should report individual marketable equity securities and individual debt securities classified as trading or AFS as either current or noncurrent under the provisions of ASC 210. This is achieved by applying one of the following two approaches consistently.

The first approach is to classify securities based on their maturities (for debt securities) and the reporting entity's reasonable expectation with regard to those securities (i.e., expectations of sales and redemptions). If the reporting entity expects to convert securities to cash within one year (or normal operating cycle), the securities should be classified as current assets. If this criterion is not met, the securities should be classified as noncurrent.

The second approach is to classify securities based on whether they represent the investment of funds available for current operations, as defined in ASC 210-10-45-1 and ASC 210-10-45-2. Under this approach, the reporting entity does not need to have a stated expectation to sell such securities within one year or normal operating cycle for such securities to be classified as current; however, the securities need to be available for use, if needed, for current operations.

HTM debt securities are, by definition, those for which management has the intent and ability to hold to maturity. Therefore, classification as current or noncurrent is based on the maturity date, or call date if exercise of the call within the next operating period or fiscal year is probable, of the individual securities. For example, HTM securities that mature within one year are classified as current.

Investments in securities (whether marketable or not) or advances made for the purposes of control, affiliation, or other continuing business advantage are excluded from the definition of current assets in ASC 210-10-45-4. Therefore, securities held for such purposes should be classified as noncurrent.

9.4.2 Deferred tax balances

ASC 320-10-45-3 through 45-6 provides guidance on the presentation of deferred tax assets arising from losses on AFS securities and the related valuation allowance, if applicable. For accounting considerations related to tax balances, see TX 12.2.3.2. For presentation and disclosure of deferred tax balances, see FSP 16.

9.5 Income statement presentation

ASC 320 does not provide specific guidance regarding presentation in the income statement other than guidance relating to other-than-temporary impairment ("OTTI"). Instead, ASC 320 broadly describes when amounts should be recognized in net income, as described in Figure 9-1. Recognition of OTTI is addressed in PwC's ARM 5010.

If the fair value of an equity or debt security is less than its amortized cost basis, the investment is impaired. For equity securities, if the impairment is deemed an OTTI, the loss is recognized in net income. For debt securities, if the impairment is deemed an OTTI, a portion of the loss is recognized in net income and a portion is recognized in OCI.

9.5.1 Other-than-temporary impairments — income statement

ASC 320-10-45-8A requires reporting entities to present the total OTTI in the income statement "with an offset" for the amount of the total OTTI that is recognized in OCI. Example 2A in ASC 320-10-55-21A illustrates the application of this guidance using three line items in the income statement.

However, there is diversity in practice as to whether the "offset" language in 320-10-45-8A is meant to allow presentation of the net impairment loss on the face of the income statement, rather than as three separate line items. We believe there are acceptable alternatives to presenting the net impairment loss as three separate line items. We believe presenting only the net impairment loss recognized in net income within the income statement would also be acceptable if that presentation is accompanied by either:

- Total OTTI and OTTI recognized in OCI presented parenthetically within the OTTI caption on the income statement

- Total OTTI and OTTI recognized in OCI presented separately at the bottom of the income statement.

We do not consider it acceptable to only present the total OTTI and OTTI recognized in OCI in the footnotes.

9.5.2 Other-than-temporary impairments — within OCI

Reporting entities should present amounts recognized in AOCI related to HTM and AFS debt securities for which a portion of an OTTI was recognized in net income separately from other components of AOCI in the financial statement that presents AOCI.

When a reporting entity recognizes an initial OTTI for an AFS security with a portion of that OTTI recorded in OCI and a portion in net income, the security has a new amortized cost basis. After the reporting entity recognizes the OTTI, it adjusts the amortized cost basis of the security for the portion of the OTTI recognized in net income. The reporting entity then adjusts the security's post-

OTTI carrying value to its fair value at the measurement date, which includes the effect of the impairment charge recorded in OCI.

The difference between the new amortized cost basis and carrying value that arises from the recognition of an initial OTTI results in the need for additional analysis to determine the total OTTI to be presented in the income statement in subsequent periods. Essentially, an additional OTTI does not exist unless the fair value of the security has declined further since the most recent OTTI (i.e., below the new amortized cost basis). However, even if the fair value of the security has not decreased subsequent to the recognition of an OTTI, if a credit loss is realized, the reporting entity may recognize an additional OTTI in the income statement.

The following examples illustrate presentation and disclosure considerations associated with recording amounts in AOCI and net income for debt securities with OTTI impairments.

EXAMPLE 9-2

Financial statement presentation of debt security with OTTI

On January 1, 20X1, FSP Corp acquires a debt security for $1,000 (at par) with a fixed interest rate of 4.5 percent per year and a maturity at December 31, 20X5. The security is classified as AFS.

On December 31, 20X4, the fair value of the debt security is $700. FSP Corp assesses whether the impairment is other-than-temporary. It determines that it does not intend to sell the security and it is not more likely than not that it will be required to sell the security. However, based on an evaluation of all available information, including a discounted cash flow analysis, FSP Corp does not expect to recover the entire amortized cost basis of the security.

FSP Corp determines a credit loss exists and, therefore, an OTTI has occurred. FSP Corp separates the total impairment of $300 (the cost basis of $1,000 less the fair value of $700 as of December 31, 20X4) into (1) the amount representing the decrease in cash flows expected to be collected (i.e., the credit loss) of $120 and (2) the amount related to all other factors of $180 (i.e., the non-credit component).

How should the reporting entity present this OTTI in its financial statements?

Analysis

In accordance with ASC 320-10-35, FSP Corp should recognize an OTTI in net income of $120 for the credit loss and recognize the remaining impairment loss of $180 separately in OCI.

After the recognition of the OTTI, the debt security's adjusted cost basis is $880 (i.e., the previous cost basis less the credit loss recognized in net income) and its carrying value is $700 (i.e., fair value). FSP Corp presents the gross $300 impairment on the face of the income statement, with the $180 non-credit impairment deducted from that amount in a separate line.

Total other-than-temporary impairment	$ 300
Portion of impairment loss recognized in OCI	(180)
Net other-than-temporary impairment loss recognized in net income	**$ 120**

Other presentation alternatives, as discussed in FSP 9.5.1, may be appropriate.

EXAMPLE 9-3

Presentation and disclosure of OCI for AFS securities with OTTI

At December 31, 20X4, FSP Corp has an AFS debt security with a $100 amortized cost basis and a fair value of $60. This impairment is considered other-than-temporary, and comprises a $10 credit-related impairment and a $30 non-credit-related component.

At March 31, 20X5, the fair value of this AFS debt security increases to $64, with no additional credit-related impairments.

How should this AFS security be presented in OCI and disclosed in the footnotes at the end of each reporting period?

Analysis

At December 31, 20X4, FSP Corp should record a $30 debit (charge) in the OTTI-related component of OCI. FSP Corp should also disclose this as a component of AOCI, as required by ASC 220-10-45-14 through 45-14A (see FSP 4.5). The credit-related OTTI charge of $10 should be classified as a realized loss in net income, and the new amortized cost basis of the security is $90.

At March 31, 20X5, there are no additional impairments to the security, as the fair value increased period over period. A $4 credit should be included in the OTTI-related component of OCI. The disclosure of AOCI components should show a $26 debit balance in the OTTI-related component of AOCI.

Further, FSP Corp should disclose the total OTTI recognized in AOCI cumulatively of $30 at December 31, 20X4, and March 31, 20X5, in accordance with ASC 320-10-50-2(aaa), which requires that the total OTTI recognized in AOCI be separately disclosed. The purpose of this disclosure is to accumulate the gross OTTI recognized since acquisition of the security, regardless of subsequent movements in the security's fair value. Therefore, subsequent increases in the fair value of the previously impaired securities *should not* be reflected in this disclosure.

Question 9-1

How should a subsequent increase in the fair value of a previously other-than-temporarily impaired AFS debt security, accompanied by an increase in expected credit losses for that debt security, be presented in equity and OCI in the current period?

PwC response

A reporting entity should recognize a realized loss for a subsequent increase in expected credit losses for a previously other-than-temporarily impaired AFS debt security. The realized loss is offset by a corresponding reduction in the previous non-credit OTTI recognized in OCI, even though the fair value of the debt security increased. That is, even though on a comprehensive income basis there is no additional impairment, the nature of the impairment has changed between the credit loss portion and the non-credit loss portion of the total OTTI amount.

The following example illustrates this point by building on the fact pattern of Example 9-3.

EXAMPLE 9-4

Subsequent increase in the fair value of a previously other-than-temporarily impaired AFS debt security with an increase in expected credit losses

Assume the same facts as Example 9-3 except as of March 31, 20X5, the AFS debt security has a fair value of $64 and an additional $5 of credit-related impairment.

What is the impact on OCI and the income statement presentation of this AFS security for the quarter ended March 31, 20X5?

Analysis

In accordance with ASC 320-10-45-8A, the income statement presentation for the quarter ended March 31, 20X5 should be as follows.

Total other-than-temporary impairment	$ 0
Portion of impairment loss recognized in OCI	(5)
Net other-than-temporary impairment loss recognized in net income	$(5)

As FSP Corp recognized the additional $5 of OTTI through net income (for the credit-related impairment), the new amortized cost basis of the security is $85.

The activity in comprehensive income for the quarter ended March 31, 20X5 consists of a $5 reclassification to net income and a $4 increase in fair value of the debt security.

Change in OTTI-related component of unrealized gain/loss	$9 credit

AOCI balances would consist of the following component at March 31, 20X5.

OTTI-related component of unrealized gain/loss	$21 debit

This is calculated as 20X4 $30 non-credit component of OTTI less $5 reclassification from OCI to net income in 20X5, and $4 unrealized gain recognized in 20X5.

Further, FSP Corp should also disclose the total OTTI recognized in AOCI cumulatively of $30 at December 31, 20X4, and $25 at March 31, 20X5 in accordance with ASC 320-10-50-2(aaa).

9.6 Disclosure – investments at fair value

ASC 320-10-50 provides disclosure guidance on investments in debt and equity securities. Generally, the disclosures are segregated by security classification (e.g., trading, AFS, or HTM), and they highlight key information to investors, including the types and term of securities held, the analysis of unrealized loss positions, and the qualitative assumptions used in determining if a security is other-than-temporarily impaired.

The disclosures are required for all interim and annual periods.

9.6.1 Major security types

Many investments disclosures are required by major security types. ASC 320-10-50-1B provides guidance on evaluating the level of detail of the disclosures. It requires reporting entities to evaluate whether discussion of certain security types should be further disaggregated if there are common characteristics underlying the securities (e.g., geographic concentration, credit quality, economic characteristics, etc.).

For example, reporting entities that separate fixed-maturity AFS securities into government bonds and mortgage-backed securities may consider whether further detail would be more beneficial to the reader. If so, the reporting entity may consider separating government bonds into U.S. government bonds and foreign government bonds, or separating mortgage-backed securities into commercial mortgage-backed securities and residential mortgage-backed securities. Financial institutions, as defined by ASC 942-320-50-1, are required to disaggregate with the level of detail specified in ASC 942-320-50-2.

For purposes of presenting example disclosures in the remainder of this chapter, the figures include three examples of major security types within fixed maturities; however, the level of disaggregation will vary by reporting entity and the nature of its portfolio.

9.6.2 *Disclosures for securities classified as AFS*

When disclosing securities classified as AFS in accordance with ASC 320-10-50-2, and as illustrated in Figure 9-2, a reporting entity should disclose the following information by major security type as of each balance sheet date presented.

- Amortized cost basis
- Aggregate fair value
- Total OTTI recognized in AOCI
- Total gains for securities with net gains in AOCI
- Total losses for securities with net losses in AOCI

Figure 9-2 illustrates an example of this disclosure for AFS securities. It includes example classes of instruments.

Figure 9-2

Example AFS disclosure of amortized cost, fair value, and total OTTI information

Note X: Investments

The following table summarizes the unrealized positions for available-for-sale equity and fixed-maturity securities, disaggregated by class of instrument.

Single year depicted for simplicity.

ASC 320-10-50-2 reference	a	b	c	aa	aaa
	Amortized cost	**Gross unrealized gains**	**Gross unrealized losses**	**Fair value**	**Total OTTI in AOCI**[1]
U.S. Treasury securities	500	50	3	547	0
Foreign government bonds	780	10	30	760	5
Asset-backed securities	20	17	7	30	6
Total fixed maturities	**1,300**	**77**	**40**	**1,337**	**11**

ASC 320-10-50-2 reference	a	b	c	aa	aaa
	Amortized cost	**Gross unrealized gains**	**Gross unrealized losses**	**Fair value**	**Total OTTI in AOCI[1]**
Total equities	**234**	**38**	**28**	**244**	**N/A**

[1] Represents the amount of OTTI in AOCI, which was not included in net income. Amount excludes unrealized gains on impaired AFS securities relating to changes in their value subsequent to the impairment measurement date.

In this example, had the equities been a larger portion of the portfolio, the reporting entity might have considered providing further detail by security type. Example types are common stock, preferred stock, and mutual funds. Further breakdown could be by industry type, entity size, or investment objective.

9.6.3 Disclosures for securities classified as HTM

When disclosing securities classified as HTM in accordance with ASC 320-10-50-5, a reporting entity should disclose the following information by major security type, as of each balance sheet date presented.

- Amortized cost basis
- Aggregate fair value
- Gross unrecognized holding gains
- Gross unrecognized holding losses
- Net carrying amount
- Total OTTI recognized in AOCI
- Gross gains and losses in AOCI for any derivatives that hedged the forecasted acquisition of the HTM securities

Figure 9-3 illustrates an example of this disclosure for HTM securities.

Figure 9-3
Example disclosure of HTM amortized cost and fair value information

Assume the reporting entity does not have amounts previously recognized in AOCI associated with these HTM securities (ASC 320-10-50-5(dd)) and the net carrying amount (ASC 320-10-50-5(d)) is presented on the face of the balance sheet.

Single year depicted for simplicity.

Note X: Investments (continued)

The following table summarizes the unrealized positions for held-to-maturity securities, disaggregated by class of instrument.

ASC 320-10-50-5 reference	a	b	c	aa
	Amortized cost	**Gross unrealized gains**	**Gross unrealized losses**	**Fair value**
U.S. Treasury securities	410	67	13	464
Foreign government bonds	280	28	30	278
Asset-backed securities	90	11	14	87
Total	**780**	**106**	**57**	**829**

9.6.4 Disclosures for AFS and HTM securities classified by maturity date

In addition to the disclosures in FSP 9.6.2 and 9.6.3, ASC 320-10-50-3 and 50-5 require presentation of investments in AFS and HTM securities, respectively, by maturity date. This disclosure should include the fair value and net carrying amount (if different than the fair value). The disaggregation by contractual maturity illustrated in Figure 9-4 (i.e., due within one year, due after one year through five years, etc.) is the minimum level of disaggregation required by ASC 942-320 for financial institutions.

For debt securities that do not have a single maturity date, such as mortgage-backed securities, reporting entities should disclose the fair value and net carrying value of these securities separately from those included in the aging groupings. If a reporting entity chooses to allocate the securities across the aging categories, it should disclose the basis for allocation. Figure 9-4 illustrates an example of a single disclosure for AFS and HTM securities.

Figure 9-4

Example disclosure of AFS and HTM securities grouping by contractual maturity

Note X: Investments (continued)

The following table summarizes the fair value and amortized cost of the available-for-sale and held-to-maturity securities by contractual maturity.

Single year depicted for simplicity.

	Available-for-sale		Held-to-maturity	
	Amortized cost	**Fair value**	**Amortized**	**Fair value**
Due within one year	434	429	117	121
Due after one year through five years	235	241	78	92
Due after five years through ten years	213	211	289	306
Due after ten years	398	426	206	223
Asset-backed securities	20	30	90	87
Total	**1,300**	**1,337**	**780**	**829**

Actual maturities may differ from contractual maturities because certain borrowers have the right to call or prepay certain obligations.

9.6.5 Disclosure of impairments of securities

ASC 320-10-50-6 through 50-8B outlines the disclosure requirements for reporting entities with impaired securities, including those with OTTI.

9.6.5.1 Investments in an unrealized loss position – quantitative disclosures

For all investments in an unrealized loss position for which an OTTI has not been recognized in net income, including investments for which a portion of an OTTI has been recognized in OCI, a reporting entity should disclose both of the following, aggregated by major security type as of each balance sheet date (in a tabular format).

- Aggregate related fair value of investments with unrealized losses
- Aggregate amount of unrealized losses (the amount by which amortized cost basis exceeds fair value)

Reporting entities should segregate these amounts by those investments in a continuous unrealized loss position for (1) less than 12 months and (2) 12 months or longer.

Figure 9-5
Example disclosure of length of time individual securities have been in a continuous unrealized loss position, aggregated by major security type

Note X: Investments (continued)

The following table summarizes the fair value and gross unrealized losses aggregated by category and the length of time that individual securities have been in a continuous unrealized loss position.

Single year depicted for simplicity.

	Less than twelve months		Greater than twelve months		Total	
	Fair value	**Gross unrealized loss**	**Fair value**	**Gross unrealized loss**	**Fair value**	**Gross unrealized loss**
U.S. Treasury securities	687	16	324	0	1,011	16
Foreign government bonds	608	29	430	31	1,038	60
Asset-backed securities	30	14	87	7	117	21
Total debt securities	**1,325**	**59**	**841**	**38**	**2,166**[1]	**97**[2]
Equity securities	**223**	**26**	**21**	**2**	**244**	**28**

[1] Represents the sum of the total fair value of the HTM and AFS debt portfolio.

[2] Represents the sum of the (1) gross unrealized losses on HTM securities of $57 (per Figure 9-3) and (2) the gross unrealized losses on AFS securities of $40 (per Figure 9-2).

When a portion of an OTTI is not recognized in net income (i.e., it is recognized in OCI), the duration of that unrealized loss is measured using the balance sheet date of the reporting period in which the OTTI was first recognized in OCI as the starting reference point. Continuous unrealized loss positions stop when either of the following happens.

- The reporting entity recognizes an OTTI in net income for the total amount by which amortized cost exceeds fair value.
- The fair value of the security equals or exceeds the amortized cost basis of the investment.

9.6.5.2 *Investments in an unrealized loss position – qualitative disclosures*

As of the latest balance sheet date, a reporting entity should include a narrative disclosure that allows a user to understand the information (both positive and negative) the reporting entity considered in reaching its conclusion as to why an impairment was not deemed other-than-temporary. The reporting entity may aggregate the disclosure by investment category, unless there are individually significant unrealized losses. ASC 320 outlines examples of the information reporting entities should consider including in this qualitative disclosure.

Excerpt from ASC 320-10-50-6

This disclosure could include all of the following:

1. The nature of the investment(s)
2. The cause(s) of the impairment(s)
3. The number of investment positions that are in an unrealized loss position
4. The severity and duration of the impairment(s)
5. Other evidence considered by the investor in reaching its conclusion that the investment is not other-than-temporarily impaired, including, for example, any of the following:
   i. Performance indicators of the underlying assets in the security, including any of the following:
      01. Default rates
      02. Delinquency rates
      03. Percentage of nonperforming assets.
   ii. Loan-to-collateral-value ratios
   iii. Third-party guarantees
   iv. Current levels of subordination
   v. Vintage
   vi. Geographic concentration
   vii. Industry analyst reports
   viii. Sector credit ratings
   ix. Volatility of the security’s fair value
   x. Any other information that the investor considers relevant.

ASC 320-10-55-23 provides a detailed narrative disclosure that illustrates these points. As included in this ASC 320 example, when an unrealized loss is not recognized in net income, the reporting entity first states that it did not intend to sell the securities nor did it believe it is more likely than not that it would be required to sell these securities before recovery of their amortized cost basis. Reporting entities should then consider what additional information is necessary to achieve the objective of the disclosure. For example, a reporting entity with asset-backed securities with more significant declines might elaborate on and describe their assessment process, considering the performance indicators noted in paragraph 5.i. of ASC 310-10-50-6.

9.6.5.3 Credit losses recognized in net income

For both interim and annual reporting periods in which an OTTI of a debt security is recognized and only the credit loss is recognized in net income, a reporting entity should disclose by major security type the methodology and significant inputs used to measure the amount related to the credit loss. Examples of significant inputs are included in ASC 320-10-50-8A and are similar to those described in ASC 320-10-50-6.

A reporting entity should disclose a tabular rollforward of the amount related to credit losses recognized in net income. This rollforward is meant to provide investors with additional information regarding management's expectations of credit losses, how those expectations develop over time, and how actual experience compares to prior expectations.

The cumulative balance being rolled forward is not an actual financial statement account balance. Rather, it represents a memo account relating to the cumulative credit loss activity recorded in income on impaired debt securities for which a portion of the impairment was recorded in OCI. One of the focus areas for investors is the disclosure of additional credit losses recognized on securities for which a credit loss had previously been recognized (item e in ASC 320-10-50-8B), as this provides some indication of management's ability to accurately estimate credit losses on a timely basis.

Subsequent increases in expected cash flows on a previously other-than-temporarily impaired debt security (item f in ASC 320-10-50-8B) are recognized as a yield adjustment on a prospective basis. We understand the intent of the FASB was to require disclosure in the rollforward of the amount recognized in net income in the current period that relates to the expected increase in cash flows. However, the components of the rollforward are identified as "minimum" disclosure, suggesting that supplemental disclosure of the entire increase in expected cash flows is not precluded. Similarly, supplemental disclosure of the accretion of discounted expected cash flows recognized in the period is not precluded.

The following figure illustrates the rollforward of credit losses recognized in net income for which a portion was recognized in OCI.

Figure 9-6
Example disclosure of the rollforward of credit losses recognized in net income on fixed maturity securities

Note X: Investments (continued)

The following table summarizes the credit loss recognized in earnings on fixed-maturity securities for which a portion of the OTTI was recognized in OCI.

Single year depicted for simplicity.

	Fair value	ASC 320-10-50-8B reference
Balance, beginning of year	129	a
Credit losses for which OTTI was not previously recognized	31	b
Credit-impaired securities disposed of, for which there was no prior intent or requirement to sell	(48)	c
Credit-impaired securities *not* disposed of, for which there was no prior intent or requirement to sell	12	d
Credit impairments on previously impaired securities	19	e
Accretion recognized due to changes in cash flows expected to be collected over the remaining expected term	(12)	f
Increases due to the passage of time	3	f
Balance, end of year	**134**	g

9.6.6 *Reclassifications out of AOCI for AFS securities*

For each income statement presented, ASC 320-10-50-9 requires a reporting entity to disclose the change in net unrealized holding gain or loss on AFS securities reported in AOCI during the period, and the amount of gains and losses reclassified out of OCI into net income upon sale of the securities. The amount is calculated as the difference between the balances in the separate component of equity at (1) period-end and (2) the beginning of the period, reflecting the additions and reclassifications to net income as the additions and deductions, respectively, from the beginning amounts. The AOCI reclassification disclosure also includes the location in the income statement of the reclassified amount. For AFS securities, the unrealized gain or loss is reclassified out of AOCI and into a "Realized gain/loss" line on the income statement upon the sale of the security. FSP 4.5.3.1 includes a sample disclosure.

Reporting entities that provide a statement of changes in stockholders' equity with the activity reported in OCI detailed separately from other equity captions should present the change in net unrealized holding gain or loss in the statement of changes in stockholders' equity.

If the reporting entity does not provide a statement of changes in stockholders' equity or the activity in the separate component of equity is not detailed on the statement, it should disclose the change in net unrealized holding gain or loss on AFS securities in the footnotes. Refer to FSP 4.5 for further discussion of this disclosure.

9.6.7 Sales, transfers, and related matters

Additional disclosures are required when investments in debt and equity securities are sold during a period or transferred between classifications (e.g., from AFS to trading), as outlined in ASC 320-10-50-9 through 50-13.

For each period for which an income statement is presented, ASC 320-10-50-9 requires the following disclosures for AFS securities.

- Proceeds from sales and maturities
- Gross realized gains and losses
- The basis on which the cost of a security sold or the amount reclassified out of AOCI into income was determined (e.g., specific identification, average cost, or other method)
- The amount of the net unrealized holding gain or loss for the period that has been included in AOCI
- The amount of gains and losses reclassified out of AOCI into income for the period

ASC 320-10-50-9 also requires disclosure of trading gains and losses on trading securities still held at the balance sheet date.

Figure 9-7 illustrates the disclosure requirements of the first two bullets above. FSP 4.5 discusses the disclosure requirements associated with the amounts in, and reclassified out of, AOCI.

In the rare circumstance, as defined by ASC 320-10-35-12, that a security is transferred from AFS to trading, the reporting entity should disclose the gross gains and gross losses included in income from the transfer.

Figure 9-7

Example disclosure of gross realized gains and losses from sales or maturities of AFS securities

Note X: Investments (continued)

The following table summarizes the gross realized gains and losses from sales or maturities of AFS securities.

Single year depicted for simplicity. These amounts are not intended to reconcile to the other example disclosures.

	Gross realized gains	Gross realized losses	Gross proceeds from sales	Gross proceeds from maturities
Fixed-maturity AFS securities	314	149	2,100	300
Equity securities	35	24	3,200	N/A
Total	**349**	**173**	**5,300**	**300**

The gross proceeds from sales and maturities may alternatively be presented on the face of the statement of cash flows.

For any sales of, or transfers from, securities classified as HTM, a reporting entity should disclose all of the following in the footnotes for each period for which an income statement is presented.

Excerpt from ASC 320-10-50-10

a. The net carrying amount of the sold or transferred security

b. The net gain or loss in accumulated other comprehensive income for any derivative that hedged the forecasted acquisition of the held-to-maturity security

c. The related realized or unrealized gain or loss

d. The circumstances leading to the decision to sell or transfer the security. (Such sales or transfers should be rare, except for sales and transfers due to the changes in circumstances identified in paragraph ASC 320-10-25-6(a) through (f).)

According to ASC 320-10-35-16, the fair value amount at the date of the transfer, adjusted for subsequent amortization, becomes the amortized cost basis of the security transferred to HTM for the disclosures required by ASC 320.

9.6.8 *Options that do not qualify for derivative accounting*

When a reporting entity enters into forward contracts and options that (1) are not derivatives subject to ASC 815 and (2) involve the acquisition of securities that will be accounted for under ASC 320, it should report those options consistent with the accounting, presentation, and disclosure of ASC 320 securities (i.e., trading, held to maturity, or available-for-sale).

In addition, the reporting entity should disclose its accounting policy for the premium paid to acquire such an option that is classified as held to maturity or available-for-sale in accordance with ASC 815-10-50-9.

9.6.9 *Beneficial interests in securitized financial assets*

A reporting entity may own debt securities representing beneficial interests in securitized financial assets that have been accounted for as sales. If so, in addition to meeting the disclosure requirements of ASC 320, the reporting entity should consider the disclosure requirements in ASC 860-20-50-4 that may apply to those beneficial interests as of the balance sheet date presented. Refer to FSP 22 for additional information on transfers.

9.7 *Disclosure – cost method investments*

ASC 325-20-50-1 provides the sole disclosure guidance specific to investments in cost method securities.

Excerpt from ASC 325-20-50-1

For cost-method investments, an investor shall disclose all of the following additional information, if applicable, as of each date for which a statement of financial position is presented in its interim and annual financial statements:

a. The aggregate carrying amount of all cost-method investments

b. The aggregate carrying amount of cost-method investments that the investor did not evaluate for impairment (see Section 325-20-35)

c. The fact that the fair value of a cost-method investment is not estimated if there are no identified events or changes in circumstances that may have a significant adverse effect on the fair value of the investment, and any one of the following:

   1. That the investor determined, in accordance with paragraphs 825-10-50-16 through 50-19, that it is not practicable to estimate the fair value of the investment

2. That the investor is exempt from estimating annual fair values under Subtopic 825-10
3. The investor is exempt from estimating interim fair values because it does not meet the definition of a publicly traded company.

9.8 Considerations for private companies

The presentation and disclosure requirements for investments are generally applicable to both public and private reporting entities.

Although S-X 5-02 requires use of the term "marketable securities" to describe investments in debt and equity securities, we believe complying with the ASC 320 guidance satisfies this S-X requirement as well. As such, we see no difference in the reporting requirements for public and private companies.

Chapter 10: Equity method investments

10.1 Chapter overview

This chapter discusses the presentation and disclosure requirements for equity method investments. ASC 323, *Investments–Equity Method and Joint Ventures*, is the primary guidance for accounting for equity method investments, but the SEC also has certain presentation and disclosure requirements for SEC registrants. Generally, ASC 323 requires equity method investments to be shown on the balance sheet of the investor as a single amount. Likewise, the investor's share of earnings or losses from an investment accounted for under the equity method should generally be shown on the income statement as a single amount. Alternatives to the single line presentation may be used in limited situations discussed later in the chapter.

ASC 323 also outlines various disclosures for equity method investments. The extent of the disclosure requirements is predicated on the significance of an investment to the investor's balance sheet and income statement.

10.2 Scope

The guidance in ASC 323 applies to all reporting entities. The following types of investments are not within the scope of this guidance:

- An investment accounted for under the derivatives and hedging guidance of ASC 815, *Derivatives and Hedging*
- An investment in the common stock of a reporting entity that is consolidated in accordance with ASC 810, *Consolidation*
- An investment in common stock accounted for using the fair value guidance of ASC 946, *Financial Services—Investment Companies*

Investments held in stock of entities other than subsidiaries are usually accounted for by one of three methods—the cost method, the equity method, or the fair value method. The equity method should be applied when an investor has the ability to exercise significant influence over the operating and financial policies of the investee, unless the investor elects the fair value option available under ASC 825, *Financial Instruments*. If the investor elects the fair value option, the investor is still required to provide the equity method disclosures as described in ASC 323.

10.3 Balance sheet presentation

ASC 323-10-45-1 requires an investment in common stock accounted for under the equity method to be shown as a single amount on the investor's balance sheet, if material. Multiple equity method investments can be aggregated for purposes of presentation on the balance sheet.

The investment in common stock may be combined with advances or investments in senior or other securities of the investee in a single amount for purposes of balance sheet presentation; however, disclosure of the types of investments will generally be required.

Typically, an investor is not permitted to record its share of each asset and liability of the investee individually (the so called "expanded equity," or "proportionate consolidation" approach). This approach is used only in accounting for unincorporated undivided interests where the investor legally owns a proportionate share of each asset and is obligated for its proportionate share of each liability as discussed in ASC 810-10-45-14. This guidance permits this approach in the extractive and construction industries. However, this method is not appropriate for an investment in a corporate entity because the investor in such circumstances owns an interest in the net assets of the corporate entity as a whole, and does not have a proportionate legal interest in each asset and liability.

When labeling balance sheet captions, the term "investments at equity" should be used only in circumstances where the carrying amount of the investment equals the investor's underlying equity in investee net assets. Generally, the basis of accounting should be described in a footnote rather than in the balance sheet caption. When the investments caption includes investments accounted for under the cost and equity methods, the amount of investment and advances accounted for under each method should be set forth either on the balance sheet or in a footnote.

An investor's share of losses of an investee may exceed the carrying amount of the investment accounted for under the equity method. In certain circumstances, an investor may continue to recognize its share of investee losses in excess of the investor's carrying amount of the investment, resulting in a balance sheet credit. In such circumstances, the carrying amount should be classified as a liability. The balance sheet caption should be appropriately descriptive to reflect the nature of this liability (e.g., "accumulated losses of unconsolidated companies in excess of investment," "estimated losses on investment," or "estimated liability–guarantee of obligation of unconsolidated affiliate").

10.4 Income statement presentation

ASC 323-10-45-1 requires the investor's share of earnings or losses from its investment in common stock accounted for under the equity method to be shown on the income statement as a single amount, except for the investor's share of extraordinary items and its share of accounting changes reported in the financial statements of the investee, which should be classified separately in the income statement. If basis differences exist (discussed in FSP 10.4.1.4) that are assigned to depreciable or amortizable assets, the investor's share of the investee's earnings should be adjusted to reflect amortization or accretion of the basis difference. Equity method investments can be aggregated for purposes of presenting the investor's share of earnings or losses in the income statement.

When practicable, the investee's financial information should be as of the same dates and for the same periods as presented in the reporting entity's financial statements. However, if the investee's financial statements are reported on a lag, the reporting entity may record its share of the earnings or losses of an investee using the most recently available financial statements, provided this approach is applied consistently.

While the equity method of accounting model does not specify a limit on the length of the lag period, the provisions relating to consolidation of subsidiaries with fiscal periods different from the parent as set forth in ASC 810-10-45-12 appear to offer a reasonable guideline. That guidance indicates that the difference in fiscal periods should normally not be more than about three months. When a lag is necessary, recognition should be given by disclosure or otherwise to the effect of any known intervening events that materially affect the balance sheet or income statement of the investor.

10.4.1 Presentation alternatives

The investor's share of the investee's earnings or losses is generally presented as a single amount in the income statement. Limited exceptions to this presentation are permissible, as discussed in this section.

Regulation S-X generally requires equity method earnings to be presented below the income tax line. However, the SEC staff has indicated that, in certain limited circumstances, it may be appropriate to include income from equity investments in operations because some reporting entities operate their business largely through equity investees, or the equity investee may be integral to the investor's operations. Even under these circumstances, classification within revenue is not allowed.

Unless permitted by the ASC 810 guidance discussed in FSP 10.3, the SEC will not accept the proportionate consolidation method because the investee's sales, cost of sales, and other items of income and expense are not those of the SEC registrant.

Example 10-1 illustrates the presentation of equity in net earnings of an investee as a single amount in the income statement.

EXAMPLE 10-1

Presentation of equity in net earnings of investee as a single amount

FSP Corp owns 40% of the common stock of Company A and has the ability to exercise significant influence over the operating and financial policies of this investee. FSP Corp accounts for Company A as an equity method investee. There are no inter-company transactions, consolidation-type adjustments required for investee capital changes, or differences between investor cost and underlying equity in investee net assets. FSP Corp is taxed at 40%.

Additionally, note that any tax provision required by ASC 740, *Income Taxes,* relating to the temporary difference arising from the use of the equity method for book purposes and the cost method for tax purposes, has been omitted to simplify the illustration.

During the year, FSP Corp has income before taxes of $160,000 and income taxes of $64,000. FSP Corp's portion of Company A's net earnings is $39,000.

How should FSP Corp present the equity in net earnings of Company A as a single amount in the financial statements?

Analysis

FSP Corp should present the equity in net earnings of Company A as a single amount as follows:

Income before income taxes and equity in net earnings of affiliate	$160,000
Income taxes	64,000
Income before equity in net earnings of affiliate	96,000
Equity in net earnings of affiliate	39,000
Net income	$135,000

The above presentation is consistent with ASC 323-10-45-1 and is the most common presentation. S-X 5-03 (SEC 4900) requires this presentation unless a different presentation is justified by the circumstances. We believe such circumstances may include (1) an investment in a partnership or other unincorporated entity, where the equity earnings or losses caption could be presented before the investor's income tax provision, or (2) in other limited cases where proportionate consolidation is permissible, as discussed in FSP 10.3.

The income statement caption for the equity method earnings should be appropriately titled depending on its nature (e.g., "Equity in net earnings of Company A," or "Share of net earnings of equity method investee"). Additionally, the subtotal for FSP Corp's income prior to its equity in net earnings in Company A (required for SEC registrants) should be appropriately titled, as illustrated above.

If the equity method earnings are of such a nature that it is acceptable for them to be presented within operations, the amount must be net of taxes as recorded by the investee in determining its net income. To do otherwise would be tantamount to proportionate consolidation.

When the investee is a partnership, the investor/partner's share of the income of the partnership is taxable at the investor level, not at the partnership. In such cases, a question may arise as to whether the equity earnings should be reported before or after the investor's income tax provision on its income statement. We would encourage the investor to report equity earnings after the income tax provision line on its income statement, as any taxes due on its equity method investment in the partnership would be reported in its income tax provision.

Figure 10-1 illustrates the various methods an investor may use for income statement presentation of equity method earnings depending on the nature of the equity method investee and whether the investee is a taxable or non-taxable entity.

Figure 10-1

Common methods of presenting earnings of equity method investees in the income statement

Earnings of non-taxable investees (A)	**Earnings of taxable investees ("net of tax" presentation)**
In operating profit (B)	In operating profit (B)
Before tax provision line item	Below tax provision line item (C)
Below tax provision line item (C)	

(A) For a non-taxable investee, there is no difference between gross or net of tax presentation, as the investee is not taxed.

(B) The SEC staff has indicated that presenting equity method earnings from an investee within the operating income section of the investor's income statement is acceptable in very limited circumstances.

(C) Any income tax levied against the investor for its share of the investee's results should be included in the investor's income tax provision line.

Another method of income statement presentation is proportionate consolidation, which reflects an investor's proportionate share of each item of income and expense of the investee, including any consolidation entries. As discussed in FSP 10.3, this presentation method is only permitted in limited circumstances.

Note that while intercompany sales between the investor and investee must be eliminated, the amount eliminated under this method cannot exceed the investor's share of investee sales. As long as intercompany sales are equal to or less than the investor's share of the investee sales, the intercompany sales should be fully eliminated.

10.4.1.1 Royalties, technical fees, interest, and dividends on advances and senior securities

There are situations where investments are made principally to secure channels of distribution or to finance licensees. In such cases, the return on the investment in common stock may be nominal and incidental to earning royalties, technical fees, and similar types of income. In other cases, in addition to an investment in common stock, the investor may have a substantial investment in the investee in the form of advances or senior securities.

In such circumstances, because of the interplay between royalties, technical fees, interest, or other items, and the return on investment in the investee entity, it may be more meaningful to combine these amounts in presenting equity in income of the investee. When such presentation is used, the following should be considered:

- The investment account in the balance sheet should include the investment in common stock, advances, and senior securities consistent with how it is presented in the income statement.

- The separate amounts and the fact that they were combined in the financial statements must be disclosed. Appropriately descriptive captions must be used (e.g., "equity in income of and technical fees and interest earned from investees").

10.4.1.2 Full or partial sale of equity method investment

The gain or loss from the sale of an equity method investment may be presented in either of the following ways in the income statement:

- Gross of tax, before the income tax provision, in non-operating income

- In the same line item in which the investor reports the equity in earnings of the investee

These methods are also appropriate to record the gain or loss when the investor's ownership interest is diluted as a result of the investee issuing additional shares, and the investor does not maintain its proportionate ownership interest (i.e., an indirect sale). Appropriate disclosures about the sale should be made in the investor's financial statements as necessary.

10.4.1.3 Other-than-temporary impairment

When an investor records an other-than-temporary impairment charge for an equity method investment, the impairment charge should generally be included as a component of the investor's share of the earnings or losses of the investee.

10.4.1.4 Difference between investor cost and underlying equity in net assets of investee

When an investor purchases an investment that will be accounted for by the equity method, the amount paid for the investment may not equal the investor's proportionate share of the investee's net book value. This is commonly referred to as a basis difference.

The guidance in ASC 323 requires that a difference between the cost of an investment and the amount of underlying equity in net assets of an investee be accounted for as if the investee were a consolidated subsidiary. The investor must identify which individual assets or liabilities have fair values different from the corresponding amounts recorded in the investee's financial statements. If the basis difference is assigned to depreciable or amortizable assets, such as PP&E or intangibles assets, the difference should be depreciated, amortized, or accreted over the related useful lives of the related assets and included as a component of the investor's share of the earnings or losses of the investee.

10.4.2 *Investee accounting changes*

An investor's equity share of an investee's accounting change should be reported in the investor's income statement as if the investor had made the change. This treatment is a logical extension of the consolidation guidance. Example 10-2 illustrates this concept.

EXAMPLE 10-2

Presentation of investor's share of an investee's accounting change

FSP Corp owns 40% of the common stock of Company C and has the ability to exercise significant influence over the operating and financial policies of this investee. FSP Corp accounts for Company C as an equity method investee. Company C recorded a cumulative effect charge as a result of an accounting change. FSP Corp's portion of Company C's net income before the cumulative effect charge is $104,000 and its portion of the cumulative effect charge is $20,000. FSP Corp's net income for the year, prior to its equity earnings in Company C, is $134,000.

How should FSP Corp present the effect of Company C's accounting change?

Analysis

FSP Corp's income statement should be presented as follows:

Income before equity in net earnings of investee and cumulative effect of change in accounting by investee	$134,000
Equity in net earnings of investee before cumulative effect of change in accounting by investee	104,000
Income before equity in cumulative effect of change in accounting by investee	238,000
Equity in cumulative effect of change in accounting by investee (see Note X)	(20,000)
Net income	$218,000

This presentation should also be applied to earnings per share disclosures. Refer to FSP 7 for information on EPS disclosures.

10.4.3 *Investment becomes qualified for the equity method*

A reporting entity with a cost method investment may increase its level of ownership such that the investor has the ability to exercise significant influence.

When this occurs, if the investor elects the equity method (as opposed to the fair value option),the change should be reflected retrospectively as if the equity method had been applied during all previous periods in which the investment was held.

For example, assume a reporting entity owns 15 percent of an investee that is accounted for using the cost method. It subsequently increases its ownership interest to 40 percent, which results in the investor applying the equity method. The investor would retrospectively reflect its previous 15 percent ownership interest using the equity method in all prior periods. Refer to FSP 30 for discussion of changes in accounting principles.

10.4.4 Investment no longer qualifies for the equity method

When an investment in common stock of an investee entity no longer qualifies for accounting under the equity method (i.e., the ability to exercise significant influence over operating and financial policies of an investee no longer exists), the investor should discontinue accruing its share of earnings or losses of the investee. This is a change of circumstances, not a change in accounting principle, and therefore is not reflected retrospectively. Additionally, the investor's share of the investee's other comprehensive income should be reclassified to the carrying value of the investment at the time of discontinuance of the equity method of accounting. In executing the reclassification, the reporting entity should first reduce the carrying value of the investment to zero and then record the remaining balance in income.

10.4.5 Change from a controlling interest to a noncontrolling investment accounted for under the equity method

U.S. GAAP considers a change in reporting entity to include "changing specific subsidiaries that make up the group of entities for which consolidated financial statements are presented." Circumstances may arise where a parent's controlling financial interest (e.g., generally an ownership interest in excess of 50 percent of the outstanding voting stock) is reduced to a noncontrolling investment that still enables it to exercise significant influence over the operating and financial policies of the investee. A change that results from changed facts and circumstances (such as a partial sale of a subsidiary), where there was only one acceptable method of accounting prior to the change in circumstances (consolidation) and only one acceptable method of accounting after the change (equity method accounting), is not a change in reporting entity and should not be accounted for retrospectively. Accordingly, a change from a controlling interest to a noncontrolling investment accounted for under the equity method should be accounted for prospectively from the date of change in control.

10.5 Statement of other comprehensive income

A reporting entity is required to record its proportionate share of its equity method investees' comprehensive income. This requirement is consistent with the guidance in ASC 323 which indicates that an investee's transactions that are of a capital nature and affect the investor's share of the investee's stockholders' equity should be accounted for as if the investee were a consolidated subsidiary.

The format used by an investee to report comprehensive income, including other comprehensive income (OCI), should not impact how the investor displays its proportionate share of OCI of its investee. Accordingly, an investor is permitted to combine its proportionate share of OCI from an equity method investment with its own OCI items and report those aggregated amounts (by each category). When a reporting entity elects to present in this manner, the statement of comprehensive income would not include additional line items that would indicate an equity method investment exists, as it is embedded in the reporting entity's components of OCI. Alternatively, the investor would be permitted to separately report the OCI items related to the equity method investee, which are depicted in Figure 10-2.

Figure 10-2

Presentation in the statement of comprehensive income and footnote disclosure for separately reporting the OCI items related to the equity method

FSP Corp
Statement of Comprehensive Income
For the year ended December 31, 20X4

Net income	$4,150
Other comprehensive income, net of deferred income taxes:	
Changes in foreign currency translation adjustments	10
Changes in defined benefit plans:	
Actuarial losses and prior service cost/credit before reclassification to net earnings	(50)
Amounts reclassified to net earnings	14
	(36)
Ownership share of equity method investment:	
Other comprehensive income, before reclassifications to net earnings	21
Amounts reclassified to net earnings	(2)
	19
Other comprehensive income, net of deferred income taxes	(7)
Comprehensive income	4,143
Comprehensive income attributable to noncontrolling interests	(3)
Comprehensive income attributable to FSP Corp	$4,140

Note X: Changes in accumulated other comprehensive income by component

The following table presents a rollforward of accumulated other comprehensive income, net of tax:

	Benefit plans	Equity method investment	Currency translation adjustments	Accumulated other comprehensive loss
Beginning balance, January 1, 20X4	(206)	33	20	(153)
Period change	(36)	19	10	(7)
Ending balance, December 31, 20X4	$ (242)	$ 52	$ 30	$ (160)

10.5.1 *Equity method – foreign operations*

Reporting entities should also apply the guidance applicable to OCI when reporting an equity method investment in an investee with foreign operations and cumulative translation adjustments accounted for in accordance with ASC 830. When the equity method is used, the reporting entity's financial statements should include a proportionate share of any investee's translation adjustments (e.g., when the investee has a subsidiary that is a foreign entity) in OCI, as well as its proportionate share of the direct effects of translating an equity method investee that reports in a foreign currency (e.g., the investee is a foreign entity).

10.6 *Disclosures*

ASC 323-10-50-1 through 50-2 sets forth guidelines regarding disclosures that should be made in the financial statements of an investor when it accounts for investments under the equity method. The guidance states:

Excerpt from ASC 323-10-50-1

…references in this Subtopic to common stock refer to both common stock and in-substance common stock that give the investor the ability to exercise significant influence over the operating and financial polices of an investee even though the investor holds 50% or less of the common stock or in-substance common stock (or both common and in-substance common stock).

ASC 323-10-50-2

The significance of an investment to the investor's financial position and results of operations shall be considered in evaluating the extent of disclosures of the financial position and results of operations of an investee. If the investor has more than one investment in common stock, disclosures wholly or partly on a combined basis may be appropriate.

The guidance also indicates that investments may be appropriately combined or grouped, either wholly or in part, for disclosure purposes.

If the investee is a variable interest entity (VIE), the investor is required to make the equity method investment disclosures in accordance with ASC 323-10-50, in addition to the required disclosures listed in the VIE model in ASC 810-10-50. Refer to FSP 18 for additional information on the required disclosures for VIEs.

ASC 323-10-50-3 requires the following disclosures with regard to equity method investments, keeping in mind that the nature and extent of disclosure may vary in each case based on the significance of the investment to the investor:

- *Name of each investee and percentage of ownership of common stock by the investor*

  Normally, the names of investees and the percentage owned would be included only for individually significant investees, for large holdings in publicly held investees, or where otherwise clearly informative to the users of financial statements. The percentage of ownership generally should be disclosed as a range where numerous individually immaterial investments in corporate joint ventures or other investees are accounted for under the equity method.

- *Accounting policies of the reporting entity with respect to investments in common stock*

  The name of any significant investee in which the investor holds 20 percent or more of the outstanding voting stock, for which the investment is <u>not</u> accounted for under the equity method, should be disclosed. The reasons why the equity method is not considered appropriate should also be disclosed. Additionally, the name of any significant investee in which the investor holds less than 20 percent of the voting stock in circumstances where such investment is accounted for under the equity method should be disclosed, along with the reasons why such treatment is considered appropriate.

- *Difference, if any, between the amount at which an investment is carried and the amount of underlying equity in net assets, and the accounting treatment for the basis difference*

  Intra-entity (intercompany) income eliminations, as well as other basis differences such as goodwill, should be disclosed. Basis differences are discussed further in FSP 10.4.1.4.

- *Market value of investments in common stock for which a quoted market value is available*

  If specific circumstances lead the reporting entity to decide not to disclose this information—e.g., when the market for a stock is thin and quoted market value may not be representative of the investor's holding, the reporting entity should disclose the reasons for reaching that determination.

- *Summarized information as to assets, liabilities, and results of operations of investees, either individually or grouped*

  The disclosure of summarized financial information is also required under SEC rules. While the disclosure requirement for summarized financial information in ASC 323-10-50-3(c) is more general in nature, the SEC disclosure requirement provides specific guidance as to the financial captions that should be disclosed. S-X 4-08(g) sets forth disclosure requirements for annual periods, and S-X 10-01(b)(1) stipulates interim disclosure requirements. Refer to FSP 10.6.1 and 10.6.2 for further discussion of SEC disclosure requirements on an annual and interim basis, respectively. Note that if an investment accounted for by the equity method exceeds 20 percent based on the investment test or income test as defined in S-X 1-02(w), separate financial statements—not just summarized financial information—are required in the Form 10-K. Refer to SEC 4400 for more information on the calculation of the significant subsidiary test.

- *Material effects of possible conversions, exercises, or contingent issuances of investee securities that would significantly affect the investor's share of reported earnings or losses of the investee*

  Investee common stock equivalents and dilutive securities are taken into account in computing the investor's earnings per share (see ASC 323-10-50-3(d)). Disclosure of the potential effects should normally be made only if the conversion, exercise, or issuance would significantly change the investor's share of investee net assets or reported income. Normally, disclosures should be limited to the nature of the contingency and the effect on income for the most recent period and financial position at the end of the period. Refer to FSP 7 for further discussion on EPS considerations.

Equity method investments may also generate temporary differences for tax purposes that must be disclosed under ASC 740. Refer to FSP 16 for required disclosures related to deferred taxes. In addition to those disclosures, SAB Topic 6.I.2, *Taxes of Investee Company*, indicates that if an equity method investee's effective tax rate differs by more than five percent from the statutory Federal income tax rate, the investor is required to disclose the tax components of the reconciliation if such information is available and material to the investor's balance sheet or income statement.

If a reporting entity would have accounted for an investment using the equity method, but instead elected to use the fair value option, the reporting entity must include the disclosures required by ASC 825-10-50-28. In addition, the reporting entity must also include the equity method disclosures above, even though it is not using the equity method for accounting purposes, except for:

- Difference, if any, between the amount at which an investment is carried and the amount of underlying equity in net assets, and the accounting treatment for the basis difference
- Market value of investments in common stock for which a quoted market value is available
- Material effects of possible conversions, exercises, or contingent issuances of investee securities that would significantly affect the investor's share of reported earnings or losses of the investee

10.6.1 Summarized financial information of equity method investees – annual SEC disclosure requirements

SEC rules provide significance thresholds for determining whether an SEC registrant is required to provide summarized financial information or full separate financial statements relating to an unconsolidated subsidiary or equity method investee. The rules are regarded by the SEC as an interpretation of ASC 323-10-50-3, which states that summarized financial information or separate statements may be required for equity investees if the investments are material in relation to the investor's financial position or results of operations. S-X 4-08(g) requires reporting entities to disclose summarized financial information of unconsolidated subsidiaries and equity method investees for all periods presented if **any** one of the three significant subsidiary tests (outlined in S-X 1-02(w)) exceed ten percent on an individual basis or on an aggregated basis by any combination of unconsolidated subsidiaries or equity method investees for any of the periods presented.

If separate financial statements of significant investees are included in an annual report to shareholders or a Form 10-K (as required by S-X 3-09), the summarized data required by S-X 4-08(g) is not required for those entities. In some cases, the financial statements required by S-X 3-09 are not filed concurrent with the Form 10-K, but rather are filed by amendment at a later date. In this case, the SEC registrant may not omit the summarized financial information for the significant investees from the financial statements.

If required, the summarized financial information disclosures must include, at a minimum, the following financial statement captions:

- Current assets
- Noncurrent assets
- Current liabilities
- Noncurrent liabilities

- Redeemable preferred stock
- Noncontrolling interest
- Net sales or gross revenue
- Gross profit (or alternatively, costs and expenses applicable to net sales or gross revenues)
- Income or loss from continuing operations before extraordinary items and cumulative effect of a change in accounting principle
- Net income or loss
- Net income or loss attributable to the entity

If the balance sheet is not classified, information should be provided that indicates the nature and amount of major components of assets and liabilities. In addition, for specialized industries, other information may be substituted for sales and related costs if they are more meaningful.

Once the significance test is triggered, summarized financial information for all equity investees must be disclosed in the aggregate or individually (not just those that are significant individually). In other words, there is not a materiality threshold for individual entities that would exempt an investee from being included in the disclosures. And although aggregation is generally permitted, the SEC staff has, in certain circumstances, issued comments that it believes aggregation is misleading or suppresses important information. In those cases, the SEC staff has requested that certain investees be presented separately. Separate information may be requested for individual investees that are significant quantitatively or qualitatively.

10.6.2 Summarized financial information of equity method investees – interim SEC disclosure requirements

S-X 10-01(b)(1) requires reporting entities to include in their interim financial statements separate summarized income statement information for each equity method investee for which (1) separate financial statements of the investee would be required for annual periods, and (2) the investee would be required to file quarterly financial information in Form 10-Q if the investee were a registrant (e.g., the investee is not a foreign business).

Reporting entities would use the investment and income tests in S-X 1-02(w) to determine whether any investees exceed 20 percent. The investment tests would be based on the two balance sheets included in the 10-Q and the income tests would be based on the year-to-date income statements included in the 10-Q. For more information on how to calculate the test refer to SEC 4520.

The minimum disclosures below must be included for each significant investee and may be aggregated with similar minimum disclosure for other significant investees. The information must be presented for both the current and prior comparative year-to-date periods included in the interim financial statements:

- Net sales or gross revenues
- Gross profit (or, alternatively, costs and expenses applicable to net sales or gross revenues)
- Income or loss from continuing operations before extraordinary items and cumulative effect of a change in accounting principle
- Net income or loss
- Net income or loss attributable to the entity

At interim, S-X 10-01(b)(1) requires income statement information, whereas the annual requirements under S-X 4-08(g) require summarized financial information for both the balance sheet and income statement. Additionally, interim disclosures must be provided for the investees that meet the significance tests, whereas on an annual basis summarized financial information for all equity investees must be disclosed once the significance test is triggered.

10.7 Considerations for private companies

The guidance on presentation and disclosure of equity method investments is similar for private and public companies. However, the SEC has particular views regarding income statement presentation and additional rules surrounding the disclosure requirements for equity method investees.

As discussed in FSP 10.6, SEC registrants are required to disclose the tax components of the investee's effective tax rate if the investee's effective tax rate differs by more than five percent from the statutory Federal income tax rate. This disclosure is not required for private companies.

In addition, the SEC rules are more prescriptive with respect to disclosures required for summarized financial information of equity method investees. Summarized financial information of equity method investees is required to be disclosed under ASC 323 if the investments are material to the investor. However, judgment must be used to determine whether an investment is material to the balance sheet and income statement of the investor. In contrast, SEC rules establish significance tests which determine whether an investor is required to disclose the equity method investee summarized financial information.

S-X 4-08(g) also establishes the specific financial statement captions that must be included in the disclosure. In contrast, ASC 323 does not specify the captions that must be included in the summarized financial information.

Lastly, S-X 10-01(b)(1) specifies interim disclosure requirements for summarized financial information of equity method investees, while such information is not explicitly required under the ASC 270 minimum disclosure requirements.

Chapter 11: Other liabilities

11.1 Chapter overview

This chapter provides considerations for reporting entities related to liabilities that are not covered by other chapters within this guide. It focuses on U.S. GAAP and SEC requirements that a reporting entity should consider with regard to liabilities when preparing the financial statements and related disclosures.

This chapter identifies common liabilities and discusses related presentation and disclosure considerations. Topics discussed include:

- Accounts and notes payable
- Accruals (including warranty, environmental, employee compensation, restructuring, etc.)
- Asset retirement obligations
- Deferred revenue
- Liabilities held for sale

11.2 Scope

In considering the scope of this chapter, it is helpful to understand the conceptual framework related to liabilities.

CON 6, par. 35

Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

Expanding on CON 6, in order to be classified as a liability, the following characteristics must be present:

- There is a present duty or responsibility to one or more entities that entails settlement by probable future transfer, or the use of assets at a specified or determinable date, on occurrence of a specified event, or on demand
- There is little or no discretion in avoiding a future transfer of assets or providing services
- An obligating event has already happened

As discussed in FSP 2, a reporting entity must consider the ASC Master Glossary definition of current liabilities in preparing a classified balance sheet.

Definition of Current Liabilities from ASC Master Glossary

Current liabilities is used principally to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities.

The presentation and disclosure considerations in this chapter do not address current versus noncurrent classification. Each reporting entity should consider their facts and circumstances in light of the ASC definition when determining how to classify liabilities in their financial statements.

11.3 Accounts and notes payable

S-X 5-02 requires a reporting entity to separately disclose amounts payable to the following in the balance sheet:

- Trade creditors
- Banks for borrowings
- Holders of commercial paper
- Factors or other financial institutions for borrowings
- Related parties
- Underwriters, promoters, and employees
- Others

The SEC regulations allow for amounts applicable to banks for borrowings, holders of commercial paper, and factors or other financial institutions for borrowings to be either separately stated in the balance sheet, or in the footnotes.

11.3.1 Trade creditors

This caption typically represents amounts owed to suppliers of goods and services that a reporting entity consumes through operations. There are numerous considerations that a reporting entity should evaluate related to these payables, the most common of which are discussed in the following subtopics.

11.3.1.1 Overdrafts (bank & book)

Book overdrafts—representing outstanding checks in excess of funds on deposit—should be classified as liabilities at the balance sheet date. Bank overdrafts—representing the total of checks honored by the bank that exceed the amount of cash available in the reporting entity's account—result in the creation of a short-term loan.

Refer to FSP 6 for presentation and disclosure considerations related to book and bank overdrafts.

11.3.1.2 *Classification of outstanding checks*

It is not acceptable for a reporting entity to reclassify all outstanding checks as a liability if the outstanding checks may be covered by funds on deposit. The generally accepted approach, including the view of the Accounting Standards Executive Committee, is to reduce the cash balance for checks issued but not yet paid by the bank.

EXAMPLE 11-1

Offset of cash deposits with outstanding checks

FSP Corp has three separate bank accounts with the same bank: a deposit account, a main account, and a disbursement account. The deposit account is used by the reporting entity to accumulate deposits from customers. At the end of each business day, any amounts in the deposit account are automatically swept into the main account. FSP Corp uses the disbursement account to write checks. Each day, the bank accumulates the amount of checks presented for payment and, pursuant to its account agreement with FSP Corp, sweeps an equal amount out of the main account into the disbursement account to cover the balance. According to the account agreement, the bank has a right to draw any amount from an account with a positive balance to cover an account with a negative balance. As of year-end, FSP Corp has a negative cash book balance in the disbursement account of $9 million (representing outstanding checks), a positive cash book balance of $4 million in the main account, and zero in the deposit account.

How should FSP Corp present its cash accounts on its balance sheet?

Analysis

Because the bank has the ability to draw any amount from an account with a positive balance to cover an account with a negative balance, FSP Corp should offset the $4 million positive balance in the checking account against the $9 million in outstanding checks. The net amount of $5 million should be reported as a current liability on FSP Corp's balance sheet.

11.3.1.3 *Checks written but not released*

Checks that have not been mailed by the end of the accounting period should not be deducted from the cash balance. They should be included with accounts payable or other appropriate liability accounts.

11.3.1.4 *Drafts payable*

A draft is an order to pay a certain sum of money. It is signed by the drawer (e.g., an insurance company for a claim payment) and payable to order or bearer (e.g., the insurance policyholder). When the draft is presented to the drawee (i.e., the bank), it is paid only upon the approval of the drawer.

Drafts and checks have different legal characteristics. A check is payable on demand, whereas a draft must be approved for payment by the drawer before it is honored by the bank.

Drafts payable should be netted against the cash balance, similar to the treatment for outstanding checks. It is acceptable, however, for a reporting entity to present drafts payable gross as a liability if the total amount is disclosed either on the balance sheet or in a footnote. This approach recognizes that there is a legal distinction between a check and a draft. The policy election must be consistently applied.

11.3.1.5 Structured payables

For a variety of reasons, a reporting entity may establish a payment program with a bank whereby the bank will make payments to vendors on behalf of the reporting entity. This could be done as part of the bank's cash management service offering, allowing the reporting entity to take advantage of discounts offered by vendors as incentives for making early payments. Alternatively, the reporting entity could provide vendors the opportunity to sell their receivables to a financial institution (which typically results in better payment terms for the reporting entity). If a vendor sells its receivable to the bank, the reporting entity becomes liable to the bank and is directed to pay the bank, as opposed to the vendor, upon the trade payable balance becoming due.

In some cases, the only change to the terms of the original trade payable is the party to whom payment is due. In other cases, the terms of the payable may change upon the vendor's transfer of the receivable to the bank. The presence of specialized financing terms requires careful evaluation and may change the economic substance of the liability from a trade payable to a debt financing. While structured payable arrangements are not directly addressed within authoritative literature, the balance sheet classification of the resulting payable should be based on the economic substance of the arrangement.

If the vendor sells its receivable to the bank, settlement of the trade payable could take place at a date later than that stated on the original invoice, and may be settled at a different amount. In these situations, reclassification of the trade payable to debt upon its transfer to the bank would likely be appropriate based on the transaction being the economic equivalent of the reporting entity borrowing money from the bank and using it to repay the vendor. If the arrangement results in balance sheet classification as debt, it would affect the classification of the payments in the reporting entity's statement of cash flows, as they would now be considered a financing activity used to pay off a vendor payable (which is typically an operating activity).

The following are some of the common factors that a reporting entity should consider when determining the balance sheet classification of structured payables:

- The roles and responsibilities of each party (a tri-party agreement may indicate a refinancing of the payable)
- Whether the program is offered to a wide range of vendors and whether vendor participation in the program is voluntary
- Impact of the transaction on other contractual arrangements
- Whether default on payment to the bank under such an arrangement would trigger a cross-default (other than a general debt obligation cross-default)
- Whether there would be an automatic drawdown on the reporting entity's line of credit with the bank upon a failure to make payment
- Any fees, interest, commissions, rebates or discounts
- Any extended deadlines for paying third parties
- Whether the terms of the payable to the bank are those typical of a trade payable
- Whether the parties to and/or character of the obligation change under the Uniform Commercial Code. Generally, in-house counsel or outside counsel can provide evidence as to whether the nature or characteristics of the obligation have changed.

EXAMPLE 11-2

Structured payables—accounts payable versus debt classification

FSP Corp and its bank ask certain of FSP Corp's vendors to enter into a new payment program. Under the payment program, the bank pays the vendors directly. FSP Corp is then obligated to pay the bank the agreed upon amount. Once a vendor's receivable has been selected for the program, further adjustments (e.g., as a result of product returns) are not permitted. Any future adjustments would be negotiated between FSP Corp and the vendor.

Should FSP Corp classify the payable to the bank as accounts payable?

Analysis

As described, the arrangement is similar to a factoring arrangement. As such, the legal classification of the payable remains that of a trade payable. As a result, FSP Corp should classify it as accounts payable. If the arrangement were substantively a refinancing of the trade payables with the bank, it should be classified as debt or other liabilities.

11.3.2 Borrowings from financial institutions or holders of commercial paper

As described in FSP 11.3, SEC regulations require reporting entities to state separately either on the balance sheet or within a footnote amounts payable to banks for borrowings; factored payables or other borrowings from financial institutions; and amounts payable to holders of commercial paper. Refer to FSP 12 for debt-related presentation and disclosure considerations.

11.3.3 Related parties

Refer to FSP 26 for considerations related to the presentation and disclosure requirements for related party transactions.

11.3.4 Underwriters, promoters, and employees

Regulation S-X 5-02 requires reporting entities to separately disclose in the financial statements amounts payable to the following classes of individuals:

- Underwriters—Section 2(a)(11) of the 1933 Securities Act broadly defines the term "underwriter" as:

Excerpt from Section 2(a)(11) of 1933 Securities Act

The term "underwriter" means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission.

- Promoters—Rule 405 of the 1933 Securities Act defines a "promoter" as:

Excerpt from Securities Act of 1933, Rule 405

(i) Any person who, acting alone or in conjunction with one or more other persons, directly or indirectly takes initiative in founding and organizing the business or enterprise of an issuer; or

(ii) Any person who, in connection with the founding and organizing of the business or enterprise of an issuer, directly or indirectly receives in consideration of services or property, or both services and property, 10 percent or more of any class of securities of the issuer or 10 percent or more of the proceeds from the sale of any class of such securities. However, a person who receives such securities or proceeds either solely as underwriting commissions or solely in consideration of property shall not be deemed a promoter within the meaning of this paragraph if such person does not otherwise take part in founding and organizing the enterprise.

- Employees—The ASC Master Glossary defines an employee as an individual over whom a reporting entity can either exercise, or has the right to exercise, sufficient control to establish an employer-employee relationship

11.3.5 Others

A reporting entity should report accounts or notes payable to other parties not included within FSP 11.3.1 through FSP 11.3.4. Others can include, but not limited to, repurchase agreements. Refer to FSP 22 for presentation and disclosure considerations related to repurchase agreements.

11.4 Accruals and other liabilities

The SEC requires entities to separately state in the balance sheet or in the footnotes any item in excess of five percent of total current liabilities, or five percent of total liabilities not otherwise addressed by the specific categories of S-X 5-02. Given the broad definition of accruals and other liabilities, this section captures the more common disclosure considerations related to accruals and other liabilities, and provides an interpretation of certain specific disclosure requirements within the accounting guidance.

11.4.1 Dividends payable

For presentation and disclosure considerations related to dividends payable and stock dividends refer to FSP 5.

11.4.2 Income taxes

Refer to FSP 16 for considerations related to income tax presentation and disclosure.

11.4.3 Employee benefits

Employee benefits are a broad topic and include a number of subtopics, some of which are discussed below, and others that are discussed in other chapters of this guide. Topics covered within this guide include:

- Compensated absences (FSP 11.4.3.1)
- Rabbi trusts (FSP 11.4.3.2)
- Pension and other postemployment benefits (FSP 13)
- Stock-based compensation (FSP 15)

11.4.3.1 *Compensated absences*

ASC 710, *Compensation,* requires an employer to accrue a liability, considering anticipated forfeitures, related to employees' compensation for future absences if all of the following criteria are met:

- The employer's obligation relating to employees' rights to receive compensation for future absences is attributable to services already rendered by the employee
- The obligation relates to rights that accumulate or vest
- Payment is probable
- The amount of payment is reasonably estimable

In certain instances, a reporting entity may have to disclose a liability even if it has not yet recorded one. ASC 710-50 requires a reporting entity to disclose compensated absences if the employer meets the first three criteria listed above, but fails to meet the final criteria (i.e., the amount is reasonably estimable).

11.4.3.2 *Rabbi trusts*

ASC 710 addresses the accounting for deferred compensation when a portion of an employee's compensation (e.g., bonuses) is invested in the stock of the employer and placed in a "rabbi trust." These invested assets are in the name of the employer and not the employee. Accordingly, the accounts of the rabbi trust should be consolidated with the accounts of the employer in the employer's financial statements. Depending on the provisions of the plan, an employee might be allowed to immediately diversify into nonemployer securities or to diversify after a holding period; other plans do not allow for diversification. The deferred compensation obligation of some plans may be settled in (1) cash, by having the trust sell the employer stock (or the diversified assets) in the open market, (2) shares of the employer's stock, or (3) diversified assets. In other plans, the deferred compensation obligation may be settled only by delivery of the shares of the employer stock.

Employer stock held by a rabbi trust should be classified and accounted for in equity in the consolidated financial statements of the employer in a manner similar to treasury stock (i.e., changes in fair value are not recognized). This presentation is required regardless of whether the deferred compensation obligation may be settled in cash, shares of the employer's stock, or diversified assets.

When diversification is not permitted and the deferred compensation obligation is required to be settled by delivery of a fixed number of shares of employer stock, the deferred compensation obligation should be classified in equity. Changes in the fair value of the amount owed to the employee should not be recognized in the rabbi trust liability.

Diversified assets held by a rabbi trust should be accounted for in accordance with U.S. GAAP for the particular asset (i.e., if the diversified asset is a marketable equity security, that security would be accounted for in accordance with ASC 320, *Investments - Debt and Equity Securities*). At acquisition, securities held by the rabbi trust should be classified as trading, available for sale, or held to maturity, depending on the nature and risks of the security.

For plans that permit diversification or cash settlement at the option of the employee, the deferred compensation obligation should be classified as a liability and adjusted to reflect changes in the fair value of the amount owed to the employee. Changes in the fair value of the deferred compensation obligation should be recorded in the income statement, even if changes in the fair value of the assets held by the rabbi trust are recorded in other comprehensive income pursuant to ASC 320.

For the EPS implications for rabbi trusts, refer to FSP 7.

11.4.4 Restructuring

ASC 420, *Exit or Disposal Cost Obligations*, addresses significant issues related to the recognition, measurement, and reporting of costs associated with exit and disposal activities, including restructuring activities.

11.4.4.1 Presentation and disclosure related to exit or disposal cost obligations

The FASB has specified certain classification requirements related to costs and reversal of liabilities that are often relevant for exit and disposal costs.

ASC 420-10 requires extensive disclosures in the footnotes in the period in which an exit or disposal activity is initiated and until that activity is completed. Disclosures related to one-time termination benefits are principally focused on the amount to be paid. ASC 420-10 does not require that reporting entities disclose specific information about the number of employees or the employee groups that are to be terminated. However, reporting entities are not precluded from voluntarily providing such information.

ASC 420-10-50-1 requires all of the following information to be disclosed in the footnotes. The disclosures required pertain to all periods, including interim periods, until the exit plan is completed.

Excerpt from ASC 420-10-50-1

a. A description of the exit or disposal activity, including the facts and circumstances leading to the expected activity and the expected completion date

b. For each major type of cost associated with the activity (for example, one-time employee termination benefits, contract termination costs, and other associated costs), both of the following shall be disclosed:

1. The total amount expected to be incurred in connection with the activity, the amount incurred in the period, and the cumulative amount incurred to date

2. A reconciliation of the beginning and ending liability balances showing separately the changes during the period attributable to costs incurred and charged to expense, costs paid or otherwise settled, and any adjustments to the liability with an explanation of the reason(s) why.

c. The line item(s) in the income statement or the statement of activities in which the costs in (b) are aggregated

d. For each reportable segment, as defined in Subtopic 280-10, the total amount of costs expected to be incurred in connection with the activity, the amount incurred in the period, and the cumulative amount incurred to date, net of any adjustments to the liability with an explanation of the reason(s) why

e. If a liability for a cost associated with the activity is not recognized because fair value cannot be reasonably estimated, that fact and the reasons why.

ASC 420-10-50-1-b(2) prescribes a reconciliation footnote. The reconciliation is intended to address potential concerns regarding the comparability of information, as well as to provide information that will aid users of the financial statements in assessing the effects of these activities over time. In addition, ASC 420-10-50-1(d) requires disclosure of the amount of costs incurred and expected to be incurred in connection with exit and disposal activities by reportable segment, for both the current period and cumulative amounts to date. In the event a reporting entity recognizes liabilities for exit costs and involuntary employee termination benefits relating to multiple exit plans, the presentation of separate information for each material individual exit plan is appropriate.

If a liability for costs associated with an exit or disposal activity is not recognized when management commits to a restructuring plan, ASC 420 requires that a reporting entity disclose information regarding the costs the entity expects to incur in connection with those activities. This provides users of the financial statements with the necessary information to assess the effects of the activity, both initially and over time.

Each provision for asset writedowns and similar allowances should be disclosed separately and distinguished from provisions for restructuring charges. For example, amounts should be disclosed separately for writedowns of PP&E, intangible assets, and inventory, leasehold termination costs, litigation costs, and environmental clean-up costs. Reporting entities should be careful when grouping together exit and involuntary termination costs, as the SEC staff has often requested greater disaggregation and more precise labeling in the income statement line items and footnotes when reporting entities group these costs together.

Provisions and writedowns unrelated to a formal restructuring plan should be disclosed separately, from those charges arising as a result of a discretionary exit decision.

Question 11-1

How should the markdown of inventory be classified when it is due to activities taken in connection with a restructuring decision?

PwC response

As discussed in SAB Topic 5.P, the SEC staff recognized that there may be circumstances in which a reporting entity might assert that inventory markdowns are costs directly attributable to a decision to exit or restructure an activity. However, given the difficulty in distinguishing inventory markdowns attributable to a decision to exit or restructure from those markdowns that are attributable to external market factors, the SEC staff has indicated that inventory markdowns should be classified in the income statement as a component of costs of goods sold.

The SEC staff has also indicated that reporting entities should evaluate restructuring liabilities at each balance sheet date (annual and interim) to ensure that unnecessary amounts are reversed on a timely manner. Disclosure should be provided when material reversals are made. A reversal of a liability should be recorded in the same income statement line item that was used when a liability was initially recorded. Amounts determined to be in excess of those required for the stated restructuring activity may not be used for other payments. The SEC staff has emphasized that costs incurred in connection with an exit plan should be charged to the exit accrual only to the extent that those costs were specifically included in the original estimation of the accrual. Costs incurred in connection with an exit plan not specifically contemplated in the original estimate of the liability should be charged to expense in the period in which they are incurred.

11.4.4.2 Income statement presentation considerations related to exit or disposal cost obligations

Reporting entities are not prohibited from separately presenting costs associated with exit or disposal activities covered by ASC 420 in the income statement, excluding those activities that involve a discontinued operation.

Because exit or disposal activities do not meet the definition of extraordinary items in ASC 225 (i.e., they are not both unusual and infrequent), they should not be presented in any manner that implies that they are similar to an extraordinary item. ASC 420 specifically requires that those costs be included in income from continuing operations before income taxes in the income statement.

The SEC provides additional guidance about the appropriate presentation of exit or disposal costs for SEC registrants:

Excerpt from SAB Topic 5.P.3

The staff believes that restructuring charges should be presented as a component of income from continuing operations, separately disclosed if material. Furthermore, the staff believes that a separately presented restructuring charge should not be preceded by a sub-total representing "income from continuing operations before restructuring charge" (whether or not it is so captioned). Such a presentation would be inconsistent with the intent of FASB ASC Subtopic 225-20.

To be consistent with the guidance in ASC 420, we believe the earnings per share effect of exit and disposal costs should not be disclosed on the face of the income statement. Additionally, revenue, related costs, and expenses that will not be continued should not be netted and reported as a separate component of income unless they qualify as discontinued operations. Refer to FSP 27 for discussion of presentation and disclosure requirements associated with discontinued operations.

11.4.5 Warranty

Although product warranties and extended warranties are excluded from the recognition and measurement requirements of ASC 460, *Guarantees,* they are still subject to certain of its disclosure requirements. Specifically, ASC 460-10-50-8(b) and ASC 460-10-50-8(c) require the reporting entity providing the guarantee (i.e., the guarantor) to disclose its accounting policy and methodology used in determining its liability for these warranties. The guarantor reporting entity should provide a tabular reconciliation of the changes in its aggregate warranty liability for each year an income statement is presented in the financial statements.

The FASB staff has confirmed that the accounting policy and methodology disclosure and the tabular reconciliation should include information about both general product warranties and deferred revenue related to extended warranties. Reporting entities may present their general product warranty and extended product warranty information in two separate reconciliations or on a combined basis in one table. Under either presentation, both the costs incurred during the year for extended warranties and the settlement of those costs should be included in the reconciliation. Because such costs are generally not accrued in the balance sheet, but are recognized directly in the income statement as an expense when incurred, this will appear in the reconciliation as an equal increase and decrease to the reserve in the same period.

The following is an example of the reconciliation of product warranty that should be presented for all income statement periods presented:

EXAMPLE 11-3

Example disclosure — reconciliation of product warranty liability

	For the year ended December 31, 20X4
Balance at the beginning of the period	$5,000
Accruals for warranties issued	1,225
Accruals related to pre-existing warranties (including changes in estimates)	375*
Settlements made (in cash or in-kind)	(2,750)
Impact of foreign exchange rate changes	80*
Balance at the end of the period	$3,930

* Could be a debit or a credit amount.

In addition to this tabular reconciliation, reporting entities should consider including narrative disclosure to explain any significant changes or unusual items presented in the table.

Reporting entities that have extended warranty programs should consider disclosing the reconciliation of beginning and ending deferred revenue, including amortization, costs incurred, and costs settled. As noted, this may be combined with the rollforward of the general warranty, or presented separately. A separate reconciliation of extended warranty information might include the following:

EXAMPLE 11-4

Example disclosure — reconciliation of deferred revenue liability

	For the year ended December 31, 20X4
Deferred revenue at the beginning of the period	$3,000
Additions for extended warranties issued	600
Amortization of deferred revenue	(1,250)
Costs incurred related to extended warranties*	0
Settlement of costs related to extended warranties**	0

	For the year ended December 31, 20X4
Impact of foreign exchange rate changes	65***
Deferred revenue at the end of the period	$2,415

* These costs are generally expensed as incurred.

** If costs were not settled in the period incurred, an additional line item would be necessary to reflect the status of that cost as a payable of the reporting entity to ensure that the balance of deferred revenue at the end of the period per the tabular reconciliation equals the balance reported in the financial statements.

*** Could be a debit or a credit amount.

11.4.6 Unconditional promises to give

ASC 720, *Other Expenses*, provides guidance on the recognition and measurement of accounting for contributions, including an unconditional promise to give. Unconditional promises (e.g., pledges to a not for profit organization) are any promise that depends only on the passage of time or demand by the promissee for performance. Disclosures for the makers of these promises and indications of the intention to give are included within ASC 450, *Contingencies* (FSP 23), and ASC 470, *Debt* (FSP 12).

11.5 Environmental accruals

ASC 410-30, *Environmental Obligations*, provides accounting considerations related to the recognition, measurement, presentation, and disclosure of environmental remediation liabilities. For SEC registrants, important interpretative guidance is included in SAB Topic 5.Y, *Accounting and Disclosures Relating to Loss Contingencies*, and SAB Topic 10.F, *Presentation of Liabilities for Environmental Costs*. The following section provides a discussion of the presentation and disclosure considerations for environmental obligations. ASC 410-30-55 provides illustrations and examples of the disclosure requirements related to environmental remediation liabilities, environmental remediation costs, loss contingencies, and liabilities with numerous potential outcomes. Additionally, refer to FSP 24 for presentation and disclosure considerations related to risks and uncertainties.

ASC 410-30 allows for the capitalization of costs if certain criteria are achieved. For example, if a reporting entity is involved in an oil spill and decides to reinforce the hulls of oil tankers to improve the safety of the ships and prevent future oil spills, those costs may be capitalized. In addition, if a reporting entity acquires fixed assets to clean up an oil spill, it may capitalize the costs unless the assets do not have a future use. Similar to other assets, a reporting entity should evaluate the recoverability of these assets. They should be classified on the balance sheet as current or noncurrent based on the ASC Master Glossary definitions. Presentation of the remediation liabilities and these related assets is discussed in the following section.

11.5.1 *Presentation considerations*

ASC 410-30-45-1 through 45-6 details other presentation matters related to accrued liabilities and assets related to environmental remediation obligations. The guidance details the following points:

- Right of setoff — If all conditions within ASC 210, *Balance Sheet*, are met, the asset and liability may be reported net. However, the FASB observed that it would be rare, if ever, that all of the conditions would be met for environmental remediation liabilities, the related receivables, and potential recoveries.

- Extraordinary item — The incurrence of environmental remediation liabilities is not an event that is unusual in nature, and therefore the costs and recoveries would not meet the criteria of an extraordinary item. The guidance specifically states that "asbestos treatment costs that are charged to expense are not extraordinary items."

- Operating expense classification — Remediation costs are required to be charged against operations since the events underlying the incurrence of the obligation relate to the reporting entity's operations. Any recoveries should be reflected in the same income statement line as the original expense. To the extent a reporting entity has earmarked assets for funding its environmental liabilities, the earnings on those assets are to be reported as investment income.

- Discontinued operations — A reporting entity should classify environmental remediation expenses and recoveries as discontinued operations if they meet the requirements in ASC 205-20, *Discontinued Operations*.

11.5.2 *Required disclosures*

ASC 410-30-50-4 through 50-7 outlines the specific disclosure requirements with respect to environmental remediation obligations. They include:

- If a reporting entity utilizes a present value measurement technique, disclose the undiscounted amount and the discount rate used in the present-value determinations.

- The disclosures required by ASC 275-10, *Risk and Uncertainties*, related to environmental remediation liabilities. Refer to FSP 24 for disclosured related to risks and uncertainties.

- The disclosures required by ASC 450-20, *Contingencies,* related to environmental remediation loss contingencies. Refer to FSP 23 for information about disclosure requirements for contingencies.

ASC 410-30-50-13 through 50-17 provides additional guidance related to the disclosure of contingencies. It specifically reminds reporting entities that if there are existing laws and regulations to report the release of hazardous substances and begin a remediation study, those requirements would represent a loss contingency subject to the disclosure considerations within ASC 450-20.

11.5.3 Additional disclosure considerations – encouraged but not required

ASC 410-30-50-8 through 50-12 outlines the following disclosures that a reporting entity should consider, but that are not required.

- The event, situation, or circumstances that might trigger recognition of a loss contingency related to a reporting entity's remediation-related obligations (e.g., upon completion of a feasibility study)
- Policy concerning the timing of recognition of recoveries
- Additional specific disclosures related to the environmental remediation loss contingencies that would be useful to further a user's understanding of the reporting entity's financial statements
- Period over which disbursements for recorded amounts will occur
- Expected period for realization of recognized probable recoveries
- Estimated time frame for resolution of the uncertainty
- Reason why an estimate of a probable or reasonably possible loss or range of loss cannot be made, if applicable
- Specific considerations related to a specific site, including the total amount accrued for the site, the nature of any reasonably possible loss contingency, whether any other parties are involved and share in the obligation, status of regulatory proceedings, or estimated time frame for resolution of the remediation loss contingency
- Details related to the amount of environmental remediation costs recognized in the income statements (e.g., amount recognized in each period, recoveries credited to environmental remediation costs in each period, where costs are captured in financial statements, etc.)

11.5.4 SEC reporting considerations

The SEC staff has indicated that certain additional disclosures should be furnished with respect to product and environmental remediation liabilities. SAB Topic 5.Y indicates that product and environmental remediation liabilities are typically of such significance that specific disclosures regarding the judgments and assumptions underlying the recognition and measurement of the liabilities are necessary to prevent the financial statements from being misleading. The SEC staff has indicated that, in addition to the disclosures required by ASC 450 and ASC 410-30, it may be necessary to disclose the following information:

Excerpt from SAB Topic 5.Y

- Circumstances affecting the reliability and precision of loss estimates.
- The extent to which unasserted claims are reflected in any accrual or may affect the magnitude of the contingency.
- Uncertainties with respect to joint and several liability that may affect the magnitude of the contingency, including disclosure of the aggregate expected cost to remediate particular sites that are individually material if the likelihood of contribution by the other significant parties has not been established.
- Disclosure of the nature and terms of cost-sharing arrangements with other potentially responsible parties.
- The extent to which disclosed but unrecognized losses are expected to be recoverable through insurance or other sources, with disclosure of any material limitation of that recovery.
- Uncertainties regarding the legal sufficiency of insurance claims or solvency of insurance carriers.
- The time frame over which the accrued or presently unrecognized amounts may be paid out.
- Material components of the accruals and significant assumptions underlying estimates.

SAB Topic 5.Y further states that reporting entities should disclose in the footnotes material liabilities that may occur upon the sale, disposal, or abandonment of a property related to site restoration, monitoring commitments, or other exit costs as a result of unanticipated contamination of assets. These disclosures would generally include the nature of the costs, total anticipated costs, total costs accrued to date, balance sheet classification of the accrued amounts (i.e., current versus noncurrent), and the amount of reasonably possible additional losses.

The SAB topic also states that if an asset held for sale will require remediation prior to the sale, or as a condition of sale, a footnote should describe how these future expenditures are considered in the assessment of the asset's value. Additionally, reporting entities should disclose if the reporting entity may be liable (unless the likelihood of a material unfavorable outcome is remote) for remediation of environmental damage relating to assets or businesses previously disposed. The SEC registrant's accounting policy with respect to such costs should be disclosed.

The SAB topic is not intended to impose an affirmative obligation to determine potential closure costs for an operating manufacturing plant that the reporting entity has no plans to sell or abandon and for which no ASC 450 obligation exists.

In addition to the specific topics discussed by the SEC staff within the SAB topic, reporting entities should be aware of the following with respect to environmental reporting:

Compliance Costs — The SEC has historically viewed the cost of compliance with all specific federal, state, local, and foreign laws relating to the environment as part of the total environmental expenditures. The SEC staff has suggested that the future estimated cost of compliance be disclosed in accordance with the guidance in SAB Topic 5.Y.

Accrued Costs — There is no requirement to disclose amounts accrued for specific contingencies unless failure to disclose such amounts would omit information material to an investor. In past comment letters, and as implied in SAB Topic 5.Y, the SEC staff has requested information on the total amounts accrued for environmental remediation liabilities, such as breakdowns by type of accrual or by type of site. In some instances, the SEC staff may request this information supplementally.

Uncertainties — The SEC staff has issued a significant number of comments related to disclosures regarding uncertainties, as discussed in FSP 24. Reporting entities should ensure that disclosures related to environmental accruals include discussion of any uncertainties. Disclosures related to environmental liabilities should include details about the uncertainties related to the estimate and the range of reasonably possible losses in excess of the amount recorded as a liability, or state that such an estimate cannot be made.

The SEC staff has indicated that the absence of disclosure about unrecorded, but reasonably possible loss contingencies pursuant to ASC 450, represents the assertion that no reasonably possible material loss contingency, in fact, exists. If a material amount is subsequently recorded, the SEC registrant can expect questions from the SEC staff. Depending on the facts and circumstances, amendments to prior disclosures to correct errors in the application of ASC 450 could be required. The SEC staff has indicated that it generally expects SEC registrants to record an estimated liability for environmental exposures.

11.5.5 Environmental policy note

Many reporting entities with significant environmental expenditures include an environmental accounting policy footnote, outlining both the reporting entity's policies with regard to classification of expenditures between capital and operating expense, and its process for determining the amount of environmental remediation obligations to accrue. ASC 235-10-50-3 requires disclosure when environmental matters are material.

EXAMPLE 11-5

Example disclosure — environmental remediation costs

FSP Corp accrues for losses associated with environmental remediation obligations when such losses are probable and reasonably estimable. Accruals for estimated losses from environmental remediation obligations generally are recognized no later than completion of the remedial feasibility study. Such accruals are adjusted as further information develops or circumstances change. Costs of future expenditures for environmental remediation obligations are not discounted to their present value. Recoveries of environmental remediation costs from other parties are recorded as assets when their receipt is deemed probable. Consolidated provisions made in 20X4 for environmental liabilities were $10 million ($11 million in 20X3), and the balance sheet reflects accumulated liabilities of $70 million and $75 million as of December 31, 20X4, and 20X3, respectively.

11.6 Asset retirement obligations

ASC 410-20 describes standards for the recognition and measurement of an asset retirement obligation (ARO). ASC 410-20 provides accounting guidance for legal obligations associated with the retirement of tangible long-lived assets. The retirement obligations included within the scope of the guidance are unavoidable obligations incurred as a result of the acquisition, construction, or development and/or normal operation of a long-lived asset. ASC 410-20 requires asset retirement obligations to be recognized at fair value as the liability is incurred with a corresponding increase in the carrying amount of the related long-lived asset, referred to as an asset retirement cost (ARC). The guidance specifically requires that accretion expense be classified as an operating expense in the income statement.

11.6.1 Disclosure requirements

ASC 410-20 requires multiple disclosures for entities that have AROs associated with their assets. A general description of any ARO and the associated assets is required. If a reporting entity has legally segregated any assets to settle the ARO, ASC 410-20 requires disclosure of the fair value of those assets. This requirement only applies to assets that have been legally restricted for settlement of the ARO, such as in a sinking fund, trust, or other arrangement, and not to any general internal funding policy that a reporting entity may adopt.

If a reporting entity has any asset retirement obligation for which no amount has been recognized, ASC 410-20 requires disclosure of the existence of the ARO and the reasons why it has not been recognized. For example, if an entity has an ARO associated with an asset with an indeterminate life, no reasonable estimation of the liability is possible, so no ARO liability is recorded. However, management should consider disclosure of the potential cash flows (based on current estimated costs) related to this unrecognized ARO.

Reporting entities are also required to reconcile the ARO liability at the beginning of the period to the ARO liability at the end of the period. This reconciliation is required for each income statement period presented, but is only required in periods when there have been significant changes in liabilities incurred or settled, accretion expense, or revision in estimated cash flows. Best practices would be to include the reconciliation (or information sufficient to allow the user to construct the reconciliation) if any of the amounts in the reconciliation are significant, without regard to whether they have changed. In other words, a reporting entity should not look only to significant changes in the components of the reconciliation, but also look to significant changes in the liability year over year. For instance, if ARO liabilities incurred during the period are significant each year but constant, we believe that the reconciliation should be provided.

11.7 Deferred revenue

Cash may be received from customers in advance of when related revenues are allowed to be recognized. Reporting entities should distinguish between current and noncurrent portions of deferred revenue and present them accordingly. If deferred revenue is recorded prior to cash receipt (e.g., an invoice is issued in advance of providing services), consideration should be given to offsetting such amount against the related accounts receivable. This avoids potential distortions in performance measures, such as days sales outstanding. The SEC staff has indicated that it is generally not appropriate for an SEC registrant to record deferred revenue in advance of cash receipt when the conditions for revenue recognition have not been met, because neither party has fulfilled its obligations under the contract.

11.8 Liabilities held for sale

ASC 205-20-45 requires segregation of the liabilities related to disposal groups classified as held for sale in the balance sheet. Assets and liabilities should not be offset and presented as a single amount. The major classes of liabilities classified as held-for-sale should be separately disclosed on the balance sheet or in the footnotes.

ASC 205-20-45 does not provide guidance on whether liabilities held for sale should be classified as current or noncurrent in the balance sheet. Generally, at the held-for-sale date, it would be acceptable to classify liabilities held for sale as current when 1) the disposal is expected to be consummated within one year of the balance sheet date, and 2) the entity expects to receive cash or other current assets upon disposal and the sale proceeds will not be used to reduce long-term borrowings. If such conditions are not met at the reporting period date, we would expect to see two line items related to the liabilities of a disposal group held for sale — current and noncurrent. Classification should be assessed each reporting period date through the sale date. Refer to FSP 8.7 for further discussion of held-for-sale disclosure requirements.

We have seen instances in practice where liabilities of discontinued components have been reclassified in the balance sheets of periods ended prior to the period in which the component becomes held for sale or is disposed of, presumably under the theory that this is an extension of the reclassification requirement for operations of discontinued components. While not required under ASC 205-20, the Codification of Statements on Auditing Standards Section 708, *Consistency of Financial Statements,* implies that such reclassifications are permissible and requires that material reclassifications be indicated and explained in the footnotes. Accordingly, provided appropriate disclosure is made, reporting entities may retroactively segregate liabilities of discontinued components in balance sheets of periods ended prior to the measurement date. For additional information related to discontinued operations, including information regarding the recently released ASU, refer to FSP 27.

We also believe that, in a spin-off transaction rather than a sale, it is acceptable to reclassify the prior period balance sheet into segregated assets and liabilities (similar to if the entity had been held for sale). However, because assets disposed of through a spin-off transaction are required to remain classified as held and used until the spin-off has occurred, reclassification of the prior year balance sheet would not be appropriate until completion of the spin-off.

11.9 Considerations for private companies

The requirements of ASC guidance discussed above apply equally to public and private companies. However, certain disclosure items are only required by SEC registrants. Figure 11-1 summarizes the SEC requirements discussed in this chapter.

Figure 11-1
Presentation and disclosure requirements applicable only to SEC registrants

Description	Reference	Section
Disclose separately, in the balance sheet or within a footnote, any item in excess of five percent of total current liabilities or total liabilities	S-X 5-02	11.4
Disclose separately amounts payable to certain parties	S-X 5-02	11.3
Specific presentation of restructuring charges	SAB Topic 5.P.3	11.4.4
Disclosure requirements for material involuntary employee termination costs or exit costs related to an acquired business	Comment letters	11.4.4.1
Disclosures related to environmental obligations	SAB Topic 5.Y SAB Topic 10.F	11.5.4

Chapter 12: Debt

12.1 Chapter overview

This chapter discusses a reporting entity's balance sheet presentation of debt and the related disclosures. It provides insight into how to assess certain facts and circumstances in determining the appropriate current or noncurrent balance sheet classification. Additionally, it discusses classification of costs incurred in issuing, restructuring, and extinguishing debt in the balance sheet and the income statement, as well as the presentation of debt extinguishment gains or losses in the income statement.

For recognition and measurement considerations relevant to debt, see PwC's accounting and financial reporting guide for *Financing transactions: debt, equity and the instruments in between.*

12.2 Scope

ASC 470, *Debt,* is the primary accounting and reporting guidance for debt, and is applicable for all reporting entities. However, its guidance for separate classification of current assets and current liabilities is only applicable when a reporting entity prepares a classified balance sheet, which is addressed in FSP 2.

For SEC registrants, S-X 4-08(k) provides incremental guidance on related party transactions (including those involving debt), and S-X 5-02 and S-X 4-06 provide disclosure requirements for long-term borrowings. SAB Topic 6.H.2, *Classification of Short-term Obligations – Debt Related to Long-Term Projects* also provides classification guidance for SEC registrants.

Finally, SEC registrants that issue registered securities that are guaranteed, or that guarantee a registered security, are subject to S-X 3-10.

Note about ongoing standard setting

As of the content cutoff date of this publication (August 31, 2014), the FASB has active projects on debt classification and debt issuance costs that may affect presentation and disclosure requirements. Financial statement preparers and other users of this publication are therefore encouraged to monitor the status of the project, and if finalized, evaluate the effective date of the new guidance and the implications on presentation and disclosure.

12.3 Balance sheet classification – term debt

Accurate debt classification is critical for reasons beyond simply complying with U.S. GAAP. First, it can impact a reporting entity's ability to raise funds. Debt classification is typically a key component in calculating ratios that prospective investors and lenders (creditors) use to gauge a reporting entity's liquidity and credit risk. Second, it can impact contractual covenant compliance. Covenants may require a reporting entity to calculate certain financial ratios that are directly affected by debt classification. One such example is working capital, which is calculated as the difference between current assets and current liabilities.

There are many classification nuances to consider, and often, a debt agreement can include terms that may yield unanticipated classification answers. These terms include:

- Call and put options
- Subjective acceleration clauses
- Debt covenants

As a general rule, if the legal term of the debt is long-term (either by its original terms or through a waiver or modification), then the debt is ordinarily presented as noncurrent. Conversely, if the legal term of the debt is short-term (either by its original terms or because of a non-waived covenant violation), the debt is generally presented as current.

12.3.1 Callable debt

Debt agreements may contain call options that provide the borrower (debtor) the option to prepay the debt prior to its maturity date. Call options can vary widely among various loan agreements. Some agreements allow for prepayment of debt anytime while others allow prepayment only upon specific contingent events.

Typically, the existence of a call option in a debt agreement should not impact classification because call options are at the borrower's discretion. The call options do not create a requirement to pay off the debt at a certain date, but rather they give the borrower a choice to pay off the debt prior to maturity.

Exercising a call right or announcing the intent to exercise a call right prior to the financial statements being issued generally does not affect classification. However, if the reporting entity's announcement of the plan to exercise a call right prior to the balance sheet date creates a legally-binding obligation or an irrevocable commitment to redeem the debt at the balance sheet date, then the debt should be classified as current.

Likewise, the announcement and execution of a call option after the balance sheet date but before the financial statements are issued has no effect on debt classification. Although there is no effect on the debts' balance sheet classification, the reporting entity should disclose the exercise of the call option subsequent to the balance sheet date as a nonrecognized subsequent event. See FSP 28.6.3.2 for discussion of this subsequent event.

12.3.2 Puttable debt[1]

Debt agreements may contain put options that allow the lender to demand repayment prior to maturity. Some put options can be exercised at any time, while others are contingently exercisable upon the occurrence of specific events. Debt classification for these types of instruments requires consideration of the terms in the debt agreement.

12.3.2.1 Due-on-demand loan agreements

Debt that is puttable by the lender based on conditions that existed at the balance sheet date is considered a due-on-demand loan. Due-on-demand loan agreements provide the lender with a right to demand repayment at any time at its discretion. The due-on-demand language can vary by agreement. Some typical examples include the following:

- The term note matures in monthly installments or on-demand, whichever is earlier
- Principal and interest are due on-demand ("redeemable") or annually

Obligations that, by their terms, are due on-demand or will be due on-demand within one year (or the operating cycle, if longer) from the balance sheet date — even if liquidation is not expected within that period — are required to be classified as current liabilities.

12.3.2.2 Subjective acceleration clauses

Long-term financing agreements may contain subjective acceleration clauses (SAC), where the lender refuses to continue to lend if the borrower experiences an adverse change. These clauses are typically referred to as Material Adverse Change (MAC) or Material Adverse Effect (MAE) clauses.

Unlike a demand provision, a SAC typically requires a covenant violation or default event to occur before it can be invoked. The ASC Master Glossary defines a subjective acceleration clause as follows:

> **Definition from ASC Master Glossary**
>
> A subjective acceleration clause is a provision in a debt agreement that states that the creditor may accelerate the scheduled maturities of the obligation under conditions that are not objectively determinable (for example, if the debtor fails to maintain satisfactory operations or if a material adverse change occurs).

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[1] ASC 470-10-45-11 refers to debt that is callable by the lender. This is common nomenclature in the banking sector. However, we have referred to these instruments as puttable because debt that is callable by the lender is equivalent to debt that is puttable to the borrower/issuer. Regardless of terminology, this feature provides the lender with the right to deliver back its loan to the borrower/issuer at a fixed price that meets the more general description of a put option.

The likelihood of the due date being accelerated determines the classification of debt with a SAC.

If the reporting entity's circumstances are such that acceleration of the due date is probable (for example, there are recurring losses or liquidity problems), long-term debt subject to a SAC should be classified as a current liability. For purposes of this determination, reporting entities should use the definition of "probable" in ASC 450, *Contingencies*.

If acceleration of the due date is judged reasonably possible, disclosure of the existence of a SAC clause is generally sufficient. The debt may be classified as noncurrent.

If the acceleration of the due date is deemed remote, neither reclassification nor disclosure is required.

Example 12-1 illustrates the different treatment for debt on-demand and debt with a subjective acceleration clause.

EXAMPLE 12-1

Demand provision versus subjective acceleration clause

As of December 31, 20X4, FSP Corp, a reporting entity whose financial condition is strong, has two outstanding loans, Loan D and Loan S. Both loans have a stated maturity date beyond December 31, 20X5 (one year from the balance sheet date).

Loan D contains a demand provision that allows the lender to put the debt to FSP Corp at any time.

Loan S contains a SAC that would allow the lender to put the debt to FSP Corp if a material adverse change in FSP Corp's financial condition occurs.

The lender historically has not accelerated due dates of loans containing similar clauses.

How should FSP Corp classify Loan D and Loan S on its balance sheet as of December 31, 20X4?

Analysis

Loan D should be classified as current. A demand provision requires current liability classification even if liquidation is not expected within the period.

Loan S should be classified as noncurrent (as long as there are no covenant violations). A SAC does not require classification of the debt as current if the likelihood of acceleration of the due date (the lender's exercise of the SAC) is not probable. Because the likelihood of acceleration of the due date is remote, no disclosure is required either.

12.3.2.3 *Contingently puttable debt*

Debt agreements may contain clauses that make the debt puttable upon certain contingent events. At each reporting period, the reporting entity should assess contingent events. If a contingent event has occurred that makes the debt obligation puttable, then current classification is required.

12.3.3 *Classification of debt with covenant violations*

Many debt agreements include covenants on the borrower for the life of the agreement. Breach of a covenant triggers an event of default, which may lead to an increase in the interest rate or a potential demand for repayment (i.e., the debt becomes due).

Figure 12-1 summarizes the various covenant violation scenarios and their related classification. It also references the section in this chapter where the scenario is discussed in detail.

Figure 12-1

Summary of debt classification resulting from covenant violations at the balance sheet date

Covenant violation scenario	Classification	Chapter reference
1) Violation; no waiver; no grace period	Current	12.3.3.1
2) Violation; no waiver; grace period		12.3.3.2
— It is probable the violation will be cured	Noncurrent	
— It is not probable the violation will be cured	Current	
3) Violation; waiver or modification		12.3.3.3
— Covenant not required to be met going forward	Current (waiver less than one year) Noncurrent (waiver for more than one year)	
— It is reasonably possible the covenant will be met at subsequent testing dates	Noncurrent	
— It is probable the covenant will not be met at subsequent testing dates	Current	

Covenant violation scenario	Classification	Chapter reference
4) Violation avoided through modification		12.3.3.4
— It is reasonably possible the covenant will be met at subsequent testing dates	Noncurrent	
— It is probable the covenant will not be met at subsequent testing dates	Current	
5) Violation occurring or anticipated after the balance sheet date	Noncurrent	12.3.3.5

See FSP 12.8.1 for a discussion of the balance sheet classification of unamortized debt issue costs and debt discount/premium associated that are reclassified to current due to a covenant violation.

12.3.3.1 *Covenant violation at the balance sheet date with no waiver obtained*

If a borrower violates a debt covenant that does not include a specified grace period, the obligation becomes puttable by the lender (i.e., due-on-demand debt). As discussed in FSP 12.3.2.1, long-term obligations that are, or will be, puttable by the lender are required to be classified as current liabilities.

12.3.3.2 *Covenant violation at the balance sheet date with no waiver obtained and a grace period*

If a covenant violation has occurred at the balance sheet date and there is a grace period in effect, these puttable obligations should be classified as current. However, if it is probable the violation will be cured within that period, ASC 470-10-45-11(b) indicates that the obligation can be classified as noncurrent.

12.3.3.3 *Covenant violation and waiver or modification at the balance sheet date*

Classification of debt that has a covenant violation waived or modified at the balance sheet date depends on the manner in which the waiver or modification was provided.

Same or more restrictive covenant is not required to be met going forward

If a covenant violation has occurred at the balance sheet date, the lender may not require the borrower to meet the same covenant, or a more restrictive covenant, in the next twelve months (although this circumstance is unusual). ASC 470-10-45-11(a) indicates that the associated obligations should be classified as current unless one of the following conditions exists:

- *The lender has waived the right to demand repayment for more than a year (or an operating cycle, if longer) from the balance sheet date*

  If the obligation is puttable because of violations of certain provisions of the debt agreement, the lender needs to waive its right with regard to only those specific violations.

- *The lender has subsequently lost the right to demand repayment for more than a year (or an operating cycle, if longer) from the balance sheet date*

  For example, if the borrower has cured the violation after the balance sheet date and the obligation is not puttable at the time the financial statements are issued, the lender has lost the right to demand repayment.

Same or more restrictive covenant is required to be met going forward

Frequently, a covenant violation occurs at the balance sheet date and the lender requires the borrower to meet the same covenant, or a more restrictive covenant, in the next twelve months. ASC 470-10-55-2 through 55-6 indicates that the obligation should be classified as a noncurrent liability at the balance sheet date if a waiver is obtained, unless the borrower concludes the chance of meeting the same or more restrictive covenants at subsequent compliance measurement dates within the next year is remote (i.e., it is probable the borrower will violate the future covenant). As long as the borrower can conclude that it is at least reasonably possible that the subsequent covenant will be met, the debt should remain classified as noncurrent.

A situation may arise where a covenant was violated at the balance sheet date and subsequently the lender granted a waiver giving up its right (arising from the covenant violated) to demand repayment for more than one year from the balance sheet date. However, it is probable that violation of the same (or a more restrictive) covenant will occur at subsequent compliance measurement dates within the next year that will make the debt callable. In these circumstances, ASC 470-10-55-4(e) requires current classification of the obligation, unless the conditions in ASC 470-10-45-13 through 45-20 for refinancing short-term debt (discussed in FSP 12.3.4) are met. If these conditions are met, the debt may be classified as noncurrent.

EXAMPLE 12-2

Classification of debt with waiver of a covenant violation at the balance sheet date, but the same covenant needs to be met going forward

FSP Corp, the borrower, is not in compliance with its working capital covenant at December 31, 20X4.

The lender waives its right to put the debt based on the December 20X4 violation until January 1, 20X6.

FSP Corp is required to meet the same working capital covenant on March 31, 20X5, and it is probable that it will not do so.

How should FSP Corp classify the debt in the December 31, 20X4 balance sheet?

Analysis

FSP Corp should classify the debt as a current liability in its December 31, 20X4 balance sheet because it is in violation of the covenant at the balance sheet date. Although it obtained a waiver at the balance sheet date, it is probable it will not meet that covenant in the next period, triggering current classification.

12.3.3.4 Covenant violations avoided at the balance sheet date through a loan modification

A borrower may determine in advance of the balance sheet date that it will not be able to meet certain covenants. To avoid a covenant violation at the balance sheet date, the borrower may seek to modify the debt agreement in advance so it will be compliant at the balance sheet date. In this fact pattern, the modification is in substance a waiver, except that it is obtained prior to the actual violation (instead of after, as a waiver would be).

ASC 470-10-55-4(d) provides guidance for when a covenant would have been violated at the balance sheet date absent a modification of the debt agreement before the balance sheet date, and for which violation is probable at the subsequent compliance date after the balance sheet date. It requires current classification of the debt, unless the provisions of ASC 470-10-45-13 through 45-20 for refinancing short-term debt (discussed in FSP 12.3.4) are met, in which case the debt may be classified as noncurrent.

EXAMPLE 12-3

Covenant violation avoided at the balance sheet date through a loan modification

FSP Corp, the borrower, does not expect to be in compliance with its working capital covenant at December 31, 20X4.

On December 15, 20X4, FSP Corp negotiates a modification to the debt agreement to eliminate this covenant until June 29, 20X5.

FSP Corp is required to meet the same working capital covenant on June 30, 20X5, and it is probable that it will not do so.

How should FSP Corp classify the debt in the December 31, 20X4 balance sheet?

Analysis

FSP Corp should classify the debt as a current liability at the balance sheet date because it would have violated the covenant at December 31, 20X4 had it not entered into the loan modification, and because it is probable it will not meet that covenant within the next year.

12.3.3.5 *Covenant violations occurring or anticipated after the balance sheet date*

ASC 470-10-55-4(a) through (c) address classification when covenant violation is probable after the balance sheet, but no violation existed at the balance sheet date. In those instances, the guidance indicates that noncurrent classification would be appropriate. This is true regardless of whether the violation occurs after the balance sheet date but before the financial statements are issued, or if the violation is anticipated to occur in the next year.

The key factor in understanding this conclusion is that compliance with debt covenants is determined at the balance sheet date. The guidance in ASC 470-10-55-2 through 55-6 is similar to subsequent events guidance — indicating that "unless the facts and circumstances would indicate otherwise," the borrower should classify the obligation as noncurrent, unless a covenant violation has occurred at the balance sheet date or would have occurred absent a waiver or loan modification.

We believe the wording "unless the facts and circumstances would indicate otherwise" was added to the guidance to permit current classification in the limited circumstances when the reporting entity concluded this was a more appropriate presentation.

EXAMPLE 12-4

Covenant violation after the balance sheet date

FSP Corp, the borrower, receives an audit opinion with an emphasis of a matter paragraph related to its ability to continue as a going concern in its December 31, 20X4 financial statements. FSP's debt agreement states that receiving an audit opinion with a going concern issue is an event of default. Therefore, this covenant was violated in the following year.

How should FSP Corp classify the debt in the December 31, 20X4 balance sheet?

Analysis

It depends.

We believe if the debt agreement contains a SAC, it should be classified as current at December 31, 20X4, assuming the subjective acceleration clause is violated as of December 31, 20X4.

If there is no SAC, FSP Corp should apply judgment. Technically, the covenant violation occurred after the balance sheet date, so a literal read of the guidance would indicate noncurrent classification. However, based on the facts and circumstances of this example (the going concern issue), FSP Corp might deem it more appropriate to classify the debt as current.

12.3.4 *Refinancing short-term debt*

Borrowers may refinance short-term debt to obtain noncurrent classification at the balance sheet date.

ASC 470-10-45-14 (a) indicates that short-term obligations should be reclassified as noncurrent at the balance sheet date if the borrower has both the intent and ability to refinance the short-term obligation on a long-term basis. The borrower can demonstrate this intent and ability by actually refinancing the short term obligation before the financial statements are issued in one of the following ways:

- Issuing a long-term obligation
- Issuing an equity security

Additionally, in lieu of actually issuing a new long-term obligation, ASC 470-10-45-14 (b) indicates that a borrower can evidence its ability to refinance on a long-term basis by entering into a financing agreement before the financial statements are issued. The financing agreement would need to satisfy all of the following conditions:

- It does not expire within one year from the balance sheet date
- It is only cancelable by the lender based on objective measures
- No violation of any provision in the agreement exists at the balance sheet date or balance sheet issuance date, or if a violation does exist, the reporting entity has obtained a waiver
- The lender is expected to be financially capable of honoring the financing agreement

12.3.4.1 *Using financing agreements that contain subjective acceleration clauses to evidence an ability to refinance short-term debt on a long-term basis*

There is a particularly high threshold to achieve noncurrent classification for debt that is otherwise current through the issuance of a financing agreement. Long-term financing agreements that contain SAC, MAC, or MAE clauses are specifically prohibited from being used to support reclassification of short-term obligations from current to noncurrent. This is because the parties to the financing agreement may interpret SAC, MAC, MAE and other nonobjectively verifiable clauses differently.

Due to their subjective nature, such clauses may result in the lender refusing to allow the reporting entity to refinance its short-term obligations. Therefore, this would undermine the reporting entity's assertion that it has the "ability" to refinance the current obligation into long-term, noncurrent debt.

An agreement that objectively defines an "adverse change" would be acceptable for purposes of demonstrating ability to refinance (or continuing to finance). The "adverse change" definition should include specific, quantifiable criteria, such as minimum working capital requirements, maximum dollar or percentage decrease in sales or earnings, or other objective measurements. If such criteria are present, noncurrent classification would be acceptable, provided the other required conditions are met.

It may be difficult to meet the objectivity standard in some cases. For example, language may appear to be objective but require the use of subjective assumptions — for example, forward-looking criteria that require the use of projections, which are subjective by their nature. Such a provision would not be considered an objectively defined "adverse change." Reporting entities should ensure that language included in agreements to provide a more precise definition of "adverse change" is truly objective, and not simply less subjective than the original language.

The following subsections discuss certain situations that may impact a reporting entity's ability to meet the requirements of ASC 470-10-45-14(b) with regard to subjective clauses.

Upfront representations and warranties

Certain clauses in financing agreements involve the reporting entity representing to the lender that, between the date of the most recent audited financial statements and the date of signing the financing agreement, there have been no MACs or MAEs. If a financing agreement requires a borrower to make such a representation each time it requests funding under the agreement, this financing agreement would not evidence an ability to borrow on a long-term basis.

On the other hand, if a date-limited representation is required only at the time of, and as a condition of, entering into the financing agreement, the borrower and the lender have the ability to evaluate whether or not a material event or a material change actually occurred prior to execution of the financing agreement. If the lender determines that such an event has not occurred, the financing agreement is executed and, thereafter, the agreement is substantively not cancelable. Therefore, the borrower is able to demonstrate its intent to refinance on a long-term basis.

The borrower needs to determine whether the MAE or MAC was a date-limited representation required only at the time of, and as a condition of, entering into the financing agreement to achieve noncurrent classification. Specifically, such representation clauses need to (1) include date range limitations for the period from the most recent audited financial statements to the date of signing the financing agreement, (2) be represented and warranted only at the time the financing agreement was entered into as a condition to execution of the agreement, and (3) not be subject to re-representation requirements in the future, such as at the time of a future draw-down request.

Dual-trigger clause qualifying language

Dual-trigger clauses—which trigger a MAE or MAC only after a sufficiently objective clause is not met (i.e., if the objectively verifiable portion is met, the second portion would never be operable)—are also acceptable for purposes of asserting ability to refinance long-term.

A dual-trigger clause may take the form of a management representation required at the time of draw down, such as:

"Since the date of our last representation to you, there have been no lawsuits filed that have had or are expected to have a material adverse effect on our financial position or results of operations."

Whether a lawsuit has been filed is an objective matter. If no lawsuits have been filed during the representation period, there is no basis for the lender to refuse to fund the draw-down request. This subjective qualifier becomes operative only after the objective event occurs. In the absence of the occurrence of the objective event, there would be no event of default that allows the lender to refuse to honor a draw-down request.

Cross-default clauses

Notwithstanding the above, there have been instances when a SAC, MAC, or MAE included in unrelated debt obligations could cause a cross-default of the long-term financing agreement that the reporting entity would use to support its "ability" assertion under ASC 470-10-45-14. If there is such a clause, the conditions of that guidance would not be met and the debt should remain classified as current.

Example 12-5 demonstrates the classification of debt when the reporting entity seeks to refinance but the new agreement contains a SAC clause.

EXAMPLE 12-5

Classification of short-term debt based on a financing agreement containing a SAC clause

At the balance sheet date, FSP Corp has a $10 million borrowing with a contractual maturity of less than 12 months. FSP Corp also has a $100 million revolving credit agreement that is unused and that has a remaining term of 5 years. Borrowings under the revolver may be long-term, as the borrower is permitted to choose any debt term from one to five years. However, future borrowings under the revolving credit agreement are subject to a SAC.

How should FSP Corp classify the $10 million borrowing at the balance sheet date?

Analysis

Even if the borrower has the intent to use the revolver to refinance its short-term obligation, it may not exclude the $10 million outstanding debt from current liabilities. This is because the SAC undermines the borrower's ability to refinance the short-term debt on a long-term basis.

12.3.4.2 Use of working capital to refinance debt

ASC 470-10-45-15 indicates that a short-term obligation should be included in current liabilities if it is repaid after the balance sheet date, and is subsequently replaced or replenished by long-term debt before the balance sheet is issued. The FASB noted that repayment of a short-term obligation before funds are obtained through a long-term financing requires the use of current assets and, as such, the short-term obligation cannot be excluded from current liabilities at the balance sheet date. Specifically, as illustrated in the example in ASC 470-10-55-33 through 55-36, the repayment of commercial paper using working capital after the balance sheet date, followed by a borrowing under a long-term revolving debt arrangement to replenish the working capital prior to the financial statement issuance date, does not meet the intent requirement for refinancing a short-term borrowing on a long-term basis.

12.3.4.3 Inability to refinance short-term debt with a commitment from a parent company

Occasionally a borrower may obtain a long-term commitment from its parent (i.e., a parent support letter) as evidence of its intent and ability to refinance a short-term obligation on a long-term basis. Such agreements need to be reviewed carefully. This is because the parent controls the subsidiary and is a related party. If the agreement can be cancelled at any time or there is no deterrent to prevent the parent from cancelling the agreement, the agreement would not meet the provisions of ASC 470-10-45-14(b)(1) and the debt therefore could not be presented as noncurrent.

12.3.4.4 Refinancing with successive short-term borrowings

A short-term obligation that will be refinanced with successive short-term obligations may be classified as noncurrent as long as the cumulative period covered by the financing agreement is uninterrupted and extends beyond one year. This would include short-term borrowings under revolving credit agreements that permit either continuous replacement with successive short-term borrowings for more than a year or conversion to term loans extending beyond a year at the reporting entity's option. These borrowings could be classified as noncurrent if the borrower intends to utilize those provisions and meets the criteria for refinancing the short-term debt on a long-term basis.

The rollover provisions should be included in the terms of the debt obligation; classification as noncurrent cannot be based solely on management's intent. For example, short-term debt in the form of commercial paper should be supported by a contractually long-term financing arrangement, such as a revolving credit agreement with sufficient unused borrowing capacity to support the ability to refinance the commercial paper. Any SACs, MACs, or MAEs in the refinancing agreements would cause the reporting entity to fail to meet the requirements to assert its ability to refinance its short-term debt on a long-term basis.

12.4 Balance sheet classification – revolving debt agreements

A line of credit or revolving debt arrangement is an agreement that provides the borrower with the ability to do all of the following:

- Borrow money at different points in time, up to a specified maximum amount
- Repay portions of previous borrowings
- Re-borrow under the same contract

Line of credit and revolving debt arrangements may include both amounts drawn by the borrower (a debt instrument) and a commitment by the lender to make additional amounts available to the borrower under predefined terms (a loan commitment).

12.4.1 Revolving debt requiring execution of a note for each borrowing

Revolving debt arrangements with a contractual term beyond one year may require the execution of a note for each borrowing under the arrangement. While the credit arrangement may permit long-term borrowings, the underlying notes may be for a shorter term, possibly less than one year. When the revolver includes individual notes, the reporting entity should classify the debt based on the term of each individual note, not based on the expiration date of the revolver, unless the conditions for noncurrent classification based on a refinancing are met (see FSP 12.3.4 for a discussion of short-term debt refinanced on a long-term basis).

Revolving debt arrangements may have a feature that gives the borrower the option to select between two different types of borrowings, each with potentially different terms. For example, a borrower may be able to choose between the following:

- A long-term loan with a certain interest rate having a maturity date consistent with the expiration date of the revolving debt arrangement
- A short-term loan with a maximum maturity of ninety days that carries a different interest rate from the first option

In such cases, the second option would require current classification unless (1) the conditions for refinancing the short-term debt on a long-term basis are met, or (2) the second option automatically converts at its maturity date, without any further actions, into the first option with a long-term maturity date.

12.4.2 *Revolving debt that specifies a borrowing base*

Some financing agreements specify objective criteria (e.g., inventory levels) the borrower needs to maintain or achieve to ensure adequate borrowing capacity. When the provisions of the financing agreement call for the attainment of specified operating results, levels of financial position, or another measure that exceeds those previously attained, the reporting entity may classify the debt as noncurrent only if it is reasonable to expect that the specified requirements can be achieved such that long-term borrowings (or successive short-term borrowings for an uninterrupted period under a financing agreement) will be available to refinance the short-term debt outstanding at the balance sheet date on a long-term basis. Meeting this test requires a high degree of assurance.

EXAMPLE 12-6

Classification of a revolver subject to working capital requirement

FSP Corp, the borrower, has $10 million outstanding on its revolving credit facility at December 31, 20X4, which matures on December 31, 20X7. The borrowing base for the revolver is based off of a specified level of working capital. FSP has reached the specified working capital level at December 31, 20X4 and it expects to maintain that same level at least through January 1, 20X6.

There are no events of default or covenants breached as of December 31, 20X4, and all other terms within the agreement are usual and customary.

How should FSP Corp classify the revolver in the December 31, 20X4 financial statements?

Analysis

Since FSP Corp has reached the specified working capital level at December 31, 20X4, and it is reasonable to expect that it will maintain the working capital level through January 1, 20X6, the debt should be classified as noncurrent.

12.4.3 *Revolving debt subject to lockbox arrangements and subjective acceleration clauses*

Borrowings that are legally long-term under a revolving credit agreement should be classified as current if they include a requirement to maintain a lockbox arrangement (or a sweep feature or other lender arrangements), whereby remittances from the borrower's customers are used to reduce the revolving debt outstanding. A revolving credit arrangement with a required lockbox is inherently short-term based on the definition of a current liability because a lockbox requires that the debt be serviced with working capital.

The only way this type of arrangement could be considered noncurrent is if the revolving credit agreement permits either (1) continuous replacement with successive short-term borrowings for more than a year or (2) conversion to term loans extending beyond a year at the reporting entity's option and the borrower intends to utilize those provisions and meets the criteria for refinancing the short-term debt on a long-term basis (as discussed in FSP 12.3.4). However, if there is a SAC in the agreement, the agreement will not meet the requirements to refinance the short-term obligation on a long-term basis and the arrangement should be classified as current.

In contrast, borrowings outstanding under a long-term revolving credit agreement that includes a requirement to maintain a "springing" lockbox (an agreement whereby remittances from the borrower's customers are not forwarded to the lender to reduce the debt outstanding until and unless an event of default occurs) are long-term obligations as long as no event of default occurred prior to the balance sheet date. A SAC in such agreement would be evaluated using the guidance in FSP 12.3.2.2.

12.4.4 Revolving debt related to long-term projects

SAB Topic 6.H.2 provides guidance for public companies that have a revolving cover loan associated with a long-term construction project.

Excerpt from SAB Topic 6.H.2

Facts: Companies engaging in significant long-term construction programs frequently arrange for revolving cover loans which extend until the completion of long-term construction projects. Such revolving cover loans are typically arranged with substantial financial institutions and typically have the following characteristics:

1. A firm long-term mortgage commitment is obtained for each project.

2. Interest rates and terms are in line with the reporting entity's normal borrowing arrangements.

3. Amounts are equal to the expected full mortgage amount of all projects.

4. The company may draw down funds at its option up to the maximum amount of the agreement.

5. The company uses short-term interim construction financing (commercial paper, bank loans, etc.) against the revolving cover loan. Such indebtedness is rolled over or drawn down on the revolving cover loan at the company's option. The company typically has regular bank lines of credit, but these generally are not legally enforceable.

When these conditions exist—representing a firm commitment throughout the construction program for permanent mortgage financing, and there are no contingencies other than completing construction, the borrowing may be classified as noncurrent with appropriate disclosure.

12.4.5 *Increasing rate debt*

Revolving debt agreements may have a maturity date that can be extended at the option of the borrower at each maturity date until final maturity. In such cases, the interest rate on the note may increase a specified amount each time the note is renewed. These types of instruments are called increasing rate debt instruments. ASC 470-10-45-7 indicates that classification of the debt as current or noncurrent should reflect the borrower's anticipated source of repayment (e.g., current assets, new short-term debt, or long-term refinancing agreement). Guidance in ASC 470-10-35 requires the borrower to estimate the life of the debt to calculate one blended effective interest rate, but the classification need not be consistent with the time frame used to determine the blended effective interest rate.

12.5 *Balance sheet classification — paid-in-kind notes*

The terms of debt instruments may permit or require the borrower to satisfy accrued interest on the debt with additional paid-in-kind (PIK) notes having identical terms (maturity date, interest rate, etc.) as the original debt. In such cases, the original debt is referred to as a PIK note. Typically, the interest may be paid either in cash or additional PIK notes, at the borrower's discretion. If the borrower intends to pay the interest with additional notes, the balance sheet classification of the accrued interest payable should be assessed under the guidance in ASC 470-10-45-14 for refinancing short-term debt (FG 12.3.4).

EXAMPLE 12-7

Classification of accrued interest settleable in PIK notes

In October 20X4, FSP Corp issues floating-rate senior PIK notes that are due on September 30, 20X9.

The notes have semiannual interest payments payable in the form of cash or additional PIK notes at FSP Corp's option.

FSP Corp intends to pay the interest in the form of additional PIK notes. The maturity date of the PIK notes delivered to settle the interest payments is the same as the original note.

How should FSP Corp classify the accrued interest on the notes as of December 31, 20X4?

Analysis

FSP Corp should classify the accrued interest as a noncurrent liability since it has both the intent and ability to refinance the short-term liability (accrued interest) on a long-term basis.

The issuance of the original PIK notes demonstrates FSP Corp's ability to consummate a refinancing of the interest on a long-term basis, with terms that are readily determinable and meet *all* of the following conditions that are based on the requirements for ASC 470-10-45-14, as follows:

- The obligation does not expire within one year from FSP Corp's balance sheet.
- The agreement (i.e., the right to satisfy interest with long-term PIK notes) is not cancellable by the lender.
- The PIK notes issued under the agreement are not puttable, except for violations for which compliance is objectively measurable.
- There is no violation of any financing agreement provisions at the balance sheet date.
- There is no available information that indicates a violation has occurred after the balance sheet date and prior to the issuance of the financial statements, which would prevent the issuer from having the right to satisfy the interest with long-term PIK notes; for example, there is no covenant violation of the original PIK notes that would do either of the following:
    - Accelerate their due date and the due date of any additional PIK notes that might be used to satisfy the interest
    - Prevent the issuer from electing to pay the interest in PIK notes while there is a covenant violation of the original PIK notes
- The lender entered into the financing agreement permitting interest to be refinanced with PIK notes.
- FSP Corp is expected to be financially capable of honoring the agreement.

Given these facts, we believe FSP Corp should classify the accrued interest as noncurrent.

12.6 *Balance sheet classification — liquidity facility arrangements for variable rate demand loans*

A Variable Rate Demand Obligation (VRDO) is a debt instrument, typically a bond, that the lender can put to (or demand repayment from) the borrower. This feature gives the lender the ability to redeem the investment on short notice (usually seven days) by putting the debt to the borrower's remarketing agent. Upon a lender's exercise of a put, the remarketing agent will resell the debt to another lender to obtain the funds to honor the put (i.e., to repay the original lender). If the remarketing agent fails to sell the debt (referred to as a "failed remarketing"), the funds to pay the lender who exercised the put will often be obtained through a liquidity facility issued by a financial institution. Liquidity facilities typically take the form of a standby or direct-pay letter of credit, line of credit, or standby bond purchase agreement.

ASC 470-10-55-7 through 55-9 addresses these instruments. The guidance indicates that the presence of a "best-efforts" remarketing agreement (typical for VRDO issuances) should not be considered when evaluating whether the VRDO should be classified as current or noncurrent.

A reporting entity should assume that a put will occur, and unless the VRDO borrower has the ability and intent to refinance the debt on a long-term basis, VRDOs should be classified as a current liability.

If a liquidity facility provides the borrower with the ability to refinance, borrowers should evaluate the terms of their liquidity agreements in light of the requirements for refinancing a short-term borrowing on a long-term basis (as addressed in FSP 12.3.4) for attributes that could impact balance sheet classification of the debt, including the following:

- *Expiration date of the commitment*

  To achieve noncurrent classification, a liquidity facility for the VRDOs cannot expire within one year of the balance sheet date. VRDOs supported by liquidity agreements that expire within one year of the balance sheet should be classified as current.

- *Covenant violations*

  Violations of covenants in liquidity agreements could cause termination of the agreement or demand for immediate repayment of any draws. Therefore, a violation of any provision in the financing agreement at the balance sheet date, or available information that indicates a violation occurred after the balance sheet date but prior to the issuance of the financial statements, would trigger current classification. A covenant violation occurring prior to or after the balance sheet date requires a waiver to be obtained to achieve noncurrent classification. The form and content of the waiver needs to be in force for at least 12 months and it should not be subject to termination beyond those conditions in the original agreement.

- *SAC, MAC, or similar clauses*

  The existence of subjective clauses that provide the lender with the ability to demand repayment based on subjective (rather than objective) criteria will typically preclude classification of the VRDOs as noncurrent.

- *Repayment terms*

  The repayment terms of the liquidity facility will impact the determination of amounts due within one year of the balance sheet date (and thus the amount of the VRDOs that must be classified as a current liability). Some liquidity facilities have repayment terms that are installment-based and others require a balloon payment at the facility's expiration date.

- *Ability to cancel*

  The lender should not have the ability to cancel the credit facility within one year from the balance sheet date except for violations of the terms of the agreement that can be objectively measured. This may include failure to meet a condition, or a breach or violation of a provision, such as a restrictive covenant, representation, or warranty.

12.7 Balance sheet classification — debt with a cash conversion feature

Upon conversion of traditional convertible debt, the lender receives common stock of the borrower, not cash. If the lender exercises its conversion option, it receives the full number of shares underlying the debt. In contrast, a convertible bond with a cash conversion feature allows the borrower to settle its obligation upon conversion, in whole or in part, in a combination of cash or stock either mandatorily or at the borrower's option. Convertible debt with cash conversion features are accounted for under the cash conversion subsections of ASC 470-20.

Excerpt from ASC 470-20-15-4 through 15-5

The guidance in the Cash Conversion Subsections applies only to convertible debt instruments that, by their stated terms, may be settled in cash (or other assets) upon conversion, including partial cash settlement, unless the embedded conversion option is required to be separately accounted for as a derivative instrument under Subtopic 815-15.

The Cash Conversion Subsections do not apply to any of the following instruments:

a. A convertible preferred share that is classified in equity or temporary equity.

b. A convertible debt instrument that requires or permits settlement in cash (or other assets) upon conversion only in specific circumstances in which the holders of the underlying shares also would receive the same form of consideration in exchange for their shares.

c. A convertible debt instrument that requires an issuer's obligation to provide consideration for a fractional share upon conversion to be settled in cash but that does not otherwise require or permit settlement in cash (or other assets) upon conversion.

ASC 470-20-45-3 indicates that the guidance in the cash conversion subsections of ASC 470-20 does not affect classification of the debt as current or noncurrent. Instead, reporting entities should consider all terms of the convertible debt instrument (including the equity component) when determining the proper classification. Therefore, regardless of the life used for amortization purposes, a borrower's determination of the classification of the liability component of the debt instrument should be based on the terms of the debt as a whole.

Some of the features in debt with a cash conversion feature may permit the lender to exercise the conversion feature at any time. They may also contain non-contingent terms that, upon conversion, require the debt principal to be settled in cash and the remaining amount to be settled in shares or cash at the borrower's option. Typically, the debt principal settlement equals the accreted value, and the remainder represents the conversion spread — i.e., the value of the stock underlying the conversion option in excess of the accreted value. When these features exist, the debt is essentially demand debt, because the lender can unilaterally choose to convert the debt at any time, and the reporting entity would be compelled to pay cash.

Therefore, the convertible debt equal to the debt principal (or accreted value) should be classified as current because of the holder's legal ability to demand payment in cash, consistent with the guidance in ASC 470-10-45-10. The fact that the conversion feature may be out-of-the-money at the balance sheet date does not change the fact that the holder may convert at any time, and the reporting entity cannot predict future stock prices that could affect the amount of cash to be paid upon conversion at some point in the next 12 months (or current operating cycle). Therefore, we believe that the entire recorded amount of the debt should be classified as current, unless the reporting entity satisfies the requirements in ASC 470-10-45-14 regarding the ability and intent to refinance the debt on a long-term basis.

With respect to contingently convertible debt securities with a cash settlement feature, if the contingency has been met as of the balance sheet date, the instruments would require current classification. If the contingency has not been met at the balance sheet date but is met prior to financial statement issuance, the debt principal should continue to be classified as noncurrent debt at the balance sheet date.

EXAMPLE 12-8

Classification of debt with a contingent cash conversion option

FSP Corp, a calendar year entity, issues convertible debt that is within the scope of the cash conversion subsections of ASC 470-20. The instrument has a stated life of 10 years, but allows the holder to put it back to the borrower at the end of 5 years. In addition, the instrument also allows the lender to convert the instrument for 90 days after a specific market price trigger is exceeded. If not converted within the 90-day period, it will cease to be convertible, unless the market price contingency is met at the end of the 90 days, after which a new three month conversion period will apply.

FSP Corp determines the expected life of the debt component is 5 years. Accordingly, FSP Corp will amortize the debt issue costs allocated to the debt component over 5 years using the interest method.

At March 31 of the second year, the market price trigger is met, which allows (but does not require) the lender to convert the debt until June 30. The lender decides not to convert the debt by June 30; and on June 30 the market price trigger is not met. Therefore, the debt ceases to be convertible by the lender on June 30.

What are the classification considerations for FSP Corp on March 31 and June 30 of the second year?

Analysis

Even though the debt is no longer convertible at the lender's option, the debt is effectively demand debt during the reporting period ended March 31 and would require current classification at March 31. At June 30, FSP Corp should reclassify the debt to noncurrent, as the lender no longer has the right to convert the debt.

12.8 Balance sheet classification — debt issuance costs, discounts, and premiums

Debt issue costs include various fees and commissions paid to third parties, including investment banks, law firms, auditors, and regulators. They do not typically include costs paid to the lender. Debt issue costs are reported in the balance sheet as a deferred asset.

Debt discounts or premiums are fees paid by the borrower to the lender(s) or received by the borrower from the lender(s) as part of the issuance of debt. Additionally, costs incurred by the lender or on behalf of the lender, which are paid by the borrower, are also classified as a debt discount. Further, a debt discount can arise from an original issue discount or allocation of proceeds received due to a detachable warrant issued with debt, a beneficial conversion feature, or bifurcated options separated from the debt. A debt discount is a contra account to the debt.

Reporting entities often classify the entire debt discount or premium, as well as the debt issue costs, as noncurrent. In preparing a classified balance sheet, many reporting entities simply reclassify only the gross amount of principal payments due in the next twelve months (or operating cycle, whichever is shorter) as current. This results in the entire discount being attributed to the noncurrent portion of the debt, until the last year of the instrument when the remaining discount/premium and deferred asset is classified as current, along with the remaining principal balance.

However, since the overall liability is measured on a present-value basis, it would also be acceptable to classify debt issue costs, discounts, and premiums as current.

12.8.1 *Impact of covenant violations at the balance sheet date on classification of debt issue costs*

When a covenant violation makes long-term debt puttable (i.e., demand debt), a reporting entity is required to classify the debt (and related debt discount or premium) as current (as addressed in FSP 12.3.3.1). We believe a reporting entity should also reclassify any remaining unamortized debt issue costs as a current deferred asset as well.

12.9 *Balance sheet classification — other*

Certain other situations may affect the balance sheet classification of debt. These are discussed in the following subsections.

12.9.1 *Subsidiary's debt when fiscal year differs from parent*

SEC registrants may need specific disclosures when a subsidiary with debt outstanding has a fiscal year that differs from its parent. For example, a subsidiary may have a material loan outstanding that is due beyond one year from its fiscal year end. However, the maturity date of the loan payable may fall within the 12 months following the parent's fiscal year end. In ASC 470-10-S99-4, the SEC staff noted that it would expect to see the debt classified as current in the parent's consolidated financial statements in this fact pattern.

12.9.2 *Debt restructuring*

Debt modifications (including troubled debt restructurings) may change the terms of the debt—for example, the amount due within one year after the date of the borrower's balance sheet may change. These modifications may result in reclassification of all or a portion of the carrying amount of the debt at the time of restructuring.

12.9.3 *Structured payables*

A reporting entity may establish a payment program with a financial institution whereby the financial institution will make payments to vendors on behalf of the reporting entity. For classification considerations of structured payables, see FSP 11.

12.10 Income statement classification

This section discusses considerations for certain items that may affect income statement classification. They include:

- Debt extinguishment gains and losses
- Modification or exchanges
- Participating mortgage loans
- Cash conversion
- Related party debt restructurings

12.10.1 Debt extinguishment gains and losses

Gains and losses from extinguishment of debt include the write-off of unamortized debt issue costs, debt discount, and/or premium. ASC 470-50-45-1 indicates that gains and losses from extinguishment of debt that are unusual in nature are not precluded from being classified as extraordinary items. Nevertheless, when the FASB superseded FAS 4, *Reporting Gains and Losses from Extinguishment of Debt—an Amendment of APB Opinion No. 30*, it indicated that application of the extraordinary classification criteria to debt extinguishment "would seldom, if ever, result in extraordinary classification of the resulting gains and losses." Accordingly, gains and losses on debt extinguishment, including troubled debt restructurings, are rarely classified as extraordinary items.

ASC 470-50-40-2 requires an extinguishment gain or loss to be identified as a separate item. However, given that neither the ASC guidance nor Regulation S-X specifies where in the income statement the gains and losses should be presented, we believe there is more than one acceptable approach. The selected approach

should be consistently applied to classifying an extinguishment gain or loss. Some approaches include:

- Classify the amount as a separate line item on the income statement
- Classify the extinguishment gain or loss in interest expense with disclosure of the components of the loss in the footnotes

12.10.2 Income statement classification related to modifications or exchanges on a revolving debt agreement

A charge to income may result from a modification or exchange of a revolving debt agreement due to unamortized deferred costs being written off when the borrowing capacity of the new arrangement is less than the borrowing capacity of the old arrangement. This charge to earnings should not be classified as extraordinary. Instead, it is treated in a manner similar to gains and losses on extinguishments (discussed in FSP 12.10.1).

12.10.3 Participating mortgage loans

Under a participating mortgage loan arrangement, the lender (mortgagee) is entitled to share in the rental or resale proceeds from a property owned by the borrower (mortgagor). Any periodic amortization of debt discount relating to a participating liability is reported in interest expense. Any gain or loss resulting from the difference between the reacquisition price and the net carrying amount on extinguishment of the debt before its due date is recognized in income in the period of extinguishment and treated as a debt extinguishment gain or loss (discussed in FSP 12.10.1).

12.10.4 Classification of expenses related to debt with conversion feature

For debt with a conversion feature, the following expenses should *not* be classified as extraordinary in the income statement.

- The unamortized discount remaining at the date of conversion for instruments with beneficial conversion features (expense recognized under ASC 470-20-40-1)

- The inducement charge when a convertible debt instrument is converted to equity securities of the borrower pursuant to an inducement offer (expense recognized under ASC 470-20-40-16)

Instead, these charges are treated in a manner similar to gains and losses on extinguishments (discussed in FSP 12.10.1).

12.10.5 Restructuring debt with related parties

If a borrower restructures its debt with a debt holder that is also an equity holder, the counterparty may be considered a related party. In that case, it may not be appropriate to recognize any associated gain or loss in the income statement under ASC 470-50-40-2. Instead, such a restructuring may be essentially a capital transaction, and the gain or loss may be required to be classified in equity. See FG 3 for details on the accounting for this type of transaction.

12.11 Disclosure

The disclosure requirements of ASC 470 vary depending on the nature of the debt. Regulation S-X also prescribes certain disclosure requirements for the debt of SEC registrants.

12.11.1 *Long-term debt*

The guidance in ASC 470-10-50-1 through 50-5 provides the following general disclosure requirements for all long-term borrowings:

- The combined aggregate amount of maturities and sinking fund requirements for each of the five years following the date of the latest balance sheet
- The circumstances surrounding any debt obligations that have a covenant violation at the balance sheet date and are classified as noncurrent
- Subjective acceleration clauses required to be disclosed under ASC 470-10-45-2 (discussed in FSP 12.3.2.2)
- If a short-term obligation is excluded from current liabilities (as discussed in FSP 12.3.4), a general description of the financing agreement and the terms of any new obligation incurred, or expected to be incurred, or equity securities issued, or expected to be issued as part of the refinancing
- Explanation of the pertinent rights and privileges of various securities outstanding, including:
    - Information regarding participation rights
    - Call price and dates
    - Conversion exercise prices or rates and pertinent dates
    - Number of shares issued upon conversion, exercise, or satisfaction of required conditions during at least the most recent annual period and any subsequent interim period presented

Example 3 in ASC 470-10-55-10 through 55-12 provides an example disclosure for a long-term borrowing.

S-X 5-02 and S-X 4-08 provide the following incremental disclosure requirements for long-term debt for public reporting entities. An SEC registrant is required to disclose the following separately in the balance sheet or in a footnote for each issue or type of debt (including capital leases). In addition, since the nature of these incremental disclosure requirements appears to be consistent with the disclosure of “pertinent rights and privileges” discussed in ASC 470, private companies may also want to consider whether to disclose this information.

- The general character of each type of debt including the rate of interest
- The date of maturity or maturities (if maturing serially)

- If the payment of principal or interest is contingent, an appropriate indication of such contingency
- A brief indication of priority
- The amount and terms (including commitment fees and the conditions under which commitments may be withdrawn) of unused commitments for long-term financing
- Any significant changes in the authorized or issued amounts of debt since the date of the latest balance sheet filed for the reporting entity
- The facts and amounts concerning any default in principal, interest, sinking fund, or redemption provisions with respect to any issue of securities or credit agreements or any covenant violation of a debt agreement, which default or violation existed at the date of the most recent balance sheet being filed, and which has not been subsequently cured. If a default or violation exists but acceleration of the obligation has been waived for a stated period of time beyond the date of the most recent balance sheet being filed, state the amount of the obligation and the period of the waiver.

12.11.2 Short-term debt

S-X 5-02 also includes disclosure requirements pertaining to short-term obligations for SEC registrants. They include:

- The amount and terms (including commitment fees and the conditions under which lines may be withdrawn) of unused lines of credit for short-term financing
- The weighted average interest rate on short term borrowings outstanding as of the date of each balance sheet presented
- The amount of the lines of credit that support a commercial paper borrowing arrangement or similar arrangements

12.11.3 Collateral

Reporting entities are required by ASC 860-30-50-1A to disclose in the balance sheet or footnotes the fact that assets are pledged as collateral against a liability.

ASC 860-30-50-1A(b)

As of the date of the latest statement of financial position presented, both of the following:

1. The carrying amount and classifications of both of the following:

    i. Any assets pledged as collateral that are not reclassified and separately reported in the statement of financial position in accordance with paragraph 860-30-25-5(a)

ii. Associated liabilities.

2. Qualitative information about the relationship(s) between those assets and associated liabilities; for example, if assets are restricted solely to satisfy a specific obligation, a description of the nature of restrictions placed on those assets.

In our view, whenever the value of the collateral is less than the amount of the debt, it may be misleading to state in the balance sheet that the receivable or payable is "secured" because "secured" may imply "fully secured." Frequently, the value of the collateral is uncertain. Even if the valuation is determinable, and the collateral appears to be adequate, there can be no assurance that such value will persist. Consequently, we do not believe that reporting entities should describe assets pledged as collateral as "secured," even if qualified (such as "partly secured"). The following are illustrative balance sheet line items:

- Notes receivable pledged as collateral against $X of loans
- Notes payable (property, plant, and equipment with a net book amount of $X has been pledged as collateral)
- Notes payable (with collateral consisting of capital stock of certain subsidiaries representing X percent of consolidated net assets)

When a reporting entity pledges stock of a consolidated subsidiary as collateral for bond or note issuances of an unconsolidated subsidiary, it should disclose this in the footnotes. It should also indicate the underlying net assets effectively pledged.

Also refer to S-X 3-16 (SEC 4900) for guidance on financial statements of affiliates whose securities collateralize any class of securities that are registered or being registered.

12.11.4 Participating mortgage loans

ASC 470-30-50-1 requires issuers of participating mortgages to disclose all of the following:

- The total amount of participating mortgage obligations
- The total amount of gross participation liabilities and the related debt discount
- The lender's participation terms related to:
  - The operations of the mortgaged real estate

- The increase in the fair value of the mortgaged real estate

12.11.5 Own-share lending arrangements (in contemplation of convertible debt issuance)

A reporting entity that enters into a share-lending arrangement on its own shares in contemplation of a convertible debt offering or other financing should disclose a description of any outstanding share-lending arrangements on its own stock. Information to be disclosed includes:

- Number of shares, term, circumstances under which cash settlement would be required, and other significant terms
- Requirements for the counterparty to provide collateral
- Reason for entering into the arrangement
- Fair value of the outstanding loaned shares as of the balance sheet date
- Treatment for the purposes of calculating earnings per share
- Unamortized amount and classification of the issuance costs
- Classification of issuance costs associated with the share-lending arrangement at the balance sheet date
- Amount of interest cost recognized relating to the amortization of the issuance cost associated with the share-lending arrangement for the reporting period
- Any amounts of dividends paid related to the loaned shares that will not be reimbursed

A reporting entity that enters into a share-lending arrangement on its own shares in contemplation of a convertible debt offering or other financing is also required to comply with the disclosure requirements of ASC 505, *Equity*. Refer to FSP 5 for discussion of these requirements.

In the period in which a counterparty defaults, or a reporting entity concludes it is probable that the counterparty to its share-lending arrangement will default, the reporting entity should disclose

- The amount of expense reported in the income statement in that period related to the default or any subsequent period
- Any material changes in the amount of expense recorded due to changes in fair value of the reporting entity's shares or probable recoveries

- If the default is probable but has not yet occurred, the number of shares related to the share-lending arrangement that will be reflected in basic and diluted earnings per share when the counterparty defaults

12.11.6 *Debt with cash conversion features*

As discussed in FSP 12.7, certain convertible debt instruments fall within the scope of the cash conversion guidance in ASC 470-20-15-4 through 15-5.

ASC 470-20-50-3 through 50-6 requires the following disclosures to be made as of each balance sheet presented for those instruments:

- The carrying amount of the equity component
- The principal amount, the unamortized discount, and the net carrying amount for the liability component

As of the most recent balance sheet date, the reporting entity should disclose the following terms.

- The remaining period over which any discount on the liability component will be amortized
- The conversion price and the number of shares issued upon conversion
- The amount by which the instrument's if-converted value exceeds its principal amount, regardless of whether the instrument is currently convertible (for public entities only)

If any derivatives are executed in connection with these convertible debt instruments, the reporting entity should disclose the following relating to the derivatives, regardless of whether the derivatives are accounted for as assets, liabilities, or equity instruments:

- The derivative transactions' terms
- How those derivative transactions relate to the instruments
- The number of shares underlying the derivative transactions
- The reasons for entering into those derivative transactions

For each period for which an income statement is presented, a reporting entity should disclose both of the following related to the liability component: (1) the effective interest rate and (2) the amount of interest cost recognized relating to both the contractual interest coupon and amortization of the discount.

12.11.7 Troubled debt restructurings

ASC 470-60-50 provides specific disclosures for a troubled debt restructuring. It requires that a troubled borrower disclose the following, either in the financial statements or the footnotes:

- A description of the principal changes in terms, major features of settlement, or both
- Aggregate gain on restructuring of payables
- Aggregate net gain or loss on transfers of assets recognized during the period (see FSP 22 for guidance on transfers)
- Per-share amount of the aggregate gain on restructuring of payables

Reporting entities may group separate restructurings within a fiscal period for the same category of payables (for example, accounts payable or subordinated debentures) for disclosure purposes.

For financial statement periods after the troubled debt restructuring, the borrower should disclose amounts contingently payable that are included in the carrying amount of restructured payables and the conditions under which those amounts would become payable or be forgiven.

12.11.8 Revolving debt related to long-term projects

When an SEC registrant classifies a borrowing under a long-term project as noncurrent based on the conditions in FSP 12.4.4, it should make appropriate disclosures regarding the existence of such conditions.

12.12 Guarantees of a reporting entity's debt by others

Guarantees of debt are subject to the same disclosures as other guarantees in ASC 460, *Guarantees*. Guarantees are addressed in FSP 23.

Guarantees of a reporting entity's debt by its principal stockholders or other related parties require incremental disclosure as related party transactions under ASC 850-10-50. Presentation and disclosure requirements associated with related party transactions are addressed in FSP 26. Although not in the scope of ASC 460, we believe guarantees obtained by a reporting entity (as opposed to those made by it) should also be disclosed, as such arrangements may indicate that the reporting entity is not able to obtain financing without the guarantees of others.

12.12.1 *Issuers of guaranteed securities*

SEC registrants may issue registered debt that is guaranteed by one or more subsidiaries, or SEC registrant-parent companies may serve as a guarantor for securities issued by one or more subsidiaries. Under the U.S. securities laws, guarantees of securities are also considered securities, and therefore may be subject to the SEC's registration and reporting requirements.

S-X 3-10 generally requires every issuer of a registered security that is guaranteed and every guarantor of a registered security to file the financial statements required for a registrant. However, S-X 3-10 provides relief that may result in significantly reduced reporting obligations (i.e., condensed consolidating financial information or narrative disclosure) if certain criteria are met. The criteria are discussed in SEC 4530.

12.12.2 *Preparing condensed consolidating financial information*

S-X 3-10(c) through (f) specifies the columns that should be presented in the condensed consolidating financial information. S-X 3-10(i) includes instructions for preparing the condensed consolidating financial information.

12.12.2.1 *Form and content of condensed consolidating financial information*

Registrants should follow the guidance in S-X 10-01 concerning the form and content of the condensed consolidating financial statements. We believe the necessary financial information should consist of condensed balance sheets, income statements, statements of comprehensive income (presented in either a single continuous statement or in two separate but continuous statements), and statements of cash flows, prepared with the same level of detail as required in interim financial statements. This level of disclosure is appropriate even in the condensed consolidating financial information included in the footnotes to annual financial statements.

Footnotes to the condensed consolidating financial information are generally not required. The condensed consolidating financial information generally should include a headnote describing the reasons why the condensed consolidating information is presented, along with any other relevant data. The SEC staff generally expects disclosure of whether each subsidiary-issuer/guarantor is "100 percent owned," and whether the guarantee is "full and unconditional" and joint and several.

S-X 3-10 requires condensed consolidating financial information for the periods specified by S-X 3-01 and 3-02 (i.e., two years of balance sheets, three years of income statements, statements of comprehensive income, and statements of cash flows). With respect to interim periods, registrants should file condensed consolidating financial statements for the same periods that the registrant's financial statements are presented (even if those financial statements are not required by S-X 3-01 and S-X 3-02).

For example, in the June 30, 20X4 Form 10-Q of a registrant with a calendar year end, the condensed consolidating financial information would be as follows

- Balance sheets as of June 30, 20X4, and December 31, 20X3
- Income statements for the three- and six-month periods ended June 30, 20X4 and 20X3
- Statements of comprehensive income for the three- and six-month periods ended June 30, 20X4 and 20X3 (in a single continuous statement with the statement of income or in two separate, but consecutive, statements)
- Statements of cash flows for the six-month periods ended June 30, 20X4 and 20X3

Smaller reporting companies should adhere to the guidance in Note 3 to S-X 8-01.

The parent company should present its investments in all subsidiaries based upon the parent's proportionate share of the subsidiaries' net assets (similar to presenting them on the equity method). Similarly, a subsidiary-issuer should present its subsidiaries (e.g., its investments in any subsidiary-guarantors) based upon its proportionate share of the subsidiaries' net assets. Subsidiary-guarantors should present any non-guarantor subsidiaries based upon their proportionate share of the subsidiaries' net assets. Non-guarantor subsidiaries should present their investment in any subsidiary-guarantors based upon their proportionate share of the subsidiaries' net assets.

The stockholders' equity, net income, and comprehensive income amounts (attributable to the reporting entity) presented in the parent reporting entity column generally should equal the corresponding consolidated amounts. In addition, noncontrolling interest generally would not be included in the parent or guarantor columns (one exception would be for nonvoting preferred stock).

Separate columns in the condensed consolidating financial information are required for each subsidiary-issuer/guarantor in any of the following situations:

- The subsidiary is not "100 percent owned" by the parent
- The relevant guarantee is not "full and unconditional"
- The relevant guarantee is not joint and several with the guarantees of other subsidiaries (if applicable)

Providing the separate column does not relieve that specific subsidiary-issuer/guarantor of its separate requirement to file full financial statements and to comply with relevant separate Exchange Act reporting obligations. If the subsidiary-issuer/guarantor is not 100 percent owned, or if the relevant guarantee is not full and unconditional, then the separate financial statements of the subsidiary-issuer/guarantor will be required (see SEC 4530.22 through

4530.222 for more information). The fact that a guarantee is not joint and several does not, by itself, trigger a requirement to provide separate financial statements of the subsidiary.

When preparing the condensed consolidating financial information, the parent's accounting basis in any subsidiaries should be "pushed down" if push-down accounting is required or permitted in the subsidiary's separate financial statements.

The parent's disclosure should include any significant restrictions on the ability of the parent reporting entity or any guarantor to obtain funds from its subsidiaries by dividend or loan. Additionally, the parent should provide the disclosures prescribed by S-X 4-08(e)(3) for the subsidiary-issuers/guarantors.

If a subsidiary-issuer/guarantor reports any amounts as a cumulative effect of a change in accounting principle or an extraordinary item, the income statement for any entity that presents that subsidiary based on the proportionate share of net assets (e.g., the parent reporting entity) should reflect the entity's share of that cumulative effect or extraordinary item as if the investor had made the change or incurred the extraordinary item directly. U.S. GAAP, however, would prohibit similar treatment for discontinued operations (because the reporting model is based largely on the equity method of accounting).[2]

12.13 Considerations for private companies

The requirements of ASC 470 apply to both public and private companies. The following disclosure and classification requirements discussed in this chapter are required for SEC registrants only:

- Disclosure requirements under S-X 5-02
- Related party disclosures under Rule 4-08(k)
- S-X 3-10 disclosures for issuer of a registered security that is guaranteed
- Classification considerations for revolving debt under long-term construction programs in SAB Topic 6.H.2

[2] As of the content cutoff date of this publication (August 31, 2014), it is unclear whether this treatment of an equity method investee's discontinued operations would still be applicable under the new discontinued operations guidance, ASU 2014-08. Financial statement preparers and other users of this publication are therefore encouraged to monitor the status of this item if it is applicable to them.

Chapter 13: Pensions and other postemployment benefits

13.1 Chapter overview

This chapter addresses the specific annual presentation and disclosure matters related to retirement benefits under ASC 715, *Compensation—Retirement Benefits*, and nonretirement postemployment benefits under ASC 712, *Compensation—Nonretirement Postemployment Benefits*. Interim presentation and disclosure requirements differ and are discussed in FSP 29.

For presentation considerations related to the presentation of retirement and other postemployment benefits in the statement of other comprehensive income, refer to FSP 4.

13.2 Scope

Retirement benefits are benefits that employers provide employees at retirement, including pensions, other postretirement benefits (OPEB), like health and welfare benefits, and similar benefits through defined contribution plans. Retirement benefits may take the form of a defined benefit or a defined contribution.

Nonretirement postemployment benefits are benefits that reporting entities provide employees after employment but before retirement, such as termination benefits.

The topics discussed in this chapter relate to the presentation and disclosure requirements for the employer's financial statements (not the benefit plan itself).

13.3 Defined benefit plans

This section covers the presentation of defined benefit plans in a reporting entity's financial statements and the disclosures in the accompanying notes.

A defined benefit plan is any retirement plan that is not a defined contribution plan, as described in FSP 13.4. Generally, a defined benefit plan is one that defines an amount of benefit to be provided, usually as a function of one or more factors, such as age, years of service, or compensation.

13.3.1 Balance sheet presentation

Balance sheet presentation of defined benefit plans involves two factors: recognition of the plan's funded status, and classification of the funded status as current and noncurrent. The funded status is the difference between the fair value of plan assets and the benefit obligation. The benefit obligation refers to the projected benefit obligation (PBO) for pension plans and the accumulated postretirement benefit obligation (APBO) for OPEB plans. The funded status and its classification as current and noncurrent are required to be determined on a plan-by-plan basis.

13.3.1.1 *Funded status presentation*

Reporting entities are required to recognize the funded status of their defined benefit plans on the balance sheet. An overfunded benefit plan has plan assets that are greater than the benefit obligation (which would be presented as a net benefit asset). An underfunded benefit plan has plan assets that are less than the benefit obligation, and an unfunded benefit plan has no plan assets (both are presented as a net benefit liability).

A reporting entity is not permitted to offset one plan's net benefit asset with another plan's net benefit liability. Further, all overfunded plans should be aggregated and recorded as a net benefit asset, and all unfunded or underfunded plans should be aggregated and recorded as a net benefit liability. Therefore, a reporting entity that has more than one plan may report both a net benefit asset and a net benefit liability on its balance sheet.

For assets to be considered plan assets, the assets must be segregated in a trust or otherwise restricted for the sole use of paying benefits. The reporting entity is generally not permitted to access the funds for other uses. Only assets that meet this definition (ASC 715-30-20 and ASC 715-60-20) can offset the liability in the balance sheet. Assets that do not meet the definition are presented gross in the balance sheet and accounted for and classified depending on the nature of the asset.

13.3.1.2 *Classification*

Reporting entities that present a classified balance sheet are required to consider whether a portion of their net benefit liability should be presented as a current liability, on a plan-by-plan basis. The current liability is the amount of the benefit obligation that is payable over the next 12 months (or the operating cycle, if longer) that exceeds the fair value of plan assets. Payments include expected benefit payments, expected settlements (e.g., lump sum payments), and payments of other items reflected in the benefit obligation (e.g., administrative or claims costs). All expected payments for an unfunded plan to be made over the next 12 months (or operating cycle, if longer) from the balance sheet date are classified as a current liability.

In determining the current liability, reporting entities should consider expected payments for the 12-month period from the balance sheet date. For example, in its 20X4 financial statements, a calendar year-end reporting entity should consider the expected payments for the period January 1, 20X5 to December 31, 20X5 in determining whether a portion should be classified as a current liability. For its March 31, 20X5 balance sheet, the reporting entity should consider the expected payments for the period April 1, 20X5 to March 31, 20X6 (and not April 1, 20X5 to December 31, 20X5). Reporting entities are not required to remeasure plan assets and obligations in order to estimate expected payments for interim reporting purposes.

For plans that are overfunded (in a net asset position), the net benefit asset should be classified as a noncurrent asset. If a reporting entity expects a refund from the plan within the next 12 months — a rare occurrence in practice — the amount and timing of the refund should be disclosed, but not recorded as a current asset.

13.3.2 Income statement presentation

Reporting entities are required to combine the various pension and OPEB cost components and present them in the financial statements on a net basis. It is not appropriate to recognize these costs separately. Net periodic benefit cost comprises:

- Service cost
- Interest cost
- Expected return on plan assets
- Amortization of prior service cost/credit
- Gains and losses
- Amortization of transition amount (this would have arisen upon the initial adoption of the guidance that is now in ASC 715)

Net periodic benefit cost is estimated at the beginning of the year, based on beginning-of-the-year (or end-of-prior-year) plan balances and assumptions.

When the plan is remeasured, typically at the end of the year, if the net benefit liability increases by more than the net periodic benefit cost recorded, the difference is referred to as an actuarial loss. How an actuarial loss is recognized will depend on the reporting entity's accounting policy for gain and loss recognition. Some reporting entities first recognize such gains and losses in OCI and subsequently recognize these amounts in net periodic benefit cost in future periods. A reporting entity that has adopted an immediate recognition policy for gains and losses will recognize the gain or loss in net periodic benefit cost in the period in which it occurs.

13.3.2.1 Capitalizing costs

Similar to other employee costs, net periodic benefit costs should be capitalized in connection with the construction or production of an asset (e.g., inventories, self-constructed assets, internal use software). The amount capitalized should be the total net periodic pension and other postretirement benefit cost attributable to the specific employees, and not an allocation of only certain components. For example, the interest cost component of net periodic benefit cost cannot be separately included as an element subject to interest capitalization.

Excerpt from ASC 330-10-55-6

...when it is appropriate to capitalize employee compensation in connection with the construction or production of an asset, the net periodic pension cost and other postretirement cost applicable to the pertinent employees for the period (including interest cost), not individual components of that amount, is the relevant amount.

The guidance does not prescribe how to determine the amount of net periodic benefit cost to allocate to the employees associated with the production or construction of an asset, or how to allocate the costs across the period the assets are being produced or constructed. This determination requires considerable judgment based on the relevant facts and circumstances.

13.3.3 Statement of stockholders' equity presentation

Reporting entities are permitted to recognize gains and losses in OCI and subsequently amortize those amounts as a component of net periodic benefit cost. Prior service cost (credit) generated from plan amendments is generally required to be treated in a similar manner, i.e., first recognize in OCI and subsequently recognized in net periodic benefit cost through amortization. As the amounts are amortized, a reclassification adjustment is recognized in AOCI. As such, the net impact on total comprehensive income (which comprises net income and OCI) is zero.

Refer to FSP 4 for further discussion of OCI reclassification adjustments.

13.3.3.1 Gains and losses

A gain or loss can result from a change in any of the following:

- The value of plan assets due to experience, both realized and unrealized, being different from that assumed (i.e., the expected return on plan assets)
- The benefit obligation resulting from experience different from that assumed
- Actuarial assumptions, including changes in discount rates

The amount of the net gain or loss recognized in AOCI, as well as the amount to amortize in the subsequent period, is recalculated at each measurement date. At a minimum, an amount should be amortized as a component of net periodic benefit cost for the year if the beginning-of-the-year net gain or loss in AOCI exceeds the "corridor" amount, i.e., 10 percent of the greater of the benefit obligation or the market-related value of plan assets.

A reporting entity may adopt an accounting policy for recognizing the net gain or loss that differs from the corridor approach described above, as long as it is a systematic method that, at a minimum, recognizes the amount that would have been recognized under the corridor method (in any period), and the reporting entity discloses its policy.

13.3.3.2 *Prior service cost*

Prior service cost (credit) arises from plan amendments that increase (decrease) benefits for services rendered in prior periods. It is measured by the change in the benefit obligation at the date the amendment is adopted. The amount to be amortized as a component of net periodic benefit cost each period is established at the date of the amendment and is not subsequently changed or recalculated, unless there is a significant event, like a curtailment. Prior service cost arising from each plan amendment should generally be amortized separately.

13.3.3.3 *Foreign pension and OPEB plans*

Companies with foreign plans need to determine at what foreign currency rate to translate amounts in AOCI that are subsequently reclassified to net income. We believe that there are two acceptable approaches to account for the translation under ASC 830, *Foreign Currency Matters*, as described in Figure 13-1 below. Selection of an approach represents an accounting policy decision that should be applied consistently.

Figure 13-1
Acceptable approaches to account for the reclassification of foreign pension and OPEB items from AOCI to net income

Approach	Requirements of presentation
Historical rate	The amount of AOCI reclassified to net income each period would be translated at the historical exchange rate in effect at the time the prior service costs/credits, net gain/loss, and transition asset/obligation were initially recognized in OCI.
Current rate	The amount of AOCI reclassified to net income each period would be translated at the current exchange rate in effect for the period in which the reclassification adjustment is reflected in net income. This typically represents the average exchange rate for the period, since pension and OPEB expense is recognized ratably over the period.

13.3.4 *Disclosure*

Information related to the reporting entity's net periodic benefit cost should be disclosed for each period that an income statement is presented. Similarly, information related to amounts presented in a reporting entity's balance sheet should be disclosed as of the date of each balance sheet presented. Information for pension plans should be provided separately from information about OPEB plans. Public reporting entities should provide the required disclosures from ASC

715-20-50-1 as further discussed in the remainder of this section. ASC 715-20-55-16 through 55-17 include an illustrative example of the disclosure requirements.

A private company should refer to the disclosures required in ASC 715-20-50-5, and to the considerations for private companies discussed at the end of this chapter.

13.3.4.1 Description of the plans

Although not specifically required, a reporting entity should consider providing a general description of the defined benefit plans it sponsors to help financial statement users understand the current and future impact the benefits have on the financial statements. The following is information that reporting entities may consider providing:

- Nature of the plans
- Benefits provided
- Employee groups entitled to benefits
- Description of the regulatory environment (e.g., ERISA) in which the plans operate
- Description of the risks to which the plans may expose the reporting entity
- Other information that would be useful to understand the plans

13.3.4.2 Amounts recognized on the balance sheet and funded status

ASC 715 requires a reporting entity to provide the amounts recognized on the balance sheet, showing separately the net assets and net liabilities. A reporting entity that presents a classified balance sheet should present the current and noncurrent liabilities recognized. A reporting entity should also disclose the funded status of the plans. These amounts should be consistent with the ending balances in the reconciliation of the benefit obligation and the fair value of plan assets, as discussed in FSP 13.3.4.3.

For defined benefit pension plans, a reporting entity should disclose the accumulated benefit obligation (ABO). The ABO is a benefit obligation measure that incorporates past and current compensation levels, but unlike the PBO, does not reflect expected benefit increases from future salary levels. The PBO is the benefit obligation that is used to calculate the net asset or liability included on the balance sheet, while the ABO is disclosed.

Reporting entities with two or more plans have additional disclosure requirements, discussed in FSP 13.3.5 and related subsections.

13.3.4.3 *Reconciliation of the benefit obligation and the fair value of plan assets*

A reporting entity should disclose a reconciliation of the beginning and ending balances of the benefit obligation and the fair value of plan assets, showing separately the items that impact the balance. Figure 13-2 identifies items that typically affect the benefit obligation, fair value of plan assets, or both.

Figure 13-2
Items that typically affect the benefit obligation, fair value of plan assets, or both

Benefit obligation	Fair value of plan assets	Both
□ Service cost	□ Actual return on plan assets	□ Contributions by plan participants
□ Interest cost	□ Contributions by reporting entity	□ Benefits paid
□ Actuarial gains and loses		□ Foreign currency exchange rate changes
□ Plan amendments		□ Business combinations
□ Curtailments		□ Divestitures
□ Termination benefits		□ Settlements

13.3.4.4 *Plan assets*

The guidance provides disclosure objectives for plan assets, indicating that the disclosures are intended to provide users of the financial statements with an understanding of:

- The plan's investment policies, strategies, and allocation decisions
- The classes of plan assets
- The inputs and valuation techniques used to measure the fair value of plan assets
- The effect of fair value measurements using significant unobservable inputs on changes in plan assets for the period
- Significant concentrations of risk within plan assets

The plan asset disclosures are intended to address users' desires for transparency about the types of assets and associated risks in a reporting entity's defined benefit pension and OPEB plans, and how economic events could have a significant effect on the value of plan assets.

Disclosure about investment policies and strategies

The guidance requires a reporting entity to disclose information regarding how investment allocation decisions are made, including factors pertinent to understanding investment policies and strategies. Disclosures should include:

- A narrative description of investment policies and strategies
- Target allocation percentages or a range of percentages considering the classes of plan assets as of the latest balance sheet presented (on a weighted-average basis for reporting entities with more than one plan)
- Other factors pertinent to an understanding of the plan's policies and strategies, such as:
    - Investment goals
    - Risk management practices
    - Permitted and prohibited investments, including whether the use of derivatives is permitted
    - Diversification
    - The relationship between plan assets and benefit obligations
- A description of the significant investment strategies of investment funds (e.g., hedge funds, mutual funds, private equity funds), if those investment funds represent a major class of plan assets.

Disclosure about classes of plan assets

A reporting entity should disclose the fair value of each class of plan assets as of each annual reporting date for which a balance sheet is presented. Asset classes should be disclosed based on the nature and risks of the assets. While separate disclosures are required for pension and OPEB plans, reporting entities may combine disclosures for multiple pension plans and multiple OPEB plans. Disclosures about U.S. and non-U.S. pension plans and U.S. and non-U.S. OPEB plans can be combined, unless the benefit obligations of plans outside of the U.S. are significant relative to the total benefit obligation and those plans use significantly different assumptions.

Examples of classes of plan assets include:

- Cash and cash equivalents
- Equity securities (segregated by industry type, reporting entity size, or investment objective)
- Debt securities issued by national, state, and local governments
- Corporate debt securities
- Asset-backed securities
- Structured debt
- Derivatives on a gross basis (segregated by type of underlying risk in the contract, e.g., interest rate risk, foreign exchange risk, credit risk)
- Investment funds (segregated by type of fund)
- Real estate

Plan assets may be invested indirectly in many different asset categories (e.g., a mutual fund may invest in several different types of assets). Reporting entities are not required to allocate such indirect investments into respective asset categories. However, reporting entities should consider the objectives of the disclosure in determining under which asset class such an investment should be disclosed. Specifically, disclosure of additional asset classes and/or further disaggregation of major categories would be appropriate if that information is expected to be useful in understanding the risks associated with each asset class or the overall expected long-term rate of return on assets.

Reporting entities are also required to provide a narrative description of the basis used to determine the overall expected long-term rate of return on assets. Such narrative should consider the classes of assets described above and include:

- The general approach used
- The extent to which the overall rate of return on assets assumption was based on historical returns
- The extent to which adjustments were made to those historical returns in order to reflect expectations of future returns and how those adjustments were determined.

Question 13-1

To meet the objective of providing financial statement users with an understanding of how investment allocation decisions are made considering the classes of plan assets disclosed, should an investment strategies disclosure be presented for each class of assets in the fair value hierarchy disclosure?

PwC response

The guidance does not explicitly require disclosure of investment strategies for each class of assets in the fair value disclosure. Accordingly, the investment strategies may be disclosed at the level provided to the portfolio managers provided it is clear how the strategy relates to the classes of plan assets. For example, if a plan's strategy is to invest 50 percent to 60 percent in equities, the reporting entity would not be required to break this target allocation into further subclasses (even where the fair value hierarchy disclosure presents several such subclasses of equities).

Disclosure about fair value measurements of plan assets

For users of the reporting entity's financial statements to assess the inputs and valuation techniques used to develop the fair value measurements of plan assets, reporting entities should disclose the following for each class of plan assets as of each annual reporting date for which a balance sheet is presented:

- The level within the fair value hierarchy in which the fair value measurements in their entirety fall, segregating fair value measurements using Level 1, Level 2, and Level 3 inputs.
- For Level 3 fair value measurements of plan assets, a reconciliation of the beginning and ending balances, separately presenting changes during the period attributable to:
    - Actual return on plan assets, separately identifying the amounts related to assets still held at the reporting date and assets sold during the period
    - Purchases, sales, and settlements, net
    - Transfers in or out of Level 3
- Information about the valuation technique(s) and inputs used to measure fair value, including a discussion of any changes in valuation techniques and inputs used during the period.

Where the inputs used to measure fair value fall within different levels of the fair value hierarchy, the presentation should be based on the lowest level input that is significant to the fair value measurement in its entirety. Assessing the significance of a particular input to the fair value measurement in its entirety requires judgment, considering factors specific to the asset.

The disclosure requirements by level are similar to those required by ASC 820, *Fair Value Measurement* (refer to FSP 20). However, the segregation of actual returns between those related to assets held and sold is in lieu of the ASC 820 requirement to segregate gains and losses recognized in earnings from those recognized in other comprehensive income. That requirement does not apply to a reporting entity's disclosures about its pension and OPEB plan assets because the delayed recognition provisions for gains and losses makes it too difficult to determine whether gains or losses on plan assets were included in net income or OCI for the period.

ASC 715 requires the Level 3 asset reconciliation to include the actual return on plan assets, separately identifying the amount related to assets still held at the reporting date and the amount related to assets sold during the period. Questions have arisen in practice about how to define and measure realized and unrealized gains and losses on plan assets, as well as the appropriate format for presenting this information. The guidance does not specify a particular way to calculate realized and unrealized gains and losses, or the format of the Level 3 reconciliation disclosure. Based on a reasonable interpretation of the requirements, a reporting entity can exercise judgment in determining the manner and format of the disclosure, so long as it satisfies the disclosure objectives of the standard and is applied consistently each period.

In considering the guidance, we believe, for example, that it would be acceptable to separately present the actual return (realized and unrealized) on plan assets still held at the reporting date, and on assets sold during the period within the reconciliation. Alternatively, the actual return (realized and unrealized) may be presented as a single line item in the reconciliation, and the amounts associated with assets still held at the reporting date disclosed in a footnote to the reconciliation.

Many reporting entities and plans use information provided by third parties in developing their fair value estimates. While reporting entities may receive information from the plan custodian or trustee regarding asset valuations and the classification of investments in the fair value hierarchy (i.e., whether inputs used to measure fair value are Level 1, 2, or 3), management remains responsible for the accuracy of such determinations. As such, reporting entities should understand the valuation methodologies used by their third party information providers. The AICPA Employee Benefit Plans Audit Quality Center Advisory, *Valuing and Reporting Plan Investments,* may help management understand its responsibility regarding the valuation and reporting of investments.

Question 13-2

How should a reporting entity determine the level of disaggregation (e.g., the appropriate unit of account) for the fair value hierarchy disclosure?

PwC response

The guidance indicates that for purposes of the fair value disclosures, the asset classes should be based on the nature, characteristics, and risks of the assets in a reporting entity's plan.

Plan investments often involve complex structures with multiple layers. In some cases, the plan may utilize a portfolio manager to manage a pool of investments (e.g., stocks and bonds) on its behalf, but the plan legally owns the underlying investments. In these situations, each individual stock and bond (i.e., CUSIP or trade lot) would be its own unit of account.

Plans may invest in an insurance contract that will generate returns based on the performance of underlying or referenced assets (e.g., pooled accounts). In these situations, a reporting entity may determine that the appropriate unit of account is the insurance contract rather than the underlying investment. Alternatively, some insurance contracts require that the underlying assets be maintained in a "separate account" of the insurance reporting entity, and sometimes the plan sponsor has some involvement in investment decisions relating to the separate account. These assets are generally not comingled with assets of the insurer or other plan sponsors, and while the insurer legally owns the assets, they may not be available to its general creditors in bankruptcy. Accordingly, it may be appropriate to look through the separate account to determine the appropriate level of the underlying investment.

Question 13-3

Should items reported in a benefit plan's financial statements that are not measured at fair value (e.g., insurance contracts, cash, accrued interest, dividends receivable) be included in the reporting entity's fair value hierarchy disclosure? Alternatively, should these be disclosed as a reconciling item in the fair value hierarchy disclosure?

PwC response

The guidance requires disclosure of the fair value of each class of plan assets and the level within the fair value hierarchy based on the inputs used to develop the fair values. Thus, all assets held by the plan are required to be recorded at fair value. The following provides guidance on specific plan assets:

<u>Demand deposits and other cash</u> — Cash on deposit held by plans is recorded at the amount on deposit. Since no judgment is required to assess the fair value of cash, and the disclosure example in ASC 715-20-55-17 explicitly includes cash, it could be included in the fair value hierarchy disclosure. It is appropriate to classify the fair value measurement for cash as Level 1 when the amounts are

available on demand. It would also be acceptable to exclude cash from the fair value hierarchy disclosure and include it as a reconciling item between the fair value hierarchy disclosure and total plan assets.

Contracts with insurance companies — ASC 715-30-35-60 states that contracts with insurance companies (other than those that are in substance equivalent to the purchase of annuities) should be accounted for as investments and measured at fair value. The guidance further states that for some contracts, contract value may be the best evidence of fair value, and if a contract has a determinable cash surrender value or conversion value, that is presumed to be its fair value.

We believe that these alternative measures are practical expedients to the required fair value measurement. This practical expedient does not relieve a reporting entity from the requirement to present such contracts as a component of the applicable major category of plan assets in the fair value disclosure. Accordingly, contracts issued by insurance companies, including those for which cash surrender value or contract value is used to estimate fair value, should be included in the fair value hierarchy disclosure.

Generally, contracts that are recorded at cash surrender value or contract value will be classified as Level 2 or Level 3, depending on the nature of the contract. For example, in some instances, the contract value or cash surrender value is based principally on a referenced pool of investment funds that actively redeems shares and for which prices may be observable, resulting in Level 2 classification. In other instances, the underlying investments may comprise less liquid funds or assets, resulting in Level 3 classification.

Dividends and interest receivable — Dividends and interest receivable included in plan assets are also required to be recorded at fair value. Given the short-term nature of these assets, reporting entities generally assert that the carrying amounts of these items approximate their fair values. A reporting entity that includes these assets in the fair value hierarchy should not classify these assets as Level 1 as there are no quoted prices in active markets. A reporting entity would need to assess the observability of inputs to determine whether the assets should be reported as Level 2 or Level 3. Alternatively, some reporting entities present these items as adjustments to reconcile the fair value hierarchy to the fair value of plan assets.

Question 13-4

Should the Level 3 asset reconciliation start with the fair value estimates reported in the prior year financial statements or the revised amounts based on any final valuations received after those financial statements were issued (and used to measure current year benefit cost and disclosed in the plan financial statements filed with Form 5500)? If the prior year estimates are used as the starting point in the reconciliation, how should the reconciliation present the "true-up" adjustments?

PwC response

Many reporting entities apply a roll forward technique to estimate the year-end fair values of alternative investments (e.g., hedge funds and private equity funds) because valuations are difficult to obtain in a timely manner for year-end reporting. In these instances, reporting entities typically develop a best estimate using asset values at a period earlier than the year-end measurement date and make adjustments to roll forward the asset values to year-end. The year-end estimates are subsequently "trued-up" when the plan receives the final valuations (e.g., in the second quarter).

Assuming the reporting entity has concluded that any subsequent changes to the prior year fair value estimates were "changes in estimates" rather than "corrections of errors" (as defined by ASC 250, *Accounting Changes and Error Corrections*), the change in estimate should be reflected as current period activity (e.g., unrealized gain or loss) in the Level 3 asset reconciliation. In that case, the reconciliation should start with the fair value estimates reported in the prior year financial statements.

Question 13-5

How should the Level 3 asset reconciliation present foreign exchange translation and transaction gains and losses?

PwC response

The effect of foreign currency translation and transaction gains and losses, to the extent they affect the change in the fair value of the Level 3 assets, may be presented as a component of actual return on plan assets for the period, or as a separate line item. If a reporting entity elects to present the foreign exchange amounts as a separate line item in the reconciliation, it is not necessary to disclose the amounts associated with assets sold and assets held at year-end.

Question 13-6

If a pension plan is party to securities lending transactions (i.e., borrower of cash and lender of securities), should the obligation to buy back the securities on loan be included in the fair value disclosures, including the fair value hierarchy disclosure?

PwC response

Yes. The liability recognized in connection with a securities lending transaction (i.e., to repurchase the securities on loan) is included in the net assets of the plan at fair value. Accordingly, it is appropriate to include the securities lending liability in the fair value disclosures, including the fair value hierarchy disclosure.

Disclosure about significant concentrations of risk

Reporting entities are required to disclose significant concentrations of risk in plan assets. The guidance does not prescribe how a significant concentration should be determined. Each reporting entity should perform a risk assessment of its plan assets to determine whether it has any significant concentrations of risk that require disclosure. Reporting entities should consider concentrations of risk related to asset type, industry, or market.

Other asset disclosures

The guidance requires the following additional asset disclosures:

- If plan assets include securities of the reporting entity or a related party, the amounts and types of securities included in plan assets
- The approximate amount of future annual benefits covered by insurance contracts, including annuity contracts issued by the reporting entity or a related party
- Any significant transactions between the reporting entity or a related party and the plan during the year
- If plan assets are expected to be returned to the reporting entity during the next year (or operating cycle if longer), the amount and timing of any such plan assets

13.3.4.5 Net periodic benefit cost and other comprehensive income

A reporting entity is required to disclose the net periodic benefit cost, amounts recognized in OCI, AOCI balances, and amounts expected to be amortized in the coming year.

Net periodic benefit cost

A reporting entity should disclose its net periodic benefit cost and disclose the components of cost for each period for which an income statement is presented, including the following:

- Service cost
- Interest cost
- Expected return on assets
- Gain or loss
- Amortization of prior service cost/credit
- Gain or loss due to settlements or curtailments

- Amortization of transition asset or obligation

Other comprehensive income and accumulated other comprehensive income

A reporting entity that defers amounts in AOCI (either gains and losses or prior service cost (credit) generated from a plan amendment) is required to disclose the following information about OCI and AOCI:

- For each year that an income statement is presented, amounts recognized in OCI during the year, including separately disclosing the net gain or loss, net prior service cost (credit), and amounts that are being reclassified or amortized from AOCI into net periodic benefit cost

- For each year that a balance sheet is presented, amounts recognized in AOCI, i.e., year-end balances in AOCI

- Amounts expected to be amortized from AOCI into net periodic benefit cost in the coming year

13.3.4.6 Expected cash flows of the reporting entity and the plan

Reporting entities should disclose expected benefit payments to be paid in each of the next five fiscal years, and the total to be paid in years five through ten. These amounts should be estimated based on the same assumptions that were used to measure the reporting entity's year-end benefit obligation.

Reporting entities should also disclose their best estimate of contributions expected to be paid to the plans in the coming year, including contributions required by funding regulations or laws, discretionary contributions, and noncash contributions. These may be presented in the aggregate.

13.3.4.7 Assumptions

ASC 715 requires reporting entities to disclose the discount rate, the rate of salary increases (if any), and the expected long-term rate of return on plan assets on a weighted average basis used to determine (1) the year-end benefit obligation, and (2) the net periodic benefit cost for the year.

Reporting entities are required to disclose the assumptions used to determine the benefit obligation for each year that a balance sheet is presented, and the assumptions used to determine the net periodic benefit cost for each year that an income statement is presented.

Since net periodic benefit cost is estimated at the beginning of the year, based on beginning-of-the-year plan balances and assumptions, the assumptions used to determine the net periodic benefit cost are generally the same assumptions as those used for measuring the benefit obligation as of the prior year end.

If a reporting entity performed an interim measurement, it should disclose either the beginning and interim rates, or a weighted average of the rates.

An SEC registrant with material defined benefit plans should disclose how it determines its assumed discount rate, either in the critical accounting policies section of MD&A or in the footnotes. That disclosure should include the specific source data used to support the discount rate and adjustments made to the source data.

If the reporting entity benchmarks its assumption off of published long-term bond indices, it should explain how it determined that the timing and amount of cash outflows related to the bonds included in the indices matches its estimated defined benefit payments. If there are differences between the terms of the bonds and the terms of the defined benefit obligations, or if the bonds are callable, the reporting entity should explain how it adjusted for the differences.

13.3.4.8 Certain disclosures for postretirement healthcare plans

ASC 715-20-50 and ASC 715-60-50 provide guidance on the disclosure requirements for postretirement healthcare plans.

Assumptions and sensitivity

Reporting entities that sponsor postretirement healthcare plans should provide specific disclosures regarding the assumptions used. These assumptions include the following:

- Healthcare cost trend rate (used to project current per capita healthcare costs)
- Direction and pattern of the trend rates
- The ultimate trend rate (the rate at which healthcare cost trends will level off in some future year)
- The year when the reporting entity expects to reach the ultimate trend rate

Reporting entities should also provide a sensitivity analysis of the healthcare cost trend rate. This includes disclosing the effect of a one percentage point increase and decrease in the assumed health care cost trend rates on the sum of service cost and interest cost components of the net periodic benefit costs, and on the benefit obligation.

Medicare Prescription Drug, Improvement and Modernization Act of 2003

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 authorized Medicare to provide prescription drug benefits to retirees. The federal government makes subsidy payments to reporting entities that sponsor postretirement benefit plans under which Medicare-eligible retirees receive prescription drug benefits that are "actuarially equivalent" to the prescription drug benefits provided under Medicare.

ASC 715-60-50 provides guidance on disclosing the effects of the subsidy by a reporting entity that offers postretirement prescription drug coverage, including a reporting entity that is unable to determine whether the benefits under its plan are actuarially equivalent to the Medicare Part D benefit. Those reporting entities should disclose (1) the existence of the Medicare Prescription Drug, Improvement, and Modernization Act, and (2) that its measures of the benefit obligation and net periodic benefit cost do not reflect any amounts associated with the subsidy, since it cannot conclude on whether the benefit is actuarially equivalent to Medicare Part D.

In the first period that a reporting entity includes the effects of the subsidy when measuring its APBO and net periodic benefit cost, it should disclose the following in both interim and annual financial statements:

- The decrease in the APBO for the subsidy that relates to benefits attributed to past service

- The effect of the subsidy on the measurement of the current period's net periodic benefit cost, including the reduction in service cost and interest cost from the effects of the subsidy and the amortization of the gain for the reduction in the APBO

When providing the expected benefit payment disclosures, the reporting entity should provide the gross benefit payments (paid and expected), including prescription drug benefits, and, separately, the gross amount of the subsidy receipts (received and expected).

13.3.4.9 Significant events

Reporting entities may take actions that significantly affect their defined benefit plans. Appropriate disclosure about the nature and impact of these events is required.

Curtailments and settlements

Two common significant events are curtailments and settlements. A curtailment is an event that significantly reduces the expected years of service of current employees or eliminates the accrual of benefits for future service for a significant number of employees. A settlement is an event that relieves the employer of the primary responsibility for the obligation to some or all participants, eliminates significant risks related to the obligation and the assets used to settle it, and is irrevocable. In these situations, the reporting entity should disclose a description of the nature of the event and the quantitative effect on the periods presented.

Termination benefits

If a reporting entity is providing special or contractual termination benefits, the reporting entity should disclose a description of the nature of the event giving rise to the benefit and the cost recognized during the year.

Negative plan amendment that may be reversed as a result of litigation

The significant increase in the cost of providing healthcare benefits to retirees has prompted a number of reporting entities to amend the terms of their benefit plans to reduce or eliminate benefits, which may be considered a "negative plan amendment." There are presently no U.S. federal laws prohibiting a reduction in OPEB benefits. However, reductions in benefits, whether made pursuant to a written plan or as a matter of historical procedure, have sometimes resulted in litigation against the reporting entity on behalf of the retirees. Such litigation may seek to retroactively reinstate the prior level of benefits.

If it is probable that the negative plan amendment will be rescinded due to litigation, the OPEB obligation should not be reduced by the effects of the negative plan amendment. If rescission is not probable, the facts and circumstances may indicate the existence of a contingent liability requiring disclosure pursuant to ASC 450, *Contingencies*.

13.3.4.10 Other disclosures

The guidance requires reporting entities to provide additional disclosures under certain circumstances, including the following:

- Any alternative methods for amortizing prior service cost or gains and losses
- A substantive commitment, such as a "past practice or a history of regular benefit increases, used as the basis for accounting for the benefit obligation"
- Japanese governmental settlement transactions, and the related required disclosures discussed in ASC 715-20-50-10
- Measurement method used for plans discussed in ASC 715-30-35-40 and 41 where the present value of benefits if the employee terminates immediately is greater than the present value of benefits calculated assuming a normal separation date (typically seen in foreign plans) (ASC 715-20-S99-2)
- Any significant change in the benefit obligation or fair value of plan assets not otherwise disclosed

As a general matter reporting entities should provide a description of all significant accounting policies. If the market-related value (MRV) is used instead of fair value for recognizing gains or losses or for calculating the expected return on plan assets, the reporting entity should disclose the methodology for determining the MRV of plan assets. If the year-end MRV significantly differs from fair value, reporting entities should disclose the year-end MRV and the expected impact on benefit expense for the upcoming year.

13.3.5 Reporting entities with two or more plans

Reporting entities may aggregate the disclosures provided for all pension plans, and for all OPEB plans, unless disaggregating in groups provides more useful information or if it is specifically required by the sections below.

13.3.5.1 Aggregate benefit obligation in excess of plan assets

Reporting entities may aggregate disclosures for plans whose plan assets exceed the benefit obligation, with separate disclosures for those plans whose benefit obligations exceed plan assets. However, ASC 715-20-50-3 requires that if a reporting entity choses to aggregate the disclosure for these plans, it needs to include the following disaggregated disclosure:

- For plans with benefit obligations in excess of plan assets as of the measurement date of each balance sheet presented, disclose the aggregate benefit obligation and aggregate fair value of plan assets

- For pension plans with an ABO in excess of plan assets, disclose the aggregate ABO and the aggregate fair value of plan assets

13.3.5.2 U.S. and international plans

A reporting entity may aggregate its disclosure for U.S. and non-U.S. plans, unless the benefit obligations for the non-U.S. plans are significant relative to the total benefit obligation and their assumptions are significantly different.

13.3.6 Subsidiaries participating in parent company plans

When a reporting entity participates in a pension or OPEB plan sponsored by an affiliated entity (e.g., parent company, sister entity), the accounting in the standalone financial statements of the reporting entity should generally follow the "multiemployer" guidance in ASC 715-80 (discussed in FSP 13.5). The multiemployer guidance differs significantly from the traditional "single employer" accounting guidance. Under multiemployer accounting, a reporting entity typically recognizes expense based on the required contribution to the plan for the period. The reporting entity only recognizes a liability if the required contribution had not been paid at the end of the period.

A subsidiary that participates in its parent's benefit plan is not required to provide the multiemployer disclosures described in FSP 13.5.1 and 13.5.2. Rather, it should disclose the name of the plan and the amount of contributions to the plan.

13.4 Defined contribution plans

A defined contribution plan is a plan that provides an individual account for each participant, and specifies how contributions to the individual's account are to be determined instead of specifying the amount of benefit the individual is to receive.

13.4.1 General disclosure

A reporting entity that sponsors a defined contribution plan should disclose the amount of cost recognized for the plan separately from its defined benefit plans. The disclosures should include a description of the nature and effect of any significant changes during the period affecting comparability, such as a change in the rate of reporting entity contributions, a business combination, or a divestiture.

13.4.2 Hybrid plans

Some plans contain features of both defined contribution and defined benefit plans. Some examples include cash balance plans and floor-offset plans. If, in substance, the plan provides a defined benefit, the accounting and disclosures should follow the requirements for a defined benefit plan.

13.5 Multiemployer plans

A multiemployer plan is a pension or OPEB plan to which two or more unrelated reporting entities contribute. The assets of the plan are commingled and can be used to provide benefits to employees of any of the participating reporting entities. These plans are usually, but not always, pursuant to a collective bargaining agreement. A reporting entity accounts for its participation in a defined benefit multiemployer plan by recognizing expense in the amount of contributions to the plan when they are required to be made, without any accrual of future contributions or consideration of the funded status of the plan.

13.5.1 Multiemployer pension plans

The disclosure requirements of ASC 715-80-50 are intended to provide information about a reporting entity's financial obligations to a multiemployer pension plan and help financial statement users better understand the financial health of all of the significant plans in which the reporting entity participates. A reporting entity should provide a narrative description of the nature of the multiemployer plans and of its participation in the plans, indicating how the risks of participating in these plans differ from those of a single-employer plan.

When information about the plan is available in the public domain (e.g., a Form 5500), reporting entities should disclose the following for each individually significant plan:

- Plan's legal name and Employer Identification Number

- For each balance sheet presented, the plan's "Zone status" (a color-coded designation based on the funded status of the plan), as defined by the Pension Protection Act of 2006 or, if not available, whether the plan was less than 65 percent funded, between 65 and 80 percent funded, or 80 percent or more funded

- For each period that an income statement is presented, the amount of the employer's contributions, whether those contributions represent more than 5 percent of total contributions to the plan per the plan's most recently available annual report (Form 5500 for U.S. plans), and the year-end date of the plan to which the annual report relates

- Expiration dates of collective bargaining agreements

- For the most recent annual period presented, whether the plan is subject to a funding improvement plan, whether the reporting entity paid a surcharge to the plan, and a description of any minimum contributions required in future periods

The guidance does not define the term "significant." When determining whether a plan is individually significant, a reporting entity should consider not only its contributions to the plan but other factors, such as the severity of the underfunded status of the plan and the relative proportion of the employer's participation in the plan.

These disclosure requirements are applicable for U.S. and non-U.S. plans, although obtaining some of this information for non-U.S. plans may be more challenging. Reporting entities may also face other challenges for U.S. or non-U.S. plans, including obtaining the information necessary to prepare the disclosures on a timely basis. Some information may be unavailable at the financial statement date. In these cases, reporting entities should use the most recent information available (which may, for example, relate to a prior fiscal year) and disclose the year-end to which the information relates.

When plan information is not available in the public domain, reporting entities should disclose, in addition to the information described above, the nature of the benefits, a qualitative description of the extent to which the reporting entity could be responsible for the obligations of the plan, and other quantitative information about the plan, such as the total plan assets, the actuarial present value of accumulated plan benefits, and the total contributions received by the plan. If information is not available without undue cost or effort, reporting entities should describe what information was omitted and the reason it was omitted, and provide alternative information to meet the overall disclosure objectives.

Reporting entities should disclose the total contributions, in the aggregate, made to all other multiemployer plans that are not individually significant, and the total contributions, in the aggregate, to all multiemployer plans.

Reporting entities should also provide a description of any significant changes that affect the comparability of total reporting entity contributions from period to period, including from a business combination or divestiture, a change in the reporting entity contribution rate, or a change in the number of employees covered by the plan during the year.

ASC 715-80-55-6 through 55-8 illustrate these disclosure requirements.

13.5.2 *Multiemployer other postretirement plans*

Reporting entities that participate in a multiemployer plan that provides OPEB benefits (such as retiree medical benefits) should disclose the amount of contributions made to the plan, the nature of the benefits provided, and the types of employees covered by these benefits.

Reporting entities should also provide a description of any significant changes that affect the comparability of total reporting entity contributions from period to period, including from a business combination or divestiture, a change in the reporting entity contribution rate, or a change in the number of employees covered by the plan during the year.

13.5.3 *Withdrawal or increase in contribution level is probable or reasonably possible*

If withdrawal from the multiemployer plan would give rise to a liability and the withdrawal is probable, the liability should be accrued. If withdrawal is reasonably possible, disclosure of the possible withdrawal liability should be made. Similar consideration should be given if it is either probable or reasonably possible that a reporting entity's contribution to the plan would increase.

13.6 *Nonretirement postemployment benefits*

A reporting entity that accounts for its nonretirement postemployment benefit plans by analogy to ASC 715 should generally provide the disclosures required by ASC 715, as discussed in FSP 13.3.4, if applicable.

13.6.1 *Termination benefits*

A reporting entity that provides contractual or special termination benefits should disclose a description of the nature of the event giving rise to the benefit, and the cost recognized during the year.

SAB Topic 5.P.4, *Restructuring Charges*, indicates that the SEC staff expect similar disclosures for employee termination benefits, whether those costs have been recognized pursuant to ASC 420, *Exit or Disposal Cost Obligations*, ASC 712, or ASC 715. See FSP 11 for discussion of disclosure requirements associated with exit or disposal costs.

13.6.2 *Other postemployment benefits*

If a reporting entity has a significant obligation for a postemployment benefit cost that was not accrued only because it cannot reasonably be estimated, then a reporting entity should disclose that fact.

13.7 *Considerations for private companies*

This section covers special considerations for private companies and highlights the differences in disclosure requirements from those applicable to public reporting entities.

A "nonpublic entity" is defined in ASC 715 as follows:

Definition from ASC 715-20-20

Any entity other than one with any of the following characteristics:

a. Whose debt or equity securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally

b. That is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets)

c. That makes a filing with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market

d. That is controlled by an entity covered by a., b., or c.

The disclosures for private company defined benefit plans are similar to those of a public reporting entity, except for the following:

Figure 13-3
Differences in disclosure requirements for private companies

Required disclosures for SEC registrants but not private companies	Required disclosures for private companies	Private company reporting reference	Section above where SEC registrant requirements are discussed
Reconciliation of the beginning and ending balances of the benefit obligation and the fair value of plan assets	End of year balances for benefit obligation and fair value of plan assets, employer and participant contributions, and benefits paid	ASC 715-20-50-5a&b	13.3.4.3

Required disclosures for SEC registrants but not private companies	Required disclosures for private companies	Private company reporting reference	Section above where SEC registrant requirements are discussed
Components of net periodic benefit cost	Amount of net periodic benefit cost	ASC 715-20-50-5q	13.3.4.5
One percentage point sensitivity analysis for healthcare cost trend rates	Not applicable	Not applicable	13.3.4.8
Significant change in benefit obligation or fair value of plan assets	Nature and effect of significant nonroutine events	ASC 715-20-50-5m	13.3.4.10
Alternative method used to amortize prior service cost or gains and losses	Not applicable	Not applicable	13.3.4.10
Substantive commitment used as a basis for accounting for benefit obligation	Not applicable	Not applicable	13.3.4.10

Chapter 14: Leases

14.1 Chapter overview

Leasing arrangements take a variety of forms and can include the lease of a single asset or a group of assets. The lease may also be part of a larger overall arrangement.

Lessees classify leases as either operating or capital leases; lessors classify leases as operating, sales-type, direct financing, or leveraged leases. The classification determines presentation and disclosure.

This chapter discusses lessees' and lessors' presentation and disclosure requirements for various types of leases. It also discusses certain arrangements that are leasing transactions in form, but not accounted for as leases, such as sale-leaseback transactions when sale recognition criteria are not met.

14.2 Scope

ASC 840, *Leases*, provides the authoritative guidance for accounting and reporting by both lessees and lessors.

Note about ongoing standard setting

As of the content cutoff date of this publication (August 31, 2014), the FASB has an active project on leases that may affect presentation and disclosure requirements. Financial statement preparers and other users of this publication are therefore encouraged to monitor the status of the project, and if finalized, evaluate the effective date of the new guidance and the implications on presentation and disclosure.

14.3 Lessees

Lessees classify leases as either operating or capital leases.

14.3.1 General disclosure requirements

Regardless of the type of lease, all lessees should disclose a general description of their leasing arrangements, including a description of leasing transactions with related parties. (Related party disclosures are discussed in FSP 26.)

The disclosures should include the significant terms of leasing arrangements, such as the following, if applicable.

- Renewal or purchase options
- Escalation clauses
- Significant penalties and guarantees, such as residual value guarantees
- Basis for determining contingent rental payments

- Restrictions imposed by the agreements, such as against paying dividends

14.3.2 *Operating leases*

In an operating lease, the lessee uses an asset for a period of time but does not obtain substantially all of the benefits or assume substantially all of the risks of owning the asset.

14.3.2.1 *Presentation*

In an operating lease, the lessee does not record a lease obligation or an asset for the right to use the asset on its balance sheet. However, since payments under a lease can vary over its term, the lessee in an operating lease may be required to recognize certain lease-related assets or liabilities. Examples of these items include prepaid or accrued rent, capitalized initial direct costs, and lease incentives received. In a classified balance sheet, the lessee in an operating lease should present these assets and liabilities as current or noncurrent with other prepaid or accrued expenses with similar maturities.

ASC 840-20-45-1 indicates that the lessee in an operating lease should include rental costs in income from continuing operations (as opposed to combining it with interest expense). Reporting entities typically include rent expense with other expenses based on function, such as cost of goods sold or selling, general, and administrative expenses.

14.3.2.2 *Disclosure*

Disclosures required for an operating lease focus primarily on the income statement and the commitments to make future payments under the lease. Example 1 of ASC 840-10-55-40 includes an illustration of a lessee's application of the disclosure requirements for an operating lease.

Scope of disclosures

Inception of an operating lease is the date the terms are agreed to by the parties. Lease commencement is the date the lessee controls the use of the property.

The specific disclosure requirements of ASC 840 apply upon lease commencement. Prior to this date, the lessee should disclose its lease commitment in a manner similar to how it discloses commitments to purchase or construct properties that it will own. See FSP 23 for discussion of commitments and contingencies.

Rental expense

A lessee in an operating lease is required to disclose rental expense for each period for which an income statement is presented, with separate disclosure for minimum rentals, contingent rentals, and sublease rentals.

This disclosure may exclude rental payments under leases with terms of a month or less that were not renewed. For example, assume a construction company rents heavy equipment on a day-to-day basis in an arrangement that may be cancelled by either party at any time. The lessee may exclude those rents from its disclosure of rental expense even if those expenses are significant.

Minimum lease payments

For operating leases that have initial or remaining noncancelable lease terms that are greater than one year, lessees should disclose the minimum rental payments for each of the next five years, and a sum for all years thereafter, followed by a total. The lessee may exclude lease payments that the lessee can avoid at its option. For example, the lessee may exclude rents due in a future extension period even if it is considered part of the lease term. However, if the lessee elects to exclude those rents, it should consider disclosing that fact.

When preparing disclosures of future minimum rental payments, a question may arise as to whether the lessee's disclosure is based on (1) the future cash it is obligated to pay, or (2) the expense it will recognize in the income statement on a straight-line basis. These amounts often differ, since many leases include non-level rents. While both approaches are acceptable, we believe the requirement was intended to reflect future cash payments. As a best practice, a lessee should clarify, for example, that the disclosure is based on contractually required cash payments while expense recognition is based upon a straight-line basis.

For foreign currency transactions, lessees should translate the amount of future minimum rental payments for purposes of the disclosure at the current exchange rate at the balance sheet date.

A lessee should also disclose the total minimum rentals it is entitled to receive under noncancelable subleases, if any, as of the date of the latest balance sheet presented.

Exit obligations

When a lessee stops using a leased asset altogether during the lease term, the transaction may be subject to the accounting and disclosure requirements of ASC 420, *Exit or Disposal Cost Obligations*. See FSP 11 for discussion of disclosures related to restructuring activities.

14.3.3 Capital leases

A lessee in a capital lease has obtained substantially all the benefits or assumed substantially all the risks of ownership of the asset. A capital lease is similar to the financed purchase of an asset.

14.3.3.1 Presentation

Lessees should separately identify the gross amount of assets recorded under capital leases for each period a balance sheet is presented. This can be presented either in the balance sheet or the footnotes.

For capital leases, lessees should also separately identify, in the balance sheet or footnotes, their obligations under capital leases. In a classified balance sheet, a lessee should present the current and noncurrent portions of their capital lease obligations in accordance with its operating cycle.

Since a capital lease is similar to other financed purchases of assets, interest expense is usually presented along with other interest in the income statement. A lessee should either present the amortization of assets under capital lease separately in the income statement, or disclose the amount in the footnotes.

14.3.3.2 Disclosure

Example 1 of ASC 840-10-55-40 includes an illustration of lessee disclosures under capital leases.

Scope of disclosure

As with operating leases, prior to the commencement date, leases are not subject to the specific disclosure requirements of ASC 840, but entities would instead discloses its lease commitment similar to a commitment to purchase or construct properties that it will own. See FSP 23 for discussion of commitments and contingencies.

Classes of capital lease assets

Regardless of whether the capital lease information is presented on the balance sheet or in the footnotes, lessees should present assets recorded under capital leases by major class according to their nature or function (e.g., manufacturing facilities, retail facilities, or transportation equipment), along with the associated accumulated amortization. The lessee may combine this information with other comparable disclosures for owned assets.

Minimum lease payments

The lessee should disclose the future minimum lease payments for each of the next five years, and a sum for all years thereafter, followed by a total. The lessee should subtract amounts representing executory costs included in the rent payment (e.g., maintenance, property taxes and property insurance) from this total to disclose the net minimum lease payments. Further, the lessee should subtract any imputed interest to disclose the present value of net minimum lease payments.

For capital leases, a lessee should also disclose the total minimum rentals it is entitled to receive under noncancelable subleases, if any, as of the date of the latest balance sheet presented.

Contingent rentals

For capital leases, the lessee should disclose contingent rental expense for each period for which an income statement is presented, and disclose where the contingent rent was presented in the income statement.

Interest expense

A lessee in a capital lease often presents interest expense with other interest in the income statement.

Amortization

A lessee in a capital lease should either present the amortization of assets under capital lease separately or disclose the amount in the footnotes.

14.3.4 Sale-leaseback transactions

Sale-leaseback transactions involve the sale of property the seller will continue to use after it has transferred legal ownership of the asset to the buyer. A sale-leaseback transaction is one in which the seller recognizes both a sale and a separate leaseback of the asset sold.

Lessees classify the leaseback of the asset as either an operating or a capital lease. As such, lessees in sale-leaseback transactions apply the presentation and disclosure guidance applicable to the classification of the leaseback, either for an operating or capital lease, addressed in FSP 14.3.2 and 14.3.3, respectively.

14.3.4.1 Presentation

A sale-leaseback transaction typically results in the seller-lessee deferring gains (or losses eligible for deferral). The presentation of the deferred gain (or loss) on the balance sheet depends on whether the lessee classifies the leaseback as a capital lease or as an operating lease.

When the leaseback is classified as a capital lease, the lessee would normally offset the deferred gain (or loss) against (or add it to) the asset.

When the leaseback is classified as an operating lease, the lessee may present the current and noncurrent portions of the deferred gain (or loss) within current or noncurrent liabilities (or assets), as appropriate.

14.3.4.2 Presentation of "failed" sale-leasebacks

Because of the strict accounting guidance applicable to the sale and leaseback of real estate (including integral equipment), these transactions frequently do not qualify for sales recognition. In these "failed" sale-leaseback transactions, the seller-lessee continues to reflect the asset it "sold" on its balance sheet as if it still legally owns the asset. The lessee would typically reflect the sale proceeds received from the buyer-lessor as a financing on its balance sheet, even though the lease might otherwise have been classified as an operating lease had the transaction qualified for sale treatment.

14.3.4.3 Disclosure of "failed" sale-leasebacks

In a failed sale-leaseback transaction, the seller-lessee should provide disclosures similar to any other financing obligation (see FSP 11 for discussion of disclosures related to various liabilities). Additionally, the seller-lessee should describe the terms of the transaction, including future commitments and obligations that arise from the transaction and the circumstances that result in the seller-lessee's continuing involvement with the "sold" asset. For example, if a seller-lessee did not account for a sale leaseback transaction as a sale because they have an option to repurchase the asset at its fair value at a future date, the lessee should disclose that provision as a form of continuing involvement with the asset.

In addition to the disclosures applicable for financing obligations discussed in FSP 12.11, the seller-lessee in a failed sale-leaseback should continue to disclose the five-year data described in FSP 14.3.2.2 for operating leases. That is, the lessee should disclose the lease payments and any lease receipts on non-cancelable subleases associated with the failed sale-leaseback for each of the next five years and all periods thereafter, with a total.

The amounts in the financing and leasing disclosures will differ from how the lessee accounts for these cash payments. In a failed sale-leaseback transaction accounted for as a financing, for example, the lessee will recognize its cash payments as interest and principal payments, whereas the leasing disclosures focus on the gross cash flows.

14.4 Lessors

Lessors may classify leases as operating, sales-type, direct financing leases, or leveraged leases.

14.4.1 General disclosure requirements

Regardless of the type of lease, all lessors should disclose a general description of their leasing arrangements, including a description of leasing transactions with related parties. (FSP 26 addresses disclosures of related party transactions.)

Lessors should also disclose their accounting policy for recognizing contingent rental income. Generally, lessors would not recognize contingent income until the contingency has been resolved. In those atypical situations when a lessor accrues contingent rental income before the lessee achieves a specified target, however, the lessor should disclose the effect on rental income compared to the amount that would have been recognized had contingent rental income been deferred until the specified target is met.

14.4.2 Operating leases

In an operating lease, a lessor transfers the use of an asset to a lessee for a period of time but does not transfer substantially all of the benefits or risks of owning the asset.

14.4.2.1 Presentation

Unlike lessees, lessors reflect assets subject to operating leases on the balance sheet. They report the leased asset either (1) together with their other property, plant and equipment (e.g., within "buildings"), or (2) as a separate line item on the balance sheet (e.g., "assets subject to operating leases"). Property subject to leases may be presented net of accumulated depreciation on the balance sheet, but the accumulated depreciation must either be shown on the face of the balance sheet or disclosed in the footnotes.

For operating leases with scheduled rent increases, the requirement to recognize rental income on a straight-line basis may generate rents receivable or deferred rent revenue on the lessor's balance sheet. Lessors should present such rent receivable or deferred rent with items of similar maturities on a classified balance sheet, for example, with other prepaids associated with long term contracts.

Lessors should present the rental income and depreciation gross in the income statement as revenue and expense, respectively.

14.4.2.2 Disclosure

The disclosure requirements for lessors' operating leases are more extensive than they are for lessees. If leasing is a significant part of a lessor's business activities (as measured by revenue, net income, or assets), a lessor should disclose the following information with respect to their operating leases.

- A general description of the leasing arrangements
- The cost and carrying amount, if different, by major classes of property according to nature or function
- Total accumulated depreciation for leased assets as of the latest balance sheet date
- Minimum future rentals on noncancelable leases as of the latest balance sheet date, in the aggregate and for each of the next five years
- Total contingent rentals included in income for each period for which an income statement is presented

As a best practice, a lessor should clarify whether the disclosure of minimum future rentals is based on actual payments or income recognition, similar to the discussion in FSP 14.3.2.2.

For foreign currency transactions, the amount of future minimum rental payments should be translated at the current exchange rate at the balance sheet date.

Example 1 of ASC 840-10-55-47 includes illustration of the disclosure requirements for lessors under operating leases.

14.4.3 Sales-type leases and direct financing leases

A lessor in a sales-type lease or direct finance lease transfers substantially all of the benefits or substantially all of the risks of ownership of the asset to a lessee. These leases are similar to a financed sale of the asset.

14.4.3.1 Presentation

In sales-type and direct financing leases, the lessor derecognizes the leased property, plant and equipment and recognizes a financing receivable on its balance sheet. The lessor presents this receivable as a separate line item or combined within the same line item as long term financing receivables or similar assets in a classified balance sheet.

The financing receivable is referred to as a "net investment in leased property." This receivable represents the present value of both the minimum lease payments receivable (net of executory costs that may be embedded in the lease payments) and the unguaranteed residual value of the property at the end of the lease (plus any capitalized initial direct costs to originate a direct financing lease). The difference between the gross cash flows and the discounted cash flows is referred to as "unearned income." These amounts are reported on the balance sheet as a single line item.

A lessor should report the amortization of initial direct costs as a component of finance or lease income in accordance with ASC 310, *Receivables*. In other words, the amortization of the initial direct cost is reported in the income statement net, as a reduction of interest income rather than as an expense.

14.4.3.2 Disclosure

If leasing is a significant part of the lessor's business activities (as measured by revenue, net income, or assets), the lessor should disclose the components that make up its net investment in sales-type or direct financing leases. Disclosure includes the following components:

- Future minimum lease payments receivable, with separate deductions for both executory costs (including any profit thereon), and the accumulated allowance for uncollectible minimum lease payments receivable

- The unguaranteed residual values accruing to the benefit of the lessor
- Initial direct costs (for direct financing leases only)
- Unearned income

Minimum lease payments

A lessor of a direct-financing or sales-type lease should disclose future minimum lease payments receivable for each of the next five fiscal years. There is no specific guidance that requires a sales-type or direct financing lessor to disclose (or that prohibits a lessor from disclosing) total minimum lease payments receivable (i.e., including amounts due beyond five years).

Contingent rentals

The sales-type or direct financing lessor should disclose total contingent rentals included in income for each period for which an income statement is presented. They should also describe the terms of their contingent rent arrangements and how and when contingent rents are recognized in income.

Example 1 of ASC 840-10-55-47 includes illustration disclosures of sales-type and direct financing leases.

14.4.4 Leveraged leases

A leveraged lease is a type of a direct finance lease that meets specific criteria. For example, in a leveraged lease, the lessor must obtain substantial nonrecourse financing from a third party. Also, the cash flows to the lessor in a leveraged lease result in a net investment in the lease that declines in the early years of the lease but then increases.

14.4.4.1 Presentation

Leveraged leases are unique in that a lessor presents the investment in the lease on the balance sheet, net of principal and interest owed on the related non-recourse debt. It is one of the few times when accounting guidance requires a reporting entity to net its receivables from one party with its obligations to a different party. Leveraged leases also have a unique revenue recognition pattern that differs from the accounting for other financial assets.

Figure 14-1 illustrates the components of a lessor's investment in a leveraged lease.

Figure 14-1
Components of the investment

The components of a lessor's investment in a leveraged lease include:

- The gross rentals receivable, net of the gross debt (principal and interest payable)
- The estimated future residual value of the leased asset
- The amounts receivable for investment tax credit ("ITC") to be realized on the transaction
- Initial direct costs from originating the lease
- Less: unearned income
- Less: Investment Tax Credit that will be recognized in income in future periods

Classified balance sheet

Presentation of leveraged leases in a classified balance sheet can be challenging because the investment in leveraged leases contains a combination of different cash inflows (e.g., rents receivable) and outflows (e.g., debt service). One of the defining features of a leveraged lease is that its investment balance declines and then rises at least once (and maybe more than once) over the lease term. This could appear to present a "negative" current portion of the investment in leveraged leases in a classified balance sheet. Therefore, an investment in a leveraged lease is typically classified entirely as a noncurrent asset because of the impracticality of separating the investment into current and noncurrent portions.

Deferred taxes

Notwithstanding that a lessor's "investment in leveraged leases" includes ITC, lessors should present deferred taxes related to leveraged leases separately from the investment in leveraged leases on its balance sheet. The lessor may present them separately on the face of the balance sheet or combine them with other deferred taxes. In either case, the lessor should disclose deferred taxes related to leveraged leases separately in the footnotes.

Presentation of the investment tax credit by a leveraged lessor in the income statement

Some lessors report the amortization of ITC on leveraged leases as operating income because they view the ITC amortization as an integral part of their rate of return on the lease financing. Other lessors report it as a component of the income tax provision. The examples included in ASC 840-30-55-29 through 55-38 include ITC amortization in income tax expense. It is also acceptable to reflect ITC amortization as part of pretax income. The elected method should be disclosed and consistently applied.

14.4.4.2 Disclosure

Given the unique accounting characteristics for leveraged leases, they require significant disclosure.

A lessor is required to provide a general description of its leveraged leasing activity. Also, if leveraged leasing is a significant part of the lessor's business activities (in terms of revenue, net income, or assets), the lessor's footnotes should disclose each of the components of the "net investment in leveraged leases," including the deferred taxes related to the leveraged lease (which is not netted against "investment in leveraged leases" on the balance sheet). This disclosure, which is typically presented in a tabular format, usually includes a subtotal of all components of the investment in leveraged leases other than the deferred taxes (which should tie to the "investment in leveraged leases" line item on the balance sheet). Deferred taxes arising from leveraged leases is then subtracted to arrive at a lessor's "net investment in leveraged leases."

A leveraged lease is not subject to the specific disclosure requirements for sales-type or direct financing leases. For example, a lessor of a leveraged lease does not need to disclose a five-year table for minimum rental payments receivable.

ASC 840-30-55-34 includes an example footnote disclosure for investments in leveraged leases.

Deferred taxes

The lessor in a leveraged lease should either present deferred taxes related to leveraged leases separately on the face of the balance sheet or disclose the amount in the footnotes.

The effect of a change in tax law or rates on leveraged leases

The basic model for accounting for taxable temporary differences arising from leveraged leases is governed by ASC 840, rather than by ASC 740. Accordingly, the accounting for a change in tax rates or tax laws may affect leveraged leases in a manner that distorts the usual relationship between income taxes and pretax income. When tax rates or laws change, and the accounting for the change on leveraged leases results in this unusual relationship, ASC 840-30-50-6 requires lessors to disclose the reason for such variation if it is not otherwise clear.

For SEC registrants, ASC 840-30-S99-2 addresses issues relating to the calculation and reporting of adjustments to net investments in leveraged leases required by a change in tax law or rates. In ASC 840-30-S99-2, the SEC noted that it expects leveraged lessors that are SEC registrants to disclose the cumulative effect that the changes in tax laws or rates have on pretax income and income tax expense.

14.5 Considerations for private companies

PCC Issue No. 13-02, *Applying Variable Interest Entity Guidance to Common Control Leasing Arrangements*, permits a private company to elect not to apply VIE guidance for assessing whether it should consolidate a lessor entity when (a) the lessor entity and the private company are under common control, (b) the private company has a leasing arrangement with the lessor entity, and (c) substantially all of the activity between the two entities is related to the leasing activity of the lessor entity. See FSP 18 for discussion of the implications in consolidation, and FSP 26 for discussion of related party transactions.

ASC 840-30-S99-2, related to lessor disclosure of the effect of changes in tax laws or rates on pretax income and income tax expense, applies only to SEC registrants.

Chapter 15: Stock-based compensation

15.1 Chapter overview

This chapter addresses presentation and disclosure considerations related to stock-based compensation awards. It also addresses nonemployee awards, implications for the separate financial statements of a subsidiary, employee stock ownership plans (ESOPs), and considerations for private companies.

For recognition and measurement topics related to stock-based compensation, refer to PwC's accounting and financial reporting guide for *Stock-based compensation guide (2013)*.

15.2 Scope

Stock-based compensation refers to all forms of employee compensation that fall within the scope of ASC 718, *Compensation—Stock Compensation*, including shares, options, and other equity instruments. Liability-classified awards are also within the scope of ASC 718 if they are based, in part, on the price of the reporting entity's stock, or settled through the issuance of equity.

SEC guidance related to stock-based compensation is included in SAB Topic 14, *Share-Based Payment*.

15.3 Presentation

This section discusses presentation requirements and considerations for the balance sheet, income statement, and statement of stockholders' equity. Presentation considerations for the statement of cash flows are discussed in FSP 6.

15.3.1 Balance sheet

Stock-based compensation awards are classified as either equity or liabilities. The criteria (outlined in ASC 718-10-25-6 through 19) for determining whether an award should be classified as equity or liability are complex. Reporting entities should carefully consider the terms of awards when determining whether an award should be equity or liability-classified. ASC 718 describes five types of awards that should be classified as liabilities. All other awards would typically be classified as equity, even if the guidance requires ongoing remeasurement of the award for expense purposes (e.g., nonemployee awards).

The following types of awards should be classified as liabilities:

- An award with conditions or other features that are indexed to something other than a market, performance, or service condition

- An award that meets certain criteria of ASC 480, *Distinguishing Liabilities from Equity*

- A share award with a repurchase feature that permits an employee to avoid the risks and rewards normally associated with stock ownership by allowing the employee to put shares to the reporting entity within six months after the employee vests in the shares; or a share award where it is probable that the employer would prevent the employee from bearing the risks and rewards that are normally associated with stock ownership within six months after share issuance

- An option or similar instrument that could require the employer to pay an employee cash or other assets, unless cash settlement is based on a contingent event that is (a) not probable, and (b) outside the control of the employee

- An option or similar instrument where the underlying stock is classified as a liability

For more on each of these types of awards, refer to SC 1.12.

15.3.1.1 *Short-term versus long-term classification*

A reporting entity should determine whether a liability-classified award is a current or noncurrent liability. A liability-classified award is generally classified as current if a vested award is payable upon demand, or if vesting is expected to occur within one year. All other liability awards are classified as noncurrent.

15.3.2 *Income statement*

Stock-based compensation expense should be included in the same income statement line or lines as the cash compensation paid to the employees receiving the stock-based awards (for example, cost of sales, R&D, or G&A).

Separate line item presentation of stock-based compensation expense in the income statement (for example, a line item titled “noncash compensation”) is not appropriate. However, the SEC staff noted in SAB Topic 14 that a parenthetical note to the respective income statement line items indicating the amount of stock-based compensation expense included therein would be acceptable, as shown in Figure 15-1.

Figure 15-1
Example of stock-based compensation parenthetical presentation

Revenues	$xx
Cost of sales (including noncash compensation of $XX)	xx
Gross margin	xx
Selling expense (including noncash compensation expense of $XX)	xx
General and administrative expense (including noncash compensation expense of $XX)	xx
Research and development expense (including noncash compensation expense of $XX)	xx
Total operating expenses	xx
Income from operations	$xx

The SEC staff has not objected to a footnote presentation on the face of the income statement (as opposed to parenthetical disclosure) indicating the amount of stock-based compensation expense included in each of the respective expense line items. However, a presentation that includes a total of the stock-based compensation expense would not be acceptable.

Other commonly accepted methods of disclosing stock-based compensation expense include footnote disclosure or presenting the total as a line item in the statement of cash flows.

15.3.2.1 Capitalized compensation cost

The guidance uses the term compensation *cost* rather than compensation *expense* to emphasize that an entity could be required to capitalize stock-based compensation under the applicable U.S. GAAP, similar to the treatment of cash compensation. For example, employee costs could require capitalization as:

- Inventory
- Deferred loan origination costs
- Contract accounting assets
- Self-constructed fixed assets
- Capitalized software (internal-use and to be sold, leased, or marketed)

A reporting entity should disclose the total compensation cost that is capitalized as part of the cost of an asset.

15.3.3 Temporary (mezzanine) equity

SEC registrants are required to classify certain awards that qualify for equity classification under ASC 718 as temporary equity, pursuant to ASR 268. This guidance applies if redemption of the award (or underlying shares) is outside of the control of the issuer. This could include awards such as:

- Shares that are redeemable at the employee's discretion after a six-month holding period, or based on contingent events
- Options with underlying shares that are redeemable at the employee's discretion after a six-month holding period, or based on contingent events
- Options with cash settlement features based on contingent events

For information on accounting for awards classified as temporary equity, refer to SC 1.12.14. FSP 5.6.3.1 discusses presentation and disclosure requirements associated with temporary equity.

15.4 Disclosure

ASC 718-10-50-1 establishes four disclosure objectives for stock-based compensation. A reporting entity that has granted stock-based compensation awards to its employees should provide information that enables users of the financial statements to understand the following:

- The nature and general terms of stock-based compensation arrangements outstanding during the period
- The income statement effects of stock-based compensation
- The method of estimating the fair value of stock-based compensation awards
- The cash flow effects of stock-based compensation

ASC 718-10-50-2 specifies the minimum information that a reporting entity should provide in its annual financial statements in order to achieve these objectives. The specific requirements are discussed in the subsections below. In addition, ASC 718-10-55-134 through 137 includes an illustrative example of the disclosure requirements.

Question 15-1

Is a reporting entity required to provide the disclosures outlined in ASC 718 in its interim financial statements?

PwC response

No. The disclosure requirements outlined in ASC 718 are only required in a reporting entity's annual financial statements. However, reporting entities should consider the guidance in ASC 270, *Interim Reporting*, which requires disclosure of significant changes since the last reporting period in interim financial statements (refer to FSP 29). Many reporting entities provide disclosures about stock-based compensation on an interim basis to provide transparency into the activity occurring during the interim period.

15.4.1 Description of awards and methods

A reporting entity should include a description of its stock-based compensation arrangements, including the general terms of the awards. Such disclosure should include the following:

- The requisite service periods and any other substantial conditions, such as vesting conditions
- The maximum contractual term
- The number of shares authorized for awards of options or other equity instruments
- The method (for example, fair value, calculated value, or intrinsic value) used to measure compensation cost

15.4.2 Option and similar awards

A reporting entity that awards stock options or similar awards (such as stock appreciation rights) to its employees should provide a rollforward of activity for the most recent year an income statement is presented. The rollforward should include the number and weighted-average exercise price (or conversion ratios) of the following groups of awards:

- Outstanding at the beginning of the year
- Granted during the year
- Exercised or converted during the year
- Forfeited during the year
- Expired during the year

- Outstanding at the end of the year
- Exercisable or convertible at the end of the year

A reporting entity must also disclose the following for fully vested awards and awards expected to vest, and for fully vested awards currently exercisable (or convertible) at the date of the latest balance sheet:

- The number
- The weighted-average exercise price (or conversion ratio)
- Aggregate intrinsic value
- Weighted-average remaining contractual term

A reporting entity should provide a description of its policy, if any, for issuing shares upon award exercise (or stock unit conversion), including the source of those shares (that is, new shares or treasury stock). If a reporting entity expects to repurchase shares in the following annual period, the reporting entity should disclose an estimate of the number (or range) of shares it will repurchase during that period.

15.4.3 Other awards

A reporting entity that grants its employees awards other than options (for example, restricted stock) should provide a rollforward of activity for the most recent year an income statement is presented. The rollforward should include the number and weighted-average grant-date fair value (or calculated value or intrinsic value, if used) for the following groups of awards:

- Nonvested at the beginning of the year
- Granted during the year
- Vested during the year
- Forfeited during the year
- Nonvested at the end of the year

15.4.4 Fair value disclosure

For each year an income statement is presented, a reporting entity should disclose:

- The weighted-average grant-date fair value (or calculated value or intrinsic value, if used) of equity awards granted during the year

- The total intrinsic value of options exercised (or stock units converted), stock-based liabilities paid, and the total fair value of shares vested during the year

For each year an income statement is presented, a reporting entity should provide a description of the method and significant assumptions used during the year to estimate the fair value (or calculated value, if used) of stock-based compensation awards, including (if applicable):

- Expected term

- Expected volatility

- Expected dividend rate

- Risk-free rate

- Discount for post-vesting restrictions and the method used to estimate it

A reporting entity that uses a valuation method that employs a range of assumptions over the contractual term of an award (e.g., a lattice model) should disclose the range of expected volatilities, dividend rates, and risk-free rates used, and the weighted-average expected volatility and dividend rate.

The guidance does not specify how to disclose the significant assumptions used when a reporting entity grants similar awards at different times throughout the year. Some reporting entities disclose a range of the significant assumptions used, while others disclose a weighted-average amount for each significant assumption.

15.4.4.1 Expected term assumption

A reporting entity's disclosure of expected term should include a discussion of the method used to incorporate the contractual term of the awards and employees' expected exercise and expected post-vesting termination behavior.

A reporting entity that elects to use the simplified method discussed in SAB Topic 14 (Section D.2, question 6) to estimate expected term for its "plain-vanilla" options should disclose its use of the method and why it was selected. Disclosure should also be made of which options were valued using this method if not all options were valued using the same methodology, and the periods in which it was used.

For more discussion of the simplified method, refer to SC 7.2.1.

15.4.4.2 Expected volatility assumption

Reporting entities should disclose how they determined the expected volatility assumption. This could include whether the reporting entity used only implied volatility, historical volatility, or a combination of both, for which time periods, and the respective weighting.

A private company may use the calculated-value method to estimate fair value when sufficient information is not available to estimate expected volatility. This would entail substituting expected volatility with an industry sector index. In this case, a reporting entity should disclose the following:

- The reasons why it is not practicable to estimate expected volatility
- The industry sector index selected and the reasons for selecting it
- How it calculated historical volatility using that index

15.4.4.3 *Change in valuation technique*

Reporting entities may decide to change option-pricing models (for example, from Black-Scholes to a lattice model). A change in option-pricing model is not a change in accounting principle and therefore does not require a preferability letter. However, reporting entities should disclose any changes to the option-pricing model used and the reasons for the change.

15.4.5 *Multiple awards*

A reporting entity that grants awards under multiple employee stock-based compensation arrangements should provide separate disclosures for different types of awards to the extent they have different characteristics. For example, it may be important for a reporting entity to:

- Provide separate disclosure of weighted-average exercise prices (or conversion ratios) at the end of the year for stock options (or stock units) with a fixed exercise price (or conversion ratio) and those with an indexed exercise price (or conversion ratio)
- Segregate the number of stock options (or stock units) not yet exercisable into those that will become exercisable (or convertible) based either (a) solely on fulfilling a service condition, or (b) fulfilling a performance condition
- Provide separate disclosures for awards that are classified as equity and those classified as liabilities

15.4.6 *Impact on financial statements*

A reporting entity should disclosure the impact of stock-based compensation on the financial statements. The disclosures should be made for each year an income statement is presented and should include:

- Total compensation cost for stock-based compensation awards recognized in income, as well as the total related income tax benefit

- Total compensation cost capitalized as part of the cost of an asset
- A description of significant modifications, including the terms, the number of employees affected, and the total incremental compensation cost resulting from the modifications

As of the latest balance sheet date presented, the reporting entity should also disclose the total compensation cost related to nonvested awards not yet recognized, and the weighted-average period over which it is expected to be recognized.

Question 15-2

Should a reporting entity reflect expected forfeitures in the disclosure of the total compensation cost related to nonvested awards not yet recognized?

PwC response

Yes. We would expect a reporting entity to disclose the amount of compensation expense it expects to record in future periods, which would reflect an estimate of awards not expected to vest (that is, estimated forfeitures).

If not separately disclosed elsewhere (for example, in the statement of cash flows), the reporting entity should also disclose the following for the most recent income statement year presented:

- Cash received from the exercise of stock options and similar awards
- Tax benefits realized from exercised stock options and similar awards
- Cash used to settle equity instruments granted under stock-based compensation awards

15.5 Separate financial statements of a subsidiary

In some situations, employees of a reporting entity receive stock-based awards from the reporting entity's parent, or an entity under common control. The reporting entity typically recognizes compensation cost in its financial statements if the awards were issued for services to the reporting entity. For example, if employees of Subsidiary A receive shares of the parent entity for services provided to Subsidiary A, Subsidiary A should recognize compensation cost with an offsetting entry to equity, representing a capital contribution from the parent. For more information on the accounting implications, refer to SC 1.6.4.

A reporting entity that recognizes stock-based compensation in its separate financial statements for stock-based awards of the parent, or an entity under common control granted to its employees, should disclose the information required by ASC 718, as summarized in FSP 15.4 above. These disclosures should include only information about awards granted to the reporting entity's employees.

15.6 Non-employee awards

Stock-based compensation awards granted to non-employees are subject to the measurement and presentation guidance in ASC 505-50, *Equity-Based Payments to Non-Employees*. A reporting entity that grants awards to non-employees should provide similar disclosure as those required by ASC 718 if that information is important to understanding the effects of the transaction on the financial statements.

ASC 505-50-S99-1 addresses the balance sheet presentation of arrangements where a reporting entity issues unvested, forfeitable equity instruments to a non-employee as consideration for future services. In this scenario, the fair value of such equity instruments should not create equity until the future services are received (i.e., the instruments are not considered "issued" for accounting purposes until they vest). Consequently, there should be no accounting recognition for these instruments at the grant date, even if a measurement date has occurred (e.g., due to the existence of a performance commitment). The reporting entity should instead record costs and equity over the period the services are received.

Refer to SC 1.6 for guidance on whether an individual is an employee or non-employee.

15.7 Employee stock ownership plans (ESOPs)

An ESOP is a stock bonus plan that is designed to facilitate employee investment in the reporting entity's stock. ESOP plans can be non-leveraged or leveraged.

A reporting entity (sponsor) with a non-leveraged ESOP contributes cash to the ESOP to purchase the sponsor's stock, or contributes its stock directly to the ESOP. A leveraged ESOP borrows funds from a lender to purchase the sponsor's shares. The sponsor generally guarantees the loan or otherwise commits, directly or indirectly, to make contributions and/or pay dividends to the ESOP. As an alternative to borrowing funds from a lender, the sponsor may directly loan funds to the ESOP. Sponsor contributions and, in most instances, dividends on the stock held by the ESOP, are used by the ESOP to service the debt.

15.7.1 Presentation

For non-leveraged ESOPs, when contributions are made and shares are purchased in the ESOP, common stock or additional paid-in capital are credited to the sponsor's equity accounts.

For leveraged ESOPs, sponsors should report the issuance of new shares or the sale of treasury shares to the ESOP, or external purchase of shares by the ESOP, when the issuance, sale, or purchase occurs, and should report a corresponding charge to "unearned ESOP shares," a contra-equity account. Sponsors should credit "unearned ESOP shares" as the shares are committed to be released, based on the cost of the shares to the ESOP.

Sponsors should report loans from outside lenders to their leveraged ESOPs as liabilities on their balance sheets and should report the related interest cost on the debt in their income statements. Sponsors with internally leveraged ESOPs (employer loans) should not report the loan receivable from the ESOP as an asset and should not report the ESOP's debt as a liability, or recognize interest income or cost on the sponsor loan.

Question 15-3

Under what circumstances should all or a portion of stock with a put option or a mandatory cash redemption feature held by an ESOP be classified outside of permanent equity in the sponsor's balance sheet?

PwC response

If there are conditions (regardless of their probability of occurrence) where holders of equity securities (that is, ESOP participants) may demand cash in exchange for their securities, an SEC registrant must reflect the maximum possible cash obligation related to those securities outside of permanent equity, in accordance with ASR 268. This is true regardless of whether the underlying shares have been allocated to participants.

Where the cash obligation relates only to a market value guarantee feature (that is, a cash feature equivalent to the amount by which the "floor" exceeds the common stock market price as of the reporting date), reporting entities are permitted to classify only that portion of the obligation outside of permanent equity.

Alternatively, a reporting entity could classify the entire guaranteed value amount outside of permanent equity (for example, in situations where there is uncertainty as to the ultimate cash obligation due to a possible market value decline in the underlying security).

15.7.2 Disclosure

Reporting entities that sponsor ESOPs should provide the disclosures described in ASC 718-40, *Employer Stock Ownership Plans*, as applicable. These include:

Excerpt from ASC 718-40-50

a. A description of the plan, the basis for determining contributions, including the employee groups covered, and the nature and effect of significant matters affecting comparability of information for all periods presented. For leveraged employee stock ownership plans and pension reversion employee stock ownership plans, the description shall include the basis for releasing shares and how dividends on allocated and unallocated shares are used.

b. A description of the accounting policies followed for employee stock ownership plan transactions, including the method of measuring compensation, the classification of dividends on employee stock ownership plan shares, and the treatment of employee stock ownership plan shares for earnings per share (EPS) computations. If the employer has both old employee stock ownership plan shares for which it does not adopt the guidance in this Subtopic and new employee stock ownership plan shares for which the guidance in this Subtopic is required, the accounting policies for both blocks of shares shall be described.

c. The amount of compensation cost recognized during the period.

d. The number of allocated shares, committed-to-be-released shares, and suspense shares held by the employee stock ownership plan at the balance-sheet date. This disclosure shall be made separately for shares accounted for under this Subtopic and for grandfathered employee stock ownership plan shares.

e. The fair value of unearned employee stock ownership plan shares at the balance-sheet date for shares accounted for under this Subtopic. (Future tax deductions will be allowed only for the employee stock ownership plan's cost of unearned employee stock ownership plan shares.) This disclosure need not be made for old employee stock ownership plan shares for which the employer does not apply the guidance in this Subtopic.

f. The existence and nature of any repurchase obligation, including disclosure of the fair value (see paragraph 718-40-30-4) of the shares allocated as of the balance sheet date, which are subject to a repurchase obligation.

g. The amount and treatment in the EPS computation of the tax benefit related to dividends paid to any employee stock ownership plan, if material.

ASC 718-40-55-9 and 55-20 provide illustrative examples of ASC 718-40-50's disclosure requirements.

15.8 Considerations for private companies

This section addresses presentation and disclosure considerations for private companies. ASC 718 defines a "public entity" as an entity that (1) has equity securities that trade on a public market (domestic or foreign), (2) files an initial prospectus in preparation to sell equity securities, or (3) is controlled by an entity that meets either of the first two criteria. Therefore, an entity with only publicly traded debt securities is a private company under ASC 718, but a subsidiary of an entity with publicly traded equity is considered a public entity itself.

The presentation and disclosure guidance in this chapter is generally applicable to both public and private companies. A private reporting entity that measures awards based on calculated value or intrinsic value should provide the disclosures in FSP 15.4 based on that measure. Additionally, private reporting entities are not required to disclose the aggregate intrinsic value for fully vested awards and awards expected to vest, or for fully vested awards currently exercisable, as discussed in FSP 15.4.2.

Although only SEC registrants are required to classify certain ASC 718 awards as temporary equity, as described in FSP 15.3.3 and 15.7.1, it is also preferable for private reporting entities to present these awards in temporary equity.

15.8.1 Disclosures in periods prior to an initial public offering

The AICPA accounting and valuation guide *Valuation of Privately-Held-Company Equity Securities Issued as Compensation* (AICPA guide) provides both valuation and disclosure best practices related to the issuance of privately-held-company equity securities as compensation, including awards that are within the scope of ASC 718. The AICPA guide recommends that private companies include information about stock-based compensation awards granted within 12 months of an initial public offering (in addition to the disclosures required by ASC 718).

Excerpt from AICPA guide, Chapter 14, *Accounting and Disclosures*

a. For each grant date, the number of equity instruments granted, the exercise price and other key terms of the award, the fair value of the common stock at the date of grant, and the intrinsic value, if any, for the equity instruments granted (the equity instruments granted may be aggregated by month or quarter and the information presented as weighted average per share amounts)

b. Whether the valuation used to determine the fair value of the equity instruments was contemporaneous or retrospective

Chapter 16: Income taxes

16.1 Chapter overview

This chapter discusses the presentation and disclosure requirements of ASC 740, *Income Taxes*, and the applicable SEC requirements (primarily S-X 4-08(h)). The presentation and disclosure requirements associated with income taxes are extensive, and certain aspects can be complicated. This chapter is organized in the following manner:

- Balance sheet presentation and disclosures for deferred tax accounts
- Income statement presentation and related disclosures
- Disclosures for uncertain tax positions
- Disclosures related to other specific topics affecting income taxes

16.2 Scope

ASC 740 applies to all domestic and foreign reporting entities that pay taxes based on income. The ASC Master Glossary defines income taxes as "domestic and foreign federal (national), state, and local (including franchise) taxes based on income." However, beyond that definition, U.S. GAAP does not provide further guidance on the term "taxes based on income," nor does it specify what characteristics differentiate taxes based on income from taxes that are based on something other than income.

Some taxes are structured such that they meet the definition of an income tax from a legal perspective. However, the legal definition of a tax structure (as an income tax or some other type of tax) is not determinative when evaluating whether the income tax guidance is applicable. We believe that a tax based on income is predicated on a concept of income less allowable expenses incurred to generate and earn that income. That said, a tax structure need not include all income statement accounts in order to be considered an income tax. For example, a tax on a subset of the income statement, such as a tax on net investment income (i.e., investment income less investment-related expenses), would also appear to be a tax on income, since it employs a net income concept. In general, practice has been that "taxes based on income" could apply to tax structures even if revenues or receipts are reduced by only one category of expense.

16.3 Balance sheet presentation of deferred tax accounts

Deferred tax assets and liabilities are a function of temporary differences between the reporting entity's accounting and tax carrying value, and the enacted current and anticipated income tax rate. A deferred tax asset on a reporting entity's balance sheet reflects the fact that the reporting entity will pay less income tax in the future because of a transaction that took place in the current period. Deferred tax assets can arise due to expenses being recorded for book accounting purposes prior to the point at which they are allowed to be deducted for tax purposes, or because income is recognized for tax purposes prior to the recognition for book accounting. They can also arise due to tax attributes such as net operating losses and tax credit carryovers.

A deferred tax liability reflects the fact that the reporting entity will pay more income tax in the future because of a transaction that took place during the current period. Deferred tax liabilities can arise when income is recorded for book accounting purposes prior to the point at which it is recorded for tax purposes. Alternatively, they can arise when expenses are deducted for tax purposes prior to their recognition for book accounting.

Deferred tax balances often result from temporary differences that relate to a particular asset or liability. A temporary difference is related to an asset or liability if reduction of the asset or liability causes the temporary difference to reverse. A "reduction" includes amortization, sale, or other realization of an asset and amortization, payment, or other satisfaction of a liability.

Reporting entities must determine the appropriate classification of deferred tax accounts on the balance sheet. Specific guidance includes ASC 740-10-45-4 through ASC 740-10-45-10.

16.3.1 Principles of balance sheet classification

Reporting entities should show deferred tax assets and liabilities separately from income taxes payable or receivable on the balance sheet. Deferred tax assets and liabilities must be classified as current or noncurrent if presenting a classified balance sheet. They should receive the same classification as the financial statement asset or liability that gave rise to the deferred tax asset or liability.

For classification purposes, deferred tax assets and liabilities related to temporary differences of financial statement assets and liabilities do not consider when a temporary difference is expected to reverse. For example, temporary differences related to inventory and vacation accruals should be classified as current because these balances are current in the financial statements. Likewise, the entire temporary difference related to property, plant, and equipment should be classified as noncurrent. This presentation mirrors the classification of the underlying asset on the financial statements and ignores the fact that a portion of the temporary difference may reverse in the current year as a result of depreciation.

Deferred tax balances can also arise from temporary differences that are not related to financial statement assets and liabilities. Common examples include:

- Operating loss or tax credit carryforwards
- Organizational costs expensed for financial reporting, but deferred for tax return purposes

- Long-term contracts accounted for using the percentage-of-completion method for financial reporting purposes, but using the completed contract method for tax purposes

- Unremitted earnings of a foreign subsidiary that are not considered indefinitely reinvested

These types of deferred tax assets and liabilities should be classified in the balance sheet based on their expected reversal date (i.e., the year in which the temporary difference reversal or carryforward is expected to affect the amount of taxes payable or refundable). If a deduction or carryforward is expected to expire unused, it should be classified as noncurrent. In certain instances, there could be both a current and noncurrent portion related to a temporary difference that arises from something other than a financial statement asset or liability (e.g., a tax credit or net operating loss where a portion will be used in one year and the balance over a longer period).

16.3.2 Balance sheet classification of valuation allowances

Reporting entities are required to record a valuation allowance to reduce the measurement of deferred tax assets when it is more likely than not that such assets will not be realized. When reporting entities have recorded valuation allowances against net deferred tax assets and carryforwards, they must determine the appropriate classification of the valuation allowance.

ASC 740-10-45-5

The valuation allowance for a particular tax jurisdiction shall be allocated between current and noncurrent deferred tax assets for that tax jurisdiction on a pro rata basis.

The pro rata allocation is performed on a gross basis (i.e., before the netting of deferred tax assets and deferred tax liabilities). This often differs from an allocation based on specific identification of the deferred tax assets and carryforwards, and can produce unusual or unexpected results. For example, a reporting entity may require a valuation allowance for particular deductible differences or carryforwards for which the deferred tax assets are classified as noncurrent. Despite this, the valuation allowance is not allocated to the specifically identified noncurrent deferred tax assets. Instead, a portion of the valuation allowance is allocated on a pro rata basis to any current deferred tax assets.

An unusual outcome could also result if a reporting entity records a valuation allowance to reserve its entire net deferred tax asset. The following example illustrates the pro rata allocation of the valuation allowance.

EXAMPLE 16-1

Pro rata allocation of a valuation allowance

FSP Corp has current deferred tax assets of $100, noncurrent deferred tax assets of $200, current deferred tax liabilities of $200, and noncurrent deferred tax liabilities of $40. All of FSP Corp's tax assets and liabilities are within one tax jurisdiction. This results in a net deferred tax asset of $60 prior to consideration of the need for a valuation allowance. FSP Corp's taxable temporary differences are expected to reverse in a similar manner as its deductible temporary differences and, therefore, assure the realization of its deferred tax assets to the extent of the deferred tax liabilities. With respect to its net deferred tax asset, in light of significant negative evidence, including a three-year cumulative loss, FSP Corp has recorded a valuation allowance of $60 to reduce its net deferred tax asset to zero.

How should FSP Corp classify its valuation allowance?

Analysis

FSP Corp should allocate its valuation allowance to its current and noncurrent deferred tax assets on a pro rata basis. As one-third of its gross deferred tax assets are current and two-thirds are noncurrent, this will result in one-third of the valuation allowance, or $20, being allocated to current deferred tax assets and two-thirds of the valuation allowance, or $40, being allocated to noncurrent deferred tax assets. As a result, FSP Corp should present on its balance sheet a net current deferred tax liability of $120 and a net noncurrent deferred tax asset of $120.

The following table summarizes the supporting computations and amounts presented on the balance sheet:

	Amount	Percentage	Total valuation allowance	Allocated valuation allowance
Current deferred tax asset	$100	33%	$60	$20
Noncurrent deferred tax asset	200	67%	60	40
Total deferred tax asset	$300			$60

	Current	Noncurrent
Deferred tax asset	$100	$200
Valuation allowance	(20)	(40)
Net deferred tax asset	$80	$160
Deferred tax liability	200	40
Amounts presented on the balance sheet		
Net current deferred tax liability	$120	
Net noncurrent deferred tax asset		$120

Note: If FSP Corp operated in multiple jurisdictions, a separate allocation would be required for each jurisdiction.

16.3.3 Offsetting and multiple jurisdictions

Reporting entities are required to offset all current deferred tax assets and liabilities within a single tax jurisdiction and present them as a single amount. Similarly, they should also offset all noncurrent deferred tax assets and liabilities within a single tax jurisdiction and present them as a single amount. Current and noncurrent deferred tax assets and liabilities of different tax-paying entities or different jurisdictions cannot be netted. A classification exercise must be completed for each applicable tax-paying entity in each tax jurisdiction. Accordingly, in a single balance sheet, deferred taxes may appear under four different classifications: current asset, current liability, noncurrent asset, and noncurrent liability.

The following example illustrates the classification of deferred tax balances between current and noncurrent.

EXAMPLE 16-2

Balance sheet classification of deferred tax accounts for each tax-paying component within each tax jurisdiction

FSP Corp carries out its operations through two separate tax-paying components (Subsidiary A and Subsidiary B) within two tax jurisdictions (Germany and Japan). There are no intercompany transactions between the two subsidiaries and no ability to file consolidated tax returns. Subsidiary A and Subsidiary B have the following deferred tax assets and liabilities at year-end:

	Germany		Japan	
	Sub A	Sub B	Sub A	Sub B
Current deferred tax assets	$50	$130	$75	$90
Noncurrent deferred tax assets	—	95	45	80
Total deferred tax assets	50	225	120	170
Current deferred tax liabilities	$(90)	$(30)	$(55)	$(130)
Noncurrent deferred tax liabilities	(60)	(110)	(20)	(60)
Total deferred tax liabilities	(150)	(140)	(75)	(190)

How should FSP Corp classify its deferred tax assets and liabilities?

Analysis

For purposes of presenting FSP Corp's consolidated balance sheet, Subsidiary A's current deferred tax assets and liabilities for Germany should be offset and presented as a single net liability ($40). Similarly, Subsidiary A's noncurrent deferred tax assets and liabilities for Germany should be offset and presented as a single net liability ($60). Separate analyses should be performed for Subsidiary A's deferred tax assets and liabilities in Japan, Subsidiary B's deferred tax assets and liabilities in Germany, and Subsidiary B's deferred tax assets and liabilities in Japan. As a result, FSP Corp should present its deferred tax assets and liabilities under four different classifications in its year-end consolidated balance sheet:

	Germany		Japan		
	Sub A	Sub B	Sub A	Sub B	Consolidated
Net current deferred tax assets	$ —	$100	$20	$ —	$120
Net noncurrent deferred tax assets	—	—	25	20	55
Net current deferred tax liabilities	(40)	—	—	(40)	(80)
Net noncurrent deferred tax liabilities	(60)	(15)	—	—	(75)

Question 16-1

A consolidated reporting entity operates in a jurisdiction that does not allow tax consolidation. However, the jurisdiction does have annual elective group relief provisions for affiliated members, where a member with a loss for tax purposes may shift its loss to an affiliate that can use the loss to offset taxable income. Is netting of the deferred tax balances permitted for balance sheet presentation in the consolidated financial statements?

PwC response

A reporting entity must first determine whether the affiliated members are considered a single tax-paying component. We believe that the determining factors for this classification are (1) whether the taxing authorities can pursue one subsidiary for the other's income tax liabilities, and (2) whether the election allows for offset in all cases (e.g., whether it allows carryback or carryforward of losses among affiliated members). If the taxing authority can pursue one subsidiary for the other's income tax liabilities and if offset is unconditionally available, the affiliated members would be considered, in substance, a single tax-paying component, which would make offsetting appropriate. However, if both of these conditions are not met, the affiliated members should be considered separate tax-paying components. As such, the deferred tax balances should not be offset, irrespective of whether the reporting entity plans to avail itself of the group relief provisions.

16.4 Disclosures related to balance sheet tax accounts

ASC 740-10-50-2 through 50-8 and ASC 740-30-50-2 require disclosures related to balance sheet deferred tax accounts, which are discussed in the following subsections.

16.4.1 Gross deferred tax assets and gross deferred tax liabilities

Reporting entities are required to disclose total deferred tax assets and total deferred tax liabilities for each period a balance sheet is presented. Balances disclosed should exclude deferred tax charges related to intercompany transactions, and deferred tax credits arising from leveraged leases. Taxes paid on an intercompany transaction accounted for as an exception to the general principles under ASC 740-10-25-3(e) are different from deferred tax assets recognized. The prepaid tax from an intercompany transfer represents an asset resulting from a past event for which the tax effect is simply deferred. Refer to TX 2.3.4 for more information on taxes related to intercompany transfers.

16.4.2 Valuation allowance and the net change in the valuation allowance

Reporting entities must disclose the total valuation allowance and the net change in the valuation allowance for each period a balance sheet is presented.

Judgment about future taxable income often enters into the determination of the valuation allowance. In such cases, management should consider disclosing the extent to which realization of the tax assets depends on such future taxable income. In some cases, SEC comment letters have indicated that certain incremental disclosures with respect to deferred tax assets are required. The SEC staff has emphasized the need to provide disclosures regarding the relevant positive and negative factors considered when assessing the realization of deferred tax assets, such as sustained pretax profitability. The SEC staff also expects ample forewarning regarding any future valuation allowance release. Refer to FSP 24 for discussion of disclosure requirements associated with significant estimates.

Question 16-2

Deferred tax assets and related valuation allowances are generally required to be presented gross in the footnotes. Is it appropriate to write off deferred assets when realization is remote?

PwC response

In certain limited situations, it may be appropriate to write off a deferred tax asset against the related valuation allowance. The effect is to reduce the amounts of disclosed gross deferred tax assets and valuation allowance. A write off might be appropriate, for example, if a reporting entity has a loss carryforward that has not yet expired in a tax jurisdiction where it no longer conducts business. There are certain carryforwards (e.g., Alternative Minimum Tax (AMT) and foreign tax-credit carryforwards) where the likelihood of utilization is extremely remote because of a reporting entity's particular facts and circumstances. In those instances, we believe it is acceptable to write off the deferred tax asset against the valuation allowance, thereby eliminating the need to disclose the gross amounts.

If limitations caused by a change in ownership (e.g., IRC Section 382) preclude the use of a portion of a carryforward or a deductible difference, writing off the deferred tax asset against the valuation allowance is considered appropriate. If carryforwards and built-in losses are subject to the same aggregate limitation, the estimate of the "permanent" loss of tax benefits should be reflected as an unallocated reduction of gross deferred tax assets.

As with many other areas of ASC 740, determining when a direct write off of the deferred tax asset is appropriate (rather than recording a valuation allowance) requires judgment and careful consideration of the relevant facts and circumstances.

16.4.3 The tax effect of each type of temporary difference and carryforward that gives rise to deferred tax assets and liabilities

Disclosure requirements regarding temporary differences and carryforward information differ between public entities (as defined by ASC 740) and private companies. Public entities must disclose the approximate tax effect of each type of significant temporary difference and tax carryforward that comprises deferred tax assets and liabilities (before allocation of valuation allowances). ASC 740 does not impose a "bright line" for determining which types of temporary differences are significant and, therefore, this assessment requires judgment. As a practical benchmark, we believe that a particular type of temporary difference should be considered significant if its deferred tax effects equal five percent or more of either total deferred tax assets (before valuation allowance) or total deferred tax liabilities, whichever is greater.

A private company is not required to provide numeric information regarding the types of temporary differences and carryforwards that give rise to significant deferred tax assets and liabilities. However, a private company must disclose the nature of significant items.

16.4.4 The amounts and expiration dates of loss and tax credit carryforwards

Reporting entities should disclose the nature and potential effects of any tax law provision that might limit the availability or utilization of loss or tax credit carryforward amounts (e.g., limitations caused by changes in ownership).

In the United States, for both regular tax and AMT, there is an annual limitation under IRC Section 382 on the use of loss and other carryforwards, and of certain built-in losses. The annual limitation exists if there has been a cumulative change in ownership of more than 50 percent within a three-year period.

Triggering the annual limitation could result in a permanent loss of potential tax benefits (e.g., when an entire carryforward cannot be utilized prior to its expiration because of the annual limitation). In this situation, the reporting entity should reduce the recorded deferred tax asset and the amount of carryforward disclosed. It may also be appropriate for reporting entities to disclose the fact that an annual limitation exists so that financial statement users understand the timeframe over which carryforwards can be used and the effect the limitation has on cash taxes each year.

The rules for computing a change in ownership are complex. It is possible for the limitation to apply to an entity that is not an acquired entity in a business combination. The limitation could be triggered, for example, by exercises of stock options, conversions of convertible debt or preferred stock, new common stock offerings, or treasury share purchases.

Unless the prospect of such a change in ownership is remote, we recommend disclosing the potential limitation in all circumstances by means of a brief statement such as: "If certain substantial changes in the entity's ownership occur, there would be an annual limitation on the amount of the carryforward(s) that can be utilized."

If there are circumstances that make the change in ownership reasonably possible in the foreseeable future, a general description of those circumstances may be warranted. More specific disclosures concerning the limitation should be made if the triggering event is probable. Some examples of circumstances that might warrant such disclosure include a planned public offering or outstanding convertible debt with an exercise price that is below market.

Regulated investment companies may need to consider additional disclosures prescribed by ASC 946-740-55-2.

16.4.5 Temporary differences for which a deferred tax liability has not been recognized

In certain situations, reporting entities might not record a deferred tax liability for specific temporary differences. This can occur, for example, when the reporting entity asserts it will indefinitely reinvest the earnings of foreign subsidiaries/corporate joint ventures back into those foreign entities and will not repatriate the earnings back to the parent. In these situations, the following disclosures are required:

- A description of the types of temporary differences and the types of events that would cause those differences to become taxable

- The cumulative amount of each type of temporary difference

- Temporary differences related to investments in foreign subsidiaries and foreign corporate joint ventures. This disclosure should include, but is not limited to, unremitted earnings and cumulative translation adjustments, and the amount of unrecognized deferred tax liability if it is determined that disclosure of an amount is practicable, or a statement that a determination is not practicable. SEC staff comment letters have focused on required disclosures in this area. In certain instances, they have asked reporting entities to explain and disclose specifically why an estimate is not practicable if not provided.

- The amount of any unrecognized deferred tax liability for each type of temporary difference (e.g., unremitted domestic corporate joint venture earnings prior to the 1993 effective date of ASC 740), excluding temporary differences related to investments in foreign subsidiaries and foreign corporate joint ventures. No disclosure is required for unremitted earnings of domestic subsidiaries if such earnings are not a temporary difference. This is because the parent expects to recover the outside basis in a tax-free manner. In addition, earnings that arose prior to the mandatory effective date of ASC 740, which would have been a temporary difference exception "grandfathered" by the standard, do not require disclosure.

For foreign subsidiaries and corporate joint ventures, the disclosures apply to unremitted earnings and, if applicable, to the entire excess book-over-tax outside basis. For more information on unremitted earnings and outside basis differences, see TX 11.

If it is at least reasonably possible that within one year there will be a change in either a reporting entity's indefinite reversal assertion or in the expected method of recovery of the investment in a domestic subsidiary, disclosure under the risks and uncertainties guidance of ASC 275-10-50-9 may be required. See FSP 24.

In comment letters, the SEC staff has asked reporting entities to describe the types of events that would trigger a tax on foreign earnings. Typical events that could trigger a tax might include:

- U.S. acquisitions or other investments, stock buybacks, and shareholder dividends to be funded by cash distributions or loans from foreign subsidiaries
- Certain foreign corporate restructurings or reorganizations
- A decision to exit a particular business or jurisdiction leading to a sale of stock to a third party
- Anticipated tax law changes that are considered unfavorable and would result in higher taxes on repatriations that occur after the change in tax law goes into effect

The SEC staff also considers the consistency between a reporting entity's MD&A disclosures of liquidity and capital resources, and its indefinite reinvestment assertions related to foreign earnings. For example, a reporting entity's MD&A might describe a business situation that necessitates significant cash, but the entity does not appear to have sufficient domestic cash available. The reporting entity's foreign subsidiaries may have sufficient cash to fund the parent, but the parent has asserted indefinite reinvestment of those funds. Such a situation may raise a question of whether it is still reasonable to assert that the parent will not repatriate some of the earnings generated by the foreign subsidiaries. The staff's comments emphasize the need to provide accurate, transparent, and plain-English disclosures of significant assertions and estimates, including those associated with undistributed foreign earnings.

16.4.6 Other required disclosures

There are additional required balance sheet disclosures for deferred tax accounts, which include:

- The nature and effect of any significant matters affecting comparability of information for all periods presented (unless otherwise evident from other disclosures)
- Any portion of the valuation allowance for deferred tax assets for which subsequently recognized tax benefits will be credited directly to contributed capital

- The amount of income tax expense or benefit allocated to each component of other comprehensive income, including reclassification adjustments, either on the face of the statements in which those components are displayed or in footnotes, as required by ASC 220-10-45-12. See FSP 4.4.1 for further discussion of these presentation options.

16.5 Income statement presentation

Total income tax expense or benefit for the year generally equals the sum of total income tax currently payable or refundable (i.e., the amount calculated in the income tax return) and the total deferred tax expense or benefit. This section discusses the appropriate presentation of income tax expense or benefit items in the financial statements.

16.5.1 Deferred tax expense or benefit

The total deferred tax expense or benefit for the year generally equals the change between the beginning-of-year and end-of-year balances of deferred tax accounts on the balance sheet (i.e., assets, liabilities, and valuation allowance). In certain circumstances, however, the change in deferred tax balances is reflected in other accounts. For example, some adjustments to deferred tax balances are recorded through other comprehensive income, such as balances related to pensions or available-for-sale investments. Other circumstances are described below.

When a business combination has occurred during the year, deferred tax liabilities and assets, net of the valuation allowance, are recorded at the date of acquisition as part of the purchase price allocation. When a single asset is purchased, the tax effect is generally recorded as an adjustment to the book carrying amount of the related asset.

Adjustments to uncertain tax positions made subsequent to the acquisition date of a business combination are recognized in earnings, unless they qualify as measurement period adjustments. See TX 10.5.5 for a discussion of evaluating whether an adjustment within the measurement period relates to circumstances that were included in the acquirer’s assessment at the date of the acquisition.

Other changes in the deferred tax balances, including those resulting from foreign currency exchange rate changes, may not be classified as a tax expense or benefit. When the U.S. dollar is the functional currency, revaluations of foreign deferred tax balances are reported as transaction gains and losses or, if considered more useful, as deferred tax benefit or expense, as described in ASC 830-740-45-1. When the foreign currency is the functional currency, revaluations of foreign deferred tax balances are included in cumulative translation adjustments. The revaluations of the deferred tax balances are not identified separately from revaluations of other assets and liabilities.

16.5.2 *Interest and penalties*

In accordance with ASC 740-10-45-25, the decision as to whether to classify interest as a component of income tax expense or interest expense is an accounting policy election. Penalties are also allowed to be classified as a component of income tax expense or another expense classification (e.g., selling, general & administrative expense) depending on the reporting entity's accounting policy.

Reporting entities are required to disclose their policy and the amount of interest and penalties charged to expense in each period, as well as the amounts accrued on the balance sheet for interest and penalties. Any change in the classification of interest or penalties is a change in accounting principle subject to the requirements of ASC 250, *Accounting Changes and Error Corrections*, and therefore must be a change to a preferable accounting method.

Although ASC 740 does not provide guidance on the balance sheet classification of accrued interest and penalties, we believe that it should be consistent with the income statement classification. If the reporting entity's accounting policy election is to classify interest and penalties as "above the line" income statement items (i.e., included in pretax income or loss), the accrued balance sheet amounts should not be included with the balance sheet tax accounts. Instead, they should be included with accrued interest and/or other accrued expense.

ASC 740 is also silent on the classification of interest income received as it relates to income taxes. We believe that the classification of interest income should be consistent with the reporting entity's treatment of interest expense (i.e., either as a component of tax expense or as a pretax income line item).

Questions may arise as to whether the disclosure of total tax-related interest should be net of any interest income and of any potential tax benefit associated with an interest deduction. We believe that interest expense should be disclosed on a gross basis. However, if a reporting entity also wishes to disclose the amount of interest income it recorded in connection with tax overpayments, and any tax benefits generated from interest deductions, it would not be precluded from doing so.

16.5.3 *Professional fees*

Reporting entities often incur professional fees working with attorneys or accountants in their efforts to minimize income tax payable (e.g., implementing tax strategies, resolving tax contingencies, or defending tax strategies). These fees do not represent payments to taxing authorities and therefore should not be classified in the income statement as income tax expense or benefit.

16.5.4 *Change in tax laws, rates, or status*

Reporting entities should include adjustments to deferred tax balances related to enacted changes in tax laws, tax rates, or tax status in income from continuing operations, regardless of whether the deferred tax balances originated from charges or credits to another category of income (e.g., discontinued operations or other comprehensive income).

Occasionally, rate changes are enacted with retroactive effects. ASC 740-10-30-26 specifies that the current and deferred tax effects of items not included in income from continuing operations that arise during the current year, but before the date of enactment, should be adjusted to reflect the rate change as of the enactment date. The adjustment should be reflected in income from continuing operations.

Example 16-3 illustrates the application of a change in tax law and how this presentation is affected by intraperiod allocation:

EXAMPLE 16-3

Presentation of the effects of a tax law change when prior year results are restated for discontinued operations

In the prior year, a provincial tax law was enacted in Germany, which resulted in a charge to FSP Corp's consolidated financial statements. This effect was appropriately recorded in tax expense from continuing operations in the financial statements for that fiscal year. In the current year, FSP Corp agrees to sell all of its operations in Germany and recasts the German operations as a discontinued operation. The results from continuing operations no longer include any operations from Germany.

Should the effects of the tax law change that were originally recorded in continuing operations also be reclassified to discontinued operations?

Analysis

No. The effect of the change in tax law should be included in income from continuing operations for the period that includes the enactment date. Therefore, the amount of taxes associated with the discontinued operation should be the difference between the taxes previously reported in continuing operations and the amount of taxes allocated to continuing operations after the decision to dispose of the German operations occurred, which would still include the impact of the tax law change.

Subsequent to disposal, FSP Corp will have no operations in Germany. There are no provisions in ASC 740 that allow FSP Corp to "backwards trace" the effects of the tax law change and reclassify them as discontinued operations. Therefore, the effect of the tax law change on deferred tax assets and liabilities should remain in continuing operations.

Refer to TX 12 for more information on intraperiod tax allocations.

Question 16-3

If an election to change a reporting entity's tax status is approved by the tax authority (or filed if approval is not necessary) after the reporting date, but before the issuance of the financial statements, should the effect of the change in tax status be recognized in the financial statements?

PwC response

No, the effect of the change in tax status should not be recognized in the financial statements, as this is considered a nonrecognized subsequent event. However, ASC 740 does require a reporting entity to disclose (1) the change in the entity's tax status for the following year, and (2) the effects of the change, if material.

16.5.5 Income taxes and net income attributable to noncontrolling interests

The financial statement amounts reported for income tax expense and net income attributable to noncontrolling interest differ based on whether the subsidiary is a C-corporation or a partnership. The tax status of each type of entity causes differences in the amounts a parent would report in its consolidated income tax provision and net income attributable to noncontrolling interests.

A C-corporation is generally a taxable entity and is responsible for the tax consequences of transactions by the corporation. Therefore, a parent that consolidates a C-corporation includes the income taxes of the C-corporation, including the income taxes attributable to the noncontrolling interest, in its consolidated income tax provision. Net income attributable to the noncontrolling interest should equal the noncontrolling interest's share of the C-corporation's net income, which would include a provision for income taxes.

The legal liability for income taxes of a partnership generally does not accrue to the partnership itself. Instead, the investors are responsible for income taxes on their share of the partnership's income. Therefore, a parent that consolidates a partnership only reports income taxes on its share of the partnership's income in its consolidated income tax provision. This results in a reconciling item in the parent's income tax rate reconciliation that should be disclosed, if material. Net income attributable to the noncontrolling interest should equal the noncontrolling interest's share of the partnership's income, which would not include a provision for income taxes.

The guidance relating to partnerships is applicable to other pass-through entities, such as limited liability companies (if they elect to be taxed as a partnership) and subchapter S-corporations. Note that limited liability companies should follow the guidance for C corporations if they elect to be taxed as such.

Example 16-4 illustrates the presentation of income tax and net income attributable to noncontrolling interests when the subsidiary is a C-Corporation or partnership:

EXAMPLE 16-4

Presentation of income tax and net income attributable to noncontrolling interest

FSP Corp has a 70% ownership interest in Subsidiary B. The other 30% is owned by an unrelated party. FSP Corp consolidates the financial statements of Subsidiary B. FSP Corp has pretax income from continuing operations of $400 for the year ended December 31, 20X4. This amount includes $100 of pretax income from continuing operations from Subsidiary B. FSP Corp's tax rate for the period is 40%. For purposes of this example, the tax effects of any outside basis differences have been ignored, and Subsidiary B is assumed to have no subsidiaries of its own.

How should income tax expense and net income be determined and presented in the consolidated financial statements?

Analysis

Assuming Subsidiary B is a C-corporation with a 40% tax rate, income tax expense and net income would be calculated and presented as follows:

Income from continuing operations, before tax	$400
Income tax expense	160[1]
Net income	240
Less: Net income attributable to noncontrolling interest	18[2]
Net income attributable to FSP Corp	$222

[1] Calculated as $400 x 40%

[2] Calculated as ($100 – (100 x 40%)) x 30%

Assuming Subsidiary B is a partnership, income tax expense and net income would be calculated and presented as follows:

Income from continuing operations, before tax	$400
Income tax expense	148[3]
Net income	252
Less: Net income attributable to noncontrolling interest	30[4]
Net income attributable to FSP Corp	$222

[3] Calculated as ($400 – (100 x 30%)) x 40%

[4] Calculated as $100 x 30%

If the subsidiary is a partnership, income attributable to noncontrolling interest should be disclosed as a reconciling item in FSP Corp's tax rate reconciliation, if material.

16.6 Disclosures related to income statement amounts

ASC 740-10-50-9 through 50-14 requires certain disclosures about income statement amounts related to income taxes. For SEC registrants, S-X 4-08(h) requires certain incremental disclosures.

16.6.1 Amount of income tax expense or benefit

Reporting entities are required to disclose the amount of income tax expense or benefit allocated to continuing operations. In practice, this is frequently presented on the face of the income statement. In addition, reporting entities must also disclose amounts separately allocated to other categories of income in accordance with the intraperiod tax allocation provisions, such as discontinued operations, cumulative effect of a change in accounting principle, and extraordinary items.

16.6.2 Effective tax rate reconciliation

Reporting entities are required to provide a tax rate reconciliation that reconciles income tax expense attributable to continuing operations to the statutory Federal income tax rate applied to pretax income from continuing operations. Foreign reporting entities should use the income tax rate in the entity's country of domicile. When a rate other than the U.S. Federal corporate income tax rate is used, the rate and basis for using that rate should be disclosed.

Reporting entities can present the reconciliation using either dollar amounts or percentages. The reconciliation should include the estimated amount and the nature of each significant reconciling item.

Common rate reconciling items include:

- Change in the valuation allowance for deductible temporary differences or carryforwards (adjusted for expirations of carryforwards or their use in the current year)
- Use of the current year's permanent differences or tax credits in the calculation of taxes payable or deferred taxes
- The effect on beginning deferred tax balances of rate changes enacted in the current year and the effect on temporary differences originating in the current year if expected to reverse in a year for which a different rate has been enacted
- Unremitted foreign earnings that are reinvested indefinitely

- Foreign tax rate differential related to tax holidays or preferential rates
- When graduated rates are a significant factor, changes to the prior year's assessment of the expected future level of annual taxable income and the difference between the average rate at which deferred taxes are provided, and the incremental effect implicit in the reconciliation
- Change in unrecognized tax benefits from uncertain tax positions[1]
- Dividends-received deduction
- Stock-based compensation shortfalls
- Goodwill impairments or tax amortization
- Foreign currency translation and transactions

Although ASC 740 does not define what "significant" means with regard to the rate reconciliation, S-X 4-08(h) does provide guidance. It requires disclosure of individual reconciling items that are more than five percent of the amount computed by multiplying pretax income by the statutory tax rate (e.g., for a U.S.-based entity subject to the 35 percent statutory tax rate, any item that increases or decreases the tax rate by 1.75 percent or more). Reporting entities should ensure that items are not disaggregated to avoid this requirement, that reconciling items below this threshold are displayed in appropriate categories, and that groupings are consistent from year to year.

In addition, the SEC staff has requested transparent disclosure in situations where an SEC registrant generates a significant amount of profit from jurisdictions with very low tax rates. They have also requested disclosures highlighting any expected changes in the future mix of profit by jurisdiction or expected changes in a jurisdiction's tax rate.

16.6.3 Significant components of income tax expense

Reporting entities are required to disclose significant components of income tax expense attributable to continuing operations.

ASC 740-10-50-9

The significant components of income tax expense attributable to continuing operations for each year presented shall be disclosed in the financial statements or notes thereto. Those components would include, for example:

a. Current tax expense (or benefit)

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[1] We believe uncertain tax positions should be separately identified, if significant.

b. Deferred tax expense (or benefit) (exclusive of the effects of other components listed below)

c. Investment tax credits

d. Government grants (to the extent recognized as a reduction of income tax expense)

e. The benefits of operating loss carryforwards

f. Tax expense that results from allocating certain tax benefits directly to contributed capital

g. Adjustments of a deferred tax liability or asset for enacted changes in tax laws or rates or a change in the tax status of the entity

h. Adjustments of the beginning-of-the-year balance of a valuation allowance because of a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years. For example, any acquisition-date income tax benefits or expenses recognized from changes in the acquirer's valuation allowance for its previously existing deferred tax assets as a result of a business combination (see paragraph 805-740-30-3).

The sum of the amounts disclosed for the components of tax expense should equal the amount of tax expense that is reported in income from continuing operations. Insignificant components can be grouped in an "other" category. These items are typically discussed in a narrative disclosure.

ASC 740-10-55-212 through 55-216 provides three examples that illustrate this disclosure requirement.

16.6.3.1 *Investment tax credits*

ASC 740-10-50-20 requires disclosures detailing the method of accounting (either the deferral method or the flow-through method) used to account for investment tax credits and the amounts involved, if material. Without reference to materiality, the U.S. tax law also requires that the method of accounting for the investment credit be disclosed in any filing with a federal agency in which the credit is used, including the SEC.

Generally accepted accounting principles in certain countries outside of the United States may allow specific tax credits (e.g., research and experimentation credits) to be reflected outside of income tax expense and presented on a net basis against the expense to which they relate. However, we generally do not believe that this presentation complies with U.S. GAAP. Rather, reporting entities should present income tax credits as a component of income tax expense.

16.6.3.2 *Adjustments of a deferred tax liability or asset for enacted changes in tax laws or rates, or a change in the tax status of the entity*

As discussed in FSP 16.5.4, the effects of changes in tax laws or rates are recognized in income from continuing operations in the period that includes the enactment date. The tax effect of the enacted tax rates on current and deferred tax assets and liabilities should be determined at the date of enactment using temporary differences and currently taxable income existing as of the date of enactment.

Changes in tax rates may be retroactive to the beginning of the current year. In these instances, we believe it would generally be sufficient to disclose (1) the effect of the rate change on beginning-of-year deferred tax balances, and (2) the effect of the rate change on current and deferred taxes provided prior to the enactment date. Both of these items should be considered in the rate reconciliation. Other disclosures might also be sufficient. In any case, the amount(s) disclosed should be clearly described.

If a reporting entity experiences a change in tax status (e.g., change from a nontaxable partnership to a taxable corporation), the deferred tax effects of that change should be disclosed as a component of income tax expense attributable to continuing operations. See TX 8.1 for discussion of changes in tax status.

16.6.4 *Additional disclosures for SEC registrants*

S-X 4-08(h) requires certain additional disclosures that are not specifically required by ASC 740. They include:

- Identifying of the source of income (loss) before tax expense (benefit) as either foreign or domestic

- Separately stating for each major component of income tax expense (i.e., current and deferred) the amounts applicable to U.S. federal income taxes, to foreign income taxes, and to other income taxes

In addition, SAB Topic 11.C., *Tax Holidays*, requires disclosure of tax holidays from income taxes that the reporting entity has been granted for a specified period, if the entity conducts business in a foreign jurisdiction. The disclosure should include the aggregate dollar and per-share effects of the tax holiday, and briefly describe the facts and circumstances, including the date on which the special tax status will terminate.

These disclosure requirements apply not only to continuing operations, but also to total pretax income and total tax expense. However, question 7 of SAB Topic 6.I., *Accounting Series Release 149 — Improved Disclosure Of Income Tax Expense,* indicates that "overall" disclosures of the components of total income tax expense (i.e., current versus deferred, and U.S. federal versus foreign versus other) are acceptable. In other words, it is not necessary to make such disclosures separately with respect to each of the different categories (continuing operations, discontinued operations, other comprehensive income, etc.) in which income tax expense is reported.

Example 16- 5 provides an example of the disclosure required if a tax holiday has been granted.

EXAMPLE 16-5

Disclosure of tax holidays

Germany grants FSP Corp a ten-year tax holiday beginning in 20X4. During the holiday, FSP Corp will be 100% exempt from taxation for the first five years, followed by five years at a reduced tax rate of 12.5%. The current statutory rate in Germany is 25%.

What should FSP Corp disclose in its 20X4 financial statements?

Analysis

FSP Corp should provide disclosure that is similar to the following to comply with the SEC disclosure requirements:

"In 20X4, we were granted an income tax holiday for our manufacturing facility in Germany. The tax holiday allows for tax-free operations through December 31, 20X9, followed by operations at a reduced income tax rate of 12.5% on the profits generated through December 31, 20Y4, with a return to the full statutory rate of 25% for periods thereafter. As a result of the tax holiday in Germany, our net income was higher by $2.0 million ($0.02 per share) for the year ended December 31, 20X4."

This type of disclosure should cover all income statement periods presented. However, for purposes of this illustration, the example footnote only covers one year.

16.7 Presentation and disclosure for uncertain tax positions

Uncertain tax positions represent tax positions taken that are subject to significant and varied interpretations of applicable tax law. ASC 740 is applicable to all income tax positions that were included on previously filed tax returns, as well as those that are expected to be included on returns that have not yet been filed (e.g., amended returns or refund claims that have not yet been filed). The timing of the filing of a tax return is irrelevant, as long as a tax position taken or expected to be taken is filed or will be filed on an original or amended return.

16.7.1 Presentation of unrecognized tax benefits

In July 2013, the FASB issued ASU 2013-11, *Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a*

Tax Credit Carryforward Exists, to provide guidance on the presentation of unrecognized tax benefits on the balance sheet. The accounting standard — codified as ASC 740-10-45-10A and 45-10B — clarifies the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists.

The guidance requires reporting entities to present an unrecognized tax benefit (or a portion thereof) in the balance sheet as a reduction to a deferred tax asset for a net operating loss carryforward or a tax credit carryforward. This requirement does not apply when the carryforward attribute is not available (under the jurisdictional tax law) to settle the additional income taxes that would result from the disallowance of a tax position. In such a case, the unrecognized tax benefit should be presented as a liability. This liability should not be classified as a deferred tax liability unless it arises from a taxable temporary difference.

Reporting entities that present classified balance sheets should present a liability-classified unrecognized tax benefit as a current liability if they anticipate payment of cash within one year. Otherwise, such amounts should be presented as noncurrent liabilities.

16.7.2 Disclosure requirements for uncertain tax positions

Uncertain tax position assessments often require judgment. Management can, at times, be concerned with including information in the financial statements that could be helpful to the taxing authority examining its tax positions. ASC 740 addresses this tension in part by requiring a qualitative discussion of only those positions where a change is reasonably possible within the next 12 months. Further, for public entities as defined in ASC 740, the quantitative rollforward of unrecognized tax benefits is prepared on a worldwide aggregated basis. The specific disclosure requirements are discussed in the following sections.

Refer also to ASC 740-10-55-217 for an illustrative disclosure about uncertainty in income taxes.

Question 16-4

For what periods should unrecognized tax benefit disclosures be provided for purposes of the annual financial statements?

PwC response

Reporting entities should provide disclosures as of the end of each annual reporting period presented in the financial statements.

To meet this requirement, we believe disclosures related to historical information reflected in the financial statements (e.g., the tabular reconciliation of unrecognized tax benefits discussed in FSP 16.7.4) should cover the years for which income statements are presented.

For disclosures that are primarily forward-looking in nature (e.g., the total amount of unrecognized tax benefit that, if recognized, would affect the effective tax rate discussed in FSP 16.7.5), we believe it is appropriate to present this information as of the most recent balance sheet date only. However, in practice, some reporting entities have taken an alternative point of view that the requirements related to unrecognized tax benefits should be presented for all periods presented. We believe either approach is acceptable for disclosures that are primarily forward-looking in nature.

16.7.3 Disclosure of positions where a change is reasonably possible in the next 12 months

Reporting entities must disclose the nature of uncertain tax positions and related events if it is reasonably possible that the positions and events could change the associated recognized tax benefits within the next 12 months. This includes previously unrecognized tax benefits that are expected to be recognized upon the expiration of a statute of limitations within the next year.

ASC 740-10-50-15 requires the following disclosures:

- Nature of the uncertainty
- Nature of the event that could occur within the next 12 months to cause the change
- Estimate of the range of the reasonably possible change, or statement that an estimate of the range cannot be made

In preparing this disclosure, all facts and circumstances, including the likelihood that a taxing authority will (or will not) identify an uncertain tax position, should be considered. In certain instances, an uncertain tax position may not meet the recognition threshold, but management expects the statute of limitations to expire within the next 12 months and does not expect the taxing authority to identify the exposure. When this occurs, the total amount of the unrecognized tax benefit should be disclosed as being expected to change within the next 12 months.

Most uncertain tax positions have a range of possible outcomes (from being fully sustained to being fully disallowed). Accordingly, we believe that, in most cases, reporting entities should be able to provide a quantitative range of the possible changes in unrecognized tax benefits.

Management will need to exercise judgment in determining the level of aggregation that is appropriate for this disclosure. While some level of aggregation is expected, we believe that the information should be appropriately detailed to provide a reader of the financial statements with some context as to which circumstances may cause the unrecognized tax benefits to significantly change.

The disclosure requirements related to unrecognized tax benefits apply annually as noted in ASC 740-10-50-15(d). However, the early warning disclosure requirements of ASC 275, *Risks and Uncertainties*, are also still applicable. Accordingly, reporting entities should disclose reasonably possible significant changes in unrecognized tax benefits on a rolling 12-month basis. As a result, at each interim period, reporting entities should have processes and controls in place that allow them to identify unrecognized tax benefits capable of changing significantly within the next 12 months.

16.7.4 Tabular reconciliation of unrecognized tax benefits

ASC 740-10-50-15 requires reporting entities to disclose a reconciliation of the beginning and ending balances of the unrecognized tax benefits from uncertain positions. This rollforward must include all unrecognized benefits — whether they are reflected in a liability, as a decrease in a deferred tax asset (irrespective of whether a valuation allowance would be required), or even an off-balance-sheet exposure (e.g., a questionable stock option windfall benefit that has not been recorded because of the prohibition on recognizing windfall benefits prior to an actual reduction in taxes payable).

Public entities must include a tabular reconciliation rollforward of the total amounts of unrecognized tax benefits at the beginning and end of the reporting period. The rollforward should cover all income statement periods presented, and include the following.

Excerpt from ASC 740-10-50-15A(a)

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

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

3. The amounts of decreases in the unrecognized tax benefits relating to settlements with taxing authorities

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

Reporting entities may consider including additional line items, such as reclassifications of a liability to or from a deferred tax liability to reflect exposures that only affect timing. Reporting entities may also consider disaggregating the above line items to provide further details. For instance, they may disaggregate details about changes that affected the effective tax rate, or changes that were recorded outside the income statement (e.g., recorded as a component of other comprehensive income, against goodwill for uncertainties arising from business combinations, or decreases due to the disposal of a business unit).

An investor in a pass-through entity (e.g., partnerships, S-corporations, or LLCs) should include in its tabular reconciliation its respective interest in the pass-through entity's underlying unrecognized tax benefits, regardless of whether the pass-through entity is consolidated or accounted for under the equity method. Conversely, an investor in a non-pass-through entity (e.g., an investment in a C-corporation) that is accounted for under the equity method would not be expected to include the uncertain tax positions of the non-pass-through investee in its tabular reconciliation. However, disclosures of significant tax uncertainties of a non-pass-through investee that could affect the investor may be appropriate.

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

Amounts reported on this line represent an uncertain tax position taken in a prior year for which measurement has changed for one of two reasons: (1) the reporting entity met one of the subsequent recognition thresholds in ASC 740-10-25-8, or (2) new information supported a change in measurement.

When a reporting entity decides to not take a position it was previously expecting to take and, as a consequence, reverses the liability previously recorded for the position, it may be appropriate to disclose the reversal of the liability in a separate line item. A sample line item description might be "Decrease in unrecognized tax benefits as a result of the withdrawal of positions previously taken or expected to be taken." If the reporting entity chooses to reflect the decrease in the liability in a more aggregated line item (such as "Decrease in unrecognized tax benefits as a result of positions taken during the prior periods"), it should consider separately disclosing that the adjustment relates to a change in intention with regard to a particular filing position.

16.7.4.2 Increases and decreases in unrecognized tax benefits recorded for positions taken during the year

On occasion, a reporting entity may take an uncertain tax position during the year, and then change its assessment of the amount of benefit to be recognized within the same annual reporting period. When this occurs, the tabular reconciliation should only reflect the net addition in existence at the end of the year when disclosing the gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during the entire year.

Question 16-5

Reporting entities sometimes take an uncertain tax position in a current year return that they also took in a previous year return. How should the effects of "rolling" positions be presented in the tabular rollforward?

PwC response

We believe that reporting entities should reflect the impact of the position taken in the current year in the "Increases and decreases in unrecognized tax benefits as a result of tax positions taken during the current period" line item. If the statute of limitations on the earlier year position expires in the current year, the impact should be reflected in the "Reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations" line item in the tabular rollforward.

16.7.4.3 The amounts of decreases in the unrecognized tax benefits relating to settlements with taxing authorities

Certain settlements with taxing authorities may result in no cash payments (e.g., a taxing authority may concede a position taken on a tax return resulting in no cash payments to the taxing authority for that position). Only amounts paid, or tax attributes (e.g., net operating losses) used in lieu of payment, should be included in this line item of the tabular reconciliation. Reporting entities should reflect a decrease in unrecognized tax benefits resulting from concessions or adjustments by the taxing authority as a change to prior-period unrecognized tax benefits.

If unrecognized tax benefits on a prior-year uncertain tax position were both established and paid out in the same year, reporting entities should report the movement gross. That is, an increase should be reflected in "The gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period" line, while the payment of cash to settle the position should be reflected in "The amounts of decreases in the unrecognized tax benefits relating to settlements with taxing authorities" line.

As illustrated in Example 16-6, an increase in unrecognized tax benefits on one position and the settlement of an unrelated position during the same period, even if for a similar amount, should be reported gross:

EXAMPLE 16-6

Tabular reconciliation – settlement of uncertain tax positions

In a prior year, FSP Corp considered two uncertain tax positions of $100 each (positions A and B). For position A, it concluded that it did not meet the recognition standard under ASC 740. For position B, it concluded it did meet the recognition standard and therefore recorded a tax benefit. As part of an overall settlement with the taxing authority shortly before year end, FSP Corp agrees to pay $100 to settle position B. The $100 is paid after year end.

How should FSP Corp reflect the settlement of the unrelated positions in the disclosure?

Analysis

A settlement reached with a taxing authority as of year end should generally be shown in the line item "Decrease in unrecognized tax benefits relating to settlements with taxing authority," notwithstanding that the actual cash payment is made subsequent to year end. This is because the uncertainty related to these particular tax positions has been resolved as of the balance sheet date and it is clear that a payment will be made subsequent to year-end.

In this example, FSP Corp's line item "Decrease in unrecognized tax benefits relating to settlements with taxing authority" would show a net decrease of $100 to reflect the $100 settlement payment. The line item "Gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period" would reflect a net change of zero due to the offsetting decrease of $100 caused by the taxing authority's concession on position A and the $100 increase caused by its adjustment on position B.

16.7.4.4 Reductions to unrecognized tax benefits resulting from a lapse of the applicable statute of limitations

Amounts reported in this line represent tax benefits that were sustained by the reporting entity because the taxing authority's period of assessment has passed.

16.7.4.5 Examples of the tabular reconciliation for unrecognized tax benefits

The following examples 16-7 through 16-9 illustrate the impact of various scenarios on the tabular reconciliation for unrecognized tax benefits.

EXAMPLE 16-7

Tabular reconciliation – valuation allowances

FSP Corp has taken various tax positions on a tax return that resulted in a net operating loss carryforward with a potential benefit of $10,000. The related deferred tax asset, if recorded, would require a full valuation allowance. Assume that only $3,000 of the potential $10,000 tax benefit has met the threshold for financial statement recognition.

What amount should be included in the tabular reconciliation of unrecognized tax benefits?

Analysis

FSP Corp should include $7,000 in the tabular reconciliation of unrecognized tax benefits. This represents the difference between the amount taken on the tax return ($10,000) and the amount recognized for financial reporting purposes ($3,000). In this case, the gross deferred tax asset and related valuation allowance reported in the income tax footnote should be $3,000. For balance sheet presentation purposes, no amount is recognized because the deferred tax asset of $3,000 is offset by the $3,000 valuation allowance.

The $7,000 reduction in the deferred tax asset is considered an unrecognized tax benefit and should be included in the annual tabular reconciliation, regardless of the fact that a valuation allowance would be required if the $7,000 were recognized.

In summary, all gross unrecognized tax benefits, whether they result in a liability or a reduction of deferred tax assets and/or refundable amounts, should be included in the tabular reconciliation.

EXAMPLE 16-8

Tabular reconciliation – refund claim filed after the balance sheet reporting date

FSP Corp expects to file a refund claim (related to a current period tax position) after the balance sheet reporting date. An unrecognized tax benefit of $10,000 will be included within the refund claim.

Should this unrecognized tax benefit be included in the year-end tabular reconciliation, even though the refund claim that will give rise to the unrecognized tax benefit has not been filed as of the balance sheet date?

Analysis

Yes. Though not recognized in the financial statements, the unrecognized tax benefit associated with this claim should be disclosed in the tabular reconciliation as required by ASC 740-10-50-15A(a).

A reporting entity is required to evaluate tax positions in a refund claim regardless of whether the claim for refund is filed as of the current-period balance sheet date or is expected to be filed, provided it is related to a current period or prior period tax position.

EXAMPLE 16-9

Tabular reconciliation – determining when to include items in reconciliation

In the fourth quarter of 20X4, FSP Corp generates a loss of $1,000 related to the sale of an investment. Because FSP Corp does not have ordinary income, or capital gains in the current year, or the applicable carryback periods, the loss is a carryforward. Management expects to take a tax return filing position characterizing the loss as ordinary rather than capital in nature. There is some support in the law for the position; however, in applying ASC 740-10-25-6, management concludes that the position does not meet the more-likely-than-not threshold for financial statement recognition.

The applicable tax rate in the jurisdiction is 40% for both ordinary income and capital gains; however, capital losses can only be used to offset capital gains. FSP Corp recognizes a $400 deferred tax asset because the carryforward constitutes a tax attribute regardless of the nature of the loss.

In 20X5, FSP Corp generates a profit that is all ordinary in nature and utilizes all of its loss carryforwards to reduce taxable income and taxes payable.

How should the unrecognized tax benefit be recorded and presented in 20X4 and 20X5?

Analysis

At December 31, 20X4, FSP Corp will not record a liability for the unrecognized tax benefit as the tax position to be taken characterizing the loss as ordinary has not resulted in a potential underpayment of tax. We believe, nonetheless, that $400 of unrecognized tax benefit should be included in the 20X4 tabular reconciliation. The capital loss attribute that would arise if the position was unfavorably settled should not impact the tabular reconciliation. ASC 740-10-20 defines an unrecognized tax benefit as "the difference between a tax position taken or expected to be taken in a tax return and the benefit recognized and measured pursuant to Subtopic 740-10." We believe this requirement is intended to apply comprehensively to all changes to tax return positions that arise based upon application of the ASC 740 recognition and measurement principles. This includes positions characterizing a loss carryforward, since the characterization determines the tax consequences of the attribute.

In 20X5, a $400 unrecognized tax benefit liability should be recorded on the balance sheet because, at the time, FSP Corp began utilizing the "as filed" 20X4 loss carryforward to reduce taxable income and thus paid less income tax than it would have had the original $1,000 loss been determined to be capital in nature.

With regard to the 20X5 tabular reconciliation, since the $400 unrecognized tax benefit was included in 20X4, no additional entry is necessary in 20X5. In addition, a deferred tax asset for the future deductible amount associated with the capital loss should continue to be recorded during 20X5 (and possibly beyond) even though, on an "as filed" basis, FSP Corp utilized the loss carryforward on the 20X5 tax return.

It should be noted that in both 20X4 and 20X5, FSP Corp must assess the realizability of the deferred tax asset based upon whether there is sufficient future taxable income of the appropriate character (i.e., future capital gains). Otherwise, a valuation allowance would be required against the deferred tax asset. In that case, the unrecognized tax benefit amount would also be disclosed because it would affect the effective tax rate (see FSP 16.7.5 for discussion of this disclosure requirement).

In addition, respective disclosure of loss carryforwards should be provided on an ASC 740 "as-adjusted" basis. We believe footnote disclosure of the amounts of loss and other tax carryforwards should be on the same basis as presented on the balance sheet (i.e., net of unrecognized tax benefits). If reporting entities also present the carryforwards in a footnote on a gross or "as filed" tax return basis, additional disclosures may be necessary to help the reader understand the difference between that amount and the balance sheet position.

16.7.4.6 *Items that should not be included in the tabular reconciliation of uncertain tax benefits*

Indirect effects between jurisdictions

An unrecognized tax benefit in one jurisdiction could have an impact on a tax liability in another jurisdiction (such as a state unrecognized tax benefit affecting the amount of state taxes that would be deductible for U.S. federal purposes). When this occurs, the tabular reconciliation of unrecognized tax benefits should not include consideration of the unrecognized tax benefit's effect in other jurisdictions. Indirect effects of uncertain tax positions on other jurisdictional tax calculations should be recorded in the financial statements, and not reflected in the tabular rollforward.

Example 16-10 discusses the amount of unrecognized tax benefit to be reflected in the tabular disclosure:

EXAMPLE 16-10

Exclusion of indirect effects of uncertain tax positions from the tabular disclosure

FSP Corp has an uncertain tax position in New Jersey of $1,000, which has not met the threshold for financial statement recognition. If the position is not sustained, FSP Corp will receive a $350 federal benefit for state taxes paid on $1,000.

Given the available facts, how should the tabular rollforward be presented?

Analysis

In this case, only the $1,000 state unrecognized tax benefit should be included in the tabular disclosure.

For purposes of balance sheet classification, consistent with ASC 740-10-45-11, FSP Corp should recognize a state liability for unrecognized tax benefits of $1,000, and a $350 federal deferred tax asset.

Interest and penalties

Interest and penalties should not be included in the annual tabular reconciliation as unrecognized tax benefits, even if a reporting entity has elected an accounting policy to classify interest and penalties as a component of income taxes.

Treatment of deposits

If a reporting entity makes an advance deposit (regardless of whether it is refundable on demand or considered by the taxing authority as a payment of taxes), it should have no impact on the amount of unrecognized tax benefit that is reflected in the tabular reconciliation. This is because advance deposits are essentially equivalent to advance tax payments. As such, they should not be included as an offset to unrecognized tax benefits in the annual tabular reconciliation disclosure.

16.7.5 *Unrecognized tax benefits that, if recognized, would affect the effective tax rate*

ASC 740-10-50-15A(b) requires disclosure of the total amount of unrecognized tax benefits that, if recognized, would impact the effective tax rate. This disclosure should include only unrecognized tax benefits that affect (if recognized) the tax provision within continuing operations.

Although this guidance specifically requires disclosure related to items that would affect the tax provision within continuing operations, reporting entities should also provide supplemental disclosures for resolutions of uncertain tax positions that, if sustained, would affect items other than the tax provision from continuing operations. Unrecognized tax benefits that may not affect the tax provision within continuing operations include:

- Timing-related uncertainties (e.g., accelerated depreciation)
- Excess tax deductions from stock-based compensation recorded in equity under ASC 718, *Compensation-Stock Compensation*
- Acquisition-related measurement period adjustments pursuant to ASC 805, *Business Combinations*
- Measurement period adjustments occurring in connection with reorganizations in fresh-start balance sheets pursuant to ASC 852, *Reorganizations*

In addition, as discussed in FSP 16.7.4.6, the indirect effects of uncertain tax positions in other jurisdictions should not be included within the tabular rollforward of unrecognized tax benefits. We understand, however, that for purposes of applying the disclosure requirements specified in ASC 740-10-50-15A(b), a reporting entity might consider the indirect effects in other jurisdictions.

Further, uncertain tax positions embedded in a net operating loss carryforward that carries a full valuation allowance would not affect the effective tax rate, as long as the uncertainty is expected to be resolved while a full valuation allowance is maintained. The guidance does not specify whether any of these positions are required to be included in this disclosure. However,we believe reporting entities should consider providing additional transparency in this disclosure. For example, if an uncertain tax benefit would create an additional net operating loss carryforward, along with an additional valuation allowance, a reporting entity may disclose that if the unrecognized tax benefit is recognized, it would be in the form of a net operating loss carryforward, which is expected to require a full valuation allowance based on present circumstances.

16.7.6 *Tax years still subject to examination by a major tax jurisdiction*

ASC 740-10-50-15(e) requires reporting entities to disclose all tax years that remain open to assessment by a major tax jurisdiction. We believe, in certain situations, this disclosure would include a jurisdiction where the reporting entity has not filed a tax return. For example, the reporting entity may have taken a tax position regarding a tax status of one of its legal entities whereby the potential tax exposure related to the reporting entity could be significant. In this fact pattern, the reporting entity may need to identify the tax jurisdiction as still being subject to examination.

16.8 *Required disclosures for other transactions with income tax effects*

ASC 740 and other accounting standards require disclosures for other transactions that have income tax effects. These are discussed in the following sections.

16.8.1 *Income tax-related disclosures for stock-based compensation*

ASC 740-718 requires extensive disclosures related to the income tax effects of stock-based compensation. See FSP 15 for these required disclosures.

16.8.2 *Pass-through entities*

Some business structures are treated as a conduit for tax purposes, where the business structure's income is not taxed directly as a legal entity but is instead passed to its owners or investors. These structures can include partnerships, certain limited liability companies, and other entities disregarded for tax purposes. As provided under ASC 740-10-50-16, a public reporting entity that is not subject to income taxes because its income is taxed directly to its owners should disclose that fact, as well as the net difference between the tax bases and the reported amounts of the reporting entity's assets and liabilities.

16.8.3 *Specific disclosure required in the separate statements of a member of a consolidated tax group*

When a reporting entity is a member of a group that files a consolidated tax return, it must disclose the following items in its separately issued financial statements:

- The aggregate amount of current and deferred tax expense for each income statement presented, and the amount of any tax-related balances due to or from affiliates as of the date of each balance sheet presented

- The principal provisions of the method by which the consolidated amount of current and deferred tax expense is allocated to members of the group, and the nature and effect of any changes in that method (and in determining related balances to or from affiliates) during the years for which the disclosures are presented

These disclosure requirements are in lieu of, rather than in addition to, the general disclosure requirements required under ASC 740. The disclosure requirements are essentially the general requirements of ASC 850, *Related Party Disclosures*, which are applied to intercorporate tax allocation. However, we believe that it is generally appropriate in separately issued financial statements to also include a description of the types, and potentially the amounts, of significant temporary differences.

In SAB Topic 1.B, *Allocation Of Expenses And Related Disclosure In Financial Statements Of Subsidiaries, Divisions Or Lesser Business Components Of Another Entity,* the SEC staff indicates that the separate return basis is the preferred method for computing the income tax expense of a subsidiary, division, or lesser business component of another entity included in consolidated tax returns. When the historical income statements in the filing do not reflect the tax provision on the separate return basis, the SEC staff typically requires a pro forma income statement for the most recent year and interim period reflecting a tax provision calculated on the separate return basis.

When a reporting entity has been included in a consolidated U.S. tax return, it is jointly and severally liable, with other members of the consolidated group, for any additional taxes that may be assessed. There may be circumstances in which it is appropriate to disclose this contingent liability, based on the disclosure requirements for loss contingencies.

For more information on separate financial statements of a subsidiary that is a member of a consolidated tax group, refer to TX 14.

16.8.4 Significant risks and uncertainties disclosures

ASC 275 requires disclosures in annual and interim financial statements of risks and uncertainties (e.g., use of estimates) related to certain key information that helps users in assessing future performance.

Although ASC 740-10-50-15(d) essentially codifies ASC 275 for uncertain tax positions, the disclosure requirements in ASC 275 are still relevant for other income tax matters, such as valuation allowances and indefinite reversal assertions for unremitted earnings of foreign subsidiaries. Additional disclosures may be required with respect to assumptions that management uses to estimate its balance sheet and income statement tax accounts.

When it is at least reasonably possible that a material adjustment will occur in the near term (generally considered approximately one year), the financial statements should disclose this potential uncertainty along with a range of potential changes to the recorded amounts. This requirement is discussed in ASC

275-10-50-6 through 50-15, and an example relating to valuation allowances is provided in ASC 740-10-55-218 through 55-222.

The threshold for disclosure is "reasonably possible," indicating that probability is more than remote. The premise behind this threshold is that significant one-time charges or benefits, such as a change in the assessment of the need for a valuation allowance, should not surprise the reader of the financial statements. The more significant the change in estimate, the more difficult it may be for a reporting entity to justify that a significant one-time event was not reasonably foreseeable at the time of its most recent previous filing. This is particularly important for SEC registrants because of their quarterly reporting requirements.

16.9 Considerations for private companies

Certain exceptions to the above requirements are available for nonpublic entities as defined in the ASC 740 glossary. A nonpublic entity is not required to numerically reconcile the statutory and effective rates or provide the approximate tax effect of each type of temporary difference and carryforward that gives rise to significant deferred tax assets and liabilities. However, a nonpublic entity must disclose the nature of significant reconciling items as well as a description of the significant temporary differences and carryforwards.

Nonpublic entities are not required to include the following disclosures:

- Tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the reporting date
- Tax holidays that have been granted by foreign jurisdictions
- The net difference between the tax bases and the reported amounts of assets and liabilities when they are structured as nontaxable entities

In addition, the following SEC requirements are only required of SEC registrants.

Figure 16-4
Presentation and disclosure requirements applicable only to SEC registrants

Description	Reference	Section
Disclose individual reconciling items that are more than five percent of the amount computed by multiplying pretax income by the statutory tax rate	S-X 4-08(h)	16.6.2
Disclose the source of income (loss) before tax expense (benefit) as either foreign or domestic	S-X 4-08(h)	16.6.4

Description	Reference	Section
Separately state for each major component of income tax expense the amounts applicable to U.S. federal income taxes, to foreign income taxes, and to other income taxes	S-X 4-08(h)	16.6.4
Disclose tax holidays granted for a specified period, if the entity conducts business in a foreign jurisdiction	SAB Topic 11.C	16.6.4

Chapter 17: Business combinations

17.1 Chapter overview

This chapter discusses the presentation and disclosure requirements of ASC 805, *Business Combinations*. The disclosure provisions under ASC 805 are intended to enable users of financial statements to evaluate the nature and financial effects of all forms of business combinations.

Presentation and disclosure considerations for pushdown accounting are also discussed in this chapter.

17.2 Scope

The disclosure guidance in ASC 805 applies to all transactions that meet the definition of a business combination, including acquisitions by not-for-profit reporting entities. It does not apply to the formation of a joint venture, nor to the acquisition of a group of assets that do not constitute a business. It also does not apply to business combinations between entities under common control.

Pushdown accounting, discussed in FSP 17.6, is applicable to U.S. GAAP reporting entities filing financial statements with the SEC. At certain ownership thresholds, pushdown of the acquirer's basis in purchased assets and liabilities in the separate financial statements of its subsidiary or acquired entity is required when those financial statements will be presented in a filing with the SEC.

In some situations, reporting entities may consolidate an acquired business in which they have less than 100 percent ownership. In these instances, the reporting entities must report a noncontrolling interest representing the portion of the acquired business they do not own. The presentation and disclosure requirements associated with noncontrolling interests are addressed in FSP 5.

Note that ASC 810-10-50-3 requires that the primary beneficiary of a variable interest entity that is a business provide the disclosures required by ASC 805. The primary beneficiary of a variable interest entity that is not a business must disclose the amount of gain or loss recognized upon initial consolidation. Refer to FSP 18 for the disclosure requirements for primary beneficiaries.

Note about ongoing standard setting

As of the content cutoff date of this publication (August 31, 2014), the Emerging Issues Task Force (EITF) has an active item on its agenda related to pushdown accounting that may affect presentation and disclosure requirements. Financial statement preparers and other users of this publication are therefore encouraged to monitor the status of the project, and if finalized, evaluate the effective date of the new guidance and the implications on presentation and disclosure.

17.3 Income statement presentation

There are a number of items that should be recognized in income under ASC 805, including transaction costs, restructuring charges, revaluations of contingent consideration, adjustments to acquired contingencies, gain or loss on previously held equity interests, and gain on bargain purchases. Reporting entities will need to exercise judgment in determining the appropriate income statement classification for these items based on their nature. Generally, the income statement recognition of items in a business combination should mirror their recognition outside of a business combination, and most items recognized in income should be classified as part of operations. For example, transaction costs should typically be recorded in operations, particularly if the acquiring reporting entity has a history of making acquisitions or expects to make more acquisitions in the future.

Additionally, depending on the nature of the items and whether they are accompanied by appropriate disclosure of the underlying components, it may be acceptable to group certain items together on the income statement. However, items such as changes in fair value measurements, settlement of certain preexisting relationships such as supply contracts, and changes in value related to income tax contingencies should generally be recorded in the income statement separate from a business combination.

Adjustments to an indemnification asset for an income tax liability should be recorded in pretax income, not as a part of income tax expense. ASC 740 narrowly defines the term "income taxes" as domestic and foreign taxes based on income. Recoveries under an indemnification agreement do not fall within the scope of this definition. Therefore, although dollar-for-dollar changes in the income tax liability and the related indemnification asset (subject to the limitations of the indemnity and collectability) will be neutral on an after-tax basis, pretax income and tax expense will both change when the amount of the income tax liability and related indemnification asset change.

Changes in fair value measurements of items such as contingent consideration may contain elements of both changes in assumptions used in the determination of fair value and changes due to the passage of time (the time value of money). Generally, we would not expect reporting entities to separate a change in fair value into its components; we would expect the reporting entities to record the entire change as a component of operating income.

17.4 Disclosures for business combinations

The disclosure provisions of ASC 805-10-50 are intended to enable users of financial statements to evaluate the nature and financial effects of:

- A business combination that occurs either during the current reporting period or after the reporting date, but before the financial statements are issued or are available to be issued

- Adjustments recognized in the current reporting period that relate to business combinations that occurred in current or previous reporting periods

The guidance indicates that the disclosure provisions should be considered minimum requirements. Reporting entities should provide additional disclosures, if necessary, to ensure the above objectives are met.

All disclosures should be made in the period in which the business combination occurs. Reporting entities should typically include the disclosures in subsequent financial statements if an acquisition occurred in a previous reporting period and that period is presented in the financial statements. For example, assume a reporting entity presents balance sheets for two years and income statements for three years in its 20X4 financial statements. If they completed a material acquisition in 20X2, then the reporting entities should disclose the 20X2 acquisition and the income statement-relevant disclosures in their 20X4 financial statements. However, certain of the original disclosures about the acquisition-date accounting may no longer be relevant to the financial statements presented, since the 20X4 financial statements would not include a 20X2 balance sheet.

The disclosure requirements of ASC 805 are applicable to acquisitions made after the balance sheet date, but before the financial statements are issued or are available to be issued.

If the initial accounting for the business combination is incomplete, reporting entities should describe which disclosures could not be made, which are preliminary, and the reasons the acquisition accounting could not be completed.

Reporting entities may complete several business combinations in the same accounting period. The disclosures outlined in ASC 805 must be reported for each material business combination. Certain disclosures can be aggregated for immaterial business combinations that are collectively material.

17.4.1 General acquisition disclosure

Per ASC 805-10-50-2, reporting entities should disclose the name and a description of the acquiree (e.g., type of business). This disclosure should also describe the primary reason the reporting entity completed the acquisition—for example, to expand global reach, increase capacity, enter a new line of business, etc. The disclosure should include the acquisition date (i.e., the date control is obtained), as well as the percentage of ownership acquired (i.e., voting equity interests). This disclosure should be included for each material business combination that occurs during the reporting period.

17.4.2 Disclosures of consideration transferred

Reporting entities must disclose the acquisition date fair value of the total consideration transferred (i.e., the purchase price) in a business combination. The consideration transferred may include items in addition to, or in lieu of, cash. In addition to disclosing the total consideration, the reporting entities must disclose the acquisition date fair value of each major class of consideration. Consideration may include cash, other assets (tangible or intangible), or a business or subsidiary of the reporting entities. A business transferred as consideration may trigger separate presentation and disclosure requirements, such as the disclosures for a discontinued operation.

Consideration transferred may also be comprised of liabilities incurred for contingent consideration or other liabilities assumed by the buyer. It may also come in the form of common or preferred stock, options, or warrants of the reporting entities or member interests of mutual entities. If equity instruments are provided as consideration, disclosure should include the number of securities issued or issuable, and the method of measuring fair value. If common stock of an SEC registrant is provided as consideration, the disclosure typically includes the number of shares issued and the price of the stock on the acquisition date.

17.4.3 Disclosure of contingent consideration and indemnification assets

The same information is required to be disclosed for both contingent consideration arrangements (ASC 805-30-50-1(c)) and arrangements where the seller indemnifies the buyer (e.g., indemnification assets) (ASC 805-20-50-1(a)):

Excerpt from ASC 805-30-50-1(c) and ASC 805-20-50-1(a)

1. The amount recognized as of the acquisition date

2. A description of the arrangement and the basis for determining the amount of payment

3. An estimate of the range of outcomes (undiscounted) or, if a range cannot be estimated, that fact and the reasons why a range cannot be estimated. If the maximum amount of the payment is unlimited, the acquirer shall disclose that fact.

Indemnification assets and the related liabilities are generally presented gross (i.e., not netted against one another) because the right of offset typically does not exist.

17.4.4 Disclosure of major classes of assets acquired and liabilities assumed

ASC 805-10-50-2 requires reporting entities to disclose the amount recognized for assets acquired and liabilities assumed as of the date of acquisition. This disclosure includes recognized contingent assets and liabilities. The disclosure is required to be prepared by each major class of assets and liabilities, and is typically presented in a tabular format that reconciles the consideration transferred to the assets/liabilities acquired. Refer to example 17-2.

17.4.5 Disclosures of acquired receivables

The following information must be disclosed for acquired receivables that are not subject to the requirements of ASC 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality*:

Excerpt from ASC 805-20-50-1

1. The fair value of the receivables

2. The gross contractual amounts receivable

3. The best estimate at the acquisition date of the contractual cash flows not expected to be collected.

ASC 805 requires these disclosures to be disaggregated by major class of receivable, such as loans, direct finance leases in accordance with ASC 840-30, *Capital Leases*, and any other class of receivables.

17.4.5.1 Disclosure requirements for finance receivables and allowance for credit losses

Reporting entities that acquire finance receivables as part of a business combination will need to assess the impact of acquired finance receivables on their existing allowance for credit loss policies. They will need to classify the acquired finance receivables into the appropriate portfolio segments and classes to be reflected in accordance with the interim and annual disclosure provisions of ASC 310 *Receivables*. Refer to FSP 8 for disclosure requirements related to finance receivables.

17.4.6 Disclosures about assets and liabilities arising from contingencies

The following information related to contingencies should be included within the financial statement footnote that describes the business combination:

Excerpt from ASC 805-20-50-1(d)

1. For assets and liabilities arising from contingencies recognized at the acquisition date:

   i The amounts recognized at the acquisition date and the measurement basis applied (that is, at fair value or at an amount recognized in accordance with Topic 450 [*Commitments*] and Section 450-20-25).

   ii. The nature of the contingencies.

   An acquirer may aggregate disclosures for assets or liabilities arising from contingencies that are similar in nature.

2. For contingencies that are not recognized at the acquisition date, the disclosures required by Topic 450 if the criteria for disclosures in that Topic are met [i.e., the contingencies are deemed reasonably possible].

If the initial accounting of a contingency is incomplete, SEC registrants are required to disclose that the purchase price allocation is preliminary/provisional. In addition, SEC registrants should disclose the following:

- A clear description of the nature of the contingency
- The reasons why the allocation is preliminary/provisional, including identification of the information that the SEC registrant has arranged to obtain
- When the allocation is expected to be finalized
- Other available information that could enable a reader to understand the magnitude of any potential adjustment

Refer to FSP 23 for further presentation and disclosure requirements related to liabilities arising from contingencies.

17.4.7 Goodwill disclosures

The following information is required to be disclosed when an acquirer recognizes goodwill in a business combination:

Excerpts from ASC 805-30-50-1

a. A qualitative description of the factors that make up the goodwill recognized, such as expected synergies from combining operations of the acquiree and the acquirer, intangible assets that do not qualify for separate recognition, or other factors

d. The total amount of goodwill that is expected to be deductible for tax purposes.

When reporting entities are required to disclose segment information, they should disclose the amount of goodwill by reportable segment. In addition, if the assignment of goodwill to reporting units is not complete as of the financial statements issuance date, the reporting entities should disclose this fact.

Refer to FSP 8 for day-two presentation and disclosure requirements related to goodwill.

17.4.8 In-process research and development (IPR&D) disclosures

SEC registrants are required to disclose the following for material IPR&D:

- Appraisal method (e.g., based on discounted probable future cash flows on a project-by-project basis)

- Significant assumptions, such as:

  a. The period in which material net cash inflows from significant projects are expected to commence

  b. Any anticipated material changes from historical pricing, margins, and expense levels

  c. The risk-adjusted discount rate applied to the project's cash flows

17.4.9 Disclosures of separate transactions and preexisting relationships

Certain transactions are recognized separate from the business combination transaction, such as transactions that effectively settle preexisting relationships between the acquirer and acquiree, transactions that compensate employees or former owners of the acquiree for future services, and transactions that reimburse the acquiree or its former owners for the acquirer's acquisition-related costs.

For transactions that are recognized separate from the acquisition of assets and assumption of liabilities in the business combination, the reporting entities should disclose the following:

- A description of the transaction
- The accounting for the transaction
- The amounts recognized for each transaction and the line item in the financial statements in which each amount is recognized
- If the transaction was the settlement of a preexisting relationship, the method used to determine the settlement amount

The disclosures should include the amount of acquisition-related costs, the amount recognized as an expense, and the line item or items on the income statement in which those amounts are recognized. Additionally, reporting entities should also disclose the amount of any issuance costs that were not expensed and how they were recognized.

17.4.10 Disclosures of bargain purchases

As described in ASC 805-30-25-2 through 25-4, a bargain purchase arises when the fair value of the net assets acquired in a business combination exceeds the consideration transferred, resulting in a gain being recorded by the acquirer. In business combinations where the acquirer makes a bargain purchase, the following items must be disclosed:

Excerpt from ASC 805-30-50-1

1. The amount of any gain recognized in accordance with paragraph ASC 805-30-25-2 and the line item in the income statement in which the gain is recognized

2. A description of the reasons why the transaction resulted in a gain.

A bargain purchase gain is recognized in earnings and is not recognized as an extraordinary item. ASC 805-30-55-14, Example 1, provides an illustration of these disclosure requirements.

17.4.11 Partial acquisitions

The reporting entities should disclose the following for each business combination in which the acquirer holds less than 100 percent of the equity interests in the acquiree at the acquisition date:

- The fair value of the noncontrolling interest in the acquiree at the acquisition date

- The valuation techniques and significant inputs used to measure the fair value of the noncontrolling interest

In addition to the above disclosures for noncontrolling interests, ASC 805-10 also requires the following disclosures for previously held equity interests in the acquiree at the acquisition date:

ASC 805-10-50-2(g)

In a business combination achieved in stages, all of the following:

1. The acquisition-date fair value of the equity interest in the acquiree held by the acquirer immediately before the acquisition date

2. The amount of any gain or loss recognized as a result of remeasuring to fair value the equity interest in the acquiree held by the acquirer immediately before the business combination (see paragraph 805-10-25-10) and the line item in the income statement in which that gain or loss is recognized

3. The valuation technique(s) used to measure the acquisition-date fair value of the equity interest in the acquiree held by the acquirer immediately before the business combination

4. Information that enables users of the acquirer's financial statements to assess the inputs used to develop the fair value measurement of the equity interest in the acquiree held by the acquirer immediately before the business combination

Note that the gain or loss discussed in ASC 805-10-50-2(g)(2) is ordinary in nature (i.e., it should not be presented as extraordinary).

17.4.12 Acquiree's financial information and pro forma financial information

In business combinations where the acquirer is a public business entity, as defined in ASC 280, *Segments,* the acquirer must disclose certain financial information related to the acquiree and provide pro forma financial data, as described in the excerpt below:

Excerpt from ASC 805-10-50-2(h)

1. The amounts of revenue and earnings of the acquiree since the acquisition date included in the consolidated income statement for the reporting period

2. If comparative financial statements are not presented, the revenue and earnings of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period (supplemental pro forma information).

3. If comparative financial statements are presented, the revenue and earnings of the combined entity as though the business combination(s) that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period (supplemental pro forma information). For example, for a calendar year-end entity, disclosures would be provided for a business combination that occurs in 20X2, as if it occurred on January 1, 20X1. Such disclosures would not be revised if 20X2 is presented for comparative purposes with the 20X3 financial statements (even if 20X2 is the earliest period presented).

4. The nature and amount of any material, nonrecurring pro forma adjustments directly attributable to the business combination(s) included in the reported pro forma revenue and earnings (supplemental pro forma information).

If any of the above disclosures are impracticable, the acquirer should disclose that fact and explain why the disclosure is impracticable.

Question 17-1

If a reporting entity presents three years of income statements, are they required to present three years of supplemental pro forma revenue and earnings of the combined entity?

PwC response

No. Reporting entities are only required to present two years (the year of the transaction, and the prior annual reporting period) of supplemental pro forma revenue and earnings of the combined entity even if its financial statements include three years of income statements. For interim reporting, the supplemental pro forma information should be presented for both the quarter and year-to-date periods.

Question 17-2

If a reporting entity acquires a business in 20X4 and presents comparative financial statements for 20X3 and 20X4, is the supplemental pro forma information for 20x3 determined by combining the revenue and earnings of the acquirer and acquiree for that period?

PwC response

No. The guidance specifically requires that the supplemental pro forma information be presented as though the business combination occurred as of the beginning of the comparative period (in this case, January 1, 20X3). This means that costs resulting from the business combination (e.g., transaction costs) should be reflected in the 20X3 pro forma earnings as though the business combination occurred on January 1, 20X3. Other specific considerations when preparing pro forma information are discussed in the following sections and Figure 17-1.

17.4.12.1 Preparation of ASC 805 pro forma information

ASC 805 does not provide specific guidance regarding how reporting entities should calculate pro forma revenue and earnings. Generally, reporting entities add the results from the financial statements of the acquiree to the historical financial results of the acquirer after making adjustments for some or all of the following:

- **Alignment of accounting policies.** For example, reporting entities would adjust the pro forma financial information for the effect of applying a different inventory accounting policy at the acquiree level.
- **The effect of fair value adjustments.** For example, reporting entities would include amortization of intangible assets and depreciation of the tangible assets recognized as part of the business combination.
- **Transaction costs.** The reporting entity would include costs resulting from the business combination in earnings as though the acquisition occurred as of the beginning of the comparative period.
- **Taxation.** The reporting entities would need to consider the tax effects of the acquisition and related adjustments as if the acquiree had been part of the reporting entity since the beginning of the comparative period.
- **Financial structure.** The reporting entities would need to consider adjustments reflecting the new capital structure, including additional financing or repayments of debt as part of the acquisition.

Adjustments that are not factually supportable are not appropriate. For example, it generally would not be appropriate to justify incorporating cost savings and other synergy benefits resulting from the business combination in pro forma amounts.

Pro forma financial information in interim financial statements of SEC registrants is subject to additional disclosure considerations as required by Article 10 of Regulation S–X.

Pro forma financial information giving effect to business combinations is often presented in SEC registration statements, proxy statements, and Form 8-Ks as required by Article 11 of Regulation S–X. Reporting entities should note that pro forma information presented in accordance with ASC 805 will likely differ from that required by Article 11 of Regulation S-X (see Figure 17-1).

Reporting entities are also required to provide disclosure of any material, nonrecurring pro forma adjustments directly attributable to the business combination.

17.4.12.2 Regulation S-X, Article 11 pro forma disclosures

Article 11 of Regulation S-X provides the SEC's requirements for the presentation of pro forma condensed financial information regarding significant business combinations that have occurred during the most recent fiscal year or subsequent interim periods. For more information on the preparation of Article 11 pro forma condensed financial information, refer to SEC 4560.

The pro forma information presented in accordance with ASC 805 will likely differ from what is required by Article 11 of Regulation S-X. Additionally, filing of Article 11 pro forma financial information does not satisfy the requirement to include ASC 805-10-50-2(h) pro forma disclosures in the footnotes.

Pro forma disclosures required by ASC 805-10-50-2(h) might be required even when Article 11 pro forma financial information is not required due to differences in the relevant materiality thresholds. Article 11 pro forma information is based on the quantitative significance of the acquisition to the acquirer under Rule 1-02(w) of Regulation S-X, whereas ASC 805 disclosure requirements are based on quantitative and qualitative materiality to the financial statements taken as a whole.

The following figure highlights ASC 805 and Article 11 requirements related to the preparation of pro forma financial information.

Figure 17-1
ASC 805 and Article 11 pro forma requirements for acquired businesses

Topic	ASC 805	Article 11
Periods to present	ASC 805 requires that U.S. public business entities disclose unaudited supplemental pro forma information for the results of operations for the current period, as well as the results of operations for the comparable prior period. Pro forma financial information related to results of operations of periods prior to the combination is limited to the results of operations for the immediately preceding period.	Article 11 requires a pro forma balance sheet based on the latest balance sheet included in the filing (unless the acquisition is already reflected in the historical balance sheet). The pro forma condensed income statement is based on the latest fiscal year and subsequent interim period included in the filing. Comparative prior year interim period information is permissible, but not required.
Length of time disclosures must be "retained"	Pro forma disclosures should be repeated whenever the year or interim period of the acquisition is presented. For example, assume FSP Corp, a calendar, year-end reporting entity, acquired SUB Corp on May 15, 20X4, and the acquisition is material to the financial statements of FSP Corp. FSP Corp would present pro forma revenue and earnings as if the acquisition occurred on January 1, 20X3, in the interim financial statements to be included in both its second and third quarter Form 10-Qs in 20X4 and in the annual financial statements to be included in its Form 10-K for 20X4. FSP Corp is required to repeat the pro forma disclosures in the interim financial statements to be included in its second and third quarter Form 10-Qs in 20X5, and its annual financial statements to be included in its Form 10-K for 20X5 and 20X6, because the period of acquisition is presented as comparative 20X4 information. FSP Corp would continue to utilize an assumed acquisition date of January 1, 20X3, when preparing the 20X4 pro forma results for the period of acquisition. No pro forma information is required for each of the quarterly and annual periods in 20X5 and 20X6 because the results of the acquired business are included on the consolidated income statement for those periods. FSP Corp would not be required to present pro forma information in the financial statements included in the first quarter 20X5 Form 10-Q because the period of acquisition	In a subsequent registration statement, a pro forma condensed balance sheet is not required if an acquisition is already reflected on the historical balance sheet; however, disclosures related to the acquisition are required. Generally, a pro forma condensed income statement must be presented until the transaction to which the pro forma disclosure relates has been reflected in the audited financial statements for a 12-month period. For example, using the acquisition details noted in the column to the left, if FSP Corp were to file a new or amended registration statement before the Form 10-K for 20X5 is filed, FSP Corp may be required to include updated pro forma financial information. Refer to SEC 4560 for further guidance on this topic

Topic	ASC 805	Article 11
	would not be presented in the comparative first quarter 20X4 financial statements. However, FSP Corp would be permitted to include first quarter 20X4 pro forma information and should evaluate whether inclusion of the information would be beneficial to the readers' understanding of the effects of the acquisition on the consolidated financial statements.	
Format	ASC 805-10-50-2h requires disclosure of revenue and earnings amounts on a pro forma basis. Additional line items (e.g., operating income, income from continuing operations) are permissible.	Article 11 requires a pro forma condensed balance sheet, pro forma condensed income statements through income (loss) from continuing operations, and explanatory footnotes, along with an introductory paragraph that provides a description of the transaction, entities involved, and periods for which the pro forma information is presented. Refer to SEC 4560 for further guidance on alternatives for a registrant to consider in presenting income from continuing operations when there is NCI.
Date of combination	If comparative financial statements are not presented, ASC 805 requires that the pro forma information be prepared for the current reporting period as though the acquisition had occurred as of the beginning of the current annual reporting period. If comparative financial statements are presented, the pro forma information should be prepared as though the acquisition occurred at the beginning of the comparable prior annual reporting period. The "as if" date of the acquisitions would not be revised in the pro forma information in future periods when additional financial statement periods are presented.	Rule 11-02(b)(6) of SEC Regulation S-X states that the pro forma adjustments related to the condensed income statement should be computed assuming the transaction was consummated at the beginning of the fiscal year presented. The SEC staff has interpreted this to mean that the pro forma adjustments are to be computed for both the annual and interim income statements, assuming that the acquisition occurred at the beginning of the annual period.
Nonrecurring items	ASC 805 requires adjustments that are nonrecurring in nature to be included in the pro forma amounts.	Rule 11-02(b)(5) of SEC Regulation S-X requires that the pro forma condensed income statement adjustments (1) be directly attributable to the transaction in question, (2) have a continuing impact on the operations, and (3) be factually supportable. As a result, charges or credits that result directly from the transaction but do not have a continuing impact (i.e., one-time in nature or nonrecurring) are not included in the pro forma condensed income statement. In addition, nonrecurring charges or credits (e.g., transaction costs) included in the acquirer's or acquiree's historical income statements that are directly attributable to the transaction should be eliminated. Such nonrecurring charges or credits are

Topic	ASC 805	Article 11
		reflected in retained earnings on the pro forma condensed balance sheet and disclosed in the footnotes to the pro forma financial information.
Footnotes	ASC 805 requires disclosure of the nature and amount of any material, nonrecurring pro forma adjustments directly attributable to the acquisition included in the reported pro forma revenue and earnings.	Article 11 requires explanatory footnotes to be sufficiently detailed to enable a clear understanding of the assumptions and calculations involved in developing each of the pro forma adjustments.
Other completed or probable transactions	ASC 805 would allow adjustments for completed business acquisitions but would not permit adjustments for other completed or probable transactions (e.g., a completed or probable significant business disposition).	Article 11 allows adjustments for other significant completed and probable transactions (e.g., a probable disposition or a probable acquisition)

17.4.13 *Financial statement effect of adjustments related to prior acquisitions*

The results of an acquired business disclosed for the first period after an acquisition may not be indicative of the ongoing performance of such a business. The disclosure provisions are intended to provide information that enables users of financial statements to evaluate the financial effects of adjustments recognized in the current reporting period relating to business combinations that occurred in the current or previous reporting periods.

Reporting entities are required to disclose the following for each material business combination, or in the aggregate for individually immaterial business combinations that are collectively material:

- Measurement period adjustments
- Contingent consideration adjustments
- Fair value disclosures under ASC 820

These disclosures are discussed in more detail in the following subsections.

17.4.13.1 *Measurement period adjustments*

An acquirer has a period of time (referred to as the measurement period) to finalize the accounting for a business combination. An acquirer should retrospectively record measurement period adjustments made to provisional amounts as if the accounting was completed at the acquisition date. The acquirer should revise comparative information for prior periods presented in the financial statements as needed, including making any change in depreciation, amortization, or other income effects recognized in completing the initial accounting.

The following information must be disclosed when there are measurement period adjustments:

ASC 805-10-50-6

If the initial accounting for a business combination is incomplete (see paragraphs 805-10-25-13 through 25-14) for particular assets, liabilities, noncontrolling interests, or items of consideration and the amounts recognized in the financial statements for the business combination thus have been determined only provisionally, the acquirer shall disclose the following information for each material business combination or in the aggregate for individually immaterial business combinations that are material collectively to meet the objective in preceding paragraph [paragraph 805-10-50-5]:

a. The reasons why the initial accounting is incomplete

b. The assets, liabilities, equity interests, or items of consideration for which the initial accounting is incomplete

c. The nature and amount of any measurement period adjustments recognized during the reporting period in accordance with paragraph 805-10-25-17.

Incremental disclosure requirement for SEC registrants

The retrospective nature of measurement period adjustments and the resulting need to revise historical financial information is more likely to have reporting implications for SEC registrants, as demonstrated by Example 17-1.

Example 17-1

Reporting of measurement period adjustments recorded by an SEC registrant

FSP Corp is an SEC registrant that reports under U.S. GAAP and has a calendar year-end. FSP Corp acquires SUB Corp on October 1, 20X4. On May 31, 20X5, new information related to facts that existed at the acquisition date arises that leads to a measurement period adjustment. FSP Corp has already filed its Form 10-K for the year ended December 31, 20X4 and a Form 10-Q for the quarterly period ended March 31, 20X5.

How should FSP Corp address the fact that its December 31, 20x4 Form 10-K and March 31, 20X5 Form 10-Q do not reflect the required measurement period adjustment?

Analysis?

FSP Corp should take the following actions in its June 30, 20X5 Form 10-Q:

- Retrospectively adjust the December 31, 20X4 balance sheet

- Reflect the adjustment on the income statement, statement of comprehensive income, cash flow statement, and statement of changes in stockholders' equity (if applicable) for the six-month period ended June 30, 20X5

- Disclose the nature and amount of the measurement period adjustment

FSP Corp should also perform the following in the December 31, 20X5 Form 10-K to properly reflect the subsequent adjustments of the provisional amounts:

- Retrospectively adjust the December 31, 20X4 balance sheet

- Retrospectively adjust the income statement, statement of comprehensive income, cash flow statement, and statement of changes in stockholders' equity for the year ended December 31, 20X4

- Retrospectively adjust the selected quarterly data in the footnotes to the financial statements for the quarterly periods ended December 31, 20X4 and March 31, 20X5

- Disclose the nature and amount of the measurement period adjustment

17.4.13.2 Contingent consideration adjustments

The following disclosures must be provided when adjustments related to contingent consideration arrangements are recorded in reporting periods subsequent to the acquisition date:

Excerpt from ASC 805-30-50-4

a. For each reporting period after the acquisition date, until the entity collects, sells, or otherwise loses the right to a contingent consideration asset, or until the entity settles a contingent consideration liability, or the liability is cancelled or expires, all of the following:

   1. Any changes in the recognized amounts, including any differences arising upon settlement.

   2. Any changes in the range of outcomes (undiscounted) and the reasons for those changes.

   3. The disclosures required by section 820-10-50.

The disclosures required by ASC 820-10-50 relate to fair value disclosures, and are discussed in the following section.

17.4.13.3 Fair value disclosures under ASC 820

The fair value disclosures required by ASC 820 are broadly applicable to most assets and liabilities measured at fair value, including those acquired in a business combination. ASC 820 requires different disclosures if the related assets or liabilities are remeasured at fair value on a recurring basis. Refer to FSP 20 for further information on fair value disclosure requirements.

ASC 805 also requires certain disclosures related to fair value. ASC 805-20-50-1(e) requires that the acquirer disclose the fair value amount of the noncontrolling interest whenever the acquirer completes a business combination where it owns less than 100 percent of the acquired entity. It also requires the acquirer to disclose the valuation techniques and significant inputs used to measure the fair value of the noncontrolling interest.

When a business combination is accomplished in stages, the following disclosures are required:

ASC 805-10-50-2(g)

1. The acquisition-date fair value of the equity interest in the acquiree held by the acquirer immediately before the acquisition date.

2. The amount of any gain or loss recognized as a result of remeasuring to fair value the equity interest in the acquiree held by the acquirer immediately before the business combination (see paragraph 805-10-25-10) and the line item in the income statement in which that gain or loss is recognized.

3. The valuation technique(s) used to measure the acquisition-date fair value of the equity interest in the acquiree held by the acquirer immediately before the business combination.

4. Information that enables users of the acquirer's financial statements to assess the inputs used to develop the fair value measurement of the equity interest in the acquiree held by the acquirer immediately before the business combination.

17.5 Example disclosures

The following example illustrates disclosures of a business combination and the goodwill rollforward discussed in FSP 8 in the annual statements of a calendar year-end reporting entity. This is one practical example, but reporting entities can use various formats to meet the disclosure requirements. The example below provides a reference to the applicable ASC 805 guidance at the end of each disclosure. ASC 805-10-55-37 provides an additional example of the disclosure requirements.

EXAMPLE 17-2

Example business combination disclosures

Note X - Acquisitions

On August 1, 20X4, FSP Corp completed the acquisition of 50% of the common shares of Submarine Corp (SUB Corp), increasing its interest from 20% to 70%, and providing FSP Corp control over SUB Corp. SUB Corp became a consolidated subsidiary of FSP Corp on this date. SUB Corp is a shoe and leather goods retailer operating in the United States and most Western European countries. FSP Corp previously accounted for its 20% interest in SUB Corp as an equity method investment. As a result of the acquisition, FSP Corp is expected to expand the sales of its shoe and leather products in the United States and Western European markets [ASC 805-10-50-2 (a)–(d)].

The acquired business contributed revenues of $44,700 and earnings of $2,700 to FSP Corp for the period from August 1, 20X4 to December 31, 20X4 [ASC 805-10-50-2(h)(1)]. The following unaudited pro forma summary presents consolidated information of FSP Corp as if the business combination had occurred on January 1, 20X3 [ASC 805-10-50-2(h)(3)]:

	Pro forma year ended December 31, 20X4 (unaudited)	Pro forma year ended December 31, 20X3 (unaudited)
Revenue	$220,300	$205,300
Earnings	$ 33,100	$ 13,200

FSP Corp did not have any material, nonrecurring pro forma adjustments directly attributable to the business combination included in the reported pro forma revenue and earnings [ASC 805-10-50-2(h)(4)].

These pro forma amounts have been calculated after applying FSP Corp's accounting policies and adjusting the results of SUB Corp to reflect the additional depreciation and amortization that would have been charged assuming the fair value adjustments to property, plant, and equipment, and intangible assets had been applied from January 1, 20X3, with the consequential tax effects.

In 20X4, FSP Corp incurred $200 of acquisition-related costs. These expenses are included in general and administrative expense on FSP Corp's consolidated income statement for the year ended December 31, 20X4 [ASC 805-10-50-2(e)–(f)] and are reflected in pro forma earnings for the year ended December 31, 20X3, in the table above.

The following table summarizes the consideration transferred to acquire SUB Corp and the amounts of identified assets acquired and liabilities assumed at the acquisition date, as well as the fair value of the noncontrolling interest in SUB Corp at the acquisition date [ASC 805-30-50-1(b) and ASC 805-20-50-1(c)]:

Fair value of consideration transferred:	
Cash	$6,500
Common shares	5,500
Contingent consideration	2,000
Total	$14,000
Fair value of FSP Corp's investment in SUB Corp held before the business combination [ASC 805-10-50-2(g)(1)]	$5,600
Fair value of the noncontrolling interest in SUB Corp [ASC 805-20-50-1(e)(1)]	$8,000

Recognized amounts of identifiable assets acquired and liabilities assumed:	
Cash and cash equivalents	$500
Trade receivables	6,500
Inventories	4,000
Available-for-sale financial assets	1,000
License (included in intangibles)	3,000
Trademarks (included in intangibles)	1,850
Property, plant, and equipment	63,500
Trade and other payables	(12,500)
Liability arising from a contingency	(1,000)
Borrowings	(37,500)
Deferred tax liabilities	(2,000)
Retirement benefit obligations	(2,500)
Total identifiable net assets	$24,850
Goodwill	$2,750

FSP Corp issued 220 common shares that had a total fair value of $5,500 based on the closing market price of $25 per share on August 1, 20X4, the acquisition date.

As a result of FSP Corp obtaining control over SUB Corp, FSP Corp's previously held 20% interest was remeasured to fair value, resulting in a gain of $900. This has been recognized in the line item "other (losses)/gains—net" on the consolidated income statement [ASC 805-10-50-2(g)].

The fair value of the noncontrolling interest of $8,000 and the fair value of the previously held equity interest of $5,600 in SUB Corp were estimated by applying a market approach and an income approach, respectively. These fair value measurements of the noncontrolling interest and the previously held equity interest are based on significant inputs not observable in the market, and thus represent Level 3 measurements. The fair value estimates for the noncontrolling interest and the previously held equity interest are based on (1) an assumed discount rate range of 20–25%, (2) an assumed terminal value based on a range of terminal EBITDA multiples between 3 and 5 times (or, if appropriate, based on long-term sustainable growth rates ranging from 3 to 6 percent), (3) assumed financial multiples of reporting entities deemed to be similar to SUB Corp, and (4) assumed adjustments because of the lack of control or lack of marketability, as relevant, that market participants would consider when estimating the fair value of the noncontrolling interest and the previously held equity interest in SUB Corp [ASC 805-20-50-1(e), ASC 805-10-50-2(g)].

The acquisition of SUB Corp includes a contingent consideration arrangement that requires additional consideration to be paid by FSP Corp to the sellers of SUB Corp based on the future net income of SUB Corp over a three-year period. Amounts are payable three years after the acquisition date. The range of the undiscounted amounts FSP Corp could pay under the contingent consideration agreement is between zero and $3,000. The fair value of the contingent consideration recognized on the acquisition date of $2,000 was estimated by applying the income approach [ASC 805-30-50-1(c)]. That measure is based on significant Level 3 inputs not observable in the market. Key assumptions include (1) a discount rate range of 10 to 15 percent, and (2) probability adjusted level of net income between $8,000 and $8,500.

As of December 31, 20X4, there were no changes in the recognized amounts or range of outcomes for the contingent consideration recognized as a result of the acquisition of SUB Corp [ASC 805-30-50-4(a)].

The goodwill is attributable to the workforce of the acquired business and the significant synergies expected to arise after FSP Corp's acquisition of SUB Corp [ASC 805-30-50-1(a)].

The goodwill is not deductible for tax purposes [ASC 805-30-50-1(d)]. All of the $2,750 of goodwill was assigned to FSP Corp's Retail Shoes segment [ASC 805-30-50-1(e)].

The fair value of the assets acquired includes trade receivables of $6,500. The gross amount due under contracts is $6,800, of which $300 is expected to be uncollectible [ASC 805-20-50-1(b)]. FSP Corp did not acquire any other class of receivable as a result of the acquisition of SUB Corp.

The fair values of the acquired license and trademark intangible assets of $3,000 and $1,850, respectively, are provisional pending receipt of the final valuations for those assets [ASC 805-10-50-6].

Prior to the acquisition, FSP Corp had a preexisting relationship with SUB Corp. FSP Corp had a receivable of $200 for certain trademark fees. These fees were disputed by SUB Corp. In 20X2, FSP Corp filed a lawsuit against SUB Corp for the $200 in disputed fees. As part of the acquisition terms, the lawsuit was settled for $150. FSP Corp recorded a loss upon settlement of $50 as a result of the acquisition, which was recorded separately from the business combination. The settlement loss was recorded in general and administrative expense on FSP Corp's consolidated income statement [ASC 805-10-50-2(f)].

A liability arising from a contingency of $1,000 has been recognized at fair value for expected warranty claims on products sold by SUB Corp during the last two years. FSP Corp expects that the majority of this expenditure will be incurred in 20X5 and that all costs will be incurred by 20X8. The potential undiscounted amount of all future payments that FSP Corp could be required to make under the warranty arrangements is estimated to be between $500 and $1,500. As of December 31, 20X4, there has been no change to the acquisition date amount recognized for the liability, nor any change in the range of outcomes or assumptions used to develop the fair value [ASC 805-20-50-1(d)].

There were no acquisitions for the year ended December 31, 20X3.

See Note XY, Subsequent Events, for disclosures regarding the acquisition of LTR Company, which took place after the balance sheet date, but before the issuance of these financial statements [ASC 805-10-50-4].

Note Y - Goodwill

The changes in the carrying amounts of goodwill for the Retail Shoes and Retail Coats segments are as follows [ASC 350-20-50-1]:

	Retail shoes segment	Retail coats segment	Total
Balance as of January 1, 20X3			
Goodwill	$6,600	$2,400	$9,000
Accumulated impairment loss	(300)	(300)	(600)
Balance as of January 1, 20X3, net	6,300	2,100	8,400
Reduction of goodwill related to dispositions	(900)	(500)	(1,400)
Effect of foreign currency	100	100	200
Balance as of December 31, 20X3			
Goodwill	5,800	2,000	7,800
Accumulated impairment loss	(300)	(300)	(600)
Balance as of December 31, 20X3, net	5,500	1,700	7,200
Increase in goodwill related to acquisition	2,750	—	2,750
Reduction of goodwill related to disposition	(300)	—	(300)
Effect of foreign currency	100	(200)	(100)
Balance as of December 31, 20X4			
Goodwill	8,350	1,800	10,150
Accumulated impairment loss	(300)	(300)	(600)
Balance as of December 31, 20X4, net	$8,050	$1,500	$9,550

17.6 Other considerations for business combinations — pushdown accounting

When certain ownership thresholds are met, pushdown of the acquirer's basis in purchased assets and liabilities in the separate financial statements of the subsidiary or acquired entity is required when those financial statements will be presented in a filing with the SEC. Pushdown is required when more than 95 percent of the voting securities are acquired in a transaction or a series of transactions. Acquisition of between 80 percent and 95 percent of the voting interest in the acquired entity may be considered substantial, depending on the facts and circumstances. In this situation, pushdown accounting is permitted, and the SEC staff strongly encourages or may require pushdown accounting. Pushdown accounting is precluded when the parent owns less than 80 percent of the voting interest in the acquired entity. Pushdown accounting is not required for private companies unless their standalone financial statements will be included as part of a public company's financial statements; e.g., under Regulation S-X 3-05 or S-X 3-09.

The application of pushdown accounting represents the termination of the old accounting entity and the creation of a new one. Accordingly, it would not be appropriate for financial statements for a given period to combine pre- and post-pushdown periods. For example, it would be inappropriate for a reporting entity with a December 31, 20X4 year-end, for which pushdown was applied as of July 1, 20X4, to present an income statement for the 12 months ended December 31, 20X4. This would also apply to the statements of cash flows, changes in stockholders' equity, and comprehensive income. Footnote disclosures related to pre- and post-pushdown periods should likewise not be combined.

For both the financial statements and in instances where footnote disclosure is presented in a tabular format, SEC registrants would generally include a vertical black line between the predecessor and successor columns to highlight for the reader the change in basis between the pre- and post-pushdown periods. The columns related to the pre-pushdown period columns are generally labelled "Predecessor Company," while the post-pushdown period columns are labelled "Successor Company." Similar designations can be used. Also included in the footnotes to the financial statements would be a discussion of the basis of presentation. This discussion should notify the reader that the reporting entity's results of operations and cash flows after the transaction are not comparable with those prior to the acquisition as a result of pushdown accounting, and therefore have been segregated in the respective financial statements.

In addition, when pushdown accounting is applied, the retained earnings of the predecessor company are not carried forward because a new basis of accounting has been established.

When pushdown accounting is applied, the reporting entity should consider disclosing the pro forma information similar to that relating to business combinations described in ASC 805 and S-X 10-01-(b)(4) in order to demonstrate the effects of the acquisition and related pushdown accounting on the acquired entity. If that pro forma information is presented, it should be presented for the entire fiscal period (i.e., reflecting the impact of the business combination and related pushdown accounting for the entire fiscal period). The pro forma information should not be presented separately for the successor and predecessor periods. Pro forma information for the prior year comparative period(s) should also be included.

17.7 Considerations for private companies

The requirements of ASC 805 apply equally to SEC registrants and private companies. Disclosures and reporting requirements related to pro forma financial information, and Articles 10 and 11 of S-X regulations only apply to SEC registrants. In addition, pushdown accounting is not required for private companies unless their standalone financial statements will be included as part of a public company's financial statements under S-X 3-05 or S-X 3-09.

Refer to FSP 8 for discussion of goodwill presentation and disclosure requirements for private companies if a reporting entity adopts the private company accounting alternative for goodwill, ASU 2014-02.

Chapter 18: Consolidation

18.1 Chapter overview

This chapter addresses presentation and disclosure matters applicable to consolidated entities and to interests in variable interest entities (VIEs) that are not consolidated by their holders.

First, the chapter discusses presentation and disclosure considerations broadly applicable to consolidated financial statements. Next, it addresses disclosure objectives and specific disclosure requirements for reporting entities that hold interests in VIEs. Then the chapter addresses voting interest entities or VOEs. The term VOE is not defined in authoritative accounting guidance, it is commonly used to refer to an entity consolidated by a reporting entity that is not a VIE. Finally, the chapter highlights other related presentation and disclosure matters, including proportionate consolidation, presentation of nonhomogenous subsidiaries, combined financial statements, and deconsolidation of a subsidiary.

The matters addressed in this chapter assume the reporting entity will consolidate an entity on the date it obtains a controlling financial interest in accordance with ASC 810, *Consolidation*, and ASC 805, *Business Combinations*, which can be defined differently depending upon the consolidation model applied. Accounting for transactions resulting in the initial consolidation or deconsolidation of a subsidiary is discussed in PwC's VE and BCG.

18.2 Scope

The primary source of authoritative guidance on consolidation and deconsolidation is ASC 810. At the time of release of this guide, the FASB was finalizing changes to the consolidation model in ASC 810. A final standard is expected in late 2014 or early 2015. This chapter does not address those updates.

ASC 810 prescribes consolidation requirements specific to VIEs, non-VIEs (with specific guidance for non-VIE limited partnerships), and also provides general accounting and disclosure guidance for all other entities.

S-X 3A-01 through S-X 3A-05 include additional consolidation-related accounting and disclosure requirements applicable to SEC registrants. Reporting entities should understand that VIE disclosures are incremental to disclosures required by other applicable areas of U.S. GAAP (e.g., ASC 860, *Transfers and Servicing*; and ASC 820, *Fair Value Measurements*).

18.3 General consolidation presentation and disclosure principles

Consolidated financial statements include the accounts of the reporting entity and all other legal entities in which the reporting entity holds a controlling financial interest (that is, subsidiaries of the reporting entity). ASC 810-10-10-1 and S-X 3A-02 affirm the fundamental principle in U.S. GAAP that consolidated financial statements are presumed to be more meaningful than separate financial statements. Determining whether a reporting entity's interest in a legal entity provides it with a controlling financial interest depends on a number of different factors.

- If the legal entity is deemed to be a VIE, the reporting entity applies the consolidation criteria in ASC 810-10-25 (power and potentially significant benefits or losses) to determine whether it has a controlling financial interest in the VIE—and thus, should consolidate the VIE. Certain entities are exempt from applying ASC 810's guidance related to VIEs; see VE 2.2 for more details.

  Refer to VE 5.3 for further details related to the determination of a VIE's primary beneficiary.

- If the legal entity is not a VIE, the reporting entity generally evaluates whether its ownership interest in the investee provides it with a controlling financial interest.

  As described in ASC 810-10-15-8, ownership of more than 50 percent of the outstanding voting shares of another entity "is a condition pointing to consolidation." There are exceptions to this presumption that would prevent consolidation by a majority equity owner or general partner as discussed in ASC 810-10-25-2 through 14, ASC 810-20-25-4 through 21, and FSP 18.10.

Consolidation presentation and disclosure requirements vary depending on whether the investee is consolidated and, if so, whether the subsidiary is a VIE or a VOE. In any event, when a reporting entity consolidates a wholly- or partially-owned subsidiary, it should disclose its consolidation policy. In addition, if a reporting entity includes its consolidation disclosures in multiple footnotes, it should cross-reference between them.

18.3.1 Presentation and disclosure considerations: partially-owned consolidated subsidiaries

The reporting entity should disclose the effects of any changes in the subsidiary's equity that is attributable to the reporting entity (e.g., a capital contribution or the reporting entity's purchase or sale of its subsidiary's equity).

When a reporting entity consolidates a less-than-wholly-owned subsidiary, ASC 810-10-45-18 to 21 requires a parent to attribute the following amounts to the controlling and noncontrolling investors on the face of the income statement.

- Consolidated net income or loss

- Consolidated comprehensive income or loss

Additionally, the following amounts that are attributable to the reporting entity should be presented on the face of the financial statements or separately disclosed in the footnotes.

- Income from continuing operations
- Income from discontinued operations
- Income from extraordinary items

Lastly, a reporting entity should perform a reconciliation of the change in stockholders' equity as of the beginning and end of the most recent reporting period, including the following components:

- Total equity (net assets)
- Equity (net assets) attributable to the reporting entity
- Equity (net assets) attributable to the noncontrolling interest(s)

This reconciliation should also include separate disclosure of net income, each component of comprehensive income, and transactions with owners acting in their capacity as owners. For transactions with owners, contributions from and distributions to the owners should be shown separately.

In addition, a reporting entity may have multiple consolidated subsidiaries for which disclosure of information described in ASC 810-10-45-18 through 21 is warranted. It may choose to present such information on an aggregated basis.

18.3.2 General consolidation disclosure considerations

S-X 3A-02 indicates that SEC registrants should consider separate disclosure of instances when (1) a majority-owned subsidiary is not consolidated, and (2) a less than majority-owned subsidiary is consolidated.

Consolidation is an area that frequently draws comments from the SEC staff. The SEC staff may request additional disclosure when a reporting entity's disclosures do not provide adequate transparency regarding its conclusions related to consolidation, including in the following areas.

- The terms of the reporting entity's interests in an entity
- The factors considered by the reporting entity when determining whether it does or does not consolidate another entity
- A discussion of why the reporting entity does not consolidate an entity in which it owns greater than 50 percent of the outstanding equity interests (or receives a majority of the entity's economics), especially upon a deconsolidation event
- If a reporting entity does not consolidate a majority-owned subsidiary, a discussion of the nature and substance of rights held by the minority investors that led the reporting entity to conclude that it should not consolidate the investee

18.4 Variable interest entities (VIEs)

Reporting entities that hold variable interests in VIEs follow ASC 810-10's presentation and disclosure requirements. These requirements address the presentation of a consolidated VIE and also stipulate specific disclosures that vary depending upon whether the reporting entity consolidates the VIE.

18.4.1 Balance sheet presentation of consolidated VIEs

In accordance with ASC 810-10-45-25, a reporting entity determined to be the primary beneficiary of a VIE is required to separately present each of the following in its consolidated balance sheet:

- The VIE's assets that can be used to settle only the VIE's obligations

- The VIE's liabilities if the VIE's creditors (or beneficial interest holders) have no recourse against the general credit of the primary beneficiary

The VIE's liabilities and assets may not be offset and reported as a single line item in the primary beneficiary's financial statements; they are required to be presented on a gross basis.

This reporting requirement does not mean that each consolidated VIE's assets and liabilities warrant separate presentation on the face of the balance sheet. The same (or similar) assets of all consolidated VIEs may be aggregated and presented as a single line item in the reporting entity's consolidated balance sheet. The same (or similar) liabilities may also be similarly aggregated as a single line item in the liability section of the reporting entity's balance sheet.

Because criteria for separate reporting of the assets and liabilities of a consolidated VIE differ, it is possible that only the assets or only the liabilities, but not both, of a particular VIE need to be separately presented. For example, the primary beneficiary of a securitization structure or a real estate entity may need to separately present the assets of the VIE because they can only be used to settle the VIE's beneficial interests or obligations. However, if the primary beneficiary guaranteed the liabilities of the VIE, separate presentation of the VIE's obligations is not required since the beneficial interest holders or lenders have recourse to the primary beneficiary's general credit.

Only the assets and liabilities of a consolidated VIE meeting the conditions in ASC 810-10-45-25 must be presented separately in the reporting entity's financial statements; the guidance does not specify how the VIE's assets and liabilities should be presented. Therefore, the reporting entity should select one of the following as a policy election and consistently apply it to all consolidated VIEs.

- Parenthetically disclose the amount of assets and liabilities related to consolidated VIEs included in each balance sheet line item

- Separately present the assets and liabilities of a consolidated VIE as long as they are appropriately captioned on the face of the balance sheet

Example 18-1 illustrates presentation alternatives for a consolidated VIE.

EXAMPLE 18-1

Balance sheet presentation alternatives for a consolidated VIE

FSP Corp determines that Company V is a VIE, and that FSP Corp is Company V's primary beneficiary. Company V's assets consist primarily of cash and accounts receivable, which can only be used to settle specific Company V short-term and long-term debt obligations. Holders of those obligations do not have recourse to FSP Corp's general credit.

Is separate presentation of Company V's assets and liabilities required?

Analysis

Yes, separate presentation is required. To comply with the presentation requirements in ASC 810-10-45-25, FSP Corp may choose to report the assets and obligations of Company V parenthetically, as shown below.

Assets	
Cash (amounts related to VIE of $3)	$20
Inventory	14
Accounts receivable (amounts related to VIE of $3)	8
Property, plant and equipment (net)	25
Other assets	3
Total assets	**$70**

Liabilities and Stockholders' Equity	
Accounts payable	$23
Short-term debt (including debt of VIE of $3)	10
Long-term debt (including debt of VIE of $3)	19
Other liabilities	13
Equity	5
Total liabilities and stockholders' equity	**$70**

If (1) Company V's assets could be used to settle any of FSP Corp's obligations, or (2) Company V's creditors had recourse to FSP Corp's general credit, FSP Corp would not be required to separately present Company V's assets and liabilities.

If a VIE's creditors have partial recourse against the VIE's primary beneficiary, separate reporting of the VIE's assets and liabilities would not be required but would be acceptable. If the VIE's assets and liabilities are not separately reported by the primary beneficiary, then the primary beneficiary should consider disclosure of this fact so users of its financial statements fully understand the risks to which they are exposed.

In some cases, a consolidated VIE's outstanding equity interests may be owned by one or more third-party investors. Provided the VIE's equity interests are reported within the equity section in the VIE's stand-alone financial statements, these interests should be reported in the primary beneficiary's consolidated balance sheet as noncontrolling interest (NCI), as shown on the example balance sheet in FSP Figure 2-1. The primary beneficiary can make a policy election to present NCI related to a consolidated VIE separately or on an aggregate basis.

18.4.2 VIE disclosures

If a reporting entity concludes that it has a variable interest in a VIE in accordance with ASC 810, it should comply with both the VIE principle disclosure objectives and the specific required VIE disclosures in ASC 810-10-50. The specific required VIE disclosures vary depending upon whether the reporting entity consolidates the VIE. Additional disclosures are often added to the specific required disclosures to comply with the principle objectives.

The principal objective of the VIE disclosures is to provide users of the reporting entity's financial statements with information that includes the following:

- Significant judgments and assumptions made in determining whether it needs to consolidate a VIE and/or disclose information about its involvement with a VIE
- The nature of the restrictions, if any, on a consolidated VIE's assets and on the settlement of the VIE's liabilities
- The nature of and changes in the risks associated with a reporting entity's involvement with a VIE
- How a reporting entity's involvement with a VIE affects its financial position, financial performance, and cash flows

The FASB's inclusion of disclosure objectives emphasizes the need for reporting entities not to assume that the specific disclosure requirements represent the minimum requirements. Instead, reporting entities should apply judgment in determining what is necessary to provide financial statement users with decision-useful information.

The content of the VIE disclosures depends on the extent to which the reporting entity is involved with the VIE, the significance and form of the involvement, and whether the VIE is consolidated. Although ASC 810-10-50-8 articulates the broad objectives of these disclosures in a principles-based manner, many of the disclosure requirements in ASC 810-10-50 are granular and prescriptive. However, reporting entities should ensure that their VIE disclosures, when viewed in their totality, clearly communicate the purpose and design of these entities and describe the significant judgments made in connection with the primary beneficiary evaluation.

Public reporting entities should be mindful of SEC focus when the reporting entity is not consolidating the VIE but is expected to absorb economics that are disproportionate to its power over the VIE. In these instances, the reporting entity should clearly disclose the existence and nature of such arrangements as well as the judgments made when determining that the reporting entity is not the VIE's primary beneficiary.

Figure 18-1 summarizes ASC 810's specific VIE disclosure requirements.

Figure 18-1
VIE disclosure requirements

<table>
<tr><th>Relationship</th><th>Disclosures</th></tr>
<tr><td>Holder of variable interests in a VIE, regardless of whether the holder is the primary beneficiary (ASC 810-10-50-5A)</td><td>
□ Methodology for concluding whether the reporting entity is (or is not) the primary beneficiary of the VIE, including disclosure of key factors, assumptions, and significant judgments used in making this determination

□ Which factors resulted in a change in reporting, if applicable, including the impact of that change on the consolidated financial statements (e.g., the reporting entity previously consolidated the VIE and is no longer consolidating it)

□ Whether financial or other support was (or will be) provided that the reporting entity was not previously contractually required to provide, including:
o The type and amount of support
o The primary reasons for providing that support
o If the reporting entity is not the primary beneficiary, qualitative and quantitative information regarding its involvement with the VIE

□ Information (quantitative and qualitative) about the reporting entity's involvement with the VIE, including its nature, size, purpose, activities, and how it is financed

□ A VIE may issue voting equity interests, and the reporting entity that holds a majority voting interest also may be the primary beneficiary of the VIE. If so, and if the VIE meets the definition of a business and the VIE's assets can be used for purposes other than settlement of the VIE's obligations, all of these disclosures are not required.
</td></tr>
</table>

Relationship	Disclosures
Primary beneficiary of the VIE (ASC 810-10-50-3 and ASC 805-10-50-1 through 4)	□ The carrying amount and classification of the VIE's assets and liabilities included in the consolidated financial statements, including qualitative information about the relationship(s) between those assets and liabilities □ If creditors of a VIE have no recourse to the reporting entity's general credit, information about lack of recourse □ Terms of arrangements that could require the reporting entity to provide support to the VIE, including events that could expose the reporting entity to loss □ On initial consolidation of a business, disclosures required by ASC 805, as described in FSP 17.4 □ On initial consolidation of a VIE that is not a business (refer to BC 1.2), the amount of gain or loss recognized (if any)
Not the primary beneficiary of the VIE (ASC 810-10-50-4)	□ The carrying amount and classification of the assets and liabilities in the reporting entity's balance sheet that relate to the reporting entity's variable interest in the VIE □ Maximum exposure to loss as a result of the reporting entity's involvement with the VIE, including how the reporting entity determined that amount and the significant sources of that exposure to loss o Disclose if the reporting entity's maximum exposure to loss cannot be quantified □ A tabular comparison of the carrying amounts of the assets and liabilities, with the corresponding maximum exposure to loss, accompanied by a description of all qualitative and quantitative reasons for the differences between the carrying amount of the assets and liabilities and maximum exposure to loss (considering all variable interests and arrangements, both explicit and implicit) □ Information about liquidity arrangements, guarantees, and/or other commitments by third parties that may affect the fair value or risk of the reporting entity's variable interests in a VIE (encouraged but not required) □ If the reporting entity is not the primary beneficiary of the VIE because there is "shared power," significant factors considered and judgments made in determining that power is shared (refer to VIE 5.1.2)

The primary beneficiary of a VIE that is a business should comply with ASC 805's disclosure requirements, as detailed in FSP 17.4. The primary beneficiary of a VIE that is not a business should disclose the amount of gain or loss, if any, recognized on the initial consolidation of a VIE. Reporting entities should pay particular attention to the sufficiency of their disclosures when such circumstances exist.

Reporting entities may find it is useful for users of their financial statements to see consolidating financial statements. A reporting entity may present consolidating financial statements in its VIE footnote including summarized balance sheet and income statement information.

18.4.2.1 Disclosure objective versus disclosure requirements

ASC 810-10 provides a list of specific disclosure requirements in addition to a more general disclosure objective.

VIE disclosure is an area that commonly draws SEC staff comments in their reviews of filings by public registrants. In our experience, the SEC staff has requested additional disclosure to comply with ASC 810-10's general disclosure objectives, such as:

- A description of why the entity being evaluated for consolidation is not a VIE
- If the reporting entity is not consolidating the VIE, particularly when it has a significant economic interest, specific judgments made in that determination
- When a VIE is deconsolidated by a reporting entity, but the reporting entity retains a significant economic interest, more discussion of the judgments made
- When decision making (i.e., "power") and economics are disproportionate, provide more clear and transparent disclosure
- For entities that issue financial guarantees, additional information about reasons for changes in consolidation conclusions
- For financial institutions:
    - Why certain investment vehicles have been consolidated and others have not
    - The consolidation model applied to specific investments
    - The qualitative and quantitative analysis used to determine the primary beneficiary
    - The sufficiency of the related disclosures

18.4.3 *Aggregation considerations*

ASC 810 allows information about "similar" VIEs to be disclosed on an aggregated basis. Aggregation is permitted if separate reporting would not provide more useful information to investors. ASC 810-10-50-9 requires that the assessment of "similar" consider the significance of each VIE to the reporting entity, and the reporting entity's exposure to the risks and rewards of each VIE on a qualitative and quantitative basis. We believe qualitative characteristics could include the following:

- The purpose and design of the VIE
- The risks it was designed to pass along to its variable interest holders
- The nature of the VIE's assets
- The magnitude and nature of the reporting entity's involvement with the VIE

When the reporting entity aggregates the disclosure, it should distinguish between VIEs that are consolidated and VIEs that are not consolidated. Reporting entities should also consider describing the basis for aggregating "similar" VIEs.

18.4.4 *Maximum loss*

As noted in Figure 18-1, a reporting entity is required to provide certain information about its exposure to "maximum loss" stemming from its involvement with a VIE that it does not consolidate. The maximum loss represents the loss that the reporting entity would incur if all of the VIE's assets were deemed worthless as of the reporting date. The amount disclosed should include any additional costs the reporting entity would incur in connection with its involvement with the VIE. Common examples include the following:

- A holder of an equity method investment would be exposed to loss equal to the current carrying value of the investment, assuming no future capital funding requirements.
- A guarantor of an entity's debt would be exposed to the amount of principal (and interest) guaranteed.
- A reporting entity that has committed to purchase goods or services from a VIE would be exposed to costs equal to the notional amount it is contractually obligated to purchase.

A reporting entity should disclose its maximum potential loss, regardless of probability. Further, reporting entities should assess whether their disclosures provide sufficient qualitative and quantitative data regarding the methodology used to calculate the maximum exposure to loss, including key inputs and assumptions.

If a reporting entity is involved with multiple VIEs, it may disclose its maximum exposure to potential losses on an aggregate basis for all similar VIEs.

18.4.5 VIE information "scope out"

ASC 810-10-15-17(c) provides a scope exception (commonly referred to as the "information scope out") for reporting entities that entered into arrangements prior to December 31, 2003 that are unable to obtain the information necessary to apply the VIE model. This scope exception exempts such a reporting entity from determining whether a legal entity in which it has a variable interest is a VIE only after making an "exhaustive effort" to obtain the necessary information.

We believe a reporting entity has made an exhaustive effort to obtain this information only if it has pursued the missing information through every available channel. The reporting entity should consider all facts and circumstances and document the basis for its decision to invoke this scope exception.

In our experience, this scope exception is rarely applied today since reporting entities holding a variable interest in another entity typically obtain information about that entity to monitor their exposure to risks or for other commercial reasons.

ASC 810-10-50-6 directs that a reporting entity choosing to avail itself of this scope exception disclose the following:

- The number of legal entities for which the information required to perform the analysis has not been made available to the reporting entity, and the reasons
- The nature, purpose, size (if available), and activities of such entities, along with the nature of the reporting entity's involvement with those entities
- The reporting entity's maximum exposure to loss due to its involvement with the legal entities
- The amount of income, expense, purchases, sales, or other measure of activity between the reporting entity and the legal entities for all periods presented

Finally, reporting entities that invoke this scope exception should supplement required disclosures with a discussion of the reasons the reporting entity is unable to obtain this information.

18.4.6 Disclosure considerations for VIEs in certain jurisdictions

Arrangements involving VIEs are commonly used in jurisdictions where foreign ownership of domestic companies is restricted. To overcome foreign ownership restrictions, reporting entities use contractual arrangements, such as options and other arrangements, to convey decision-making and economic rights to the reporting entity, which could cause the reporting entity to consolidate the VIE.

These structures may involve holding companies designed to comply with these foreign ownership restrictions. In some cases, the registrant consolidates the holding company and the holding company consolidates the VIE. These structures have drawn increased SEC staff comments, particularly with regard to registrants' consolidation conclusions. SEC staff comments in this area often include requests for expanded disclosures about the risks associated with the registrant's involvement with such VIEs, consistent with ASC 810-10-50-8 broad disclosure objectives.

To help financial statement users better understand the judgments in connection with the consolidation assessment of VIEs in jurisdictions where holding companies are designed to comply with foreign ownership restrictions, we believe (and the SEC staff stated at the 2013 AICPA Conference) that the reporting entity should consider describing the following matters in sufficient detail relative to these VIE arrangements.

- Terms of the contractual arrangements with the VIE that were considered in the consolidation analysis (e.g., duration, decisions requiring consent of minority investors, renewal provisions, and revocability clauses)
- Service or other fees paid by the VIEs to the holding company under contractual arrangements
- Cash paid from the VIE to the reporting entity
- How such arrangements convey a controlling financial interest (i.e., the power to direct the entity's economically most significant activities and a potentially significant economic interest in the VIE)
- The critical judgments made in relation to the reporting entity's involvement in the VIE (e.g., the validity and enforceability of contracts with the parties involved)
- Whether there are any restrictions on the reporting entity's contractual rights
- Disaggregated balance sheet and income statement information
- Disclosure about retained earnings of the VIE when deferred taxes are not recognized

18.4.7 Disclosure requirements for asset managers qualifying for the ASU 2010-10 deferral

In February of 2010, the FASB issued ASU 2010-10 to indefinitely defer FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*, for reporting entities having interests in (1) certain investment entities that have the attributes of entities subject to ASC 946, *Financial Services – Investment Companies* and

(2) registered and certain unregistered money market funds. The amendments introduced by ASU 2010-10 do not, however, defer the disclosure requirements of ASC 810-10-50 for investment companies deemed to be VIEs.

18.5 Voting interest entities (VOEs)

A reporting entity with an interest in an entity first determines whether the entity is a VIE. Reporting entities applying the VIE model would follow the presentation and disclosure requirements as discussed in 18.4, in addition to those in 18.3.

If the entity is not a VIE, then the reporting entity would apply the VOE model. Under the VOE model, the reporting entity (investor) will generally consolidate the investee if it owns a majority of the entity's voting shares. However, ownership of a majority of voting shares does not always convey control to the investor. Depending on the investee's legal form (e.g., corporation, partnership or limited liability company), rights held by other equity investors may indicate the majority owner (or general partner or managing member) does not control the investee. In that case, consolidation by the majority owner (or general partner or managing member) is inappropriate. Reporting entities applying the VOE model would follow the general consolidation presentation and disclosure principles in 18.3 and consider the disclosure requirements included in the following sections, depending upon the legal form of the entity.

18.5.1 Corporations

If a reporting entity owns an interest in a legal entity that (1) is not a VIE, and (2) has a governance structure that operates like a corporation (i.e., it is governed by a board of directors (or equivalent) appointed or approved by its stockholders or owners), consolidation of the investee is generally required if the reporting entity owns greater than 50 percent of the investee's outstanding equity shares (or interests).

Despite owning a majority of a corporation's outstanding voting shares, in certain circumstances a reporting entity may conclude that consolidation is inappropriate. This might occur when the minority equity investors have substantive participating rights. In such instances, the reporting entity should consider disclosing the following:

- The noncontrolling rights that allow the minority investors to effectively participate in decisions made in the ordinary course of business, the frequency with which such rights can be exercised and why they are substantive

- The dispute resolution process if the majority investor and minority investors are unable to reach an agreement

EXAMPLE 18-2

Disclosure considerations when substantive participating rights prevent a majority investor from consolidating a voting interest entity

FSP Corp owns 60% of VOE Corp's outstanding equity, with the remaining 40% owned by ABC Corp. Through its 60% equity interest, FSP Corp can appoint a majority of VOE Corp's board members.

FSP Corp determines that VOE Corp is not a VIE. Accordingly, FSP Corp applies the voting interest entity model to determine whether it should consolidate VOE Corp.

Although FSP Corp owns a majority of VOE Corp's equity, it determines that it does not have a controlling financial interest in VOE Corp since ABC Corp can veto the hiring, firing, and compensation of VOE Corp's Chief Executive Officer, Chief Operating Officer, and Chief Financial Officer.

What disclosures, if any, should FSP Corp consider in its consolidation footnote?

Analysis

FSP Corp should consider disclosing the existence of the participating right held by ABC Corp and the judgments made in concluding that this right (1) is substantive, and (2) provides VOE Corp with the ability to block key decisions made in the ordinary course of business.

FSP Corp's specific disclosures should provide transparency into the judgments made when concluding that it should not consolidate VOE Corp, despite its majority ownership interest.

18.5.2 Partnerships

A reporting entity with an interest in a partnership first determines whether the partnership is a VIE. Assuming the partnership reporting entity is not a VIE, the reporting entity would apply the VOE model and follow the general presentation and disclosures covered in 18.3. In addition, a reporting entity may wish to present additional information to investors about consolidated partnerships or similar entities that are not VIEs. ASC 810-20-45-1 indicates that this additional information could be conveyed by: (1) providing consolidating financial statements, or (2) separately by classifying the partnership's assets and liabilities of the partnerships on the face of the reporting entity's consolidated balance sheet. Other presentation alternatives may be acceptable.

If the reporting entity is the general partner of a non-VIE partnership (or entity with a governance structure that is the functional equivalent of a limited partnership) and is not consolidating the partnership, it should consider disclosing the reason why, including the nature of substantive kick-out, liquidation, or participating rights held by the limited partners, and the specific factors considered when determining that such rights are substantive (e.g., such rights are exercisable by a simple majority of the limited partners unrelated to the general partner).

The factors reporting entities should consider when evaluating whether kick-out and other rights are in fact substantive will depend on the nature of the rights granted to the limited partners. Specific factors are described in detail in ASC 810-20-25-8 and may include the following:

- The limited partners' mechanism to call a vote to remove the general partner
- The frequency with which such rights can be exercised
- That the kick-out right can be exercised without cause
- The vote required to replace the general partner (e.g., a single limited partner or a simple majority of the limited partners), including whether the vote is cast on an absolute basis (no consideration of capital account balances) or instead is based on the relative magnitude of the limited partners' capital accounts
- Whether the general partner and its related parties are excluded from the vote
- What factors were considered when determining that no significant operational or significant barriers exist that would preclude or disincentivize the limited partners from exercising such rights

In practice, kick-out and liquidation rights are most commonly granted to limited partners in a limited partnership. When limited partners have been granted liquidation rights, the reporting entity (general partner) should consider disclosing the following:

- The limited partners' mechanism to call a vote to liquidate the limited partnership
- The frequency with which such rights can be exercised
- That the liquidation right can be exercised without cause
- The vote required to liquidate the limited partnership, including whether the vote is cast on an absolute basis or instead is based on the relative magnitude of the limited partners' capital accounts
- Whether the general partner and its related parties are excluded from the vote
- Whether the limited partners are subject to operational or financial barriers that would preclude or disincentivize them from exercising such rights (e.g., a significant termination penalty payable to the general partner upon dissolution of the limited partnership, absent cause)

If the limited partners have been granted participating rights, the reporting entity (general partner) may consider disclosure of the following:

- The noncontrolling rights that allow the limited partners to effectively participate in decisions made in the ordinary course of business
- The frequency with which such rights can be exercised
- Whether the exercise of such rights is subject to any operational barriers
- The dispute resolution process if the general partner and limited partners are unable to reach an agreement

EXAMPLE 18-3

Disclosure considerations when substantive participating rights prevent a general partner from consolidating a limited partnership that is a voting interest entity

FSP Corp is the general partner of VOE LP. FSP Corp determines that VOE LP is not a VIE. As such, FSP Corp evaluates VOE LP for consolidation under the voting interest entity model for limited partnerships (ASC 810-20).

At formation, a simple majority of the limited partners unrelated to FSP Corp were granted the right to liquidate VOE LP without cause at any time. FSP Corp evaluated the substance of the liquidation right and determined that it should not consolidate VOE LP.

What information should FSP Corp disclose in its consolidation footnote with respect to its involvement with VOE LP?

Analysis

Although not required by ASC 810-20, FSP Corp should consider disclosing the key judgments made when determining that the liquidation right rebuts the presumption that FSP Corp, as general partner, unilaterally controls VOE LP.

Such disclosures may include the following.

- A description of the mechanism that allows the limited partners to exercise the liquidation right
- Whether any barriers that would disincentivize the limited partners from exercising the vote exist, for example, termination penalties

Refer to FSP 18.5.2 for additional factors that a reporting entity may wish to consider disclosing.

18.6 Proportionate consolidation

The term “proportionate consolidation,” although not included in the codification, means presenting an investor’s pro-rata share of its assets and liabilities in each applicable line item of the investor’s balance sheet, and pro-rata results of operations in each applicable line item in its income statement. This presentation may be used in two situations, if certain conditions are met.

- *Undivided interest*

  If an investor holds an undivided interest in assets, is proportionately liable for each liability, and no other separate legal entity exists, then the reporting entity is outside of the scope of equity method accounting (ASC 323). Therefore, the investor should include, on a proportionate basis, the assets and liabilities in the investor’s balance sheet and the results of operations in the investor’s income statement. If the assets are real estate subject to joint control, then the investment would be in the scope of equity method accounting (ASC 323) and proportionate presentation would be precluded. The presentation and disclosure requirements of ASC 323 would apply.

  In the utilities industry, there are unique considerations for undivided interests predicated on an SEC Staff Accounting Bulletin that are further discussed in UP 15.

- *Equity method in the construction and extractive industries*

  An investor that holds an interest in a legal entity that is an unincorporated joint venture in the construction or extractive industry accounted for under the equity method of accounting (ASC 323) may elect proportionate consolidation. To determine whether a legal entity is an unincorporated joint venture, the reporting entity should consider its governance attributes to determine whether it is more akin to a corporation or a partnership. If the legal entity has governance attributes that are more representative of a corporation (e.g., a board of directors as opposed to a general partner or managing member), it may be considered an unincorporated joint venture.

  To qualify as an extractive industry, activities of the investee must be limited to extraction of mineral resources such as oil and gas exploration and production. A reporting entity engaged in activities such as refining, marketing, or transporting extracted mineral resources would not qualify to elect proportionate gross presentation. In that case, the presentation and disclosure requirements of ASC 323 would apply.

18.7 Combined financial statements

If a reporting entity concludes that consolidated financial statements are not required, it may be appropriate to bring together the balance sheet, income statement equity, and cash flow accounts of two or more affiliated companies into a single set of comprehensive financial statements (i.e., as a single reporting entity). It may also be appropriate when components of a business that are not legal entities are carved-out from a reporting entity. The financial statements of the affiliated group are referred to as "combined" financial statements and should be labeled as such (as opposed to "consolidated").

While consolidated financial statements are prepared on the basis of a controlling financial interest, as defined in the applicable model in ASC 810, combined financial statements are not. Combined statements may be prepared, for example, for entities under common control, because the resulting financial statements may be more meaningful than consolidated financial statements of the common parent. Combined financial statements may also be appropriate when entities are under common management.

When a reporting entity prepares combined financial statements, it eliminates intra-entity transactions and profits or losses, and treats noncontrolling interests, foreign operations, different fiscal periods, or income taxes in the same manner as in consolidated financial statements.

18.8 Consolidation procedures

The preparation of consolidated financial statements is based on the assumption that the reporting entity and its consolidated subsidiaries operate as a single economic entity. The presentation of a consolidated group may require certain adjustments for transactions occurring between the reporting entity and its subsidiaries. As a general rule, the amounts reported in consolidated financial statements should reflect the economic effects of only those transactions between the consolidated reporting entity and third parties.

18.8.1 Eliminating intra-entity transactions in consolidation

Consistent with the single economic entity premise, when preparing consolidated financial statements, a consolidated reporting entity should eliminate all intra-entity balances and transactions with its consolidated subsidiaries, including:

- Accounts payable/receivable
- Sales and purchases
- Interest
- Dividends
- Intra-entity lease arrangements
- Intra-entity profit or loss on assets remaining within the consolidated group

As a result of the foreign exchange transaction guidance in ASC 830, foreign exchange gains (losses) on intra-entity transactions, if present, may not eliminate in consolidation. Reporting entities are encouraged to consider disclosure in such situations.

18.8.1.1 Capital transactions between a reporting entity and its subsidiaries

A reporting entity may enter into transactions with a consolidated subsidiary that impact the subsidiary's capital structure. Such transactions include the subsidiary's payment of stock dividends to the reporting entity or a recapitalization of the subsidiary. Although these transactions may affect the subsidiary's stand-alone financial reporting, they should not affect the reporting entity's consolidated retained earnings balance, as such amounts would eliminate in consolidation.

For purposes of presenting consolidated financial statements, the reporting entity's retained earnings balance should reflect (1) its accumulated retained earnings balance, plus (2) the retained earnings of the subsidiary accumulated after the date the reporting entity obtains a controlling financial interest in the subsidiary (i.e., the acquisition date), less (3) any distributions made to the reporting entity's stockholders, including noncontrolling interest.

Similarly, a reporting entity and a consolidated subsidiary may enter into intra-company lending arrangements for commercial and/or tax purposes. Upon initial consolidation of the subsidiary, the reporting entity should eliminate the intercompany receivable/payable balances in consolidation and related interest income or expense.

18.8.2 Fiscal periods of a reporting entity and its subsidiary

The financial information in a set of consolidated financial statements is generally presumed to have been prepared as of the same date. If a subsidiary's financial statements are not available in a timely manner, a reporting entity may consolidate a subsidiary's financial statements as of a date that differs from the reporting entity, provided the difference does not exceed 93 days, as described in ASC 810-10-S99-2.

If the consolidated financial statements include the financial information of subsidiaries as of a date that differs from the reporting entity, the consolidated reporting entity should recognize, by disclosure or adjustment, the effects of events at the subsidiary level that have occurred during the intervening lag period and are material to the consolidated balance sheets or income statements. Each case requires an evaluation of the facts and circumstances to determine whether such events should be addressed through disclosure, or whether an adjustment to the consolidated financial statements is appropriate. In practice, recognition of most intervening events, other than intercompany transactions requiring elimination in consolidation, is typically by disclosure only. The reporting entity should also expressly indicate the closing date of the subsidiary financial information and briefly explain why different reporting dates were used.

Anytime a consolidated subsidiary reports the results of its operations on a lag relative to its parent, the presentation of the subsidiary's operations may appear unusual. These presentation issues may be more pronounced in the year a reporting entity acquires a subsidiary whose results of operations will be reported on a lag. We encourage disclosure when a reporting entity's financial statements do not fully reflect the income statement and/or balance sheet of a recently-acquired subsidiary due to presentation of the subsidiary's financial information on a lag, so users of the financial statements understand the impact of a newly-acquired subsidiary on the consolidated financial statements.

EXAMPLE 18-4

Initial consolidation of a subsidiary that reports its operations on a lag relative to its parent

FSP Corp acquires Target Corp on February 1, 20X4. Although FSP Corp and Target Corp both have fiscal years that end on December 31, FSP Corp will not be able to obtain quarterly financial results for Target Corp in time to report those results as part of its publicly-filed consolidated financial statements for the interim period ended March 31, 20X4. FSP Corp expects a similar delay in obtaining Target Corp's results in all future periods. Therefore, FSP Corp adopts an accounting policy whereby the operations of Target Corp are consolidated on a one quarter (i.e., three months) lag and Target Corp's operating results for the period from February 1, 20X4 (date of acquisition) through March 31, 20X4 are omitted from FSP Corp's consolidated statement of operations for the quarter ended March 31, 20X4. These results will be included in FSP Corp's consolidated statement of operations for the quarter ended June 30, 20X4.

Should FSP Corp disclose the impact of its consolidation policy for Target Corp in its first quarter consolidated financial statements? If so, what specific information should be disclosed?

Analysis

Yes. FSP Corp should disclose its policy of reporting Target Corp's results on a one quarter lag, the fact that Target Corp's 20X4 first quarter results of operations are excluded from its consolidated results of operations, and the fact that the Target Corp balance sheet information included in FSP Corp's consolidated balance sheet as of March 31, 20X4 is as of the acquisition date and, if applicable, whether such amounts are preliminary and subject to potential measurement period adjustments. FSP Corp should also disclose or adjust its consolidated operating results for any intervening events at Target Corp (between the acquisition date and March 31, 20X4) that materially impact FSP Corp's consolidated financial position or results of operations. These same policy and related disclosures would also be included in FSP Corp's annual financial statements.

A change in the reporting date of a subsidiary is an accounting change which can be made only if the change results in preferable accounting in accordance with ASC 250. It would be difficult to justify the preferability of a change in the reporting period of a subsidiary that has the result of creating (or lengthening) a lag period.

The reporting entity should follow the disclosure requirements in ASC 250-10-50 for changes in an accounting principle when a reporting entity changes or eliminates a previously-existing difference in subsidiary reporting periods. That is, the reporting entity would retrospectively adjust the financial statements for all prior periods presented and disclosure should be made in the footnotes.

ASC 250-10-45-9 provides an exception in cases where retrospective adjustment is not practicable. If a reporting entity meets the conditions to qualify for the impracticability exception, it would not be required to retrospectively apply the effects of the change in accounting principle.

When a reporting entity creates, changes, or eliminates a difference in an existing subsidiary's reporting period, it would be inappropriate to including a subsidiary's results for a period greater or less than twelve months in the reporting entity's consolidated annual financial statements. Reporting and disclosing changes in an accounting principle are addressed in FSP 30.

18.8.3 Specialized industry accounting principles in consolidation

Reporting entities may encounter recognition and measurement complexities when consolidating subsidiaries that follow specialized industry accounting principles. For example, a private equity fund that is consolidated by its general partner may report its investments at fair value in its stand-alone fund financial statements in accordance with the specialized industry accounting principles in ASC 946, *Financial Services - Investment Company*.

Under ASC 810-10-25-15, reporting entities should retain specialized industry accounting in consolidation and related accounting policy disclosures, if material, assuming the specialized accounting practice is appropriate at the subsidiary level. However, we believe reporting entities should carefully evaluate such situations to avoid potential abuses of this guidance.

18.8.4 Presentation of nonhomogeneous subsidiaries

As noted in FSP 18.3, a reporting entity generally consolidates another entity in which it holds a controlling financial interest. In some situations, the reporting entity and a consolidated subsidiary may have very different or "nonhomogeneous" operations (e.g., the reporting entity is a manufacturer and the subsidiary is in the insurance industry).

No detailed authoritative guidance directly addresses how the assets, liabilities, and results of operations attributable to a nonhomogeneous subsidiary should be presented and disclosed in the consolidated financial statements of its parent. It is our understanding that the FASB did not prescribe presentation guidance with respect to nonhomogeneous subsidiaries to provide reporting entities flexibility based on their unique situation.

In our view, a reporting entity should consider various factors when determining the best presentation alternative for users of its financial statements.

- *Regulation S-X rules and financial statement user needs*

  Both are biased toward expanded line item disclosure and disaggregation of information.

- *The materiality of the nonhomogeneous subsidiary*

  For example, the more material a subsidiary with an unclassified balance sheet is to the consolidated financial statements, the more likely that it is appropriate to present a consolidated unclassified balance sheet.

- *Diversity of the reporting entity and nonhomogeneous subsidiary's operations*

  The more diverse a nonhomogeneous subsidiary's operations are from the remainder of the reporting entity, the more appropriate expanded line item disclosure may be.

- *Future plans with regard to the subsidiary*

  A reporting entity's strategic plan for the subsidiary may affect whether the subsidiary's financial information should be presented on an aggregated or disaggregated basis. For example, it may be appropriate to disaggregate a nonhomogeneous subsidiary that is expected to expand. Disaggregated information may provide transparency that allows financial statement users to understand the nonhomogeneous subsidiary's contribution to the reporting entity's overall growth and performance.

In some cases, reporting entities may choose to provide consolidating financial data. This presentation alternative separates all income statement and balance sheet elements of the nonhomogeneous subsidiary from the remainder of the reporting entity in columnar format. Such amounts are then totaled to derive consolidated amounts.

There are several possible approaches for presentation of nonhomogeneous operations. The reporting entity should choose a reasonable approach that it believes will be most meaningful to its financial statement users, being mindful of the prohibition in Regulation S-K Item 10(e) against including non-GAAP financial measures in the financial statements.

18.9 Change in entities in the consolidated group

S-X 3A-03 requires public reporting entities to disclose material changes in the subsidiaries it includes or excludes in its consolidated or combined financial statements when compared to the prior fiscal year.

Reporting entities should follow ASC 805's disclosure requirements (addressed in FSP 17) for newly-consolidated entities and, if applicable, those required by ASC 810.

If a subsidiary of an SEC registrant is not consolidated, the reporting entity should disclose the reason for excluding the subsidiary from its consolidated financial statements and the basis of accounting for its investment.

A change in a reporting entity's interest in an investee may impact the manner in which it accounts for that interest. For example, a reporting entity may account for its interest in an investee following the equity method of accounting and subsequently acquire additional shares, thereby resulting in consolidation. The following section addresses the presentation and disclosure requirements to consider in such instances.

18.9.1 Change from equity method or cost method to consolidation

Initial consolidation of an investee previously reported under the equity or cost method should be accounted for prospectively as of the date the entity obtained a controlling financial interest. Although prior years' financial statements of the subsidiary would not be consolidated with those of its parent because there was no controlling financial interest at those dates, public business entities should provide pro forma information required by ASC 805-10-50-2. See FSP 17.4.12.1 for more details.

If a change in ownership occurs after the balance sheet date, it may be a nonrecognized subsequent event requiring disclosure. Refer to FSP 28.6.3.9 for further discussion.

18.9.2 Deconsolidation

A reporting entity will deconsolidate a subsidiary (or derecognize a group of assets that meet the definition of a "business") upon the loss of control, consistent with the guidance in ASC 810-10-40-3A. From that time forward, the reporting entity would no longer present the subsidiary's total assets, liabilities and results of operations in their consolidated financial statements. The reporting entity may, however, be required to follow the presentation and disclosure requirements for discontinued operations following the deconsolidation of a subsidiary or "business," as further discussed in FSP 27.

In the period a subsidiary is deconsolidated (or a group of assets that meet the definition of a business is derecognized), the reporting entity should include the following disclosures in the consolidated footnotes or, where appropriate, on the face of the income statement, as required by ASC 810-10-50-1B.

- The amount of any gain (loss) recognized
- The portion of any gain (loss) recognized that relates to the remeasurement of any retained interest in the deconsolidated subsidiary (or derecognized group of assets) to fair value
- The income statement line item in which the gain (loss) is included (unless separately presented on the face of the income statement)

- A description of the valuation techniques utilized to measure the fair value of any direct or indirect retained interest in the deconsolidated subsidiary (derecognized "business"). Other disclosures may also apply (e.g., those required by ASC 820 regarding the fair value measurement's level within the fair value hierarchy)

- Information regarding the inputs used to measure the fair value of the retained interest

- The nature of any continuing involvement with the former subsidiary (group of assets) upon deconsolidation (derecognition)

- Whether the transaction resulting in deconsolidation (derecognition) involved a related party

- Whether the former subsidiary ("business") will be a related party after deconsolidation (derecognition)

It may be more effective to include such disclosures in the notes to the consolidated financial statements rather than on the face of the reporting entity's income statement. A reporting entity should present the information in a single note or by cross-referencing other footnotes.

18.10 Considerations for private companies

S-X 3A-01 through S-X 3A-04 provide reporting requirements applicable only to SEC registrants.

ASU 2014-07, *Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements, a consensus of the Private Company Council* (ASC 810-10-15-17A through C) allows private companies to avoid applying the VIE model to certain qualifying common control leasing arrangements. If elected, the presentation alternative comes with certain disclosure requirements.

18.10.1 Private company alternative – common control leasing arrangements

Many private companies lease properties from sister entities (the lessor) that are under the control of a common parent. These arrangements are required to be analyzed under the VIE consolidation guidance, which may lead to the lessee consolidating the lessor. However, a nonpublic business entity (private company) may elect not to apply the VIE model to these arrangements if certain criteria are met. If the private company lessee qualifies and adopts this accounting guidance, it should disclose information about the lessor legal entity in combination with the disclosures required by other authoritative accounting literature in a single note or by cross-referencing within the footnotes. These disclosures include the following.

- The amount and key terms of liabilities recognized by the lessor that could potentially require the private lessee to provide financial support to the lessor

(such as amount of debt, interest rate, maturity, pledged collateral, and guarantees of the debt)

- □ A qualitative description of circumstances not recognized in the financial statements of the lessor that could potentially require the private lessee to provide financial support to the lessor

The lessor entity may have recognized outstanding debt obligations, environmental liabilities,or asset retirement obligations in its stand-alone financial statements that the private lessee should consider when making such disclosures. Additionally, the private lessee may have unrecognized commitments and contingencies related to the common control leasing arrangement that should also be considered for disclosure.

The private company should disclose guarantees associated with these arrangements in combination with the disclosures required by other authoritative accounting literature (e.g., ASC 460, ASC 850, and ASC 840) and may combine them in a single footnote or by cross-referencing other footnotes.

ASU 2014-07 is effective for annual periods beginning after December 15, 2014 and interim periods within annual periods beginning after December 15, 2015. Early adoption is permitted.

Private company lessees that elect this accounting alternative should retrospectively apply the requirements of ASU 2014-07 to all periods presented in their consolidated financial statements.

Chapter 19: Derivatives and hedging

19.1 Chapter overview

Derivatives represent certain rights or obligations that meet the definitions of assets or liabilities. Reporting entities use derivatives to manage their exposure to various risks such as interest rate risk, foreign exchange risk, price risk, and credit risk or for speculation. This chapter discusses the requirements for presenting and disclosing freestanding and embedded derivatives, including those to which hedge accounting is applied. The following aspects are covered:

- Balance sheet classification and presentation of derivatives, including offsetting considerations
- Income statement presentation of derivatives
- Disclosure requirements

19.2 Scope

ASC 815, *Derivatives and Hedging*, establishes presentation and disclosure requirements for all nongovernmental reporting entities that use derivative instruments.

ASC 820, *Fair Value Measurement*, provides guidance on determining fair value of all instruments, including derivatives. The presentation and disclosure requirements specific to fair value measurements are included in FSP 20.

19.3 Balance sheet presentation

All derivative instruments subject to ASC 815 should be recognized on the balance sheet at fair value.

19.3.1 Balance sheet classification – current versus noncurrent

ASC 815 does not provide specific guidance on the balance sheet classification of derivatives. General guidance on classification is included in ASC 210-10-45 and detailed in FSP 2.3.4. Regardless of whether it follows this general guidance, or applies any of the exceptions discussed in this section, a reporting entity with significant derivative activity should disclose its accounting policy for determining the balance sheet classification of derivatives.

Applying the general classification guidance to a derivative can be difficult since a derivative may be either an asset or a liability at any point in time. It may be an asset in one period and switch to a liability in the next period (or vice versa), and its fair value is often a "net" number that may consist of a current asset and a noncurrent liability or a noncurrent asset and a current liability at any point in time. Additionally, because of the unique characteristics of derivatives, comparison to other balance sheet accounts may not be helpful. Even securities subject to ASC 320, *Investments – Debt and Equity Securities,* which are classified in accordance with the same guidance in ASC 210, *Balance Sheet*, do not share all of the characteristics of derivatives.

Given the lack of specific classification guidance for derivatives, we believe the following general rules should govern the determination of the balance sheet classification for a derivative in a classified balance sheet:

- A derivative that matures within one year should be classified as current

- A derivative that allows the counterparty to terminate it at fair value at any time should be classified as current when its fair value is a net liability, as is required by ASC 210-10-45-7 for liabilities due on demand (addressed in FSP 12.3.2.1). Such termination provisions may be documented in either the trade confirmation or the master agreement with the counterparty. (For example, this would result in current classification for options written by the reporting entity, a liability, and exercisable within one year.)

If neither of these situations applies, the derivative should be separated into its current and noncurrent components depending on the timing of the cash flows. That is, the fair value related to the cash flows occurring within one year should be classified as current, and the fair value related to the cash flows occurring beyond one year should be classified as noncurrent.

Exceptions to the general rules include the following:

- A derivative that would otherwise have been classified as a current liability in whole or in part may be shown as noncurrent if all of the following occur:

  - The derivative is designated as a hedge of the forecasted issuance of long-term debt.

  - After the balance sheet date but before the balance sheet is issued, the reporting entity has issued long-term debt (or entered into a financing arrangement that clearly permits the reporting entity to refinance on a long-term basis).

  - All of the applicable conditions in ASC 470-10-45 for refinancing short-term debt on a long-term basis have been met.

- A derivative that would otherwise have been classified as a current asset because its fair value is a net asset and its final maturity is within one year should be presented as noncurrent if the derivative is designated as a fair value or cash flow hedge of (1) the acquisition or construction of a noncurrent asset or (2) the liquidation of debt that is classified as long-term

This second exception is supported by the provisions of ASC 210-10-45-4, which discuss the classification of assets designated for expenditure in the acquisition or construction of noncurrent assets or segregated for the liquidation of long-term debt. If the derivative were designated to offset maturing debt that has properly been presented as a current liability, it may be classified as a current asset.

From a practical standpoint, the bifurcation of derivatives into their current and noncurrent portions and the determination of their fair values may add another layer of complexity to applying the provisions of ASC 815. If discounting is not considered significant to the valuation of the current portion of the derivative instrument, we do not object to presenting the current portion undiscounted. In this instance, the current portion would be based on the net cash flows expected within one year, and the noncurrent portion would reflect the difference between the total fair value and that shown as current.

Alternatively, a reporting entity may choose not to separate a derivative into its current and long-term portions, provided the following rules are consistently applied to all derivatives in all periods:

- A derivative whose fair value is a net liability is classified in total as current

- A derivative whose fair value is a net asset is classified in total as noncurrent, except if the current portion is a liability, in which case the current portion should be presented as a current liability

A reporting entity should review those individual derivatives whose fair values are net assets to ascertain whether the current portion is a liability. It will often know (or be able to estimate) whether the current portion of a derivative is a liability either through its knowledge of forward prices/rates for the underlying or from details contained in the derivative's valuation report.

EXAMPLE 19-1

Balance sheet classification of a derivative that is a net liability

On January 1, 20X4, FSP Corp enters into a forward contract with Counterparty B that requires FSP Corp to acquire specified volumes of a commodity, which will be delivered on December 31, 20X5 and December 31, 20X6. The contract does not allow either party to terminate the contract prior to maturity. There is no master netting agreement in place with Counterparty B. At inception, the forward contract has a fair value of zero, and FSP Corp accounts for it as a derivative (i.e., the normal purchases and normal sales scope exception does not apply).

On December 31, 20X4, the derivative contract is in a $100 unrealized loss position from FSP Corp's perspective (i.e., it is a liability). The fair value is determined from observable market data, inclusive of FSP Corp's credit risk. Based on FSP Corp's analysis of the expected cash flows, approximately $40 of the unrealized loss position relates to commodities to be delivered during 20X5, and the final delivery will be during 20X6.

How should FSP Corp present this derivative in a classified balance sheet?

Analysis

As of December 31, 20X4, FSP Corp may present the derivative in either of the following ways (provided the approach taken is applied consistently).

Separately present current and noncurrent portions

	Current liabilities	Noncurrent liabilities
Derivative liability	$ 40	$ 60

Present entirely as a current liability

	Current liabilities	Noncurrent liabilities
Derivative liability	$ 100	$ 0

EXAMPLE 19-2

Balance sheet classification of a derivative that is a net asset

On June 30, 20X4, FSP Corp enters into an interest rate swap agreement with Counterparty C. The contract requires annual payments commencing on June 30, 20X5 for three years. The terms of the arrangement call for FSP Corp to receive from Counterparty C payments based on 30-day LIBOR and pay to Counterparty C a fixed rate of interest.

On December 31, 20X4, the contract is in a $2 million unrealized gain position from FSP Corp's perspective (i.e., it is an asset). The unrealized gain is made up of the net present value of each of the three payments:

Payment date	Fair value
June 30, 20X5	$ (500,000)
June 30, 20X6	$ 850,000
June 30, 20X7	$ 1,650,000
	$2,000,000

How should FSP Corp present this derivative in its December 31, 20X4 classified balance sheet?

Analysis

At December 31, 20X4, FSP Corp should present this derivative as follows:

Noncurrent assets	$2,500,000
Current liability	$(500,000)

However, if the current portion of the derivative instrument were an asset, FSP Corp could have elected to (1) present the entire derivative as noncurrent or (2) separately present the components as current and noncurrent, as applicable.

19.3.2 *Balance sheet offsetting of derivatives*

As discussed more fully in FSP 2.4, assets and liabilities should only be netted on the balance sheet if they meet the conditions in ASC 210-20-45-1. Those conditions are:

- The parties owe each other determinable amounts.
- The reporting party has the legal right to set off the amount owed with the amount owed by the other party.
- The reporting party intends to set off.
- The right of setoff is legally enforceable.

However, ASC 815-10-45-5 provides an exception for derivatives to the third criterion. Even if the reporting party does not intend to set off the gross amounts, ASC 815 allows netting if the derivatives are with the same counterparty and the reporting entity has the right to set off the amounts owed under the derivatives pursuant to a "master netting arrangement" that is legally enforceable.

Although the term "master netting arrangement" is not specifically defined, ASC 815-10-45-5 provides some insight into master netting arrangements.

Excerpt from ASC 815-10-45-5

A master netting arrangement exists if the reporting entity has multiple contracts, whether for the same type of derivative instrument or for different types of derivative instruments, with a single counterparty that are subject to a contractual agreement that provides for the net settlement of all contracts through a single payment in a single currency in the event of default on or termination of any one contract.

Legal analysis and judgment are required in determining whether a transaction is governed by a master netting arrangement or similar agreement and in determining the legal rights that the reporting entity/counterparty have, as it may vary by contract and by jurisdiction. Determining the legal rights should include an analysis of the operation of the contract itself and the enforceability of rights to set off.

The standard contracts for over-the-counter (OTC) derivatives developed by the International Swaps and Derivatives Association, Inc. (ISDA) generally contain such provisions and qualify for the netting treatment, provided they are enforceable at law in the jurisdiction in which they are transacted. These agreements may allow for net settlements of payments in the normal course and offsetting of all contracts with a given counterparty in the event of bankruptcy or default of one of the two parties to the transaction. To avail themselves of the net presentation, reporting entities should ensure their contractual arrangements include the appropriate terms and that they are enforceable.

If the conditions for offsetting are met, a reporting entity may elect to report the fair value of its derivative transactions on a net basis by counterparty. The choice to offset or not is an accounting policy election. Reporting entities should disclose the policy and apply it consistently.

Notwithstanding the above, ASC 815-10-45-2 indicates that netting a *hedging* derivative's asset/liability against the *hedged* liability/asset is not permitted even if all four criteria in ASC 210-20-45-1 are met.

Question 19-1

Futures exchanges require an initial margin deposit and maintenance of the margin as long as the contract is open.

Should the futures margin deposit be classified as part of the carrying amount of an item that is being hedged, or may it be netted against the derivative?

PwC response

The margin deposit represents a current receivable from the broker and should not be included as part of the carrying amount of the hedged item.

The margin deposit also does not constitute an initial net investment[1], since it is a separate contractual requirement imposed by the futures exchange (i.e., as collateral for the futures contract) and is not a part of the futures contract itself.

However, a margin deposit may be netted against the fair value of the derivative if the requirements for netting of derivatives are met.

19.3.2.1 Offsetting collateral

A reporting entity is required to recognize amounts for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable). A

[1] Initial net investment is the second of three criteria, all of which must be met for a financial instrument to be considered a derivative, in accordance with ASC 815-10-15-83. It states that to be classified as a derivative, the "contract requires either no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors."

reporting entity may offset "fair value amounts" recognized for derivatives and "fair value amounts" recognized related to collateral arising from derivatives that are subject to a master netting agreement. ASC 815-10-45-5 indicates that for the collateral receivable or payable, "fair value amounts" include amounts that approximate fair value. This applies only to collateral and should not be analogized to other receivables and payables.

A reporting entity that reports its derivatives net should also offset its cash collateral asset or liability against the fair value amounts recognized for derivatives executed with the same counterparty under the same master netting agreement provided the amounts for collateral meet the criteria for offsetting

As a corollary, if the reporting entity does not report its derivatives on a net basis, it is precluded from netting the related fair value amounts with the cash collateral.

19.3.2.2 Use of clearing houses

Reforms mandated by the Dodd-Frank Act changed the way certain reporting entities trade certain derivatives (such as interest rate and credit default swaps) by requiring them to be traded through designated electronic trading platforms, and cleared through registered clearing houses. As a result, derivatives have increasingly been executed through a clearing house, rather than transacted bilaterally in an over-the-counter ("OTC") market.

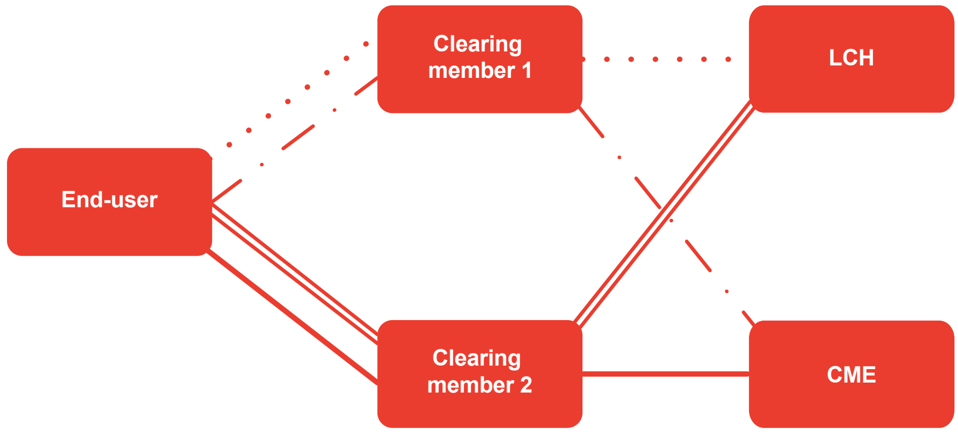
There are significant differences between OTC derivatives that are traded bilaterally and those that are traded through a clearing house. A bilateral trade generally only requires one contract (for example, an ISDA agreement supplemented by a credit support annex that has historically governed the rules for collateralization between the two parties). Cleared derivatives require multiple legal contracts between the end-user, swap execution facility, swap dealer, and clearing member. The clearing members, in turn, need to have contracts with the clearing house. The common agreement the end-user firm needs to sign with the clearing member is a futures account agreement (FCM agreement) together with an "OTC addendum," which is needed to accommodate these derivatives. The following figure highlights some of the key differences between bilateral and cleared derivatives that may affect presentation and disclosure.

Figure 19-1
Key differences between derivatives executed bilaterally versus through a clearing house

Bilateral derivatives	Cleared derivatives
▫ All aspects of an agreed trade — legal, credit, market, and operational risks — are dealt with directly between the two transacting parties. ▫ Posting of collateral is not required unless each party agrees to it as a requirement for the trade. Any collateral agreements are customized. ▫ Nonperformance risk of the trade resides with both parties to the extent the trade is uncollateralized.	▫ Trades are executed through a swap execution facility/swap dealer and then "back to back" or novated to the clearing house. Multiple parties are involved, including an end-user (e.g., a corporate reporting entity), swap execution facility, swap dealer broker, clearing member, and clearing house. ▫ Requirements for initial margin are set by the clearing house irrespective of the quality of the counterparty. ▫ Variation margin is subject to daily movement.

The following figure illustrates the flow of a derivative when a clearing house is used. It demonstrates that an end-user may have relationships with different clearing members associated with the same clearing house. Certain trades may clear through one or more clearing house as well.

Figure 19-2
Flow of cleared derivatives



Note: Each different line formatting represents a particular group of trades through the same clearing member and clearing house.

LCH = London Clearing House
CME = Chicago Mercantile Exchange

Determining the appropriate presentation for cleared derivatives requires a legal analysis of the facts and circumstances and the contractual rights in place with the clearing member. Reporting entities need to review trades individually to see if netting provisions exist with different clearing members when evaluating their ability to net under ASC 210 and ASC 815. Netting requires the trade to flow through both the same clearing member and clearing house. We are not aware of instances in which legal counsel has supported the netting of transactions that are separately traded through different clearing members (clearing member 1 and 2 in Figure 19-2), even if the trades ultimately clear at the same clearing house.

Margin

The clearing house requires margin to be posted to insulate itself from any losses as a result of adverse price movements and a default of the clearing member or end-user. Margin can consist of cash, securities, or other collateral.

Variation margin is an amount that is required to be paid or received periodically as dictated by the clearing member and/or clearing house. The clearing house will determine a "value" used to calculate the amount of variation margin owed or due to be received. In addition to the pure change in "value" of the derivative, the clearing house may decide to incorporate an additional amount to be posted to mitigate any nonpayment risk or for other reasons. Moreover, in some cases the clearing member may request an amount in addition to what is dictated by the clearing house for the same reasons. Therefore the periodic movement of variation margin may not be a pure representation of the change in the derivative's value.

A reporting entity might present the periodic movements of variation margin as either (1) a payment of collateral or (2) a settlement of an open position. This determination is not an accounting election, but rather requires a legal assessment of the specific terms of each trade and the legal relationship with the clearing member and clearing house.

If the cash payment amounts are considered a payment of collateral associated with open positions, the derivative and the accumulated collateral need to be assessed for the balance sheet netting provisions of ASC 210 and ASC 815, as well as footnote disclosures required by ASC 210.

If the cash movements are considered legal settlements of an open contract, the position is fully or partially settled each day as cash is moved.

Question 19-2

Does a reporting entity need to consider different accounting treatments depending on whether cash or securities are provided as margin?

PwC response

As noted above, the financial reporting presentation of the margin depends on the legal arrangements with the clearing member and clearing house. A reporting entity might present the periodic movements of variation margin as either (1) a settlement of an open position or (2) a payment of collateral. If considered a settlement, there is no recognized collateral to offset. If considered a payment of collateral, then the distinction as to whether cash or securities are presented comes into play.

When a reporting entity posts a financial asset other than cash, it should evaluate ASC 860, *Transfers and Servicing*, to determine whether it has relinquished effective control, and accordingly, if it is appropriate to derecognize the financial asset.

When cash is provided as margin, a reporting entity will typically record a receivable "due from the clearing member" equal to the cash posted.

In the case of cash collateral, a reporting entity should consider any margin posted in light of the balance sheet netting provisions of ASC 210 and ASC 815, as well as footnote disclosures required by ASC 210.

19.3.3 Presentation of hybrid financial instruments measured at fair value

ASC 815 requires reporting entities that have hybrid financial instruments with embedded derivative features meeting certain criteria to separately account for the embedded derivative feature and the host contract. Although this requires separate accounting, we do not believe this requires separate financial statement presentation.

For purposes of balance sheet presentation, we believe the embedded feature and host contract may be presented on a combined basis because the combined presentation is reflective of the overall cash flows for that instrument. However, when the host contract would be presented in equity or mezzanine equity, we generally believe the host contract and embedded derivative feature should be presented separately.

In addition, ASC 815-15-30-1 allows a reporting entity to elect fair value accounting (the fair value option, as discussed in FSP 20.5) for an entire hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, unless the instrument is included in the listing of scope exceptions in ASC 825-10-15-5. Thus, the instrument would not be separated into the embedded derivative feature and the host in the financial statements.

19.4 Income statement presentation

This section addresses income statement geography and gross versus net presentation for derivative instruments. In some cases, the presentation differs based on whether the derivative is designated in a qualifying hedge under ASC 815. However, ASC 815 generally does not provide much guidance for determining income statement presentation of derivatives. However, in recognition of the potential diversity in practice that could arise, the guidance does require detailed disclosure of where derivative-related gains and losses are presented in the income statement.

19.4.1 Presentation of derivative gains and losses — gross versus net

Generally, the determination of whether gains and losses on derivatives should be reported as separate line items in the income statement (presented gross) or combined in a single financial statement line item (presented net) is a matter of judgment that depends on the relevant facts and circumstances. Reporting entities should consider the guidance in ASC 845, *Nonmonetary Transactions*, relative to nonmonetary exchanges and the gross versus net reporting indicators provided in ASC 605-45, *Revenue Recognition—Principal Agent Considerations*, in making this determination. Further, as discussed in ASC 815-10-55-62, to support gross presentation, there should be economic substance to the transaction. Reporting entities that present gains and losses gross should disclose the policy for gross presentation in the footnotes.

If a derivative is held for trading purposes, ASC 815-10-45-9 indicates that gains and losses (realized and unrealized) should be shown net in the income statement, whether or not settled physically.

19.4.2 Presentation of gains and losses on hedging derivatives

ASC 815 does not specify the income statement geography of changes in the fair value of derivatives designated as hedges. In practice, reporting entities generally reflect the effective portion of the changes in fair value of derivatives in the same income statement line item as that of the hedged item. For fair value hedges, the effective portion of the derivative is reported through income. For cash flow hedges, the effective portion is reclassified into income from AOCI. For net investment hedges, the effective portion of the gain or loss on the hedging derivative is recorded in CTA. The ineffective portion is recorded directly in income.

For the ineffective portion, reporting entities may present the ineffectiveness (1) in the same line item as that of the hedged item (as the ineffectiveness may be viewed as a related cost of the hedging relationship), or (2) in a separate line item such as other income or expense (as the ineffectiveness may be viewed as being extraneous to the hedging relationship).

19.4.3 Presentation of derivatives not in qualifying accounting hedges

ASC 815 does not provide specific guidance on the income statement presentation of gains and losses of derivatives that are not designated in a hedging relationship. Thus, diversity in practice has developed.

The reporting entity may make a policy election regarding the income statement classification of non-hedging derivatives. They may either report the fair value fluctuations associated with the derivative in the same line as the hedged item, or in another reasonable income statement line item. For example, a reporting entity earns revenue in a currency other than its functional currency and executes a foreign currency derivative to hedge that exposure. Although it represents an economic hedge, the reporting entity chooses not to designate this derivative as a hedge under ASC 815. The reporting entity may elect to either report the changes in fair value associated with the derivative in the same line as revenue, or in foreign currency gains and losses in the income statement. We believe either is acceptable as long as the policy decision is reasonable and applied consistently.

ASC 815 allows for income statement presentation within multiple income statement line items only for the effective and ineffective portions of gains and losses related to derivatives that are designated and qualify for hedge accounting. Otherwise, all changes in fair value of a derivative should be shown in a single line item in the income statement.

If a derivative is not designated in a qualifying hedge relationship, splitting gains and losses into more than one income statement line items is generally not appropriate. Classification should be consistent with the nature and intent of the derivative instrument. Some view these derivatives as “economic hedges” and believe they should follow similar income statement presentation as hedging derivatives (i.e., including realized gains and losses in the same location as the economically hedged item and unrealized gains and losses in a separate location). However, this is generally not considered appropriate, because it is similar to the “synthetic accounting” model, which is not permitted under ASC 815.

Income statement presentation may vary by industry. Generally, the banking industry applies the practice of reporting all derivatives that do not qualify for hedge accounting in a single line item in the income statement. Other reporting entities, including many insurers, determine income statement classification on an instrument-by-instrument basis, treating similar derivatives in a consistent manner. For example, derivatives that an insurer believes economically hedge policyholder benefit obligations may be recognized in the benefits expense line item, while derivatives entered into purely for investment reasons may be classified as investment income.

Question 19-3

Reporting entities may issue warrants that are classified as liabilities and recognized at fair value through net income. The terms of these warrants may entitle the holder to dividend payments when dividends are paid to common stockholders.

How should the issuer classify the dividend-equivalent payments to the warrant holder in its income statement?

PwC response

We believe the warrant holder's right to dividend-equivalent distributions impacts the fair value of the warrant and should be included in determining the change in fair value of the warrant through the income statement. The payment in cash for the actual dividend would then reduce the recorded amount of the warrant on the balance sheet, representing a partial settlement of the warrant liability. As a result, the issuer should recognize a gain or loss on the fair value change of the warrant, rather than a warrant expense only when a dividend is declared.

Since gains or losses on non-hedging derivatives should not be split into multiple line items, the income statement effect of the warrant should be shown on one line item. Once the line item is identified, the reporting entity should apply this accounting policy decision consistently.

Question 19-4

A reporting entity has two derivatives. The first — an interest rate swap — economically hedges the reporting entity's exposure to the variability in cash flows of a specific floating-rate asset. The second derivative — an interest rate cap — economically hedges the reporting entity's exposure to the variability in cash flows on a specific floating-rate liability should interest rates rise above a certain level.

The reporting entity did not apply hedge accounting under ASC 815. Because hedge accounting was not applied, these derivatives have been recorded at fair value on the balance sheet with changes in fair value recorded in current-period net income.

How should the gains and losses on the two derivatives be presented in the reporting entity's income statement?

PwC response

We believe the gain/loss can be presented on the same income statement line item as the economically hedged item or on a separate line item, such as "other income/expense." If the reporting entity took the former approach, the gains or losses on the derivatives would be reported in different line items of the income statement. Gains or losses on the swap would be recognized in the "interest income" line item, while the gains or losses on the cap would be recognized in the "interest expense" line item. If the reporting entity took the latter approach, it would recognize the gains or losses on both derivatives in the "other income/expense" line of the income statement.

Whichever approach the reporting entity selects should be applied consistently. In addition, when derivatives are used as economic hedges of assets or liabilities, the reporting entity should disclose the purpose of the derivative activity and its accounting policy for the derivatives, including where the gains or losses are presented on the income statement and the amounts for each period.

19.5 Disclosure

The disclosure guidance outlined in this chapter applies to all interim and annual reporting periods for which a balance sheet and income statement are presented.

If information on derivatives (or nonderivatives that qualify and are designated as hedging instruments) is disclosed in more than one footnote, a reporting entity should cross-reference the derivative footnote to any other applicable footnotes.

19.5.1 Disclosure objectives

The FASB explicitly includes in ASC 815-10-50-1 three primary disclosure objectives for a reporting entity's derivative activity. Those objectives are to disclose information to help financial statement users understand:

- How and why a reporting entity uses derivatives
- How derivatives and related hedging items are accounted for
- How derivatives and related hedging activities affect a reporting entity's financial position, financial performance, and cash flows

19.5.2 Qualitative disclosure requirements

As described in ASC 815-10-50-1A, a reporting entity that holds or issues derivatives (or nonderivatives that are designated and qualify as hedging instruments) should describe in the footnotes the objective, context, and strategies for issuing or holding derivatives. The purpose of these disclosures is to enhance the overall transparency of a reporting entity's derivative activity by helping stakeholders understand the nature of the derivatives and evaluate the success of those activities, their importance to the reporting entity, and their effect on the reporting entity's financial statements.

As discussed in ASC 815-10-50-2 and 50-5, these qualitative disclosures may be more meaningful if described in the context of a reporting entity's overall risk-management profile. In its qualitative disclosures, the reporting entity should distinguish between:

- Objectives and strategies for derivatives used for risk management purposes and those used for other purposes (at a minimum based on the instruments' primary underlying risk exposure such as interest rate risk or credit risk)

- The accounting designations of derivative instruments (e.g., cash flow hedging, fair value hedging, and net investment hedging relationships)

For derivatives not designated as hedging instruments, reporting entities should also describe the purpose of the derivative activity.

A reporting entity should disclose derivative contracts by the type of risk being hedged (e.g., interest rate, commodity price risk, foreign currency).

19.5.2.1 Accounting policy disclosures

S-X 4-08(n) requires that SEC registrants' disclosures include descriptions of the accounting policies used for derivative financial instruments and derivative commodity instruments, and the methods of applying those policies that materially affect their financial performance.

SEC registrants should describe:

- Each method used to account for derivative financial instruments and derivative commodity instruments and the types of instruments accounted for under each

- The criteria required to be met for each accounting method used, including for hedge accounting, and the accounting method used if the criteria are not met

- The method used to account for terminations of derivatives designated as hedges or derivatives used to affect directly or indirectly the terms, fair values, or cash flows of a designated item

- The method used to account for derivatives when the designated item matures or is sold, extinguished, or terminated, as well as the method used to account for derivatives hedging a forecasted transaction, when the forecasted transaction is no longer likely to occur

- Where and when derivative financial instruments and derivative commodity instruments, and their related gains and losses, are reported in the financial statements

There is some overlap between these SEC-specific requirements and those that are required for all entities by ASC 815.

ASC 815-10-50-4C, for example, requires disclosure of the amount of gains and losses on derivative instruments and related hedged items and the line item on the income statement in which they are included (or, when applicable, identify gains and losses initially recognized in OCI), as discussed in FSP 19.5.3.1. By extension, a reporting entity should likewise disclose where in the income statement ineffectiveness is recorded.

In addition, ASC 815-30-50-1 requires disclosure of the amount of gains and losses reclassified into earnings as a result of the discontinuance of cash flow hedges because it is probable that the original forecasted transactions will not occur by the end of the originally specified time period or within the additional period of time. This is discussed further in FSP 19.5.3.4.

19.5.2.2 Balance sheet classification

A reporting entity with a significant number of derivatives should disclose its accounting policy for determining the balance sheet classification of derivatives.

19.5.3 Quantitative disclosure requirements

The disclosures outlined in the following sections are primarily quantitative in nature, but may include qualitative features that are intended to provide context to a reporting entity's derivative or hedging activities. Further, the quantitative disclosures about derivatives may be enhanced if similar information is disclosed about other financial instruments or nonfinancial assets and liabilities to which the derivative instruments are related by activity. As such, a reporting entity is encouraged, but not required, to present a thorough depiction of its activities by disclosing that information.

19.5.3.1 Disclosures required in a tabular format

A reporting entity that holds or issues derivatives (or nonderivatives designated and qualifying as hedging instruments) is required to disclose the following in a tabular format:

- The fair value of the derivatives and the line item on the balance sheet in which they are included

- The amount of gains and losses on derivative instruments and related hedged items and the line item on the income statement in which they are included (or, when applicable, identify gains and losses initially recognized in OCI)

The FASB decided to prescribe a tabular format as it believed that using tables would improve the transparency of the disclosure and would help financial statement users understand the effects of derivatives on a reporting entity's balance sheet, income statement, and statement of cash flows. ASC 815-10-55-182 provides an example of the tabular quantitative disclosure.

Gross disclosure in the footnotes versus net presentation on the balance sheet

The fair values of the derivatives included in the tabular disclosure should be prepared using gross fair value amounts, even though their presentation in the balance sheet may give effect to applicable master netting arrangements and credit support arrangements with collateral (as discussed in FSP 19.3.2). The FASB expressed its belief that disclosing the fair value amounts on a gross basis would help users understand how and why a reporting entity uses derivatives.

In addition to segregating by grouping and by major type of instrument (e.g., interest rate contracts, foreign exchange contracts, equity contracts, commodity contracts, and credit contracts), derivative assets and liabilities should be segregated between those that are qualifying and designated as hedging instruments and those that are not. When segregating derivative assets and liabilities, a reporting entity should consider the classification within the classified balance sheet (i.e., current, noncurrent).

Because ASC 815 requires the tabular disclosure to be prepared on an instrument-by-instrument basis that disregards the effect of netting arrangements and collateral positions, it is possible that individual amounts included in the disclosure will not agree with the amounts presented in the balance sheet. The FASB accepted this potential inconsistency between the gross amounts disclosed in the footnote and those presented net in the balance sheet because the alternative of disclosing information on a net basis could provide misleading information about the types of risks being managed with derivatives.

A reporting entity that has multiple derivatives with a single counterparty subject to a master netting arrangement may incorporate certain risks (e.g., nonperformance risk) into its valuation of the derivatives at the portfolio level. While the reporting entity may determine on a qualitative basis that the impact of those portfolio-level valuation adjustments need not be allocated for purposes of its ASC 815 hedge effectiveness assessment, a reasonable allocation for purposes of preparing the contract-level tabular disclosures may be necessary.

Although not required by ASC 815, reporting entities may wish to enhance these tabular disclosures by including a reconciliation of the amounts in the table to the amounts in the balance sheet.

Gains and losses by type of contract

ASC 815-10-50-4A requires disclosure of the amount of gains and losses for derivatives and related hedged items and where those amounts are reported in the income statement (or, when applicable, the balance sheet, for gains and losses initially recognized in OCI).

The disclosure requirement includes tabular presentation, provided in separate columns for gains and losses by accounting designation (e.g., fair value hedges, cash flow hedges, or net investment hedges) and by type of derivative contract (e.g., interest rate contracts, foreign exchange contracts, equity contracts, commodity contracts, credit contracts).

Gains and losses are required to be presented separately for fair value hedges, cash flow hedges, net investment hedges and derivatives that are not qualifying or designated as hedging instruments.

In addition to these disclosure requirements, additional disclosure considerations are included in the following sections of this chapter: fair value hedges of foreign currency (FSP 19.5.3.4), cash flow hedges (FSP 19.5.3.5), net investment hedges (FSP 19.5.3.6), and non-qualifying or non-designated (FSP 19.5.3.7).

The income statement table does not require the disclosure of gains and losses on derivatives to distinguish between those that exist at the end of the reporting period and those that are no longer held at the end of the reporting period. In addition, a reporting entity with fair value hedges may present the gains and losses related to hedged items in a nontabular format.

ASC 815-10-50-4C also requires the gains and losses related to hedged items that are qualifying and designated in a hedging relationship to be disclosed apart from gains and losses related to hedged items that are not qualifying or designated in hedging relationships. The FASB concluded that if amounts were aggregated, it would be difficult for users to analyze the effect of the underlying risks being managed—especially because there is no requirement to designate the hedging instrument and hedged item at the start of the hedging relationship.

Finally, if a proportion of a derivative is designated in a qualifying hedging relationship and a proportion is not designated, the reporting entity should allocate the related amounts in the disclosure table.

19.5.3.2 Volume of derivative activity

ASC 815-10-50-1B requires disclosure about the volume of derivative activity. This might include the total notional amount of interest rate derivatives outstanding during a period, described and segregated in a meaningful way to allow a user to understand the gross or net financial implications. It may also include other directional information about the reporting entity's derivative positions (e.g., distinguishing receive-fixed interest rate swaps from pay-fixed interest rate swaps).

19.5.3.3 Fair value hedges of foreign currency

Fair value hedges relating to foreign currency exposure require additional disclosure beyond those in FSP 19.5.3.1.

Derivatives and nonderivatives may give rise to foreign currency transaction gains or losses under ASC 830, *Foreign Currency Matters*. For those that have been designated and qualify as fair value hedging instruments, and for the related hedged items, as described in ASC 815-25-50-1, a reporting entity should disclose the requirements in Figure 19-3.

Figure 19-3
Additional required disclosures for foreign currency transaction gains or losses

Hedged items/ hedging instrument	ASC reference	Required disclosures
For foreign currency derivatives and nonderivatives that have been designated and have qualified as fair value hedging instruments and for the related hedged items	815-25-50-1(a)	The net gain or loss recognized in net income during the reporting period representing (1) the amount of the hedges' ineffectiveness and (2) the component of the derivative instruments' gain or loss, if any, excluded from the assessment of hedge effectiveness.
	815-25-50-1(b)	The amount of net gain or loss recognized in net income when a hedged firm commitment no longer qualifies as a fair value hedge.

Complying with these requirements can be complex. For example, in the case of fair value hedges, a reporting entity will need to make separate disclosures for the net gain or loss recognized in net income during the reporting period that represents the amount of the hedges' ineffectiveness, and the component of the derivatives' gain or loss that is excluded from the assessment of hedge effectiveness.

19.5.3.4 Cash flow hedges

Cash flow hedges require additional disclosure beyond those in FSP 19.5.3.1. In accordance with ASC 815-10-50-4C, a reporting entity should disclose, in a tabular format, the location and amount of gains and losses by type of contract related to the following:

- The effective portion recognized in OCI
- The effective portion accumulated in other comprehensive income (AOCI) during the term of the hedging relationship subsequently reclassified to net income
- The ineffective portion and the amount excluded from effectiveness testing

In addition, the following requirements specific to a cash flow hedge are described in ASC 815-30-50-1:

Excerpt from ASC 815-30-50-1

b. A description of the transactions or other events that will result in the reclassification into earnings of gains and losses that are reported in accumulated other comprehensive income

c. The estimated net amount of the existing gains or losses that are reported in accumulated other comprehensive income at the reporting date that is expected to be reclassified into net income within the next 12 months

d. The maximum length of time over which the entity is hedging its exposure to the variability in future cash flows for forecasted transactions excluding those forecasted transactions related to the payment of variable interest on existing financial instruments

e. The amount of gains and losses reclassified into earnings as a result of the discontinuance of cash flow hedges because it is probable that the original forecasted transactions will not occur by the end of the originally specified time period or within the additional period of time discussed in ASC 815-30-40-4 through 40-5.

ASC 815-30-45 provides guidance for determining the amount of gains and losses that will be reclassified into net income in the next 12 months for hedge relationships with multiple cash flow exposures that are designated as the hedged item for a single derivative. It indicates that the total amount reported in OCI should first be allocated to each of the forecasted transactions. The sum of the amounts expected to be reclassified into net income in the next 12 months for each of those items would then be the amount disclosed, which could result in an amount greater than or less than the net amount reported in AOCI.

A reporting entity should display, as a separate classification within OCI, the net gain or loss on derivative instruments designated and qualifying as cash-flow hedging instruments that are reported in OCI (as described in ASC 815-30-50-2), in addition to the disclosure requirements associated with AOCI, as described in FSP 4.5.

Reporting entities should also separately disclose a rollforward of the activity for such net gains and losses that are deferred in OCI pursuant to ASC 220, *Comprehensive Income*. The rollforward should include the beginning and ending accumulated net derivative gain or loss, the related change in the net gain or loss that is associated with current period transactions, and any amount of the net gain or loss that was reclassified as net income during the period.

EXAMPLE 19-3

Example disclosure of AOCI rollforward for cash flow hedge activity

As of December 31, 20X4, FSP Corp, a U.S. based commodity manufacturer and exporter, has entered into the following cash flow hedge transactions.

- In 20X2, FSP Corp entered into a forward exchange contract to hedge the foreign currency risk associated with the anticipated purchase of equipment from a vendor in the United Kingdom[2] (i.e., a cash-flow hedge of a forecasted foreign currency-denominated transaction). The purchase occurred as planned at the end of 20X2, and the loss recognized on the forward exchange contract was deferred in OCI and is being reclassified into net income consistent with the depreciation of the equipment.

- In 20X2, FSP Corp entered into a 10-year interest rate swap concurrent with its issuance of 10-year variable-rate debt (i.e., a cash-flow hedge of future variable-rate interest payments).

- During the period 20X1 through 20X4, FSP Corp continuously purchased corn futures contracts to hedge its anticipated purchases of corn inventory (i.e., a cash-flow hedge of future variable corn-price payments). FSP Corp applies the first-in first-out method (FIFO) method to value its inventory.

- In January 20X4, FSP Corp entered into a two-year forward exchange contract to hedge a forecasted export sale of corn cereal to a large customer in Japan. The sale is to be denominated in Japanese yen and is expected to occur in December 20X6.

In June 20X4, FSP Corp closed out the forward contract, but it does not expect the forecasted transaction not to occur.

Assume FSP Corp has a 40% effective tax rate.

How should FSP Corp disclose the impact on AOCI of these transactions in the rollforward of AOCI in the 20X4 financial statements?

Analysis

The following table is the before-tax tax reconciliation (FSP Corp could alternatively select an after-tax option) of beginning and ending AOCI amounts for 20X4 as supporting documentation for the comprehensive income disclosures. Assume for simplicity that the only activity in AOCI is the cash flow hedge amounts reclassified out of AOCI.

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[2] In this transaction, FSP Corp had a selection of vendors in the United Kingdom from which to purchase the equipment. It determined at the beginning of 20X2 that it was best to hedge the foreign currency exposure on the expected equipment price (through a forward exchange contract) and continue to search for a vendor of choice rather than to negotiate a firm commitment with a specific vendor.

The required disclosures regarding the income statement line item for each reclassification adjustment and the qualitative information related to the cash flow hedges are not presented in this analysis for simplicity.

Before-tax rollforward of accumulated other comprehensive income (AOCI) in equity

	Year adjust-ments originated in AOCI[5]	Beginning balance in AOCI 1/1/X4	Derivative (gains) losses recognized in OCI in 20X4	Amount amortized or reclassified out of OCI to net income	Ending balance in AOCI 12/31/X4
Equipment[1]	20X2	$ 240	N/A	$ (60)	$180
Interest-rate swap hedging variability of future cash flows[2]	20X2–20X4	(80)	(20)	10	(90)
Futures hedging forecasted purchase of inventory[3]	20X1–20X4	(350)	(170)	300	(220)
Forward hedging future export sale[4]	20X4	—	100	—	100
Totals		$(190)	$ (90)	$250	$ (30)

[1] The initial loss deferred in OCI was $300. The life of the equipment is five years, resulting in a removal from OCI of $60 per year of the previously-deferred loss. The timing and percentage of the removal matches the timing and percentage of the equipment's annual depreciation. For purposes of this example, it is presumed that the equipment has no salvage value.

[2] Amounts deferred in OCI are recognized in net income as the variable rate changes.

[3] Amount reflected in OCI represents the effects of netting the results from the purchase of several futures contracts each year with reclassifications to net income pursuant to inventory sales. Amounts removed from OCI and recognized in net income vary depending on FSP Corp's inventory cost flow assumption (FIFO, for purposes of this example).

[4] The amount will be removed from OCI when the forecasted sale occurs.

[5] The column is not a required disclosure but included for illustrative purposes.

The disclosures of the related tax effects allocated to each component of the balances accumulated in other comprehensive income would be presented as follows:

Related tax effects allocated to each component of other comprehensive income

	Before-tax amount	Tax expense (benefit)	Net-of-tax amount
Effects of cash flow hedges included in OCI:			
Derivative gains	$ (90)	$ 36	$ (54)
Reclassification adjustments	250	(100)	150
Total	$ 160	$ (64)	$ 96

Note: Alternatively, in this illustrative example, the tax amounts for each component can be displayed parenthetically on the face of the financial statement in which OCI is reported.

The following table presents a rollforward of accumulated other comprehensive income by component. All amounts are shown before tax. Only one year was presented for simplicity.

Changes in accumulated other comprehensive income by component

	Forward exchange contracts[1]	Interest-rate swaps	Futures contracts	Accumulated other comprehensive income
Beginning balance, January 1, 20X4	$240	$(80)	$(350)	$(190)
Current period change[2]	40	(10)	130	160
Ending balance, December 31, 20X4	$280	$(90)	$(220)	$ (30)

[1] Amounts represent the combined activity for the anticipated equipment purchase and the forward contract.

[2] For simplicity, the change for the period has been reflected as a single line item rather than splitting the change into new amounts entering into OCI from hedging transactions and amounts reclassified from AOCI into net income, as is required by ASC 815-30-50-2 and ASC 220-10-45-14A. For an example of the full disclosure, refer to FSP 4.5.4.1.

Although this table displays the change in OCI for each type of derivative contract, ASC 815-30-50-2(b) requires disclosure of only the net changes in the cash flow hedge amounts in OCI.

19.5.3.5 Net investment hedges

Net investment hedges require disclosures that are incremental to those discussed in FSP 19.5.3.1. In accordance with ASC 815-10-50-4C, a reporting entity should disclose, in a tabular format, the location and amount of gains and losses by type of contract related to:

- The effective portion recognized in OCI
- The effective portion subsequently reclassified to net income
- The ineffective portion and the amount excluded from effectiveness testing

19.5.3.6 Non-qualifying or non-designated derivatives

In accordance with ASC 815-10-50-4C(e), a reporting entity should separately disclose the amount of gains and losses related to derivative instruments not qualifying or designated as hedging instruments in a tabular format, as well as the income statement line item in which they are included.

A reporting entity may elect a policy to include in its trading activities derivative instruments that are not designated or qualifying as hedging instruments. In this situation, ASC 815-10-50-4F permits the reporting entity to not separately disclose gains and losses relating to these activities in a tabular form provided all of the following are disclosed:

- The gains and losses on trading activities recognized in the income statement, disaggregated by major types of items (e.g., fixed income/interest rates, foreign exchange, equity, commodity, or credit)
- The line items on the income statement in which trading activities gains and losses are included
- A description of the nature of its trading activities and related risks and how the reporting entity manages those risks

If a reporting entity uses this disclosure option, it should include a footnote in the required tables (discussed throughout FSP 19.5.3 and its subsections) referencing the alternative disclosure presentation for trading activities.

The FASB's intent for these disclosures is to assist investors and creditors in understanding a reporting entity's objectives for all of its derivatives. As noted in FSP 19.5.2, when derivatives are used as economic hedges of assets or liabilities, preparers are required to disclose the purpose of the derivative activity. Further, we believe reporting entities should disclose their accounting policy with respect to economic hedges, including where the gains or losses are presented on the income statement and the amounts for each period.

19.5.4 Disclosure of credit-risk-related contingent features

ASC 815-10-50-4H provides the disclosure requirements related to credit-risk-related contingent features, as summarized in Figure 19-4.

Figure 19-4
Disclosures relating to credit-risk-related contingent features

Disclosure attribute	ASC reference	Required to disclose
Credit-risk-related contingent features	815-10-50-4H (a-b)	Existence and nature of derivatives that contain credit-risk-related contingent features and the circumstances in which those features could be triggered in derivatives that are in a net liability position at the end of the reporting period
	4H (c)	Aggregate fair value amounts of derivatives that contain credit-risk-related contingent features that are in a net liability position at the end of the reporting period
	4H (d)	Aggregate fair value of assets already posted as collateral at the end of the reporting period
	4H (e-f)	Aggregate fair value of additional assets that would be required to be posted as collateral and/or needed to settle the instrument immediately, if the credit-risk-related contingent features were triggered at the end of the reporting period

19.5.5 Disclosure of credit derivatives

In accordance with ASC 815-10-50-4K, for each balance sheet presented, the seller of credit derivatives (e.g., credit default swaps, credit spread options, credit index products) should disclose the following for each credit derivative (or each group of similar credit derivatives) and hybrid instrument that has an embedded credit derivative. These disclosures are required even if the likelihood of the seller having to make payment under the credit derivative is remote.

- The nature of the credit derivative, including:
  - The approximate term of the credit derivative
  - The reason(s) for entering into the credit derivative

   - Any events or circumstances that would require the seller to perform under the credit derivative

   - The current status (as of the balance sheet date) of the payment/performance risk of the credit derivative, which may be based either on recently issued external credit ratings or current internal groupings used by the reporting entity to manage its risk.

- The fair value of the credit derivative

- The nature of any recourse provisions that enable the seller to recover all or a portion of the amounts paid under the credit derivative, including the nature of any collateral held by third parties that the seller can liquidate

- The approximate extent to which the seller can use the proceeds of collateral held by third parties to reduce the maximum potential amount of future payments under the credit derivative

- The maximum potential amount of future payments the seller could be required to make under the derivative (and if applicable, including if the credit derivative provides for no limitations to the maximum potential future payments)

   - This should be presented on an undiscounted basis and should not be reduced by any recourse or collateral provisions.

   - If the seller is unable to develop an estimate of the maximum potential amount of future payments, the reasons why such an estimate cannot be made should be disclosed.

Reporting entities that use internal groupings as the basis for disclosing the current status of the payment/performance risk are required to disclose how those groupings are determined and used for managing risk. Given the latitude provided by the FASB to use internal groupings, diversity in practice regarding these disclosures exists. Reporting entities should use judgment to determine whether the information disclosed achieves the objectives. Reporting entities should consider whether additional contextual information is needed to understand these disclosures and to enhance comparability with peers.

We believe the disclosures required by ASC 815-10-50-4K are also applicable to investments classified as trading and investments classified as available-for-sale. Therefore, investors should maintain an inventory of all investments in beneficial interests, including trading securities and those for which the fair value option has been applied. This inventory can be used to determine whether the investors are sellers of credit derivatives as a result of their investment, and thus subject to the disclosure requirements in ASC 815-10-50-4K.

Additionally, when hybrid instruments have embedded credit derivatives, the seller of the embedded credit derivative should disclose the information for the entire hybrid instrument, not just the embedded feature. ASC 815-10-50-4L provides further guidance on how a reporting entity may present the information on credit derivatives.

Excerpt from ASC 815-10-50-4L

One way would be…first to segregate disclosures by major types of contracts…and then, for each major type, provide additional subgroups for major types of referenced (or underlying) asset classes…

We believe reporting entities should consistently apply a meaningful aggregation methodology for disclosing this information. That will enables financial statement users to understand, at a reasonable level of detail, the amount of credit risk the reporting entity is exposed to due to these instruments.

In certain situations, a reporting entity may engage in other risk management activities that could offset its maximum potential exposure. For example, a reporting entity may manage its risk on a net basis, or its derivatives may be subject to master netting arrangements that it uses to manage exposure to certain risks across multiple types of derivatives. In such instances, we believe reporting entities should consider providing additional disclosure that provides appropriate context for the disclosure of maximum potential future payments.

Traditional credit-linked notes provide that repayment of note principal to the investor/credit derivative seller is not required upon default of the referenced obligation. Thus, the investor is exposed to the credit risk of both the issuer and the referenced obligation. Because the seller does not make any physical cash payment under the terms of the embedded credit derivative, questions have arisen as to whether disclosure of the maximum potential amount of future payments is required for credit-linked notes. Given the FASB's intent to provide users with similar informative disclosures for instruments with similar economic risks, we believe reporting entities should disclose the outstanding principal balance as the maximum amount of future payments, consistent with the economics of the hybrid instrument. That is, by forgoing the principal amount due under the host contract, the seller of the credit derivative may be viewed as "paying" to the insured party the host note principal upon default of the referenced obligation.

The disclosure requirements do not apply to embedded derivative features relating to the transfer of credit risk that are in the form of subordination of one financial instrument to another (i.e., when the subordination scope exception in ASC 815-15-15-9 applies). Therefore, an investor in, or issuer of, beneficial interests in a fully-funded cash vehicle would not be subject to these disclosures if there were no other written credit derivatives present in the vehicle.

19.5.6 Disclosures related to offsetting (netting) derivatives

A reporting entity should disclose its policy of entering into master netting arrangements to mitigate the credit risk of financial instruments. It should also disclose information about the arrangements to which the reporting entity is party and a brief description of the terms, including the extent to which they would reduce the reporting entity's maximum amount of loss due to credit risk. Reporting entities should describe the rights of setoff associated with their recognized assets and liabilities that are subject to an enforceable master netting arrangement or similar agreement, including the nature of those rights. Additionally, reporting entities may conclude that other qualitative disclosures are necessary for fulsome disclosure of the reporting entity's use of offsetting.

A reporting entity may make a decision to offset derivatives against cash collateral (discussed in FSP 19.3.2.1). ASC 815-10-50-8 requires the following disclosures depending on the netting election.

Excerpt from ASC 815-10-50-8

a. A reporting entity that has made an accounting policy decision to offset fair value amounts shall separately disclose amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral that have been offset against net derivative positions.

b. A reporting entity shall separately disclose amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral under master netting arrangements that have not been offset against net derivative instrument positions.

c. A reporting entity that has made an accounting policy decision to not offset fair value amounts shall separately disclose the amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral under master netting arrangements.

Refer to FSP 2.4 for general presentation requirements and FSP 19.3 for balance sheet presentation requirements specific to derivatives.

In addition to the disclosure requirements in ASC 815, ASC 210-20-50-1 through 50-6 provides the balance sheet offsetting disclosure requirements for derivatives, including embedded derivatives, repurchase agreements, reverse repurchase agreements, securities borrowing and securities lending transactions.

These disclosures require the presentation of gross and net information about transactions that are (1) offset in the financial statements or (2) subject to an enforceable master netting arrangement or similar agreement, regardless of whether the transactions are actually offset in the balance sheet.

For these types of transactions, reporting entities are required to disclose certain quantitative information in a tabular format, separately for assets and liabilities. The information required includes:

- The gross amounts of those recognized assets and those recognized liabilities

- The amounts offset in accordance with the guidance in ASC 210-20-45 and ASC 815-10-45 to determine the net amounts presented in the balance sheet

- The net amounts presented in the balance sheet

- The amounts subject to an enforceable master netting arrangement or similar agreement not otherwise included in the second bullet (not netted on the balance sheet), including:

  - The amounts related to recognized financial instruments and other derivatives where m*anagement makes an accounting policy election not to offset, or* the **amounts do not** meet some or all of the guidance in either ASC 210-20-45 or ASC 815-10-45

  - The amounts related to financial collateral (including cash collateral)

- The net amount after deducting the amounts relating to the master netting arrangement from the amounts presented in the balance sheet

All transactions subject to agreements that legal counsel has determined qualify as master netting arrangements and are in scope of the disclosure requirements should be included in the tabular offsetting disclosure. Specifically, they should be included in the column "Gross amounts not offset in the statement of financial position" (if they are not offset in the financial statements), not just transactions denominated in the same currency. When the master netting agreement permits netting across currencies, all transactions should be included in column D.

Figure 19-5

Illustrative tabular disclosure of offsetting

This figure is excerpted from ASC 210-20-55-20 and explained in the sections that follow.

				Gross amounts not offset in the statement of financial position D		
Description	Gross amounts of recognized assets	Gross amounts offset in the statement of financial position	Net amounts of assets presented in the statement of financial position	Financial instruments	Cash collateral received	Net amount
	A	B	C = A - B	Da	Db	F = C - D

19.5.6.1 *Disclosures related to collateral*

The offsetting balances disclosed in column D may include both cash and financial instrument collateral. However, there are limits to the amount of offsetting that is permissible, such as excess collateral, thereby limiting the amounts reported in column D. For example, assume a reporting entity entered into a reverse sale and repurchase agreement. The agreement is accounted for as a collateralized lending whereby the carrying amount of the loan is $90 million and the fair value of the collateral received is $105 million. The amount of collateral received included in the disclosure is limited to the carrying value of the loan (e.g., $90 million) unless rights to collateral can be enforced across financial instruments.

Therefore, collateral balances disclosed in accordance with the guidance may not agree with other collateral disclosures, or may not provide financial statement users with a full appreciation of the nature of collateral received or posted given the exclusion of overcollateralization from column D. Reporting entities may wish to provide information on overcollateralization as a supplement to the required disclosures.

Additionally, the balances disclosed in the financial instrument collateral disclosures may not be included on the balance sheet due to the related recognition guidance for that instrument. For example, the collateral associated with a reverse repurchase agreement accounted for as a secured lending would not be recorded on the balance sheet. Although such collateral is not recognized in the financial statements, it will be captured by the disclosure requirements (as illustrated in Example 1 in ASC 210-20-55-20 and Example 2 in ASC 210-20-55-21).

While not required, reporting entities may further disaggregate the collateral balances disclosed into additional categories, such as on-balance sheet collateral and off-balance sheet collateral. This supplemental disclosure may help financial statement users better understand how the amounts disclosed are reported in the financial statements.

19.5.6.2 Level of disaggregation

The guidance allows for flexibility with respect to how certain items are disclosed. Reporting entities can choose to disclose items either by type of financial instrument (e.g., derivatives or reverse repurchases) or by counterparty for columns C through F. When disclosures are disaggregated by financial instrument type, collateral data by instrument may not be available. For example, a single ISDA master netting agreement may govern many different types of derivatives. In some cases, collateral is only posted once the aggregate fair value of the derivatives subject to the single master agreement exceeds a defined threshold.

ASC 210-20-55-22 provides an offsetting disclosure example for a sophisticated entity. This example disaggregates derivatives by instrument type and by clearing mechanism (e.g., exchange-traded versus over-the-counter). The example notes that a sophisticated entity is one that engages in “significant derivative activity.” In this example, the reporting entity further disaggregates the derivative line item into underlying risk, as discussed in ASC 815-10-50-4D, with further disaggregation based on how the derivative is transacted.

There will be judgment involved in determining the level of disaggregation required. We believe the extent of a reporting entity's derivative activity and its business purpose should be the drivers of this determination, in addition to the materiality of the transactions. For example, a non-financial services reporting entity may engage in material derivative activity for hedging purposes, but the types of derivatives it enters into or the associated clearing mechanism may be relatively narrow in scope (e.g., solely foreign exchange derivative contracts). In contrast, a financial institution that has extensive derivative operations and transacts in multiple types of derivatives using multiple types of clearing mechanisms should consider providing more disaggregated disclosures.

For reporting entities that elect to disaggregate the disclosure by financial instrument type instead of by counterparty, collateral posted by or received from a given counterparty will need to be allocated to the respective financial instruments with that counterparty. While collateral may not be posted on an instrument-by-instrument basis (e.g., in a pool across instrument types), we believe a reasonable allocation methodology should be utilized to allocate collateral received by instrument type for disclosure purposes. A similar approach may be taken to allocate the netting that is applied on the balance sheet by counterparty (e.g., column B in the disclosure).

The allocation method adopted is a matter of judgment and a variety of methods may be appropriate, depending on the facts and circumstances. Whatever method is adopted, reporting entities should apply it consistently and consider disclosing the methodology used. Reporting entities may want to consider the allocation methods described in FV 9.2.4 and 9.4 in the context of allocation methods for credit risk in the determination of fair value.

The tabular disclosure of offsetting requires gross and net balances related to transactions that are subject to master netting arrangements, regardless of whether those balances are offset in the balance sheet. If a reporting entity has instruments that meet the scope of the disclosures, but that do not meet the offsetting guidance in ASC 210 or ASC 815, or that management does not elect to offset, the amounts required to be disclosed in column A would equal the amounts required in column C.

The amounts disclosed in column C should reconcile to the individual financial statement line item on the balance sheet. To facilitate this reconciliation, reporting entities may elect to include all derivatives, repurchase agreements, and securities lending transactions in the disclosure, regardless of whether the transactions are subject to an enforceable master netting arrangement or similar agreement. Typically, reporting entities separate contracts that are subject to master netting arrangements or similar agreements from ones that are not, but still include them in the disclosure, to facilitate reconciliation to the balance sheet.

If a reporting entity only includes transactions subject to a master netting arrangement in its disclosure, and the balances in column C feed into a financial statement line item that includes other balances (e.g., other assets or liabilities not subject to a master netting arrangement), the reporting entity should reconcile the disclosure to the total derivative, repurchase agreement, or securities lending balance (including those types of transactions that are not in the scope of the disclosure because they are not subject to a master netting arrangement or similar agreement).

We do not believe that details of the other balances in the financial statement line item need to be included in that reconciliation. For example, if derivative assets are reported as part of "other assets," we do not believe it is necessary to include details about other items reported in "other assets" in reconciling derivative assets in this disclosure to the financial statement line item.

Question 19-5

A reporting entity that transacts in the futures market is often required to maintain a margin deposit account with its broker or the futures exchange. Depending upon the contract terms, an open futures contract may require periodic cash payments based on market movements. Should those periodic cash payments be included in the tabular disclosure?

PwC response

The determination of whether such periodic cash payments are a settlement of a contract (and the entering into of a new contract) or the posting of collateral may impact what is required to be disclosed. A reporting entity should consult with legal counsel to make this determination.

We believe that if margin and periodic cash payment amounts are considered collateral amounts associated with the open positions, they should be included in the disclosure. If such amounts are considered settlements of an open contract, then they would not be required to be included, as they would not be considered collateral. In that case, these amounts would not appear in the disclosure at all.

Question 19-6

How should a reporting entity allocate collateral in the disclosure if the amounts relate to both derivatives and non-derivative positions?

PwC response

It depends.

An entity may engage in derivative transactions with a counterparty that are accounted for as derivatives under ASC 815 and also transactions that meet the definition of a derivative or are legally considered derivatives subject to a master netting arrangement or similar agreement, but are not accounted for as derivatives under ASC 815 because they meet a scope exception. Collateral may be posted on these transactions based on the net position.

When posting collateral on the net position, reporting entities should consider whether the disclosure should include the entire collateral balance or only an allocated portion. The allocation method adopted is a matter of judgment and a variety of methods may be appropriate, depending on the facts and circumstances. Whatever method is adopted, reporting entities should apply it consistently and disclose the methodology used.

In addition, reporting entities should consider if they are already using an allocation method for items such as allocation of collateral when presenting the net derivative position on their balance sheet as a result of credit or netting adjustments. The allocation methodology used for collateral generally will not impact the balance sheet because the balance sheet is often more aggregated than the tabular disclosure. Because the tabular disclosure requires disaggregation of balances by class and collateral is often posted on a pooled basis, the allocation methodology for collateral will impact how it is allocated to each class of transaction in the table. If the reporting entity is already using an allocation methodology on the balance sheet, a consistent methodology should be utilized for the disclosure (so it reconciles to the balance sheet).

19.5.7 Hybrid financial instruments measured at fair value

FSP 20.5.2 includes disclosures for instruments measured at fair value under the fair value option, including hybrid financial instruments. Further, ASC 815-15-50-2 requires that reporting entities disclose information that allows users to understand the effect of changes in the fair value of these instruments on net income, whether at fair value because of the fair value option or the practicability exception in ASC 815-15-30-1(b).

19.5.8 Embedded conversion options

When an embedded conversion option previously accounted for as a derivative no longer meets the separation criteria, ASC 815-15-50-3 indicates that a reporting entity should disclose:

- The changes causing the embedded conversion option to no longer require separation as a derivative

- The amount of the conversion option reclassified to stockholder's equity

19.6 Considerations for private companies

Most requirements for reporting and disclosing derivatives are applicable to both public and nonpublic reporting entities. Only one set of requirements — the accounting policy disclosures in S-X 4-08(n) — are not applicable to private companies. However, two of the accounting policy disclosures have similar requirements under ASC 815 that are applicable to private companies, as noted in FSP 19.5.2.1.

Also, there is one election that simplifies hedge accounting for private companies in certain cases.

19.6.1 Private company alternative — hedge accounting

With the issuance of ASU 2014-03, *Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps—Simplified Hedge Accounting Approach*, the FASB's Private Company Council provided an additional hedge accounting alternative (the simplified hedge accounting approach) for certain types of swaps that economically convert a variable-rate borrowing into a fixed-rate borrowing. This simplified approach is only available when all six qualifying conditions are met. It is effective for private companies for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015.

All of the presentation and disclosure requirements of ASC 815 continue to apply.

ASU 2014-03 allows for a private company to measure a designated swap at settlement value rather than fair value (although the disclosures for fair value measurements required by ASC 820 are still required for amounts disclosed at settlement value). Any amounts disclosed at settlement value should be clearly designated as such, and disclosed separately from amounts disclosed at fair value.

In addition, ASU 2014-03 provides that reporting entities that record a swap under the simplified hedge accounting approach should not consider the instrument a derivative for purposes of determining if the fair value disclosure requirements of ASC 825-10-50-3 are applicable. Therefore, a private company with total assets less than $100 million that only records swaps under the simplified hedge accounting approach will be exempt from those fair value disclosures.

Refer to FSP 20.7 for discussion of the fair value disclosure requirements for private companies.

Chapter 20: Fair value

20.1 Chapter overview

This chapter outlines the presentation and disclosure considerations for assets and liabilities measured or disclosed at fair value. This includes quantitative and qualitative disclosure requirements for recurring and nonrecurring fair value measurements.

It also details the additional disclosures required for assets and liabilities presented at fair value based on the fair value option.

The fair value hierarchy, the basis for many of the required fair value disclosures, is addressed in more detail in FV 4.

20.2 Scope

ASC 820, *Fair Value Measurement* ("ASC 820" or the "fair value standard"), defines fair value and establishes a framework for measuring it. It includes disclosure requirements for fair value measurements required or permitted by all accounting pronouncements.

ASC 820-10-50-1 requires disclosures for assets and liabilities measured at fair value on a recurring and nonrecurring basis after initial recognition (i.e., on "Day 2"). Fair value disclosures are not required for assets and liabilities that are only initially recognized at fair value (e.g., in a business combination, asset retirement obligations (AROs) under ASC 410, or exit or disposal cost obligations under ASC 420).

ASC 820-10-50-2 indicates that measurements based on fair value (e.g., fair value less cost to sell) are also subject to the disclosure requirements in ASC 820.

The requirements related to the presentation of assets and liabilities at fair value are addressed in other U.S. GAAP and are not within the scope of ASC 820.

ASC 825, *Financial Instruments*, includes incremental fair value disclosures.

Note about ongoing standard setting

As of the content cutoff date of this publication (August 31, 2014), the FASB has an active project that may affect fair value disclosure requirements. Financial statement preparers and other users of this publication are therefore encouraged to monitor the status of the project, and if finalized, evaluate the effective date of the new guidance and the implications on presentation and disclosure.

20.2.1 Determining whether account balances are included in scope

As there are various accounting pronouncements that govern the reporting of balances at fair value, questions often arise as to what balance sheet items should be included within the fair value disclosure requirements. This section describes the requirements related to several common balance sheet categories.

20.2.1.1 *Cash equivalents*

Many reporting entities classify certain short-term debt and equity securities, such as treasury bills, money market funds, and commercial paper, as part of cash equivalents. This classification is consistent with the *Statement of Cash Flows* guidance in ASC 230-10-20. However, these securities may still be subject to the disclosure requirements of ASC 320-10-50 in the *Investments-Debt and Equity Securities* guidance and the fair value standard.

Whether cash equivalents are within the scope of the fair value standard's disclosure requirements depends upon how the instruments presented as cash equivalents are classified for measurement purposes.

Certain held-to-maturity securities (HTM) may be considered cash equivalents and carried at amortized cost. Such instruments are subject to the more limited disclosure requirements of ASC 820-10-50-2E for instruments disclosed at fair value, but not measured at fair value.

20.2.1.2 *Investments*

Debt and equity securities classified as trading or available-for-sale, and therefore measured at fair value, are subject to the fair value disclosure requirements of ASC 820. Held-to-maturity securities are carried at amortized cost and are therefore subject to the more limited disclosure requirements of ASC 820-10-50-2E. The fair values of HTM securities are required to be measured consistent with the provisions of ASC 820 when preparing the disclosures required by ASC 320, *Investments in Debt and Equity Securities*.

20.2.1.3 *Servicing assets and liabilities*

When recorded at fair value at the reporting date, servicing assets and liabilities are subject to the disclosure requirements of ASC 820, in addition to the disclosures required by ASC 860-50-50. Those disclosures are addressed in FSP 22.

20.2.1.4 *Hedged items*

For a hedged item that is reported at fair value or has been in a hedging relationship for changes in its overall fair value from inception such that it is essentially measured at its full fair value, we believe it would be appropriate to apply the disclosure requirements of ASC 820-10-50-1 through 50-3.

For a hedged item reported on a measurement basis other than fair value, we do not believe the partial measurement of fair value, achieved through the adjustments of carrying value, requires the reporting entity to provide the disclosures of the fair value standard for the hedged item as a whole or for the adjustments to the carrying value separately.

20.2.1.5 *Pension plan assets*

Plan assets of a defined benefit pension or other postretirement plan accounted for under ASC 715, *Compensation – Retirement Benefits,* are excluded from the scope of ASC 820. However, these assets are subject to the disclosures required by ASC 715-20-50-1(d)(iv) for public entities and ASC 715-20-50-5(c)(iv) for nonpublic entities. Refer to FSP 13 for these disclosure requirements.

20.2.1.6 *Excess 401(k) plans*

Excess 401(k) plans provide employees with an opportunity to increase savings beyond the limits of the reporting entity's qualified 401(k) plan. Employee contributions to an excess 401(k) plan are generally part of the general assets of the reporting entity but the amount due to the employee is tracked using a "phantom account."

We believe reporting entities can make a policy election to measure the phantom account at fair value. If the reporting entity measures the liability at fair value, the disclosures required by ASC 820 are necessary. If it is not measured at fair value, the phantom account is not subject to ASC 820 for measurement or disclosure.

20.2.1.7 *Goodwill and indefinite-lived intangibles*

While goodwill and indefinite-lived intangibles are not remeasured at fair value on a recurring basis, the impairment models for goodwill and indefinite-lived intangible assets are based on an assessment of fair value. When an impairment loss is recognized, the goodwill and indefinite-lived intangible assets are recorded at fair value and are subject to the disclosures of ASC 820. This information will supplement the required disclosures in ASC 350, *Intangibles-Goodwill & Other*. In the absence of an impairment, there is no requirement to disclose information about the fair value used in the impairment test.

20.2.1.8 *Long-lived assets to be disposed of by sale*

An adjustment to assets held for sale to reflect fair value less costs of disposal is recognized on a nonrecurring basis. Such adjustments are recognized only in periods in which the fair value does not exceed the carrying value at the date the decision to sell was made. Therefore, the ASC 820 disclosure requirements will apply each time the reporting entity adjusts the recorded amount of the long-lived assets held for sale.

20.3 *Fair value hierarchy*

To increase consistency and comparability in fair value measurements, the fair value standard establishes a hierarchy to prioritize the inputs used in valuation techniques. Knowledge of the fair value hierarchy is important in understanding the disclosure requirements for assets and liabilities measured and/or disclosed at fair value. The level in the fair value hierarchy and the significant inputs used in a fair value measurement are two of the fundamental disclosure requirements of the fair value standard.

20.3.1 Overview

There are three levels to the fair value hierarchy. Level 1 is the highest priority and, along with Level 2, represents observable inputs, and Level 3 is the lowest priority and represents unobservable inputs.

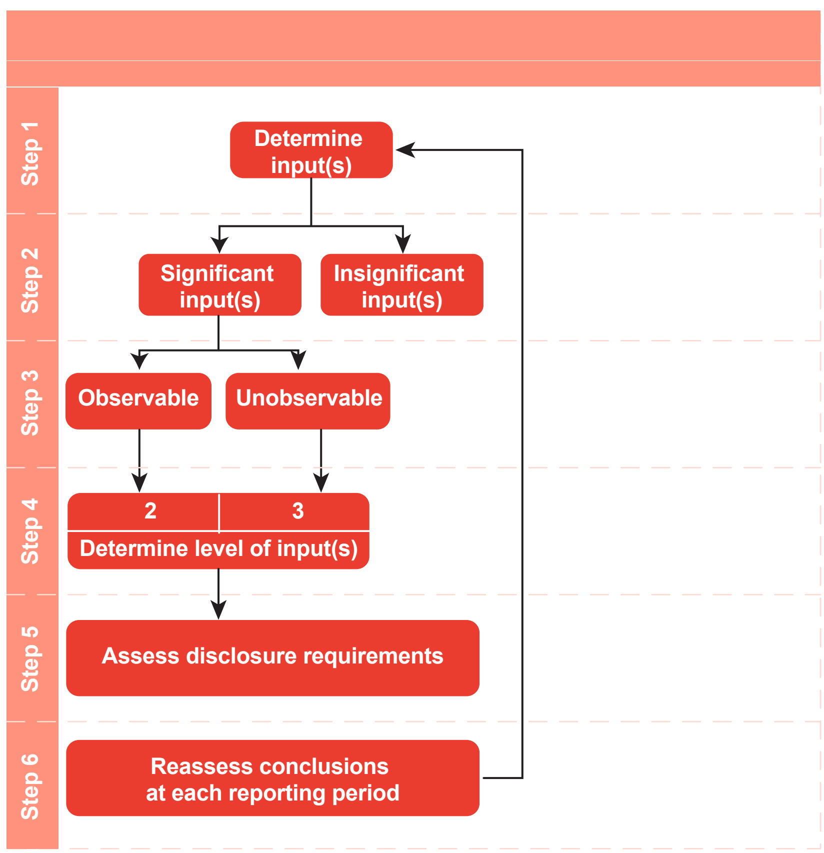
By distinguishing between inputs that are observable in the marketplace, and therefore more objective, and those that are unobservable, and therefore more subjective, the hierarchy is designed to indicate the relative reliability of the fair value measurements.

Disclosure is required by level; as the level decreases, disclosure increases. Certain required disclosures are applicable only to those fair value assets and liabilities characterized as Level 3.

The following figure illustrates the steps in determining the level within the fair value hierarchy of a fair value measurement. Level 1 fair value measurements have been excluded from the framework as they have a Level 1 price for the entire unit of account.

Figure 20-1

Fair value hierarchy framework (for Levels 2 and 3)



20.3.2 *Steps 1 through 3 in the fair value hierarchy framework*

The first three steps in the fair value hierarchy framework provide the information to determine the level of inputs, which in turn, provides the basis for disclosure. The decisions made in these steps affect the measurement of the asset or liability's fair value and lead to the classification in Step 4. Steps 1 through 4 are addressed in more detail in FV 4. In this Guide, we summarize Step 4 and address Steps 5 and 6.

Step 1, *Determine all inputs to valuation techniques*, requires reporting entities to inventory the assumptions that were used in determining fair value.

Step 2, *Determine which inputs are significant*, requires reporting entities to assess the significance of each input. This step is important for purposes of meeting the disclosure requirements as the asset or liability is categorized in its entirety in the lowest level of a significant input.

Step 3, *Determine if significant inputs are observable or unobservable*, directly impacts the level in which the asset or liability will be disclosed.

20.3.3 *Step 4: Determine level in the hierarchy of the significant input (or all significant inputs)*

The evaluation of the significant input(s) determines the asset or liability's classification within the fair value hierarchy. Some of the key characteristics of each level in the hierarchy are included in Figure 20-2.

Figure 20-2
Characteristics of each level in the fair value hierarchy

Level	Characteristics
1	Observable Quoted prices for identical assets or liabilities in active markets (unadjusted)
2	Quoted prices for similar items in active markets Quoted prices for identical/similar items, no active market Liabilities traded as assets in inactive markets
3	Unobservable inputs (e.g., a reporting entity's own data) Market participant (not entity-specific) perspective is still required

A common misconception is that securities that are "less risky" should be categorized in Level 1. For instance, many might perceive U.S. Treasury securities as essentially risk-free, and, therefore expect them to be in Level 1 of the fair value hierarchy. However, certain Treasury securities are more appropriately categorized in Level 2 because they do not trade in an active market.

Level 1

In practical terms, the list of instruments that likely qualify as Level 1 fair value measurements is fairly narrow. It includes the following:

- Listed equity securities traded in active, deep markets (for example, NYSE, NASDAQ, etc.)
- London Metal Exchange (LME) futures contract prices
- On-the-run Treasury bonds[1]
- Treasury bills (both on- and off-the-run,[2] because of the high volume of trades and pricing that is based on those trades)
- Exchange-traded futures and options
- Open-ended mutual funds with published daily net asset values (NAV) at which investors can freely subscribe to or redeem from the fund
- Closed-ended registered mutual funds (for example, exchange-traded funds or ETFs) traded on active markets (the exchange price may represent a Level 1 input)

Question 20-1

Can a single price source or quote be considered a Level 1 valuation?

PwC response

Maybe. Absent the source being transactions on an exchange, in general, a single source would not be a Level 1 input since a single market-maker would almost, by definition, suggest an inactive market. However, in some rare cases, a single market-maker dominates the market for a particular security such that trading in that security is active, but all trading flows through that market-maker. In those limited circumstances, a reporting entity may be able to support a determination that the input is Level 1.

Absent that fact pattern, the reporting entity should determine if the single broker quote represents a Level 2 or Level 3 input. These are facts and circumstances-based determinations. Key considerations in making this assessment are addressed in FV 4.

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[1] On-the-run Treasury bonds and notes are the most recently issued of a given maturity. They are the most frequently traded and, therefore, the most liquid.

[2] Off-the-run Treasury bills, bonds, and notes are those that were issued before the most recent issue and are still outstanding.

Question 20-2

Should a reporting entity that invests in a fund that invests primarily in exchange-traded equity securities "look through" the fund to determine the level of the fund in the fair value hierarchy?

PwC response

No. The reporting entity should first determine the appropriate unit of account (i.e., what is being measured). As indicated in ASC 820-10-35-2E, the unit of account is determined based on other applicable U.S. GAAP.

We would expect the unit of account for interests in mutual or alternative fund investments to be the interest in the fund itself, rather than the individual assets and liabilities held by the fund. An investor cannot simply "look through" an interest in an alternative investment to the underlying assets and liabilities to determine the classification of the fair value measurement. Thus, the reporting entity should assess the categorization within the fair value hierarchy based on the interest in the fund itself and not the securities within the fund.

The investment could be classified as Level 1 if the fair value measurement of the interest in the fund (not the underlying investments) was based on observable inputs that reflect quoted prices (unadjusted) for identical assets in active markets (i.e., the fund is exchange-traded).

Level 2

Examples of Level 2 inputs include the following:

- A dealer quote for a nonliquid security, provided the dealer is standing ready and able to transact
- Posted or published clearing prices, if corroborated with market transactions
- Vendor- or broker-provided indicative prices, if due diligence by the reporting entity indicates such prices were developed using observable market data

Examples of instruments that are typically Level 2 measurements include the following:

- Most U.S. public debt
- Short-term cash instruments
- Certain derivative products

Level 3

Examples of inputs that are considered Level 3 include the following:

- Inputs obtained from broker quotes that are indicative (i.e., not firm and able to be transacted upon) or not corroborated with market transactions
- Management assumptions that cannot be corroborated with observable market data
- Vendor-provided prices, not corroborated by market transactions

Common examples of instruments that are typically Level 3 measurements include the following:

- Complex instruments, such as longer-dated interest rate and currency swaps and structured derivatives
- Fixed income asset-backed securities, depending on the specific asset owned (i.e., the specific tranche), the nature of the valuation model used, and whether the inputs are not observable
- Goodwill or indefinite-lived intangible assets, when recognized at fair value in the period in which an impairment is recognized
- Held-for-sale real estate
- Contingent consideration that is subsequently measured at fair value

20.3.4 Step 5: Assess disclosure required by the fair value standard

The disclosure requirements of the fair value standard can be divided into two areas: those explaining (1) the fair value of the entire asset or liability, and (2) the significant input(s) to the fair value measurement.

20.3.4.1 Disclose the fair value of the entire asset/liability

ASC 820-10-50-2(b) requires reporting entities to disclose the level that a measurement falls in its entirety within the fair value hierarchy. The disclosure should segregate Level 1, Level 2, and Level 3 measurements by class of assets or liabilities. A fair value measurement, which may be the result of multiple inputs, is categorized in its entirety by reference to its lowest level (i.e., least reliable) significant input. For a Level 1 measurement, there is only a Level 1 price.

20.3.4.2 Disclose all significant Level 3 inputs in a table

To conclude that a fair value measurement should be classified as Level 3, reporting entities only have to identify one significant unobservable input. The fair value standard's disclosure requirements, however, require reporting entities to identify *all* significant unobservable inputs and disclose quantitative information about them. Also, reporting entities need to describe the valuation techniques and inputs. Figure 20-4 includes disclosure requirements related to significant inputs.

20.3.5 Step 6: Reassess

The categorization of a particular instrument in the fair value hierarchy may change over time. As markets evolve, certain markets become more or less liquid, inputs become more or less observable, and the level within the fair value hierarchy could change. Therefore, it is important to evaluate the continued appropriateness of the levels in which fair value measurements are categorized at each reporting date.

20.4 Disclosure

The disclosure requirements in the fair value standard are intended to provide information about the following:

- When a reporting entity measures assets and liabilities at fair value
- The valuation techniques and inputs used to measure fair value
- The effect of fair value measurements on net income and other comprehensive income

The fair value disclosure requirements vary depending on whether (1) the asset or liability is measured on a recurring or nonrecurring basis, (2) it is classified in Level 1, 2, or 3 of the fair value hierarchy, and (3) the reporting entity is public or nonpublic, as defined in ASC 825.

ASC 820 sets out minimum requirements and emphasizes the reporting entity's responsibility to meet the overall disclosure objectives, which may require additional disclosures if necessary to provide additional context based on the reporting entity's facts and circumstances.

20.4.1 Main requirements

For all interim and annual reporting periods, there are specific quantitative and qualitative disclosures required for assets and liabilities measured at fair value.

Reporting entities should make the disclosures for, at a minimum, each class of asset and liability, with sufficient detail to permit reconciliation of the disclosures to the line items in the balance sheet.

Figure 20-3 delineates the fair value disclosure requirements for both recurring and nonrecurring measurements, other than those specific to valuation techniques and unobservable inputs (which are included in Figure 20-4).

Quantitative disclosures included within this figure should be presented in a tabular format in accordance with ASC 820-10-50-8.

Figure 20-3

Fair value disclosure requirements other than valuation techniques and significant inputs

Disclosure requirement	ASC reference	Related information
The fair value measurement at the end of the reporting period For nonrecurring fair value measurements, the reasons for the measurement	820-10-50-2(a)	
The level that a measurement falls in its entirety within the fair value hierarchy, segregated between Level 1, Level 2 and Level 3 measurements, by class of assets or liabilities	820-10-50-2(b)	ASC 820-10-50-2E indicates that this disclosure is also applicable to assets and liabilities for which fair value is only disclosed. For discussion of the fair value hierarchy, see FV 4 (summarized in FSP 20.3).
For recurring fair value measurements of assets and liabilities held at the end of the reporting period: □ The amounts of any transfers between Level 1 and Level 2 □ The reasons for the transfers □ The reporting entity's policy for determining when a transfer has occurred	820-10-50-2(bb)	Disclose transfers into each level separately from transfers out of each level. For further discussion of transfers between levels, see FSP 20.4.1.2.

Disclosure requirement	ASC reference	Related information
For recurring Level 3 fair value measurements, a reconciliation of the beginning and ending balances (e.g., the Level 3 rollforward), separately presenting changes during the period attributable to any of the following. □ Total gains or losses for the period, separately presenting gains or losses recognized in income and gains or losses recognized in OCI □ A description of where the gains or losses are recognized in income or recognized in OCI are reported in the statement of income or in OCI □ Purchases, sales, issues, and settlements (each type disclosed separately) □ All transfers in and out of Level 3, the reasons for those transfers, and the reporting entity's policy for determining when a transfer occurs	820-10-50-2(c)	Disclose transfers *in* to Level 3 separately from transfers *out* of Level 3. Present these rollforward disclosures on either a gross or a net basis. ASC 820-10-55-101 illustrates an example rollforward disclosure for recurring Level 3 fair value measurements. For further discussion, see FSP 20.4.1.3.

Disclosure requirement	ASC reference	Related information
For recurring Level 3 fair value measurements □ The total amount of gains or losses for the period included in income attributable to the change in unrealized gains and losses □ The line item where those unrealized gains and losses are reported in net income	820-10-50-2(d)	The amount disclosed as the unrealized gain/loss relating to assets and liabilities held at the end of the reporting period should be consistent with (1) the reporting entity's policy for the timing of transfers of securities into and out of Level 3 (e.g., beginning of the period or end of the period) and (2) the amount of total gains and losses included in the Level 3 rollforward table for that period. This is because the unrealized gain/loss should only be included for the period in which the instrument was Level 3.
The highest and best use of a nonfinancial asset measured or disclosed at fair value when it differs from its current use, and why	820-10-50-2(h)	ASC 820-10-50-2E indicates that the disclosure is also applicable to assets and liabilities for which fair value is only disclosed.
The accounting policy decision to use the exception applicable to financial assets and liabilities with offsetting positions in market risks or counterparty credit risk (the "portfolio exception")	820-10-50-2D	See FV 6 for discussion of the portfolio exception.
Existence of the credit enhancement (for issuers of debt with an inseparable third-party credit enhancement that is recorded as a liability that is measured at fair value)	820-10-50-4A	See FV 8 for a discussion of the measurement of liabilities with inseparable third-party credit enhancements.
The nature and risks of the investments and whether the investments are probable of being sold at amounts different from NAV per share (for investments for which NAV per share is calculated, regardless of whether the practical expedient to use NAV as fair value is used)	820-10-50-6A	For further discussion, see FSP 20.4.1.4.

20.4.1.1 Disclosure of asset impairments

When a long-lived asset is impaired, it is written down to fair value and should be included as a nonrecurring fair value measurement (1) in the quarter in which the impairment was taken, (2) in subsequent quarters, and (3) in the year of impairment.

The reporting entity should include the nonrecurring measurement disclosures from the quarter in which the impairment was recorded in its subsequent quarterly and annual filings that cover the period in which the impairment was recognized. We believe this approach is consistent with the interim and annual disclosure requirements for impairments under ASC 360, *Property, Plant & Equipment*.

20.4.1.2 Transfers between levels in the hierarchy

As noted in 20.3.5, there are instances when the level of a fair value measurement may change. Reporting entities should disclose and consistently follow a policy for determining when transfers between levels are recognized. The policy should be the same for transfers in and out of all levels.

Examples of the different policies that can be used to record transfers include (1) the actual date of the transfer, (2) assuming the transfer occurs at the beginning of the period (i.e., beginning of the quarter or year-to-date period), or (3) assuming the transfer occurs at the end of the period.

There are practical implications associated with the reporting entity's chosen policy regarding when transfers are recorded. For example, unrealized and realized gain and loss activity during the period would not be reflected in the Level 3 rollforward for the period if a reporting entity applies an end-of-period convention for transfers in.

As a practical matter, reporting entities may only have formal procedures for assessing the level in the hierarchy at the end of an external reporting period (i.e., at the end of each quarter). In this case, assuming end-of-period transfers in and out may be the most efficient.

A reporting entity's policy choice with respect to the timing of transfers in and out of the levels will also impact the relationship between the year-to-date disclosures and quarter disclosures. Use of end-of-period or beginning-of-period methods generally will result in quarterly information that does not sum to the year-to-date totals because the beginning and ending dates for timing of a transfer may be different in a year-to-date disclosure than in a quarterly disclosure. Once a reporting entity makes the election of either the end-of- or beginning-of-period method, it should be applied consistently.

Reporting entities should evaluate transfers to determine the reason for the transfer between levels. They should assess whether the transfer is being made in the appropriate period or should be evaluated as a correction of an error.

20.4.1.3 Level 3 rollforward disclosure

A reporting entity can exclude from the Level 3 rollforward instruments purchased and sold or transferred in and out of Level 3 in the same period.

Question 20-3

How should a reporting entity calculate unrealized gains and losses for an interest bearing security held at period-end for purposes of the Level 3 rollforward?

PwC response

There are several acceptable methods for determining unrealized gains/losses for items still held at the reporting date.

- *Method A—"Balance sheet view"*

  Determine unrealized gains and losses as the fair value of the security less its amortized cost basis. This view holds that gains and losses are realized at maturity or sale date; thus the entire gain/loss is considered unrealized until maturity or sale.

- *Method B—"Income statement view"*

  Determine unrealized gains and losses as the total gains and losses during the period less the cash received or paid (i.e., what is realized) for those items. This view holds that each individual cash receipt or settlement represents a realized gain or loss.

- *Method C*

  First, determine any realized gains or losses as the difference between the beginning-of-the-period expected cash flows and actual cash flows for the period. Then, determine unrealized gains or losses as the difference between the remaining expected cash flows for future periods at the beginning and end of the period.

The fair value standard does not specify a particular method. As a result, we consider all views to be acceptable. Reporting entities should select a method, disclose which method is used, and apply it consistently.

Question 20-4

Are impairment losses, including other-than-temporary impairments (OTTI),[3] considered realized or unrealized in the Level 3 rollforward?

PwC response

The fair value standard requires disclosure of recognized gains and losses and unrealized gains and losses related to assets and liabilities held at the balance sheet date in the Level 3 rollforward.

We believe there are two acceptable methods to preparing the Level 3 rollforward information for fair value adjustments to securities for which there has been an OTTI.

- *Method A*

  Present OTTI losses and significant declines in value as “realized” in the Level 3 rollforward table. This view is supported by the guidance in ASC 320, which describes the nature of OTTI losses as “realized.”

- *Method B*

  Present OTTI losses and significant declines in value as “unrealized” in the Level 3 rollforward table. The overall objective of the Level 3 rollforward disclosures is to present the income statement impact of Level 3 fair value measurements the reporting entity has not verified with an observable transaction (i.e., a sale in the marketplace). Proponents of this view believe that recognition of an OTTI is not an observable or realized transaction.

The fair value standard does not specify a particular method. As a result, we consider both views to be acceptable. Reporting entities should select a method, disclose which method is used, and apply it consistently.

Example 20-1 illustrates the fair value standard’s requirements for disclosure of amounts transferred between levels in the Level 3 rollforward.

[3] As of the content cutoff date of this publication (August 31, 2014), the FASB has an active project that may affect the impairment of available-for-sale securities. Financial statement preparers and other users of this publication are therefore encouraged to monitor the status of the project, and if finalized, evaluate the effective date of the new guidance and the implications on presentation and disclosure.

EXAMPLE 20-1

Calculating unrealized gains or losses in the Level 3 rollforward

A reporting entity has an accounting policy that, for purposes of the required Level 3 rollforward transfers in to and out of Level 3 are deemed to occur at the beginning of the quarter.

What amounts should be included in the disclosure for the quarter and year-to-date periods for items transferred *into or out of* Level 3 during the quarter?

Analysis

The value of Investment A, a trading security, changes during the six-month period as follows:

1/1/20X4		$100
Unrealized loss	$(5)	
3/31/20X4		$95
Unrealized loss	$(10)	
6/30/20X4		$85

Transfer into level 3

Investment A is classified as Level 2 at 1/1/20X4 and 3/31/20X4. Management transfers Investment A in the second quarter ending 6/30/20X4 and classifies it as Level 3 at that date. There are no other Level 3 securities.

The rollforward table required to be disclosed is as follows:

Level 3 rollforward	3 months ended 6/30/20X4	6 months ended 6/30/20X4
Beginning balance	$0	$0
Transfer in	$95	$95
Unrealized loss	$(10)	$(10)
Ending balance	$85	$85

Level 3 rollforward	3 months ended 6/30/20X4	6 months ended 6/30/20X4
Amount of total loss for the period included in income that is attributable to the change in unrealized loss relating to assets held at the end of the reporting period	$(10)	$(10)

Because the reporting entity has a policy that all transfers are deemed to occur at the beginning of the quarter, the unrealized loss while classified as a Level 3 investment is ($10), whereas a policy that considered the transfers as of the beginning of the period (1/1/20X4) would have reflected a cumulative year-to-date unrealized loss of ($15).

Transfer out of level 3

Assume instead that Investment A is classified as Level 3 at 1/1/20X4 and 3/31/20X4. Management transfers Investment A out of a Level 3 measurement in the quarter ending 6/30/20X4 and classifies it as Level 2 at that date.

The rollforward table required to be disclosed is as follows:

Level 3 rollforward	3 months ended 6/30/20X4	6 months ended 6/30/20X4
Beginning balance	$95	$100
Transfer out	$(95)	$(95)
Unrealized loss	$(0)	$(5)
Ending balance	$0	$0
Amount of total loss for the period included in income attributable to the change in unrealized loss relating to assets held at the end of the reporting period	$(0)	$(5)

Because the reporting entity recorded the transfer as of the beginning of the quarter (i.e., 4/1/20X4), the unrealized loss during the three months ended June 30, 20X4 is not part of the rollforward. For the same reason, the unrealized loss reported in the first quarter is reflected in the rollforward for the six month period ended June 30, 20X4.

In this example, if the reporting entity were to deem transfers as occurring at the beginning of the year-to-date period (January 1 for the year-to-date six months ended June 30), it would result in different disclosures.

20.4.1.4 Use of net asset value as a practical expedient

The fair value standard contains a practical expedient under which reporting entities are permitted to use NAV, without adjustment, as fair value for investments that meet the criteria of ASC 820-10-15-4 through 15-5. Investments that would qualify include most interests in hedge funds, private equity funds, real estate funds, venture capital funds, offshore fund vehicles, and funds of funds.

In addition to the other disclosure requirements of the fair value standard, ASC 820-10-50-6A requires disclosures related to investments for which an NAV is calculated. These disclosures are required for each interim and annual period, regardless of whether the practical expedient is used. ASC 820-10-55-107 illustrates the requirements and includes the following description of the intent of the disclosures.

Excerpt from 820-10-55-107

...this Topic requires a reporting entity to disclose information that helps users to understand the nature, characteristics, and risks of the investments by class and whether the investments are probable of being sold at amounts different from net asset value per share...

If a reporting entity uses the NAV practical expedient and the investment is categorized in Level 3, the reporting entity may omit the disclosure regarding quantitative information about significant unobservable inputs used in the fair value measurement.

Note about ongoing standard setting

As of the content cutoff date of this publication (August 31, 2014), the FASB has an active project to determine how certain investments whose fair values are measured at NAV as a practical expedient should be categorized within the fair value hierarchy. Financial statement preparers and other users of this publication are therefore encouraged to monitor the status of the project, and if finalized, evaluate the effective date of the new guidance and the implications on presentation and disclosure.

20.4.1.5 Disclosures for financial instruments not measured at fair value

ASC 825 requires that reporting entities, except those that meet the criteria in ASC 825-10-50-3 (i.e., nonpublic entities, entities with total assets less than $100 million, and certain entities that do not invest in derivatives), annually disclose the fair value of all financial instruments, whether or not recognized on the balance sheet at fair value, except for any of the instruments listed in ASC 825-10-50-8.

Excerpt from ASC 825-10-50-8

a. Employers' and plans' obligations for pension benefits, other postretirement benefits including health care and life insurance benefits, postemployment benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements (see Topics 710; 712; 715; 718; and 960)

b. Substantively extinguished debt subject to the disclosure requirements of Subtopic 405-20

c. Insurance contracts, other than financial guarantees (including financial guarantee insurance contracts within the scope of Topic 944) and investment contracts, as discussed in Subtopic 944-20

d. Lease contracts as defined in Topic 840 (a contingent obligation arising out of a cancelled lease and a guarantee of a third-party lease obligation are not lease contracts and are subject to the disclosure requirements in this Subsection)

e. Warranty obligations (see Topic 450 and the Product Warranties Subsections of Topic 460)

f. Unconditional purchase obligations as defined in paragraph 440-10-50-2

g. Investments accounted for under the equity method in accordance with the requirements of Topic 323

h. Noncontrolling interests and equity investments in consolidated subsidiaries (see Topic 810)

i. Equity instruments issued by the entity and classified in stockholders' equity in the statement of financial position (see Topic 505).

ASC 825-10-50-2E notes the specific disclosures required for financial instruments for which fair value is only disclosed. They are referenced in the "Related Information" column of Figures 20-3 and 20-4.

If these disclosures are in more than one footnote, ASC 825-10-50-12 requires that one of the footnotes include a summary table listing fair value and the related carrying amounts and referencing where the other disclosures can be found.

Also, ASC 825-10-50-15 indicates that the fair values of financial instruments should not be netted unless the conditions for offsetting under ASC 210 *Balance*

Sheet or ASC 815 *Derivatives and Hedging*, are met. These are addressed in FSP 2.4 (general conditions) and FSP 19.3.2 (conditions for derivatives).

When carrying value approximates fair value

A fair value measurement for financial instruments recorded on a basis other than fair value is required to be disclosed, unless carrying value approximates fair value. Management should carefully evaluate a conclusion that the fair value of its financial instruments approximates carrying value. Even if carrying value approximates fair value, the disclosure of the level in the fair value hierarchy of the fair value measurements is still required.

Trade receivables and payables

ASC 825-10-50-14 provides an exception to the fair value disclosures for trade receivables and trade payables with carrying values that approximate fair value. Because these instruments are scoped out of the fair value disclosure requirement, reporting entities are not required to provide fair value hierarchy information. We do not believe this exception to the disclosure should be extended to other financial assets or financial liabilities, as this guidance is specific to trade receivables and trade payables.

As with financial instruments, management should carefully evaluate a conclusion that the fair value of its trade receivables or trade payables approximates carrying value. While that will often be the case, management should consider the nature, risk, and terms of the trade receivable or payable. For example, the fair value of structured or long-term trade receivables and payables may not approximate their carrying amounts. In such cases, a reporting entity would be required to disclose the fair value of the related trade receivable or payable along with the level in the fair value hierarchy.

When it is not practicable to estimate fair value

ASC 825-10-50-16 indicates that when it is not practicable to estimate the fair value of a financial instrument based on an assessment of the cost versus the related benefit, the reporting entity should still disclose information pertinent to the fair value, such as the carrying amount, effective interest rate, and maturity, along with the reasons why it is not practicable to estimate the fair value.

At times, it may be practicable to estimate the fair value of a portfolio, rather than a single instrument. If that is the case, the reporting entity may disclose that portfolio fair value. Further, if the reporting entity can only measure the fair value of a subset of a class of financial instruments, it should disclose the fair values of the instruments within the subset.

20.4.2 Disclosure of valuation techniques and unobservable inputs

The following figure includes the qualitative and quantitative fair value disclosure requirements relating to valuation techniques and inputs. The concepts of valuation techniques and inputs are addressed in FV 4.

Figure 20-4

Fair value disclosure requirements of valuation techniques and unobservable inputs

Disclosure requirement	ASC reference	Related information
For Level 2 and Level 3 fair value measurements, a description of the valuation technique(s) and the inputs used in determining the fair values of each class of assets or liabilities If the reporting entity has changed its valuation technique, disclose the change and the reason for making it.	820-10-50-2(bbb)	ASC 820-10-50-2E indicates that these disclosures are also applicable to assets and liabilities for which fair value is only disclosed. For further discussion of qualitative disclosures for Level 3 instruments, see FSP 20.4.2.3.
For Level 3 fair value measurements, quantitative information about *all* significant unobservable inputs used in the fair value measurement	820-10-50-2(bbb)	These disclosures are not required for assets and liabilities for which fair value is only disclosed. For further discussion, see FSP 20.4.2.1.
For Level 3 fair value measurements, a description of the valuation processes used by the reporting entity (including, for example, how an entity decides its valuation policies and procedures and analyzes changes in fair value measurements from period to period)	820-10-50-2(f)	ASC 820-10-55-105 requires that a reporting entity expand its disclosure of policies and guidelines, and provide additional information on internal reporting procedures. For further discussion, see FSP 20.4.2.3.
For recurring Level 3 fair value measurements, a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement	820-10-50-2(g)	If there are interrelationships between those inputs and other unobservable inputs used in the fair value measurement, a reporting entity should also provide a description of those interrelationships and how they might magnify or mitigate the effect of changes in unobservable inputs on the fair value measurement. For further discussion, see FSP 20.4.2.3.

20.4.2.1 *Table of significant unobservable inputs*

The main disclosure requirement for unobservable inputs is a quantitative disclosure of significant unobservable inputs.

Level of disaggregation – table of significant unobservable inputs

The quantitative disclosures of significant unobservable inputs are presented by class of assets and liabilities. Reporting entities need to apply judgment to determine the appropriate classes of assets and liabilities and should provide information sufficient to permit reconciliation to the line items presented in the balance sheet. Although the disclosure requirements of the fair value standard do not specifically require disclosing such a reconciliation, it has become a leading practice.

The fair value standard does not prescribe the level of disaggregation (below the class level of assets and liabilities), but it does state that fair value measurements will often require greater disaggregation than the line items in the balance sheet and a reporting entity should determine classes based on the nature, characteristics, and risks of the assets and liabilities. The disclosure should contain sufficient detail to allow users to understand the unobservable inputs and how those inputs vary over time.

When considering how detailed the quantitative disclosures should be, a reasonable starting point is an evaluation of the classes for each of the assets and liabilities included in other fair value disclosures (e.g., the fair value hierarchy), followed by consideration of the nature and risk of the types of assets and liabilities and inputs in each class. The objective of this exercise is to determine whether there are reasonable levels of homogenous pools of inputs for the Level 3 assets and liabilities that can be separated out of the related class.

The classification of measurements in the fair value disclosures as Level 3 assets or liabilities typically affects the level of disaggregation (i.e., the number of classes may need to be greater for fair value measurements using significant unobservable inputs). ASC 820-10-50-2B indicates that using the classes determined in other standards (e.g., ASC 320) is acceptable.

For example, a reporting entity's derivative assets and liabilities may be disaggregated at the class level (e.g., interest rate instruments, commodity instruments, and foreign exchange rate instruments). However, the reporting entity's commodity instruments may comprise a number of different types of commodities that do not share similar risk characteristics. The reporting entity may conclude that disaggregating its commodity derivatives by type of commodity would provide more meaningful information.

Similarly, a reporting entity may disaggregate mortgage-backed securities into residential and commercial securities, or disaggregate private equity securities by industry.

ASC 820-10-55-100 provides an example of disaggregation.

Wide range of values

When there is a wide range of values for the significant unobservable inputs, we believe it is a best practice to include the weighted average, or some other measure of the distribution, and to disclose the way in which it is calculated. This will de-emphasize the impact of outliers. Assuming like portfolios, inclusion of weighted averages will aid in comparing disclosures for different reporting entities.

Inputs to inputs

Level 3 fair value measurements may contain a number of unobservable inputs. Such unobservable inputs may be developed using a variety of assumptions and "underlying" unobservable inputs (e.g., a number of assumptions are used to arrive at a long-term growth rate input).

We would generally not expect these underlying inputs used to develop significant unobservable inputs ("inputs to inputs") to be included in the quantitative disclosures. Most inputs use underlying assumptions; the disclosure of these underlying assumptions could result in a significant amount of additional information being disclosed, adding unnecessary complexity to the disclosure. As a result, the overall disclosure could become less understandable. We believe inclusion of such information is beyond the scope of the disclosure requirement.

In addition, the example in ASC 820-10-55-103 includes disclosure of inputs such as weighted average cost of capital, long-term revenue growth rate, and long-term pretax operating margin. These unobservable inputs are based on a variety of assumptions. For example, a weighted average cost of capital input may include a number of assumptions such as the risk-free rate, effective tax rate, required equity rate of return, and the proportion of debt versus equity. These underlying inputs are not included in the example disclosure.

Derivative assets and liabilities and their related unobservable inputs

We believe, similar to the fair value hierarchy table disclosure, derivative assets and liabilities should generally be presented on a gross basis in the quantitative disclosure of unobservable inputs.

Any unobservable inputs that are applied to positions valued on a gross basis should be classified with the corresponding derivative asset or liability on a gross basis.

Unobservable inputs applied to value a net derivative position (such as when it meets the requirements for netting on the balance sheet or is a net position under the "portfolio exception") may be shown net in the disclosure.

20.4.2.2 *Third-party pricing*

Management is responsible for all valuation and should evaluate whether it has performed sufficient diligence over the fair value measurements and inputs obtained externally, including the related fair value hierarchy level determinations.

ASC 820-10-50-2(bbb) allows a reporting entity to omit certain quantitative disclosures if the unobservable inputs are not developed by the reporting entity (e.g., when a reporting entity uses prices from prior transactions or obtained from third-party pricing sources without adjustment).

Even if the reporting entity elects the "third-party exception," it should provide the qualitative sensitivity disclosures for any significant inputs if required by ASC 820-10-50-2(g) and reasonably available.

Reporting entities should not ignore quantitative unobservable inputs that are significant to the fair value measurement and that are reasonably available to the entity. Therefore, when a reporting entity is contemplating use of this exception, we would expect it to make a reasonable attempt to obtain quantitative information from the third party about unobservable inputs being used.

The third-party exception may only be applied if a reporting entity uses the price obtained from a prior transaction or a third party without significant adjustment. Consequently, significant adjustments would invalidate the third-party pricing exception and require the reporting entity to make the quantitative disclosures in ASC 820-10-50-2(bbb).

Under ASC 820-10-55-104(b), reporting entities that use third-party pricing for their fair value measurements should also consider whether it is appropriate to disclose how third-party information such as broker quotes, pricing services, net asset values, and relevant market data were considered in the measurement of fair value. Whenever a reporting entity uses unobservable inputs it has not developed, it should consider disclosing information to allow users of the financial statements to understand how it has used those inputs in its fair value measurements. Specifically, disclosures would include the following:

- How and the extent to which the reporting entity uses brokers and pricing services to determine its fair value measurements
- The nature and amount of assets valued using brokers or pricing services
- The classification of the assets and liabilities valued based on brokers or pricing services in the fair value hierarchy
- Information on the use of multiple broker quotes
- The reasoning and methodology for any adjustments made to prices from brokers or pricing services

- The extent to which the brokers are using observable market information as compared to proprietary models and unobservable data
- Whether the quotes are binding
- Procedures performed to validate the fair value measurements

20.4.2.3 Qualitative disclosures for Level 3 fair value measurements

In addition to the quantitative disclosures, the fair value standard requires certain qualitative disclosures relating to Level 3 fair value measurements. As listed in Figure 20-4, these disclosure requirements include (1) a description of the valuation process in place for both recurring and nonrecurring Level 3 fair value measurements and (2) a qualitative discussion about sensitive inputs used in recurring Level 3 fair value measurements.

ASC 820-10-50-2(g) requires a narrative disclosure about the sensitivity of recurring Level 3 fair value measurements to certain changes in unobservable inputs. The disclosure should include, at a minimum, discussion of the unobservable inputs included in the quantitative table. This guidance requires the potential effect of changes in unobservable inputs to be described if such changes might result in a significantly different fair value measurement. Furthermore, if there are interrelationships between those inputs and other unobservable inputs used in the fair value measurement, the reporting entity should also disclose such interrelationships and the potential impact on sensitivity. ASC 820-10-55-106 provides an example disclosure of the sensitivity analysis.

The guidance does not require a quantitative disclosure about sensitivity; therefore, reporting entities are not required to provide specific amounts or quantify the potential changes in the inputs or the fair value measurements. Reporting entities typically elaborate on the sensitivity of significant unobservable inputs associated with each type of classification included in the quantitative recurring Level 3 disclosure. For instance, if a reporting entity has corporate debt and collateralized mortgage-backed securities (CMBS) classified as Level 3, it may disclose how the significant unobservable input of yield is affected by movement in credit spreads, or movements in prepayment assumptions, respectively.

20.4.3 Concentrations of credit risk of all financial instruments

Reporting entities are required to disclose all significant concentrations of credit risk arising from financial instruments. This disclosure applies to significant credit risk from an individual counterparty or groups of counterparties if those counterparties are engaged in similar activities and have similar economic characteristics (referred to as “group concentrations”).

The required disclosures for each significant concentration are identified in Figure 20-5. These requirements are not applicable to the financial instruments referenced within ASC 825-10-50-22, which include financial instruments of a pension plan and the securities described in ASC 825-10-50-8(a), (c), (e), and (f).

Figure 20-5
Required disclosures for each significant concentration of credit risk

Disclosure requirement	Related information
Information that identifies group concentrations	Shared activity, region, or economic characteristic
Maximum amount of loss due to credit risk	This is the amount the reporting entity would incur if counterparties failed. It is based on the gross fair value of the financial instrument, and assuming the collateral proved to be of no value to the reporting entity.
Collateral	□ The reporting entity's policy of requiring collateral □ The reporting entity's access to that collateral □ The nature and description of the collateral
Master netting arrangements	□ The reporting entity's policy of entering into master netting arrangements □ The arrangements to which the reporting entity is a party at the balance sheet date □ A description of the terms of the arrangements, including their ability to reduce the reporting entity's maximum amount of loss

20.4.4 *Market risk of all financial instruments*

Reporting entities are encouraged to disclose quantitative information about the market risk of financial instruments, while taking into consideration its management of those risks. These disclosures will likely differ and evolve for each reporting entity. Example quantitative disclosures are included in ASC 825-10-50-23, and reporting entities are encouraged to develop others where appropriate. This is in addition to the information regarding market risk of financial instruments in the MD&A that is required by Financial Reporting Release 48.

20.5 *Fair value option*

In addition to the standards that require assets and liabilities to be reported at fair value, GAAP provides reporting entities with a fair value option (FVO) to measure certain financial instruments and other items on the balance sheet at fair value.

The key standards that have a FVO, as discussed in FV 5, include:

- *ASC 815-15, Derivatives and Hedging—Embedded Derivatives*, which provides a FVO for certain hybrid financial instruments that contain an embedded derivative that would otherwise require separation

- *ASC 860-50, Transfers and Servicing—Servicing Assets and Liabilities*, which permits a reporting entity to choose between the amortization method and the fair value measurement method for each class of separately-recognized servicing assets and servicing liabilities

- ASC 825-10, *Financial Instruments—Overall*, which provides a measurement basis election for most financial instruments (i.e., a choice of either historical cost or fair value), including equity method investments, allowing reporting entities to mitigate potential mismatches that arise under the current mixed measurement attribute model

Because the FVO is not a requirement, its election may result in reduced comparability of financial reporting, both among similar reporting entities and within a single entity, because similar assets or liabilities could be reported under different measurement attributes (i.e., some at historical cost and some at fair value). However, the disclosure provisions in those topics are intended to mitigate this by requiring (1) identification of instruments for which the option is elected, and (2) extensive information about the effects on the financial statements.

20.5.1 Presentation of FVO

ASC 825-10 permits reporting entities to apply the FVO on an instrument-by-instrument basis. Therefore, a reporting entity can elect the FVO for certain instruments, but not others within a group of similar instruments (e.g., only a portion of an identical portfolio of corporate securities).

20.5.1.1 Presentation of instruments with FVO versus without FVO

ASC 825-10-45-2 permits reporting entities to present the fair value and non-fair-value amounts (1) aggregated in the same balance sheet line item (parenthetically disclosing the amount measured at fair value included in the aggregate amount), or (2) in two separate line items.

Securities for which the reporting entity elects the FVO are presented in the same category (i.e., trading, available for sale, or held-to-maturity) as other securities required to be measured at fair value with changes in fair value recorded in income. If a reporting entity elects the FVO for one or more investments, it may use terminology such as “securities carried at fair value” in describing these securities, instead of the “trading” terminology in ASC 320.

20.5.1.2 *Presentation of changes in fair value under the FVO*

ASC 825-10 does not include guidance on geography for items measured at fair value under the FVO, including how to present dividend income, interest income, or interest expense, but the reporting entity should disclose its policy for such recognition.

We believe reporting entities may apply one (or some variation) of the following models for reporting interest income and expense.

- Present the entire change in fair value of the FVO item, including the component related to accrued interest, in a single line item in the income statement.

  Some industries, such as investment companies, are required to show investment income separately, and therefore, can only apply this approach to a certain extent. For others, presenting investment income separately is common industry practice. When determining the amount to separately report as investment income from instruments for which the fair value option is elected, if existing U.S. GAAP prescribes a method of calculating interest income for identical instruments not carried at fair value, we believe the same model should be applied to instruments carried at fair value.

- Separate the interest income or expense from the full change in fair value of the FVO item and present that amount in interest income/expense. Present the remainder of the change in fair value in a separate line item in the income statement. The allocation of the change in fair value to interest income/expense should use an appropriate and acceptable method under U.S. GAAP.

  Examples of instances when interest income or expense is permitted to be broken out separate from other changes in fair value are: (1) derivatives that have been designated in qualifying hedging relationships, (2) certain investments in debt and equity securities, (3) certain originated or acquired loans (as referenced in ASC 825-10-50-28(e)(2), and (4) certain debt.

Each presentation covers the same net change in fair value of the item measured at fair value under the FVO, but can result in significant differences in individual line items in the income statement. We encourage reporting entities to use the single line presentation because splitting the change in fair value creates an amount in a line item that is just a residual difference. In either case, reporting entities should select a policy for income statement presentation that is appropriate for their facts and circumstances, disclose the policy in the footnotes, and follow it consistently.

20.5.2 *Disclosure of FVO*

FVO disclosures help financial statement readers understand the extent to which the reporting entity uses the FVO, management's reasons for electing the FVO, and how changes in fair values affect net income for the period.

ASC 825-10 requires additional disclosures if the FVO is elected for only some of the eligible items within a group of similar eligible items (e.g., a description of those similar items and reasons for partial election). In addition, the reporting entity should disclose the amounts to which it applied the FVO and the amounts to which it did not apply the FVO within that group.

When a reporting entity has elected the fair value option for loans, long-term receivables, long-term debt, or loans held as assets, ASC 825-10-50-28 and 50-30 provide additional disclosure requirements specific to these instruments.

ASC 825-10-55-6 through 55-13 includes an example disclosure that integrates FVO disclosure requirements with the fair value standard's requirements. The example is for illustrative purposes only and does not present the only method to comply with the disclosure requirements.

20.5.2.1 Disclosures for instruments that would otherwise have been accounted for under the equity method

ASC 825-10-50-28(f) refers reporting entities that have elected to account for certain equity method investments using the fair value option to also disclose certain equity method disclosures, specifically, the requirements of ASC 323-10-50-3, excluding ASC 323-10-50-3(a)(3), (b) and (d). Refer to FSP 10 for discussion of equity method disclosure requirements.

20.6 Considerations for private companies

Certain of the fair value disclosures are not required for nonpublic entities. The fair value standard refers to the first definition of a "nonpublic entity" within the Master Glossary of the FASB Codification.

Definition from ASC Master Glossary

Nonpublic entity: Any entity that does not meet any of the following conditions:

a. Its debt or equity securities trade in a public market either on a stock exchange (domestic or foreign) or in an over-the-counter market, including securities quoted only locally or regionally.

b. It is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over the counter market, including local or regional markets).

c. It files with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market.

d. It is required to file or furnish financial statements with the Securities and Exchange Commission.

e. It is controlled by an entity covered by criteria (a) through (d).

ASC 820-10-50-2F indicates that the disclosures not required for nonpublic entities, as defined, include the following.

- The level that a measurement falls in its entirety within the fair value hierarchy, segregated between Level 1, Level 2 and Level 3 measurements, by class of assets or liabilities (ASC 820-10-50-2(b))

- Information about transfers between Level 1 and Level 2 of the fair value hierarchy (ASC 820-10-50-2(bb))

- For Level 3 fair value measurements, quantitative information about *all* significant unobservable inputs used in the fair value measurement (ASC 820-10-50-2(bbb))

- Information about the sensitivity of a fair value measurement categorized within Level 3 to changes in unobservable inputs and any interrelationships between those unobservable inputs (ASC 820-10-50(g))

- The highest and best use of a nonfinancial asset measured or disclosed at fair value when it differs from its current use, and why (ASC 820-10-50-2(h))

Further, as noted in FSP 20.4.1.5, the disclosures for financial instruments that are not measured at fair value are not required for any nonpublic entity that meets the criteria in ASC 825-10-50-3.

20.6.1 Private company alternative - hedge accounting

With the issuance of ASU 2014-03, *Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps—Simplified Hedge Accounting Approach*, the FASB's Private Company Council provided an additional hedge accounting alternative (i.e., the simplified hedge accounting approach) for certain types of swaps to economically convert a variable-rate borrowing into a fixed-rate borrowing. Refer to FSP 19.6.1 for further discussion.

The guidance allows a private company to measure the designated swap at settlement value rather than fair value. All of the presentation and disclosure requirements of ASC 815 and ASC 820 continue to apply; however, as the simplified approach allows for the swap to be recorded at settlement value, this may be used in place of fair value for disclosure purposes. Any amounts disclosed at settlement value should be clearly designated as such, and disclosed separately from amounts disclosed at fair value.

Chapter 21: Foreign currency

21.1 Chapter overview

In today's global business environment, a reporting entity is likely to have transactions in foreign currencies and may have foreign operations.

This chapter addresses the key elements of presentation and disclosure guidance and other considerations necessary for complete and accurate financial reporting of the impact of foreign currency. This chapter also addresses the presentation and disclosure of exchange gains and losses, cumulative translation adjustments (CTA), and income taxes relating to transactions in a foreign currency. This chapter also outlines other required and suggested disclosures, including those related to the effects of changes in the foreign currency exchange rate, dealer transactions, using multiple foreign currency exchange rates, and reporting foreign currency commitments and contingencies.

The presentation of foreign currency cash flows is addressed in FSP 6.

21.2 Scope

ASC 830, *Foreign Currency Matters*, provides financial accounting and reporting guidance for foreign currency transactions and for translating foreign currency financial statements.

21.3 Transaction gains and losses

Transaction gains and losses result from transactions whose terms are denominated in a foreign currency.

21.3.1 Presentation

Foreign currency transaction gains and losses included in determining net income are required to be disclosed either on the face of the income statement or in the footnotes.

Practice has been to aggregate all transaction gains and losses and classify the net amount in a single caption in the income statement. Although ASC 830 is not specific, we believe classification of the transaction gains and losses in operating income is reasonable given the nature of the accounts that generate these gains and losses.

In some cases, notably highly inflationary economies, inclusion of the foreign currency gains or losses on a reporting entity's income statement in a single line item with all other transaction gains and losses may be distortive. In those cases, reporting entities may elect alternative presentations, as noted in Example 21-1.

EXAMPLE 21-1

Presentation of foreign currency gains in highly inflationary economies

A Venezuelan subsidiary of a U.S. reporting entity has a U.S. dollar functional currency because the Venezuelan economy is deemed highly inflationary.

The Venezuelan subsidiary has significant long-term debt denominated in Venezuelan Bolivars. The interest rate on such debt is variable, and given the rate of inflation, is high. The remeasurement of the Bolivar-denominated liability results in a significant exchange gain.

Should the Venezuelan subsidiary show the impact of foreign currency gains and losses separate from interest expense?

Analysis

Economies with high inflation rates tend to also have high interest rates. As the interest rate on the debt is variable, this may result in unusually high interest expense. In order to reflect the economic substance, we believe a reasonable presentation would be to present the incurred interest expense net of the related exchange gain.

That is, the Venezuelan subsidiary may classify exchange gains arising from operations in the highly inflationary economy against the related income statement line item. This would reflect the true economic substance of the transaction.

We believe a similar approach could be applied in economies that are not considered highly inflationary, but where interest expense may not reflect economic substance.

There should be consistency in how foreign exchange gains or losses are reflected against related line items to avoid distortion. For example, it may be inappropriate to classify foreign exchange gains and losses related to cost of sales in that line item if those related to revenue are not similarly presented. To reflect it appropriately, the reporting entity should thoroughly understand the major causes of the aggregate exchange gain or loss.

If a reporting entity elects this presentation for a particular foreign entity, it should apply it consistently for both gains and losses within that foreign entity and for all periods presented. It should also apply the policy consistently across other foreign entities with similar distortion issues. Finally, we believe that similar types of exchange gains and losses should be presented similarly.

21.3.1.1 Changes in foreign exchange rates are not extraordinary

As changes in foreign exchange rates are customary, ASC 830-10-45-19 indicates that they would not meet the definition of an extraordinary item even if the transaction gains and losses are the result of significant fluctuations in foreign currency.

21.3.1.2 *Presentation option for dealer transactions*

ASC 830-20-45-2 provides banks and other dealers in foreign currency an option to present gains and losses arising from foreign currency transactions as dealer gains or losses rather than as transaction gains or losses.

21.3.1.3 *Presentation of transaction gains and losses on deferred tax assets and liabilities*

Deferred tax assets and liabilities are considered monetary items and should be remeasured at current exchange rates with the related gains and losses included in income. ASC 830-740-45-1 indicates that the transaction gain or loss on deferred tax assets and liabilities may be presented either (1) with other transaction gains and losses or (2) as a component of the deferred tax benefit or expense on the income statement if that presentation is deemed more useful to financial statement users.

21.3.2 *Disclosure*

If transaction gains and losses are included in various financial statement line items, ASC 830-20-45-1 requires the reporting entity to aggregate the transaction gains and losses and disclose the total net gain or loss in the footnotes.

We believe a reporting entity should disclose its presentation policy if it reflects components of the transaction gains or losses against the related income statement line item (FSP 21.3.1).

21.3.2.1 *Disclosure of transaction gains and losses on deferred tax assets and liabilities*

If the reporting entity chooses to present transaction gains and losses in the income tax line item on the income statement, it should still include such amounts in the disclosure of the aggregate transaction gain or loss for the period required by ASC 830-20-45-1.

21.4 *Cumulative translation adjustments*

CTA results from the process of translating financial statements from a foreign entity's functional currency into the reporting currency of the reporting entity. Unlike foreign currency transaction gains and losses, which are recorded in net income, CTA should be reported in OCI.

21.4.1 *Presentation*

When presenting CTA in the financial statements, the title of the line item should be clear so the reader understands that the balance is due to foreign currency translation. The FASB has recommended the title “Equity Adjustment from Foreign Currency Translation” for this account.

ASC 830-30-45-18 indicates that an analysis of the changes in the CTA account during the period can be included in any of the following.

- A separate financial statement
- The footnotes
- The statement of changes in stockholders' equity

In the statement of stockholders' equity, CTA can be shown individually or aggregated with other items that affect OCI such as unrealized gains and losses on available-for-sale investments. FSP Figure 5-1 presents an example statement of stockholders' equity with OCI as one line item.

If aggregated as in Figure 5-1, the reporting entity should present a detailed break out of all components of other comprehensive income in the statement of comprehensive income or the footnotes.

ASC 830-230-55-4 includes an example showing the presentation of CTA as part of the reconciliation of stockholders' equity. CTA may be included as its own line item or aggregated with other items in AOCI, with the detail presented in the statement of comprehensive income or the footnotes.

FSP Figures 4-2 and 4-3 illustrate the presentation of CTA on the statement of comprehensive income.

21.4.1.1 Releases of CTA

ASC 830-30 precludes the release of CTA for derecognition events that occur within a foreign entity (i.e., when a reporting entity ceases to have a controlling financial interest in a subsidiary or a group of assets that by itself was not a foreign entity) unless such events represent a complete or substantially complete liquidation of the foreign entity. Derecognition events related to investments in a foreign entity (i.e., when a reporting entity ceases to have a controlling financial interest in a subsidiary or a group of assets that is itself a foreign entity) result in the release of all CTA related to the derecognized foreign entity, even when a noncontrolling financial interest is retained.

The release of CTA would generally be recorded as a component of operating income, although presentation in nonoperating income may also be acceptable.

21.4.2 Disclosure

ASC 830-30-45-20 details what should be included in the CTA disclosure.

ASC 830-30-45-20

At a minimum, the analysis shall disclose all of the following:

a. Beginning and ending amount of cumulative translation adjustments

b. The aggregate adjustment for the period resulting from translation adjustments (see paragraph 830-45-12) and gains and losses from certain hedges and intra-entity balances (see paragraph 830-20-35-3)

c. The amount of income taxes for the period allocated to translation adjustments (see paragraph 830-30-45-21)

d. The amounts transferred from cumulative translation adjustments and included in determining net income for the period as a result of the sale or complete or substantially complete liquidation of an investment in a foreign entity (see paragraph 830-30-40-1).

Reporting entities should also consider disclosing a description of the translation principle employed in the financial statements. Example 21-2 includes an example disclosure of a translation principle.

EXAMPLE 21-2

Example disclosure – translation principle

Assets and liabilities have been translated to the reporting currency using the exchange rates in effect on the consolidated balance sheet dates. Equity accounts are translated at historical rates, except for the change in retained earnings during the year which is the result of the income statement translation process. Revenue and expense accounts are translated using the weighted average exchange rate during the period. The cumulative translation adjustments associated with the net assets of foreign subsidiaries are recorded in accumulated other comprehensive loss in the accompanying consolidated statements of stockholders' equity.

21.5 Other disclosures

In addition to the required disclosures, we encourage reporting entities to consider disclosures in each of the following areas, as detailed in the remainder of this section.

- The effects of changes in foreign currency exchange rates
- The use of multiple foreign currency exchange rates
- Operations in highly inflationary economies
- The existence of foreign currency commitments and contingencies

- How functional currency is determined
- Foreign currency hedging policies

Disclosures in these areas will provide the users of the financial statements with increased transparency into how foreign currency has impacted or will impact the operations and financial position of the business.

21.5.1 Foreign currency commitments and contingencies

As outlined in FSP 23, reporting entities are required to disclose commitments and contingencies in the footnotes. When commitments and contingencies (such as leases, dividend restrictions, or the income tax effect of unremitted earnings) are denominated in a foreign currency, the reporting entity should ensure that these amounts are presented in the footnotes in the reporting currency.

ASC 830 does not specify the exchange rate to be used to present the amounts in such instances; however, common practice is to present the amounts using the exchange rate at the balance sheet date, with disclosure of the fact that current rates have been used, as suggested by ASC 830-20-30-3 and ASC 830-20-35-2.

In certain instances, alternative exchange rates or disclosures may be more appropriate, including the following.

- *A singular, significant unrecognized contingency exists for a number of years (e.g., a foreign tax assessment)*

  The amount may be disclosed in the foreign currency with parenthetical disclosure of the reporting currency amount specified at current rates. This approach avoids the possible confusion resulting from the effects of subsequent rate changes.

- *Disclosure of foreign retained earnings (e.g., subject to either taxation on repatriation or dividend restrictions)*

  The amount may appear inappropriate if translated at current rates when the retained earnings themselves are translated at historical rates in the primary financial statements. In such cases, judgment and expanded disclosure (e.g., use of a dual translation) should resolve any potential confusion.

21.5.2 Effects of foreign currency exchange rate changes during the period and subsequent to period-end

Reporting entities include the effects of all exchange rate changes occurring during the year either in income (for transaction gains and losses) or as a component of OCI (for translation gains and losses).

If significant exchange rate changes occur subsequent to the balance sheet date, reporting entities should consider additional disclosure.

If disclosure of a subsequent exchange rate change is merited, the reporting entity should consider including the effect on unsettled balances pertaining to foreign currency transactions. If it is not practical to determine the effects, the reporting entity should consider stating that fact in the footnotes.

We encourage additional disclosure regarding the broader economic circumstances surrounding rate changes to assist financial statement users in understanding the effects on the results of operations and to improve the comparability of current results with prior periods.

Additional disclosures may include:

- *The effects of translating revenue and expenses at the rates in effect at each reporting period*

  This disclosure assists users in understanding the true performance of a reporting entity.

- *The economic effects of rate changes*

  ASC 830-20-50-3 notes that these could include the effects on selling prices, sales volume, and cost structures.

- *Changes in exchange controls subsequent to year-end*

  Changes in exchange controls could significantly impact the ability of a reporting entity to transact in a foreign currency after the balance sheet date due to restrictions on purchases and sales of foreign currency within a specific country.

For further discussion of subsequent events, see FSP 28.

21.5.3 Multiple foreign currency exchange rates

In circumstances such as highly inflationary economies and pre-highly inflationary economies, different rates may be used to remeasure balances denominated in a foreign currency and to translate balances from a foreign entity's functional currency to the reporting currency. This may occur when there is an official rate set by a government for use in exchanging funds and an alternative parallel rate that may also be legally available.

ASC 830-30-S99 outlines the minimum expected disclosure requirements for SEC registrants when there are multiple foreign currency exchange rates available.

Excerpt from ASC 830-30-S99-1

- Disclosure of the rates used for remeasurement and translation.

- A description of why the actual US dollar denominated balances differ from the amounts reported for financial reporting purposes, including the reasons for using two different rates with respect to remeasurement and translation.

- Disclosure of the relevant line items (e.g., cash, accounts payable) on the financial statements for which the amounts reported for financial reporting purposes differ from the underlying US dollar denominated values.

- For each relevant line item, the difference between the amounts reported for financial reporting purposes versus the underlying US dollar denominated values.

- Disclosure of the amount that will be recognized through the income statement (as well as the impact on the other financial statements) as part of highly inflationary accounting.

In certain cases, multiple exchange rates may be used for remeasurement. If multiple exchange rates are used, reporting entities should consider providing an explanation of the criteria used to make the decision of which rate to use, the relative significance of the various exchange rates, and the risks and limitations associated with the chosen rates.

21.5.4 Other recommended disclosures in highly inflationary economies

We encourage robust disclosure regarding operations in highly inflationary economies. Reporting entities should consider disclosing the following related to subsidiaries in highly inflationary economies:

- □ A description of the business (including the types and amounts of materials imported, plant and equipment in country, and the impact of regulations such as price controls on the business)

- □ Summarized financial information (including balance sheet, statement of cash flows, and income statement)

- □ Net monetary assets and liabilities by currency

- □ The amount of any gain or loss that resulted from exchange rates that have changed

21.5.5 Determination of functional currency

ASC 830 does not require disclosure of the factors considered in determining functional currency. Nevertheless, in some instances, disclosure of the factors may be necessary to provide comparability and improved understanding of the results of operations.

21.5.6 *Foreign currency hedging policy*

Reporting entities should disclose their foreign currency hedging policy when it has a material impact on the financial statements and/or its disclosure will enhance the comparability and transparency of the financial statements.

21.6 *Considerations for private companies*

The requirements of ASC 830 apply equally to public and private companies. SEC requirements in ASC 830-30-S99 regarding disclosure in the case of multiple foreign currency exchange rates apply only to SEC registrants.

Chapter 22: Transferred financial assets, servicing assets, and servicing liabilities

22.1 Chapter overview

This chapter discusses the presentation and disclosure requirements for transfers of financial assets and provides example disclosures for various types of transfers.

The chapter's content is organized as follows: First, we address disclosure objectives and the aggregation of disclosures. Next, we discuss presentation and disclosure considerations applicable to various types of transfers. Finally, we highlight pending disclosure requirements for certain transfers prescribed in new accounting guidance issued in June 2014.

Disclosure examples included in this chapter address some of the more common types of financial asset transfers, including:

- An originator's sale of whole loans to a securitization trust that it does not consolidate, with the reporting entity retaining servicing and holding an economic interest in the trust

- A lender's periodic sales of participation interests in certain loans to third-party investors

- A reporting entity's periodic transfers of trade receivables to a multi-seller commercial paper conduit in exchange for cash and a subordinated interest in the conduit collateralized by the receivables sold

- Repurchase and securities lending transactions involving exchanges of securities for cash and reported as collateralized borrowing arrangements

The examples are illustrative only and are written in general terms. As such, they may not include all the disclosures required by authoritative accounting literature relevant to a particular transaction's facts and circumstances.

22.2 Scope

ASC 860, *Transfers and Servicing*, is the principal source of authoritative guidance for evaluating the financial reporting and disclosure implications of transfers of financial assets within its scope. Certain provisions in ASC 860 were amended in June 2014; see FSP 22.8 for a discussion of the updated disclosure requirements.

Also highlighted in the chapter are the presentation and disclosure requirements for SEC registrants in Rules 4-08(b) and 4-08(m) of Regulation S-X, which deal with collateralized financing activities (principally transactions involving repurchase or reverse repurchase agreements).

Further, S-X 9-03 includes guidance on banks' presentation of receivables and payables arising from resale and repurchase agreements accounted for as secured financings.

22.3 Disclosure objectives and aggregation of disclosures

The disclosure requirements under U.S. GAAP capture a broad array of transactions involving the transfer of a financial asset. As explained more fully in TS 2, a reporting entity first determines whether a transfer meets the criteria for sale accounting (derecognition) in ASC 860 or whether the transfer should be reported as a secured borrowing. This determination dictates the characterization of the transaction for financial statement purposes. The scope and content of the required disclosures depend, in part, on the accounting for the transfer (sale or secured borrowing) and the extent to which the transferor continues to be involved with the asset(s) subsequent to the transfer.

For the most part, the disclosure provisions in ASC 860 are detailed and prescriptive. However, reporting entities should keep in mind ASC 860's broader disclosure objectives when applying these requirements in practice. This is particularly true when a reporting entity is evaluating how to summarize and present information about numerous complex transactions involving transfers of financial assets in a manner most useful to readers.

22.3.1 Disclosure objectives

ASC 860-10-50-3 cites four broad objectives that frame the specific disclosure requirements set forth elsewhere in ASC 860. A reporting entity may need to supplement those required disclosures with additional information to achieve the broad disclosure objectives. In this regard, 860-10-50-4 emphasizes that a reporting entity should pay particular attention to disclosing the facts and circumstances of a transfer, the nature of its continuing involvement with transferred financial assets, and the effect that such involvement may have on the reporting entity's financial position, financial performance, and cash flows.

A reporting entity's "continuing involvement" with transferred assets can take many forms, consistent with the Master Glossary's broad definition.

Excerpt of definition from ASC Master Glossary

Continuing Involvement: Any involvement with the transferred financial assets that permits the transferor to receive cash flows or other benefits that arise from the transferred financial assets or that obligates the transferor to provide additional cash flows or other assets to any party related to the transfer.

Common forms of continuing involvement on the part of the transferor include:

- Contracts to service the assets subsequent to transfer
- Seller representations and warranties with respect to the assets sold

- Recourse or guarantee arrangements relative to the transferred assets, or similar undertakings

- Derivatives, such as interest rate swaps and call options, executed with the transferee contemporaneously with, or in contemplation of, the transfer

- Beneficial interests (e.g., debt securities and/or trust certificates) issued by a securitization vehicle that acquired the financial assets

TS 2.2 and ASC 860-10-05-4 provide additional examples of potential forms of continuing involvement by a transferor.

ASC 860's sale accounting model requires consideration of all forms of involvement that the reporting entity (including consolidated affiliates and agents) has or expects to have with transferred financial assets. The underlying sale accounting analysis (including related legal opinions, if any) may serve as a useful starting point for identifying elements of continuing involvement that may warrant disclosure.

22.3.2 Aggregation of disclosures

ASC 860-10-50-4A permits a reporting entity to aggregate disclosures for multiple transfers having similar characteristics if separate reporting of each transfer would not provide financial statement users with information that is more useful. However, at a minimum, aggregated disclosures generally should distinguish between transfers that are accounted for as sales and those that are accounted for as secured borrowings. Transfers that are accounted for as sales should also distinguish between (1) transfers to securitization entities and (2) all other transfers. Reporting entities should also disclose how similar transfers have been aggregated.

ASC 860-10-50-5 provides the following quantitative and qualitative considerations when determining how to aggregate:

- The nature of the transferor's continuing involvement

- The types of assets transferred

- Risks attributable to the transferred assets that the transferor continues to bear and how that risk profile changed because of the transfer

- Information regarding risks and uncertainties required to be disclosed in ASC 310-10-50-25 and concentrations involving loan product terms

We believe reporting entities that intend to provide aggregated information about multiple transfers of financial assets may also consider the following characteristics when evaluating the most meaningful basis on which to aggregate this information:

- The legal form of the financial assets transferred

- If receivables or loans have been transferred, whether collateralized and, if so, the type of collateral (e.g., first-lien residential mortgage loans, second-lien home equity loans or lines of credit, commercial real estate loans, and auto loans)

- The nature and extent of the transferor's continuing involvement with the transferred assets (e.g., subordinated or senior beneficial interests issued by securitization trusts, guarantees or similar credit support arrangements, or derivative instruments, such as interest rate or total return swaps)

- Similar valuation assumptions and techniques used to measure beneficial interests in the transferred assets

We understand that the SEC staff has required registrants to provide the disclosures called for in ASC 860-20-50 (discussed in FSP 22.4) by each type of asset sold in securitization transactions.

Striking a balance between disclosures that are too detailed or too aggregated can be highly facts-and-circumstances specific. However, ASC 860-10-50-6 reminds reporting entities that, regardless of their relative level of detail, the disclosures should "clearly and fully" explain the following:

- The transferor's risk exposure related to transferred financial assets

- Any restrictions on the assets of the reporting entity stemming from these transactions

22.3.3 Location of disclosures

In practice, we find that reporting entities sometimes incorporate ASC 860-related disclosures into footnotes that address broader topical matters or provide information required by other accounting pronouncements, including the following:

- Providing information about transfers of financial assets to securitization entities and describing the forms of involvement with those assets and beneficial interests retained in a footnote that discloses information about variable interest entities required by ASC 810, *Consolidation* (see FSP 18)

- Disclosing information about repurchase and resale agreements, and securities lending activities, in a footnote that addresses the reporting entity's collateralized financing activities more generally

- Providing information about the reporting entity's approach to valuing servicing assets and servicing liabilities in a footnote that discloses information about fair value measurements for all asset classes in accordance with ASC 820, *Fair Value Measurement* (see FSP 20)

22.3.4 *Considerations for consolidated financial statements*

When evaluating the necessary disclosures, a reporting entity should consider not only the transferor's involvement with transferred financial assets, but also involvements on the part of the transferor's consolidated affiliates included in the financial statements presented and the transferor's agents. For disclosure purposes, involvement by consolidated affiliates and agents is considered equivalent to involvement by the transferor itself, as noted in ASC 860-10-50-7.

22.3.5 *Accounting policy disclosures footnote*

Reporting entities should describe their principal accounting policies for transfers of financial assets if such transactions are common and/or material. These policy disclosures should be tailored to address specific types of transfers that the reporting entity has undertaken or that remain outstanding.

The following is an example summary of a reporting entity's accounting policies relating to transfers of financial assets generally. More prescriptive accounting policy disclosures required by ASC 860 or Regulation S-X with respect to such transfers are discussed later in this chapter.

EXAMPLE 22-1

Example disclosure — summary of significant accounting policies for transfers of financial assets

Note X: Summary of Significant Accounting Policies

<u>Transfers of Financial Assets</u>

The Company accounts for transfers of financial assets as sales when it has surrendered control over the related assets. Whether control has been relinquished requires, among other things, an evaluation of relevant legal considerations and an assessment of the nature and extent of the Company's continuing involvement with the assets transferred. Gains and losses stemming from transfers reported as sales are included in "[line item]" in the accompanying statements of income. Assets obtained and liabilities incurred in connection with transfers reported as sales are initially recognized in the balance sheet at fair value.

Transfers of financial assets that do not qualify for sale accounting are reported as collateralized borrowings. Accordingly, the related assets remain on the Company's balance sheet and continue to be reported and accounted for as if the transfer had not occurred. Cash proceeds from these transfers are reported as liabilities, with attributable interest expense recognized over the life of the related transactions.

22.4 Transfers reported as sales with transferors having continuing involvement

ASC 860-20-50-3 and 50-4 prescribe the disclosures for securitizations, asset-backed financing arrangements, and similar transfers that meet the following two conditions:

Excerpt from ASC 860-20-50-2

a. The transfer is accounted for as a sale

b. The transferor has continuing involvement with the transferred financial assets.

Certain disclosures for these types of transfers are required for each income statement presented, while others must be made for each balance sheet presented.

22.4.1 Disclosures for each income statement presented

For each period for which an income statement is presented, disclosure requirements for transfers reported as sales with transferors having continuing involvement include:

- *Characteristics of the transfer*

  This information should include (1) a description of the reporting entity's continuing involvement with the transferred assets, (2) the nature and initial fair value of proceeds obtained and liabilities incurred, and (3) the gain or loss on sale.

- *Information about initial fair value measurements of assets obtained and liabilities incurred in connection with the transfer*

  This should include their level within the fair value hierarchy, key inputs and assumptions used in measuring fair values, and valuation techniques used. The reporting entity should provide quantitative information about (1) assumed discount rates, (2) expected prepayments (including the expected weighted-average life of prepayable financial assets), and (3) anticipated credit losses, including expected static pool losses.

  The reporting entity may report the range of assumptions used if it has aggregated its transfer-related disclosures.

- *Cash flows between the transferor and transferee(s)*

  There should be separate disclosures of (1) proceeds from new transfers, (2) proceeds from collections reinvested in revolving-period transfers, (3) purchases of previously transferred financial assets, (4) servicing fees, and (5) cash flows received from interests (including beneficial interests) in the transferred assets held by the transferor.

See examples 22-2 and 22-4 for an illustration of these disclosure requirements.

22.4.2 Disclosures for each balance sheet presented

As of each balance sheet date, regardless of when the related transfer occurred, ASC 860-20-50-4 requires a transferor to disclose the following information about its ongoing involvement with the financial assets sold:

- *Qualitative and quantitative information about the transferor's continuing involvement with transferred financial assets*

  Information to be disclosed includes:

  - With respect to the transferred assets, (1) the total amount of principal outstanding at the balance sheet date, (2) the amount that has been derecognized, and (3) the amount that continues to be recorded in the balance sheet

  - Contractual arrangements that could require the reporting entity to provide financial support (e.g., liquidity arrangements and obligations to purchase assets) to the transferee or its beneficial interest holders

  - A description of circumstances that could expose the reporting entity to loss, and the amount of maximum exposure to loss, stemming from contractual support arrangements

  - The type, amount and reason for any support–financial or otherwise—provided by the reporting entity to the transferee (or its beneficial interest holders) that was not previously contractually required. Additionally, if the reporting entity assisted the transferee (or its beneficial interest holders) in obtaining support, that should be disclosed.

  A reporting entity is encouraged–but not required—to disclose any third-party liquidity arrangements, guarantees, and/or other commitments that may affect the fair value of the reporting entity's interest in the transferred assets.

  These disclosures should allow financial statement users to readily comprehend the reason(s) for the reporting entity's continuing involvement with the transferred financial assets and the risk profile of that involvement. The disclosures should also clarify whether and how the transfer altered the reporting entity's risk profile to those assets, including (but not limited to) credit and interest rate risk.

- *Information relating to subsequent measurements of assets or liabilities attributable to the reporting entity's continuing involvement with transferred financial assets*

Information to be disclosed includes:

- A discussion of relevant accounting policies

- Key assumptions (or range of assumptions, if the disclosures have been aggregated) used to measure the fair value of such assets or liabilities, including, but not limited to, (1) discount rates, (2) expected prepayments (including the expected weighted-average life of prepayable financial assets), and (3) anticipated credit losses, including expected static pool losses, if applicable

- *Sensitivity analysis*

  This disclosure should include the hypothetical impact on the fair value of a transferor's interests in the transferred assets (including servicing assets and servicing liabilities) stemming from two or more unfavorable variations from expected levels for each key assumption, keeping all other key assumption(s) unchanged. Further, the reporting entity should describe the objectives, methodology, and limitations of the sensitivity analysis or stress test.

  In practice, although there is no explicit requirement, certain reporting entities stress their key assumptions using variations of 10 percent and 20 percent. However, a reporting entity should use those thresholds that it considers most meaningful in the circumstances.

- *Asset quality of transferred financial assets and managed assets*

  This includes:

  - Information about the asset quality of transferred financial assets and any other assets the reporting entity manages together with them (separated between assets that have been derecognized and assets that continue to be recognized)

  - For receivables, delinquencies at the end of the period and credit losses, net of recoveries, during the period

  This asset quality information is intended to provide financial statement users with an understanding of the risks inherent in the transferred financial assets within the broader context of other financial assets and liabilities (and the associated risks) the reporting entity manages together with transferred assets.

The disclosures in ASC 860-20-50-4 are in addition to those that may be required under other U.S. GAAP. For example, a reporting entity that owns a beneficial interest in transferred financial assets in the form of an asset-backed security should also consider the disclosure requirements in ASC 320, *Investments–Debt and Equity Securities*, applicable to debt securities more generally. See FSP 9 for a discussion of those requirements.

Example 22-2 illustrates a disclosure for a securitization of receivables (in this case, loans secured by automobiles) reported as a sale with continuing involvement. For simplicity, this and the following examples omit any required comparative amounts.

EXAMPLE 22-2

Example disclosure — securitizations of auto loans reported as sales with beneficial interests obtained and servicing retained

This example illustrates the application of certain of the requirements in ASC 860-20-50-3 and 50-4.

Note X—Securitization of Automobile Loans

During 20x4, the Company sold pools of automobile loans in various securitization transactions. In these securitizations, the Company retained servicing responsibilities and received beneficial interests in the form of subordinated asset-backed securities. The Company owns only an insignificant portion of these subordinated securities and receives annual servicing fees approximating x% of the outstanding principal balance of the loans serviced. The Company and other investors in the subordinated beneficial interests have rights to cash flows after the investors holding each securitization trust's senior securities have first received their contractual returns. The investors and the securitization trusts have no recourse to the Company's assets; holders of the securities issued by each trust can look only to the loans owned by the trust for payment. The beneficial interests held by the Company are subject principally to the credit risk stemming from the underlying transferred auto loans.

The securitization trusts used to effect these transactions are variable interest entities that the Company does not consolidate. See Note Z, "Variable Interest Entities," for more information about these trusts.

The asset-backed securities received in connection with these transactions are initially measured in the Company's balance sheet at their fair value. Related servicing assets are also initially recognized at fair value. Gains or losses arising from these securitizations are measured as the difference between the transferred loans' carrying values and the sum of (a) the initial fair value of the beneficial interests received and any servicing asset and (b) cash proceeds. In 20X4, the Company recognized pretax gains of $xx.x million attributable to the foregoing securitization activity. These gains are included in "[line item]" reported in the accompanying statements of income.

Quoted market prices are rarely available for beneficial interests obtained in connection with these transactions. Accordingly, the Company generally estimates the initial fair value of its subordinated interests based on the present value of expected future cash flows. These cash flows are calculated using best estimates of market-based assumptions — anticipated credit losses, prepayment speeds and weighted average lives of the related loans, and discount rates commensurate with the risks inherent in the interests. These estimates are sometimes developed based on inputs observable in relevant markets, in which case the beneficial interests may fall within Level 2 of the fair value hierarchy. In other instances, because certain of the inputs used are not observable, the beneficial interests fall within Level 3 of the hierarchy.

Key economic assumptions used in measuring the beneficial interests obtained at the securitization date resulting from securitizations completed during 20X4 were as follows:

- Expected credit losses on underlying loans: x.x% to x.x% (annual rate)
- Expected annual prepayment rate of underlying loans: x.x% to x.x%
- Weighted average life of underlying loans: x.x to x.x (years)
- Rates used to discount residual cash flows: xx.x% to xx.x%

The Company remeasures the carrying value of its subordinated beneficial interests and servicing assets at each reporting date to reflect their current fair value, with corresponding gains and losses credited or charged to income. At December 31, 20X4, key economic assumptions and the sensitivity of the current fair value of the subordinated beneficial interests held by the Company to 10% and 20% adverse changes in those assumptions are as follows ($ in millions):

	20X4
Carrying amount/fair value of subordinated beneficial interests	$x,xxx
Weighted average life of underlying loans (years)	x.x-x.x
Assumed prepayments (annual rate)	x.x-x.x%
Impact of 10% adverse change	$(xx)
Impact of 20% adverse change	$(xxx)
Expected credit losses (annual rate)	x.x-x.x%
Impact of 10% adverse change	$(xx)
Impact of 20% adverse change	$(xxx)
Annual rate used to discount residual cash flows	xx.x-xx.x%
Impact of 10% adverse change	$(xx)
Impact of 20% adverse change	$(xxx)

These sensitivities are hypothetical and should be viewed in that context. As the figures indicate, the change in fair value based on a stated percentage variation in an assumption generally cannot be extrapolated because the relationship between the change in an assumption and the change in fair value may not be linear. Also, the effect of a variation in a particular assumption on the fair value of the beneficial interests is calculated independently of any other assumption. In reality, changes in one assumption may result in changes to other(s), leading to a combined effect that could magnify or counteract the indicated change in value. For example, increases in market interest rates generally slow prepayments and may lead to increased credit losses.

The following table summarizes certain cash flows received from and paid to securitization trusts during 20X4 ($ in millions):

Proceeds from securitizations	$x,xxx
Servicing fees received	xx
Principal and interest collections received on subordinated beneficial interests	xxx
Purchases of delinquent loans, and payments relating to seller representation and warranty recourse obligations	(xx)

The following table presents quantitative information about automobile loans managed by the Company (including those owned and securitized) and related delinquent loans ($ in millions) as of December 31,20X4:

	Principal amount of loans	Principal amount of loans 60 days or more past due	Net credit losses (charge offs) during 20X4
Total loans managed (owned and securitized)	$x,xxx	$xxx	$xx
Components of managed loans:			
Securitized loans	x,xxx	xx	xx
Loans held in portfolio or for sale	xxx	xx	x

22.5 *Sales of loans and trade receivables*

ASC 860-20-50-5 requires reporting entities to present separately in the income statement or disclose in the footnotes the aggregate amount of gains or losses on sales of loans or trade receivables (including adjustments to record loans held for sale at the lower of cost or fair value) for each period presented. In certain instances, the reporting entity may find it appropriate to integrate this information into the disclosures required for loans and trade receivables by ASC 310, *Receivables*. See FSP 8.3 for more information about those disclosure requirements.

Example 22-3 illustrates a reporting entity's disclosures about its periodic sales of participating interests in certain loans to institutional investors. Disclosures of loans in general are addressed in FSP 8.

Example 22-4 illustrates a reporting entity's disclosure about sales of trade receivables to a multi-seller commercial paper conduit under a revolving financing facility.

EXAMPLE 22-3

Example disclosure — sales of loans (transfers of participating interests)

This example illustrates the application of certain of the requirements of ASC 860-20-50-5.

Note X — Sales of Loan Participations

During 20X4, the Company sold participations in certain commercial and construction development loans in transactions negotiated with various institutional investors. In each case, the Company retains servicing responsibilities for the underlying loan as well as a participating interest in the loan. Interests sold and retained are pari passu, and entitle each holder (including the Company) to all cash flows received from the underlying loan proportionate to its interest, net of the servicing fee. The Company receives annual servicing fees approximating x% (for commercial loans) and x% (for construction development loans) of the outstanding loan balance owned by others.

The investors have no recourse to the Company for failure of the underlying debtors to pay amounts contractually due. Since all participating interests are pari passu, the Company's retained interests are subject to the same credit, prepayment, and interest rate risks as the transferred interests, and mirror the risks of each loan as a whole. These interests are included in the Company's loan portfolio and are accounted for at amortized cost, net of an allowance for loan losses.

In 20X4, the Company recognized pretax gains of $xx.x million on sales of participations in commercial loans and $x.x million on similar sales involving construction development loans.

EXAMPLE 22-4

Example disclosure — sales of trade receivables (under a revolving financing facility with a multi-seller commercial paper conduit)

This example illustrates the application of certain of the requirements in ASC 860-20-50 -3 through 50-5.

Note X — Sales of Trade Receivables

In 20X4, the Company entered into a revolving accounts receivable financing arrangement with a multi-seller commercial paper conduit managed by a major domestic bank. The facility, whose maximum capacity is $xxx million, is scheduled to expire in October 20X5 unless renewed by the mutual consent of the parties.

Under the arrangement, the Company may sell eligible short-term trade receivables to the conduit on a monthly basis in exchange for cash and a subordinated interest. The transfers are reported as sales in the accompanying financial statements. The subordinated interest, a receivable from the conduit, is referred to as the “deferred purchase price (DPP).” Generally, at the transfer date, the Company receives cash equal to approximately 90% of the value of the sold receivables. The Company continues to service the receivables sold in exchange for a fee.

The DPP is carried at fair value, which is remeasured monthly to take into account activity during the period (the Company’s interest in newly-transferred receivables and collections on previously transferred receivables attributable to the DPP), as well as changes in estimates of future interest rates and anticipated credit losses. Changes in the DPP’s value attributable to fluctuations in interest rates and revised estimates of anticipated credit losses have been and are expected to be immaterial, as the underlying receivables are short-term and of high credit quality. The valuation estimate of the DPP falls within Level 3 of the fair value hierarchy.

During 20X4, the Company sold receivables having an aggregate face value of $xx million to the conduit in exchange for cash proceeds of $xx million, of which $xx million was funded by re-invested collections. Losses incurred on these sales during the year amounted to $x.x million, and are included in “[line item]” in the accompanying statements of income. Related servicing fees for the period were immaterial.

At December 31, 20X4, the outstanding principal amount of receivables sold under this facility amounted to $xx million. The carrying amount of the related DPP receivable in the accompanying balance sheet was $x.x million and is classified within “[line item].”

22.6 Collateral and transfers reported as secured borrowings

A borrower may grant a security interest in financial assets to a lender (the secured party) that serves as collateral for the borrower's obligation(s). Under these arrangements, the debtor frequently is required to transfer the collateral to the lender or to a custodian. This section assumes that this transfer of collateral would not result in derecognition of the collateral under ASC 860. ASC 860 and Regulation S-X prescribe certain presentation and disclosure requirements for reporting entities involved in these transactions.

22.6.1 Balance sheet presentation — general considerations

If a secured party (transferee of collateral) has the right by contract or custom to sell or repledge collateral received, ASC 860-30-45-1 requires the transferor of the collateral to report the asset on its balance sheet separately from other assets not encumbered or pledged (e.g., as "securities pledged to creditors"). However, ASC 860-30-45-3 clarifies that a transferor has discretion regarding the classification and terminology used to comply with this requirement.

Similarly, ASC 860-30-45-2 directs that liabilities incurred by the secured party (obligor) arising from securities lending transactions or repurchase agreements (also referred to as "repos") be separately classified on its balance sheet. However, once again, ASC 860 does not prescribe how a reporting entity should characterize these liabilities. In practice, we have seen the following descriptions used:

- "Securities loaned or sold under repurchase agreements" or "Securities loaned or sold under agreements to repurchase"
- "Repurchase agreements"
- "Securities sold under agreements to repurchase" or "Securities sold under repurchase agreements"

Similarly, we have seen reporting entities use the following terms to describe receivables relating to resale agreements (also referred to as "reverse repurchase agreements" or "reverse repos") and securities borrowing transactions:

- "Securities borrowed or purchased under resale agreements" or "Securities borrowed or purchased under agreements to resell"
- "Resale agreements" or "Securities borrowed"
- "Securities purchased under agreements to resell" or "Securities purchased under resale agreements"

Reporting entities that prepare their financial statements in accordance with Regulation S-X should also consider these presentation requirements:

- Under S-X 4-08(m), if the aggregate carrying amount (or market value, if higher) of securities or other assets sold under repurchase agreements exceeds 10% of total assets, a registrant is required to present the aggregate related liability separately on the balance sheet. Similarly, if the aggregate carrying amount of reverse repurchase agreements exceeds 10% of total assets, a registrant is required to present the aggregate related receivable separately on the balance sheet.

- Banks subject to the reporting requirements in S-X 9-03 frequently combine amounts owed by them (due to them) under repurchase agreements or securities lending agreements with the liability (receivable) arising from borrowing (selling) Federal funds, and report the aggregate liability (receivable) amount as a single line item on the balance sheet. S-X 9-03 prohibits any net presentation of these obligations and receivables.

22.6.2 Balance sheet presentation — offsetting considerations

A reporting entity may offset (present net) receivables and payables if a right of setoff exists, as defined in ASC 210-20-45-1. Contractual terms and settlement conventions prevalent in the securities lending markets usually preclude these transactions from meeting the four conditions cited in that paragraph. Thus, receivables and payables stemming from securities lending and borrowing activities are often reported gross on the balance sheet.

Notwithstanding the criterion in ASC 210-20-45-1(c), payables and receivables arising from repurchase and reverse repurchase agreements may also qualify for balance sheet offset if the contractual terms and related settlement arrangements meet the six criteria cited in ASC 210-20-45-11. These conditions are specific to repos/reverse repos, and are not applicable by analogy to other transactions. Further, the reporting entity's choice to offset (or not) is to be applied consistently.

Excerpt from ASC 210-20-45-11

…[A]n entity may, but is not required to, offset amounts recognized as payables under repurchase agreements accounted for as collateralized borrowings and amounts recognized as receivables under reverse repurchase agreements accounted for as collateralized borrowings if all of the following conditions are met:

a. The repurchase and reverse repurchase agreements are executed with the same counterparty.

b. The repurchase and reverse repurchase agreements have the same explicit settlement date specified at the inception of the agreement.

c. The repurchase and reverse repurchase agreements are executed in accordance with a master netting agreement.

d. The securities underlying the repurchase and reverse repurchase agreement exist in book entry form and can be transferred only by means of entries in the records of the transfer system operator or securities custodian…

e. The repurchase and reverse repurchase agreements will be settled on a securities transfer system…, and the entity must have associated banking arrangements in place…

f. The entity intends to use the same account at the clearing bank or other financial institution at the settlement date in transacting both the cash inflows resulting from the settlement of the reverse repurchase agreement and the cash outflows in settlement of the offsetting repurchase agreement.

A reporting entity may not offset payables and receivables arising from repurchase and reverse repurchase agreements based solely on the existence of a master netting arrangement with the counterparty.

22.6.3 Disclosure considerations relating to offsetting and master netting arrangements

A reporting entity that offsets amounts attributable to (1) repurchase and reverse repurchase agreements and/or (2) securities borrowing and lending transactions is subject to the disclosure requirements in ASC 210-20-50. The disclosures in ASC 210-20-50 also extend to reverse repurchase and repurchase agreements, and to securities borrowing and lending transactions, subject to enforceable master netting arrangements regardless of whether the related receivables and payables are offset in the reporting entity's balance sheet.

See FSP 19.5.6 for information about ASC 210-20-50's disclosure requirements.

22.6.4 Disclosures specific to repurchase and reverse repurchase agreements

If the aggregate carrying amount (or market value, if higher) of securities or other assets sold under repurchase agreements exceeds 10 percent of total assets, S-X 4-08(m) requires a registrant to disclose in the footnotes:

- The carrying value and market value of the assets sold (exclusive of trading assets or assets obtained under reverse repurchase agreements), segregated by security type and grouped by ranges of the agreements' maturity dates, along with the associated liability and related interest rate(s), presented in a tabular format

- If the amount at risk under these agreements (as defined in the rule) with any single counterparty (or group of related counterparties) exceeds 10 percent of stockholders' equity, the counterparty's (or group's) name, the amount at risk with each, and the weighted average maturity of the underlying agreements

If the aggregate carrying amount of reverse repurchase agreements exceeds 10 percent of total assets, a registrant is required to provide the following disclosures:

- The registrant's policy with regard to taking possession of the securities or assets under the agreements
- Provisions to ensure that the market value of the underlying assets remains sufficient to protect the registrant in the event of counterparty default and disclosures about the nature of those provisions
- If the amount at risk under these agreements (as defined in the rule) with any single counterparty (or group of related counterparties) exceeds 10 percent of stockholders' equity (or net asset value, if an investment company), the counterparty's (or group's) name(s), the amount at risk, and the weighted average maturity of the underlying agreements

22.6.5 Collateral-related disclosures

ASC 860-30-50-1A requires the following disclosures about collateral:

- The reporting entity's policy for requiring collateral or other security in repurchase agreements and securities lending transactions
- As of the latest balance sheet date presented, the carrying amount and classification of assets pledged as collateral that are not reclassified and separately reported in the balance sheet, and associated liabilities
- As of the latest balance sheet date presented, qualitative information about the relationship between the pledged assets and associated liabilities (e.g., restrictions on the use of the collateral pledged to secure certain obligations)
- With respect to collateral the reporting entity is permitted to sell or repledge:
    - The fair value of the collateral and the fair value of any portion sold or repledged for each balance sheet presented
    - Information about the sources and uses of the collateral

S-X 4-08(b) also requires registrants to provide information about assets mortgaged, pledged, or otherwise subject to lien, and identify the obligations collateralized for the most recent balance sheet filed. This information may appear on the face of the balance sheet or in the footnotes.

Example 22-5 illustrates a reporting entity's discussion of its accounting and reporting policies relating to repurchase (resale) agreements and securities lending (borrowing) transactions, accompanied by a discussion of its policies regarding related collateral.

EXAMPLE 22-5

Example disclosure — summary of significant accounting policies: repurchase and securities lending transactions and related collateral arrangements

This example illustrates the application of certain of the requirements in ASC 860-30-50-1A.

Note X: Summary of Significant Accounting Policies

<u>Securities Financing Arrangements</u>

Securities purchased under agreements to resell and securities sold under agreements to repurchase are reported as financing transactions, and thus the related receivables and payables are presented in the accompanying balance sheets at the amounts at which the securities subsequently will be resold or reacquired as specified in the respective agreements. Such amounts include accrued interest. Receivables and payables arising from these agreements are offset in the balance sheet where permitted under applicable accounting standards. It is the Company's policy to take possession of securities purchased under agreements to resell. On a daily basis, the Company monitors the fair value of the underlying securities as compared to the related receivable, including accrued interest, and requests additional collateral as necessary. The Company's agreements with third parties specify their rights to request additional collateral. All collateral is held by the Company or a custodian.

Securities borrowed and securities loaned transactions also are reported as financing transactions, and thus the related receivable and payables are carried at the amounts of cash advanced and received, respectively, plus accrued interest. The Company measures the fair value of the securities borrowed and loaned against the cash collateral on a daily basis. Additional cash collateral is obtained as necessary to ensure such transactions are adequately collateralized. The Company's agreements with third parties specify their rights to request additional collateral. All collateral is held by the Company or a custodian. It is the Company's policy to accept only cash collateral in connection with these transactions.

For certain resale agreements and securities-borrowed transactions, securities received qualify for recognition on the balance sheet, in which case they are recorded at fair value, along with a corresponding obligation to return them. Cash collateral received in connection with repurchase agreements and securities-lending arrangements is recorded on the Company's balance sheet, along with the related obligation to reacquire the securities. Securities sold under repurchase agreements and securities loaned that the transferee-borrower may sell or repledge are reclassified and reported separately on the accompanying balance sheet.

22.7 Servicing assets and servicing liabilities

Inherent in all financial assets, servicing comprises activities such as collecting principal and interest, maintaining escrow accounts, pursuing workouts and restructurings of delinquent loans, and initiating foreclosures. A reporting entity may recognize a servicing asset or a servicing liability arising from a contractual undertaking to service a financial asset or group of financial assets. TS 5.2 discusses under what circumstances a servicing asset or liability should be recognized.

22.7.1 Balance sheet presentation

Servicing assets and liabilities are initially measured at fair value, consistent with the guidance in ASC 860-50-30.

Servicing assets are to be reported separately from servicing liabilities on the reporting entity's balance sheet. Offsetting is not permitted. Further, ASC 860-50-45-1 requires that a reporting entity's balance sheet distinguish between servicing assets/liabilities subsequently measured at fair value and those measured using the amortization method.

ASC 860-50-45-2 provides two options for how a reporting entity may meet the separate reporting requirement:

- Presenting separate line items for the amounts subsequently measured at fair value versus those subsequently measured under the amortization method

- Combining all amounts in one line, with parenthetical disclosure of the amount measured at fair value

22.7.2 Disclosures applicable to all servicing assets and liabilities

Recognized servicing assets and/or liabilities are subject to the applicable disclosure requirements in ASC 860-50-50. The scope and content of the disclosures depends, in part, on whether the servicer measures the assets and liabilities at amortized cost or fair value, which is an accounting policy election. TS 5.2 discusses the principal accounting and measurement considerations relative to these assets and liabilities.

A reporting entity should first consider the disclosure requirements in ASC 860-50-50-2, which are generally applicable to servicing assets and liabilities, and then apply the specific disclosure requirements predicated on how these assets and liabilities are subsequently measured.

ASC 860-50-50-2

For all servicing assets and servicing liabilities, all the following shall be disclosed:

a. Management's basis for determining its classes of servicing assets and servicing liabilities.

b. A description of the risks inherent in servicing assets and servicing liabilities and, if applicable, the instruments used to mitigate the income statement effect of changes in the fair value of the servicing assets and servicing liabilities.

c. The amount of contractually specified servicing fees, late fees, and ancillary fees earned for each period for which results of operations are presented, including a description of where each amount is reported in the statement of income.

d. Quantitative and qualitative information about the assumptions used to estimate fair value (for example, discount rates, anticipated credit losses, and prepayment speeds).

See TS 5.2.5 for matters a reporting entity should consider when identifying classes of servicing assets and liabilities. The remaining disclosure requirements in ASC 860-50-50 are class-specific, so the reporting entity's determination of the appropriate classes of servicing assets and liabilities has both accounting and disclosure implications.

ASC 860-50-50-2 also encourages, but does not require, a reporting entity to disclose quantitative information about instruments used to manage the risks inherent in servicing assets and liabilities. This information may include the fair value of the instruments at the beginning and end of the period and the assumptions used to estimate the fair value. As part of this discussion, reporting entities may find it useful to explain why certain instruments were chosen to execute related risk management strategies, and how they are used in the context of those strategies.

See Example 22-6 for an illustration of certain of these required disclosures.

22.7.3 Disclosures of servicing assets and liabilities subsequently measured at fair value

Servicing assets and liabilities that are subsequently measured at fair value are subject to the fair value disclosure requirements in ASC 820, which are addressed in FSP 20. In addition, for each income statement period presented, with respect to servicing assets and liabilities subsequently measured at fair value, the reporting entity should disclose the activity in the balance of each class of servicing assets and liabilities in accordance with ASC 860-50-50-3, including, but not limited to:

- Beginning and ending balances
- Additions (purchases of servicing assets, assumptions of servicing liabilities, and recognition of servicing obligations that result from transfers of financial assets)
- Disposals
- Changes in fair value during the period attributable to (1) changes in valuation inputs or assumptions or (2) other changes in fair value and a description of those changes
- Other changes that affect the balance and a description of those changes

The disclosure should include a description of where changes in fair value are reported in the income statement. See Example 22-6 for an illustration of certain of these required disclosures.

22.7.4 Disclosures of servicing assets and liabilities subsequently measured under the amortization method

ASC 860-50-50-4 requires the following disclosures for servicing assets and liabilities subsequently measured under the amortization method, for each period for which an income statement is presented:

- The activity in the balance of each class of servicing assets and liabilities including but not limited to:
  - Beginning and ending balances
  - Additions (purchases of servicing assets, assumptions of servicing liabilities, and recognition of servicing obligations resulting from transfers of financial assets)
  - Disposals
  - Amortization
  - Valuation allowance to adjust the carrying value of servicing assets
  - Other-than-temporary impairments
  - Other changes that affect the balance and a description of those changes

    This disclosure should include a description of where changes in the carrying amount are reported in the income statement for each period.
- The fair value for each class of recognized servicing assets and liabilities at the beginning and end of the period

- The risk characteristics used to stratify servicing assets for purposes of measuring impairment. If the predominant risk characteristics and corresponding strata are changed, the reporting entity should disclose that fact and the reasons for those changes.

- For each period for which an income statement is presented, the activity by class in any valuation allowance of servicing assets, including:

  - Beginning and ending balances

  - Aggregate additions charged and recoveries credited to operations

  - Aggregate write-downs charged against the allowance

Example 22-6 illustrates a reporting entity's discussion of its accounting and reporting policies relating to servicing assets and liabilities, and the disclosures about the changes in the balances of those assets and liabilities during the reporting period.

Although presented here as a single footnote, a reporting entity may prefer instead to include certain of the information in its summary of significant accounting policies.

EXAMPLE 22-6

Example disclosure — servicing assets and servicing liabilities

This example illustrates the application of certain of the requirements in ASC 860-50-50 -2 through 50-4.

Note X: Servicing Assets and Servicing Liabilities

In accordance with applicable accounting standards, the Company records a separate servicing asset or servicing liability representing the right or obligation to service third-party mortgage loans or mortgage loans that it has securitized in transactions accounted for as a sale. If servicing is retained in connection with these securitizations, the resulting servicing asset or liability is initially recorded at its fair value as a component of the transaction's sale proceeds. Initial measurement is based on an analysis of discounted cash flows based on assumptions that market participants use to estimate fair value including, but not limited to, estimates of prepayment rates, default rates, discount rates, contractual servicing fee income, escrow account earnings, and ancillary income and late fees.

Servicing assets and servicing liabilities are subsequently measured at either fair value or amortized in proportion to, and over the period of, estimated net servicing income. The Company elects one of those methods on a class basis. A class is determined based on (1) the availability of market inputs used in determining the fair value of servicing assets and servicing liabilities, and/or (2) our method for managing the risks of servicing assets and servicing liabilities. Based on consideration of these factors, the Company currently applies the fair value method when accounting for servicing rights related to residential real estate loans. The amortization method is followed with respect to servicing rights for commercial mortgage loans.

Servicing assets and servicing liabilities relating to commercial mortgage loans are amortized in proportion to, and over the period of, estimated net servicing income. The impairment of those servicing assets or increases in fair values of servicing liabilities (above carrying values) are evaluated through an assessment of the fair value of those assets and liabilities via a disaggregated, discounted cashflow method under which the assets and liabilities are disaggregated into various strata, based on predominant risk characteristics. The net carrying value of each stratum is compared to its estimated fair value to determine whether adjustments should be made to carrying values or amortization schedules. Impairment of a servicing asset is recognized through a valuation allowance and a charge to current period earnings if it is considered to be temporary or through a direct write-down of the asset and a charge to current period earnings if it is considered other-than-temporary. An increase in the fair value of a servicing liability above its carrying value is recognized through an increase in the liability and a charge to current period earnings. The predominant risk characteristics of the underlying commercial mortgage loans that are used to stratify the servicing assets and liabilities for impairment purposes generally include the (1) loan origination date, (2) loan rate, (3) loan type and size, (4) loan maturity date, and (5) geographic location.

The rate of prepayment of loans serviced (both commercial and residential) is the most significant estimate involved in the measurement process. Estimates of prepayment rates consider prepayment history, projections observed or inferred in the marketplace, industry trends, and other considerations. Actual prepayment rates frequently differ from those projected by management due to changes in a variety of economic factors, including prevailing interest rates and the availability of alternative financing sources to borrowers. If actual prepayments of the loans being serviced were to occur more quickly than projected, the Company may be required to write down the carrying value of servicing through a charge to earnings (or in the case of a servicing liability, reduce the carrying value through a credit to earnings in certain circumstances) in the current period. Conversely, if actual prepayments of the loans being serviced were to occur more slowly than had been projected, the carrying value of servicing assets could increase, and servicing income would exceed previously projected amounts; in the case of a servicing liability, a charge to earnings may be required in these circumstances. Accordingly, the servicing assets actually realized, or the servicing liabilities actually incurred, could differ from the amounts initially recorded.

Changes in the balances of servicing assets and servicing liabilities for residential mortgage loans measured using the fair value method for the year ended December 31, 20X4 were:

	Residential mortgage loans	
	Servicing assets	Servicing liabilities
Fair value as of January 1, 20X4	$xx,xxx	$xxx
Additions:		
Purchases of servicing assets	x,xxx	N/A
Assumption of servicing obligations	x,xxx	xx
Servicing obligations that result from transfers of financial assets	xx,xxx	xx
Subtractions — disposals:	(xx)	(x)
Changes in fair value:		
Due to change in valuation inputs or assumptions used in valuation model	xx/(xx)	xx/(xx)
Other changes in value	xx/(xx)	xx/(xx)
Fair value as of December 31, 20X4	$xxx,xxx	$xx

Changes in the balances of servicing assets and servicing liabilities for commercial mortgage loans subsequently measured using the amortization method for the year ended December 31, 20X4 are as follows:

	Commercial mortgage loans	
	Servicing assets	Servicing liabilities
Carrying amount as of January 1, 20X4	$xx,xxx	$xxx
Additions:		
Purchases of servicing assets	xxx	N/A

	Commercial mortgage loans	
	Servicing assets	Servicing liabilities
Assumption of servicing obligations	xx	x
Servicing obligations that result from transfers of financial assets	x,xxx	x
Subtractions:		
Disposals	(xx)	(x)
Amortization	(x,xxx)	(xx)
Other-than-temporary impairments	(xx)	N/A
Recognition of additional servicing liability stemming from increase in fair value	N/A	x
Carrying amount before valuation allowance	xx,xxx	xxx
Valuation allowance for servicing assets:		
Beginning balance	xxx	N/A
Provision charged to operations	xx	N/A
Other-than-temporary impairments	(xx)	N/A
Sales and disposals	(xx)	N/A
Ending balance	xxx	N/A
Carrying amount as of December 31, 20X4	$xx,xxx	$xxx

	Commercial mortgage loans	
	Servicing assets	Servicing liabilities
Fair value as of January 1, 20X4	$xx,xxx	$xxx
Fair value as of December 31, 20X4	$xx,xxx	$xxx

22.7.5 *Disclosures related to electing fair value measurement of servicing assets and liabilities in a subsequent year*

ASC 860-50-35-3(d) allows a reporting entity, at the beginning of its fiscal year, to subsequently measure at fair value a class of servicing assets or liabilities previously accounted for under the amortization method. ASC 860-50-50-5 requires separate disclosure of the amount of the cumulative-effect adjustment to retained earnings resulting from the election, which is irrevocable.

22.8 *Pending disclosure requirements: ASU 2014-11*

In June 2014, the FASB issued Accounting Standards Update No. 2014-11, *Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures* ("ASU 2014-11" or "new standard"). In addition to amending the accounting standards in ASC 860 applicable to certain transactions, ASU 2014-11 requires a transferor to disclose more information about various transactions involving the transfer of financial assets.

22.8.1 *New disclosures for repurchase agreements, repurchase-to-maturity transactions, and securities lending transactions*

For repurchase agreements, repurchase-to-maturity transactions[1] and securities lending agreements that in each case are reported as secured borrowings as of a reporting date, newly-added ASC 860-30-50-7 directs obligors (i.e., reporting entities that have transferred financial assets (collateral)) to provide the following information for each interim and annual period:

Excerpt from ASC 860-30-50-7

a. A disaggregation of the gross obligation by the class of collateral pledged. An entity shall determine the appropriate level of disaggregation and classes to be

[1] Under ASU 2014-11, a repurchase-to-maturity transaction is required to be accounted for as a secured borrowing.

presented on the basis of the nature, characteristics, and risks of the collateral pledged.

1. Total borrowings under those agreements shall be reconciled to the amount of the gross liability for repurchase agreements and securities lending transactions disclosed in accordance with paragraph 210-20-50-3(a) before any adjustments for offsetting. Any difference between the amount of the gross obligation disclosed under this paragraph and the amount disclosed in accordance with paragraph 210-20-50-3(a) shall be presented as reconciling item(s).

b. The remaining contractual maturity of the repurchase agreements, securities lending transactions, and repurchase-to-maturity transactions. An entity shall use judgment to determine an appropriate range of maturity intervals that would convey an understanding of the overall maturity profile of the entity's financing agreements.

c. A discussion of the potential risks associated with the agreements and related collateral pledged, including obligations arising from a decline in the fair value of the collateral pledged and how those risks are managed.

ASC 860-30-55-4 illustrates one approach for meeting ASC 860-30-50-7's quantitative disclosure requirements.

22.8.2 New disclosures for certain transfers of financial assets reported as sales

ASU 2014-11 also requires reporting entities to provide more information about transactions that (1) involve a transfer of a financial asset reported as a sale and (2) are accompanied by an agreement (entered into with the transferee in contemplation of the transfer) that results in the reporting entity retaining substantially all of the exposure to the economic returns of the transferred asset during the transaction's term. Examples of these transactions include:

- Cash-settled repurchase agreements having a fixed or determinable redemption price that settle prior to the maturity date of the transferred financial asset

- Transfers of financial assets accompanied by an agreement under which the reporting entity retains substantially all of the transferred asset's economic returns (e.g., in the form of a total return swap)

Under newly added ASC 860-20-50-4D, a reporting entity is required to disclose the following about these transactions at each reporting date:

Excerpt from 860-20-50-4D

a. The carrying amount of assets derecognized as of the date of derecognition:

   1. If the amounts that have been derecognized have changed significantly from the amounts that have been derecognized in prior periods or are not representative of the activity throughout the period, a discussion of the reasons for the change shall be disclosed.

b. The amount of gross cash proceeds received by the transferor for the assets derecognized as of the date of derecognition.

c. Information about the transferor's ongoing exposure to the economic return on the transferred financial assets:

   1. As of the reporting date, the fair value of assets derecognized by the transferor.

   2. Amounts reported in the statement of financial position arising from the transaction (for example, the carrying value or fair value of forward repurchase agreements or swap contracts). To the extent that those amounts are captured in the derivative disclosures presented in accordance with paragraph 815-10-50-4B, an entity shall provide a cross-reference to the appropriate line item in that disclosure.

   3. A description of the arrangements that result in the transferor retaining substantially all of the exposure to the economic return on the transferred financial assets and the risks related to those arrangements.

Transfers of financial assets meeting the two conditions cited in ASC 860-20-50-2 (and thus subject to the detailed disclosure requirements in ASC 860-20-50-3 and 50-4, as described in FSP 22.4) are scoped out of ASC 860-20-50-4D's disclosure requirements. Similarly, the disclosure provisions in that paragraph do not extend to repurchase agreements accounted for as sales because the financial assets to be acquired fail to meet the conditions in ASC 860-10-40-24(a) to be considered "substantially the same."

22.8.3 Effective dates

Public reporting entities are required to comply with the disclosure requirements in ASC 860-20-50-4D for interim and annual reporting periods beginning after December 15, 2014. The enhanced disclosures required by ASC 860-30-50-7 are effective for annual periods beginning after December 15, 2014 and interim periods beginning after March 15, 2015.

For all other reporting entities, the disclosure provisions in ASU 2014-11 are effective for annual periods beginning after December 15, 2014 and for interim periods beginning after December 15, 2015.

In all cases, the new disclosures are not required for comparative periods prior to the applicable effective date.

22.9 Considerations for private companies

The presentation and disclosure considerations required in ASC 860 pertain to both public and private entities.

The presentation and disclosure requirements in S-X 4-08(b), S-X 4-08(m), and S-X 9-03 apply only to financial statements filed with the SEC.

Chapter 23: Commitments, contingencies, and guarantees

23.1 Chapter overview

This chapter discusses the presentation and disclosure considerations related to commitments, contingencies, and guarantees. Certain topics that may reasonably fall under the umbrella of commitments, contingencies, and guarantees are discussed in other chapters due to their close relationship to the topics in those chapters. FSP 23.8 provides cross references to other chapters where additional information related to these topics can be found. In addition, certain commitments are unique to certain industries and are discussed in the accounting guidance specific to that industry. Because this guide is intended for a broad array of reporting entities, industry-specific guidance is not covered herein.

23.2 Scope

ASC 440, *Commitments*, provides general guidance for commitments. The guidance within ASC 440 is broken down into two categories of commitments: general commitments and unconditional purchase obligations. Both categories are covered in this chapter.

ASC 450, *Contingencies*, contains guidance on the recognition, measurement, presentation and disclosure requirements related to loss contingencies. Disclosures of gain and loss contingencies continue to be an area of focus for the SEC, investors, and auditors.

ASC 460, *Guarantees,* provides guidance on a guarantor's recognition, measurement, and disclosures for certain guarantees, including financial guarantees, performance guarantees, indemnifications, indirect guarantees of indebtedness of others, and product warranties. The required disclosures include information on the nature of the guarantees, potential maximum payments under the guarantees, as well as possible recoveries.

23.3 Commitments

Although ASC 440 is the prevailing guidance related to commitments, it does not address presentation matters. For SEC registrants, S-X 5-02 (25) requires commercial and industrial companies to include the caption "Commitments and contingent liabilities" on the balance sheet. The SEC staff requires this caption to appear on the balance sheet whenever a footnote bears such a title or one that is similar. If no such footnote exists or the only disclosed commitments are, for example, immaterial lease commitments, then the caption need not appear on the balance sheet.

23.3.1 General commitments

ASC 440 requires the following items to be disclosed in the financial statements:

- Unused letters of credit (See FSP 12)
- Long-term leases (See FSP 14)

- Assets pledged as security for loans (See FSP 12)
- Pension plans (See FSP 13)
- The existence of cumulative preferred stock dividends in arrears (See FSP 5)

Additionally, commitments, including those related to a commitment to acquire a plant, an obligation to reduce debts, an obligation to maintain working capital, or an obligation to restrict dividends, should also be disclosed.

23.3.2 Unconditional purchase obligations

Unconditional purchase obligations, such as take-or-pay contracts and through-put contracts, are types of commitments for which specific disclosures are required. An unconditional purchase obligation that has **all** of the following characteristics is required to be disclosed:

Excerpt from ASC 440-10-50-2

a. It is noncancelable, or cancelable only in any of the following circumstances:

   1. Upon the occurrence of some remote contingency
   2. With the permission of the other party
   3. If a replacement agreement is signed between the same parties
   4. Upon payment of a penalty in an amount such that continuation of the agreement appears reasonably assured.

b. It was negotiated as part of arranging financing for the facilities that will provide the contracted goods or services or for costs related to those goods or services (for example, carrying costs for contracted goods). A purchaser is not required to investigate whether a supplier used an unconditional purchase obligation to help secure financing, if the purchaser would otherwise be unaware of that fact.

c. It has a remaining term in excess of one year

Future minimum lease payments that might otherwise constitute an unconditional purchase obligation using the criteria above are not required to be disclosed under this guidance as long as the required disclosures associated with ASC 840, *Leases*, are met.

The nature and extent of the required disclosures related to unconditional purchase obligations will vary depending on whether these commitments are unrecognized or recognized.

23.3.2.1 *Unrecognized commitments*

The following disclosures are required for material unrecognized commitments, unless the aggregate commitment for all unrecognized commitments is immaterial:

- The nature and term of the commitment
- The aggregate amount of the purchase obligation that is fixed and determinable as of the balance sheet date and for each of the five succeeding years (if determinable)
- The nature of any variable components of the commitment
- The amounts purchased under the purchase obligation for each period that an income statement is presented

ASC 440 encourages, but does not require, reporting entities to disclose the amount of imputed interest necessary to reduce the unconditional purchase obligations to present value. The discount rate should be the initial effective interest rate of the borrowings that financed the facility that will provide the goods or services, if known. If the discount rate is not known, the reporting entity should use its incremental borrowing rate at the time the commitment originated.

Question 23-1

Are capital leases not yet recorded by the lessee (because the lease term has not yet commenced) subject to the disclosure requirement of ASC 440?

PwC response:

Yes. Although the lease is not subject to the specific disclosure requirements of ASC 840, disclosure would be appropriate similar to a commitment for the purchase or construction of properties to be owned. Similar disclosure would be appropriate for operating leases between inception and the beginning of the lease term.

Assume a lease is signed on November 1; however, the term of the lease and usage of the leased property begin the following February 1 and the lessor will retain possession and control of the property through January 31. The classification of the lease, as either capital or operating, should be determined as of November 1, the date of the inception of the lease. The lease should be recorded at the beginning of the lease term, February 1; however, the lease represents a commitment that, if material, should be disclosed at any intervening financial statement dates.

23.3.2.2 *Recognized commitments*

For unconditional purchase obligations that are recorded on the balance sheet, reporting entities must disclose the aggregate amount of payments for the obligations for each of the five succeeding years following the balance sheet date.

Commonly recognized commitments include capital leases and net losses on firm inventory purchase commitments. Unconditional purchase obligations may also be subject to the provisions of ASC 815, *Derivatives and Hedging*. (See DH 9 for discussion of purchase commitments as derivatives). In this instance, reporting entities would follow the disclosure requirements of both ASC 440 and ASC 815.

23.4 Contingencies

U.S. GAAP defines a contingency as follows:

ASC 450-20

Contingency: An existing condition, situation, or set of circumstances involving uncertainty as to possible gain (gain contingency) or loss (loss contingency) to an entity that will ultimately be resolved when one or more future events occur or fail to occur.

The following sections discuss the disclosure considerations for loss and gain contingencies as provided by ASC 450.

23.4.1 Loss contingencies

Loss contingencies are relatively common — examples include product warranties, litigation exposure, environmental remediation, and collectability of receivables, among others.

There are three separate potential recognition, presentation and disclosure outcomes with regard to loss contingencies. Depending on the facts and circumstances, a reporting entity may need to accrue a liability and disclose the nature of the liability. In other situations, a reporting entity may only be required to disclose the loss contingency in the footnotes but not accrue a liability. Finally, some scenarios may arise where neither accrual nor disclosure is required.

23.4.1.1 Accrual and disclosure required

ASC 450 requires a loss contingency to be accrued when it is both probable and reasonably estimable. The accrual's balance sheet classification should take into consideration the period in which the reporting entity will ultimately settle the contingency. If the period of expected settlement is within one year of the balance sheet date, the reporting entity should generally classify the contingency as a short-term liability. Otherwise, it should be classified as long-term.

When an accrual is recorded, the nature of the accrual (and in some circumstances the amount accrued) may need to be disclosed in the footnotes to keep the financial statements from being misleading. Because these accruals are estimates, the FASB recommends that reporting entities make that clear by using terms such as "estimated liability" or "a liability of an estimated amount" in describing the nature of the accrual. The term "reserve" should not be used in the disclosures related to these contingencies. A reporting entity should disclose any losses that may be incremental to what was accrued if the additional loss is reasonably possible and materially different from what has been accrued.

ASC 450 states that disclosure is preferable to accrual in situations where a reasonable estimate of the loss cannot be determined.

23.4.1.2 No accrual, but disclosure required

Disclosure is required when:

- A material loss contingency is probable but not reasonably estimable.

  A reporting entity is required to disclose the nature of the contingency and the fact that an estimate cannot be made, or

- A material loss contingency is reasonably possible but not probable.

  A reporting entity is required to disclose the nature of the contingency and an estimate of the possible loss, range of loss, or disclose the fact that an estimate cannot be made.

If a material loss contingency arises after the balance sheet date but before the financial statements are issued, disclosure may be necessary. The assessment as to whether disclosure is necessary should be based on the principles articulated in ASC 855, *Subsequent events*. If disclosure is deemed necessary, a reporting entity should describe the nature of the loss contingency and an estimate of the loss or range of possible losses. If no estimate can be made, then the reporting entity should disclose that fact. Refer to FSP 28 for further information on subsequent events disclosures.

For material loss contingencies that are reasonably possible but not probable, the SEC frequently comments on companies that have incomplete or omitted disclosures pursuant to ASC 450, specifically related to the lack of disclosures regarding the nature of the contingency and the possible range of loss amounts or the statement that an estimate cannot be made. The staff also cautions reporting entities that the recording of a material accrual for a contingent liability should typically not be the first disclosure regarding the material contingency. A foreshadowing disclosure that precedes an accrual for a material contingent liability is typically expected.

ASC 450 does not provide specific guidance as to the level of required disclosures that need to be made (that is, individual contingency or some other aggregate level). However, it requires that reporting entities disclose information to keep the financial statements from being misleading. There is a natural tension between greater transparency (important to financial statement users) and the potential consequences to a reporting entity's defense positions that may come with this increased transparency. One way to alleviate some of this tension is to aggregate losses. This approach has been accepted by the SEC staff and enables users to have sufficient data, but does not provide such specific information that it could prejudice a legal matter.

Additionally, reporting entities will need to consider the guidance in SAB Topic 5.Y, *Accounting and Disclosures Relating to Loss Contingencies*, as there is no definitive guidance on whether an accrual must be made for legal costs that the reporting entity expects to incur in defending itself in connection with a loss contingency. Some believe that the accrual of the loss should factor in all costs and, if the legal costs are reasonably estimable, they should be accrued in accordance with ASC 450, regardless of whether a liability can be estimated for the contingency itself. Others, however, argue that legal fees should be recognized as incurred when the legal services are provided and, therefore, should not be recognized as part of a loss contingency accrual. As specified in ASC 450-20-S99-2 how an entity treats legal costs should be based on a consistently applied accounting policy. When legal costs are expected to be material or are a significant part of a loss accrual, the entity should disclose its policy.

Question 23-2

In a two-step income statement, where should a reporting entity include litigation expense?

PwC response

Generally, litigation expense, whether expensed as incurred or accrued as part of the ASC 450 accrual, should be classified as an operating expense.

Unasserted claims

An unasserted claim is one that has not yet been asserted either because the potential claimant is unaware of the matter or because the potential claimant has elected not to pursue it. As discussed in ASC 450-20-50 and ASC 450-20-55-14 through 55-15, if assertion of a claim is judged probable, accrual or disclosure, or both, should be made based on the probability and ability to estimate any loss arising from the claim. ASC 450-20-50-6 indicates that disclosure is required when assertion of the claim is considered probable and there is a reasonable possibility the outcome will be unfavorable. While ASC 450-20-50-6 indicates when disclosure of unasserted claims is required, we believe disclosure should also be considered even if the claim is not considered probable.

23.4.1.3 Neither accrual nor disclosure required

Disclosure is generally not required for a loss contingency involving an unasserted claim or assessment if it is not probable that a claim will be asserted. Additionally, ASC 450 does not require disclosure of loss contingencies when the possibility of loss is remote. However, reporting entities should consider disclosing information in the footnotes if the disclosure would keep the financial statements from being misleading. Though ASC 450 does not require disclosure of remote contingencies, ASC 460 requires certain remote loss contingencies to be disclosed. Refer to FSP 23.6.1 for further discussion related to these contingencies.

23.4.2 Recovery of a loss

A claim for loss recovery (e.g., an insurance claim) generally can be recognized when a loss event has occurred and recovery is considered probable. If the claim is subject to dispute or litigation, a rebuttable presumption exists that recoverability of the claim is not probable. If the potential recovery exceeds the loss recognized in the financial statements or relates to a loss not yet recognized in the financial statements, such recovery should be recognized under the gain contingency model discussed in FSP 23.5.

23.4.2.1 Insurance recoverables

Reporting entities often manage risk by purchasing traditional insurance. Although a reporting entity transfers risk through an insurance policy, it generally has the primary obligation with respect to any losses. Therefore, the reporting entity is typically required to accrue and present the gross amount of a loss even if it purchased insurance to cover the loss.

Generally, amounts receivable under an insurance contract should not be offset against the reporting entity's liability, as purchasing insurance generally does not relieve the purchaser of its primary obligation to make payments related to losses that result from risk.

Excerpt from ASC 720-20-45-1

…unless the conditions of ASC 210-20-45-1 are met, offsetting prepaid insurance and receivables for expected recoveries from insurers against a recognized incurred but not reported liability or the liability incurred as a result of a past insurable event would not be appropriate.

Sometimes, an insurance company may agree to pay the harmed party directly, on the insured's behalf, but this does not extinguish or provide a legal release from the insured's obligation prior to payment to the harmed party, as is required for liability extinguishment.

For example, most states require an employer to provide its employees with workers' compensation coverage if they are injured on the job. Accordingly, an employer has an obligation to its employees. The employer may choose to purchase insurance for some or all of its workers' compensation risk. The employer's decision in this respect generally does not change its legal obligation to its employees, although its decision could affect whether there is an asset to record when an employee is injured. In addition, an employer's legal obligation is not altered if the purchased insurance contract includes all claims handling and direct contact with employees. Even if (1) the insurance company is not a credit risk, or (2) the state provides an insurance guarantee fund for insolvent insurance carriers, the employer generally still has the primary obligation to pay any claims and, if so, should record a liability. Assistance from legal counsel may be needed to understand whether a liability has been extinguished by purchasing workers' compensation insurance.

23.4.2.2 *Financial statement classification of recovery*

Several pieces of guidance govern the presentation and disclosure of insurance recoveries:

- ASC 605-40, *Revenue Recognition – Gains and Losses*[1]
- ASC 410-30, *Environmental Obligations*
- ASC 225-30, *Income Statement – Business Interruption Insurance*

Revenue recognition model (ASC 605-40)

ASC 605-40 provides guidance on involuntary conversions of nonmonetary assets (such as property or equipment) to monetary assets (such as insurance proceeds). It requires recognition of a gain or loss on this type of involuntary conversion, measured as the difference between the carrying amount of the nonmonetary asset and the amount of monetary assets received. As such, insurance recoveries are recorded in the same financial statement line as the related loss up to the amount of loss. To the extent that insurance proceeds are in excess of the related loss, which may occur with replacement cost insurance, the gain is typically included in other income. In a two-step income statement, it is often shown as nonoperating income. Most insurance proceeds do not require the insured to perform anything further to keep the proceeds and are typically not refundable; therefore, full or partial deferral of recognition of the proceeds should be rare.

EXAMPLE 23-1

Considerations for casualty loss with a potential insurance recovery

On June 1, 20X4, FSP Corp's equipment is heavily damaged while being transported from its manufacturing facility to its retail facility. Due to the nature of the damage, FSP Corp determines that there is a total loss. The equipment had a net book value of $7 million and an estimated replacement value of $6 million as of the date of loss. FSP Corp files a property and casualty claim with its insurer for recovery of $6 million. Based on its discussions with the insurer and review of the policy by in-house experts, FSP Corp concludes that it has a covered loss under the policy and that it is probable the insurer will settle the claim for at least $5 million. However, the insurer has communicated to FSP Corp that the amount of final settlement is subject to verification of the identity of the equipment damaged and the receipt of additional market data regarding its value.

How should FSP Corp recognize, measure, and disclose the loss of the equipment and the potential insurance recovery?

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[1] In May 2014, the FASB release new revenue guidance that is effective for public companies beginning in 2017. The revenue guidance discussed in this chapter does not reflect this new guidance. For information on the new revenue recognition guidance, refer to PwC's accounting and financial reporting guide for *Revenue from contracts with customers, global edition*.

Analysis

FSP Corp should recognize a reduction in the net book value of the equipment of \$7 million and recognize an asset of \$5 million for the probable recovery of its loss (a loss recovery asset on the balance sheet). FSP Corp should recognize any remaining recovery (i.e., any excess over \$5 million) when recovery of an additional amount is probable (e.g., when the identity of the damaged equipment has been established and additional market data confirm its value). FSP Corp should record the insurance recovery in the same financial statement line item in the income statement as the related loss was recorded. To the extent the loss is material, FSP Corp should disclose the nature of the events leading to the loss and additional amounts that are expected to be recovered.

Insurance recoveries of environmental obligations (ASC 410)

ASC 410-30-35-8 and ASC 410-30-35-9 address insurance recoveries related to environmental obligations. The guidance indicates that an asset related to an insurance recovery should be recognized only when realization of the claim underlying the recovery is probable. The guidance stipulates that there is a rebuttable presumption that realization of the claim is not probable if the claim is the subject of litigation.

Probable recoveries should be reflected separately as an asset in the balance sheet and not netted against the remediation liability, consistent with ASC 210-20, *Balance Sheet—Offsetting*. ASC 410-30-45-2 states that it would be rare, if ever, that the facts and circumstances surrounding environmental remediation liabilities and related receivables and potential recoveries would meet the criteria of ASC 210-20. The financial statements should also include a discussion of material uncertainties that may affect the measurement and realization of the asset and liability.

Business interruption insurance (ASC 225)

ASC 225 provides guidance related to the presentation and disclosure of business interruption insurance proceeds. Business interruption insurance is insurance that a reporting entity might purchase to cover losses caused by the loss of use of property and equipment. This insurance typically provides for reimbursement of qualifying costs while a reporting entity rebuilds the damaged property. The guidance allows a reporting entity to determine the classification of recoveries as long as the classification does not conflict with existing U.S. GAAP. For example, to classify business interruption insurance recoveries as revenue, the requirements of FASB Concepts Statement No. 6, *Elements of Financial Statements,* must be met.

ASC 225 also requires a reporting entity to disclose certain information in the footnotes for period(s) in which recoveries are recognized. These include:

- The nature of the event that caused the business interruption losses

- The aggregate amount of business interruption insurance recoveries recognized each period and the income statement line item in which the recoveries were included

23.4.3 *Lawsuits covered by insurance*

SEC staff comment letters have emphasized disclosures related to pending settlements regarding lawsuits that are covered by insurance. Specifically, reporting entities have been asked to disclose how insurance arrangements have affected conclusions concerning settlements and the likely effect that litigation and future settlements will have on the financial statements. Accordingly, it is important for reporting entities to ensure that any liabilities that are covered by insurance are properly disclosed in accordance with ASC 450.

23.5 Gain contingencies

ASC 450 indicates that contingent gains should not be recognized prior to the gain being "realized" or "realizable." A realized gain is one where cash (or other assets, such as claims to cash) has already been received without expectation of repayment. A gain is realizable when assets are readily convertible to known amounts of cash or claims to cash. We believe the recognition of a gain is appropriate at the earlier of when the gain is realizable or realized. The assessment of whether a gain not yet realized is realizable requires significant judgment and should include the evaluation of the following factors, among others:

- Whether there is a signed agreement or legally enforceable contract that stipulates the terms of the gain or settlement, and whether the settlement is subject to any pending or expected appeal

- Whether the counterparty has the ability or wherewithal to pay the amount

- Whether the right to receive the proceeds meets the definition of an asset in CON 6, *Elements of Financial Statements* (i.e., a probable future economic benefit obtained or controlled as a result of past transactions or events)

As discussed in FSP 23.4.2, a claim for loss recovery (e.g., an insurance claim) generally can be recognized when a loss event has occurred and recovery is considered probable. If the potential recovery exceeds the loss recognized in the financial statements or relates to a loss not yet recognized in the financial statements, such recovery should be evaluated under the gain contingency model.

23.5.1 *Recoveries representing gain contingencies*

Consistent with the guidance in ASC 450, *Contingencies*, AICPA TPA 5400.05, Question 4, states that a gain related to an insurance recovery should not be recognized until any contingencies relating to the insurance claim have been resolved (as the gain would not be realized until the related contingencies have been resolved).

AICPA TPA 5100.35 illustrates the treatment of a gain relating to an insurance recovery for an involuntary conversion of a building caused by a natural disaster that was not in dispute and that is realized after the date of the balance sheet but before the release of the financial statements. The guidance notes that the gain (the amount of insurance proceeds received in excess of the carrying value of a building which was destroyed prior to the balance sheet date) cannot be recognized until the subsequent period because it was not realized at the balance sheet date. This guidance does not explicitly address the recognition of the insurance proceeds equal to the carrying value of the destroyed building (the loss recognized in the financial statements), although the example implies that a receivable was recorded equal to the recognized loss by noting that "there was no loss to record" at the balance sheet date.

A gain contingency may be considered "realizable" prior to the receipt of cash, depending on the facts and circumstances. For example, a gain could be recorded at the balance sheet date if (1) it is acknowledged by the insurance company that a payment is due, (2) information is received prior to the release of the financial statements that will confirm the amount, and (3) collection is probable. However, if the existence of the claim is being disputed by the insurance company, the amount would not be considered realizable and should only be recognized upon settlement of the dispute.

If the reporting entity expects a possible gain contingency, disclosure is required:

ASC 450-30-50-1

Adequate disclosure shall be made of a contingency that might result in a gain, but care shall be exercised to avoid misleading implications as to the likelihood of realization.

23.6 Guarantees

For guarantees that fall within the scope of ASC 460, guarantors are required to recognize a liability equal to the fair value of the guarantee upon its issuance and to provide specific disclosures related to the guarantee. Guarantors may be excluded from the scope of the initial liability recognition provisions included in ASC 460-10-25-1 depending on the type of guarantee; however, the disclosure requirements outlined in ASC 460 may still be required.

Guarantees and indemnification for litigation arising out of the performance of the directors' and officers' duties are not within the scope of ASC 460. ASC 460-10-15-7 states that employment-related guarantees are excluded from the scope. Because indemnification of directors and officers would be considered part of their respective compensation packages, it therefore represents an employment-related guarantee outside the scope of ASC 460. See ASC 460-10-15-7 for additional arrangements that are excluded from its scope.

The disclosures required by ASC 460 do not eliminate or affect disclosure requirements under other applicable guidance, such as disclosures required under:

- ASC 825 related to disclosures of the fair value of financial guarantees
- ASC 450 related to disclosures for contingent losses that have a reasonable possibility of occurring
- ASC 815 related to guarantees accounted for as derivatives
- ASC 275 for disclosures of significant risks and uncertainties that could significantly affect the amounts reported in the financial statements in the near term.

23.6.1 ASC 460 disclosure requirements

Guarantors are required to disclose the following information about each guarantee, or group of similar guarantees. ASC 460 is silent as to whether the disclosures relate to the current period only, or to comparative periods presented in the financial statements. Our view is that comparative disclosures are required for all of the following for all periods for which a balance sheet is presented:

- The nature of the guarantee including:
  - Approximate term
  - How it originated
  - Events and circumstances that would require performance
  - Current status (as of the balance sheet date) of the payment/performance risk

  If a reporting entity uses internal groupings for disclosure of the payment/performance risk status of its guarantees, it must disclose how such groupings are determined and used for managing risk.

- The maximum potential amount of future payments (undiscounted) that the guarantor could be required to make under the guarantee. With regard to this disclosure:
  - The amount of potential future payments should not be reduced by any potential recoveries under collateralization or recourse provisions in the guarantee.
  - If there is no limitation to the maximum potential future payments based on the terms of the guarantee, then this fact must be disclosed.

    - If the amount of the maximum estimated future payments under the guarantee cannot be estimated, the guarantor must disclose this fact along with the reasons for why an estimate cannot be determined.

- The current carrying amount of any guarantor's obligations under the guarantee (including any amount recognized under the contingency guidance within ASC 450). This disclosure is required regardless of whether the guarantee is freestanding or embedded within another contract.

- The nature of recourse provisions, if any, that would allow the guarantor to recover amounts paid under the guarantee. A reporting entity should also consider disclosing the value of any recovery that could occur, such as from the guarantor's right to proceed against an outside party, if the amount is estimable.

- The nature of any assets held either by third parties or as collateral that the guarantor could obtain to recover amounts paid under the guarantee, upon the occurrence of any triggering event or condition.

- The approximate extent to which the proceeds from the liquidation of assets held either by third parties or as collateral would cover the maximum potential future payments under the guarantee, if such amount is estimable.

The information outlined above is required to be disclosed even when there is a remote probability of the guarantor making any payments under the guarantee or group of guarantees. ASC 460 states the following:

ASC 460-10-50-2

An entity shall disclose certain loss contingencies even though the possibility of loss may be remote. The common characteristic of those contingencies is a guarantee that provides a right to proceed against an outside party in the event that the guarantor is called on to satisfy the guarantee. Examples include the following:

a. Guarantees of indebtedness of others, including indirect guarantees of indebtedness of others

b. Obligations of commercial banks under standby letters of credit

c. Guarantees to repurchase receivables (or, in some cases, to repurchase the related property) that have been sold or otherwise assigned

d. Other agreements that in substance have the same guarantee characteristic.

Guarantees issued by a reporting entity to benefit related parties, such as equity method investees and joint ventures, require incremental disclosures pursuant to ASC 850, *Related Party Disclosures*. Additionally, guarantees of a reporting entity's indebtedness by its principal shareholders or other related parties should be disclosed, if material, as required by ASC 850-10-50. Although not in the scope of ASC 460, we believe that guarantees obtained by a reporting entity (as opposed to those made by it) should also be disclosed, as such disclosures may indicate that the reporting entity is not able to obtain financing without the guarantees of others. Related party transactions are addressed in FSP 26. ASC 460-10-50-2 requires disclosure of guarantees of the indebtedness of others, including indirect guarantees as defined therein. In addition, the recognition and disclosure requirements of ASC 460 apply to such indirect guarantees if they are legally binding.

Disclosures related to intercompany guarantees are only required in the financial statements of the issuer of the guarantees.

EXAMPLE 23-2

Intercompany guarantees

FSP Corp provides a guarantee on a loan that Sub Co has received from a third party bank. FSP Corp issues consolidated financial statements that include Sub Co. In addition, Sub Co issues stand-alone financial statements.

Which reporting entity's financial statements should include disclosure about the intercompany guarantee?

Analysis

As the issuer of the guarantee, FSP Corp must include disclosure of the guarantee in any financial statements it issues. Although Sub Co is not required to disclose FSP Corp's guarantee of its debt in Sub Co's stand-alone financial statements, we believe Sub Co should disclose the parent's guarantee so users of Sub Co's financial statements have an understanding of Sub Co's liquidity.

23.6.2 Fair value disclosures

Reporting entities that issue guarantees must also consider the disclosure requirements set forth in ASC 825, *Financial Instruments*. The disclosure requirements vary depending on whether an entity is an SEC registrant or a private company.

ASC 825 requires reporting entities to disclose the fair value of all financial instruments regardless of whether the instrument is carried at fair value in the balance sheet. A guarantee generally would be considered a financial instrument. Therefore, while an entity may not be remeasuring a guarantee at fair value for purposes of recording it on the balance sheet, a reporting entity may be required to determine the fair value of a guarantee for disclosure purposes. This would also include determining where the guarantee belongs in the fair value hierarchy (i.e., Level 1, 2, or 3). See FSP 20 for more on fair value disclosure requirements.

23.6.3 Joint and several liability

Under joint and several liability, the total amount of an obligation is enforceable against any of the parties to the arrangement. For example, under joint and several liability in a lending arrangement, the lender can demand payment in accordance with the terms of the arrangement for the total amount of the obligation from any of the obligors or any combination of the obligors. The obligors cannot refuse to perform on the basis that they individually only borrowed a portion of the total, nor that other parties are also obligated to perform. However, the paying obligor may be able to pursue repayment from the other obligors, depending on the agreement among the co-obligors and the laws covering the arrangement.

ASC 405-40, *Obligations Resulting from Joint and Several Liability Arrangements*, addresses disclosure of obligations resulting from joint and several liability arrangements for which the total amount under the arrangement is fixed at the reporting date. The guidance does not address obligations resulting from joint and several liability arrangements that are specifically addressed within other existing guidance, such as asset retirement and environmental obligations (refer to FSP 11), contingencies (refer to FSP 23.4), compensation retirement benefits (refer to FSP 13), and taxes (refer to FSP 16).

23.6.3.1 Disclosure requirements

A reporting entity is required to disclose for each liability or each group of similar liabilities resulting from joint and several liability arrangements:

- The nature of the arrangement, including how the liability arose, the relationship with other co-obligors, and the terms and conditions of the arrangement

- The total amount outstanding, which cannot be reduced by the effect of any amounts that may be recoverable from other co-obligors, under the arrangement

- The carrying amount, if any, of the reporting entity's liability and the carrying amount of any receivable recognized

- The nature of any recourse provision that would allow for recovery from other entities of amounts paid, including any limitations on the potential recovery of amounts

- In the period of initial recognition and measurement or in a period the measurement of the liability changes significantly, the corresponding entry and where it was recorded in the financial statements.

While not addressed in the guidance, we would encourage reporting entities to disclose the undiscounted amount of the liability, as well as the discount rate used, if discounted.

23.7 Off-balance sheet considerations

Off-balance sheet credit risk refers to the credit risk related to off-balance sheet loan commitments, standby letters of credit, certain financial guarantees, and other similar instruments (except for derivative instruments).

23.7.1 Off-balance-sheet credit risk

ASC 942-825, *Financial Instruments,* requires the following disclosures for financial instruments with off-balance-sheet credit risk (except for those instruments in the scope of ASC 815, *Derivatives and Hedging*):

Excerpt from ASC 942-825-50-1

a. The face or contract amount

b. The nature and terms, including, at a minimum, a discussion of the:

   1. Credit and market risk of those instruments

   2. Cash requirements of those instruments

   3. Related accounting policy

c. The entity's policy for requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments.

In addition to the disclosure requirements discussed above, a reporting entity should evaluate whether there are credit losses related to these instruments. If the conditions of ASC 450-20 are met, a liability for the credit loss on these instruments should be recognized and reported separately from the allowance for loan and lease losses.

23.8 Interaction with other guidance

U.S. GAAP requires reporting entities to disclose other commitments and contingencies related to specific accounting topics. Refer to the following chapters for further presentation and disclosure considerations on these topics:

- Commitments to make future ESOP contributions (FSP 15)
- Environmental costs (FSP 11)
- Leases including guarantees (FSP 14)
- Product and extended warranty programs (FSP 11)

- Subsequent events (FSP 28)

23.9 Considerations for private companies

The requirements of ASC 440, ASC 450, and ASC 460 apply equally to SEC registrants and private companies. SEC requirements included in the following table apply only to SEC registrants.

Description	Authoritative reference	Section
Requirement for specific balance sheet caption "Commitments and Contingent Liabilities"	S-X 5-02(25)	23.3
Accounting for legal costs expected to be incurred in defending a loss contingency	ASC 450-20-S99-2	23.4.1.2

In addition, ASC 405-40 related to joint and several liability obligations is currently effective for SEC registrants. The guidance will be effective for private companies for fiscal years ending after December 15, 2014, and interim periods thereafter. ASC 405-40-65-1 provides specific transition guidance for companies adopting the standard. A private company would only apply this standard to those obligations that existed at the beginning of a company's fiscal year of adoption.

Chapter 24: Risks and uncertainties

24.1 Chapter overview

Risks and uncertainties represent conditions that may impact a reporting entity's financial results in future periods. Providing information about these conditions to financial statement users is therefore useful to enable them to assess a reporting entity's future prospects.

With regard to disclosing risks and uncertainties, this chapter covers the following topics:

- Scope of ASC 275, *Risks and Uncertainties*
- Disclosures required by ASC 275
- Interaction of ASC 275 with other guidance
- Going concern disclosure considerations
- Considerations for private companies

24.2 Scope

ASC 275 requires that financial statements include disclosures about the risks and uncertainties existing as of the date of the financial statements with respect to:

- The nature of the reporting entity's operations (FSP 24.3.1)
- The use of estimates in preparing the financial statements (FSP 24.3.2)
- Certain significant estimates (FSP 24.3.3)
- Current vulnerability related to certain concentrations (FSP 24.3.4)

These required disclosures apply to all reporting entities that issue financial statements prepared in conformity with U.S. GAAP. The disclosure requirements do not encompass risks and uncertainties that may be associated with the following:

- Management or key personnel
- Proposed changes in government regulations or accounting principles
- Internal control deficiencies
- Impacts of acts of war, God, or sudden catastrophes

The assessment of a reporting entity's ability to continue to operate as a going concern also falls under the umbrella of risks and uncertainties. Going concern is a specific uncertainty related to the assumption that a reporting entity is viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading, or seeking protection from creditors pursuant to laws or regulations. Historically, there was no U.S. GAAP guidance addressing going concern, but PCAOB AU 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,* addressed potential disclosures specific to going concern uncertainties that reporting entities should consider in certain circumstances. However, in August 2014, the FASB issued accounting guidance requiring management to assess their reporting entity's ability to continue as a going concern and provide disclosure in certain circumstances.

24.3 Disclosure requirements

This section discusses the disclosure requirements of ASC 275. Reporting entities should assess these disclosure requirements at each reporting date, considering changes to internal operations as well as changes to the industry and broader macroeconomic environment.

ASC 275 does not require disclosures to be segregated in the financial statements or otherwise identified as being provided to comply with ASC 275. The required disclosures may be grouped together in one footnote or included in other footnote disclosures as appropriate. When comparative periods are presented, the disclosure requirements of ASC 275 apply only to the most recent period presented.

24.3.1 Nature of the reporting entity's operations

A reporting entity should disclose the following within the financial statements related to the nature of its operations:

- Major products or services sold or provided
- Principal markets, including the locations of those markets
- For reporting entities that operate in more than one business, the relative importance (without quantification) of each business and the basis for such determination. For example, a reporting entity may disclose that its two business lines generate equal amounts of revenue or that one business line accounts for substantially all net income.

Typically, SEC registrants combine this information with their segment disclosures. Not-for-profit entities should describe their principal services performed and the revenue sources for those services.

Refer to Examples 1 and 2 within ASC 275-10-55 for examples of disclosures related to the nature of the reporting entity's operations.

24.3.2 Use of estimates in preparing the financial statements

Accounting estimates represent a reporting entity's judgment about the outcome of future events. A reporting entity should disclose that management's application of U.S. GAAP requires the pervasive use of estimates. This disclosure is intended to inform users of the inherent uncertainties present in the financial statements of all reporting entities, and that subsequent resolution of some matters could differ significantly from the resolution that is currently expected. Typically this disclosure is included in the basis of presentation footnote, though it is not required to be included there.

Example 3 within ASC 275-10-55 provides an example of this disclosure. While this example provides generic language for this required disclosure, reporting entities will often tailor this disclosure to list specific accounting policies that are subject to estimates (e.g., pension and benefit plans, valuation of goodwill and intangible assets, and allowance for doubtful accounts). Additionally, reporting entities should consider disclosing how estimates are developed (e.g., historical experience or other assumptions believed to be reasonable given the facts and circumstances). In practice, these disclosures are typically included within the relevant financial statement footnotes.

24.3.3 Certain significant estimates

A reporting entity should disclose certain significant estimates that affect the carrying amount of assets and liabilities, as well as those that were used in developing the disclosures related to gain or loss contingencies. ASC 275 provides criteria to help determine which estimates must be disclosed.

Excerpt from ASC 275-10-50-8

Disclosure regarding an estimate shall be made when known information available before the financial statements are issued or are available to be issued…indicates that both of the following criteria are met:

a. It is at least **reasonably possible** that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the **near term** due to one or more future confirming events. . . .

b. The effect of the change would be material to the financial statements.

A reporting entity should consider all information available before the financial statements are issued or available to be issued as defined in ASC 855, *Subsequent Events*, in assessing the above criteria. The assessment of the criteria for disclosure under ASC 275 should be performed separately from any assessment under ASC 855. For example, an event subsequent to the balance sheet date may not meet the criteria for disclosure under ASC 855, but disclosure may still be required under ASC 275. Such a disclosure should include a description of the uncertainty and indicate that it is at least reasonably possible that a change in the estimate will occur in the near term. Refer to FSP 28 for a further discussion of disclosure requirements related to subsequent events.

ASC 275 indicates that “reasonably possible” should be interpreted to mean that the likelihood of occurrence is more than remote but less than likely. “Near term” should be interpreted as not exceeding one year from the date of the financial statements.

Reporting entities should consider risk-reduction activities when assessing whether the above criteria have been met. Disclosure is not required if a reporting entity concludes that the impact of a change in estimate would not be material as a result of risk-reduction activities. For example, a reporting entity may conclude that a change in the allowance for doubtful accounts estimate would not have a material impact on the financial statements because of a requirement that customers prepay for orders if they do not pass a credit check. A reporting entity should assess materiality based on the magnitude of the *potential* change in the recorded amount and not the amount currently recorded (which could be zero).

Additionally, ASC 275 clarifies how to assess materiality when considering the change in useful life of an intangible asset. The criterion would be met if a change in useful life of an intangible asset or a change in expected likelihood of renewal or extension of an intangible asset would be material either individually or in the aggregate by major intangible asset class.

ASC 275 includes a list of areas where these types of disclosures may be more common, though the list is not intended to be comprehensive.

Excerpt from ASC 275-10-50-15

The following are examples of assets and liabilities and related revenues and expenses, and of disclosure of gain or loss contingencies included in financial statements that, based on facts and circumstances existing at the date of the financial statements, may be based on estimates that are particularly sensitive to change in the near term:

a. Inventory subject to rapid technological obsolescence

b. Specialized equipment subject to technological obsolescence

c. Valuation allowances for deferred tax assets based on future taxable income

d. Capitalized motion picture film production costs

e. Capitalized computer software costs

f. Deferred policy acquisition costs of insurance entities

g. Valuation allowances for commercial and real estate loans

h. Environmental remediation-related obligations

i. Litigation-related obligations

j. Contingent liabilities for obligations of other entities

k. Amounts reported for long-term obligations, such as amounts reported for pensions and postemployment benefits

l. Estimated net proceeds recoverable, the provisions for expected loss to be incurred, or both, on disposition of a business or assets

m. Amounts reported for long-term contracts.

Part of the challenge in determining the need for disclosure is assessing whether an estimate is subject to change in the near term.

EXAMPLE 24-1

Disclosure of percentage-of-completion contract estimates

FSP Corp enters into a material long-term construction contract with a customer that is accounted for under the percentage-of-completion (POC) method in accordance with ASC 605-35, *Construction-Type and Production-Type Contracts*. Prior to year end, FSP Corp identifies an issue with the building site that may require additional construction costs of up to 50% of the original budget. Further survey of the land is required to determine the extent of additional construction and should be completed within six months. FSP Corp considers it reasonably possible that the additional costs will be incurred. The additional costs, if required, would represent a material increase in the budgeted amount.

Is disclosure required under ASC 275?

Analysis

This estimate would meet the criteria for disclosure under ASC 275-10-50-8. FSP Corp considers the likelihood of incurring the additional costs as reasonably possible and the confirming event (the land survey) will occur in the near term. Additionally, the additional costs would be material. FSP Corp should disclose that it is at least reasonably possible that completion costs for the contract will materially increase in the near-term. Based on the above facts, this change in estimate does not represent an error as contemplated by ASC 250, *Accounting Changes and Error Corrections*. Refer to FSP 30 for disclosure requirements related to errors in previously issued financial statements.

The SEC staff has frequently commented on significant estimates related to:

- Business combinations (estimates used in the valuation of acquired intangible assets and contingent consideration)

- Goodwill and asset impairments (estimates driving fair value in goodwill and asset impairment analysis)

- Contingencies (estimates of reasonably possible loss/range of reasonably possible losses or an explanation of why the reporting entity is unable to make such an estimate)

- Income taxes (valuation allowances and permanent reinvestment of foreign undistributed earnings assertion)

For more information on disclosure considerations related to business combinations, goodwill and asset impairments, contingencies, and income taxes, refer to FSP 17, FSP 8, FSP 23, and FSP 16, respectively.

Also refer to ASC 275-10-60 for references to additional examples of disclosures.

24.3.4 *Current vulnerability related to certain concentrations*

Vulnerabilities from concentrations arise when a reporting entity is exposed to a greater risk of loss than if it had mitigated that risk through diversification. A reporting entity should disclose such concentrations when all of the following criteria are met:

- Concentration exists at the financial statement date

- Concentration results in vulnerability to a near-term severe impact

- It is at least reasonably possible that the events that could result in the severe impact will occur in the near team

"Severe impact" in this context means a significant financially disruptive effect on a reporting entity's normal functioning. Severe impact is a higher threshold than material. Matters may be material in that they impact the decisions of a financial statement user but do not disrupt the operations of a reporting entity. For example, the loss of business from a large customer may materially impact a reporting entity's results but not disrupt the entity's operations. The concept of severe impact, however, would include matters that are less than catastrophic. "Reasonably possible" and "near term" should be interpreted consistent with the discussion in FSP 24.3.3.

ASC 275 requires disclosure of the following defined concentrations (as opposed to a broader set of potential concentrations about which management may be aware) if they meet the criteria listed in the first set of bullets above in this section:

- Volume of business transacted with a specific customer, supplier, or lender (disclosure is required for public entities (as defined in ASC 280) when revenue from a specific customer equals 10 percent or more of total revenue; however, a reporting entity should still consider disclosure in cases where the threshold has not been met)

- Revenue from particular products or services for which a severe impact may result due to volume or price changes or the loss of patent protection

- Available sources of supply for materials, labor, or services
- Market or geographic area in which a reporting entity conducts its operations

ASC 275-10-50-18 states that it is always considered at least reasonably possible that any customer, grantor, or contributor will be lost in the near term and that operations located outside the reporting entity's home country may be disrupted in the near term.

Concentrations meeting the criteria in the first set of bullets above in this section should be disclosed in sufficient detail to inform users of the general nature of the associated risk.

ASC 275 includes additional disclosure requirements for concentrations of labor subject to collective bargaining agreements and concentrations of operations outside of a reporting entity's home country if the criteria for disclosure of concentrations are met.

Excerpt from ASC 275-10-50-20

For those concentrations of labor…subject to collective bargaining agreements and concentrations of operations located outside of the entity's home country…the following specific disclosures are required:

a. For labor subject to collective bargaining agreements, disclosure shall include both the percentage of the labor force covered by a collective bargaining agreement and the percentage of the labor force covered by a collective bargaining agreement that will expire within one year.

b. For operations located outside the entity's home country, disclosure shall include the carrying amounts of net assets and the geographic areas in which they are located.

Sufficiently disclosing concentrations is a challenge for many reporting entities as the disclosure often reflects a potential company weakness. As a result, the SEC staff has commented on certain risks related to concentrations. Frequent areas of comment include:

- Concentration of significant customers or class of customers, including identifying the magnitude of receivables by foreign governments
- Concentration of cash or operations in specific countries or regions, and whether there are government regulations in those countries protecting the balances (similar to Federal Deposit Insurance Corporation (FDIC) insurance)
- Existence of concentrations of credit risk including specific counterparties or groups of counterparties that are similarly impacted by macroeconomic factors

Refer to Examples 2 and 4 through 8 in ASC 275-10-55 for examples of disclosures related to concentrations.

24.3.5 *Assessment of disclosure criteria*

Significant judgment is required to determine whether a material change in estimate or near-term severe impact from a concentration is reasonably possible. The outcome of future events alone should not be used to determine whether the reporting entity's inclusion or exclusion of a particular disclosure was an error. For example, if the reporting entity discloses a significant estimate, but that estimate is not followed by a material change, it does not imply that the disclosure should not have been made. Likewise, if the reporting entity experiences a severe impact related to a concentration that was not previously disclosed, it would not suggest that the reporting entity failed to comply with the disclosure requirements if an appropriate judgment had been made that the concentration did not meet the requirements for disclosure.

24.4 *Interaction with other guidance*

Disclosures required by ASC 275 are not mutually exclusive with those required by other U.S. GAAP, as many of the requirements are similar to or overlap with other required disclosures. In addition, certain disclosure requirements in ASC 275 supplement the requirements of other authoritative pronouncements. While there are many pieces of accounting guidance that address disclosures of risks and uncertainties, the following topics are specifically referenced by ASC 275.

24.4.1 *ASC 450, Contingencies*

ASC 450 requires the disclosure of loss contingencies as discussed in FSP 23. ASC 275 does not change those requirements but supplements them. For example, ASC 450 does not differentiate between near- and long-term contingencies. Therefore, if an estimate within the scope of ASC 450 meets the criteria for disclosure under ASC 275 as discussed in FSP 24.3.3, the reporting entity should also disclose that it is at least reasonably possible that a change in the estimate will occur in the near term.

In addition, estimates that do not require disclosure in accordance with ASC 450 should be assessed under ASC 275. For example, estimates associated with long-term operating assets and amounts reported under profitable long-term contracts that are not within the scope of ASC 450 should be considered for disclosure under ASC 275. Disclosures related to the estimate of gain on a contract accounted for under the percentage-of-completion method would not be within the scope of ASC 450, but may meet the criteria discussed in FSP 24.3.3 above.

24.4.2 *ASC 360, Property, Plant and Equipment*

The disclosure requirements of ASC 275 are applicable to potential near-term impairments of long-lived assets accounted for under ASC 360. ASC 360 includes examples of events or changes in circumstances that indicate when the carrying amount of such assets may not be recoverable. However, a reporting entity should not base its conclusion on the need for disclosure on the outcome of an impairment test performed under ASC 360. Disclosure may be required under ASC 275 even if a reporting entity concludes that an impairment charge is not required. Refer to FSP 8 for further discussion.

24.4.3 *ASC 280, Segment Reporting*

Disclosure of some concentrations, such as assets or operations located outside the reporting entity's home country, may be made to comply with ASC 280. Such disclosures need not be repeated to comply with ASC 275 and may be combined with segment footnote disclosures. Refer to FSP 25 for further discussion.

24.4.4 *ASC 825, Financial Instruments*

Disclosures of the concentration of credit risks and other financial instruments are not required under ASC 275. However, disclosure of these concentrations may be required pursuant to ASC 825. Refer to FSP 20 for further discussion.

24.5 Going concern

As previously noted, in August 2014, the FASB issued ASU 2014-15, *Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*, requiring management to assess the reporting entity's ability to continue as a going concern. Reporting entities are required to comply with this new guidance for their first annual period ending after December 15, 2016, but early adoption is permitted.

Prior to the issuance of ASU 2014-15, there was no accounting guidance on disclosures about going concern. Instead, auditing standards were the primary guidance for going concern assessments. Guidance on both the auditing guidance ("existing guidance") and accounting guidance ("new guidance") are covered in this chapter and are separately identified as such, where applicable.

24.5.1 *Assessing going concern under the existing guidance*

Auditing standards require auditors to assess the reporting entity's ability to continue as a going concern. The auditing guidance also includes disclosures that the auditor should consider in assessing the financial statement impact of any doubt that may exist about the reporting entity's ability to continue as a going concern. While the auditing standards indicate that auditors should "consider" these disclosures, it is the responsibility of both the reporting entity and the auditor to conclude that the financial statements are not materially misleading (which would represent a departure from U.S. GAAP). Therefore, it is often necessary for reporting entities to include the types of disclosures outlined below. These disclosures are separate from those required under ASC 275, although some disclosures required under ASC 275 may be indicative of going concern risk.

Excerpt from PCAOB AU 341.02

The auditor has a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited.

A reporting entity may consider including the following disclosures if substantial doubt exists after consideration of management's plans:

- Conditions and events that gave rise to the conclusion of substantial doubt about the reporting entity's ability to continue as a going concern
- Potential impacts of such conditions and events
- Management's assessment of the significance of those conditions and events along with any mitigating factors
- Potential discontinuance of operations
- Information regarding the recoverability and classification of recorded assets or amount and classification of liabilities

A reporting entity should also consider disclosing the principal conditions and events that initially raised the question of whether a reporting entity is able to continue as a going concern even if substantial doubt is alleviated and no reference to going concern is included in the auditor's report. For example, a reporting entity may be required to disclose that it does not have sufficient liquidity to repay borrowings if it is unable to obtain a waiver or modification of its debt, even if it believes it will be able to avoid default. The reporting entity may also disclose plans put in place to avoid default or violation of a covenant.

The SEC staff has issued comment letters related to the adequacy of disclosures when the auditor's report references substantial doubt about a reporting entity's ability to continue as a going concern. Reporting entities should consider the liquidity disclosures within management's discussion and analysis (MD&A) for inclusion in the financial statement footnotes, as MD&A disclosures are not a substitute for adequate footnote disclosure. MD&A disclosures are not covered within this Guide; refer to SEC Volume 6200 for additional information.

24.5.2 Assessing going concern under the new guidance

The new guidance requires management to assess if there is substantial doubt about the reporting entity's ability to continue as a going concern within one year after the financial statement issuance date. This assessment should be performed in connection with each annual and interim period. Management should consider relevant conditions that are known (and reasonably knowable) at the financial statement issuance date.

Substantial doubt exists if it is probable that the reporting entity will be unable to meet its obligations within one year after the issuance date. The new guidance defines substantial doubt, incorporating a likelihood threshold of "probable" similar to the current use of that term in existing guidance for loss contingencies (see FSP 23).

The reporting entity is required to provide additional disclosure if conditions give rise to substantial doubt. However, management will need to assess if its plans will alleviate substantial doubt to determine the specific disclosures.

Figure 24-1

Going concern disclosures required by ASU 2014-15

Required disclosures

If substantial doubt is alleviated by management's plans, disclose:	If the initially-identified substantial doubt is not alleviated by management's plans, disclose:
▫ Principle conditions or events that initially gave rise to substantial doubt	▫ A statement indicating that there is substantial doubt about the reporting entity's ability to continue as a going concern within one year after the issuance date
▫ Management's evaluation of the significance of those conditions or events in relation to the reporting entity's ability to meet its obligations	▫ Principal conditions or events giving rise to substantial doubt
▫ Management's plans that alleviated substantial doubt	▫ Management's evaluation of the significance of those conditions or events in relation to the reporting entity's ability to meet its obligations
	▫ Management's plans that are intended to mitigate those conditions or events

If management's assessment of going concern yields a conclusion that conditions do not give rise to substantial doubt, no disclosures are required specific to going concern uncertainties. However, disclosures of the identified conditions, risks, uncertainties, or contingencies may still be required under other guidance in U.S. GAAP (e.g., ASC 450).

24.6 *Required disclosures for development stage entities*

While ASC 275 is applicable to all reporting entities, those reporting entities that have not commenced principal operations (commonly referred to as development stage entities) have not always applied the requirements in practice. The diversity is the result of the wording in ASC 275, which refers to disclosure of a reporting entity's operations rather than its activities.

Accounting Standards Update (ASU) 2014-10, Development Stage Entities (Topic 915): *Elimination of Certain Financial Reporting Requirements, Including an Amendment to Variable Interest Entities Guidance in Topic 810, Consolidation*, clarifies this requirement by expanding the scope of the existing ASC 275 guidance (emphasis added in excerpt below, which explicitly includes development stage entities within scope). The ASU does not impact the existing disclosure requirements for non-development stage entities.

ASC 275-10-50-1

All of the disclosures required by this Subtopic shall be included in the basic financial statements. Reporting entities shall make disclosures in their financial statements about the risks and uncertainties existing as of the date of those statements in the following areas:

a. Nature of operations, including the activities in which the entity is currently engaged if principal operations have not commenced

b. Use of estimates in the preparation of financial statements

c. Certain significant estimates

d. Current vulnerability due to certain concentrations.

These four areas of disclosure are not mutually exclusive. The information required by some may overlap. Accordingly, the disclosures required by this Subtopic may be combined in various ways, grouped together, or placed in diverse parts of the financial statements, or included as part of the disclosures made pursuant to the requirements of other Topics.

Conforming amendments were also made to ASC 275-10-05-2 and ASC 275-10-50-2.

The provisions of ASU 2014-10 related to ASC 275 should be applied prospectively and will be effective for interim and annual reporting periods beginning after December 15, 2014, for public business entities. The effective date for all other reporting entities is annual reporting periods beginning after December 15, 2014, and interim reporting periods beginning after December 15, 2015.

Refer to Example 1A in ASU 2014-10 for an example of a disclosure for a reporting entity that has not commenced planned principal operations.

24.7 Considerations for private companies

ASC 275 is applicable to both SEC registrants and private companies. However, the different environments in which SEC registrants and private companies operate may affect their considerations regarding the adequacy of disclosures of risks and uncertainties. Filings of SEC registrants are subject to review by the SEC staff and the registrants are accountable to shareholders who must rely on publicly disclosed information. Private company stakeholders are often lending institutions and shareholders who typically have more access to management to obtain information that may not be disclosed in the financial statements. While this difference may potentially influence the level of transparency in financial statement disclosures, both types of reporting entities should take care to provide an appropriate level of disclosure to meet their reporting objectives.

While private companies are not subject to the guidance requiring disclosure of revenue from a specific customer that comprises 10 percent or more of total revenue, they are still subject to the general concentration disclosure requirements. In addition, private companies may identify vulnerabilities from concentrations more frequently. For example, it may be more likely that a private company has a concentration of accounts receivable from one customer or has cash held at one financial institution that exceeds FDIC limits.

24.7.1 Going concern

With regard to existing going concern guidance, AICPA AU-C 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, is the relevant professional standard related to going concern considerations for private companies. The disclosures referenced within AICPA AU-C 570 are generally consistent with those in PCAOB AU 341.

The new going concern guidance discussed in FSP 24.5.2 is applicable for all companies, including private companies, for the annual period ending after December 15, 2016 and for all interim and annual periods thereafter, with early adoption permitted.

Chapter 25: Segment reporting

25.1 Chapter overview

The objective and basic principles of ASC 280 are to provide information about the different types of business activities a reporting entity engages in and the different economic environments in which it operates. This information is intended to help users of the financial statements (1) better understand the reporting entity's performance, (2) better assess its prospects for future net cash flows, and (3) make more informed judgments about the reporting entity as a whole.

This chapter outlines the application of ASC 280 and includes relevant examples and practical insights, as well as a comprehensive, illustrative example.

25.2 Scope

ASC 280 applies to public reporting entities (i.e., reporting entities that are required to file financial statements with the SEC, provide financial statements for the purpose of issuing any class of securities in a public market, or are conduit bond obligors). The disclosure requirements of ASC 280 are not required for not-for-profit organizations or private companies.

For public entities, the proper application of ASC 280 is important from both a disclosure standpoint and for purposes of goodwill impairment testing. The determination of operating segments is the basis for determining reporting units. Reporting units are the unit of account used for goodwill impairment testing purposes for all public companies and for private companies that have not elected entity-wide goodwill impairment testing. For additional private company segment reporting considerations, see FSP 25.8.

ASC 280 provides the following guidance with regard to scope and the definition of a public entity:

ASC 280-10-15-3

The guidance in this Subtopic does not apply to the following entities:

a. Parent entities, subsidiaries, joint ventures, or investees accounted for by the equity method if those entities' separate company statements also are consolidated or combined in a complete set of financial statements and both the separate company statements and the consolidated or combined statements are included in the same financial report. However, this Subtopic does apply to those entities if they are public entities and their financial statements are issued separately.

b. Not-for-profit entities (regardless of whether the entity meets the definition of a public entity as defined above).

c. Nonpublic entities.

ASC 280-10-20 Glossary

Public Entity

A business entity or a not-for-profit entity that meets any of the following conditions:

a. It has issued debt or equity securities or is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).

b. It is required to file financial statements with the Securities and Exchange Commission (SEC).

c. It provides financial statements for the purpose of issuing any class of securities in a public market.

In certain instances, the financial statements of a private company may be included in the filing of an SEC registrant (e.g., due to SEC rules regarding significant equity method investments or acquired entities). Even if the private company's financial statements are included in an SEC registrant's filing, the private company is not required to include segment information in its separate financial statements.

25.3 Application overview

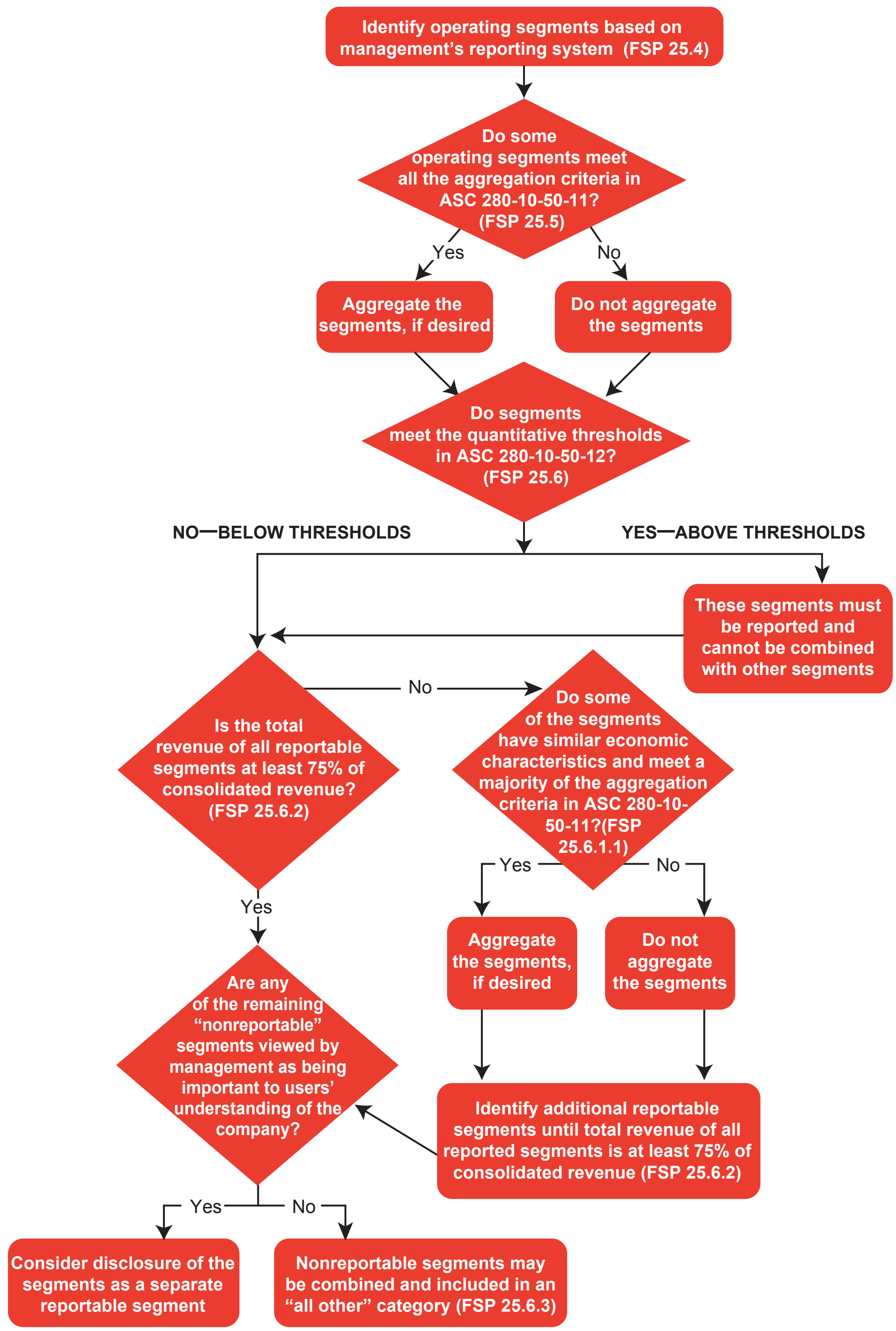
ASC 280 utilizes the "management approach," whereby external segment reporting is aligned with management's internal reporting. Segments based on a reporting entity's internal reporting structure are meant to provide financial statement users with an ability to see a reporting entity "through the eyes of management."

There are specific steps that reporting entities should follow when applying ASC 280:

- Identify operating segments
- Aggregate operating segments, if applicable, into reportable segments
- Determine if reportable segments cover a sufficient amount of the reporting entity's operations
- Determine if additional entity-wide disclosures are necessary

Figure 25-1 depicts how these four steps are applied in determining reportable segments.

Figure 25-1
Steps for determining reportable segments



25.4 Identifying operating segments

ASC 280-10-50-1 defines an operating segment as follows:

ASC 280-10-50-1

An operating segment is a component of a public entity that has all of the following characteristics:

a. It engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same public entity).

b. Its operating results are regularly reviewed by the public entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance.

c. Its discrete financial information is available.

Identifying operating segments continues to be a common area of comments from the SEC staff. The proper determination of operating segments begins with understanding:

- the reporting entity’s organizational structure and how individuals within the organization are compensated
- the reporting entity’s operations including its budgeting process
- the individual or individuals responsible for allocating resources and assessing performance (referred to as the chief operating decision maker, or CODM)
- the information regularly reviewed by the CODM to carry out this function.

25.4.1 Business activities

Business activities are ongoing economic and operating activities that create value for a reporting entity, such as the production and sale of a product to a customer. Identifying operating segments that engage in business activities is usually straightforward and is primarily based on a company’s revenue streams and its organizational structure. A business activity does not necessarily require dedicated assets to earn revenues and incur expenses and does not necessarily require that revenues and expenses be generated externally (i.e., the transactions could be intercompany).

Research and development business units that do not earn revenues, but whose results are regularly reviewed by the CODM, may be considered operating segments. Although research and development centers do not typically earn revenues, their activities may not be incidental as they may serve as an integral component of the reporting entity's business.

Reporting entities may have a corporate headquarters which carries out centralized functions such as accounting, treasury, information technology, legal, human resources, environmental, and internal audit. As discussed in ASC 280-10-50-4, corporate departments that do not earn revenues or earn revenues that are only incidental to the activities of the reporting entity would not be considered operating segments. If not considered an operating segment, revenue and expenses of corporate departments should be reported in the reconciliation of the segment totals to the related consolidated totals. For further guidance on the presentation of reconciling items in segment disclosures, see FSP 25.7.5.

Question 25-1

Can a vertically integrated operation of a reporting entity that does not have external revenues (i.e., a component of a reporting entity that sells primarily, or even exclusively, to other components of an entity) be considered an operating segment?

PwC response

Generally, yes. In defining an operating segment as a portion of a business that may earn revenues and incur expenses, the FASB recognized that not all business activities of a reporting entity necessarily earn revenues. While, in many cases, transfer prices are charged by one component of an entity to another, the fact that transfer prices are not assessed would not necessarily exempt such operations from being considered operating segments.

In some cases, a manufacturing entity is managed as an operating cost center and does not reflect separate revenues because overall customer revenues are not allocated to the cost centers. Provided that all the other criteria under ASC 280-10-50-1 are met, such components would be considered operating segments.

A reporting entity may have a disposal strategy that involves a "run-off" of operations (i.e., it will cease accepting new business but continue to provide service under existing contracts until they expire or are terminated). Run-off operations should be evaluated to determine if they meet the definition of an operating segment.

Example 25-1 provides an illustration of the segment determination for a component that is being run-off.

EXAMPLE 25-1

Run-off operations or operations in liquidation

FSP Corp, an insurance reporting entity, discontinues its workers' compensation line of business and is no longer writing new workers' compensation policies. However, existing customers in that line of business can continue to renew policies for indefinite periods under the original policies' conditions. The run-off operations do not meet the criteria for discontinued operations and the segment is being maintained as a result of contractual requirements. For internal reporting, separate financial results are maintained for the run-off operations and are reviewed by the CODM.

Does FSP Corp's workers' compensation line of business meet the definition of an operating segment?

Analysis

Because the operating component's performance is regularly reviewed by the CODM, it meets the definition of an operating segment. See FSP 27.5.1.4 for further discussion of the impact of a discontinued operation on segment reporting.

25.4.2 Determination of the CODM

Information regularly reviewed by the CODM is integral to identifying operating segments. Proper determination of the CODM is therefore critical to the application of ASC 280. The CODM is a function (not necessarily an individual) that allocates the resources of the reporting entity and assesses the performance of its segments.

Often, the CODM will be an individual who is either the chief executive officer (CEO) or the chief operating officer (COO). Reporting entities should carefully consider which individual is acting in this role and be able to thoroughly explain the rationale for their conclusion. While the CEO or COO may receive input from others within the reporting entity, decisions to assess performance and allocate resources are usually made by one individual. In some cases, though, the decision-making power does rest with a group and not with any specific individual within the group. When considering whether a group is the CODM function, it is important to evaluate how decisions are made, including in circumstances where not all group members agree.

In some instances, the SEC staff has questioned whether an identified individual can act alone in the CODM function when the information the CODM is represented to use to manage the business may not appear sufficient. In some of these cases, an additional member or group of members of management may be determined to be part of the CODM function.

In instances where a group of individuals or a committee with joint decision making is the CODM function, careful consideration should be given to the information that the group uses to assess performance and allocate resources. Typically as a CODM group increases in size, the amount of information at least someone in the group receives increases. Judgment is required to determine whether the information received by individual members of the CODM function should be considered part of the information that is regularly reviewed by the CODM group.

When preparing carve-out financial statements or separate financial statements of a subsidiary, determination of appropriate segment disclosures should be made at the carve-out entity or subsidiary level, which usually will not be the same as the segments reported in the parent company's consolidated financial statements. This would entail identifying the CODM at the carve-out entity or subsidiary level and determining what information that CODM regularly reviews to allocate resources and assess performance.

25.4.3 Information regularly reviewed by the CODM

To be a component, discrete financial information must be available. Discrete financial information can consist of limited operating information, such as revenue and operating expenses, and need not include balance sheet information.

Understanding all of the information the CODM regularly reviews to assess performance and allocate resources is critical regardless of the method by which the CODM receives the information. In many instances, the information used by the CODM can be found in printed reports that are distributed on a regular basis. Information could also be obtained by the CODM through the reporting entity's information systems. The CODM might also receive information in periodic meetings with segment managers.

Determining what discrete financial information the CODM uses to assess performance and allocate resources can be challenging because management typically has access to a significant amount of readily available information through the reporting entity's information systems. Information received by the CODM, regardless of how it is obtained, is generally used in some way to measure performance and/or make resource allocation decisions.

Typically, revenues, operating expenses, and profitability measures that are important to management's decision making will be available for a reporting entity's components. However, certain components may only have limited financial information, such as revenue-only data by product line or by customer. For most reporting entities, revenue-only data would not be considered sufficient financial information for decision making related to resource allocation or performance evaluation. For instance, revenue-only information may be used to allocate resources within a segment, but may not be sufficient to evaluate performance. For certain businesses however, revenue-only data may serve as an adequate surrogate as a performance measure for that component, such as where cost of sales or services are minimal.

For all businesses, it is important to obtain a thorough understanding of how the components operate, what financial information or financial ratios would be considered sufficient to measure performance, and how the CODM utilizes the full complement of information received. It is often useful to meet with the CODM to understand what information is received and how the information is used to manage operations.

Question 25-2

If a CODM is accountable for Sarbanes-Oxley 302 and 906 certifications for wholly-owned subsidiaries that issue stand-alone financial statements, would that indicate that each separate subsidiary should be treated as an operating segment in the parent company's consolidated financial statements?

PwC response

Not necessarily. The existence of Sarbanes-Oxley 302 and 906 certifications for wholly-owned subsidiaries that issue standalone financial statements does not necessarily cause the subsidiaries to be considered operating segments if the consolidated reporting entity can demonstrate that resources are allocated and performance is assessed on a different basis. This evidence may include, among other things, the reporting entity's organizational structure, financial information regularly reviewed and used by the CODM, the compensation incentives for segment management, the level of information included in capital and operating budgets and the reporting package provided to the board of directors.

For example, if a reporting entity demonstrates that a CODM regularly receives financial information at a more aggregated level than the subsidiary level at which the certifications are issued, and the CODM regularly reviews this information to assess performance and allocate resources, these more aggregated components may be considered the reporting entity's operating segments. However, in this circumstance, the reporting entity should also evaluate how the information provided to the CODM for Sarbanes-Oxley 302 or 906 certifications is being used to ensure that this information is not being used for resource allocation or performance assessment purposes.

25.4.3.1 Multiple sets of information received by the CODM

In some cases, the CODM may receive multiple sets of component information to assess the performance and allocate resources of business units. For instance, in reporting entities that are geographically dispersed and have a variety of products, it is not uncommon for the CODM to see some form of product information as well as operating results by geography. Another example could be a "drill-down" of disaggregated product information within a product category. If more than one set of segment information is used by the CODM, other factors may identify the single set of components which comprise the operating segments, including the nature of the business activities for each component, the existence of segment managers for the components, and the information presented to the board of directors.

When multiple levels of component information are reviewed, it is important to consider the composition of the underlying business activities in the different sets of components, as dissimilar business activities are often considered a starting point when identifying operating segments. An entity's business activities are usually apparent from its external communications. Business activity discussions in the reporting entity's other publicly available information, such as press releases, the reporting entity's website, and other SEC filings, are important considerations when assessing whether segment disclosures are representative of how management views the business. However external communications may not always align with how the CODM assesses performance and allocates resources. For example, if the CODM reviews operating results at a more disaggregated level, this could indicate the segments are likewise at a lower level.

Many segments are managed by a segment manager who has direct accountability to, and maintains regular contact with, the CODM. Like the CODM, the segment manager is a function and not necessarily a manager with a specific title. In some instances, a segment manager can manage more than one segment, or the CODM can also be a segment manager. Segment managers who are held accountable for the operating results of a segment usually have compensation arrangements that incorporate the segment's performance. ASC 280-10-50-8 indicates that if there is only one set of components for which segment managers are held responsible, that set of components constitutes the operating segments. However, there are times when the CODM may assess performance and allocate resources at a level lower than the immediate segment managers that report to the CODM. It would be difficult to conclude that the operating segments exist at a higher level (i.e., the level at which segment managers are identified) in cases where performance is assessed and resources are managed by the CODM at a lower level.

Additionally, if multiple sets of information are reviewed by the CODM, the information provided to the reporting entity's board of directors could indicate the level at which performance is assessed and resources are allocated. It would be unusual for the board to receive information at a level below that of a reporting entity's operating segments. Conversely, reporting entities often have operating segments at a level lower than the information reviewed by the board of directors.

Examples 25-2 and 25-3 illustrate the determination of operating segments when a CODM receives two overlapping sets of information.

EXAMPLE 25-2

Matrix form of organization

FSP Corp has identified its CEO as the CODM. In assessing performance and deciding how to allocate resources, the CEO reviews two overlapping sets of financial information. The first set contains disaggregated information based on product lines, and the second set contains disaggregated information based on geographic area. The reporting entity has vice presidents who are responsible for each of the product lines and has other vice presidents who are responsible for the geographic areas. All vice presidents report directly to the CEO. In addition, both sets of information are provided to the reporting entity's board of directors.

How should FSP Corp determine which set of financial information is most indicative of its operating segments?

Analysis

ASC 280-10-50-9 indicates that, in situations where a reporting entity has a matrix form of organization, the internal reporting based on product lines would constitute the operating segments. When two sets of information are used to assess performance and decide how to allocate resources, the operating segments should be based on the product lines. Absent compelling facts and circumstances to the contrary, operating segments based on products are deemed to provide financial statement users with the most useful information about the business activities of the reporting entity. Therefore, in this example, the product lines would most likely be the reporting entity's operating segments.

EXAMPLE 25-3

Organization with overlapping sets of information

FSP Corp operates four product lines in North America and the same four product lines in several international markets. The North American operations comprise 90% of the reporting entity's revenue. The CODM reviews two overlapping sets of financial information—the first set contains information for North America disaggregated by product lines while the second set contains worldwide information disaggregated by location (i.e., each worldwide location, including North America). The reporting entity has vice presidents who are responsible for each of the four North American product lines as well as a vice president responsible for the North American market and a vice president responsible for the remaining international markets. All vice presidents report directly to the CODM. In addition, both sets of information are provided to the reporting entity's board of directors.

How should FSP Corp determine which set of financial information is most indicative of its segments?

Analysis

Although product lines would typically constitute the operating segments, there could be circumstances where a combination of the product lines and geographic locations are identified as operating segments. In this example, each of the four product lines in North America are most likely the operating segments. Each of the international locations may be an operating segment, depending on the level at which performance is reviewed and resources are allocated by the CODM, or the international market itself may be an operating segment.

25.4.3.2 *Investments in unconsolidated entities*

Reporting entities may have investments in unconsolidated entities that meet the definition of an operating segment. The assessment is the same as when determining all other segments, (i.e., evaluate the reporting information used by the CODM to assess performance and allocate resources).

Example 25-4 illustrates the determination of whether activities of a reporting entity conducted through joint venture arrangements or equity method investees are operating segments.

EXAMPLE 25-4

Joint venture arrangements and equity method investees

FSP Corp is a multinational telecommunications provider whose foreign wireless-service businesses are jointly owned by FSP Corp and various foreign companies. FSP Corp is not the sole shareholder of the foreign businesses due to local restrictions on U.S. companies having a majority ownership. FSP Corp accounts for these joint venture arrangements using the equity method. The CODM, however, reviews the full financial results of each joint venture for decision-making purposes and a vice president is in charge of managing and monitoring the foreign wireless services.

Do the joint venture operations qualify as operating segments?

Analysis

To the extent FSP Corp manages its joint venture operations separately and conditions (a) through (c) of ASC 280-10-50-1 are met (see FSP 25.4), the joint venture operations would qualify as operating segments. When the full financial results of an equity method investee are reviewed by the CODM, the asset and operating measures regularly reviewed would be disclosed.

If the financial results reviewed by the CODM are prepared on a proportionate basis (i.e., based on FSP Corp's proportionate ownership of the investee), the external segment reporting of the joint venture activities should also be presented on a proportionate basis.

Since the total of all segments' financial amounts must be reconciled to the corresponding amounts reported in the consolidated financial statements, appropriate eliminations would need to be reflected to reconcile amounts reported for segment purposes to those amounts reflected in the consolidated financial statements. For example, since the joint ventures' revenue information is not included in the revenue amount reported in the consolidated financial statements under the equity method, an elimination of the revenue amount disclosed for the joint ventures would need to be reflected as a reconciling item. For further guidance on the presentation of reconciling items in segment disclosures, see FSP 25.7.5.

The analysis would be the same for an equity method investment that is not a joint venture.

To the extent that segment disclosures are provided for separately managed joint ventures or other equity method investees, such disclosures would not necessarily satisfy the disclosure requirements of ASC 323. ASC 323-10-50-3(c) requires that summarized financial information of joint ventures and other investments accounted for under the equity method be provided, if certain thresholds are met. Accordingly, the disclosures required by ASC 323 may need to be provided in addition to any segment disclosures.

25.5 Aggregation

Once the operating segments of a reporting entity are determined, the guidance permits aggregation of two or more operating segments if they exhibit similar economic characteristics and other operating similarities.

ASC 280-10-50-11 details the criteria that must be met in order to aggregate operating segments.

Excerpt from ASC 280-10-50-11

Operating segments often exhibit similar long-term financial performance if they have similar economic characteristics. For example, similar long-term average gross margins for two operating segments would be expected if their economic characteristics were similar. Two or more operating segments may be aggregated into a single operating segment if aggregation is consistent with the objective and basic principles of this Subtopic, if the segments have similar economic characteristics, and if the segments are similar in all of the following areas:

a. The nature of the products and services

b. The nature of the production processes

c. The type or class of customer for their products and services

d. The methods used to distribute their products or provide their services

e. If applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities.

The FASB decided that if operating segments have characteristics so similar that they were expected to have essentially the same future prospects, separate reporting of segment information would not add significantly to an investor's understanding of the reporting entity. Therefore, aggregation of two or more operating segments is permitted if they have similar economic characteristics (referred to in this chapter as the quantitative aggregation criteria) and have similarity in all of the areas identified in ASC 280-10-50-11 (referred to in this chapter as the qualitative aggregation criteria). However, a reporting entity is not required to aggregate operating segments even if all of the aggregation conditions are met.

Through comment letters to registrants and its public statements, the SEC staff has stressed that meeting the quantitative and qualitative criteria is a high hurdle and their tolerance for differences in performance metrics and other qualitative characteristics is relatively low when assessing whether operating segments can be aggregated.

25.5.1 Quantitative aggregation criteria

The similarity of economic characteristics of two operating segments should be carefully evaluated from both a historical and expected future performance perspective. In practice, several years of historical and several years of estimated future financial data are typically used for purposes of this evaluation. A reporting entity should consider not only the similarity of financial performance but also the economic conditions, exchange control regulations, and underlying currency risks. If a reporting entity cannot demonstrate similar economic characteristics, then aggregation is not permitted. That is, it would not be appropriate to rely on the similarity of the qualitative aggregation criteria provided by ASC 280-10-50-11 to aggregate operating segments if they do not meet the quantitative criteria.

For example, assume a reporting entity sells centrally produced, identical products to similar classes of customers in two different countries in which the regulatory environments are the same. Operating results for each country are separately reported internally and meet the qualitative aggregation criteria. However, due to differences in selling price, and therefore profit margin, as well as differences in currency risk and exchange control, it may be difficult to support an assertion of similar economic characteristics. As a result, it may be challenging to support aggregating the individual country segments.

Through comments to registrants, the SEC staff has questioned whether the "similar economic characteristics" test was met when measuring the difference in financial performance between operating segments. We believe a reporting entity should consider the relative percentage difference of the operating measure and not just the absolute difference. For example, where the CODM uses gross margin to evaluate operating segment performance, the difference between a gross margin of 55 percent and 50 percent is a 5 percent absolute value difference, but represents a 10 percent relative difference. Although there is no "bright line" when assessing similarity, operating segments with differences between performance measures of 5 percent or less likely would be considered economically similar, whereas differences in excess of 10 percent may not meet the economic similarity criterion for aggregation.

While the similarity of long-term average gross margins is a particularly important factor and is included as an example in ASC 280-10-50-11, when a reporting entity is determining whether the economic characteristics of its segments are similar, other relevant factors should also be considered. For instance, the similarity of the performance measures that are regularly provided to the CODM, as well as other performance factors such as trends in sales growth, returns on assets employed, and operating cash flow should also be evaluated. Competitive and operating risks associated with each segment should be considered as these factors could impact prospective results of the segments. Two or more operating segments considered to have similar long-term performance should be impacted similarly by events that have significant economic consequences.

Management should document its basis for concluding that operating segments are economically similar and should update the analysis on an annual basis, or more frequently if conditions that affect economic similarity change. In some circumstances, "temporary" dissimilarity (in economic characteristics) among operating segments may not necessarily preclude aggregation of operating segments if long-term economic similarity can still be demonstrated based on credible projections of future operations. Accordingly, a current change in operating performance may not necessarily result in a change to the composition of the reportable segments.

A reporting entity should monitor and consider whether its segment determinations are consistent with its publicly available information and disclosures. For example, press releases, investor presentations, analyst conference calls, and non-financial statement sections of SEC filings often include information regarding the nature of products and services, the type and class of customers, and how the reporting entity addresses its various market segments. If such information is not consistent with a reporting entity's segment determinations, it may call into question those segment determinations.

Question 25-3

Assuming all other qualitative aggregation criteria are met, would a reporting entity be precluded from aggregating a start-up business with mature businesses based solely on the fact that the current economic characteristics of the start-up business differ from those of its mature businesses?

PwC response

No. One of the objectives of requiring disclosures about segments is to help users assess the future prospects of a reporting entity's business. Further, ASC 280-10-50-11 indicates that segments with similar economic characteristics often exhibit similar long-term financial performance. Accordingly, to the extent that the future financial performance (including the competitive and operating risks) of the start-up business is expected to be similar to that of a reporting entity's mature businesses in the near term, the economic characteristics requirement for aggregation would be satisfied.

For example, a retail chain may have mature store locations in five major cities. In the current year, the retail chain opens additional stores in those cities. Each store constitutes a separate operating segment because the CODM of the retail chain reviews financial results and makes decisions on a store-by-store basis. The retail stores meet all of the qualitative aggregation criteria. Typically, the economic characteristics of a new store quickly match the characteristics of a mature store. These "start-up" stores may meet the economic similarities requirement for aggregation with mature stores if management can establish that the financial performance of the mature and new stores are expected to converge in the near term.

Question 25-4

Assuming all other qualitative aggregation criteria are met, would a reporting entity be precluded from aggregating a newly acquired operating segment with its existing operating segment if the historical economic characteristics of the acquired operating segment are not similar?

PwC response

It depends. The differing historical results of the newly acquired operating segment compared to the reporting entity's existing operating segment may indicate that the economic characteristics of the two operating segments are not similar. However, further analysis of future performance expectations should be considered. Since the reporting entity has limited operating results for the newly acquired operating segment, and the seller's historical results may not be relevant, the reporting entity would need to evaluate the newly acquired operating segment's future prospects. This evaluation would include the newly acquired operating segment's budget and the actions that management has taken or expects to take shortly after the acquisition. There should also be an evaluation of the achievability of management's proposed changes to the acquired operating segment. If, after evaluating the future prospects, the two operating segments are expected to be economically similar within the near term, the two operating segments may be aggregated.

25.5.2 Qualitative aggregation criteria

Operating segments must also be similar in five qualitative areas (i.e., criteria (a) through (e) of 280-10-50-11) to be aggregated. The qualitative criteria are equally applicable to reporting entities with components organized based on products or services and those organized by geographic area.

ASC 280 includes the following five qualitative areas:

The nature of products and services

Products and services are generally similar when they have the same customer utility. For example, two operating segments that produce products that can be substituted for each other may be considered similar.

Operating segments that represent different components of a vertically integrated operation require judgment and typically should not be aggregated solely on the basis that they comprise a single end product or service. This is because the specific product or service that each of the vertically integrated segments contributes to the end product could differ. The operations that produce each component of the end product should be evaluated separately, particularly if there is a separate market for each of the components.

The nature of production processes

Production processes include not only the types of machinery and facilities that produce a specific product, but also the types of labor and raw materials used in the production process. Production processes are often similar if segments (which sell similar products) produce the products in a central manufacturing facility. When operating segments source all or most of their products from external suppliers, the production processes of the outsourced items should be evaluated.

For reporting entities that provide services, the similarity of the service delivery process and the training and skills of the employees delivering the services should be evaluated.

The type or class of customer for the products and services

The type or class of customer may be distinguished by several different factors, including the customer's industry, use of the product and service, purchasing power and location, and the sales and marketing approach directed to the customer. Often, similar classes of customers will react to changes in economic events in a similar fashion.

The methods used to distribute the products or services

For a reporting entity with product sales, different methods of distribution could be used for sales directly to end users versus those to wholesalers or distributors. Methods of distribution to end users should further be evaluated for similarities or differences based on whether the sales are made through the internet, by catalog, or through retail locations.

If applicable, the nature of the regulatory environment

Many industries and services have specific regulations to which they are subject. The regulatory environment criterion applies to those situations where a unique regulatory environment relating to each operating segment exists. For example, in a situation where a reporting entity has a banking segment and an insurance segment, each part of the business operates in a unique regulatory environment. In some cases, different regulatory agencies may still be considered similar if the nature and extent of the regulation are alike.

Example 25-5 provides an illustration of the regulatory environment qualitative criterion.

EXAMPLE 25-5

Understanding the regulatory environment criterion

FSP Corp is a liquor retailer that operates stores in the New York and Florida regions. The state regulations for liquor retailers differ from state to state (e.g., licensing, purchases, days of operation). However, the economic characteristics are similar, as are the nature of the products, production process, type of customer, and distribution methods. For internal purposes, management prepares, and the CODM reviews, separate financial results for each region (New York and Florida). The principal reason for preparing the results separately is to maintain the information necessary to comply with state requirements and for tax-return preparation purposes.

Could FSP Corp aggregate the New York and Florida segments?

Analysis

While the Florida and New York regions are each operating segments, FSP Corp would not be precluded from combining these segments solely on the basis that the state regulations differ. In this case, while the specific regulations may vary by state, the nature of regulation (i.e., controlling the sale of liquor products) is the same in New York and Florida.

25.6 Quantitative thresholds

Once a reporting entity identifies its operating segments and determines whether aggregation is appropriate, it should determine which of those operating segments (or aggregated operating segments) are required to be presented as reportable segments based upon the quantitative thresholds established by ASC 280-10-50-12 (referred to in this chapter as the 10 percent tests and the 75 percent revenue test). In addition, a reporting entity should identify any operating segment (or aggregation of operating segments) that it will elect to present as a reportable segment even though it is not required to be reported based on these quantitative thresholds.

25.6.1 The 10 percent tests

The 10 percent tests established by ASC 280-10-50-12 are as follows:

Excerpt from ASC 280-10-50-12

A public entity shall report separately information about an operating segment that meets any of the following quantitative thresholds:

a. Its reported revenue, including both sales to external customers and intersegment sales or transfers, is 10 percent or more of the combined revenue, internal and external, of all operating segments.

b. The absolute amount of its reported profit or loss is 10 percent or more of the greater, in absolute amount, of either:

    1. The combined reported profit of all operating segments that did not report a loss

    2. The combined reported loss of all operating segments that did report a loss.

c. Its assets are 10 percent or more of the combined assets of all operating segments.

Operating segments that do not meet any of the quantitative thresholds may be considered reportable, and separately disclosed, if management believes that information about the segment would be useful to readers of the financial statements.

The 10 percent tests are based on the reported measures of revenue, profit, and assets that are used by the CODM to assess performance and allocate resources. A reporting entity must separately report a segment if the operating segment (or aggregated operating segment) meets any of the 10 percent tests.

Revenue

The revenue test should be evaluated based on the reported measure of segment revenue, which may include or be comprised entirely of intersegment revenues. If a segment's reported revenue is 10 percent or more of the reporting entity's combined revenue, the segment is a reportable segment. Combined revenue is the sum of all operating segment revenue, including intersegment revenue, which may be greater than the reporting entity's consolidated revenues.

Profit

The profit test is based on the absolute amount of the reported profit or loss for each segment. If a segment's absolute amount of profit or loss is 10 percent or more of the greater of either (1) the combined loss of all operating segments that reported a loss, or (2) the combined profit of all operating segments that reported a profit, then the segment is a reportable segment. This test will usually yield different results than simply comparing the operating segment's profit or loss to consolidated profit or loss. An example is shown in Figure 25-2 below:

Figure 25-2
Example of segment profit test

Operating segment	Reported profit or (loss)	(Absolute value of reported profit or loss) / (absolute value of the greater of combined reported profit of all segments that did not report a loss or combined reported loss of all segments that reported a loss)	Is the operating segment a reportable segment?
A	$112	50%	Yes
B	$(15)	7%	No
C	$90	40%	Yes
D	$21	9%	No

Operating segment	Reported profit or (loss)	(Absolute value of reported profit or loss) / (absolute value of the greater of combined reported profit of all segments that did not report a loss or combined reported loss of all segments that reported a loss)	Is the operating segment a reportable segment?
Consolidated profit	**$208**		
Combined profit of all segments that did not report a loss	$223		
Combined loss of all segments that reported a loss	$(15)		

Assets

The asset test is based on segment assets reported to the CODM. If a segment's reported assets are 10 percent or more of the combined assets of all operating segments, the segment is a reportable segment. This test may yield different results than simply comparing the segment's total assets to consolidated assets. If a CODM does not review asset information, this test may not be applicable.

If different measures are reported by different segments, a consistent measure should be utilized to perform the 10 percent tests. Example 25-6 provides an illustration of how the 10 percent tests are applied when a reporting entity's operating segments report different measures of segment profitability and assets.

EXAMPLE 25-6

Performing the 10 percent tests when profitability and asset measures are not the same for all segments

FSP Corp has three operating segments, none of which can be combined under the aggregation criteria. The following is reported to the CODM:

- Segment 1 measures profitability based on operating income, with pension expenses reported on the cash basis. Segment 1 is the only segment for which pension expense is reported (i.e., while the other segments do provide pension benefits, they are not allocated any pension expense). Asset information is limited to the presentation of accounts receivable.

- Segment 2 measures profitability based on pretax income, which includes an internal cost-of-capital amount charged by "corporate" only to Segment 2. Asset information is limited to the presentation of accounts receivable and fixed assets.

- Segment 3 measures profitability based on after-tax income. Asset information is limited to the presentation of accounts receivable.

All segments of the reporting entity are profitable.

How should FSP Corp evaluate the operating segments using the 10 percent tests?

Analysis

If segments are evaluated based on different measures of profit or loss, the criterion of ASC 280-10-50-12(b) should be applied to a consistent measure of profit or loss that is determined for each segment even if that measure is not regularly provided to the CODM for all segments. In the above example, since operating income is available for all segments, it may be the most consistent measure for performing the 10 percent profit test.

Accounts receivable would be the most consistent asset measure on which to perform the 10 percent tests, as it is the only asset measure reviewed by the CODM. See Example 25-8 for a discussion of the 10 percent tests when no asset information is reviewed by the CODM.

Question 25-5

Are reporting entities required to apply the 10 percent tests to their operating segments when determining their reportable segments for each interim period?

PwC response

Generally, the composition of reportable segments does not change absent an internal reorganization; therefore, a reporting entity need not apply the quantitative thresholds in each interim period. However, if facts and circumstances would suggest that the application of the quantitative thresholds would reveal additional reportable segments, those segments may need to be disclosed as new reportable segments. For example, a segment that was previously immaterial (i.e., did not meet the 10 percent tests) but now meets the 10 percent tests should be disclosed if management expects the segment will continue to be significant. A reporting entity may consider whether aggregation with other operating segments is appropriate. The reporting entity's prior years' interim segment information that is presented for comparative purposes must be revised to reflect the new reportable segment, unless impracticable.

Question 25-6

How should the 10 percent tests be applied in determining the significance of an operating segment that is comprised solely of an equity method investment?

PwC response

The 10 percent tests for both segment profitability and assets would be measured using the amounts that most closely correspond to the amounts reflected in the reporting entity's consolidated financial statements. We believe the 10 percent revenue test is not applicable since equity method investments are presented as a net amount on both the balance sheet and income statement. The 10 percent revenue test would require the reporting entity to gross up a proportionate share of the investee's external revenues, which is not consistent with the measurements reflected in the reporting entity's consolidated financial statements.

As indicated in ASC 280-10-55-2, reporting entities are not precluded from voluntarily disclosing those operating segments comprised solely of equity method investments that, although not required to be reported based on the 10 percent tests, may contribute to a user's understanding of the reporting entity.

25.6.1.1 Immaterial operating segments

Immaterial operating segments and immaterial groups of aggregated operating segments (i.e., those that do not meet the 10 percent tests) may be combined with other immaterial operating segments to produce a reportable segment only if all three of the following are true:

- The aggregation is consistent with the objective and basic principles of ASC 280
- The segments have similar economic characteristics
- The operating segments share a majority of the qualitative aggregation criteria in ASC 280-10-50-11

Question 25-7

In order to aggregate two or more operating segments that do not individually meet the 10 percent tests, do the immaterial operating segments need to share a majority of all of the items included in ASC 280-10-50-11, including similar economic characteristics?

PwC response

According to ASC 280-10-50-13, immaterial operating segments must always have similar economic characteristics and meet a majority of the remaining five aggregation criteria included in ASC 280-10-50-11 to produce a reportable segment. When immaterial operating segments are not aggregated because they do not meet these criteria, the immaterial operating segments should be combined and disclosed in an "all other" category (assuming the 75 percent revenue test, as discussed in FSP 25.6.2, has been met). The "all other" category is presented separately from other reconciling items in the reconciliation required for segment disclosures. See FSP 25.7.5 for a discussion of reconciliations.

25.6.2 The 75 percent revenue test

ASC 280-10-50-14 requires that reportable segment external revenues aggregate to at least 75 percent of a reporting entity's consolidated revenue. If aggregate reported revenue is less than this threshold, additional reportable segments should be identified, even if those additional segments do not meet the 10 percent tests, until at least 75 percent of consolidated revenue is included in reportable segments. While the 10 percent revenue test to identify reportable segments is based on the measure of revenue used by the CODM to assess performance and allocate resources, the 75 percent revenue test is based on a reporting entity's consolidated revenue.

ASC 280 does not provide guidance as to which otherwise non-reportable operating segments should be selected as reportable segments to achieve the "75 percent threshold." Accordingly, although we would expect a reporting entity to select the most meaningful operating segments, which could be the largest in terms of revenue, the reporting entity may choose any segment and not necessarily the next largest. For example, while a reporting entity with five operating segments that comprise 74 percent, 9 percent, 8 percent, 7 percent, and 2 percent of consolidated revenue, respectively, could choose to separately disclose any one or more of the four latter segments in addition to the first segment to achieve the 75 percent revenue test requirement, we believe the reporting entity should consider what is most meaningful to the financial statement users.

ASC 280-10-50-18 also indicates there may be a practical limit to the number of reportable segments.

ASC 280-10-50-18

There may be a practical limit to the number of reportable segments that a public entity separately discloses beyond which segment information may become overly detailed. Although no precise limit has been determined, as the number of segments that are reportable in accordance with paragraphs 280-10-50-12 through 50-17 increases above 10, the public entity should consider whether a practical limit has been reached.

A reporting entity may not limit the number of reportable segments to 10 segments if it has not met the 75 percent revenue test. In particular, ASC 280-10-50-14 states that "additional operating segments shall be identified as reportable segments until at least 75 percent of total consolidated revenue is included in reportable segments." Accordingly, if a reporting entity has 20 different operating segments, all of which are the same size and none of which meet the aggregation criteria in ASC 280-10-50-11, it would be expected to disclose at least 15 operating segments as reportable (i.e., 15 segments each having 5 percent of consolidated revenue).

25.6.3 "All other" category

The remaining non-reportable segments and other business activities that are not identified as operating segments should be combined and disclosed in an "all other" standalone category. Non-reportable segments should not be combined with a reportable segment unless the aggregation criteria in ASC 280-10-50-11 have been met. The "all other" category should be presented alongside the reporting entity's reportable segments. However, the "all other" category should not be identified as a reportable segment itself. Additionally, the "all other" category should not include nor be a part of the other reconciling items. See FSP 25.7.5 for further discussion of reconciling items that are needed to bridge the totals from reportable segments and the "all other category" to consolidated financial statement totals.

While ASC 280 allows for combined reporting of non-reportable segments in an "all other" category, a reporting entity is not precluded from separately presenting an operating segment that is below the quantitative thresholds if the reporting entity believes it is important to financial statement users.

25.7 Disclosures

Disclosures are required by ASC 280 for each period for which an income statement is presented, except for reconciliations of balance sheet amounts (which are required only for each year that a balance sheet is presented). Although a suggested format is presented in ASC 280-10-55-48, the guidance allows for flexibility. The segment disclosures follow the management approach, meaning it shows the measures used by the CODM to assess performance and allocate resources. As such, adjustments, eliminations, and allocations that are made in the preparation of information for use by the CODM should be included in the reported segment information.

ASC 280 requires disclosure of certain general information related to segments. This includes information about the factors used to identify reportable segments, the types of products and services from which segments generate revenues, and whether operating segments have been aggregated.

In addition, ASC 280 requires disclosure of the following:

- Information about profit or loss and assets — This includes disclosures of the asset and certain income statement captions, including the performance measures regularly reviewed by the CODM.

- Information about investments and expenditures — This includes disclosures about investments in equity method investees and expenditures for additions to long-lived assets.

- Information about the measurement of segment profit or loss and assets — This includes disclosures about transactions between segments, differences between segments, changes from prior year measurements, and asymmetrical segment allocations.

- Reconciliations — This includes disclosures of reconciliations of the specific segment information to the amounts included in the consolidated financial statements.

- Entity-wide information — This includes disclosures of financial and other qualitative information categorized based on products and services, geographic areas, and customers if not already provided elsewhere in the segment disclosures.

25.7.1 General information

ASC 280-10-50-21 provides the requirements for general segment information disclosures.

Excerpt from ASC 280-10-50-21

A public entity shall disclose the following general information:

a. Factors used to identify the public entity's reportable segments, including the basis of organization (for example, whether management has chosen to organize the public entity around differences in products and services, geographic areas, regulatory environments, or a combination of factors and whether operating segments have been aggregated)

b. Types of products and services from which each reportable segment derives its revenues.

If a reporting entity combines non-reportable operating segments into an "all other" category, the types of products and services within the "all other" category should also be disclosed.

25.7.2 Information about profit or loss and assets

ASC 280-10-50-22 through 50-24 provides the required disclosures for segment profit or loss and assets.

Excerpt from ASC 280-10-50-22

A public entity shall report a measure of profit or loss and total assets for each reportable segment. A public entity also shall disclose all of the following about each reportable segment if the specified amounts are included in the measure of segment profit or loss reviewed by the chief operating decision maker or are otherwise regularly provided to the chief operating decision maker, even if not included in that measure of segment profit or loss:

a. Revenues from external customers

b. Revenues from transactions with other operating segments of the same public entity

c. Interest revenue

d. Interest expense

e. Depreciation, depletion, and amortization expense

f. Unusual items as described in paragraph 225-20-45-16

g. Equity in the net income of investees accounted for by the equity method

h. Income tax expense or benefit

i. Extraordinary items

j. Significant noncash items other than depreciation, depletion, and amortization expense.

A public entity shall report interest revenue separately from interest expense for each reportable segment unless a majority of the segment's revenues are from interest and the chief operating decision maker relies primarily on net interest revenue to assess the performance of the segment and make decisions about resources to be allocated to the segment. In that situation, a public entity may report that segment's interest revenue net of its interest expense and disclose that it has done so.

ASC 280-10-50-23

Disclosure of interest revenue and interest expense included in reported segment profit or loss is intended to provide information about the financing activities of a segment.

ASC 280-10-50-24

If a segment is primarily a financial operation, interest revenue probably constitutes most of segment revenues and interest expense will constitute most of the difference between reported segment revenues and reported segment profit or loss. If the segment has no financial operations or only immaterial financial operations, no information about interest is required.

Any of the segment information specified in ASC 280-10-50-22 that is regularly provided to the CODM would need to be disclosed, even if the performance measure used by the CODM does not include such items. For example, if operating income is the measure of segment profitability used by the CODM to assess performance but segment interest expense is regularly reported to the CODM, segment interest expense should be disclosed because interest expense is one of the specific items identified for disclosure in ASC 280-10-50-22.

As noted in ASC 280, the disclosures are required at the reportable segment level. However, a reporting entity is not precluded from disclosing this information at a more detailed level if the more detailed presentation meets the objectives of ASC 280. For example, a reportable segment with three different but similar external revenue streams can choose to voluntarily provide disclosure of the different revenue streams.

Example 25-7 provides an illustration of when a reporting entity may need to separately report information that is not individually reported to the CODM but included in the performance measure used by the CODM.

EXAMPLE 25-7

Disclosing depreciation and amortization expense

FSP Corp internally reports the following discrete financial information to its CODM: revenue, operating income, total assets, volumes, and various industry statistics. Depreciation and amortization expense are components of both (1) cost of sales and (2) selling, general, and administrative expense, none of which is identified and reported separately to the CODM, but are included in operating income. Operating income is the measure of segment profitability used by the CODM to assess performance and allocate resources of the segments.

Is FSP Corp required to disclose depreciation and amortization expense for its reportable segments?

Analysis

Yes. ASC 280-10-50-22 requires the disclosure of specified items that are included in the measurement of segment profit or loss that is reviewed by the CODM, notwithstanding the fact that the individual items may not be separately identified for the CODM. Therefore, separate disclosure of depreciation and amortization expense by reportable segment is required since depreciation and amortization are components of operating income (i.e., the measure of profit or loss used by the CODM).

Also, if the measure of segment profit or loss regularly reviewed by the CODM did not include depreciation and amortization, but depreciation and amortization were provided separately to the CODM, then the amounts would still need to be disclosed.

Operating segment-level asset information provided to the CODM is required to be disclosed and included in the 10 percent asset test calculation consistent with ASC 280-10-55-12 through 55-15, which indicates that items required by paragraph ASC 280-10-50-22 and 50-25 that are regularly provided to the CODM must be disclosed. In some instances, a reporting entity's CODM may not receive total assets information for each segment. For example, the CODM may only receive select asset data, such as inventory and accounts receivable. In this instance, total assets need not be disclosed for each reportable segment but, rather, the sum of inventory and accounts receivable must be disclosed. This total should be disclosed as "segment assets," and the total segment assets should be reconciled to the reporting entity's total consolidated assets. A reporting entity should also disclose the composition of "segment assets."

Ratios or a combination of financial information may be regularly reviewed by the CODM. For example, a reporting entity's CODM may review net working capital but not its gross components (i.e., current assets and current liabilities). Although working capital has an asset component, the current asset component is not what is used by the CODM to assess performance and allocate resources. Therefore, the asset information is not required to be reported, nor is working capital required to be disclosed. Nonetheless, a reporting entity could elect to voluntarily report net working capital by reportable segment if it meets the objectives and basic principles of ASC 280. If it does so, the total of all reportable segments' working capital should be reconciled to total consolidated working capital.

If no asset information is disclosed for a reportable segment, the fact and reason should be disclosed. Example 25-8 provides an illustration of segment reporting considerations when asset information is not provided to the CODM.

EXAMPLE 25-8

Reporting considerations when asset information is not provided to the CODM

FSP Corp internally reports the following financial information to its CODM for each of its operating segments: revenues, operating income, net income, volumes, and various industry statistics. Asset and other balance sheet information are not reported to the CODM.

Is FSP Corp still required to disclose asset information for its reportable segments since that information is not reported to the CODM?

Analysis

No. Because asset information is not provided to the CODM, the reporting entity would not be required to report segment asset information. In addition, when identifying reportable segments, the reporting entity cannot perform the asset-based 10 percent test. ASC 280-10-50-27 states that "only those assets that are included in the measure of the segment's assets that is used by the chief operating decision maker shall be reported for that segment." If asset information is not reported, the fact and the reasons for not providing the information should be disclosed.

However, the disclosure of long-lived assets by geographic area is required pursuant to the entity-wide disclosure requirements of ASC 280-10-50-41, even if such information is not provided to the CODM. See FSP 25.7.6.

25.7.3 *Information about investments and expenditures*

ASC 280-10-50-25 provides the required segment disclosures for investments in equity method investees and expenditures for additions to long-lived assets.

Excerpt from ASC 280-10-50-25

A public entity shall disclose both of the following about each reportable segment if the specified amounts are included in the determination of segment assets reviewed by the chief operating decision maker or are otherwise regularly provided to the chief operating decision maker, even if not included in the determination of segment assets:

a. The amount of investment in equity method investees

b. Total expenditures for additions to long-lived assets other than any of the following:

   1. Financial instruments
   2. Long-term customer relationships of a financial institution
   3. Mortgage and other servicing rights
   4. Deferred policy acquisition costs
   5. Deferred tax assets.

ASC 280 requires these investment and expenditure disclosures because they improve a financial statement user's ability to estimate the cash-generating potential and cash requirements of reportable segments.

An example disclosure is included in ASC 280-10-55-48, which illustrates a suggested format for certain disclosures required by ASC 280-10-50-22 and ASC 280-10-50-25.

25.7.4 *Information about the measurement of segment profit or loss and assets*

ASC 280-10-50-29 provides the disclosure requirements for information about the measurement of segment profit or loss and assets.

Excerpt from ASC 280-10-50-29

A public entity shall provide an explanation of the measurements of segment profit or loss and segment assets for each reportable segment. At a minimum, a public entity shall disclose all of the following:

a. The basis of accounting for any transactions between reportable segments.

b. The nature of any differences between the measurements of the reportable segments' profits or losses and the public entity's consolidated income before income taxes, extraordinary items, and discontinued operations (if not apparent from the reconciliations described in paragraphs 280-10-50-30 through 50-31). Those differences could include accounting policies and policies for allocation of centrally incurred costs that are necessary for an understanding of the reported segment information.

c. The nature of any differences between the measurements of the reportable segments' assets and the public entity's consolidated assets (if not apparent from the reconciliations described in paragraphs 280-10-50-30 through 50-31). Those differences could include accounting policies and policies for allocation of jointly used assets that are necessary for an understanding of the reported segment information.

d. The nature of any changes from prior periods in the measurement methods used to determine reported segment profit or loss and the effect, if any, of those changes on the measure of segment profit or loss.

e. The nature and effect of any asymmetrical allocations to segments. For example, a public entity might allocate depreciation expense to a segment without allocating the related depreciable assets to that segment.

In instances where the measure of segment profitability is not consistent across operating segments, the reporting entity should provide a description of how segment profitability is measured for each reportable segment.

In instances where the CODM uses more than one measure to assess performance and allocate resources, the reporting entity should determine which measure is most consistent with that presented in the consolidated financial statements and disclose that measure as the reported segment profitability measure. For example, assume the CODM of the reporting entity uses both operating income and pretax income to assess performance and allocate resources. Segment operating profit is determined based on the same measurement principles that are used in the determination of consolidated operating profit. However, segment pretax income includes certain internal cost-of-capital charges that are eliminated in consolidation. In this situation, segment operating profit should be the measure reported externally because operating profit most closely aligns with the measure reported in the consolidated financial statements. If segment pretax income was determined based on the same measurement principles as consolidated pretax income, then segment pretax income would be the measure reported externally as this is the measure that is most similar to consolidated pretax income, which is the measure ASC 280-10-50-30(b) requires to be reconciled to segment profit/loss.

In either case, disclosures should be made for interest income and expense because that information is included in the pretax income measure provided to the CODM (consistent with ASC 280-10-55-12 through 55-15). The disclosure requirements specific to segment interest income and expense are discussed in FSP 25.7.2.

Question 25-8

Because the premise of the "management" approach is that external segment reporting should correspond to a reporting entity's internal reporting, would segment information need to be modified if a reporting entity's internal reporting is not in conformity with U.S. GAAP?

PwC response

No. ASC 280 requires information to be reported on the same basis it is reported internally, even if the segment information is not in conformity with U.S. GAAP or the accounting policies used in the consolidated financial statements. Examples of such situations include segment information reported on a cash basis or on a local U.S. GAAP basis for segments comprised of foreign subsidiaries, or when management uses EBITDA as its measure of segment profitability. The reporting entity should disclose the nature of any differences between the segment's measurements of profit or loss and assets and those measurements used in the consolidated financial statements for each reportable segment as prescribed by ASC 280-10-50-29.

25.7.5 Reconciliations

Certain information included in the segment disclosures must be reconciled to the reporting entity's consolidated financial measures. ASC 280-10-50-30 through 50-31 provide the requirements for these reconciliations.

Excerpt from ASC 280-10-50-30 through 50-31

A public entity shall provide reconciliations of all of the following:

a. The total of the reportable segments' revenues to the public entity's consolidated revenues.

b. The total of the reportable segments' measures of profit or loss to the public entity's consolidated income before income taxes, extraordinary items, and discontinued operations. However, if a public entity allocates items such as income taxes and extraordinary items to segments, the public entity may choose to reconcile the total of the segments' measures of profit or loss to consolidated income after those items.

c. The total of the reportable segments' assets to the public entity's consolidated assets.

d. The total of the reportable segments' amounts for every other significant item of information disclosed to the corresponding consolidated amount. For example, a public entity may choose to disclose liabilities for its reportable segments, in which case the public entity would reconcile the total of

> reportable segments' liabilities for each segment to the public entity's consolidated liabilities if the segment liabilities are significant.
>
> All significant reconciling items shall be separately identified and described. For example, the amount of each significant adjustment to reconcile accounting methods used in determining segment profit or loss to the public entity's consolidated amounts shall be separately identified and described.

Reconciliations related to segment revenue and profit measures are required for each year an income statement is presented, and reconciliations of balance sheet amounts are required only for each year that a balance sheet is presented. An example is included in ASC 280-10-55-49, which illustrates the disclosures required by ASC 280-10-50-30(a) through (c).

Question 25-9

If a reporting entity's measure of segment profitability is net income, should the total of segment net income be reconciled to the total consolidated net income or to the total consolidated pretax income?

PwC response

ASC 280-10-50-30(b) allows a reporting entity whose measure of segment profitability is below the pretax income line (e.g., net income) to reconcile that measure, in aggregate for its reportable segments, to the corresponding consolidated total or the consolidated pretax total. In this case, we believe that the more meaningful presentation would be a reconciliation of the total of segment net income to the total consolidated net income.

ASC 280-10-50-30(b) requires that measures of segment profitability that are above the pretax line (e.g., operating profit) be reconciled to consolidated pretax income.

Question 25-10

Can a reporting entity reconcile a non-GAAP measure of segment profitability, e.g., EBITDA, to a reporting entity's consolidated EBITDA, if that measure is further reconciled to pretax income?

PwC response

No. Although ASC 280 recognizes that a segment measure of profitability may be a measure that is not a traditional U.S. GAAP measure, ASC 280 does not permit reconciliation to a consolidated non-GAAP measure. For example, the following presentation would not be appropriate.

Reportable segment 1 EBITDA	$200
Reportable segment 2 EBITDA	150

Reportable segment 3 EBITDA	100
Subtotal reportable segments	450
Unallocated corporate overhead	(50)
Unallocated pension expense	(20)
Consolidated EBITDA	$380
Depreciation and amortization	(30)
Interest	(50)
Consolidated pretax income	$300

It is not appropriate to present the "Consolidated EBITDA" amount (i.e., $ 380), while it would be acceptable to present the "Subtotal reportable segments" amount (i.e., $450).

Although Regulation S-K 10(e)(1)(ii)(C) precludes non-GAAP measures in the financial statements or financial statement footnotes, this prohibition is not applicable to measures of segment profitability as such measures are required to be disclosed by U.S. GAAP. However, this rule would preclude use of consolidated EBITDA, as presented in the above reconciliation, as such disclosure is not required by U.S. GAAP.

25.7.6 Entity-wide disclosures

The guidance requires certain entity-wide disclosures, which include information about a reporting entity's products and services, geographic areas, and major customers. In some cases, these requirements may already be met through other disclosures in the standard. ASC 280 requires these entity-wide disclosures even if this information is not reviewed by the CODM, and even if the reporting entity operates in only one segment. The entity-wide disclosures are only required in annual reports.

25.7.6.1 Information about products and services

ASC 280-10-50-40 requires entity-wide disclosures related to products and services.

ASC 280-10-50-40

A public entity shall report the revenues from external customers for each product and service or each group of similar products and services unless it is impracticable to do so. The amounts of revenues reported shall be based on the financial information used to produce the public entity's general-purpose financial statements. If providing the information is impracticable, that fact shall be disclosed.

Reporting entities whose segment revenues are derived from a broad range of different products and services should provide revenue information for the entity-wide disclosures related to its products and services. This disclosure should be made even if there is only one reportable segment in instances when that segment has different products and services.

Missing or inadequate disclosures of revenues from external customers for each product and service is a common area for SEC staff questions. The SEC staff may also question entity-wide disclosures that are not consistent with how products are described or grouped in other sections of the reporting entity's filings (e.g., Form 10-K, Item 1, Business) or other external communications.

When determining the level at which products and services should be reported, it may be helpful to consider whether a majority of the characteristics described in ASC 280-10-50-11 for determining whether segments can be aggregated are met. For example, if all products have similar production processes, classes of customers, and economic characteristics as evidenced by similar rates of profitability, similar degrees of risk, and similar opportunities for growth, a reporting entity may conclude that all of its products are similar and that no additional disclosures by product type are necessary.

Question 25-11

If a reporting entity has two operating segments based on products and services, and the two operating segments meet all of the criteria required for aggregation into a single reportable segment, must the entity-wide disclosures related to products and services be presented under ASC 280-10-50-40?

PwC response

It depends. Since the two operating segments meet the aggregation criteria, the nature of the products and services in each operating segment could be similar and therefore the entity-wide disclosures related to products and services need not be provided. However, if the two segments each sold a range of products and services, the reporting entity would be required to present the entity-wide products and services-related disclosures.

Question 25-12

If a reporting entity has one operating segment, and therefore one reportable segment, must the information required for entity-wide disclosures related to products and services be presented under ASC 280-10-50-40?

PwC response

It depends. A reporting entity may have only one operating segment (and thus only one reportable segment) that sells a range of products and services. In this case, the reporting entity would be required to present the entity-wide products and services-related disclosures. However, the reporting entity may conclude the entity-wide products and services-related disclosures are not necessary if it can demonstrate that its products and services are essentially similar using the aggregation criteria in ASC 280-10-50-11.

25.7.6.2 Information about geographic areas

One of the purposes of entity-wide disclosures is to provide information about the geographic areas in which the reporting entity generates its revenues and holds its long-lived assets. ASC 280-10-50-41 provides the entity-wide disclosure requirements for geographic areas.

Excerpt from ASC 280-10-50-41

A public entity shall report the following geographic information unless it is impracticable to do so:

a. Revenues from external customers attributed to the public entity's country of domicile and attributed to all foreign countries in total from which the public entity derives revenues. If revenues from external customers attributed to an individual foreign country are material, those revenues shall be disclosed separately. A public entity shall disclose the basis for attributing revenues from external customers to individual countries.

b. Long-lived assets other than financial instruments, long-term customer relationships of a financial institution, mortgage and other servicing rights, deferred policy acquisition costs, and deferred tax assets located in the public entity's country of domicile and located in all foreign countries in total in which the public entity holds assets. If assets in an individual foreign country are material, those assets shall be disclosed separately.

The amounts reported shall be based on the financial information that is used to produce the general-purpose financial statements. If providing the geographic information is impracticable, that fact shall be disclosed. A public entity may wish to provide, in addition to the information required by the preceding paragraph, subtotals of geographic information about groups of countries.

An example is included in ASC 280-10-55-51 that illustrates the disclosures required by ASC 280-10-50-41. In addition to disclosure of material revenues and long-lived assets by country, a reporting entity may wish to provide subtotals of revenues and long-lived assets based on groups of countries in a geographic region, such as Europe, Asia, or North America. The guidance in ASC 280-10-55-22 allows for flexibility in determining how revenue can be attributed to geographic areas. Reporting entities may choose to attribute revenue on the basis of (1) the location of the customer, (2) the location to which the product is shipped (which may differ from the location where the customer resides), or (3) the location where the sale originated. The attribution method should be reasonable and consistently applied, and a reporting entity must disclose the basis it has selected for attributing revenue to geographic areas.

One of the reasons for requiring disclosure of long-lived assets (rather than total assets) in geographic areas is that long-lived assets are potentially at greater risk than current assets because they are difficult to move and relatively illiquid. While ASC 280-10-50-41 explicitly excludes financial instruments, long-term customer relationships of a financial institution, mortgage and other servicing rights, deferred policy acquisition costs, and deferred taxes from the entity-wide disclosure of long-lived assets, ASC 280-10-55-23 indicates that long-lived assets implies physical assets that cannot be readily removed. Accordingly, goodwill and other intangible assets should not be included in the entity-wide disclosure of long-lived assets.

Example 25-9 provides an illustration of determining long-lived asset disclosures by geographic area.

EXAMPLE 25-9

Reporting long-lived assets by geographic area

FSP Corp, a U.S.-domiciled reporting entity with operations in 25 countries, has determined that it has two reportable segments (U.S. and International) and that its long-lived assets in two individual foreign countries (England and China) are material.

For which geographic areas should FSP Corp disclose tangible long-lived assets?

Analysis

FSP Corp should separately disclose tangible long-lived assets for the U.S., England, China, and all other foreign countries combined. Although the long-lived assets in the U.S. may not be material, the guidance requires disclosure related to the reporting entity's country of domicile.

Question 25-13

If a reporting entity has reportable segments represented by the geographic areas U.S., Canada, and Asia, would the reporting entity be required to disclose revenue and long-lived asset information for each country in Asia, if material?

PwC response

Yes. Revenue and long-lived assets must be disclosed for each country in which such balances are material. The individual country disclosures are required even if the Asian operations are not managed on an individual country basis (i.e., even if the CODM does not review or assess performance on an individual country basis).

To the extent that it is impracticable to provide the individual country information, that fact should be disclosed. These circumstances are expected to be rare.

25.7.6.3 Information about major customers

ASC 280-10-50-42 provides the entity-wide disclosure requirements for major customers.

Excerpt from ASC 280-10-50-42

A public entity shall provide information about the extent of its reliance on its major customers. If revenues from transactions with a single external customer amount to 10 percent or more of a public entity's revenues, the public entity shall disclose that fact, the total amount of revenues from each such customer, and the identity of the segment or segments reporting the revenues. The public entity need not disclose the identity of a major customer or the amount of revenues that each segment reports from that customer. For purposes of this Subtopic, a group of entities known to a reporting public entity to be under common control shall be considered as a single customer, and the federal government, a state government, a local government (for example, a county or municipality), or a foreign government each shall be considered as a single customer.

One of the objectives of disclosing information about major customers is to provide a measure of the concentration of credit risk to the reporting entity. Neither the identity of a major customer or the amount of revenues that each segment reports from that customer is required to be disclosed.

An example is included in ASC 280-10-55-52 that illustrates the disclosures required by ASC 280-10-50-42.

Question 25-14

Is there a threshold at which entity-wide disclosures can be considered immaterial?

PwC response

Unlike reportable segment disclosures, there is no quantitative threshold for determining when entity-wide disclosures are required. Assessing what is material is a matter of judgment. Both qualitative and quantitative factors should be considered. We believe that, when assessing entity-wide disclosures from a quantitative perspective, it would be reasonable to apply a threshold similar to the 10 percent tests provided in ASC 280-10-50-12. For example, a reporting entity would disclose revenues from external customers attributed to an individual foreign country if revenues from that country are greater than 10 percent of consolidated revenues. However, qualitative factors may indicate that information is material even if it does not exceed 10 percent of the consolidated total.

25.7.7 Interim period information

Reduced disclosures may be presented in condensed financial statements of interim periods. If a complete set of financial statements is presented in an interim period, then the full disclosure requirements of ASC 280 apply.

ASC 280-10-50-32 through 50-33 provides the disclosure requirements for condensed financial statements of interim periods.

ASC 280-10-50-32 through 50-33

A public entity shall disclose all of the following about each reportable segment in condensed financial statements of interim periods:

a. Revenues from external customers

b. Intersegment revenues

c. A measure of segment profit or loss

d. Total assets for which there has been a material change from the amount disclosed in the last annual report

e. A description of differences from the last annual report in the basis of segmentation or in the basis of measurement of segment profit or loss

f. A reconciliation of the total of the reportable segments' measures of profit or loss to the public entity's consolidated income before income taxes, extraordinary items, and discontinued operations. However, if a public entity allocates items such as income taxes and extraordinary items to segments, the public entity may choose to reconcile the total of the segments' measures

> of profit or loss to consolidated income after those items. Significant reconciling items shall be separately identified and described in that reconciliation.
>
> Interim disclosures are required for the current quarter and year-to-date amounts. Paragraph 270-10-50-1 states that when summarized financial data are regularly reported on a quarterly basis, the information in the previous paragraph with respect to the current quarter and the current year-to-date or the last 12 months to date should be furnished together with comparable data for the preceding year.

Entity-wide disclosures, including disclosures about major customers, are not required in interim periods. However, if a reporting entity were to transact a significant amount of business with a new (or previously insignificant) customer during an interim period that was expected to continue in future periods, management should consider providing the disclosures required by ASC 280-10-50-42.

25.7.8 Revision of information for changes in segments

When reporting entities change the structure of their internal organization, the information regularly reviewed by the CODM may change. This could result in changes in operating segments and changes in the determination of reportable segments. If the reportable segments change in the current period, corresponding information for earlier periods should be revised, including information for interim periods, so that all segment disclosures are comparable. This requirement applies to all disclosures that can practically be revised. A change in reportable segments should be accompanied by disclosure of the reasons for the change and, when appropriate, that the change has been reflected through retroactive revision of prior period segment information.

ASC 280 does not specify how to analyze organization changes to determine when a change in operating or reportable segments is necessary. However, the determination of operating segments is based on the information regularly reviewed by the CODM. As a result, if there are changes in how the CODM allocates resources and assesses performance, or there are changes to how the information is presented to the CODM, a reporting entity will likely need to reassess its segment reporting.

When determining whether there has been a change that could impact the determination of its operating segments, the reporting entity may consider whether there has been a change in the following:

- The CODM
- The information regularly reviewed by the CODM
- The organizational structure
- The individuals who regularly meet with the CODM

- The budgeting process or level at which budgets are reviewed by the CODM
- The information regularly reported to the board of directors
- The information the reporting entity communicates to external parties such as investors, creditors, and customers

ASC 280 requires prior period segment information to be revised (if practicable) when there has been a change in the composition of the segments resulting from changes in the structure of a reporting entity's internal organization. If a reporting entity changes a segment measure (e.g., begins using EBITDA instead of operating income as its measure of profit or loss), a revision is not required. However as illustrated in FSP 25.7.11, a reporting entity may elect to revise the disclosures for a change in segment measure.

ASC 280 also requires revision of prior period segment information (if practicable) when a previously insignificant operating segment becomes significant (i.e., the operating segment meets the 10 percent tests).

Example 25-10 illustrates an analysis of segments when their relative significance changes year over year.

EXAMPLE 25-10

Change in segment significance

FSP Corp has eight operating segments, none of which qualify for aggregation. Five of the segments were disclosed as reportable segments in 20X4, based on the 10 percent tests. The aggregate external revenues of these segments exceeded 75 percent of FSP Corp's consolidated revenues. The remaining three segments were combined in an "all other" category. In 20X5, one of the three segments that was included in the "all other" category in 20X4 became quantitatively material (i.e., it exceeded the threshold for the 10 percent tests). Also in 20X5, one of the five reportable segments was no longer quantitatively material.

How should FSP Corp reflect these changes in its segment disclosures?

Analysis

The segment that is now material should be presented as a reportable segment. Pursuant to ASC 280-10-50-17, when FSP Corp presents prior period segment data in the 20X5 financial statements, segment data for all prior periods must be revised to reflect the new reportable segment as a separate segment, unless it would be impracticable to do so.

For the segment that no longer meets the quantitative thresholds (assuming the segment is not considered to be of continuing significance), disclosure of its individual results need not be made in 20X5. In this case, prior period segment disclosures could also be revised to conform to the current period presentation (provided the threshold for the 75 percent revenue test is met for all periods). If management views the 20X5 segment to be of continuing significance, that segment's disclosures should continue to be made.

While the entity-wide disclosure provisions of ASC 280 do not discuss the revision of entity-wide disclosures, we believe that the entity-wide information from period to period should be comparable. Accordingly, we believe that the guidance contained in ASC 280-10-50-16 through 50-17, as well as the revision provisions of ASC 280-10-50-34 through 50-35, should be applied to entity-wide disclosures.

Example 25-11 provides an illustration of factors to consider in assessing whether to revise previous periods' segment information when a reporting entity has an internal reorganization of financial reporting without changing its organizational structure.

EXAMPLE 25-11

Consideration of changes in internal financial reporting within operating segments

FSP Corp has four operating segments. It has decided to move one of its product lines from one operating segment (Segment X) to another (Segment Z) for internal reporting purposes. FSP Corp did not change its management structure, and has determined that it still has the same four operating segments. The only change to the CODM package as a result of the internal reorganization change is the inclusion of the respective product line information within Segment Z reporting and its removal from Segment X reporting as of the date of the change.

How should this change in internal financial reporting be considered in FSP Corp's segment assessment?

Analysis

If the changes to the segment assets and operating results as a result of reclassifying the assets, liabilities, and results of operations materially affect the trend in asset balances and/or the reported results, FSP Corp should consider revising its previously reported segment disclosure information. If, however, the segment information does not materially change the segments' financial information, generally a reporting entity is not expected to revise the previously reported segment information.

In determining whether the change to the Segment X and Z financial information is material, FSP Corp might consider, among other things, whether the CODM package (or other information regularly reviewed by the CODM) has been adjusted retrospectively or whether the product line is considered a separate asset group (as defined in ASC 360). If the product line is a separate asset group, this may indicate that the composition of the segments has changed significantly and prior period segment information should be revised.

25.7.8.1 *When to reflect changes in segment reporting*

Changes in reportable segments as a result of changes in organization, the information regularly reviewed by the CODM, the significance of an operating segment (from immaterial to material), or the aggregation of operating segments should only be reflected when the financial statements include the period in which the change occurred. Changes in segments arising after a reporting entity's period-end but before the issuance of the reporting entity's financial statements should be treated as an unrecognized (i.e., "Type II") subsequent event. However, the reporting entity should disclose in the current period financial statements that the change in reportable segments will occur in subsequent periods and the reasons for the change.

Examples 25-12 and 25-13 provide illustrations of when segment reporting changes should be reflected in a reporting entity's financial statements.

EXAMPLE 25-12

Change in segment structure subsequent to year end

In the fourth quarter of 20X4, FSP Corp's management determined that it will change the way it manages and operates the reporting entity and is in the process of modifying FSP Corp's information system to produce financial information to support the new structure. The changes will require FSP Corp to revise its segment reporting. It is anticipated that the modification to the system will be completed in the first quarter of 20X5, at which point management will reorganize its operations and reporting structure and begin to manage its operations under its new segment structure.

How should this planned change affect FSP Corp's 20X4 segment disclosures?

Analysis

FSP Corp should present its 20X4 segment disclosure information under the reporting structure in place during 20X4. It should not revise its segment disclosure using the new reporting structure until the first quarter of 20X5, which is the period in which management will change the way it manages and operates the business.

EXAMPLE 25-13

Changing operating segments for financial reporting purposes prior to changing the CODM package

FSP Corp manufactures watches in three product lines: low, medium, and high-end. Each of these product lines has two distinct watch types (sport and formal). FSP Corp identified each product line as an operating segment. Each of the product lines has a vice president who reports to the CEO, who is the CODM. Monthly meetings are held between the vice presidents of the three product lines and the CODM to discuss the results for each product line. The CODM package and information reviewed at the monthly meetings consists of revenue and expenses by product line.

During FY 20X4, the existing CEO retired and the new CEO became the new CODM. The new CODM changed certain aspects of FSP Corp's internal reporting roles and marketing strategy, and began meeting with the product managers to assess performance of each of the watch types (sport and formal) within each product line in order to gain better insight into how the business is operating. In addition, the CODM implemented a new marketing campaign which focused on the sport and formal type watches versus the previous marketing campaign, which focused only on the three distinct product lines. The new CODM began allocating resources at the watch type level (sport and formal) rather than at the product line level (low, medium and high-end). Although no changes have yet been made to the CODM reporting package, the CODM is now regularly receiving watch-type operating profitability information through regular meetings with the six product managers. The product managers oversee the financial results of each watch type and provide additional reports to the CODM. In the first quarter of 20X5, FSP Corp intends to change the formal CODM package to reflect the information on the six distinct businesses that the new CEO is reviewing, rather than just the three that the previous CEO reviewed.

What impact should the change in information being reviewed by the CODM have on FSP Corp's determination of operating segments?

Analysis

Although the CODM package had not yet been updated, FSP Corp should likely reflect the six watch types as operating segments for the 20X4 year-end financial statements, but a careful evaluation of all relevant factors is required.

The change in the CODM warrants a review of the operating segments given the new CODM's different management style and regular review of new or different information when assessing performance and allocating resources. In order to support a change in operating segments prior to a formal change in the CODM package, FSP Corp would need to demonstrate that significant changes have been made in how the CODM is managing the business.

In this example, FSP Corp changed the manner in which operating results are regularly reviewed by the CODM in 20X4. In addition to meeting with vice presidents of the three distinct product lines, the new CODM now also meets with the product managers of the six individual watch types. Additionally, FSP Corp changed the way that it markets its products, and the CODM is using more disaggregated financial information to manage the business. FSP Corp does not view these changes as temporary and intends to make the change to the CODM package in the near future to reflect the way the new CODM views the business.

Based on these factors, it would appear appropriate to conclude that FSP Corp had a change in its operating segments during 20X4. It is paramount to understand when this change has occurred to determine if FSP Corp has been operating, and is being managed, based on the new operating segments during the financial reporting period that is to be presented.

25.7.9 *Revision of prior period segment information is impracticable*

ASC 280-10-50-35 provides guidance for additional disclosures in situations where retroactive revision of segment information is impracticable.

ASC 280-10-50-35

If a public entity has changed the structure of its internal organization in a manner that causes the composition of its reportable segments to change and if segment information for earlier periods, including interim periods, is not restated to reflect the change, the public entity shall disclose in the year in which the change occurs segment information for the current period under both the old basis and the new basis of segmentation unless it is impracticable to do so.

ASC 280-10-50-17 states that "information is impracticable to present if the necessary information is not available and the cost to develop it would be excessive." We expect such situations to be rare as it is usually possible to obtain the necessary prior period information. The SEC staff has been skeptical that revising prior periods is impracticable.

Similar to changes to reportable segments made during annual periods, if prior year interim segment information is not revised, then the current period segment disclosures should be presented on both the old basis and new basis, unless it would prove impracticable to do so.

25.7.10 *Changes of reportable segments during an interim period*

A reporting entity may change its organizational structure, or a previously immaterial segment may become material, during an interim period. If that change results in a change in reportable segment information in the interim period, the financial statements should be prepared on the basis of the new segments that were created during the current interim period. The previously filed interim reports are not required to be amended. However, the interim information for those previously filed quarters will need to be revised (unless it is immaterial or impracticable) when the quarters are presented for comparative purposes in the following year's interim filings.

Question 25-15

If changes in a reporting entity's internal management reporting structure changes its basis for segment reporting during an interim period, must full footnote disclosure be provided in the interim period condensed financial statements as if the revision were reported in a complete set of annual financial statements included in the Form 10-K?

PwC response

No. Full footnote disclosures are not required. However, ASC 280-10-50-34 through 50-35 require that the limited interim period information be revised and provided in the quarterly report. ASC 280-10-50-32(e) also requires the interim financial statements to describe differences in the basis of segmentation or in the basis of measurement of segment profit or loss from the last annual report. Certain line items required for the annual footnote disclosure as provided in ASC 280-10-50-22 and ASC 280-10-50-25 may be omitted from the condensed financial statements included in the interim period quarterly report.

25.7.11 Changes in segment performance measures

Reporting entities may choose to change their measure of segment profit and loss (e.g., from operating income to EBITDA). In contrast to an organizational change that causes a change to segment reporting, a change in a segment performance measure may not require revision to previously reported segment disclosures. Additional disclosures are required if prior year's information is not revised, as described in ASC 280-10-50-36.

ASC 280-10-50-36

Although restatement is not required to reflect a change in measurement of segment profit and loss, it is preferable to show all segment information on a comparable basis to the extent it is practicable to do so. If prior years' information is not restated, paragraph 280-10-50-29(d) nonetheless requires disclosure of the nature of any changes from prior periods in the measurement methods used to determine reported segment profit or loss and the effect, if any, of those changes on the measure of segment profit or loss.

Example 25-14 provides an illustration of a change in segment performance measures.

EXAMPLE 25-14

Change in segment performance measures

FSP Corp has five operating segments, which are also its reportable segments. Historically, the internal reporting package reviewed by the CODM included certain unallocated items, such as interest income/expense and pension costs. These unallocated items were disclosed in FSP Corp's footnotes as part of its reconciliation of total segment profits/losses to consolidated net income. The

CODM recently requested that pension costs be allocated to the five operating segments based on employee headcount as the CODM believes pension cost should be considered in assessing segment performance and in making resource allocation decisions. The internal reporting package reflected this change as of December 31, 20X4.

How should FSP Corp reflect this in its segment disclosures?

Analysis

The change in allocation represents a change in the measure of segment performance. FSP Corp should reflect this new segment measure in the period the change occurred. Because this is not a change in the identified reportable segments, FSP Corp would not be required to revise prior periods to reflect this change, but may elect to do so. In either case, FSP Corp should disclose the nature of the change in the segment performance measure and the effect the change has on the measure of segment profit or loss as required by ASC 280-10-50-29(d).

25.7.12 Case study — applying ASC 280

Example 25-15 is a case study in how to apply the provisions of ASC 280. It also provides example disclosures based on the outcome of the case study.

EXAMPLE 25-15

Illustrative application of ASC 280 and related disclosures

The following example provides general background information relating to FSP Corp, a fictitious consumer products reporting entity. The general background is followed by an analysis regarding the determination of FSP Corp's CODM, its operating segments, the operating segments that qualify for aggregation, and which operating segments or aggregated operating segments are reportable segments. An example footnote is also provided.

General background

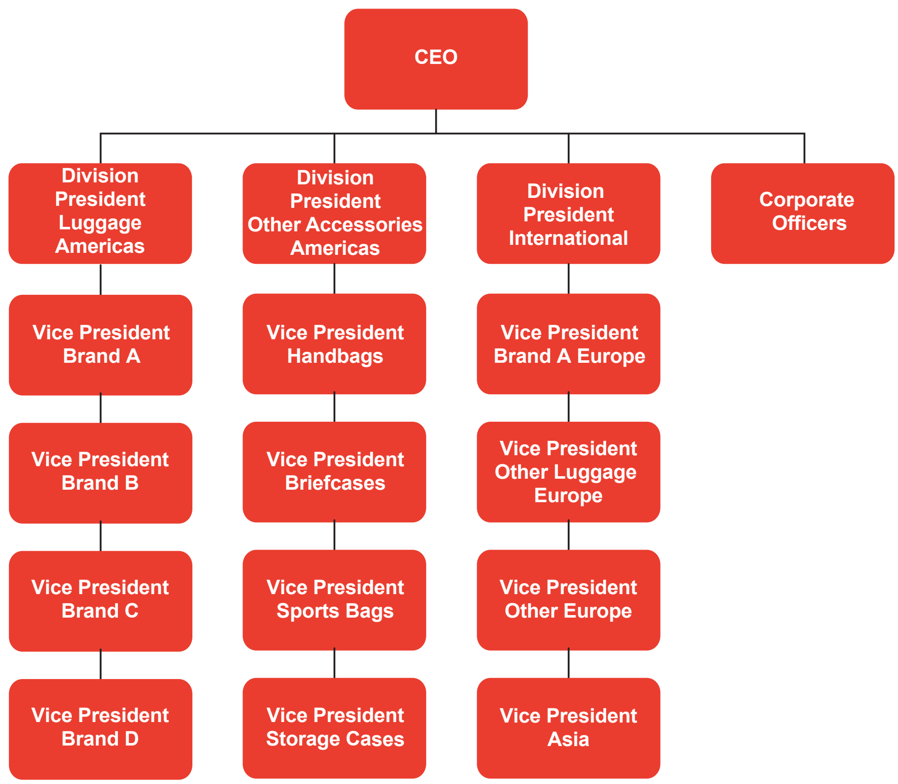
FSP Corp's operations include manufacturing, marketing, and distribution of luggage and related accessories. The products consist of four types of branded luggage, as well as handbags, briefcases, sports bags, and storage cases. FSP Corp is a global organization with sales in Europe, Asia, and the Americas. FSP Corp is organized as 12 marketing units, each with their own Vice President who is accountable for sales and performance of his/her unit. These marketing units are grouped into three divisions and the Vice Presidents of the 12 marketing units report to their respective Division President. Approximately 50% of sales are from the four marketing units that compose the "Luggage Americas Division." Approximately 30% of sales come from the four marketing units that comprise the "International Division." The remaining 20% of sales are from the four marketing units that compose the "Other Accessories Americas Division."

FSP Corp produces its luggage products through a network of six owned manufacturing facilities. The handbags, briefcases, sports bags, and storage cases ("Other Accessories") are produced by various independent suppliers. Other Accessories Americas Division is primarily a domestic operation, although the accessories are also sold internationally through the International divisions' marketing units. FSP Corp's product lines are sold primarily to retailers who, in turn, sell the items to individual customers. FSP Corp also owns eight handbag retail locations in the U.S. that sell handbag products directly to end customers (handbags are also sold through third party retailers). The results of these locations are included in the handbag marketing unit.

FSP Corp does not have any investments accounted for under the equity method and has a December 31 year-end.

The following is an organization chart for FSP Corp:

FSP Corp organization chart



The CEO allocates resources and assesses the performance of FSP Corp primarily based on the results of each marketing unit. The CEO regularly receives information from the three Division Presidents, as well as the Corporate Officers (Chief Financial Officer, General Counsel, and Vice President of Human Resources) who report directly to the CEO.

Information reported to the CODM

Each marketing unit prepares a monthly "Operating Report" which is sent to the applicable Division President. It reflects the marketing unit's current-month and year-to-date sales; gross margin; earnings before interest, taxes, depreciation, and amortization (EBITDA); and working capital. EBITDA is the single most important measurement used by the marketing unit Vice Presidents, Divisional Presidents, and CEO to assess performance of the marketing units, divisions, and FSP Corp as a whole. Most incentive compensation is based on EBITDA at the marketing unit level.

The monthly Operating Reports are reviewed by the Division Presidents. Divisional results are prepared for each division and sent to the Division Presidents and CEO. The Operating Reports are also made available to the CEO, who may not review these reports in as much detail as the Division Presidents, but finds it useful to have the disaggregated information available to analyze specific performance questions.

Additionally, the CEO is apprised of each marketing unit's performance by:

- A monthly all-day meeting with the Division Presidents and marketing unit Vice Presidents that is devoted to a discussion of recent operating results. The marketing unit Operating Reports and the consolidated division level reports are typically used as information sources during these meetings.

- Frequent phone calls with the Division Presidents

- Quarterly strategy meetings with marketing unit Vice Presidents, at which forecasts, business issues, opportunities, and competitors are discussed.

Each quarter, the board of directors is provided with a report that summarizes sales, operating income, EBITDA, and working capital for each of the Divisions.

The following tables represent information reported in the Operating Reports.

LUGGAGE AMERICAS DIVISION
Information reported as of and for the year ended December 31, 20X4
($ in thousands)

	Brand A	Brand B	Brand C	Brand D	Division total
Sales	$420	$220	$180	$100	$920
Gross margin	$126	$69	$57	$32	$284
Percentage of sales	30%	31%	32%	32%	
EBITDA	$80	$40	$32	$18	$170

	Brand A	Brand B	Brand C	Brand D	Division total
EBITDA margin	19%	18%	18%	18%	
Working capital	$200	$200	$150	$60	$610

OTHER ACCESSORIES AMERICAS DIVISION
Information reported as of and for the year ended December 31, 20X4
($ in thousands)

	Handbags	Briefcases	Sports bags	Storage cases	Division total
Sales	$100	$80	$75	$75	$330
Gross margin	$41	$31	$29	$19	$120
Percentage of sales	41%	39%	39%	25%	
EBITDA	$25	$20	$20	$15	$80
EBITDA margin	25%	25%	27%	20%	
Working capital	$20	$20	$15	$15	$70

INTERNATIONAL DIVISION
Information reported as of and for the year ended December 31, 20X4
($ in thousands)

	Brand A Europe	Other Luggage Europe	Other Europe	Asia	Division total
Sales	$300	$160	$100	$50	$610
Gross margin	$93	$51	$20	$7	$171
Percentage of sales	31%	32%	20%	14%	
EBITDA	$60	$33	$15	$6	$114

	Brand A Europe	Other Luggage Europe	Other Europe	Asia	Division total
EBITDA margin	20%	21%	15%	12%	
Working capital	$150	$60	$20	$10	$240

CONSOLIDATED
Information reported as of and for the year ended December 31, 20X4
($ in thousands)

	Total divisions before eliminations	Eliminations	Consolidated
Sales	$1,860	$(60)	$1,800
Gross margin	$575	$(10)	$565
Percentage of sales	31%	17%	31%
EBITDA	$364	$(10)	$354
Working capital	$920		$920

Segment Analysis

Determination of the CODM

The CODM of FSP Corp is the CEO. The CEO makes the overall decisions about FSP Corp's resource allocation and assesses the performance of its segments. Although the Division Presidents and Corporate Officers also assist in the decision-making process, the CEO has historically made and will continue to make the overall decisions for FSP Corp.

Determination and identification of operating segments

FSP Corp's operating segments are its 12 marketing units. Based on the preceding tables that reflect FSP Corp's internal reporting, each marketing unit earns revenue, incurs expenses, and has discrete financial information readily available. In addition, the monthly Operating Reports are provided to and reviewed by the CODM. The CEO uses the information related to all 12 marketing units as the basis for assessing the marketing units' performance and deciding what resources are to be allocated to them.

Determination of reportable segments

Assessing which operating segments meet all of the aggregation criteria

Since FSP Corp aligns its business by division, management first considered whether the marketing units within each division met all of the required aggregation criteria. Management prepared a long-term economic analysis for each marketing unit using gross margin, EBITDA, sales growth, and operating cash flows for the last three years plus forecasted results for the next three years. The impacts of foreign currency were also considered for the international operating segments.

Based on the analysis of past, current, and future expected results considering the guidance outlined in FSP 25.5.1, management concluded the operating segments representing the marketing units (Brands A, B, C and D) of the Luggage Americas Division were quantitatively similar. Management assessed the similarly of the qualitative characteristics as follows.

- **The nature of the products and services** — All of these operating segments market luggage and, in many cases, the same types of soft shell luggage (the points of difference tend to be the price of the products, style, and external material).

- **The nature of the production processes** — The nature of the production processes is similar across all four operating segments. The production of the different brands uses common machinery and equipment in FSP Corp's owned U.S. facilities. In many cases, raw materials are sourced from the same suppliers and used across brands, and some piece parts are produced centrally for different operating segments in the same manufacturing facility. There are no significant technology differences in the production processes across brands.

- **The type or class of customer for their products and services** — Each brand shares similar classes of customers, which are primarily U.S. retail department stores. U.S. retail department stores usually carry many of FSP Corp's brands.

- **The methods used to distribute their products or provide their services** — Each brand shares similar distribution methods, which primarily involve shipments to retail department stores by common carriers directly from FSP Corp's manufacturing facilities.

- **The nature of the regulatory environment** — There are no specific differences in the regulatory environment for any of the four operating segments.

Management determined the operating segments met all of the qualitative aggregation criteria. FSP Corp will aggregate the four operating segments in the Luggage Americas Division to produce a reportable segment called "Luggage Americas."

Based on the analysis of past, current, and future expected results considering the guidance outlined in FSP 25.5.1, management concluded the Brand A Europe and Other Luggage Europe marketing units of the International Division were quantitatively similar. Management assessed the similarly of the qualitative characteristics as follows.

- **The nature of the products and services** — These operating segments market luggage and, in many cases, the same types of soft shell luggage (the points of difference tend to be the price of the products, style, and external material).

- **The nature of the production processes** — The nature of the production processes is similar for both segments. The luggage is manufactured in the same U.S. plants as those described in the "Luggage" reportable segment.

- **The type or class of customer for their products and services** — Each brand shares similar classes of customers, which are primarily European retail department stores.

- **The methods used to distribute their products or provide their services** — Each brand shares similar distribution methods, which primarily involve shipments to retail department stores by common carriers directly from FSP Corp's manufacturing facilities.

- **The nature of the regulatory environment** — Although the marketing units operate in different countries, there are no significant differences in the regulatory environment.

Management determined these operating segments met all of the qualitative aggregation criteria. FSP Corp will aggregate the Brand A Europe and Other Luggage Europe operating segments to produce a reportable segment called "Luggage Europe."

Although some of the other marketing units shared similar economic characteristics with each other, none of the other marketing units met all of the aggregation criteria listed in ASC 280-10-50-11. Therefore, no other operating segments were aggregated with each other.

<u>Quantitative thresholds</u>

FSP Corp next performed the quantitative assessments necessary to determine which of its operating segments or aggregated operating segments are required to be presented separately as reportable segments in its segment disclosures. The quantitative threshold tests should be based on the combined total of FSP Corp's operating segments. In this example, the total is not adjusted for intersegment items that are otherwise eliminated in consolidation, since the operating segments' results are reported to the CODM inclusive of such items (i.e., segment performance measures used to assess marketing unit performance include intercompany transactions).

Assessments of the 10 percent tests are as follows:

A. 10 percent test – revenue

($ in thousands)	**Luggage Americas**	**Luggage Europe**	**Handbags**	**Briefcases**	**Sports bags**	**Storage cases**	**Other Europe**	**Asia**	**Total**
External sales	$860	$460	$100	$80	$75	$75	$100	$50	$1,800
Total sales, excluding eliminations	$920	$460	$100	$80	$75	$75	$100	$50	$1,860
Percentages									
External sales	48%	26%	5.5%	4%	4%	4%	5.5%	3%	100%
Total sales, excluding eliminations	49%	25%	5.5%	4%	4%	4%	5.5%	3%	100%

Only the Luggage Americas and Luggage Europe reportable segments meet the 10 percent revenue test that requires separate presentation in FSP Corp's segment disclosures.

B. 10 percent test - profit (EBITDA)

($ in thousands)	**Luggage Americas**	**Luggage Europe**	**Handbags**	**Briefcases**	**Sports bags**	**Storage cases**	**Other Europe**	**Asia**	**Total**
EBITDA	$170	$93	$25	$20	$20	$15	$15	$6	$364
Percentage	47%	26%	7%	5%	5%	4%	4%	2%	100%

The Luggage Americas and the Luggage Europe reportable segments are the only segments that meet the 10% segment profit test requiring separate presentation in FSP Corp's segment disclosures.

C. 10% test - assets

Because an asset measure of operating or reportable segment assets is not reported to FSP Corp's CODM, the 10% asset test is not applicable.

<u>Immaterial operating segments which meet the majority of the aggregation criteria</u>

Following aggregation of operating segments that met all of the aggregation criteria in ASC 280-10-50-11 and the application of the 10 percent tests, FSP Corp determined which remaining immaterial operating segments shared similar long-term economic characteristics and met the majority of the qualitative criteria in ASC 280-10-50-11.

Based on the analysis of past, current, and future expected results considering the guidance outlined in FSP 25.5.1, management concluded Handbags, Briefcases, and Sports Bags marketing units have similar long-term economic characteristics and assessed the similarly of the qualitative characteristics as follows.

- **The nature of the products and services** — The Handbags, Briefcases, and Sports Bags operating segments all represent a similar type of product (personal accessories) and the points of difference tend to be the type and style of accessory.

- **The nature of the production processes** — The nature of the production processes across the operating segments is dissimilar. Handbags are sourced from several independent suppliers. The majority of the Handbags are produced in factories; however, several lines of handbags are entirely handmade. The production process for Sports Bags is primarily through an external supplier factory. The raw materials for Sports Bags primarily consist of synthetic fabrics and zippers. Briefcases are entirely handmade by a number of different independent family businesses. The raw materials for handbags primarily consist of leather, silver, and brass, all of which have had significant price fluctuations in recent years.

- **The type or class of customer for their products and services** — Each of the operating segments shares similar classes of customers, which are primarily retail department stores. The Handbag segment, however, does operate some retail locations which sell products directly to the end customers.

- **The methods used to distribute their products or provide their services** — Each brand shares similar distribution methods, which primarily involves shipments to retail department stores by common carriers.

- **The nature of the regulatory environment** — There are no significant differences in the regulatory environment for any of these operating segments.

Management determined the operating segments met a majority of the aggregation criteria. Based on this analysis, FSP Corp will aggregate the Handbags, Briefcases, and Sport Bags segments to produce a reportable segment "Other Accessories."

D. The 75% revenue test

Because the Luggage Americas reportable segment represents 48% of consolidated sales, the Luggage Europe reportable segment represents 26% of consolidated sales, and the Other Accessories reportable segment represents an additional 14% of external sales, total revenues of all identified reportable segments exceeds the 75% threshold. No further reportable segments are required to be disclosed. If the 75% threshold was not reached, FSP Corp would have needed to identify which of the operating segments that would otherwise be included in the "All Other" category would be presented as a separate reportable segment until the 75% threshold was achieved.

<u>All Other</u>

Management analyzed the remaining operating segments (Storage Cases, Other Europe, and Asia) and concluded that none of these segments warranted separate presentation as a reportable segment as they would not provide additional useful information to the readers of the financial statements. Therefore, the remaining segments were aggregated into an "All Other" category.

Accordingly, FSP Corp has three reportable segments (Luggage Americas, Luggage Europe, and Other Accessories) and an additional All Other category, which account for 100 percent of FSP Corp's total consolidated revenues.

Measurement

FSP Corp's measure of segment profitability that is most relied upon by management is EBITDA. Thus, EBITDA will be reported as the measure of segment profit in the segment disclosure. In accordance with ASC 280-10-50-30, it must reconcile aggregate EBITDA for the reportable segments to consolidated income before income taxes.

Information about profit or loss and assets

EBITDA is the primary measure of segment profitability regularly reviewed by the CODM. No segment-level disclosure is required of interest expense, depreciation and amortization, unusual charges, income tax expense/benefit, and extraordinary items since these amounts are not included in EBITDA nor separately provided to the CODM. Further, FSP Corp does not have any investments accounted for under the equity method.

Since asset information by operating or reportable segment is not reported to the CODM, the individual asset disclosures described in ASC 280-10-50-22 are not applicable to FSP Corp.

Entity-wide disclosures

A. Information about products and services

The CODM has access to and regularly reviews internal financial reporting by marketing unit, which are primarily organized by product. Furthermore, operating segments have been aggregated into reportable segments based on similar products. Therefore, entity-wide disclosures of information about products and services would not be required.

B. *Information about geographic areas*

Outside the United States, Germany, and Italy, no other country would be sufficiently significant to require separate disclosure. FSP Corp will disclose revenues and long-lived assets from its United States and foreign operations. For this disclosure, FSP Corp has determined that foreign sales will be reported by the country in which the legal subsidiary is domiciled.

C. Information about major customers

FSP Corp has no single customer representing greater than 10 percent of its consolidated revenues, and therefore this disclosure is not required.

Example Footnote

Segment Information[1]

FSP Corp is organized primarily on the basis of products and operates three divisions which comprise 12 separate marketing units. These 12 marketing units are our operating segments, and each of these segments is led by a Vice President. Resources are allocated and performance is assessed by our CEO, whom we have determined to be our Chief Operating Decision Maker (CODM).

Certain of our operating segments have been aggregated as they contain similar products managed within the same division, are economically similar, and share similar types of customers, production, and distribution. Four of our marketing units have been aggregated to form the “Luggage Americas” reportable segment, and two of our marketing units have been aggregated to form the “Luggage Europe” reportable segment. Three of our otherwise non-reportable marketing units have been aggregated to form the “Other Accessories” reportable segment, and the remaining three marketing units have been combined and included in an “All Other” category. The following is a brief description of our reportable segments and a description of business activities conducted by All Other.

Luggage Americas — Segment operations consist of product design, manufacturing, marketing, and sales of soft shell luggage in the U.S.

Luggage Europe — Segment operations consist of manufacturing, marketing, and sales of soft shell luggage in Europe.

Other Accessories — Segment operations consist of product design, marketing, and sales of handbags, briefcases, and sports bags, primarily in the U.S.

All Other — Operations consist of marketing and sales of luggage and accessories in certain international markets and the design, marketing, and sales of storage cases.

The accounting policies of the segments are the same as those described in the “Summary of Significant Accounting Policies” for FSP Corp. FSP Corp evaluates the performance of its segments and allocates resources to them based on earnings before interest, taxes, depreciation, and amortization (EBITDA). Segment EBITDA includes intersegment revenues, as well as a charge allocating all corporate headquarters costs.

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[1] Note: For this illustrative example, only two years of segment results were presented. SEC registrants typically require the presentation of three years of segment results.

The table below presents information about reported segments for the years ending December 31:

20X4

($ in thousands)

	Luggage Americas	Luggage Europe	Other accessories	All other	Total
Sales	$920	$460	$255	$225	$1,860
EBITDA	$170	$93	$65	$36	$364

20X3

($ in thousands)

	Luggage Americas	Luggage Europe	Other accessories	All other	Total
Sales	$885	$425	$230	$202	$1,742
EBITDA	$164	$86	$58	$32	$340

A reconciliation of total segment sales to total consolidated sales and of total segment EBITDA to total consolidated income before income taxes, for the years ended December 31, 20X4 and 20X3, is as follows:

Sales ($ in thousands)	**20X4**	**20X3**
Total segment sales	$1,860	$1,742
Elimination of intersegment revenue	(60)	(40)
Consolidated sales	$1,800	$1,702

EBITDA	**20X4**	**20X3**
Total segment EBITDA	$364	$340
Depreciation and amortization	(50)	(45)
Intersegment profit	(15)	(11)

EBITDA	20X4	20X3
Interest	(80)	(70)
Consolidated income before income taxes	$219	$214

The following tables present sales and long-lived asset information by geographic area for the years ended December 31, 20X4 and 20X3. Asset information by segment is not reported internally or otherwise regularly reviewed by the CODM.

Sales ($ in thousands)	20X4	20X3
United States	$1,260	$1,191
Germany	177	170
Italy	180	175
All Other Foreign	183	166
	$1,800	$1,702

Long-lived Assets ($ in thousands)	20X4	20X3
United States	$1,090	$1,035
Foreign	260	245
	$1,350	$1,280

Foreign revenue is based on the country in which the legal subsidiary is domiciled.

25.8 Considerations for private companies

For public companies, the proper application of the framework in ASC 280 is important as operating segments are the starting point for the identification of reporting units (the unit of account for goodwill impairment testing purposes). This is also true for private companies that have not elected to apply the goodwill accounting alternative in ASU 2014-02*, Intangibles-Goodwill and Other (Topic 350): Accounting for Goodwill*, or that have elected to apply the alternative but still test goodwill impairment at the reporting unit level.

If a private company elects to apply the goodwill accounting alternative in ASU 2014-02, and further elects to test goodwill for impairment at the entity level (rather than at a reporting unit level), the application of ASC 280 (to identify operating segments as a starting point for determining reporting units) would not be applicable.

While the disclosures of ASC 280 are not required for private companies, some private companies believe these elective disclosures are meaningful to the financial statement users, particularly those that anticipate an initial public offering in the near term. A private company that chooses to disclose segment information need not apply the disclosure requirements of ASC 280 in their entirety.

Chapter 26: Related parties

26.1 Chapter overview

Transactions with parties related to a reporting entity are relatively common. Some related party transactions may not be carried out on an arm's-length basis. As such, when related party relationships and transactions are identified and disclosed, users of financial statements can better evaluate their impact to the financial statements. ASC 850, *Related Party Disclosures,* is the primary accounting guidance on this topic, coupled with certain SEC guidance. This chapter describes the relevant presentation and disclosure requirements and provides examples of common related party relationships and transactions.

26.2 Scope

ASC 850 covers transactions and relationships with related parties. It applies to all reporting entities, including the separate financial statements of a subsidiary, as noted in ASC 850-10-15-2. Identifying related party relationships and transactions requires a reporting entity to first determine whether a party meets the definition of a "related party."

ASC 850-10-20

Related parties include:

a. Affiliates of the entity. [That is, a party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an entity.]

b. Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825-10-15, to be accounted for by the equity method by the investing entity

c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management

d. Principal owners of the entity and members of their immediate families

e. Management of the entity and members of their immediate families

f. Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests

g. Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

The SEC believes, as discussed in SEC FRM 9610.3, that reporting entities should consider whether to disclose information about parties that fall outside of the definition of a related party, but with whom a relationship exists that enables the parties to negotiate terms of material transactions that may not be available for other, more clearly independent, parties on an arm's-length basis. This could include, for example, doing business with former management. The SEC believes that reporting entities should disclose such circumstances when a user of the financial statements may not be able to understand the reporting entity's results of operations without a clear explanation of these arrangements and relationships.

26.3 Related party presentation matters

S-X 4-08(k) requires reporting entities to identify material related party transactions on the face of the balance sheet, income statement, or statement of cash flows to draw attention to their existence. SEC guidance also specifically requires disclosure of receivables due from related parties, securities of related parties, and indebtedness of related parties on the face of the balance sheet.

In addition, certain U.S. GAAP topics also require separate identification of material items on the face of the financial statements, including receivables (ASC 310), investments (ASC 323), payables (ASC 405), and equity (ASC 505).

For example, a reporting entity should separately identify amounts of revenue earned from or expenses incurred to a related party on the face of its income statement. ASC 850 also specifies that a reporting entity should separately identify notes or accounts receivable from officers, employees, or affiliated entities on its balance sheet and not include such items under a general heading such as notes receivable or accounts receivable.

26.3.1 Common control transactions

Some related party transactions involve transactions between entities under common control, such as a transfer of a business or a combination of businesses. These transactions could result in the change of a reporting entity. For more on the presentation and disclosure requirements associated with a change in reporting entity, refer to FSP 30.

26.4 Related party required disclosures

The disclosure provisions of ASC 850 are intended to enable users of financial statements to evaluate the nature and financial effects of related party relationships and transactions. In general, the disclosures outlined below are required when the financial statements include material related party transactions. However, related party transactions are subject to these disclosure requirements even if they are not given accounting recognition in the financial statements.

Related party transactions that occur in the ordinary course of business, such as compensation arrangements, expense allowances, and other similar items, may not require the same extent of disclosure. For example, a private company whose only employees are its owners may not need to provide detail about compensation arrangements beyond their existence even though compensation is being paid to related parties. In some situations, the relationship's effect on the financial statement may be pervasive enough that disclosing the relationship alone is sufficient. Regardless, SEC registrants need to include sufficient disclosure to address SEC requirements, including S-X 4-08(k).

It may be appropriate to aggregate similar transactions by type of related party. Before aggregating, the reporting entity should consider whether disclosure of the name of a related party is necessary for a user to understand the relationship.

Related party transactions eliminated in the preparation of consolidated or combined financial statements are not required to be disclosed in those statements.

ASC 850 provides guidance on related party disclosures.

ASC 850-10-50-1

The disclosures shall include:

a. The nature of the relationship(s) involved

b. A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, for each of the periods for which income statements are presented, and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements

c. The dollar amounts of transactions for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period

d. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement

e. The information required by paragraph 740-10-50-17.

ASC 740-10-50-17

An entity that is a member of a group that files a consolidated tax return shall disclose in its separately issued financial statements:

a. The aggregate amount of current and deferred tax expense for each statement of earnings presented and the amount of any tax-related balances due to or from affiliates as of the date of each statement of financial position presented

b. The principal provisions of the method by which the consolidated amount of current and deferred tax expense is allocated to members of the group and the nature and effect of any changes in that method (and in determining related balances to or from affiliates) during the years for which the above disclosures are presented.

The above disclosures are incremental to identification of related party transactions on the face of the financial statements.

26.4.1 *Disclosures about common control relationships*

A reporting entity may also need to consider whether to disclose common control ownership or common management even though there may not have been any transactions with the reporting entity.

ASC 850-10-50-6

If the reporting entity and one or more other entities are under common ownership or management control and the existence of that control could result in operating results or financial position of the reporting entity significantly different from those that would have been obtained if the entities were autonomous, the nature of the control relationship shall be disclosed even though there are no transactions between the entities.

26.4.2 *Disclosures about arm's-length basis of transactions*

Transactions involving related parties cannot be presumed to be at arm's length. As discussed in ASC 850-10-50-5, a reporting entity should only disclose that a transaction was at arm's length when it can substantiate such a representation.

For example, a reporting entity may want to disclose that a loan arrangement between the reporting entity and a related party is at arm's length. Such disclosure would only be appropriate if the reporting entity is able to substantiate that the terms of the loan are equivalent to terms it would have obtained with an unrelated lender. Similarly, a reporting entity may sell services to third parties and related parties at the same rate. In this situation, the reporting entity may be able to substantiate that the transactions occur at arm's length.

26.5 *Common related party transactions*

In order to comply with the related party disclosure requirements, a reporting entity must identify all of its transactions with related parties. This section includes examples of common transactions with related parties. Once a related party transaction is identified, a reporting entity should determine the appropriate presentation and disclosure based on the requirements in ASC 850, SEC guidance (if applicable), and other relevant guidance, if any. Reporting entities should consider the substance of the related party transaction, which could be different than the legal form of the arrangement, when determining the appropriate presentation and disclosure.

26.5.1 *Investments, including equity method investments and investments in joint ventures*

Equity method investees are, by definition, related parties. A reporting entity could hold investments in other related parties, including partnerships or joint ventures. In addition to the disclosures in FSP 26.4, refer to FSP 10 for information about disclosures for such investments.

26.5.2 Leasing arrangements

Use of a reporting entity's property and equipment by a related party, or use of a related party's property and equipment by the reporting entity, is often subject to the terms of a lease. In addition to the disclosures in FSP 26.4, refer to FSP 14 for disclosures related to leases.

A reporting entity also needs to include certain VIE disclosures discussed in FSP 18 if the related party lease arrangement results in the existence of a variable interest. A private company lessee may also elect the PCC alternative for common control leasing arrangements, as discussed in FSP 26.6.1.

26.5.3 Centralized treasury function

There may be instances where a reporting entity is part of a corporate structure that has a centralized treasury function, such as centrally managed payables, receivables, and cash accounts. Refer to FSP 6 for information about the presentation and disclosure of cash flows when this arrangement is present.

26.5.4 Debt

Financial structures may result in borrowing and lending relationships among related parties. Common examples include lending relationships between parents and subsidiaries, among subsidiaries, between advisors and funds they advise, and between shareholders and the companies in which they invest, among others. A reporting entity should disclose the terms of related party lending relationships upon issuance and while the debt remains outstanding, consistent with the disclosures discussed in FSP 12.

As discussed in ASC 470-50-40-2, upon modification or extinguishment of related party debt, a reporting entity should consider whether the modification or extinguishment transaction is, in substance, a capital transaction. If the reporting entity concludes that it is a capital transaction, it should provide the disclosures discussed in FSP 5.

If a related party's securities constitute a substantial portion of the collateral for any class of an SEC-registered (or to be registered) reporting entity's securities, the reporting entity may need to include the related party's separate financial statements in certain SEC filings. Refer to SEC 4540 for further discussion.

Question 26-1

Are there disclosures that a reporting entity should consider with regard to related party debt arrangements that are incremental to the debt disclosures required by ASC 470?

PwC response

Because related party debt may not be issued in an arm's-length transaction, a reporting entity should consider disclosure of certain information in addition to the lending terms required to be disclosed by ASC 470—for example, commitment fees or fees incurred to structure the debt. A reporting entity should also consider disclosing situations when unused commitments for long-term financing arrangements may be withdrawn. For example, an investor may lend to an equity method investee but limit the capacity of the loan to the amount that it has available on its line of credit with a third-party lender.

26.5.5 Guarantees

A reporting entity may make guarantees for the benefit of related parties. In those cases, the guarantor is required to comply with the disclosure requirements discussed in FSP 26.4, as well as several other U.S. GAAP topics (as applicable): Guarantees (refer to FSP 23), equity method investments (refer to FSP 10), and VIEs (refer to FSP 18).

Under the US securities laws, a guarantee (whether registered or to be registered) of a security that is registered or to be registered is considered to be a security separate and apart from the security it guarantees. Reporting entities with these circumstances should consider the guidance in S-X 3-10 and FSP 12.

26.5.6 Equity

Related party arrangements are common between a reporting entity and its shareholders. Securities held by related parties may be different classes of common or preferred equity, or have different rights such as liquidation preferences, voting rights, or dividend rights. These special terms may need to be disclosed as related party transactions.

The SEC requires certain disclosures when a reporting entity is restricted in its ability to transfer or dividend assets (cash or other assets) from its subsidiaries. SEC registrants should comply with the disclosure requirements in S-X 4-08(e), discussed in SEC 4510.

26.5.7 Advances to and receivables from related parties

Related party receivables from the sale of equity have specific presentation and disclosure requirements. Refer to FSP 5 for further discussion.

Parent companies may have taken on debt resulting from the purchase of the reporting entity, but not applied pushdown accounting. Or, a reporting entity may sell substantially all of its manufactured goods to a parent and only settle its receivable periodically (see FG 5.5). Both of these are related party transactions that could have presentation or disclosure implications.

26.5.8 Business combinations

A business combination may include the settlement of a preexisting relationship such as between a vendor and customer, licensor and licensee, or plaintiff and defendant. If the counterparty in the preexisting relationship was a related party before the business combination, but is no longer a related party after the business combination, a reporting entity should still consider appropriate disclosure in accordance with the principles underlying ASC 850. For disclosures related to business combinations, including those related to the settlement of a preexisting relationship, refer to FSP 17.

26.5.9 Deconsolidation of a subsidiary

ASC 810 provides guidance for deconsolidation of a subsidiary and derecognition of a group of assets on a prospective basis as a result of an event. In the period that either a subsidiary is deconsolidated or a group of assets is derecognized, it requires the reporting entity to disclose: (i) whether the transaction that resulted in the deconsolidation or derecognition was with a related party and (ii) whether the former subsidiary or entity acquiring the assets will be a related party after deconsolidation.

26.5.10 Compensation arrangements

Compensation arrangements among related parties can take many forms, including royalty arrangements or payments made or received for various services, such as accounting, management, engineering, marketing, and legal services. They could include payments of cash, other assets, or equity. These arrangements can result in compensation at levels that are not commensurate with market rates.

In addition to the disclosures described in FSP 26.4, SEC guidance (SEC FRM 7220.1) also specifically requires a reporting entity to provide quantified disclosure of significant related party compensation arrangements that resulted in below market compensation expense.

26.5.11 Franchisors

A franchise arrangement may constitute a related party relationship. For example, a franchisor may own outlets that it also operates, or significantly influence the management or operating policies of the franchisee such that the franchisee might be prevented from fully pursuing its own separate interest. ASC 952-605-45 requires franchisors to distinguish revenue and costs related to franchisor-owned outlets from revenue and costs related to franchised outlets where practicable. ASC 952-605-50-3 also requires disclosures about significant changes in franchisor-owned outlets.

26.6 Considerations for private companies

The requirements of ASC guidance discussed above apply equally to public and private companies. SEC requirements discussed in this chapter apply only to SEC registrants. Figure 26-1 summarizes the SEC requirements discussed in this chapter.

Figure 26-1
Presentation and disclosure requirements applicable only to SEC registrants

Description	Reference	Section of this chapter
Disclose certain information about parties that fall outside of the definition of a related party	SEC FRM 9610.3	26.2
Identify the related party transaction on the face of the financial statements[1]	S-X 4-08(k)	26.3
Include quantified disclosure of significant compensation arrangements with related parties that result in below market compensation expense	SEC FRM 7220.1	26.5.10
Include a related party's separate financial statements in certain SEC filings if a related party's securities constitute a substantial portion of the collateral for any class of an SEC-registered reporting entity's securities	S-X 3-16	26.5.4
Include financial statement of a guarantor who guarantees a registered security	S-X 3-10	26.5.5
Disclose certain information when a reporting entity is restricted in its ability to transfer or dividend assets from its subsidiaries	S-X 4-08(e)	26.5.6

[1] Other areas of U.S. GAAP may require disclosure of related party transactions on the face of the financial statements for both public and private companies. Refer to FSP 26.3.

26.6.1 Private company alternative — common control leasing

ASU 2014-07, *Applying Variable Interest Entity Guidance to Common Control Leasing Arrangements*, exempts private companies from the requirement to apply the consolidation guidance for variable interest entities to lessor entities under common control when certain criteria are met.

A private company that adopts this alternative will not consolidate the lessor entity or be required to make the related VIE disclosures. However, the private company is required to disclose arrangements that expose it to providing financial support to the lessor entity. This could include: (1) the amount and key terms of liabilities recognized by the lessor entity (such as debt, environmental liabilities, and asset retirement obligations) or (2) a qualitative description of arrangements not recognized in the lessor entity's financial statements (such as commitments or contingencies).

The above disclosures are required in addition to the disclosure requirements for related parties, leases (as discussed in FSP 14), and guarantees (as discussed in FSP 23).

Chapter 27: Discontinued operations

27.1 Chapter overview

U.S. GAAP requires separate presentation of discontinued operations in financial statements in certain circumstances. The objective of separately identifying discontinued operations is to provide users of financial statements the ability to clearly understand the portion of a reporting entity's operations that will not continue in the future and to provide comparability of historical financial results with a company's continuing operations.

This chapter provides guidance on evaluating whether a component of an entity meets the criteria for discontinued operations reporting, and the presentation and disclosure requirements for reporting discontinued operations. In April 2014, the FASB issued new guidance on discontinued operations, which we refer to as the "revised standard" throughout this chapter. Guidance on both the current and revised standard are covered in this chapter and are separately identified as such, where applicable.

The guidance on presenting discontinued operations in the statement of cash flows is addressed in FSP 6 and the impact on earnings per share is addressed in FSP 7.

27.2 Scope

A reporting entity that disposes of a component or has a component that qualifies as held for sale may meet the criteria for presentation as a discontinued operation under the current or revised standard. The current and revised standards apply to all business entities, as well as not-for-profit entities. However, oil and gas properties that are accounted for using the full-cost method of accounting as prescribed by the SEC are excluded from the scope of the current and revised standards.

27.3 Criteria for reporting discontinued operations

For a reporting entity's component(s) to qualify as a discontinued operation, at the balance sheet date it must either be disposed of (e.g., through sale, abandonment, or spin-off) or meet the held for sale criteria of ASC 360-10-45-9 (refer to BCG 10.4.2 for held for sale guidance), and meet the additional criteria of ASC 205-20 that is discussed in this section. A component of an entity is defined as follows:

ASC 205-20-20

Component of an Entity: A component of an entity comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. A component of an entity may be a reportable segment or an operating segment, a reporting unit, a subsidiary, or an asset group.

We do not believe that a component can be at a lower level than an asset group.

Question 27-1

Can a reporting entity that sells an operation but retains certain assets associated with the operation (e.g., working capital or a facility) consider the operation a component of the reporting entity?

PwC response

Although the retained assets would not be part of the disposal group, the operations and cash flows associated with the assets to be sold may still constitute a component of a reporting entity as defined in ASC 205-20-20. In that situation, the results of operations of the component would be classified as discontinued operations provided the conditions of ASC 205-20 are met.

A reporting entity's assessment of whether a component qualifies for discontinued operations reporting should occur when the component initially meets the criteria to be classified as held for sale. For abandonments, spin-offs, and exchanges, the assessment should take place when the component is disposed of.

A disposal group should be classified as held for sale in the period all of the conditions in ASC 360-10-45-9 are met. These conditions must be met at the balance sheet date for the disposal group to be classified as held for sale on that date. New information resulting from a change in circumstances that occurred after the balance sheet date, but prior to issuance of the financial statements, would not be considered in evaluating whether the disposal group in question would be classified as held for sale at the balance sheet date.

However when evaluating a disposal group, that has been disposed of or is classified as held for sale at the balance sheet date, for purposes of determining if the criteria for discontinued operations presentation have been met (under the current standard), the reporting entities should evaluate significant events or circumstances that occur after the balance sheet date until the issuance of the financial statements for purposes of assessing significance of continuing involvement or continuing cash flows. Subsequent to the issuance of the financial statements, a reporting entity should continue to reassess whether a disposal group qualifies for discontinued operations presentation for the one-year period subsequent to disposal, regardless of whether the disposal group initially qualified for presentation as discontinued operations. Refer to FSP 27.3.1.3 for guidance on reassessing discontinued operations. The revised standard eliminated consideration of subsequent events to assess continuing cash flows or continuing involvement to determine if the criteria for a discontinued operation was met.

A reporting entity may have a disposal strategy that involves the "run-off" of operations (e.g., the reporting entity will cease accepting new business but will continue to provide services under existing contracts until they expire or terminate). Under ASC 360-10-45-15, a component of a reporting entity that is to be abandoned through the run-off of operations should not be reported as a discontinued operation until all operations, including run-off operations, cease.

The following sections provide guidance to determine whether the component meets the conditions in ASC 205-20 to be reported as a discontinued operation. FSP 27.3.1 discusses the criteria under the current standard; FSP 27.3.2 discusses the criteria under the revised standard.

27.3.1 Conditions required for reporting discontinued operations — current standard

A component that is either disposed of (e.g., through sale, abandonment, or spin-off) or meets the criteria to be classified as held for sale under ASC 360 is to be reported as discontinued operations if both of the following conditions of ASC 205-20-45-1 are met:

Excerpt from ASC 205-20-45-1

a. The operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the reporting entity as a result of the disposal transaction

b. The reporting entity will not have any significant continuing involvement in the operations of the component after the disposal transaction

If a plan of disposal involves multiple components, each component should be evaluated individually, and only components that meet the criteria for discontinued operations treatment should be reported as discontinued operations. If a plan of disposal involves one component to be disposed of via multiple disposal transactions, discontinued operations is appropriate only if the entire component is to be disposed of and each disposal group individually meets the other criteria above.

When determining whether a plan of disposal contains multiple components (e.g., a business that is sold in pieces to multiple buyers in multiple transactions), the reporting entity must carefully consider whether portion(s) of the group of assets to be disposed of can be distinguished, operationally and financially, from the group. A reporting entity's historical determination of asset groups for impairment testing of long-lived assets may be useful in making this evaluation. Depending on the length of time that passes between the disposals of portions of the group (usually one year), it may be difficult to conclude that the disposals are part of a single component.

27.3.1.1 *Elimination of ongoing operations and cash flows along with significant continuing involvement — current standard*

ASC 205-20-55-4 through 55-8 provides guidance for assessing whether future operations and cash flows have been eliminated from the ongoing operations of a reporting entity. ASC 205-20-55-9 through 55-14 focuses on whether a reporting entity expects to generate cash flows from activities involving the disposed component after its disposal. The evaluation of whether operations and cash flows have been eliminated requires significant judgment. For example, outsourcing certain processes and functions of a business may or may not represent an elimination of the operations and future cash flows.

ASC 205-20 introduces the concept of "direct" versus "indirect" cash flows, which are determined by both the nature and the significance of the cash flows. The nature of direct cash flows includes the reporting entity recognizing revenues and costs that likely would have been generated by the disposed component absent the disposal transaction (a "migration") or it may also relate to the continuing of revenue-producing or cost-generating activities through active involvement with the disposed component (a "continuation of activities").

Cash flows of the component are not eliminated if the continuing cash flows to or from the reporting entity are considered direct cash flows. Cash inflows from revenue-producing activities or cash outflows from cost-generating activities are considered direct cash flows if either of the following is true:

- Significant cash inflows/outflows are expected to be recognized by the ongoing reporting entity as a result of a migration of revenues/costs from the disposed component to the ongoing entity after the disposal transaction

- Significant cash inflows/outflows are expected to be received/incurred by the ongoing reporting entity as a result of a continuing activities between the ongoing entity and the disposed component after the disposal transaction

The migration of revenues or costs reflects continued transactions with the same customers or vendors of the disposed component. ASC 205-20-55-70 through 55-71 provides an illustration of a migration of revenues that result from the replacement of several smaller retail outlets with a new superstore in the immediate geographic region. ASC 205-20-55-67 through 55-69 provides an additional example of migration resulting from the replacement of one distribution method (e.g., brick-and-mortar store) with another (e.g., internet-based sales channel).

In contrast, ASC 205-20-55-63 through 55-65 notes that the disposal of a commercial office building (that represents a component of a reporting entity) and simultaneous purchase of another commercial office building in the same geographic region would not necessarily indicate a migration, even if the ongoing entity believes that certain lessees from the sold building will also be lessees in the new building. This is because the customers in the new building (lessees) have not necessarily migrated from the old facility. Rather, they have leased additional space in the new facility and have not necessarily terminated their prior lease agreements.

Question 27-2

Does the closure of individual retail outlets of a commercial entity result in the closed outlets being reported as discontinued operations?

PwC response

The facts and circumstances of each store closure needs to be considered in such an evaluation. If a store is considered an asset group, has self-contained operations, and is geographically located in such a way that its closure would not result in the migration of the store's customer cash flows (i.e., the customers would not be expected to shop at another store in the chain or shop using the company's e-commerce site), it would likely qualify for discontinued operations reporting. However, a store that is integrated may not qualify for discontinued operations as there may be a migration of revenues. Careful consideration should be given to all relevant facts and management assumptions regarding the store closure decision and expected customer behaviors to determine the appropriate classification. Refer also to ASC 205-20-55-70 through 55-71.

An ongoing reporting entity might continue revenue-producing or cost-generating activities of the disposed component through active involvement with the disposed component after the disposal transaction. For example, the ongoing reporting entity may have sold (or purchased) products or services to (from) the disposed component before its disposal (which were recognized as intercompany sales). It may continue to sell (purchase) similar products or services to (from) the disposed component, or a related party of the disposed component after its disposal through arrangements such as a supply agreement or a transition services agreement.

If the ongoing reporting entity determines that it will generate continuing cash flows as a result of a migration or continuation of activities, it must evaluate whether those cash flows will be significant to the ongoing entity. ASC 205-20-55-14 specifically requires significance to be based on gross cash inflows and outflows and does not permit an entity to assess only the net effect of cash flows, even if the transactions may be presented on a net basis in the financial statements. The evaluation is a matter of judgment and should be based on a comparison between (1) the expected continuing cash flows to be generated by the ongoing entity after the disposal transaction, and (2) the cash flows that would have been expected to be generated by the disposed component absent the disposal transaction, including cash flows from both third-party and intercompany transactions.

The ongoing entity should assess whether continuing cash flows are expected to be generated, for example, from transactions with the disposed component, such as a purchase/supply agreement whereby the seller continues to purchase/supply goods and/or services from/to the disposed component.

Examples of the computations performed to evaluate significance include:

- Cash inflows expected to be received by the ongoing entity divided by the expected cash inflows (e.g., revenue) of the disposed component

- Cash outflows expected to be incurred by the ongoing entity related to generating cash inflows (e.g., cost of goods sold or selling expenses) from the disposed component divided by the total expected cash outflows of the disposed component

- Cash outflows expected to be paid by the ongoing entity for other transactions related to the disposed component divided by the total expected cash outflows of the disposed component

ASC 205-20 provides examples for calculating the significance of continuing cash flows. However, it does not provide guidance for the period over which cash flows should be considered when evaluating significance. Practice has developed to measure significance using the estimated cash flows during the year following the disposal of the component. However, the period to be used is a matter of judgment.

The guidance does not provide any bright lines with respect to determining the significance of cash flows. However, the examples contained in ASC 205-20-55-27 through 55-81 suggest that continuing cash flows of 20 percent or more would generally be considered significant while continuing cash flows of 5 percent or less are generally considered insignificant. Judgment is required in circumstances in which continuing cash flows exceed 5 percent but are less than 20 percent.

Reporting entities should also consider qualitative factors in addition to the quantitative measures of significance. For example, if the cash flows will continue for a period of less than 12 months after the disposal date, it may suggest that the cash flows are not as significant. Conversely, if the cash flows will continue for a period longer than 12 months after the disposal date, a greater level of scrutiny may be placed on the quantitative significance of those cash flows.

The guidance refers to "indirect" cash flows as those cash flows that are not "direct." ASC 205-20-55-19 provides the following examples of circumstances that would be considered "indirect" and would not constitute continuing cash flows:

ASC 205-20-55-19

The circumstances discussed in paragraph 205-20-45-5 would not constitute continuing cash flows or continuing involvement. Examples include the following:

a. The resolution of contingencies that arise pursuant to the terms of the disposal transaction, such as the resolution of purchase price adjustments and indemnification issues with the purchaser

b. The resolution of contingencies that arise from and that are directly related to the operations of the component prior to its disposal, such as environmental and product warranty obligations retained by the seller

c. The settlement of employee benefit plan obligations (pension, postemployment benefits other than pensions, and other postemployment benefits), provided that the settlement is directly related to the disposal transaction

In addition, ASC 205-20-55-39 through 55-40 refers to direct cash flows that are not significant (i.e., generally less than 5 percent) as indirect.

Finally, ASC 205-20-55-13 provides examples of continuing cash flows that would generally not be considered a migration or continuation of activities (i.e., would be considered indirect cash flows):

- Interest income from seller financing
- Contingent consideration
- Dividends
- A passive royalty interest in the disposed component's operations (essentially a different form of contingent consideration), in contrast to the continued and active use of a patent, trademark, or intellectual property retained by the seller.

27.3.1.2 Assessing if there is significant continuing involvement with the disposed component — current standard

In situations where the ongoing reporting entity does not generate direct cash flows from the disposed component (i.e., significant continuation or migration of cash flows), the reporting entity still needs to evaluate whether it has significant continuing involvement in the operations of the disposed component. All types of continuing involvement should be assessed, individually and in the aggregate, and should reflect both quantitative and qualitative considerations.

ASC 205-20-55-17 provides several factors that should be considered in assessing whether a contract or arrangement enables the ongoing reporting entity to exert significant influence over the disposed component's operating and financial policies. This evaluation will depend on the significance and extent of involvement in the operations, the rights conveyed to each party, and the pricing of such arrangements. Continuing involvement should be assessed at the individual component level. In cases where a disposal group contains more than one component, assessing continuing involvement should be performed for each component contained within the disposal group.

The following example illustrates the evaluation of continuing involvement when a disposal group contains more than one component.

EXAMPLE 27-1

Evaluation of continuing involvement

FSP Corp has five operations that aggregate into one operating segment, and is in the process of disposing of four of the five operations, all of which qualify as held for sale. Each operation within the operating segment qualifies as a component under ASC 360-10-20. The four operations will be sold to one buyer in a single transaction. FSP Corp will have continuing involvement with one of the four operations in the form of a supply agreement, but will not have any continuing involvement with the other three operations. The continuing involvement is assessed to be insignificant when compared to the four operations in the aggregate, but is significant in relation to the specific operation that FSP Corp will enter into a supply agreement with.

Analysis

The specific operation entering into the supply agreement with FSP Corp should not be classified as a discontinued operation. The other three operations being sold should be classified as discontinued operations, assuming the other conditions in ASC 205-20-45-1 are met.

A retained cost method investment in common stock or in-substance common stock alone would not be considered significant continuing involvement. However, a retained equity method investment would be considered significant continuing involvement and, therefore, would preclude discontinued operations treatment under current guidance. Further as indicated in SAB Topic 5.Z, *Accounting and Disclosure Regarding Discontinued Operations*, the SEC staff believes that retention of an ongoing interest sufficient to enable a reporting entity to exert significant influence over the component's operating and financial policies is indicative of a level of continuing involvement with the component that is inconsistent with its classification as a discontinued operation. In a one-step income statement format, gains or losses on disposals of businesses that do not qualify as a discontinued operation should be reported within income from continuing operations as "other general expenses." In a two-step income statement format, gains or losses may either be classified within operations or within non-operating gains and losses.

27.3.1.3 Other considerations when assessing whether a component is a discontinued operation — current standard

Reporting entities should reassess whether the criteria for discontinued operations reporting continue to be met for one year after the date the component is actually disposed of if significant events or circumstances occur that may change the original assessment. This reassessment should be performed regardless of whether the initial determination was that the component qualified as a discontinued operation (and then within the reassessment period it no longer qualifies) or if the component initially did not qualify as a discontinued operation (but during the reassessment period it later qualifies). The same threshold levels discussed in FSP 27.3.1.1 (i.e., 5 percent or less generally considered insignificant, 20 percent or more generally considered significant) should apply in both situations.

The current ASC 205-20 guidance about subsequent events recognizes that the assessment period may extend beyond one year after the disposal date if events or circumstances beyond a reporting entity's control occur within one year after the disposal extend the period required to eliminate the direct cash flows or significant continuing involvement. That extension is appropriate only if the reporting entity (1) takes the actions necessary to respond to those situations and (2) expects a favorable resolution to the delay. For example, the assessment period may be extended beyond one year if the nature of the business requires extensive, time-consuming regulatory approvals. The following example illustrates the evaluation of the discontinued operations criteria for events occurring during the reassessment period.

EXAMPLE 27-2

Evaluation of events during reassessment period

FSP Corp operates 3 businesses that each qualify as components under ASC 205. In April 20X4, FSP Corp determined that it would sell Component 1. FSP Corp through its Component 2 business, enters into a significant long term supply contract with Component 1. As a result, FSP Corp determines that the disposal of Component 1 does not meet the criteria (under ASC 205-20) for discontinued operations classification. The significant supply contract is the only factor that precludes discontinued operations classification of Component 1. Subsequently in November 20X4, FSP Corp sold Component 2.

Should FSP Corp reassess its discontinued operations conclusion for Component 1 in light of the sale of Component 2?

Analysis

Yes, FSP Corp should reassess Component 1 as a discontinued operation because the sale of Component 2 is a significant event within the one-year period following disposal of Component 1, which results in an expectation that the cash flows of Component 1 will now be eliminated during the assessment period. As the supply contract is the only factor that had precluded discontinued operations presentation for Component 1, that component should be reclassified to discontinued operations on the held for sale date of Component 2. This follows the guidance of ASC 205-20-55-20 through 55-23, which indicates that there is an assessment period for discontinued operations presentation when the sale of a component occurs.

If a significant event or circumstance occurs and the ongoing reporting entity no longer expects that the discontinued operations criteria will be met by the end of the assessment period, the component's operations should cease to be presented as discontinued operations. In this situation, the operations of the component originally presented as discontinued operations should be reclassified to reflect the updated status for all periods presented. Refer to FSP 27.5.1.2 for presentation and disclosure requirements of a discontinued operation that is subsequently retained.

The FASB staff has noted that seller-provided financing generally does not constitute significant continuing involvement, unless such financing effectively enables the seller to participate in or significantly influence the continuing operations of the disposed component. In certain circumstances, seller-provided financing could preclude sale accounting and/or discontinued operations treatment. For example, the reporting entity may also need to assess if the seller-provided financing results in the seller being considered the primary beneficiary in a variable interest entity requiring consolidation under ASC 810, *Consolidation*.

Question 27-3

Do reporting entities that routinely buy and sell components as part of their normal course of business, such as a real estate reporting entity that frequently sells leased properties and purchases new properties, need to report their disposals as discontinued operations?

PwC response

Yes. While the presentation of discontinued operations may suggest a permanent contraction of the reporting entity's business when in fact the proceeds are reinvested in new components that are similar to those disposed, the current standard does not provide an exception to discontinued operations reporting for reporting entities that frequently dispose of components that otherwise meet the criteria for reporting on a discontinued operation.

27.3.1.4 Equity method investments — current standard

In the current guidance a disposal of an investment accounted for under the equity method, which is not part of a larger component, does not qualify for reporting as a discontinued operation under ASC 205-20 because the investment is not an "operation." Including the component in discontinued operations is appropriate if the investment is part of a larger component that otherwise meets discontinued operations reporting requirements. Prior periods should be reclassified for all periods in which the investment was part of the larger component provided the conditions for discontinued operations presentation are met. The previously recognized equity method income (loss) would not be reclassified for any prior periods that the equity method investment was not part of the larger component group (for example, when the entity owns solely the equity investment prior to acquiring a controlling interest).

Example 27-3 demonstrates some of the principles associated with assessing discontinued operations presentation of disposals involving equity method investments.

Example 27-3

Discontinued operations presentation when selling equity method investments

In September 20X4, FSP Corp sells 60% of its interest in wholly-owned Subsidiary A, resulting in equity method accounting for the remaining 40% investment.

Should FSP Corp classify its sale of 60% of Subsidiary A as discontinued operations? What if FSP Corp sells the remaining 40% equity method investment two years later?

Analysis

Discontinued operations is not appropriate for the initial sale of the 60% of Subsidiary A because FSP Corp retained an equity method investment (i.e., the criteria in ASC 205-20-45-1 (discussed in FSP 27.3.1) would not be met for the 60% sale of a component).

The sale of the 40% interest in Subsidiary A two years later would also not qualify for discontinued operations reporting because 1) the reassessment period described in 205-20-55-20 through 55-23 has ended and 2) the equity method investment is not an "operation."

An investor should not report discontinued operations in its income statement for its share of the discontinued operations of an equity method investee. Rather, the investor should report its share of the investee's discontinued operations in the income statement line item containing its share of the investee's earnings or losses. Similarly, since the disposal of the entire equity investee may not be shown as a discontinued operation pursuant to ASC 360-10-15-5, we believe that disposal of a portion of an equity investment in an equity investee similarly should not be shown in discontinued operations under current guidance.

A reporting entity may have an equity method investment that later becomes a wholly-owned subsidiary. When the subsidiary that was once an equity method investment is disposed of and qualifies for discontinued operations, questions arise as to how the prior periods should be presented. The results of operations of the subsidiary would be presented in discontinued operations for only the prior periods that the parent had a controlling financial interest in the subsidiary. The following example illustrates this presentation.

EXAMPLE 27-4

Presentation of a component that was previously an equity method investment

On December 1, 20X1, FSP Corp acquires a 40% interest in Subsidiary Y that is accounted for as an equity method investment. On January 1, 20X3, FSP Corp acquires the remaining 60% interest in Subsidiary Y, which results in FSP Corp

consolidating Subsidiary Y. On April 30, 20X4, FSP Corp sold 100% of Subsidiary Y. Subsidiary Y is a component meeting all of the criteria for discontinued operations presentation.

In its December 31, 20X4 financial statements, should FSP Corp present the operations of Subsidiary Y as discontinued operations or as continuing operations?

Analysis

FSP Corp should present the results of operations of Subsidiary Y for the periods it was a subsidiary (i.e., January 1, 20X3 through April 30, 20X4) within discontinued operations. The results of operations during the period that the interest in Subsidiary Y was accounted for under the equity method should be reported within continuing operations because ASC 360-10-15-5 prohibits a reporting entity from reporting the disposal of an equity method investment as discontinued operations.

27.3.2 Conditions required for reporting discontinued operations – revised standard

Under the revised standard, a component of a reporting entity or a group of components of a reporting entity that are disposed or meet the criteria to be classified as held for sale should be reported in discontinued operations if the disposal represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results.

Significant continuing involvement or continuing cash flows and operations with a disposed component or group of components no longer precludes a reporting entity from presenting those components as discontinued operations under the revised standard. However, reporting entities should still consider the nature and extent of continuing involvement in order to evaluate whether there has been a strategic shift that has (or will have) a major effect on their operations and financial results.

Evaluating whether a disposal constitutes a discontinued operation begins with assessing whether a strategic shift has occurred. The revised standard states that a strategic shift could include the "disposal of a major geographical area, a major line of business, a major equity method investment, or other major parts of an entity." The concept of a strategic shift is intended to be reporting entity specific based on qualitative and quantitative facts and circumstances. For example, a reporting entity that only operates in the Northeast region of the U.S. may conclude that each state represents a major geographical area. In contrast, a large multinational reporting entity may conclude that each continent represents a major geographical area.

Once a reporting entity determines that a disposal constitutes a strategic shift, it must also determine whether the disposal has had or will have a major effect on the reporting entity's operations and financial results to be considered a discontinued operation. Therefore, the disposal of a business may represent a strategic shift, but if its disposal does not or will not have a major effect on the reporting entity's operations and financial results, it would not be treated as a discontinued operation. A reporting entity may consider certain metrics when evaluating the quantitative impact of a disposal, including a combination of total assets and liabilities, revenues, operating income, pretax income, EBITDA, net income, and operating cash flows. In terms of the evaluation period, we believe the greatest emphasis should be placed on the most recently completed, current, and next annual reporting periods.

The revised standard provides no "bright line" guidance on what is the minimum threshold for a disposal having a major effect. However, it does include five examples of strategic shifts that have or will have a major effect on a reporting entity's operations and financial results and therefore result in reporting a disposed component or group of components as a discontinued operation. These examples, included in the revised standard, relate to the following:

- The sale of a product line that represents 15 percent of a reporting entity's total revenues

- The sale of a geographical area that represents 20 percent of a reporting entity's total assets

- The sale of all of a reporting entity's stores in one of its two types of store formats that historically provided 30 to 40 percent of the reporting entity's net income and 15 percent of current period net income

- The sale of a component that is an equity method investment that represents 20 percent of the reporting entity's total assets

- The sale of 80 percent of a product line that accounts for 40 percent of total revenue, but the seller retains 20 percent of its ownership interest

Along with the examples in the revised standard, we believe that disposing of a reportable segment will, in most cases, be the type of strategic shift that qualifies as a discontinued operation. A reporting entity should carefully consider whether disposing of an operating segment or reporting unit represents a strategic shift in operations. SEC registrants may also want to consider the extent to which the component's performance was previously presented or discussed in MD&A, earnings releases, and other communications in reaching their conclusion.

Reporting entities that prepare subsidiary-level financial statements should separately evaluate whether a strategic shift has occurred and whether it has (or will have) a major effect on the reporting entity's operations and financial results at each level. A subsidiary may reach a different conclusion than its parent.

27.3.2.1 *Acquired business that qualifies as held for sale upon acquisition – revised standard*

Any business or nonprofit activity that upon acquisition meets the held for sale criteria is required to be presented as a discontinued operation regardless of whether it represents a strategic shift that has (or will have) a major effect on a reporting entity's operations and financial results. The held for sale criteria in ASC 360-10-45-9(d) is the only criteria required to be met at the acquisition date, and the remaining criteria should be probable of being met within a short period of time following the acquisition date, which is usually within three months. Refer to FSP 8.7 for additional information on the held for sale criteria.

The objective of this requirement is to include in discontinued operations those businesses that will never be considered part of a reporting entity's continuing operations.

27.4 Presentation

This following section provides guidance on the presentation requirements in a reporting entity's financial statements when reporting discontinued operations. The balance sheet and income statement are addressed below. The statement of stockholders' equity is not impacted by discontinued operations reporting. For reporting on the statement of cash flows refer to FSP 6. Differences between the current standard and the revised standard are identified when differences exist.

27.4.1 *Balance sheet*

A component of a reporting entity that meets the criteria for discontinued operations reporting and held for sale classification should follow the balance sheet presentation requirements in ASC 360-10-45-14. Refer to FSP 8.7 for further information about presenting assets held for sale on the balance sheet including current and non-current classification.

27.4.1.1 *Balance sheet — current standard*

ASC 205-20 does not require the assets and liabilities of a qualifying discontinued component to be reclassified in balance sheets prior to the period that the component is disposed of or becomes held for sale. However, the guidance in both PCAOB AS 6.11, *Evaluating Consistency of Financial Statements,* and AICPA AU 420.17, *Consistency of Application of Generally Accepted Accounting Principles,* implies that such reclassifications are permissible and requires material reclassifications be indicated and explained in the financial statements or footnotes. A reporting entity may retrospectively separate assets and liabilities held for sale in the balance sheets of prior periods provided the appropriate disclosures are made and the assets and liabilities held for sale can be reliably identified.

We also believe that in a spin-off transaction, it is acceptable to retrospectively separate the assets and liabilities of the entity being spun off (similar to if the entity had been held for sale) in the prior period balance sheets. However, because the assets disposed of through a spin-off transaction are required to remain classified as held and used until the spin-off has occurred, reclassification of the prior year balance sheet would not be appropriate until the spin-off is completed.

27.4.1.2 Balance sheet — revised standard

The revised standard requires the assets and liabilities of a disposal group that is held for sale to be presented separately for the current period and all prior periods. Even if a discontinued operation is disposed of by sale before the end of a reporting period and therefore is not classified as held for sale at the end of the period, the assets and liabilities of the discontinued operation must be presented separately as held for sale in the prior period balance sheet. Refer to FSP 8.7 for guidance on the balance sheet classification of assets held for sale. Assets and liabilities for disposal groups classified as held for sale that do not qualify as discontinued operations are not required to be reclassified in prior periods.

Reporting entities must continue to disclose separately, either in the balance sheet or in the footnotes, the major classes of assets and liabilities of a discontinued operation classified as held for sale for all periods presented. While the revised standard does not specify how to determine which classes of assets and liabilities held for sale should be considered major, an example included in the revised standard included cash, trade receivables, inventories, property, plant and equipment, trade payables, and short-term borrowings.

If the major classes of assets and liabilities of a discontinued operation classified as held for sale are disclosed in the footnotes, reporting entities must reconcile the disclosure to the total assets and total liabilities of the disposal group classified as held for sale presented on the face of the balance sheet for all periods presented. If the disposal group includes assets and liabilities that are not part of the discontinued operation, the reconciliation should show them separately from the assets and liabilities of the discontinued operation.

We believe the guidance in FSP 27.4.1.1 related to the classification of assets and liabilities in the prior period balance sheets of an entity being spun off would also be applicable under the revised standard.

27.4.2 Income statement

A reporting entity with a component that meets the conditions for discontinued operations should report the results of operations of the component, less applicable income taxes (benefit), as a separate component of income before extraordinary items (if applicable). A reporting entity should separately present the gain or loss recognized on the disposal of the component either on the face of the income statement or in the footnotes. Figure 27-1 illustrates an income statement when a reporting entity reports a discontinued operation:

Figure 27-1
Income statement presentation of discontinued operations

	Amount
Income from continuing operations, net	$xxx,xxx
Discontinued operations:	
Loss from operations of discontinued Component X	
(including loss on disposal of $xxx,xxx)	(xxx,xxx)
Income tax benefit	xxx,xxx
Loss on discontinued operations	(xxx,xxx)
Net income	$xxx,xxx

Costs associated with an exit or disposal activity that directly involves a discontinued operation are required by ASC 420-10-45-2 to be included in the results of discontinued operations. Additionally, impairment losses (as measured under the held for sale model) that directly involve a discontinued operation should be included in the results of discontinued operations.

The expenses that qualify for inclusion in discontinued operations are the direct operating expenses incurred by the disposed component that may be reasonably segregated from costs of the ongoing reporting entity. Indirect expenses, such as allocated corporate overhead, should not be included in discontinued operations based on ASC 205-20-45-9. Generally, costs and expenses that are expected to continue in the ongoing reporting entity after the disposal date should not be allocated to discontinued operations and instead should be included in the results of continuing operations.

Depending on facts and circumstances, examples of direct costs that may be reported in discontinued operations include:

- Personnel expenses for employees employed by the disposed component
- Intangible asset amortization associated with intangible assets disposed of in the transaction
- Lease-related costs for facilities that were used by the disposed component
- Interest expense associated with debt to be assumed by the buyer or repaid in conjunction with the disposal (see FSP 27.4.2.4)
- Third-party transaction costs associated with the disposal

Although usually an allocation, income tax amounts associated with the component being disposed should be reported in discontinued operations. Refer to TX 12.2.3.2 for additional information on the intraperiod allocation of income tax amounts to discontinued operations.

The following example illustrates the evaluation of whether rent expense and lease termination costs should be presented in discontinued operations or continuing operations.

EXAMPLE 27-5

Presentation of rent expense and lease termination costs associated with a disposed component

FSP Corp sells one of its businesses, Component X, to Company B during 20X4. Component X's operations have taken place on three floors (out of ten) of an office building leased by FSP Corp. The lease has a remaining term of five years. Upon sale of Component X, FSP Corp permanently exits these three floors but will continue to operate in the remaining office space within the leased facility. The exited floors are considered functionally independent assets (i.e., could be fully utilized by another party because they have separate entrances, access to restrooms, etc.) and, therefore, FSP Corp recognizes a liability for the fair value of the remaining rents, reduced by estimated sublease rentals, as of the date it exited the space (i.e., cease-use date) in accordance with ASC 420-10-30-8.

Assuming Component X's operations meet the criteria for discontinued operations, should FSP Corp present the related rent expense and lease termination costs in discontinued operations within its income statement?

Analysis

Because the three floors being permanently exited were used by Component X and were functionally independent from the remaining facility, the lease-related costs for this space are considered to be directly related to the component and therefore should be classified within discontinued operations.

Given a different fact pattern, such as if the three floors were not functionally independent and the lease was not terminated, there would be no lease termination charge recorded as the criteria in ASC 420-10-30-8 would not have been met and rent expense incurred for these three floors would be classified within continuing operations. Other costs (e.g., moving, cleaning, reconfiguration, etc.) associated with the leased space are not directly related to the disposal of Component X and also would not qualify for discontinued operations reporting.

If sales have been made to the discontinued operation by a consolidated affiliate and have been eliminated in consolidation, it would be appropriate to recast these sales (and the related costs) in continuing operations for periods prior to the disposal or held for sale date only if these sales will be made to third parties (e.g., the disposed component that is now a third party) subsequent to the disposition.

The following example illustrates the income statement presentation of an intercompany transaction with a disposed component that will continue after the disposal.

EXAMPLE 27-6

Presentation of intercompany transactions with a disposed component

FSP Corp enters into a sale agreement with Buyer to sell FSP Corp's wholly-owned subsidiary (Subsidiary X). Subsidiary X historically performed certain services for FSP Corp. Subsidiary X's fee for the services is $100 and the cost to deliver those services is $80. This intercompany transaction, determined to be at fair value, is eliminated in consolidation. Subsequent to disposal, the services are expected to continue between Subsidiary X and FSP Corp for approximately two years pursuant to a contractual agreement with Buyer. Through review of the guidance in ASC 205, FSP Corp concludes that Subsidiary X is a component and that it meets all of the criteria to report Subsidiary X as a discontinued operation.

How should FSP Corp present this transaction before and after Subsidiary X's disposal?

Analysis

We believe FSP Corp may present the intercompany transaction as a gross-up in its pre-disposal income statement by reporting the $100 service fee charged by Subsidiary X as an operating expense in continuing operations and reporting the fee revenue of $100 and related costs of $80 (net $20 profit) as a component of discontinued operations of Subsidiary X. This presentation provides consistent reporting of results from continuing operations since FSP Corp will continue to pay — and record in continuing operations — the service fees to Subsidiary X after the disposition pursuant to the two-year contractual agreement with Buyer.

Situations arise where the working capital of the disposed component is retained by the reporting entity. These working capital accounts would therefore not be presented as assets held for sale on the reporting entity's balance sheet. However, the results of operations of the disposed component, which would include the prior revenues and expenses related to the working capital accounts retained by the ongoing reporting entity, would be reported in discontinued operations on the income statement for the current and prior periods in accordance with ASC 205-20-45-3. The following example illustrates a situation where the working capital of the disposed component is retained by a reporting entity.

EXAMPLE 27-7

Working capital of disposed component retained

On March 1, 20X4, FSP Corp executes a definitive agreement to sell Component X. Assets to be sold include equipment, customer relationships, and other intangible assets. As part of the sale, FSP Corp retains working capital of Component X, which includes trade and non-trade accounts receivable, and certain accrued expenses arising from operations before closing. All retained working capital is short-term and expected to liquidate within a few months after the closing.

While the sale of certain assets of Component X will not close until April 30, 20X4, they meet the held for sale criteria under ASC 360-10-45-9 as of the quarter ended March 31, 20X4. Component X meets the definition of a component under ASC 360-10-20, and also meets both of the discontinued operations criteria.

What effect should the disposal of Component X have on FSP Corp's balance sheet and income statement in its March 31, 20X4 financial statements?

Analysis

The working capital that is retained by FSP Corp should not be presented as assets held for sale on the balance sheet. While retained working capital was part of Component X, which constituted the discontinued operations, it is not a part of the disposal group. The assets and liabilities of Component X that will be sold are presented as held for sale at March 31, 20X4. The results of operations of Component X (which include prior revenues and expenses related to the above working capital items) should be reported in discontinued operations on the income statement of FSP Corp for the current period and prior periods.

27.4.2.1 Gain or loss on disposal

The gain or loss on a disposed component is calculated as the consideration received from the disposal of the component less its carrying value and, if applicable, costs incurred to sell the component. In addition, any adjustments to the disposal group to record it at the lower of its carrying amount or fair value less cost to sell would be included in the gain or loss on disposal. Refer to BCG 10.4.2 for discussion of the types of costs that may be included in costs to sell a disposal group.

When a portion of a reporting unit that constitutes a business (as defined in ASC 805-10-20) is to be disposed of, goodwill associated with that business should be included in the carrying amount of the business in determining the gain or loss on disposal in accordance with ASC 350-20-40-2. In situations where a portion of a reporting unit's goodwill is allocated in determining the gain or loss, we believe it may also be appropriate to allocate a portion of any prior year goodwill impairment charge related to the reporting unit to discontinued operations.

27.4.2.2 Earnings per share

Refer to FSP 7 for guidance on the calculation and presentation of earnings per share when a reporting entity presents a discontinued operation.

27.4.2.3 Transition service agreements

Revenues and costs associated with transition services provided by an ongoing reporting entity to a disposed component after a disposition should not be reflected in the discontinued operations line item, but rather in continuing operations of the ongoing reporting entity. Each reporting entity must use judgment to determine appropriate classification of the revenues and costs (i.e., which income statement line item to include them in) within continuing operations. Revenue recognized from transition services should be recorded in other income if the services provided do not relate to the business in which the entity operates. Disclosure of the amount, nature, and classification of the cash flows should also be considered. See FSP 27.5.

27.4.2.4 Debt-related items

If debt of a discontinued operation is to be assumed by the buyer or is required to be repaid as a result of the disposal transaction, interest related to such debt should be allocated to the discontinued operation. The allocation to discontinued operations of other consolidated interest that is not directly attributable to or related to other operations of the reporting entity is permitted but not required. Other consolidated interest that cannot be directly attributed to other operations of the reporting entity is allocated based on the following ratio:

Net assets of discontinued operation

Less: Debt required to be paid off as part of disposal transaction

Divided by

Net assets of consolidated reporting entity

Plus: Consolidated debt

Less: Debt of the discontinued operation that will be assumed by buyer

Less: Debt required to be paid off as part of the disposal transaction

Less: Debt that is directly attributed to other operations

Excerpt from ASC 205-20-45-8

This allocation assumes a uniform ratio of consolidated debt to equity for all operations (unless the assets to be sold are atypical — for example, a finance company — in which case a normal debt to equity ratio for that type of business may be used). If allocation based on net assets would not provide meaningful results, then the reporting entity should allocate interest to the discontinued operations based upon debt that can be identified as specifically attributed to those operations.

The method used to allocate interest is considered an accounting policy election which should be applied consistently to all discontinued operations.

The SEC staff expects registrants to disclose their accounting policy for allocating interest to a discontinued operation, which should include the method of allocation. The amount of interest allocated to discontinued operations should also be disclosed for all periods presented. Similar disclosures would be appropriate for nonregistrants.

The following is an example of how to allocate interest to discontinued operations that is not directly attributable to or related to other operations of a reporting entity.

EXAMPLE 27-8

Allocation of interest to discontinued operations

FSP Corp sells Component Y on June 30, 20X4 and determines that it should report Component Y's operations as discontinued operations in its consolidated financial statements for the year ended December 31, 20X4. FSP Corp's borrowing arrangement requires that a portion of the proceeds of the sale of Component Y be used to repay FSP Corp's consolidated debt, and FSP Corp allocates interest expense for the repaid debt to discontinued operations in accordance with ASC 205-20-45-6. FSP Corp also makes an accounting policy decision to allocate interest on other consolidated debt not directly attributable to its other operations to discontinued operations as permitted by ASC 205-20-45-7.

For purposes of determining the amount of interest to allocate, assume a uniform ratio of consolidated debt to equity for all operations and:

For FSP Corp:

- Net assets: $50,000
- Consolidated debt: $15,000 — comprised of $1,000 at 8% interest (required to be repaid from proceeds of sale of Component Y) and $14,000 at 6% interest
- Portion of consolidated debt directly attributable to other operations of FSP Corp: $8,000 at 6% interest

For Component Y:

- Gross assets: $13,000 (after considering any impairment)
- Debt to be assumed by the buyer: $2,000 at 6% interest

- Net assets to be sold: $11,000 (gross assets less debt to be assumed by the buyer)
- Debt required to be repaid from sale proceeds: $1,000 at 8% interest

How should FSP Corp allocate interest expense to discontinued operations?

Analysis

FSP Corp should allocate interest expense of $122 to discontinued operations.

This is calculated as follows:

Part I: Calculate interest on debt to be assumed and debt required to be repaid:

Interest on debt to be assumed by the buyer:	
$2,000 x 6% x 6 / 12 months	$60
Interest on debt required to be repaid:	
$1,000 x 8% x 6 / 12 months	40
	$100 **(A)**

Part II: Calculate interest on other consolidated debt that is not directly attributable to other operations of FSP Corp.

Step 1: Calculate the percentage of interest on other consolidated debt that is not directly attributable to other operations of FSP Corp to be allocated to Component Y.

Net assets sold (after recognizing any impairment) less debt required to be repaid from sale proceeds: $11,000 — $1,000 = $10,000 **(B)**

—to—

Net assets of FSP Corp:		$50,000
Plus:	Consolidated debt	15,000
Less:	Debt to be assumed by the buyer	(2,000)
	Debt required to be repaid from sale proceeds	(1,000)
	Debt that is directly attributed to other operations of FSP Corp	(8,000)
		$54,000 **(C)**

(B) ÷ **(C)** = $10,000 ÷ $54,000 = 18.5% **(D)**

Step 2: Calculate interest on other consolidated debt that is not directly attributable to other operations of FSP Corp.

Consolidated debt	$15,000
Debt to be assumed by the buyer	(2,000)
Debt required to be repaid from sale proceeds	(1,000)
Debt that is directly attributed to other operations of FSP Corp	(8,000)
Debt not directly attributable to other operations of FSP Corp	$4,000 **(E)**

(D) x (E) x interest rate x months / 12 = 18.5% x $4,000 x 6% x 6 / 12 = $22 **(F)**

Step 3: Calculate total interest expense to be allocated to discontinued operations = **(A)** + **(F)** = $100 + $22 = $122

Gains or losses from the extinguishment of corporate-level debt obligations (i.e., those that are not specific to the disposed component) in connection with the sale transaction should not be included in discontinued operations. Even when the debt is required to be extinguished in connection with a sale, gains or losses from the extinguishment of corporate-level debt is not considered to be directly associated with the disposed component. In addition, such debt would not be classified within the held for sale category of the balance sheet as it is not part of the disposal group. However, amortization of discounts, premiums, or debt issuance costs, and prepayment penalties incurred on debt that is directly related to the disposed component should be reported in discontinued operations.

27.4.2.5 Pension settlements and curtailments

The impact of a settlement or curtailment that is directly related to the disposal transaction should be recognized in discontinued operations. The settlement of a pension benefit obligation is considered directly related to the disposal transaction if there is a demonstrated cause-and-effect relationship between the two events and if the settlement occurs no later than one year following the disposal transaction.

If a settlement has occurred as a result of the disposal transaction (for example, there is a transfer of a pension benefit obligation to the buyer), the reporting entity should recognize in discontinued operations the net gain or loss included in accumulated other comprehensive income associated with the plan, plus any transition asset remaining in accumulated other comprehensive income from the initial application of ASC 715-30. If only part of the projected benefit obligation is settled, the reporting entity should recognize a pro rata portion of the settlement equal to the percentage reduction in the projected benefit obligation.

A reporting entity will recognize in discontinued operations the prior service cost included in accumulated other comprehensive income associated with the years of service no longer expected to be rendered as a result of a curtailment, and any decrease (a gain) or increase (a loss) in the projected benefit obligation associated with the plan. Additionally, if an employer disposes of a component that results in a termination of some employees' services earlier than expected, but does not significantly reduce the expected years of future service of present employees covered by the pension plan, measuring the effects of the reduction in the work force in the same manner as a curtailment is appropriate for purposes of determining the gain or loss on the disposal.

27.4.2.6 Income tax allocation and adjustments

Discontinued operations have certain income tax accounting implications that must be considered. Such implications must be considered both in the year of the discontinued operation, and potentially in periods afterward. Refer to TX 12 (intraperiod tax allocation) and TX 16.9.1 (backwards tracing) for further discussion of tax considerations for discontinued operations.

27.4.2.7 Derivatives

The following sections provide guidance on the classification between continuing operations and discontinued operations of gains and/or losses related to cash flow hedges and foreign currency forward contracts.

Cash flow hedges

If a reporting entity had cash flow hedges related to the operations of a component that is being disposed of, management should consider the hedge documentation in determining whether the effects of the derivative instruments should be reclassified into discontinued operations. If the hedged cash flows specifically relate to the group of assets and liabilities being disposed, gains and/or losses resulting from the cash flow hedges in prior periods should be classified as part of discontinued operations. This assessment should be performed even if the derivative instruments are not included in the disposal group to be sold by the reporting entity.

Foreign currency forward contracts

A reporting entity may enter into a foreign currency forward contract to mitigate exchange rate risks from the sale of a component transacted in a currency other than the reporting entity's functional currency. Any gains or losses on these forward contracts should be reported in continuing operations as these amounts do not qualify as direct operating expenses incurred by the disposed component under the guidance in ASC 205-20.

27.4.2.8 Noncontrolling interest

When a reporting entity disposes of a majority-owned consolidated subsidiary that is classified as discontinued operations, it needs to consider the impact when presenting the controlling and noncontrolling interests' operating results. Refer to FSP 18 for additional details on presentation matters related to noncontrolling interest.

27.4.2.9 Extraordinary items and cumulative effect of changes in accounting principles

Generally, extraordinary items and the cumulative effect of changes in accounting principles are not allocated between continuing and discontinued operations. Accordingly, if a reporting entity has either an extraordinary item or a nonvoluntary change in accounting principle that may have impacted the discontinued operations for any of the periods presented, these items should continue to be presented at their full amounts, net of the related income tax effects, in their appropriate locations in the income statement. No portion of these items is required to be reclassified into discontinued operations. This treatment is based on the view that neither an accounting change nor an extraordinary item is part of a reporting entity's normal operations. Therefore, their effects need not be allocated between those operations that are continuing and those that have been discontinued.

27.4.2.10 Predecessor financial statements

When a reporting entity is a successor to a predecessor entity, questions arise as to whether a discontinued operation of the successor should be presented in the predecessor's income statement. An example of an event that gives rise to a predecessor/successor reporting scenario is the push-down of the parent's basis as a result of the acquisition of the successor company, or the application of fresh-start reporting by a reporting entity upon emergence from bankruptcy. Since the successor entity is considered a new reporting entity for accounting purposes, one might conclude that the predecessor financial statements should not be retrospectively adjusted to reflect the successor's discontinued operations.

As discussed in SEC FRM 13210.2, predecessor financial statements are required to be retrospectively adjusted to reflect the impact of a successor's discontinued operations. ASC 205 does not provide any exceptions to retrospectively adjusting all periods presented to reflect the impact of a discontinued operation. This view achieves comparability for the discontinued operation for all fiscal periods presented, which the SEC staff believes is an important and useful factor for readers to assess trend information in financial statements. However, the SEC staff noted that SEC registrants should contact the SEC staff if unusual facts and circumstances may inhibit a reporting entity from reclassifying a discontinued operation in predecessor fiscal periods.

Notwithstanding the SEC staff's views expressed above, we generally do not believe that other successor changes in accounting policies (e.g., a change from the LIFO method of inventory costing to FIFO) should be reflected in predecessor financial statements.

27.4.3 Other presentation matters

The following subsections cover the presentation of multiple component disposals that are individually immaterial, spin-off transactions, and considerations for presenting discontinued operations when a reporting entity reissues financial statements.

Refer to FSP 27.5.2.8 for disclosure requirements of individually significant disposals that do not qualify for discontinued operations reporting under the revised standard.

27.4.3.1 Individually immaterial discontinued operations

Under the current standard, a reporting entity may have multiple components that it is disposing of that it concludes are individually "immaterial." The FASB noted that entities are not required to apply the provisions of ASC 205-20 to immaterial transactions. While there is no guidance as to how materiality should be evaluated, we believe materiality should be evaluated on a case-by-case basis. When evaluating the materiality of a component, a reporting entity should also consider the impact on each caption in the financial statements, including the materiality of a gain or loss on the sale of the component. If financial results of more than one immaterial component are presented during the period, we believe that a reporting entity should aggregate the financial results of the immaterial components when determining the need to present the combined financial results as discontinued operations in the financial statements.

27.4.3.2 Presentation of spin-off transactions

When a reporting entity completes a spin-off transaction, a question arises whether it is appropriate for the parent company to view the spin-off of the subsidiary as a change in the reporting entity, or present the spun-off entity in discontinued operations if it meets the discontinued operations criteria. If presented as a change in reporting entity, the parent's historical financial statements would be retrospectively adjusted as if the reporting entity never had an investment in the subsidiary. Refer to FSP 30.6 for further discussion of presenting a change in reporting entity.

The guidance in ASC 360-10 provides support for presenting the reporting entity being spun-off as a disposal. Specifically, ASC 360-10-40-4 indicates that if a long-lived asset is to be disposed of in an exchange or a distribution to owners in a spin-off, and if that exchange or distribution is to be accounted for based on the recorded amount of the nonmonetary asset relinquished, the asset should continue to be accounted for as held and used until it is exchanged or distributed. If the disposal group qualifies as a component of the contributing reporting entity, it should be assessed for discontinued operations reporting on the exchange or distribution date.

The SEC generally will not allow a parent reporting entity to retrospectively adjust its financial statements to reflect a spin-off as a change in the reporting entity (i.e., sometimes referred to as a "de-pooling"). If the parent reporting entity was required to file periodic reports under the 1933 Exchange Act within one year prior to the spin-off, the SEC staff believes the reporting entity should reflect the disposition as held for sale in conformity with ASC 360 as this presentation most fairly and completely depicts for investors the effects of the previous and current organization of the reporting entity. However, in limited circumstances involving the initial registration of a reporting entity under the Exchange Act or Securities Act, the SEC staff has not objected to financial statements that retrospectively reflect the reorganization of the business as a change in the reporting entity if the spin-off transaction occurs prior to effectiveness of the registration statement. The criteria the SEC staff considers when determining whether a “de-pooling” is acceptable in an initial registration as found in SAB Topic 5.Z, *Accounting and Disclosure Regarding Discontinued Operations,* are that the reporting entity and subsidiary:

- Are in dissimilar businesses
- Have been managed and financed historically as if they were autonomous
- Have no more than incidental common facilities and costs
- Will be operated and financed autonomously after the spin-off
- Will not have material financial commitments, guarantees, or contingent liabilities to each other after the spin-off

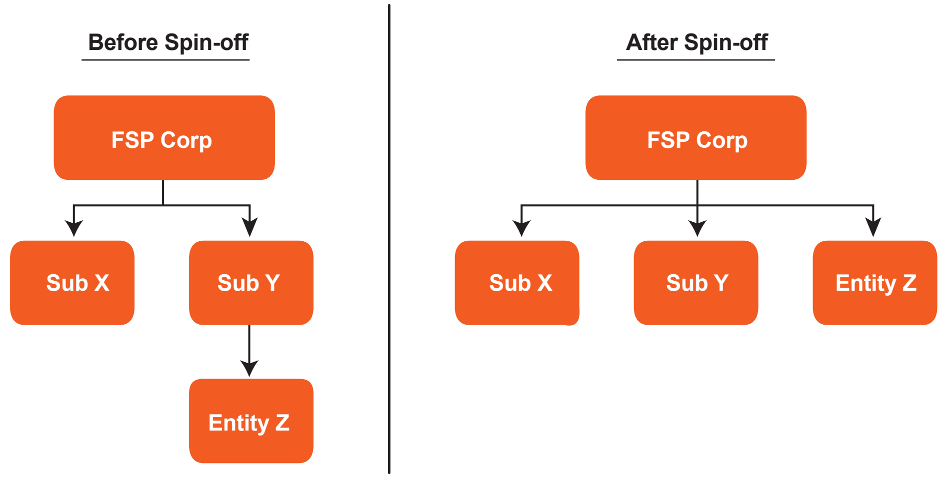
All of the criteria listed above should be met to “de-pool” a transferred business retroactively from its historical financial reporting periods. Although this guidance is specific to SEC registrants, we believe the underlying concepts are applicable to private companies as well.

The following example illustrates the presentation in the income statement of a spin-off transaction.

EXAMPLE 27-9

Spin-off presentation

FSP Corp is comprised of two-wholly owned operating subsidiaries, Subsidiary X and Subsidiary Y. In July 20X4, Subsidiary Y spins off one of its legal entities, Entity Z, to parent FSP Corp by distributing the stock of Entity Z to its sole shareholder, FSP Corp. Entity Z is a component under ASC 360-10-20, as its operations and cash flows can be clearly distinguished from Subsidiary Y, both operationally and for financial reporting purposes. Both Subsidiary Y and Entity Z have similar businesses. Entity Z meets the criteria for discontinued operations presentation under the current and revised standards. The following is a diagram of the organizational structure of FSP Corp before and after the spin-off.



How should Subsidiary Y present the spin-off of Entity Z in its standalone financial statements?

Analysis

Generally, Subsidiary Y should account for the spin-off by presenting the operations of Entity Z as discontinued operations upon successful completion of the spin-off. Retrospectively adjusting Subsidiary Y's financial statements to reflect the spin-off of Entity Z as a change in reporting entity (i.e., de-pooling) would not be appropriate since they operate in similar businesses.

Spin-off costs

Generally, costs that are incurred to accomplish a spin-off should be classified as part of discontinued operations once the spin-off is completed. Such costs are similar to transaction costs incurred in connection with a sale, which are classified as discontinued operations. However, bonuses paid by the reporting entity to the reporting entity's employees (not employees of the spun-off entity) for the successful completion of the spin-off transaction should be reflected in continuing operations. Such payments are not considered "costs to sell" under ASC 360-10-35-38 and, therefore, would not be reported in discontinued operations.

27.4.3.3 Reissuance of financial statements

When previously released financial statements are reissued (e.g., in connection with a new or amended registration statement or proxy/information statement), the SEC staff's view is that the reclassification to reflect a discontinued operation should not be made in the historical financial statements until the financial statements are issued for the period in which the event triggering discontinued operations occurred. However, pro forma financial information might be required at an earlier point in time as discussed in SEC 4560.

For SEC registrants, financial statements are "issued" when complete financial statements are first issued to the public for general use and reliance in a format that conforms with U.S. GAAP (with an audit report in the case of annual financial statements). Issuance can occur when the financial statements appear in a shareholder's report, a proxy statement, or a filing with the SEC. The issuance of an earnings release does not constitute financial statement issuance. Refer to ASC 855-10-S99-2 for a complete discussion of the "issuance date" of financial statements.

The following example highlights the requirements for presenting discontinued operations when financial statements are reissued.

Example 27-10

Discontinued operations presentation in reissued financial statements

FSP Corp is a calendar year-end SEC registrant that intends to reissue its financial statements in connection with a public registration of securities on October 10, 20X4. Further, on September 29, 20X4, FSP Corp to sell a component of its business, but had not yet released its financial statements for the period ended September 30, 20X4.

Should FSP Corp reflect the discontinued operations in its reissued financial statements?

Analysis

No. Although the event which will trigger discontinued operations treatment has occurred at the time the registration statement will be filed, the financial statements have not been filed for the period in which the trigger to present the component as a discontinued operation occurred (i.e., the Form 10-Q for the period ended September 30, 20X4). As such, the annual financial statements included in the October 10, 20X4 registration statement should not include discontinued operations presentation for the component. Any financial statements issued or reissued after the financial statements for the period ended September 30, 20X4 have been issued should give retrospective effect to the discontinued operations.

27.5 Disclosure

The minimum disclosure requirements for discontinued operations are prescribed by ASC 205-20-50 and differ for the current standard as compared to the revised standard. The requirements of both are discussed herein.

27.5.1 Financial statement disclosures — current standard

Disclosures required in periods in which disposal groups have been sold or are classified as held for sale (regardless of whether discontinued operations reporting is being applied) are found in ASC 205-20-50-1.

ASC 205-20-50-1

The following shall be disclosed in the notes to financial statements that cover the period in which a long-lived asset (disposal group) either has been sold or is classified as held for sale under the requirements of paragraph 360-10-45-9:

a. A description of the facts and circumstances leading to the expected disposal, the expected manner and timing of that disposal, and, if not separately presented on the face of the statement, the carrying amount(s) of the major classes of assets and liabilities included as part of a disposal group

b. The gain or loss recognized in accordance with paragraphs 360-10-35-40 and 360-10-40-5 and if not separately presented on the face of the income statement, the caption in the income statement or the statement of activities that includes that gain or loss

c. If applicable, amounts of revenue and pretax profit or loss reported in discontinued operations

d. If applicable, the segment in which the long-lived asset (disposal group) is reported under Topic 280.

These disclosures are required for all disposals, while subsections FSP 27.5.1.1 through 27.5.1.5 are required only where applicable.

27.5.1.1 Continuing cash flows and continuation of activities — current standard

The following information should be disclosed in the footnotes for each discontinued operation that generates continuing cash flows:

Excerpt from ASC 205-20-50-4

a. The nature of the activities that give rise to continuing cash flows

b. The period of time continuing cash flows are expected to be generated

c. The principal factors used to conclude that the expected continuing cash flows are not direct cash flows of the disposed component.

Additionally, reporting entities should disclose in all periods presented any amounts included in continuing operations that include a continuation of revenues and expenses that were previously intercompany transactions (i.e., eliminated in previously issued consolidated financial statements). Further, ASC 205-20-50-6 requires any types of continuing involvement that the ongoing reporting entity will have with the disposed component after the disposal transaction to be disclosed in the period in which operations are initially classified as discontinued.

27.5.1.2 Discontinued operations subsequently retained — current standard

When a reporting entity has a component that is held for sale and meets the criteria for discontinued operations reporting, there may be circumstances that arise that result in a reporting entity deciding not to sell the component. The results of operations of the component previously reported in discontinued operations are to be reclassified and included in income from continuing operations for all periods presented, and any loss on measurement at the reclassification date should also be reported in continuing operations. A loss, if any, that was recognized when the asset was first classified as held for sale is not adjusted in the prior period financial statements. Additionally, the reporting entity should describe the facts and circumstances leading to the decision to change the plan of sale, and its effect on the income statement for each of the periods presented should be disclosed in the period when that decision occurs. Refer to FSP 8.7 for the disclosure requirements of disposal groups that no longer meet the held for sale criteria.

27.5.1.3 Allocation of interest to discontinued operations — current standard

SEC registrants should disclose their accounting policy for allocating interest to a discontinued operation, which should include the method of allocation. The amount of interest allocated to discontinued operations should also be disclosed for all periods presented.

27.5.1.4 Segment disclosures — current standard

As discussed in ASC 280-10-55-7, a reporting entity is not required to disclose the information required by ASC 280, *Segment Reporting*, for the disposal of a reportable segment that qualifies for discontinued operations reporting. In addition, segment information for periods prior to the disposal of the reportable segment is not required to be restated in the comparative periods.

A discontinued operation that is part of a reportable segment would not be included in the segment disclosures in the period it is classified as a discontinued operation. Furthermore, prior periods would need to be restated for comparative purposes.

27.5.1.5 Adjustments to amounts reported in discontinued operations — current standard

Certain adjustments to amounts previously reported in discontinued operations should also be classified in discontinued operations in accordance with ASC 205-20-45-4 through 45-5 and ASC 205-20-50-5. The nature and amount of such adjustments should be disclosed. Circumstances that could give rise to presenting amounts as discontinued operations in subsequent periods include:

- Resolution of contingencies related to the disposal transaction, such as the resolution of the purchase price and indemnification agreements
- Resolution of the disposed component's contingencies such as environmental and product warranty obligations retained by the seller
- Settlement of employee benefit obligations directly related to the disposal transaction

This guidance also applies to amounts not previously reported in discontinued operations that are directly related to the disposal component. Developments subsequent to the disposal date that are not directly related to the disposal of the component, or the operations of the component, prior to the disposal are not "directly related to the disposal" as contemplated by ASC 205-20-45-4. Such amounts are reported within continuing operations. For example, subsequent changes in the carrying value of assets received upon disposition of a component do not affect the determination of gain or loss at the disposal date, but represent the consequences of management's subsequent decisions to hold or sell those assets. Gains and losses, dividend and interest income, and portfolio management expenses associated with assets received as consideration for discontinued operations should be reported within continuing operations.

27.5.2 Financial statement disclosures — revised standard

Disclosures required in periods in which disposal groups have been sold or are classified as held for sale that qualify as a discontinued operation under the revised standard are described below:

ASC 205-20-50-1

The following shall be disclosed in the notes to financial statements that cover the period in which a discontinued operation either has been disposed of or is classified as held for sale under the requirements of paragraph 205-20-45-1E:

a. A description of both of the following:

    1. The facts and circumstances leading to the disposal or expected disposal.

    2. The expected manner and timing of that disposal.

b. If not separately presented on the face of the statement where net income is reported (or statement of activities for a not-for-profit entity) as part of discontinued operations (see paragraph 205-20-45-3B), the gain or loss recognized in accordance with paragraph 205-20-45-3C.

c. Subparagraph superseded by Accounting Standards Update No. 2014-08.

d. If applicable, the segment(s) in which the discontinued operation is reported under Topic 280 on segment reporting.

When a business or nonprofit activity is classified as held for sale upon acquisition and therefore is reported as a discontinued operation, no additional disclosures are required beyond those described above. A reporting entity that disposes of an equity method investment that qualifies as a discontinued operation should consider the additional disclosures in FSP 27.5.2.1. A reporting entity with component(s) that result in discontinued operations for any other reason should make the following disclosures to the extent the information is not presented on the face of its financial statements:

ASC 205-20-50-5B

An entity shall disclose, to the extent not presented on the face of the financial statements as part of discontinued operations, all of the following in the notes to financial statements:

a. The pretax profit or loss (or change in net assets for a not-for-profit entity) of the discontinued operation for the periods in which the results of operations of the discontinued operation are presented in the statement where net income is reported (or statement of activities for a not-for-profit entity).

b. The major classes of line items constituting the pretax profit or loss (or change in net assets for a not-for-profit entity) of the discontinued operation (for example, revenue, cost of sales, depreciation and amortization, and interest expense) for the periods in which the results of operations of the discontinued operation are presented in the statement where net income is reported (or statement of activities for a not-for-profit entity).

Reporting entities must reconcile both (1) pretax profit or loss and (2) the major line items constituting pretax profit or loss to the after-tax profit or loss from discontinued operations that is presented on the face of the income statement. The reconciliation must be provided for all periods in which the results of the discontinued operation are presented. The example reconciliation provided in ASC 205-20-55-103 includes the line items of revenue, cost of sales, selling, general and administrative expenses, and interest expense.

A reporting entity may not have owned the entire discontinued operation prior to its disposal. If the discontinued operation includes a noncontrolling interest, the pretax profit or loss attributable to the parent should be separately disclosed for each of the periods that an income statement is presented.

27.5.2.1 *Equity method investment discontinued operations disposals — revised standard*

When a reporting entity disposes of an equity method investment that qualifies to be presented as a discontinued operation, the reporting entity should disclose summarized information about the assets, liabilities, and results of operations of the investee if that information was disclosed in financial reporting periods before the disposal based on ASC 323-10-50-3(c), as further discussed in FSP 10.

27.5.2.2 *Changes to a plan of disposal — revised standard*

A reporting entity may change its plan of sale. In the period in which the decision is made to change the plan for selling the discontinued operation, a reporting entity should disclose a description of the facts and circumstances leading to the decision to change that plan. It should also disclose the change's effect on the results of operations for the period and any prior periods presented when it makes a decision to change its plan. Disclosures required when a reporting entity retains significant continuing involvement are discussed in the following subsections.

27.5.2.3 *Continuing cash flows and continuation of activities — revised standard*

A reporting entity is required to disclose information about its significant continuing involvement with a discontinued operation after the disposal date. It must continue to make these disclosures until the results of operations of the discontinued operation in which the reporting entity retains significant continuing involvement are no longer presented separately as discontinued operations in the income statement.

ASC 205-20-50-4A

An entity shall disclose the following in the notes to financial statements for each discontinued operation in which the entity retains significant continuing involvement after the disposal date:

a. A description of the nature of the activities that give rise to the continuing involvement.

b. The period of time during which the involvement is expected to continue.

c. For all periods presented, both of the following:

   1. The amount of any cash inflows or outflows from or to the discontinued operation after the disposal transaction

   2. Revenues or expenses presented, if any, in continuing operations after the disposal transaction that before the disposal transaction were eliminated in consolidated financial statements as intra-entity transactions.

A reporting entity may retain a noncontrolling investment in a disposed component and account for the component under the equity method prospectively. In those situations, there are additional disclosures required related to the equity method investment retained:

ASC 205-20-50-4A

c. For a discontinued operation in which an entity retains an equity method investment after the disposal (the investee), information that enables users of financial statements to compare the financial performance of the entity from period to period assuming that the entity held the same equity method investment in all periods presented in the statement where net income is reported (or statement of activities for a not-for-profit entity). The disclosure shall include all of the following until the discontinued operation is no longer reported separately in discontinued operations:

   1. For each period presented in the statement where net income is reported (or statement of activities for a not-for-profit entity) after the period in which the discontinued operation was disposed of, the pretax income of the investee in which the entity retains an equity method investment

   2. The entity's ownership interest in the discontinued operation before the disposal transaction

   3. The entity's ownership interest in the investee after the disposal transaction

   4. The entity's share of the income or loss of the investee in the period(s) after the disposal transaction and the line item in the statement where net income is reported (or statement of activities for a not-for-profit entity) that includes the income or loss.

27.5.2.4 Discontinued operations subsequently retained — revised standard

When a reporting entity has a component that is held for sale and meets the criteria for discontinued operations reporting, there may be circumstances that arise that result in a reporting entity deciding not to sell the component. The results of operations of the component previously reported in discontinued operations are to be reclassified and included in income from continuing operations for all periods presented, and any loss on measurement at the reclassification date should also be reported in continuing operations in the period of reclassification. A loss, if any, that was recognized when the asset was first classified as held for sale is not adjusted in the prior period financial statements. Additionally, the reporting entity should describe the facts and circumstances leading to the decision to change the plan of sale and its effect on the income statement for each of the periods presented should be disclosed in the period when that decision occurs. Refer to FSP 8.7 for the disclosure requirements of disposal groups that no longer meet the held for sale criteria.

27.5.2.5 *Allocation of interest to discontinued operations — revised standard*

SEC registrants should disclose their accounting policy for allocating interest to a discontinued operation, which should include the method of allocation. The amount of interest allocated to discontinued operations should also be disclosed for all periods presented.

27.5.2.6 *Segment disclosures — revised standard*

As discussed in ASC 280-10-55-7, a reporting entity is not required to disclose the information required by ASC 280, *Segment Reporting,* for a reportable segment that qualifies for discontinued operations reporting. In addition, segment information for periods prior to the disposal of the reportable segment is not required to be restated in the comparative periods.

A discontinued operation that is part of a reportable segment would not be included in the segment disclosures in the period it is classified as a discontinued operation. Furthermore, prior periods would need to be restated for comparative purposes.

27.5.2.7 *Adjustments to amounts reported in discontinued operations – revised standard*

Certain adjustments to amounts previously reported in discontinued operations should also be classified in discontinued operations in accordance with ASC 205-20-45-4 through 45-5 and ASC 205-20-50-5. The nature and amount of such adjustments should be disclosed. Circumstances that could give rise to presenting amounts as discontinued operations in subsequent periods include:

- Resolution of contingencies related to the disposal transaction, such as the resolution of the purchase price and indemnification agreements
- Resolution of the disposed component's contingencies such as environmental and product warranty obligations retained by the seller
- Settlement of employee benefit obligations directly related to the disposal transaction

This guidance also applies to amounts not previously reported in discontinued operations that are directly related to the disposal component. Developments subsequent to the disposal date that are not directly related to the disposal of the component, or the operations of the component, prior to the disposal are not "directly related to the disposal" as contemplated by ASC 205-20-45-4. Such amounts are reported within continuing operations. For example, subsequent changes in the carrying value of assets received upon disposition of a component do not affect the determination of gain or loss at the disposal date, but represent the consequences of management's subsequent decisions to hold or sell those assets. Gains and losses, dividend and interest income, and portfolio management expenses associated with assets received as consideration for discontinued operations should be reported within continuing operations.

27.5.2.8 Individually significant disposal not eligible for discontinued operations – revised standard

The revised standard requires new disclosures about pretax profit or loss for an individually significant component of a reporting entity that has been disposed of or is classified as held for sale but does not qualify as a discontinued operation. If an individually significant component includes a noncontrolling interest, the pretax profit or loss attributable to the parent must be disclosed. Reporting entities must also disclose the gain or loss recognized on a disposal group that is either classified as held for sale or disposed of.

All reporting entities must provide the disclosures for the initial period in which an individually significant component is sold or classified as held for sale. An individually significant component that is held for sale should continue to provide the disclosures in each reporting period that it remains held for sale. SEC registrants and certain not-for-profit entities must also include comparative disclosures for all prior periods presented in the income statement as well.

The revised standard does not provide guidance about how to evaluate whether an individual component is significant, or whether to consider the gain or loss on disposal when determining significance. Reporting entities must exercise judgment in assessing significance and should consider both quantitative and qualitative factors about the effect of the disposal on their balance sheet, income statement, and statement of cash flows. Reporting entities should also consider whether disclosure should be provided when multiple disposals of individually insignificant components occur in the same reporting period.

27.6 Considerations for private companies

The requirements of ASC 205-20 apply equally to SEC registrants and private companies. However, certain items discussed in this chapter are incremental presentation and disclosure requirement prescribed by the SEC for SEC registrants. Those incremental requirements are summarized in Figure 27-2.

Figure 27-2

Presentation and disclosure requirements applicable only to public business entities

Description	Reference	Section of this chapter
Application of discontinued operations to predecessor's financial statements for successor's disposal activity	SEC FRM 13210.2	27.4.2.10
Depooling the results of a spun-off component	SAB Topic 5.Z	27.4.3.2
Periods required to be disclosed for individually significant disposals	ASC 205	27.5.2.8

Chapter 28: Subsequent events

28.1 Chapter overview

This chapter describes what subsequent events are and the types of subsequent events. It explains the distinction between recognized and nonrecognized subsequent events and describes the disclosure requirements for subsequent events in financial statements and reissued financial statements. Finally, included within this chapter are a number of common examples of each type of subsequent event. The examples are not all-inclusive, but are intended to provide a framework for evaluating and categorizing subsequent events as recognized or nonrecognized, which can require significant judgment.

28.2 Scope

The scope of ASC 855, *Subsequent Events*, is broad and encompasses all subsequent events that are not addressed in other parts of U.S. GAAP. For example, U.S. GAAP specifically addresses the presentation and disclosure of subsequent events for income taxes (740-10-25-15), EPS (260-10-55-12), and gain contingencies (450-30-25-1). Industry specific guidance also exists, such as ASC 926-855, which addresses the treatment of a specific subsequent event in the film industry.

In addition to the FASB guidance, SEC registrants are required to evaluate the guidance within the following SAB Topics included in this chapter:

SAB Topic 4.C	Change in Capital Structure
SAB Topic 5.M	Other Than Temporary Impairment of Certain Investments in Equity Securities

28.3 Evaluation of subsequent events

The date through which a reporting entity evaluates subsequent events differs depending on whether the entity is (1) an SEC filer or a conduit bond obligor or (2) a non-SEC filer. For a reporting entity that is an SEC filer, as discussed in FSP 28.3.1, or a conduit bond obligor, as discussed in FSP 28.3.2, subsequent events are events or transactions that occur after the balance sheet date but before the reporting entity issues financial statements. The SEC staff has provided its view as to when financial statements are considered “issued” in ASC 855-10-S99-2.

Excerpt from ASC 855-10-S99-2

. . . Generally, the staff believes that financial statements are “issued” as of the date they are distributed for general use and reliance in a form and format that complies with generally accepted accounting principles (U.S. GAAP) and, in the case of annual financial statements, that contain an audit report that indicates that the auditors have complied with generally accepted auditing standards (GAAS) in completing their audit. Issuance of financial statements then would generally be the earlier of when the annual or quarterly financial statements are widely distributed to all shareholders and other financial statement users or filed with the Commission. Furthermore, the issuance of an earnings release does not constitute issuance of financial statements because the earnings release would not be in a form and format that complies with U.S. GAAP and GAAS.

For non-SEC filers, subsequent events are events that occur after the balance sheet date but before the reporting entity's financial statements are available to be issued. Financial statements are "available to be issued" when they are prepared in accordance with U.S. GAAP and the reporting entity has obtained all necessary approvals (e.g., from management and the board of directors) to issue them.

28.3.1 SEC filer

ASC 855 defines an SEC filer.

Partial definition from ASC 855-10-20

An entity that is required to file or furnish its financial statements with either of the following:

a. The Securities and Exchange Commission (SEC)

b. With respect to an entity subject to Section 12(i) of the Securities Exchange Act of 1934, as amended, the appropriate agency under that Section.

This definition specifically excludes financial statements of other reporting entities that are included in SEC filings. For example, financial statements of acquired businesses or equity investees that are not otherwise SEC filers should evaluate subsequent events through the date the financials are available for issuance rather than up to the date the financial statements are issued.

When a reporting entity has no registered securities but voluntarily files financial statements with the SEC, the filings should comply with all of the SEC's requirements. A voluntary filer cannot choose which regulations to comply with in its filings.

Question 28-1

Under ASC 855, does a reporting entity that files financial statements with the SEC in an IPO qualify as an "SEC filer"?

PwC response

No. An entity that files an IPO does not become an SEC filer until its registration statement goes effective. As a result, a reporting entity that had previously reached the cut-off for recognizing subsequent events does not reopen and extend its subsequent event period.

28.3.2 Conduit bond obligor

ASC 825 defines conduit debt securities. A conduit bond obligor is an entity that issues such securities.

Partial definition from ASC 825-10-20

Conduit Debt Securities: Certain limited-obligation revenue bonds, certificates of participation, or similar debt instruments issued by a state or local governmental entity for the express purpose of providing financing for a specific third party (the conduit bond obligor) that is not a part of the state or local government's financial reporting entity.

If a reporting entity is a conduit bond obligor for conduit debt securities that are traded in a public market, the reporting entity is required to evaluate subsequent events through the date the financial statements are issued, similar to an SEC filer.

28.4 Types of subsequent events

There are two types of subsequent events:

- Recognized subsequent events (commonly referred to as Type I)

Excerpt from ASC 855-10-25-1

… subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements.

Recognized subsequent events are pushed backed and recorded in the financial statements to be issued. Examples include the realization of a loss on the sale of investments, inventories, or properties held for sale when the subsequent act of sale confirms a previously existing unrecognized loss. See FSP 28.5.1 for other examples.

- Nonrecognized subsequent events (commonly referred to as Type II)

Excerpt from ASC 855-10-25-3

… subsequent events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after the balance sheet date but before the financial statements are issued or available to be issued.

Nonrecognized subsequent events are considered for disclosure based on their nature to keep the financial statements from being misleading. An example is a natural disaster that destroys a facility after the balance sheet date. See FSP 28.6.3 and 855-10-55-2 for other examples.

28.5 Recognized subsequent events

Recognized subsequent events are reflected in the financial results of the reporting entity. The reporting entity should also evaluate the events for additional disclosure considerations based on the applicable standards governing the events.

28.5.1 Examples of recognized subsequent events

The following are some examples of subsequent events that reporting entities should evaluate to determine whether they need to be recognized in the financial statements.

- Settlements of litigation related to events giving rise to a claim that took place prior to the balance sheet date (FSP 28.5.1.1)
- Change in capital structure (stock dividends, splits, or reverse splits) (see FSP 28.5.1.2)
- Sales of securities at a loss (see FSP 28.5.1.3)
- Changes in lower of cost or market considerations related to inventory valuation (see FSP 28.5.1.4)
- Covenant violations occurring or anticipated after the balance sheet date (see FSP 12.3.3.5)
- Refinancing short-term borrowings (see FSP 12.3.4)

28.5.1.1 Litigation settlements

Loss contingencies

A settlement of litigation resulting in a loss related to events that took place prior to the balance sheet date is typically considered a recognized subsequent event.

Gain contingencies

A reporting entity may have a settlement resulting from a claim that existed at the balance sheet date that results in a gain. The gain and related receivable are typically not reflected as a recognized subsequent event. Rather, gain contingencies are recognized in the period the asset is realized or realizable. Therefore, the reporting entity would not adjust the financial statements for a gain contingency related to litigation, although disclosure may be appropriate.

28.5.1.2 *Change in capital structure*

SAB Topic 4.C indicates that a change in a registrant's capital structure due to a stock dividend, stock split, or reverse split occurring after the date of the latest reported balance sheet, but before the issuance of the financial statements or the effective date of the registration statement, whichever is later, should be given retroactive effect in the balance sheet. Historically, the SEC has not objected to utilizing either approach (i.e., retrospective adjustment or recording the change in the period consummated). However, in an IPO, the reporting entity should give retrospective effect in the balance sheet.

If a reporting entity retroactively reflects a change in capital structure, it should disclose the retroactive treatment, explain the change made, and state the date the change became effective in a footnote. If a reporting entity records the change in capital structure in the period consummated, it should consider disclosing the change.

28.5.1.3 *Sales of securities at a loss*

When a reporting entity sells an equity security at a loss subsequent to the balance sheet date but prior to the issuance date or the date the financial statements are available for issuance, it should assess whether an other-than-temporary impairment existed at the balance sheet date. This would involve considering the general guidance on other-than-temporary impairments in ASC 320[1] and SAB Topic 5.M for equity securities.

The sale of equity securities at a loss subsequent to the balance sheet date, but prior to the issuance date or the date the financial statements are available for issuance is generally a strong indicator that an other-than-temporary impairment existed at the balance sheet date. The closer to the end of a previous reporting period that a security is sold at a loss, or the larger the number of sales of such securities, the greater the weight of evidence needed to support a conclusion that an other-than-temporary impairment did not exist at the balance sheet date.

28.5.1.4 *Changes in lower of cost or market considerations related to inventory valuation*[2]

ASC 330-10-35 establishes the lower-of-cost-or-market ("LCM") rule as the guiding principle in assessing whether cost or a lower estimate of realizable value should be used for valuing inventories.

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[1] As of the content cutoff date of this publication (August 31, 2014), the FASB has an active project that may affect the impairment of available-for-sale securities. Financial statement preparers and other users of this publication are therefore encouraged to monitor the status of the project and, if finalized, evaluate the effective date of the new guidance and the implications on presentation and disclosure.

[2] As of the content cutoff date of this publication (August 31, 2014), the FASB has an active project on the measurement of inventory. Financial statement preparers and other users of this publication are therefore encouraged to monitor the status of the project and, if finalized, evaluate the effective date of the new guidance and the implications on presentation and disclosure.

Determining the net realizable value (NRV) at the balance sheet date is a matter of judgment. Reporting entities should consider all data available, including subsequent changes in product prices. For example, a subsequent decrease in selling prices may indicate that a problem existed at the balance sheet date. However, increases in selling prices subsequent to the balance sheet date, but prior to the issuance date or the date the financial statements are available for issuance, would likely demonstrate that a decline in selling prices at the balance sheet date was temporary, indicating that a lesser or no LCM provision is required.

28.6 Nonrecognized subsequent events

ASC 855 does not provide any bright line tests for determining which subsequent events require disclosure; it is a decision based on specific facts and circumstances that requires judgment.

Consider the following examples:

- A regular quarterly cash dividend declared subsequent to the balance sheet date at the same rate per share as dividends declared during the period being reported on might not be worthy of disclosure. However, if a reporting entity that had paid dividends regularly for several years decided to eliminate cash dividends subsequent to the balance sheet date, disclosure may be warranted.

- Cancellation of a sales contract subsequent to the balance sheet date may not need to be disclosed unless it is reasonably certain that the financial effect will be significant. For example, if the reporting entity reasonably anticipates replacement of the customer or additional sales to present customers, it may not need to disclose the cancellation. However, disclosure may be appropriate if reduced income appeared certain, a major factory were to be closed, or other significant changes in operations were expected to result.

Generally, in order for a subsequent event to require disclosure (1) the event should have a determinable significant effect on the balance sheet at the time of occurrence or on the future operations of the reporting entity and (2) without disclosure of it, the financial statements would be misleading.

28.6.1 Disclosure requirements for nonrecognized subsequent events

If a reporting entity determines that disclosure is necessary, it should include:

- the nature of the event, and

- an estimate of the impact on the financial statements or an assertion that an estimate cannot be made.

The guidance within ASC 855 does not require a reporting entity to present all required subsequent events disclosures in one footnote. Rather, management may determine where to include the disclosures within the financial statements.

28.6.2 *Pro forma financial data*

Depending on the nature and magnitude of the nonrecognized subsequent event, a reporting entity may include pro forma financial data in the footnotes. Alternatively, in certain more significant situations, the reporting entity may include a pro forma column on the historical balance sheet that reflects the transaction as if it occurred on the balance sheet date. For example, a reporting entity that is undergoing an IPO will often include pro forma financial data on the balance sheet to reflect the conversion of preferred stock to common stock.

28.6.3 *Examples of nonrecognized subsequent events*

The following are some examples of events that occur after the balance sheet date but before the financial statements are issued or available to be issued. Because the events generally do not relate to conditions existing at the balance sheet date, they are not recognized in the financial statements. However, depending on the nature of the event, reporting entities should consider footnote disclosure. A key determinant is whether the financial statements would be misleading without disclosure of the event.

- Business combinations (see FSP 28.6.3.1)
- Exercise of a call option on debt (see FSP 28.6.3.2)
- Debt extinguishments (see FSP 28.6.3.3)
- Changes in the classification of long-lived assets (see FSP 28.6.3.4)
- Changes in the conditions of contingently redeemable instruments (see FSP 28.6.3.5)
- Acceptance by an employee of special termination benefits after the balance sheet date (see FSP 28.6.3.6)
- Subsequent events impacting construction-type or production-type revenue contracts (FSP 28.6.3.7)
- Bankruptcy filing (see FSP 28.6.3.8)
- Changes in ownership interest (see FSP 28.6.3.9)
- Litigation settlements resulting in a gain (see FSP 28.5.1.1)
- Changes in capital structure (see FSP 28.5.1.2 for instances when an event should be considered a recognized subsequent event; other events should be considered for disclosure)
- Changes in segments (see FSP 25.7.8)
- Settlements of litigation related to events giving rise to a claim that took place after the balance sheet date

- Issuance of new notes, bonds, or other indebtedness
- Damage from fire, flood, or other casualty
- Changes in foreign exchange rates
- Adoption of welfare, pension, compensation, or stock option plans

28.6.3.1 Business combinations

ASC 805 requires a reporting entity to disclose information that enables users of its financial statements to evaluate the nature and financial effect of a business combination. The guidance is applicable to business combinations that occur either in the current reporting period or after the balance sheet date, but before the financial statements are issued or available to be issued. However, disclosure is not required for the specific aspects (e.g., purchase price allocation) of a business combination in which the accounting is incomplete. The reporting entity should include all other disclosure requirements, such as the nature of the acquisition, consideration, etc. For aspects of a business combination that are not disclosed, the reporting entity should indicate which disclosures could not be made and why. See FSP 17.4 on disclosures in a business combination.

28.6.3.2 Exercise of a call option on debt

The announcement and execution of a call option by the creditor after the balance sheet date with no violation of covenants at the balance sheet date does not impact the debt's classification at the balance sheet date. For further discussion, see FSP 12.3.1.

Although there is no effect on the debt's balance sheet classification, the reporting entity may need to disclose the exercise of the call option subsequent to the balance sheet date as a nonrecognized subsequent event.

28.6.3.3 Debt extinguishments

A reporting entity should not recognize a debt extinguishment occurring subsequent to the end of the fiscal year but prior to the issuance date or the date the financial statements are available for issuance. Any gain or loss associated with the debt extinguishment should be recorded in the period in which the debt is considered extinguished (see FG 3.7).

A reporting entity should consider disclosing the likely effect of a planned extinguishment in the footnotes.

28.6.3.4 Changes in the classification of long-lived assets

ASC 360-10-45-13 does not permit a reporting entity to consider new information resulting from a change in circumstances that occurred after the balance sheet date in evaluating whether long-lived assets held for use should be classified as held for sale at the balance sheet date.

If subsequent to the balance sheet date, but prior to the issuance date or the date the financial statements are available for issuance, the criteria for classification of the assets as held for sale are met, a reporting entity should consider providing disclosures similar to those set out in ASC 205-20-50-1:

- a description of the facts and circumstances leading to the expected disposal
- the expected manner and timing of the disposal
- the carrying amount(s) of the major classes of assets and liabilities included as part of a disposal group

In performing the required reassessment, for a period of up to one year after the original assessment, of whether the held for sale criteria continue to be met, a significant event or change in circumstance may occur causing the reporting entity to no longer expect the assets to meet the held for sale criteria in ASC 205-20-45-1. In that case, the assets should be reclassified as held for use, the reporting entity should cease to present the component's operations as discontinued operations, and consider disclosing in the footnotes the facts and circumstances that led to the change.

28.6.3.5 Changes in the conditions of contingently redeemable instruments

A reporting entity may receive information after the balance sheet date, but prior to the issuance date or the date the financial statements are available for issuance, that indicates a contingently redeemable instrument has become unconditionally redeemable. The issue is whether the instrument should be reclassified as of the balance sheet date. We believe this matter should be treated the same as any other subsequent event.

If the information received indicates the instrument was unconditionally redeemable on the balance sheet date, the reporting entity should adjust the financial statements to reflect that the instrument has been reclassified as a liability.

If the information received indicates that the event satisfying the condition, and thus causing the instrument to become unconditionally redeemable, occurred after the balance sheet date, the reporting entity should not adjust the financial statements, but should instead consider appropriate disclosures.

28.6.3.6 Acceptance by an employee of special termination benefits after the balance sheet date

Special termination benefits arise when the employer offers, for a short period of time, to provide certain additional benefits to employees electing voluntary termination, including early retirement. There may be situations when a special termination benefits offer extends beyond the balance sheet date. Reporting entities should record irrevocable acceptances at the balance sheet date as a termination liability and disclose as nonrecognized subsequent events offers still outstanding at that date that have not yet been irrevocably accepted.

28.6.3.7 Subsequent events impacting construction-type or production-type revenue contracts

For construction-type or production-type revenue contracts, ASC 605-35 requires a reporting entity to disclose events occurring after the date of the financial statements that are outside the normal exposure and risk aspects of a contract. The guidance explicitly precludes a reporting entity from recognizing these as refinements of the estimating process of the prior period.

28.6.3.8 Bankruptcy filing

If the filing date of a reporting entity's bankruptcy occurs after the balance sheet date, but prior to the issuance date or the date the financial statements are available for issuance, the reporting entity should treat the filing as a nonrecognized subsequent event. In that case, the financial statements would not reflect any accounting under ASC 852-10, *Reorganizations*, nor would they include the debtor-in-possession label, as discussed in BLG 3.2. The reporting entity should assess whether disclosures, including pro forma disclosures, are appropriate to keep the financial statements from being misleading.

28.6.3.9 Changes in ownership interest

There may be a change of ownership interest during the period between the date the financial statements of an equity investee or a subsidiary and the consolidated financial statements are prepared. The change of ownership interest may occur as a result of:

- Transactions in which control is maintained, gained, or lost
- Transactions involving equity investees, or
- A complete disposition of all holdings by a parent.

When the reporting period of the subsidiary financial statements precede the reporting period of the parent, questions may arise as to the period in which the change in ownership should be recorded. Generally, the transaction should be recorded in the period of occurrence in the consolidated financial statements, irrespective of any differences between the dates of the financial statements of the equity investee or subsidiary and the consolidated financial statements. Further, the consolidated reporting entity should consider disclosing the change in ownership.

28.7 Parent/subsidiary financial statements

A question often arises as to how a reporting entity that is a subsidiary of another entity should determine the date to be used when evaluating subsequent events in its standalone financial statements. That is, should the reporting entity utilize (1) the issuance date of the parent company consolidated financial statements, (2) the date the standalone financial statements are issued, or (3) the date the standalone financial statements are available for issuance?

Generally, our view is that when the parent company has issued financial statements or the financial statements are available to be issued, it is acceptable for the subsidiary reporting entity to utilize the issuance date of the parent company consolidated financial statements in determining the date through which to evaluate subsequent events for adjustment to the financial statements.

EXAMPLE 28-1

Impact of subsequent events on subsidiary financial statements

Parent Co consolidates a non-SEC filer subsidiary, Sub Co, into its consolidated audited financial statements filed with the SEC. The consolidated Parent Co's calendar year-end financial statements were issued on March 10, 20x5.

Following the issuance of the Parent Co's financial statements, Sub Co was required to issue audited Sub Co financial statements (Sub Co financial statements had not been previously prepared). On May 1, 20x5, litigation brought against Sub Co was settled for a material amount in excess of the liability recorded in the parent company consolidated financial statements. The calendar year-end financial statements of Sub Co were available to be issued on May 15, 20x5.

How should this subsequent event impact the financial statements of the parent and the subsidiary?

Analysis

Parent Co's financial statements are not affected as the subsequent event occurred after Parent Co's financial statements were issued on March 10, 20x5.

We believe an acceptable view is to consider Sub Co's financial statements as issued when the parent company statements were issued. Following that view, Sub Co should consider the issuance of its financial statements to constitute a reissuance and, therefore, evaluate subsequent events for disclosure only. Sub Co would consider disclosing the settlement of the litigation in its financial statements as a nonrecognized subsequent event.

28.8 Reissuance of financial statements

ASC 855 defines revised financial statements as statements that are revised for either the correction of an error or the retrospective application of U.S. GAAP. A reporting entity may need to revise and reissue financial statements in reports filed with the SEC, other regulatory agencies, or other stakeholders.

This typically leads to the question of whether an updated evaluation of subsequent events is required after the original issuance of the financial statements. A reporting entity should consider whether subsequent events have occurred that warrant disclosure. However, ASC 855-10-25-4 prohibits a reporting entity from recognizing additional subsequent events unless the adjustment is required by U.S. GAAP or regulatory requirements. For example, the retrospective application of an accounting standard such as discontinued operations or a segment change would be reflected in the financial statements. However, the subsequent settlement of a lawsuit at a loss greater than reflected in the financial statements as originally issued would not be recognized in the reissued financial statements; rather, it would be disclosed.

28.9 Considerations for private companies

The majority of the requirements of ASC 855 apply equally to public and private companies. In addition, ASC 855 requires non-SEC filers to include additional disclosures.

28.9.1 Disclosures not required for private companies

The following disclosures are required only for SEC filers.

Description	Authoritative reference	FSP Guide chapter reference
Change in registrant's capital structure	SAB Topic 4.C	28.5.1.2
Assessment of other-than-temporary impairment	SAB Topic 5.M	28.5.1.3

28.9.2 Additional disclosure requirements for private companies

ASC 855 requires the following additional disclosures for reporting entities that are not SEC filers:

- The date through which subsequent events were evaluated
- Whether the disclosed date is the date the financial statements were issued or the date the financial statements were available to be issued (as discussed in FSP 28.3)
- The date through which subsequent events were evaluated in revised (reissued) financial statements

Chapter 29: Interim financial reporting

29.1 Chapter overview

Presentation and disclosure requirements are often applicable for both interim and annual financial statements. However, in some instances, interim financial statements may include condensed presentation and fewer disclosures. This chapter provides guidance on the financial statement presentation and disclosure requirements for interim reporting periods. The chapter distinguishes between general recurring disclosure requirements and transaction-specific disclosure requirements, and indicates instances where interim disclosure requirements are identical to the annual requirements. In situations where the interim disclosure requirements are different than those required in annual reporting periods, the specific interim requirements are discussed.

29.2 Scope

Interim financial information is intended to provide users with timely information about a reporting entity. Because each interim period is an integral part of the annual period, interim financial statements are generally prepared based on the expectation that users will read the annual financial statements in conjunction with the interim financial statements. In general, interim financial information is not expected to repeat annual financial information, but rather provide an update from the prior year-end. Therefore, interim financial information may be condensed and include limited footnote disclosures.

ASC 270, *Interim Reporting*, and Article 10 of Regulation S-X ("Article 10") are the two primary sources for presentation and disclosure requirements for interim financial reporting. ASC 270 provides minimum disclosure requirements for all reporting entities that prepare interim financial statements. Article 10 provides reporting requirements for SEC registrants, including the financial statements that should be presented and the periods that should be covered by each respective financial statement.

Certain other guidance includes considerations for interim financial reporting; the more significant guidance is discussed in this chapter.

29.3 Presentation of interim financial information

U.S. GAAP includes minimal presentation requirements for interim financial reporting. As such, many reporting entities follow the requirements of Article 10, although that guidance is only required for SEC registrants. Interim period financial statements may, at the option of the reporting entity, be either of the following:

- A complete set of financial statements with either full footnote disclosures or only limited footnote disclosures that update the most recently audited footnotes for significant changes

- Condensed financial statements with limited footnote disclosures

Reporting entities qualifying for smaller reporting company status (as defined by S-K 10(f)) may follow the requirements of S-X 8-03 rather than Article 10.

If Article 10 is followed, the interim financial statements are usually labeled as "condensed." This is because the financial statement line items are not shown in the same level of detail and/or there are fewer footnotes as compared to annual financial statements.

If certain line item captions are required to be presented separately, but were permitted to be combined in prior interim financial statements (e.g., due to immateriality), the comparative periods must be retroactively reclassified to conform to the current period presentation.

SEC regulations do not require interim financial statements to be audited. However, S-X 3-03(d) and S-X 10-01(b)(8) prescribe that if the interim financial statements are unaudited, there should be disclosure that all adjustments necessary for a fair statement of the results for the periods presented have been included and that such adjustments are of a normal recurring nature. Alternatively, if applicable, the reporting entity should describe any other-than-normal recurring adjustments. Reporting entities should also clearly disclose that certain information was derived from the prior annual audited financial statements. Example 29-1 provides an example of this disclosure.

EXAMPLE 29-1

Example disclosure – unaudited interim financial statements

Note X

In the opinion of the Company, the accompanying unaudited condensed consolidated financial statements contain all adjustments, consisting of only normal recurring adjustments, necessary for a fair statement of its financial position as of September 30, 20X4, and its results of operations for the three months and nine months ended September 30, 20X4, and 20X3, and cash flows for the nine months ended September 30, 20X4, and 20X3. The condensed consolidated balance sheet at December 31, 20X3, was derived from audited annual financial statements, but does not contain all of the footnote disclosures from the annual financial statements.

Although there are no requirements as to the placement in the footnotes of the language used in the example disclosure, we suggest such disclosure be included as a separate section in the accounting policy footnote or in a separate footnote immediately preceding the accounting policy footnote.

The use of the words "fair statement" rather than "fair presentation" in the example disclosure is intentional. Unless the interim financial statements are accompanied by complete footnote disclosures, the phrase "fairly presented" should not be used as that wording is only appropriate in the context of full U.S. GAAP financial statements and footnotes.

29.3.1 *Presentation requirements — balance sheet*

Article 10 requires interim financial information to include balance sheets as of the end of the most recent quarter and the preceding fiscal year. An interim balance sheet for the comparable prior year quarter does not need to be included unless it is necessary to understand seasonal fluctuations.

Article 10 allows certain balance sheet line items to be condensed, as described in the following excerpt:

S-X 10-01(a)(2)

Interim balance sheets shall include only major captions (i.e., numbered captions) prescribed by the applicable sections of this Regulation with the exception of inventories. Data as to raw materials, work in process and finished goods inventories shall be included either on the face of the balance sheet or in the notes to the financial statements, if applicable. Where any major balance sheet caption is less than 10% of total assets, and the amount in the caption has not increased or decreased by more than 25% since the end of the preceding fiscal year, the caption may be combined with others.

In practice, many reporting entities start with their annual balance sheet and identify line items that can be combined with other line items using the thresholds outlined in Article 10 (i.e., 10 percent of total assets, 25 percent change since preceding fiscal year). However, as discussed in the excerpt above, reporting entities are required to disclose the components of inventory on an interim basis even if the change is not significant from the annual reporting period.

29.3.2 *Presentation requirements — income statement*

Article 10 requires interim financial information to include income statements for the most recent quarter, the corresponding quarter in the preceding year, and the year-to-date periods for both years. The reporting entity may also present an income statement for the cumulative twelve month period ended during the most recent fiscal quarter and for the corresponding preceding period if that information would be meaningful to financial statement users.

Article 10 allows the income statement to include condensed line items as compared to the annual period as described below.

S-X 10-01(a)(3)

Interim statements of income shall also include major captions prescribed by the applicable sections of this Regulation. When any major income statement caption is less than 15% of average net income for the most recent three fiscal years and the amount in the caption has not increased or decreased by more than 20% as compared to the corresponding interim period of the preceding fiscal year, the caption may be combined with others. In calculating average net income, loss years should be excluded. If losses were incurred in each of the most recent three years, the average loss shall be used for purposes of this test. Notwithstanding these tests, Rule 4-02 of Regulation S-X ["Items not material"] applies and de minimis amounts therefore need not be shown separately, except that registrants reporting under Article 9 shall show investment securities gains or losses separately regardless of size.

In addition to the SEC requirements, ASC 270 requires publicly traded reporting entities to report sales or gross revenues, provision for income taxes, extraordinary items (including related income tax effects), net income, and comprehensive income.

If EPS is required to be presented, Article 10 indicates such amount should be shown on the face of the income statement. A computation of per share earnings (on both a basic and diluted basis) should be disclosed unless the computation can be clearly determined from the information contained in the financial statements. Disclosure of dividends declared per common share is also required on the face of the income statement.

29.3.3 Presentation requirements — comprehensive income

ASC 220, *Comprehensive Income*, requires a reporting entity to report a total for comprehensive income in condensed financial statements of interim periods, either as a single continuous statement with the income statement or as two separate consecutive statements. There is no requirement to disclose the components of comprehensive income. However, if there is a significant difference in the components of comprehensive income from the prior year end, or a significant difference in comprehensive income compared with net income, the major components should be disclosed.

Reporting entities should also present the changes in the components of accumulated other comprehensive income (AOCI) for the current period. They are required to present separately the amount of the change that is due to reclassifications, and the amount that is due to current period other comprehensive income. These changes could be shown either before or net-of-tax, and displayed either on the face of the financial statements or in the footnotes. Although ASC 220 indicates that the information should be presented for the current period, we believe that providing comparative information is also useful to financial statement users.

ASC 220 also requires that reporting entities present (either in a single footnote or parenthetically on the face of the financial statements) the effect of significant amounts reclassified from each component of accumulated other comprehensive income based on its source (e.g., related to cash flow hedges from interest rate contracts) and the income statement line items affected by the reclassification (e.g., interest income or interest expense). If a component is not required to be reclassified to net income in its entirety (e.g., net periodic pension cost), reporting entities should instead cross reference to the related footnote for additional information (e.g., the pension footnote).

Question 29-1

Is an SEC registrant required to disclose the change in each component of AOCI as noted in ASC 220-10-45-14A on both a quarter-to-date and year-to-date basis?

PwC response

As discussed in FSP 29.3.5, Article 10 does not require a statement of changes in stockholders' equity, but it does require a balance sheet as of the end of the most recent quarter and the preceding fiscal year end. As such, the disclosure requirements of ASC 220-10-45-14A should be provided on a year-to-date basis at a minimum. However, a reporting entity can report such data on a quarter-to-date basis as well. If a reporting entity decides to add quarter-to-date data, such presentation and disclosure should be applied consistently by presenting the information for the comparative prior period as well.

Further, while this information can be presented in a footnote, it is more typical to include a statement of changes in stockholders' equity.

Question 29-2

ASC 220 requires reporting entities to present net income and other comprehensive income in either a single continuous statement of comprehensive income or in two separate, but consecutive, statements of net income and other comprehensive income.

Can a reporting entity use a different format for interim reporting than in its annual financial statements?

PwC response

Yes, a reporting entity can use a format for its interim reporting that differs from the format in its annual financial statements. For example, electing a one-statement format for interim reporting purposes would not prevent an entity from using the two-statement format in its annual financial statements. Both formats provide the same information.

Reporting entities that elect to provide only the minimum information required for interim reporting—that is, only present total comprehensive income — would only have a single line in their second statement under the two-statement format. Therefore, they may prefer to use the one-statement format for interim reporting and add the total comprehensive line to that statement.

29.3.4 Presentation requirements — cash flow statement

Article 10 requires the statement of cash flows to be presented for the year-to-date period and for the corresponding period of the prior year. The reporting entity may also present a statement of cash flows for the cumulative twelve month period ended during the most recent fiscal quarter and for the corresponding preceding period if that information would be meaningful to financial statement users.

Similar to the balance sheet and income statement, the statement of cash flows may also be presented on a condensed basis as described below.

S-X 10-01(a)(4)

The statement of cash flows may be abbreviated starting with a single figure of net cash flows from operating activities and showing cash changes from investing and financing activities individually only when they exceed 10% of the average of net cash flows from operating activities for the most recent three years. Notwithstanding this test, Rule 4-02 applies and de minimis amounts therefore need not be shown separately.

Interim cash flow statements do not require separate disclosure of the amounts of cash interest and taxes paid during the interim periods. While Article 10 allows the statement of cash flows to start with a single figure for cash flows from operating activities, reporting entities may want to consider whether stakeholders would benefit from expanded cash flows from operating activities, similar to annual presentations, rather than the abbreviated presentation.

29.3.5 Presentation requirements — statement of changes in stockholders' equity

Article 10 does not require reporting entities to present a statement of changes in stockholders' equity or disclosures of changes in equity in the footnotes unless there are significant changes in equity accounts subsequent to the most recent year end. If there are significant changes, those changes should be disclosed either in a separate statement of changes in stockholders' equity or in the footnotes.

Notwithstanding the Article 10 guidance, ASC 810, *Consolidation*, requires a reporting entity with one or more less-than-wholly-owned subsidiaries to reconcile the beginning and end of period carrying amounts of total equity, equity attributable to the parent, and equity attributable to the noncontrolling interest for each reporting period.

As such, we believe a reporting entity should include (either in a statement of changes in stockholders' equity or in the footnotes) an equity reconciliation from the beginning of the current fiscal year to the balance sheet date, as well as for the comparative year-to-date period presented in the quarterly filing.

ASC 505, *Equity*, also requires reporting entities to summarize the rights and privileges of the various securities outstanding, and the number of shares issued upon conversion, exercise, or satisfaction of required conditions.

29.3.6 Presentation requirements — development stage entities

S-X 10-01(a)(7) requires development stage reporting entities to provide the condensed cumulative financial statements and disclosures required by ASC 915, *Development Stage Entities*, as of the date of the latest balance sheet presented.

However, the FASB's issuance of ASU 2014-10, *Development Stage Entities (Topic 915)*: *Elimination of Certain Financial Reporting Requirements, Including an Amendment to Variable Interest Entities Guidance in Topic 810, Consolidation*, may lead to a change in this requirement. For reporting periods beginning after December 15, 2014, reporting entities are no longer required to present inception-to-date information on the statements of income, cash flows, and changes in stockholders' equity. However, as of the content cutoff date for this publication (August 31, 2014), it remained unclear whether the SEC would eliminate the requirement under S-X 10-01(a)(7). Financial statement preparers and other users of this publication are therefore encouraged to monitor the status of the SEC's decision on this topic.

29.4 Interim footnote disclosures

Since interim periods are an integral part of an annual period, reporting entities can assume stakeholders have access to the annual financial information and can prepare most of their disclosures in the context of an update to the most recently filed annual financial statements. ASC 270 also acknowledges the balance between timely interim financial reporting and the amount of detail disclosed, and therefore provides more limited disclosure requirements for interim financial information as compared to annual financial statements.

As such, interim reporting generally should not simply repeat information disclosed in the previous annual financial statements (e.g., significant accounting policies or details of account balances that have not changed significantly). Disclosures should typically focus on items that have changed significantly since year end or events that occurred subsequent to the annual financial statements (e.g., new borrowings, business combinations or dispositions, debt or equity issuances, etc.).

There may be circumstances where information is not significant in the context of the annual results of operations but is material in the context of the interim results. This information should be discussed in the interim report.

Although the interim footnote disclosures should be prepared using this overarching guidance, there are certain specific interim reporting requirements, discussed later in this section.

Certain disclosures may also be necessary to ensure comparability with prior periods.

ASC 270-10-45-8b

Some costs and expenses incurred in an interim period, however, cannot be readily identified with the activities or benefits of other interim periods and shall be charged to the interim period in which incurred. Disclosure shall be made as to the nature and amount of such costs unless items of a comparable nature are included in both the current interim period and in the corresponding interim period of the preceding year.

The following subsections discuss certain interim footnote disclosures required by ASC 270 and Article 10. FSP 29.4.1 through 29.4.6 include general recurring interim disclosure requirements. FSP 29.4.7 includes disclosure requirements for certain transactions. If the required interim disclosures are identical to the annual disclosure requirements, the topic is listed in a chart that references where more information on the annual disclosure requirements can be found. Otherwise, if the annual and interim disclosure requirements differ, the interim requirements are discussed.

29.4.1 General recurring interim reporting requirements that are identical to annual reporting requirements

Figure 29-1 lists accounting topics that have identical interim and annual reporting requirements, and a reference to discussion of the annual disclosure requirements.

Figure 29-1
General recurring topics with identical interim and annual disclosure requirements

Topic	Reference
Commitments and contingencies*	FSP 23
Debt and equity securities	FSP 9
Derivatives and hedging	FSP 19
EPS	FSP 29.3.2 and FSP 7
Fair value (assets and liabilities per ASC 820 and financial instruments per ASC 825)	FSP 20
Guarantees, including product warranties	FSP 11 and FSP 23
Joint and several arrangements	FSP 23

Topic	Reference
Registered guarantors/guarantees	Regulation S-X 3-10, FSP 12, and FSP 31
Related parties	FSP 26
Taxes collected from customers and remitted to government authorities	FSP 3
Variable interest entities	FSP 18

*With respect to contingencies, reporting entities are required to disclose material contingencies whether or not there has been a change since the last annual reporting period. Disclosures should be repeated or updated as applicable in all reporting periods until the contingencies have been removed, resolved, or have become immaterial. However, since interim financial statements include year-to-date information, contingencies resolved during one quarter of a fiscal year should continue to be disclosed in the subsequent quarterly financial statements of the same fiscal year.

ASC 270 also indicates that contingencies and other uncertainties that could affect the fairness of presentation of interim financial data should be disclosed in interim reports in the same manner as required for annual reports. When assessing whether a transaction or uncertainty is material for purposes of disclosure, materiality should be assessed in relation to the annual financial statements.

29.4.2 Defined benefit pension plans and other postemployment benefits

The following interim disclosures should be provided for defined benefit pension plans and other defined benefit postretirement benefit plans of publicly traded reporting entities in interim periods.

Excerpt from ASC 270-10-50-1(j)

1. The amount of net periodic benefit cost recognized, for each period for which a statement of income is presented, showing separately the service cost component, the interest cost component, the expected return on plan assets for the period, the gain or loss component, the prior service cost or credit component, the transition asset or obligation component, and the gain or loss recognized due to a settlement or curtailment

2. The total amount of the employer's contributions paid, and expected to be paid, during the current fiscal year, if significantly different from amounts previously disclosed...Estimated contributions may be presented in the aggregate combining all of the following:

   i. Contributions required by funding regulations or laws
   ii. Discretionary contributions
   iii. Noncash contributions.

The disclosures should be provided for all periods presented. The amounts should reflect the actual expense recorded and should not be changed to reflect "normalized" expense for the year.

Reporting entities must also disclose certain information about Medicare subsidy effects on its postretirement health care benefit plan. See FSP 13 for further information on these disclosures.

29.4.3 Equity method investees

Article 10 requires certain disclosure for equity method investees.

S-X 10-01(b)(1)

(1) Summarized income statement information shall be given separately as to each subsidiary not consolidated or 50 percent or less owned persons or as to each group of such subsidiaries or fifty percent or less owned persons for which separate individual or group statements would otherwise be required for annual periods. Such summarized information, however, need not be furnished for any such unconsolidated subsidiary or person which would not be required pursuant to Rule 13a-13 or 15d-13 to file quarterly financial information with the Commission if it were a registrant.

While income statement information is required, it is not necessary to provide balance sheet information of equity method investees. See FSP 10 for further information on disclosures required for equity method investments in interim periods.

29.4.4 Financing receivables and allowances for credit losses

ASC 270 requires reporting entities to disclose the following information about the credit quality of financing receivables and the allowance for credit losses:

- Nonaccrual and past due financing receivables
- Allowance for credit losses related to financing receivables
- Impaired loans
- Credit-quality information related to financing receivables
- Modifications of financing receivables

29.4.5 Reportable operating segments

Reduced segment disclosures may be presented when condensed financial statements of interim periods are issued. If a complete set of financial statements is presented in an interim period, then the full disclosure requirements of ASC 280 apply. Refer to FSP 25.7.7 for discussion of presentation and disclosure requirements for segments in interim periods.

29.4.6 *Seasonal revenue, costs, or expenses*

Certain reporting entities are subject to seasonal variations, which could cause interim results to not be indicative of the estimated results for the full fiscal year. Reporting entities subject to material seasonal variations should disclose the seasonal nature of their activities. They should also consider supplementing interim financial information with information from the 12-month period ended as of the most recent interim date along with comparative data from the corresponding 12-month period of the prior year.

For example, as noted in Article 10, certain agricultural reporting entities may present rolling 12-month interim financial information in lieu of year-to-date information if management believes it is more appropriate and necessary for an understanding of the impact of seasonal fluctuations.

Some SEC registrants may also elect to present balance sheets as of the end of the prior year quarter as supplemental disclosure for comparative purposes.

29.4.7 *Other interim reporting requirements for certain transactions*

To the extent applicable, additional reporting may be necessary as a result of events or transactions that occur in the interim period. The following subsections discuss several of these situations.

29.4.7.1 *Other interim reporting requirements for certain non-recurring transactions that are identical to annual reporting requirements*

Figure 29-2 lists accounting topics that are non-recurring in nature that have identical interim and annual reporting requirements, and a reference to discussion of the annual disclosure requirements.

Figure 29-2
Non-recurring topics with identical interim and annual disclosure requirements

Topic	Reference
Collaborative arrangements**	FSP 3
Early warning and changes to risks and uncertainties	FSP 24
Going concern	FSP 24
Issuance of equity	FSP 5
New debt arrangements	FSP 12
Restructuring	FSP 11

Topic	Reference
Share-lending arrangements	FSP 12
Subsequent events	FSP 28

**Collaborative arrangement disclosures are only necessary in the period in which the arrangement commences and all annual periods thereafter.

29.4.7.2 Business combinations

The disclosure requirements of ASC 805, *Business Combinations*, are applicable for business combinations that occur either during the current reporting period, or after the reporting date but before the financial statements are issued. Therefore, the required disclosures should be included in interim financial statements, as applicable.

S-X 10-01(b)(4) requires certain pro forma financial information to be provided for material business combinations that have occurred during the period.

S-X 10-01(b)(4)

Where a material business combination has occurred during the current fiscal year, pro forma disclosure shall be made of the results of operations for the current year up to the date of the most recent interim balance sheet provided (and for the corresponding period in the preceding year) as though the companies had combined at the beginning of the period being reported on. This pro forma information shall, at a minimum, show revenue, income before extraordinary items and the cumulative effect of accounting changes, including such income on a per share basis, and net income, net income attributable to the registrant, and net income per share.

Though the intent of this Article 10 guidance is to require pro forma information in interim financial statements that is consistent with the pro forma information required by the accounting standards, certain differences exist. Refer to FSP 17 for further discussion of disclosures associated with business combinations, and SEC 4560 for discussion of SEC pro forma requirements associated with business combinations.

If the transaction is reflected as a combination of entities under common control, S-X 10-01(b)(3) requires supplemental disclosure of the results of the entities combined for all periods presented. See FSP 30 for further discussion regarding entities under common control or change in reporting entities.

29.4.7.3 Changes in accounting principles or estimates

Reporting entities may make a change in accounting principle (e.g., adopt a new accounting standard or acknowledge the impact of a change for a standard not yet adopted), a change in estimate, or identify an error during an interim reporting period. FSP 30 discusses the presentation and disclosure requirements for each of these events.

29.4.7.4 Discontinued operations

Article 10 requires disclosure of the amount and earnings per share impact of a discontinued operation on revenue and net income for each period presented. Refer to FSP 27 for more information on presentation and disclosure of discontinued operations in interim periods.

29.4.7.5 Disposal of a component of a reporting entity and extraordinary, unusual, or infrequently occurring items

Material effects of disposals of a component of a reporting entity, and unusual and infrequently occurring transactions and events that are not designated as extraordinary items in the interim financial statements should be reported separately.

If extraordinary items and discontinued operations are reported net of tax in the annual financial statements, they should be similarly reported in interim financial statements.

Note about ongoing standard setting

As of the content cutoff date of this publication (August 31, 2014), the FASB has an active project on classifying items as extraordinary that may affect presentation and disclosure requirements. Financial statement preparers and other users of this publication are therefore encouraged to monitor the status of this project, and if finalized, evaluate the effective date of the new guidance and the implications on presentation and disclosure.

29.4.7.6 Significant changes in estimates or provisions for income taxes

Reporting entities should make their best estimate of the effective tax rate expected to be applicable for the full fiscal year for interim reporting purposes, and disclose any significant changes in such estimates from period to period. If a reporting entity determines that it is unable to reliably estimate its annual effective tax rate, the discrete-period computation method may be used. The reporting entity's assertion that it cannot reliably estimate its annual effective tax rate should be disclosed so that financial statement users can understand the manner in which the interim tax provision was determined.

When a reporting entity applies the requirements of ASC 740, *Income Taxes*, in interim periods, a significant variation in the customary relationship between income tax expense and pretax income may result. Unless apparent from the financial statements or the nature of the reporting entity's business, the reasons for significant variations in the customary relationship between income tax expense and pretax accounting income should be disclosed.

In addition, if important developments occur during the year or if the tax amounts reported for the interim periods do not adequately reflect events that the reporting entity expects to occur, disclosure of these matters should be considered. Interim period disclosures related to income taxes often include:

- Tax effects of significant unusual or infrequent items that are recorded separately or items that are reported net of their related tax effect

- Significant changes in estimates or provisions for income taxes (e.g., changes in the assessment of the need for a valuation allowance that occur during the period)

- Material changes to (1) uncertain tax benefits, (2) amounts of uncertain tax benefits that if realized would affect the estimated annual effective tax rate, (3) total amounts of interest and penalties recognized in the balance sheet, (4) positions for which it is reasonably possible that the total amount of uncertain tax benefits will significantly increase or decrease within the next 12 months, and (5) the description of tax years that remain open by major tax jurisdiction

Material changes in unrecognized tax benefits that occur during an interim period should be disclosed during the interim period. A reporting entity should not delay disclosure of material changes until the end of the annual reporting period.

29.5 Fourth quarter considerations

SEC registrants are required to report interim financial information for the first three quarters of each fiscal year on a Form 10-Q. A Form 10-Q does not need to be filed for the fourth quarter of any fiscal year; however, S-K 302 requires disclosure of certain interim information within the annual report (but not necessarily as part of the audited financial statements) for most public reporting entities (exceptions noted in S-K 302(a)(5)).

If a fourth quarter statement is separately issued, it should follow the format and content of earlier quarterly statements.

If a public reporting entity has not prepared a separate fourth quarter statement, nor disclosed the results of that quarter in a separate section of the annual report, and it is not subject to the requirements of Regulation S-K, ASC 270-10-50-2 nonetheless requires the following to be disclosed in a footnote to the annual financial statements:

- Extraordinary, unusual, or infrequently occurring items recognized during the fourth quarter

- Disposal of a component(s) during the fourth quarter

- Aggregate effect of year-end adjustments that are material to that fourth quarter

- Changes to accounting principles made during the fourth quarter

29.6 Considerations for private companies

The primary guidance for the form and content of condensed interim financial information is Article 10, which applies to SEC registrants. Private companies that provide interim information should comply with the provisions of ASC 270 that are applicable to nonpublic companies. In addition, they may also consider complying with the provisions of ASC 270 that are applicable to publicly traded entities, as well as the form and content guidance of Article 10. Private company interim financial information should include a footnote advising that the financial information should be read in conjunction with the latest annual financial statements.

Private company interim financial reporting is often driven by bank covenants or private equity reporting requirements. Not-for-profit entities are often subject to continuing disclosure agreements in connection with tax-exempt financing, which may require the provision of interim financial information. While being mindful of the interim reporting requirements of Article 10 and ASC 270, private and not-for-profit entities should follow the specific financial reporting requirements as mandated by their bank, investor, or continuing disclosure agreements.

The following subsections discuss specific differences in disclosure requirements for private entities as compared with public entities.

29.6.1 Accumulated other comprehensive income

Private companies that have adopted ASU 2013-02, *Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*, are not required to present, either parenthetically on the face of the financial statements or in a single footnote, amounts reclassified out of each component of accumulated other comprehensive income on an interim basis. However, private companies are required to follow the reporting requirements related to accumulated other comprehensive income during interim periods.

29.6.2 Defined benefit pension plans and other postemployment benefits

Private companies are not required to provide all of the interim disclosures about defined benefit pension plans and other defined benefit postretirement benefit plans described in FSP 29.4.2. Private company disclosure requirements are as follows:

ASC 715-20-50-7

A nonpublic entity shall disclose in interim periods for which a complete set of financial statements is presented the total amount of the employer's contributions paid, and expected to be paid, during the current fiscal year, if significantly different from amounts previously disclosed … Estimated contributions may be presented in the aggregate combining all of the following:

a. Contributions required by funding regulations or laws

b. Discretionary contributions

c. Noncash contributions.

29.6.3 Financial instruments not measured at fair value

Interim disclosures for financial instruments not measured at fair value (discussed in FSP 20), but for which fair value is disclosed are not required for entities that do not meet the Master Glossary's definition of a publicly traded company.

Definition from ASC Master Glossary

Publicly Traded Company: A business entity that has any of the following characteristics:

a. Whose securities are traded in a public market on a domestic stock exchange or in the domestic over-the-counter market (including securities quoted only locally or regionally)

b. That is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets)

c. Whose financial statements are filed with a regulatory agency in preparation for the sale of any class of securities in a domestic market

Chapter 30: Accounting changes

30.1 Chapter overview

An accounting change is generally the result of one of three scenarios: a change in accounting principle, a change in estimate, or a correction of an error. Distinguishing between each scenario can sometimes be difficult, but the distinction is critical to applying the appropriate reporting framework.

This chapter provides guidance on how to distinguish between a change in accounting principle, change in estimate, or error correction, and addresses the applicable presentation and disclosure considerations for each. It also discusses the presentation and disclosure related to changes in the reporting entity.

30.2 Scope

ASC 250, *Accounting Changes and Error Corrections*, is the primary guidance governing accounting changes, though other provisions of U.S. GAAP and SEC guidance also impact specific aspects of accounting changes. The U.S. GAAP guidance is applicable to all reporting entities, including not-for-profit and private companies. Although the SEC guidance is only required to be applied by reporting entities whose financial statements are filed with the SEC, private companies are encouraged to consider the SEC guidance as well.

30.3 Differentiating between a change in accounting principle, a change in estimate, or a correction of an error

Determining whether a change in accounting represents the application of a new (different) accounting principle, a change in estimate, or a correction of an error can often be difficult and may require judgment.

In several areas of U.S. GAAP, reporting entities can elect from more than one acceptable accounting principle. A change in accounting principle is a change from one acceptable method to another. Examples include changing pension accounting methods related to actuarial gains and losses and a change in the composition of the elements of inventory costing.

In contrast, a change in estimate results from incorporating new information or modifying the estimating techniques affecting the carrying amount of assets or liabilities as of the date the change is made. Changing inputs for estimating uncollectible receivables based on new information is an example of a change in the estimating technique.

The distinction between a change in accounting principle and a change in estimate is important because a change in accounting principle is generally applied retrospectively (by recasting prior periods), while a change in estimate is prospective, affecting only current and future periods. In addition, reporting entities cannot change accounting principles unless the new method is "preferable."

Distinguishing a change in estimate from an error is also important. While a change in estimate results from new information or developments, an error reflects the misapplication of facts or information that was available at a previous financial statement reporting date. If the “new” information was known, or could have been known, as of the prior period, it is generally indicative of an error in the previous accounting.

Reporting entities should consider the following questions to help differentiate among a change in accounting principle, change in estimate, or a correction of an error:

- What was the rationale for the accounting change?
- Did the estimation model change, or just the inputs?
- Why did the inputs to the estimation model change and when was a change in inputs supportable?
- Is the reporting entity applying the accounting principle to a new business, new balances, or new transaction streams, or is the accounting principle applicable to balances and transaction streams to which it should have been applied in the past?
- If the accounting results have changed significantly, can the changes be substantiated by developments in the business?

30.4 Change in accounting principle

A change in accounting principle is a change from one acceptable method to another. It can be required by newly issued guidance or as the result of a decision by the reporting entity to adopt a different accounting principle on the basis that it is preferable.

New accounting guidance generally provides specific transition requirements (e.g., prospective application or cumulative catch up adjustment). Accordingly, the provisions of ASC 250 do not apply when a reporting entity is adopting a new accounting pronouncement that specifies the manner of adopting the change. However, if transition requirements are not provided, a change in accounting principle must be reported in accordance with ASC 250.

The adoption of accounting principles in the following situations are outside the scope of ASC 250:

Excerpt from ASC 250-10-45-1

Neither of the following is considered to be a change in accounting principle:

a. Initial adoption of an accounting principle in recognition of events or transactions occurring for the first time or that previously were immaterial in their effect

b. Adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring.

Note that, generally, accounting principles that are not material are not disclosed in the footnotes. Therefore, it would be unusual for an accounting principle that is disclosed in previously issued financial statements to be deemed immaterial for the purposes of considering ASC 250-10-45-1a.

30.4.1 Justification for a change in accounting principle

Once an accounting principle is adopted, it should be applied consistently when accounting for similar events and transactions. A reporting entity that wants to change an accounting principle must justify that the allowable alternative accounting principle is preferable.

Preferability may vary depending upon the circumstances of the reporting entity. For example, one reporting entity may deem the LIFO inventory method to be preferable due to the nature of its inventory costs, while for others, FIFO may be most appropriate. The disclosure should include an explanation of why the newly adopted change is preferable. SAB Topic 6.G.2.b, *Reporting Requirements for Accounting Changes,* provides guidance on assessing the justification for a change in accounting principle. It includes considerations such as whether an authoritative body has deemed one accounting principle preferable to another, how the change impacts business judgment and planning, and whether the change results in improved financial reporting.

30.4.2 Preferability letters

While preferability must be established for all accounting changes, not all changes require the issuance of a preferability letter. Emphasis of certain changes are required in the auditor's report for all reporting entities, and preferability letters are required for material accounting changes made by public reporting entities.

If there has been a change in an accounting principle or in the method of its application that has a material effect on the comparability of the reporting entity's financial statements, the auditor is required to discuss the change in an explanatory paragraph in the auditor's report that identifies the nature of the change and refers to the footnote in the financial statements that discusses the change.

For public reporting entities (except for Foreign Private Issuers) that make material accounting changes, a registrant's independent accountant is required to provide a letter (commonly known as a "preferability letter") indicating whether or not the reporting entity's change to an alternative principle is, in the accountant's judgment, preferable under the circumstances. SEC 3140.4 and 3130.17 provide guidance on the form and content of preferability letters.

30.4.3 Presentation and disclosure considerations

ASC 250 requires that a change in accounting principle be reported through retrospective application to all prior periods, unless impracticable. Retrospective application requires the following:

- The cumulative effect of the change to the new accounting principle on periods prior to those presented should be reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented.

- The effect, if any, must be reflected in the opening balance of retained earnings (or other appropriate components of equity or net assets) for the earliest period presented.

- Financial statements for each individual prior period presented should be adjusted to reflect the period-specific effects of applying the new accounting principle.

SAB Topic 5.F, *Accounting Changes Not Retroactively Applied Due to Immateriality,* provides the SEC staff's view on instances when an accounting change that is required to be adopted by retrospective application is considered to be immaterial to prior period financial statements. The SEC staff believes that the amount should be reflected in the results of operations for the period in which the change is made unless the cumulative effect is material to current operations or to the trend of the reported results of operations. In this case, the individual income statements of the earlier years should be retrospectively adjusted. See SAB 99, *Materiality,* for evaluating materiality.

ASC 250 also requires specific financial statement disclosures with respect to a change in accounting principle, as outlined in ASC 250-10-50-1.

Excerpt from ASC 250-10-50-1

An entity shall disclose all of the following in the fiscal period in which a change in accounting principle is made:

a. The nature of and reason for the change in accounting principle, including an explanation of why the newly adopted accounting principle is preferable.

b. The method of applying the change, including all of the following:

    1. A description of the prior-period information that has been retrospectively adjusted, if any.

2. The effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item, and any affected per-share amounts for the current period and any prior periods retrospectively adjusted. Presentation of the effect on financial statement subtotals and totals other than income from continuing operations and net income (or other appropriate captions of changes in the applicable net assets or performance indicator) is not required.
3. The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented.

…Financial statements of subsequent periods need not repeat the disclosures required by this paragraph. If a change in accounting principle has no material effect in the period of change but is reasonably certain to have a material effect in later periods, the disclosures required by (a) shall be provided whenever the financial statements of the period of change are presented.

The guidance above indicates that the disclosure generally does not need to be repeated in subsequent period financial statements. However, when an accounting change occurs and prior periods are not retrospectively adjusted due to impracticability, the disclosures should be included in subsequent periods until all periods are prepared using the new principle.

SAB Topic 6.I.3, *Net of Tax Presentation,* clarifies that when items are reported on a net of tax basis, additional disclosures of the nature of the tax component should be provided. This is accomplished by reconciling the tax component associated with the item to the applicable statutory income tax rate. This guidance is applicable to cumulative effect adjustments related to changes in accounting principle, which are presented net of tax.

Question 30-1

Do the columns on the primary financial statements need to be labelled "As restated" when there has been a retrospective change in accounting principle?

PwC response

No. However, the reporting entity should include clear disclosure in the footnotes about the effect of the change on the affected financial statement line items and any per-share amounts are required by ASC 250-10-50-1. See FSP 7 for discussion of per-share considerations.

30.4.3.1 The impracticability exception

Sometimes it is not practical for reporting entities to calculate the retrospective impact of an accounting change due to lack of available information. The guidance acknowledges this complication, and provides criteria that a reporting entity must meet to deem retrospective application impracticable.

ASC 250-10-45-9

It shall be deemed impracticable to apply the effects of a change in accounting principle retrospectively only if any of the following criteria are met:

a. After making every reasonable effort to do so, the entity is unable to apply the requirement.

b. Retrospective application requires assumptions about management's intent in a prior period that cannot be independently substantiated.

c. Retrospective application requires significant estimates of amounts, and it is impossible to distinguish objectively information about those estimates that both:

    1. Provides evidence of circumstances that existed on the date(s) at which those amounts would be recognized, measured, or disclosed under retrospective application

    2. Would have been available when the financial statements for that prior period were issued.

Sometimes it may be impracticable to determine the period-specific effects of a change on prior annual or interim periods even when the cumulative effect can be determined. For example, it may be possible to determine the impact for annual periods but not interim periods. In these situations, carrying amounts of assets and liabilities as of the earliest period should be adjusted for the cumulative effect of the change to the new accounting principle. Any offsetting adjustment should be made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position).

If it is impracticable to determine the cumulative effect of applying a change in accounting principle, then the new accounting principle should be applied prospectively as of the earliest date practicable. Note that the disclosure provisions discussed in FSP 30.4.3 would still apply.

30.4.3.2 Indirect effects of a change in accounting principle

ASC 250 indicates that retrospective application should include only the direct effects of a change in accounting principle, including any related income tax effects. Indirect effects that would have been recognized if the newly adopted accounting principle had been followed in prior periods should not be included in the retrospective application. If indirect effects are actually incurred, they should be reported in the period in which the accounting change is made. Specific disclosures are outlined in ASC 250-10-50-1(c).

ASC 250-10-50-1(c)

c. If indirect effects of a change in accounting principle are recognized both of the following shall be disclosed:

1. A description of the indirect effects of a change in accounting principle, including the amounts that have been recognized in the current period, and the related per-share amounts, if applicable

2. Unless impracticable, the amount of the total recognized indirect effects of the accounting change and the related per-share amounts, if applicable, that are attributable to each prior period presented. Compliance with this disclosure requirement is practicable unless an entity cannot comply with it after making every reasonable effort to do so.

Example 30-1 demonstrates the concept of an indirect effect of an accounting change.

EXAMPLE 30-1

Indirect effect of an accounting change

FSP Corp changes to a preferable accounting principle in 20X4. The retrospective application of the change results in an increase in reported net income for 20X3. FSP Corp's bonus plan is tied to reported net income, and the 20X3 bonus payment would have been higher if the new accounting principle had actually been adopted in 20X3. Though not required to do so under the bonus plan, FSP Corp elects to pay the incremental bonus amount in 20X4.

Should FSP Corp report the incremental bonus payment in the retrospective application of the change in accounting principle?

Analysis

No. The incremental bonus payment is an indirect effect of the accounting change and would not be included in the retrospective application in 20X3. Rather, the additional bonus expense should be reported in 20X4. Had FSP Corp chosen not to pay the incremental bonus, there would be no impact on 20X3 or 20X4.

30.4.3.3 Disclosure of the impact that recently issued accounting standards will have on the financial statements

SAB 74, *Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period*, discusses the SEC staff's view regarding required disclosures when a new accounting standard has been issued but is not yet effective. The SEC staff emphasizes that reporting entities should provide meaningful (non-boilerplate) disclosure based on known information. Financial statement and nonfinancial statement disclosures should not be duplicative because their objectives are different. Although there will be exceptions, the SEC staff's view suggests a general principle that the retrospective effects of a new accounting standard would most likely be disclosed in the financial statements while the future/prospective effects would most likely be discussed in MD&A.

Often, a reporting entity will initially disclose that it is assessing the impact of a new standard and begin to provide more detailed disclosures as the information is available. SAB Topic 74 describes the disclosures to be made.

Excerpt from SAB Topic 74

- A brief description of the new standard, the date that adoption is required and the date that the registrant plans to adopt, if earlier.
- A discussion of the methods of adoption allowed by the standard and the method expected to be utilized by the registrant, if determined.
- A discussion of the impact that adoption of the standard is expected to have on the financial statements of the registrant, unless not known or reasonably estimable. In that case, a statement to that effect may be made.
- Disclosure of the potential impact of other significant matters that the registrant believes might result from the adoption of the standard (such as technical violations of debt covenant agreements, planned or intended changes in business practices, etc.) is encouraged.

Each new accounting standard must be analyzed to determine the appropriate disclosure. The level of information available may differ based on the nature of the standard and from one reporting entity to another.

If a recently issued standard will impact the presentation of, but not materially affect, the financial statements, SAB 74 encourages the reporting entity to disclose that a standard has been issued and that its adoption will not have a material effect on its financial position or results of operations.

30.5 Change in accounting estimate

A change in estimate results from new information or modifications to the estimating techniques affecting the carrying amount of assets or liabilities.

ASC 250 indicates that changes in accounting estimates should not be accounted for by restating or retrospectively adjusting the amounts reported in the financial statements of prior periods or by reporting pro forma amounts. A change in accounting estimate should be accounted for in the period of change and prospective periods, if applicable.

It is important for reporting entities to maintain sufficient documentation to support revisions to estimates and the timing of such revisions. A revision to an estimate should be based on events, facts, or circumstances that occurred during the period in which the estimate was revised.

ASC 250 requires specific financial statement disclosures with respect to changes in accounting estimates.

ASC 250-10-50-4

The effect on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), and any related per-share amounts of the current period shall be disclosed for a change in estimate that affects several future periods, such as a change in service lives of depreciable assets. Disclosure of those effects is not necessary for estimates made each period in the ordinary course of accounting for items such as uncollectible accounts or inventory obsolescence; however, disclosure is required if the effect of a change in the estimate is material. When an entity effects a change in estimate by changing an accounting principle, the disclosures required by paragraphs 250-10-50-1 through 50-3 also are required. If a change in estimate does not have a material effect in the period of change but is reasonably certain to have a material effect in later periods, a description of that change in estimate shall be disclosed whenever the financial statements of the period of change are presented.

At times, a change in estimate can result from a change in accounting principle. A common example is a change in the method of depreciation applied to fixed assets, which is effectively a change in the estimate of the future benefit or pattern of consumption. In such cases, the effect of the change in accounting principle, or the method of applying it, may be inseparable from the effect of the change in accounting estimate. Such changes should be accounted for as a change in estimate. As with changes in accounting principles, this type of change may only be made if it is preferable. Other changes in estimate do not require an assessment of preferability.

30.6 Change in the reporting entity and common control transactions

A change in reporting entity is a change that results in financial statements that, in effect, are those of a different reporting entity. Examples include changing subsidiaries within a consolidated group or changing the entities included in a set of combined financial statements. Business combinations accounted for by the acquisition method and consolidation of variable interest entities pursuant to Topic 810, *Consolidation*, are not considered changes in the reporting entity.

Excerpt from ASC 250-10-50-6

When there has been a change in the reporting entity, the financial statements of the period of the change shall describe the nature of the change and the reason for it. In addition, the effect of the change on income before extraordinary items, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), other comprehensive income, and any related per-share amounts shall be disclosed for all periods presented. Financial statements of subsequent periods need not repeat the disclosures required by this paragraph. If a change in reporting entity does not have a material effect in the period of change but is reasonably certain to have a material effect in later periods, the nature of and reason for the change shall be disclosed whenever the financial statements of the period of change are presented.

Combinations between entities that are under common control are included within the *Transactions Between Entities Under Common Control* subsections of ASC 805-50. Common control transactions occur frequently, particularly in the context of reorganizations, spin-offs, and initial public offerings.

Refer to BCG 10 for details on assessing whether common control exists, and BCG 8 for additional guidance on accounting for combinations between entities or businesses under common control.

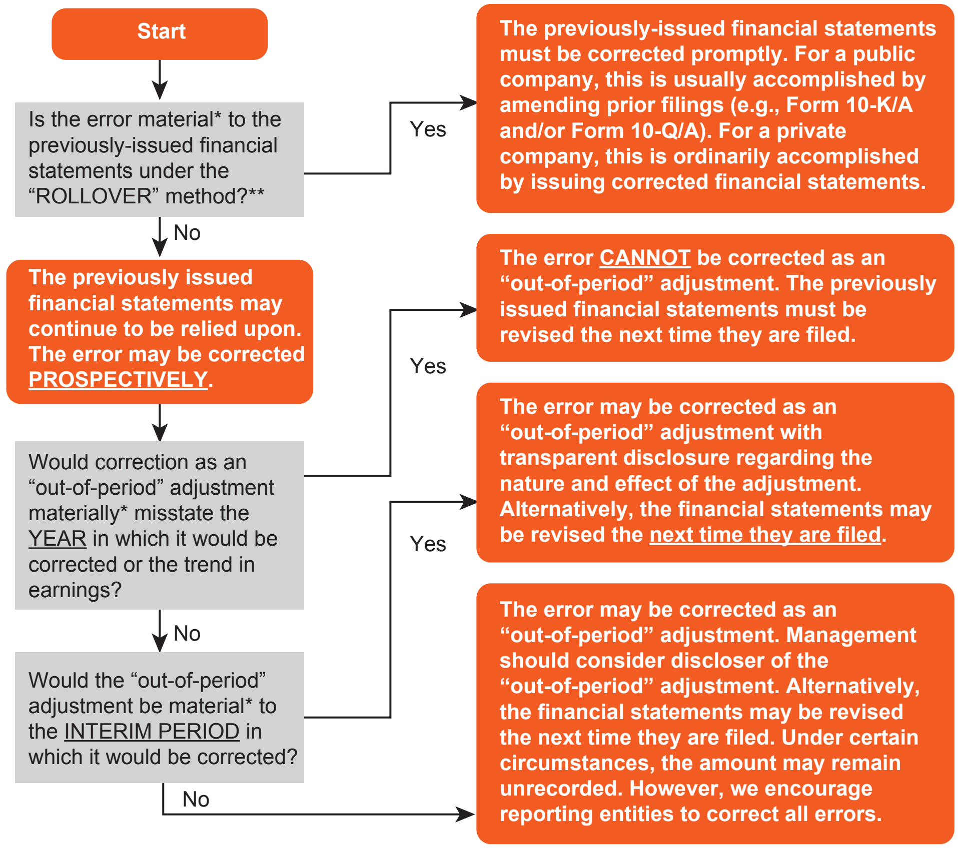
30.7 Correction of an error

When a reporting entity identifies an error in previously issued financial statements, its first step is to determine whether it is material to any previously issued financial statements. If not, they must then evaluate whether the correction of the error in the current period would result in a material misstatement of the current period's financial statements. For SEC registrants (and a best practice for all reporting entities), SAB 99 requires both a qualitative and quantitative assessment of materiality.

Figure 30-1 depicts the materiality framework for evaluating errors in previously issued financial statements.

Figure 30-1

Framework for evaluating errors in previously issued financial statements



* The materiality evaluation requires significant professional judgment and should consider all relevant qualitative and quantitative factors. The evaluation may need to include factors that are not specifically mentioned in SAB 99.

** The "rollover" method is used to evaluate whether previously issued financial statements are materially misstated. The "rollover method" involves an analysis of the error(s) on all of the financial statements. The "iron curtain" error analysis does not impact the decision regarding whether or not previously issued financial statements are materially misstated.

Materiality analyses require significant judgment. A materiality analysis must consider all relevant qualitative and quantitative factors (including company/industry-specific factors).

Errors in financial statements filed with the SEC must be evaluated using both the "iron curtain" method (for the current period) and the "rollover" method (for prior periods) to determine whether they are quantitatively significant.

- The "rollover" method quantifies income statement errors based on the amount by which the income statement for the period is actually misstated — including the reversing effect of any prior period errors. Identified misstatements in the previous period that were not corrected need to be considered to determine any "carryover effects."

- The "iron curtain" method quantifies income statement errors based on the amount by which the income statement would be misstated if the accumulated amount of the errors that remain in the balance sheet at the end of the period were corrected through the income statement during that period.

Many reporting entities whose financial statements are not filed with the SEC also evaluate errors using both of these methods. The use of both methods is commonly referred to as the "dual" method of evaluating errors.

30.7.1 Restatements

Upon determination that the previously issued financial statements are materially misstated, they should be corrected promptly.

- For an SEC registrant, the correction of a material misstatement is ordinarily accomplished by performing both of the following:
  - Filing an Item 4.02 Form 8-K to indicate that the previously issued financial statements should no longer be relied upon
  - Amending prior filings (e.g., filing Form 10-K/A and/or Form 10-Q/A, or, in limited circumstances, a Form 10-K when filing of the subsequent year's Form 10-K is imminent)
- For a private company, the correction of a material misstatement is ordinarily accomplished by the company issuing corrected financial statements that indicate that they have been restated and include its auditor's reissued audit report. Alternatively, it is permissible to reflect the restatement in the soon-to-be issued comparative financial statements. Where the restatement is to be reflected in the soon-to-be issued comparative financial statements, the financial statements and auditor's report would indicate that the prior periods have been restated. Users of the previously issued financial statements also must be notified that they should no longer rely on those financial statements.

Excerpt from ASC 250-10-45-23

Restatement requires that:

a. The cumulative effect of the error on periods prior to those presented shall be reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented.

b. An offsetting adjustment, if any, shall be made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period.

c. Financial statements for each individual prior period presented shall be adjusted to reflect correction of the period-specific effects of the error.

When only a single period is presented, the cumulative effect of the error should be recorded as an adjustment to beginning retained earnings.

Further, ASC 250 requires specific financial statement disclosures with respect to a correction of an error.

ASC 250-10-50-7 through ASC 250-10-50-9

When financial statements are restated to correct an error, the entity shall disclose that its previously issued financial statements have been restated, along with a description of the nature of the error. The entity also shall disclose both of the following:

a. The effect of the correction on each financial statement line item and any per-share amounts affected for each prior period presented

b. The cumulative effect of the change on retained earnings or other appropriate components of equity or net assets in the statement of financial position, as of the beginning of the earliest period presented.

When prior period adjustments are recorded, the resulting effects (both gross and net of applicable income tax) on the net income of prior periods shall be disclosed in the annual report for the year in which the adjustments are made and in interim reports issued during that year after the date of recording the adjustments.

When financial statements for a single period only are presented, this disclosure shall indicate the effects of such restatement on the balance of retained earnings at the beginning of the period and on the net income of the immediately preceding period. When financial statements for more than one period are presented, which is ordinarily the preferable procedure, the disclosure shall include the effects for each of the periods included in the statements. (See Section 205-10-45 and paragraph 205-10-50-1.) Such disclosures shall include the amounts of income tax applicable to the prior period adjustments.

The above disclosures are required in the interim (if applicable) and annual period of the change and can be discontinued when the annual financial statements of the subsequent period are issued.

While including only narrative disclosure is not prohibited, a tabular format, supplemented with a narrative discussion, is generally clearer given the amount of information that usually needs to be disclosed. Consistent with current practice, we recommend prominent placement of the restatement disclosure in the footnotes to ensure that readers understand the impact of the changes on the financial statements and any related footnotes.

30.7.2 Revisions and out-of-period adjustments

If the previously issued financial statements are not materially misstated, then the error may be corrected prospectively. While ASC 250 only contemplates reporting the correction of an error by restating the previously issued financial statements, many identified errors do not result in a material misstatement to previously issued financial statements. In that case, the error may be corrected in one of two ways:

- Recording an out-of-period adjustment, with appropriate disclosure, in the current period, assuming that such correction does not create a material misstatement in the current period
- Revising the prior period financial statements the next time they are presented

When the correcting amounts are material to current operations or trends for operating results, reporting entities should revise the previously issued financial statements the next time they are issued. Correcting prior year financial statements for immaterial errors would not require previously issued auditor reports to be corrected as users can continue to rely on those previously issued financial statements.

A revision disclosure is similar to a restatement disclosure. When financial statements are revised, the audit opinion is not modified, nor are the financial statement columns labeled “as restated.”

EXAMPLE 30-2

Practical example of the error evaluation process

FSP Corp is a calendar year-end SEC registrant. In early April 20X4, FSP Corp identified a long-term incentive compensation obligation for one of its salespeople which it had inadvertently neglected to record since 20X0. If FSP Corp had properly accounted for the bonus, it would have recorded an additional $30 of compensation expense in each of the years 20X0 through 20X3.

- FSP Corp’s reported income in each of the years 20X0 through 20X3 was $1,000.
- FSP Corp projects its 20X4 income will be $1,000.

Note: Income tax effects are ignored for purposes of this example. Additionally, this example assumes that there are no other errors affecting any of the years. If there were additional errors (whether unadjusted or recorded as “out-of-period” adjustments), those errors would also need to be considered in the materiality analysis.

What analysis should FSP Corp perform to determine if the errors are material?

Analysis

Quantifying the errors in the previously issued financial statements

FSP Corp has quantified the errors under both the "rollover" and the "iron curtain" methods as follows:

Year	Reported income	Rollover method	Iron curtain method
20X0	$1,000	$30 (3%)	N/A
20X1	$1,000	$30 (3%)	N/A
20X2	$1,000	$30 (3%)	N/A
20X3	$1,000	$30 (3%)	N/A
20X4	$1,000 (Projected)	N/A	$120 (12%)

Evaluating whether the affected financial statements are materially misstated

FSP Corp should consider whether the errors quantified under the "rollover" method (i.e., $30 or 3% of income per year) are material to the financial statements for any of the years 20X0 through 20X3. In making this analysis, FSP Corp should consider all relevant qualitative and quantitative factors.

Note: The above analysis focuses on the effects of the errors on the income statement. However, the analysis must also consider the impact of the error on the full financial statements, including disclosures (e.g., segment reporting).

Determining how to correct the errors

If FSP Corp determines that any of the years 20X0 through 20X3 are materially misstated when the errors are evaluated under the "rollover" method, then those years must be promptly corrected (as discussed in FSP 30.7.1).

If FSP Corp determines that none of the years 20X0 through 20X3 (or quarters for 20X3) are materially misstated when the errors are quantified under the "rollover" method, then the errors can be corrected prospectively in current or future filings (as discussed in FSP 30.7.2). Prospective correction may be accomplished in one of two ways (depending on the circumstances):

- FSP Corp may correct the errors as an "out-of-period" adjustment in its first quarter 20X4 interim financial statements if the correction would not result in a material misstatement of the estimated fiscal year 20X4 earnings ($1,000) or to the trend in earnings. This is true even if the "out-of-period" adjustment is material to the first quarter 20X4 interim financial statements. If the "out-of-period" adjustment is material to the first quarter 20X4 interim financial statements (but not material with respect to the estimated income for the full fiscal year 20X4 or to the trend of earnings), then the correction may still be recorded in the first quarter, but should be separately disclosed (in accordance with ASC 250-10-45-27).

- If FSP Corp cannot correct the errors as an "out-of-period" adjustment without causing a material misstatement of the estimated fiscal year 20X4 earnings ($1,000) or to the trend in earnings, then the errors must be corrected by revising the previously issued financial statements the next time they are filed (e.g., for comparative purposes). For instance, the quarterly financial statements for the first quarter of 20X3 and the December 31, 20X3 balance sheet presented in FSP Corp's March 31, 20X4 Form 10-Q should be revised to correct the error. The revised financial statements should include transparent disclosure regarding the nature and amount of each error being corrected. The disclosure should provide insight into how the errors affect all relevant periods (including those that will be revised in subsequent filings).

30.7.3 *Reclassifications*

Sometimes it is necessary for reporting entities to reclassify an amount from a prior year from one financial statement caption to another for comparability purposes due to changes in the business. For example, if a balance becomes large enough to require a separate line item in the current year, then the balance in the prior year should also be shown on the same line item for comparability. In these circumstances, the basis of presentation note should include disclosure to indicate that the change in the prior year was made to conform to the current year presentation and explain the nature and magnitude of the change.

Misclassifications

A change in classification to correct an error should be evaluated using the framework discussed in FSP 30.7 and should be clearly disclosed as an error.

30.8 *Interim reporting considerations*

Accounting changes and changes in estimates may occur at any time during the year. This section discusses the disclosure requirements when changes occur during an interim period.

30.8.1 *Changes in accounting principle*

Interim financial statements should disclose any changes in accounting principle made during the period from the accounting principles applied in any of the following periods:

- The comparable interim period of the prior annual period
- The preceding interim periods in the current annual period
- The prior annual report

See FSP 30.4.3.1 for further information on the impracticability exception of retrospective application when a reporting entity changes an accounting principle.

Whenever possible and permitted by the applicable guidance, reporting entities should adopt accounting changes during the first interim period of a fiscal year. The materiality of changes in accounting principle should be assessed in relation to the estimated full fiscal year income rather than interim income. Changes that are only material to the interim period of adoption but not to the estimated full year financial results should be separately disclosed in the interim period.

An accounting change that affects only interim periods (such as in the method of recognizing advertising expenses in interim periods) is acceptable only if it is preferable in the circumstances. Such a change does not require any reference in the auditor's report on the annual financial statements (as there is no effect on the annual financial statements).

If a change is made in other than the first interim period, the impracticability exception, discussed in FSP 30.4.3.1, may not be applied to prior interim periods of the fiscal year in which the change is made. Therefore, if the retrospective application to pre-change interim periods is impracticable, the change may only be made as of the beginning of a subsequent fiscal year.

30.8.2 Recently adopted standards

Interim financial statements should include disclosures required by a recently adopted standard similar to those required to be included in annual financial statements. These disclosures should continue to be provided in subsequent interim financial statements until the accounting change is reflected in the annual financial statements. Refer to FSP 30.4.3.3 for disclosure requirements for accounting standards that have been recently issued but not yet adopted.

When a reporting entity adopts a new accounting standard in an interim period, both annual and interim period financial statement disclosures prescribed by the new accounting standard are expected in each interim report in the year of adoption, to the extent not duplicative of other disclosures.

30.8.3 Change in estimates

The effect of a change in estimate, including a change in the estimated annual effective tax rate, should be accounted for in the period in which the change in estimate is made. Prior interim periods should not be restated. However, the effect on earnings of a change in estimate in a current interim period should be reported in both the current period and subsequent interim periods, if material to any period presented. The change should also be disclosed in the interim periods for the subsequent year to avoid misleading comparisons.

30.8.4 Adjustments related to prior interim periods

Errors related to prior interim periods should be assessed using the framework discussed in FSP 30.7. When an error is identified during an interim period and it has been determined that prior periods are not materially misstated, for the purpose of determining how to correct the error, amounts should be compared to the estimated income for the quarter and the full fiscal year.

As discussed in FSP 30.7.2 and shown in Figure 30-1, corrections that are material with respect to an interim period, but not material with respect to the estimated income for the full fiscal year or to the trend of earnings, can be corrected as an out-of-period adjustment and separately disclosed in the interim period. Alternatively, the previously issued financial statements may be revised the next time they are issued.

Previously reported interim financial data should not be restated because of year-end adjustments made in the normal course of the year-end close process, unless such process identifies errors related to prior interim periods. The effect of significant year-end adjustments, such as changes in provisions for doubtful accounts, that are not error corrections should be included in fourth quarter income.

30.9 Other matters

Accounting changes may arise as part of a spin-off, sale, or business combination. Presentation and disclosure considerations vary depending on the circumstances.

30.9.1 Spin-off or sale of a subsidiary of an SEC-registered reporting entity

Reporting entities sometimes sell or spin-off divisions or subsidiaries. A spin-off is a transaction where a portion of a reporting entity becomes a new, separate reporting entity and the shareholders of the original reporting entity receive a pro rata ownership in the spun-off reporting entity.

Prior to spin-off, a subsidiary must follow the accounting principles of its parent. When a subsidiary is spun-off, it can change to an accounting principle different from that used by its parent provided that the change is preferable. Such change should be retrospectively applied in the financial statements.

The spun-off subsidiary must disclose the nature of the change in accounting principle and explain why the newly adopted accounting principle is preferable.

In addition, if a parent reporting entity only spins off a portion of its interest in a subsidiary and will continue to reflect the subsidiary in consolidation after the spin-off or sale, the subsidiary can only change its accounting principle if the parent changes its accounting principle, obtains and files a preferability letter, and reflects the change in accounting principle using the normal method required by ASC 250. This results in congruity between the reporting by the parent and the subsidiary/investee on a go-forward basis.

A subsidiary cannot, however, retrospectively reflect changes in estimate. Such changes should be reflected in the period in which they occur in both the consolidated and subsidiary financial statements.

30.9.2 Conforming accounting policies of acquired entities

The need to conform the accounting policies of an entity acquired in a business combination to those of the acquiring reporting entity is discussed in BC 2.12.

30.10 Considerations for private companies

There are no specific considerations for private companies. The guidance in ASC 250 is equally applicable to private and public reporting entities.

Chapter 31: Parent company financial statements

31.1 Chapter overview

This chapter discusses circumstances under which presentation of parent company financial statements may be appropriate or required. In addition to covering presentation and disclosure requirements, the chapter also outlines methodologies to be applied in presenting parent company financial statements, and other preparation considerations.

The primary sources of guidance on parent company financial statements include:

- ASC 810-10, *Consolidation—Overall*
- S-X 3-10*, Financial statements of guarantors and issuers of guaranteed securities registered or being registered*
- S-X 5-04*, What schedules are to be filed*
- S-X 12-04, *Condensed financial information of registrant*
- SEC FRM 2810, *Parent-only Financial Statements (Condensed)*
- SEC FRM 2500, *Guarantors of Securities*

31.2 Scope

Consolidated financial statements are the general-purpose financial statements of a parent that has one or more subsidiaries. In certain circumstances, parent-only financial statements may be required in addition to consolidated financial statements. The existence of preferred stockholders, loan or other agreements, or other special requirements (e.g., reporting requirements for not-for-profit entities such as healthcare providers and statutory reporting requirements for downstream noninsurance holding companies) may necessitate the preparation of financial statements for the parent company alone.

Parent company financial statements should not be used as a substitute for consolidated financial statements. ASC 810-10-45-11 permits presentation of parent company financial statements as a supplement to the consolidated financial statements when such a presentation is the most effective means of presenting pertinent information. Parent company financial statements should generally be presented in the same report with the reporting entity's consolidated financial statements (e.g., SEC filings).

S-X 5-04 requires parent company financial statements (Schedule I) when the restricted net assets of consolidated subsidiaries exceed 25 percent of consolidated net assets as of the most recent fiscal year end. When the significance threshold is met, SEC registrants should present condensed financial information for the parent company in Schedule I as of the same dates and for the same periods as the consolidated financial statements (as prescribed by S-X 12-04). Refer to SEC 4510.3 for additional guidance.

31.3 Presentation requirements for parent company financial statements

There is no prescribed format for preparing parent company financial statements other than as described in S-X 12-04. SEC registrants preparing parent company financial statements should follow these requirements unless another format is specified by a legal agreement or other special requirement.

31.3.1 Format of parent company financial statements

S-X 12-04 specifies that parent company financial statements should be presented in the format prescribed for condensed statements by S-X 10-01 as it relates to the balance sheet, income statement, and statement of cash flows. The presentation of earnings per share, while permitted, is not required in parent company financial statements. The condensed financial information should also include a total for comprehensive income presented in either a single continuous statement or in two separate but consecutive statements.

31.3.2 Footnote disclosures

Parent company financial statements should include a statement in the footnotes explaining the fact that they are not the general-purpose financial statements of the reporting entity. In rare instances where parent company financial statements are presented without accompanying consolidated financial statements (e.g., prepared for limited distribution in accordance with requirements of a contractual agreement), the footnotes should indicate that the financial statements are not presented in accordance with U.S. GAAP.

If parent company financial statements are included within the same SEC filing as the consolidated financial statements, the footnotes may cross-reference to the consolidated financial statements for required disclosures of material contingencies, significant provisions of long-term obligations, mandatory dividend or redemption requirements of redeemable stocks, and guarantees of the parent, including the five-year schedule of debt maturities. The following example illustrates this.

EXAMPLE 31-1

Example – basis of presentation

Basis of Presentation. The parent company financial statements [information] should be read in conjunction with the Company's consolidated financial statements and the accompanying notes thereto. For purposes of these [this] condensed financial statements [information], the Company's wholly owned and majority owned subsidiaries are recorded based upon its proportionate share of the subsidiaries' net assets (similar to presenting them on the equity method).

Additional footnotes to parent company information may be required to supplement the disclosures in the consolidated financial statements. In addition, S-X 12-04 requires SEC registrants to disclose separately the amounts of cash dividends paid to the parent for each of the last three fiscal years by consolidated subsidiaries, unconsolidated subsidiaries, and 50 percent or less owned persons accounted for by the equity method. The disclosure of dividends paid may be made either within the footnotes or on the face of the statement of cash flows, if clearly labeled.

31.4 Presenting subsidiaries and investees in parent company financial statements

In parent company financial statements, investments in noncontrolled entities are presented differently from investments in consolidated subsidiaries.

31.4.1 Investments in noncontrolled entities

A parent company's investment in a noncontrolled entity is accounted for on the same basis applied in preparing the consolidated financial statements. Therefore, investments accounted for under the cost method, equity method, or by applying the fair value option in the consolidated financial statements should be accounted for in a similar manner in the parent company financial statements. As a result, the carrying amount of the investment is the same in the consolidated and parent company financial statements.

31.4.2 Investments in consolidated subsidiaries

Reporting entities prepare condensed consolidating financial information to meet prerequirements for guarantors and issuers of guaranteed securities. S-X 3-10(i)(3) specifies that the parent company column of the consolidating financial information should present investments in subsidiaries based upon the parent's proportionate share of the subsidiaries' net assets (similar to the equity method of accounting). Similarly, parent company financial statements should present investments in consolidated subsidiaries based on the guidance in S-X 3-10.

In consolidated financial statements, the net carrying amount of a subsidiary includes the carrying amounts of the subsidiary's specific assets and liabilities measured using the parent's basis (and noncontrolling interest account, if applicable) plus the parent's share of earnings less its share of dividends since the date of acquisition. In parent company financial statements, the net total of these amounts should equal the amount reported in the balance sheet as the parent company's equity in the underlying net assets of the subsidiary, as required by S-X 3-10. In addition, total stockholders' equity, net income, and comprehensive income amounts (attributable to the parent company) presented in the parent company financial statements should be equal to the corresponding consolidated amounts.

Although the guidance in S-X 3-10 is similar to the equity method guidance prescribed by ASC 323, *Investments—Equity Method and Joint Ventures*, it may not yield the same result because certain items are handled differently under ASC 323 than they are in consolidation. In other words, application of the guidance in S-X 3-10 does not result in presentation of the parent company's investment as if the consolidated subsidiary were accounted for under the equity method. A few examples of potential differences are outlined in Figure 31-1 below.

Figure 31-1

Selected differences in application of the guidance in S-X 3-10 and the equity method of accounting

Transaction	Equity method investment in accordance with ASC 323	Consolidated subsidiary presented in accordance with S-X 3-10
Impairment losses	Recognize if the investment's carrying amount exceeds its fair value and the decline in fair value is deemed to be other-than-temporary.	Recognize proportionate share of the consolidated subsidiary's impairment losses.
Acquisition costs	Include in consideration transferred to acquire an equity method investment and capitalize as a component of the cost of the assets acquired.	In a business combination, expense and do not include as part of the consideration transferred.
Capitalized interest on investee's qualifying assets	Capitalize interest on the investment only to the extent that the investee has qualifying activities as described in ASC 835-20.	As long as qualifying assets and interest cost exist within the consolidated group, record proportionate share of the consolidated subsidiary's capitalized interest.
Losses in excess of investment	Discontinue recording losses when the investment (and net advances) is reduced to zero unless the investor has committed to provide further financial support to the investee.	Continue recording losses, as discontinuation would result in the carrying amount of the investment not equaling the parent company's share of the subsidiary's net assets.
Change in previously held equity interest	If control is acquired, treat as a step acquisition and remeasure to fair value with any difference from the carrying value recognized as a gain or loss in the income statement. If the investment represents an entire foreign entity, the entire cumulative translation adjustment (CTA) balance related to the foreign entity is reclassified into earnings.	Treat a change in interest (not constituting a change in control) as an equity transaction. If the consolidated subsidiary represents an entire foreign entity, none of the CTA balance is reclassified unless the parent company ceases to have a controlling financial interest.

31.4.3 *Special situations requiring cost method accounting*

Investments accounted for under the equity method or consolidation method are accounted for under the cost method in the parent company financial statements in two special situations:

- When the cost method is prescribed by a regulatory agency solely for filing with that agency (see PCAOB AU 623, *Special Reports,* paragraphs .08 through .10)

- When the cost method is prescribed by a loan or other agreement for filing with the lender or other specified party (see PCAOB AU 623 paragraphs .27 through AU 623.30)

These two special situations are not applicable to financial statements or information prepared in accordance with U.S. GAAP and/or SEC reporting requirements.

31.5 *Other considerations*

A number of items should be considered when preparing parent company financial statements. The following discussion covers certain of these considerations, but is not intended to be all-inclusive.

31.5.1 *Accounts and adjustments recorded at the parent company level*

Some reporting entities maintain certain accounts related to subsidiaries in the parent company's books and records. The parent company's presentation of these amounts should be the same as if the accounts or adjustments had been recorded directly in the books and records of the subsidiary entity. This is particularly important for subsidiaries that are foreign entities due to the impact of foreign currency translation.

Examples of accounts often recorded at the parent company level include reserves for income tax or environmental exposures, deferred income taxes, goodwill, intangible assets, and purchase accounting adjustments. Additionally, some reporting entities record audit adjustments or other post-closing adjustments at the parent level without pushing them down to the accounting records of the foreign entity. The functional currency equivalent of such amounts, based upon historical exchange rates, should be assumed to be "pushed down" to the financial statements of the foreign entity for purposes of foreign currency translation.

31.5.2 *Accounting changes and extraordinary items*

Any amounts reported by a subsidiary as a cumulative effect of a change in accounting principle or an extraordinary item should be reflected in the income statement of the parent company as its share of that cumulative effect or extraordinary item as if the parent had made the change or incurred the extraordinary item directly.

Note about ongoing standard setting

As of the content cutoff date of this publication (August 31, 2014), the FASB has an active project on classifying items as extraordinary items that may affect presentation and disclosure requirements. Financial statement preparers and other users of this publication are therefore encouraged to monitor the status of the project, and if finalized, evaluate the effective date of the new guidance and the implications on presentation and disclosure.

31.5.3 Discontinued operations

The principle applied for accounting changes and extraordinary items described in FSP 31.5.2 does not apply to discontinued operations because ASC 360 currently prohibits it. If a subsidiary reports a component as a discontinued operation, the parent company should not classify its proportionate share as a discontinued operation because the parent-only reporting model is based largely on the equity method of accounting. The parent company would, however, report its share of the subsidiary's discontinued operations in the income statement line used for its share of the investee's earnings or losses.

Upon adoption of ASU 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,* disposals of equity method investments will be eligible for discontinued operations presentation if they meet specified criteria. As of the content cutoff date of this publication (August 31, 2014), it is unclear whether, once adopted, discontinued operations of a consolidated subsidiary will be treated by the parent company similar to accounting changes and extraordinary items in parent company-only financial statements, as discussed in FSP 31.5.2. Financial statement preparers and other users of this publication are therefore encouraged to monitor the status of this item if it is applicable to them. Refer to FSP 27 for further discussion of discontinued operations.

31.5.4 Cash dividends received from subsidiaries

As discussed in FSP 31.4.2, in parent company financial statements (including the statement of cash flows), the parent's subsidiaries are treated similarly to equity method investments. Cash dividends received from subsidiaries should be classified within operating activities unless they represent a return of investment, in which case the appropriate classification would be within investing activities. Refer to FSP 6 for further discussion of the presentation of dividends received in the statement of cash flows.

31.6 Considerations for private companies

There are no special presentation or disclosure considerations for private companies. Private companies that are required to prepare parent company financial statements should follow the format that is specifically prescribed by the entity or agreement requiring the statements. However, private companies may look to SEC guidance for additional considerations.

Chapter 32: Limited liability companies and limited partnerships

32.1 Chapter overview

The presentation and disclosure guidance in this chapter applies to limited liability companies ("LLCs"), Limited Partnerships ("LPs") and other partnerships as noted in the chapter. The guidance also applies to LLCs that elect to be treated as partnerships unless otherwise indicated in this chapter. It does not apply to reporting entities that have investments in partnerships (such investments are included in FSP 9 and FSP 18 for variable interest entities). Master Limited Partnerships ("MLPs") should apply the presentation and disclosure requirements of LPs, unless otherwise indicated in this chapter.

Many of the SEC's presentation and disclosure requirements for partnerships also apply to LLCs. Due to the nature of a partnership (i.e., owned by partners as opposed to stockholders), there are incremental and different presentation and disclosure requirements versus those of a corporation. This chapter focuses on the incremental requirements in Regulation S-X for both LLCs and partnerships. The primary differences between the financial statements of these various legal entities are the presentation of owners' equity and the reconciliation of U.S. GAAP to other bases of accounting, as applicable. Depending on the legal structure of the entity, the term "owners' equity" may be replaced, for example, by the term "members' equity" for LLCs. We use the term "owner" and "member" interchangeably in this chapter unless specific requirements apply to one legal structure and not another, in which case we will explicitly indicate the appropriate terminology.

This chapter also addresses the calculation of earnings per unit (EPU) for master limited partnerships and the presentation and disclosure requirements of a newly-formed partnership.

32.2 Scope

Limited partnership accounting records are often maintained consistent with applicable provisions of the Internal Revenue Code and support the preparation of income-tax basis financial statements. Such financial statements are prepared primarily for the purpose of providing income tax data to the limited partners. However, partnerships that are SEC registrants should comply with Regulation S-X and clearly disclose equity and income data for the general partners on a U.S. GAAP basis.

Limited liability companies often elect to be treated as partnerships for federal tax purposes. ASC 272, *Limited Liability Entities*, states that in order to be classified as a partnership for federal income tax purposes, an LLC should lack at least two of the four characteristics present in a corporation. These characteristics are: (1) limited liability, (2) free transferability of interests, (3) centralized management, and (4) continuity of life.

LLCs that are subject to income taxes are also subject to ASC 740.

Other relevant guidance in this chapter for partnerships and for LLCs that report as partnerships and are SEC registrants includes:

- SAB Topic 4.E, *Receivables from sale of stock*
- FRP 405
- Rule 502(b) of Regulation D
- SEC FRM 3410.1-3410.4
- S-X Article 8, *Financial statements of smaller reporting companies*
- Section 15(d) of the Securities Exchange Act of 1934

LLCs often have many of the characteristics of both corporations and partnerships, and significant judgment may be required to determine the appropriate presentation model (ASC 205 or ASC 272).

32.3 Presentation

Once a reporting entity has determined its identity as an LP or LLC, it should adhere to the applicable presentation and disclosure requirements.

32.3.1 Basis of accounting – LPs and LLCs that are partnerships

The SEC staff has indicated in FRP 405 that LPs (or LLCs that report as partnerships) that are SEC registrants should present U.S. GAAP-basis financial statements as their primary financial statements using Form 10-K, except in certain circumstances as specified by Rule 502(b) of Regulation D. This is even if their accounting records are maintained under a separate basis of accounting.

ASC 205-10-45-1A indicates that a full set of financial statements includes: balance sheet, income statement, statement of comprehensive income, statement of cash flows, and statement of changes in owners' equity (see FSP 32.3.4).

If a reporting entity that does not present U.S. GAAP-basis financial statements wishes to issue securities under Regulation D, an exception under Rule 502(b) of that regulation may apply. Although it would be unusual, an LP may be permitted to prepare financial statements on a federal income tax basis if it cannot obtain U.S. GAAP financial statements without unreasonable expense or effort.

32.3.2 Basis of accounting – LLCs that are not partnerships

LLCs that do not report as partnerships should provide a complete set of financial statements including a balance sheet, income statement, statement of cash flows, statement of changes in members' equity (may be an individual statement, combined with the income statement, or in the footnotes), and footnotes.

An LLC's financial statements should clearly indicate that the financial statements presented are those of an LLC in the heading of each statement. Although ASC 272 does not explicitly include a statement of comprehensive income, practice indicates that reporting entities include the statement consistent with the requirements of ASC 205. Based on ASC 205, we believe it should be presented to comply with U.S. GAAP.

32.3.3 Comparative financial statements

LLCs and partnerships that are SEC registrants are subject to the comparative financial statement requirements of S-X 3-01(a) (discussed in FSP 1.2.2). Presentation of comparative financial statements is encouraged for LLCs and partnerships that are not subject to SEC regulations, but not required.

32.3.4 Owners'/Members' equity

The presentation of equity of an LLC and a partnership is similar given the parallels in the structure, principally the multiple owners (known as members and partners) in the reporting entity. The equity section of the balance sheet should be titled members' equity (LLCs) or owners' equity (partnerships) in contrast to shareholders' or stockholders' equity for a corporation.

Similar to reporting entities that have multiple classes of common or preferred stock (refer to FSP 5), LLCs and partnerships report the amounts of each class of members' equity separately, either on the face of the balance sheet within the equity section or within the footnotes. Each member class' rights, preferences, and privileges should be included in the disclosure to distinguish them.

SAB Topic 4.F clarifies the presentation of members' equity.

SAB Topic 4.F

Facts: There exist a number of publicly held partnerships having one or more corporate or individual general partners and a relatively larger number of limited partners. There are no specific requirements or guidelines relating to the presentation of the partnership equity accounts in the financial statements. In addition, there are many approaches to the parallel problem of relating the results of operations to the two classes of partnership equity interests.

Question: How should the financial statements of limited partnerships be presented so that the two ownership classes can readily determine their relative participations in both the net assets of the partnership and in the results of its operations?

Interpretive Response: The equity section of a partnership balance sheet should distinguish between amounts ascribed to each ownership class. The equity attributed to the general partners should be stated separately from the equity of the limited partners, and changes in the number of equity units authorized and outstanding should be shown for each ownership class. A statement of changes in partnership equity for each ownership class should be furnished for each period for which an income statement is included.

The income statements of partnerships should be presented in a manner which clearly shows the aggregate amount of net income (loss) allocated to the general partners and the aggregate amount allocated to the limited partners. The statement of income should also state the results of operations on a per unit basis.

If the LP maintains separate accounts for varying components within an individual members' equity account, it should present the balance within each component on the face of the balance sheet or in the footnotes. Examples of such components are undistributed earnings, earnings available for withdrawal, and unallocated capital.

Despite the limited economic risk for a participating member inherent in an LLC because of its legal structure, the results of the LLC's operations could cause some members to have a liability balance. The LLC should report this deficit. Further, the LLC should disclose the legal limitations on liabilities for each member, whether in a net deficit position or not.

32.3.4.1 Capital contributions

After an LLC's formation, members may make contributions to the LLC to grow the business or to infuse additional cash into a business facing liquidity issues. When a member makes a cash contribution, it is classified as additional paid in capital (APIC) within members' equity on the balance sheet. Often, a member will issue a note to an LLC as a promise to contribute additional capital. The transaction may be a sale of capital stock or a contribution to paid-in capital. ASC 505-10-45-2 generally does not permit this note receivable to be presented as an asset, except in very limited circumstances.

Excerpt from ASC 505-10-45-2

[The receivable may be recorded as an asset when] … there is substantial evidence of ability and intent to pay within a reasonably short period of time…. such notes may be recorded as an asset if collected in cash before the financial statements are issued or available to be issued…

SAB Topic 4.E provides similar guidance. The SEC staff notes that a receivable may be considered an asset when cash is received before the financial statements are issued.

Excerpt from SAB Topic 4.E

The staff will not suggest that a receivable from an officer or director be deducted from stockholders' equity if the receivable was paid in cash prior to the publication of the financial statements and the payment date is stated in a note to the financial statements.

32.3.5 *Other presentation considerations*

The partnership should also present actual cash distributions per partnership unit.

32.4 Disclosure

32.4.1 *Reconciliation between statements prepared on different bases*

For SEC registrants, FRP 405 indicates that it may be desirable to include financial data on the tax basis of accounting within the U.S. GAAP-basis financial statements. Ordinarily, LPs distribute tax basis information to their partners after the balance sheet date because of the limited partners' personal tax reporting responsibilities. Then, the LP distributes the annual report including audited U.S. GAAP-basis financial statements later.

We encourage presentation in the footnotes of a reconciliation to the U.S. GAAP-basis financial statements if the LP includes audited tax-basis statements in an SEC filing as additional information to the audited U.S. GAAP-basis financial statements. A note or some similar reference in the tax-basis statements, if filed, should state that U.S. GAAP-basis financials are included elsewhere in the filing.

If provided, the reconciliation of U.S. GAAP- to tax-basis information should include, at a minimum:

- net income/loss on the U.S. GAAP-basis to the tax-basis balance (frequently described as excess/deficit of revenue collected over/under expenses disbursed)
- total assets on the U.S. GAAP basis to total assets on the tax basis, and
- partners' capital/deficit on the U.S. GAAP basis to partners' capital/deficit on the tax basis.

32.4.2 *Income tax matters*

Designation of tax status is considered to be a tax position under ASC 740. Partnerships (and LLCs that are treated as partnerships) are generally not taxpayers; instead, the general and limited partners (or LLC members) pay taxes on their shares of the profits. The partnership should monitor its continued qualification as a non-tax-paying entity, with disclosure of any developments in the entity or in legislation that might subject it to corporate taxation.

U.S. GAAP-basis financial statements of an LP should include a footnote indicating that the partnership itself is not subject to federal income tax. The following is an example of a disclosure of a partnership's tax matters.

EXAMPLE 32-1

Example disclosure – partnership tax matters

No provision for federal income taxes is necessary in the financial statements of the partnership because, as a partnership, it is not subject to federal income tax and the tax effect of its activities accrues to the partners.

In certain circumstances, partnerships may be held to be associations taxable as corporations. The IRS has issued regulations specifying circumstances under current law when such a finding may be made, and management has obtained an opinion of counsel based on those regulations that the partnership is not an association taxable as a corporation. A finding that the partnership is an association taxable as a corporation could have a material adverse effect on the financial position and results of operations of the partnership.

LLCs that are subject to income taxes are also subject to ASC 740. Refer to FSP 16.

32.4.2.1 Change in tax status

The tax implications of a change from (1) a partnership to a corporation or (2) a corporation to a partnership are subject to the recognition requirements of ASC 740. ASC 740 also applies for recording deferred tax assets and liabilities for temporary differences on the day the tax status changes. See FSP 16.

In SEC FRM 3410.1-3410.4, the SEC also has incremental guidance for conversions of a partnership or similar tax-exempt entity to a corporation. Historical financial statements need to include pro forma information for tax and EPS on the face of the financial statements. If taxes are the only adjustments as a result of the formation of the corporation, the reporting entity is required to include pro forma EPS for only the latest fiscal year-end and current stub period. Also, reporting entities are encouraged, but not required, to include pro forma information for all periods presented. If other adjustments in addition to taxes are required, the reporting entity should show only the latest fiscal year and interim period. The reporting entity should continue to include such pro forma presentation in subsequent years until the year of conversion is no longer presented in the comparative financial statements. Undistributed earnings or losses of partnerships should be reclassified to paid-in capital in the pro forma statements, as if a distribution had been made to the owners with a subsequent contribution to equity within the new structure. Following the conversion, partnerships that pay distributions to owners from equity issuance proceeds (not from retained earnings) should present pro forma EPS for the latest year and interim period giving effect to the conversion (but not the offering) if the conversion will result in a material reduction to EPS (excluding the effects of the offering). Refer to FSP 32.6 for further information on conversion to partnerships.

32.4.3 Related parties

As noted in FSP 26, ASC 850 requires disclosure of all material related party transactions and agreements. In the context of partnerships, related party disclosures include:

- the relationship of the general partner to the partnership
- the extent of the general partner's equity interest
- the nature of any management contract between the partnership and the general partner or other party, and
- any relationship between the general partner and other related parties.

LLCs would be expected to include similar disclosures for transactions between its members.

FRP 405 promotes U.S. GAAP-basis financial statements as the best available financial data. Following U.S. GAAP would require inclusion on the face of the primary financial statements any related party amounts and disclosure of all related party transactions in the footnotes, particularly regarding the relationship and transactions between a general partner and other related parties.

Common related party transactions for MLPs include human resource and supply arrangements. Presentation and disclosure of related party transactions in general is addressed in FSP 26.

32.4.4 Finite life of the entity

If there is a finite life of the entity, it should disclose the date it will cease to exist.

32.5 Calculating earnings per unit (EPU) for MLPs

MLPs should present earnings per partnership unit ("EPU") on the face of the income statement under ASC 260-10-55-102 through 55-110, *Earnings Per Unit,* for those units that are publicly held.

Publicly traded MLPs often issue multiple classes of securities that may participate in partnership distributions according to a formula specified in the partnership agreement. A typical MLP is generally formed by the general partner contributing mature assets with stable cash flows to the partnership in exchange for its general partner interest (the GP Interest) and incentive distribution rights (the IDRs). The MLP then issues publicly-traded common units held by limited partners (the Common Units).

Generally, the IDRs are viewed as being a return on the GP's investment, whereby the GP has an additional mechanism to participate in the performance of the partnership and represent a separate class of nonvoting limited partner interest (LP interest). However, some arrangements are structured such that the IDRs are not a separate LP interest, but are embedded within the GP Interest. When the IDRs are a separate LP interest, then the holder of the IDRs (which is initially the GP) may transfer or sell the IDRs, subject to the consent of the limited partners (LPs) prior to a specified date.

When the IDRs are embedded within the GP Interest, the IDRs cannot be detached and transferred. Except for the GP Interest, the IDR holder does not have a separate residual ownership interest in the partnership. MLPs are predominately utilized in the energy industry and, more specifically, in the pipeline business because of the stable income generated by those businesses.

As a result of this capital structure, MLPs are required to apply the two-class method to calculate EPU. When applying the two-class method to the interests of the GP and LPs in MLPs, questions have arisen about the effect of IDRs on the computation of EPU.

32.5.1 IDRs that are participating securities

IDRs that are a separate class of LP interest are participating securities because they have a right to participate in earnings with common equity holders. Therefore, to calculate EPU, current period earnings are allocated to the GP, LP, and IDR holder using the two-class method in ASC 260. When calculating EPU under the two-class method, the MLP would reduce (or increase) net income (or loss) for the current reporting period by the amount of available cash that has been or will be distributed to the GP, LPs, and IDR holder for that reporting period.

The partnership agreement may contractually limit the amount of distributions to holders of the IDRs. Therefore, the MLP should allocate the undistributed earnings, if any, to the GP, LPs, and IDR holder, utilizing the distribution waterfall (that is, a schedule included in the partnership agreement that prescribes distributions to the various interest holders at each threshold). The undistributed earnings should be allocated to the IDR holder based on the contractual participation rights of the IDR to share in current period earnings. Therefore, if the partnership agreement includes a "specified threshold" as described in ASC 260-10-55-30, an MLP should not allocate undistributed earnings to the IDR holder once the specified threshold has been met. If the partnership agreement includes a "specified threshold," that threshold would generally recognize that a legal mechanism exists that allows the partnership to make a distribution to the LP interests outside the distribution waterfall.

The MLP should allocate any excess of distributions over earnings to the GP and LPs based on their respective sharing of losses specified in the partnership agreement (that is, the provisions for allocation of losses to the partners' capital accounts for the period presented). If the IDR holders do not share in losses, the MLP would not allocate the excess of distributions over earnings to the IDR holders. However, if the IDR holders have a contractual obligation to share in the losses of the MLP on a basis that is objectively determinable (as described in ASC 260-10-45-67), the MLP should allocate the excess of distributions over earnings to the GP, LPs, and IDR holders based on their respective sharing of losses specified in the partnership agreement for the period presented.

32.5.2 IDRs that are not participating securities

IDRs that are embedded in the GP interest are not separate participating securities. However, because the GP and LP interests are separate classes of equity, the MLP would apply the two-class method in computing EPU for the GP and LP interests.

For purposes of the EPU calculation, in some cases, the MLP would reduce (or increase) net income (or loss) for the current reporting period by the amount of available cash that will be, but has not yet been, distributed to the GP (including the distribution rights of the embedded IDRs) and LPs for that reporting period. The following example illustrates application of the two-class method of computing EPU.

Question 32-1

An MLP has multiple classes of stock. However, only one of the classes is registered with the SEC. Does the entity report EPU for each class?

PwC response

No. EPU is only required for registered securities, although the MLP is not precluded from calculating EPU for all classes. This is similar to reporting entities with both common and preferred stock, whereby entities are only required to report EPS for common stock but are not precluded from reporting EPS for preferred stock.

EXAMPLE 32-2

Two-class method of computing EPU

Assume a partnership agreement requires the GP to distribute available cash within 60 days following the end of each fiscal quarter. The MLP is required to file financial statements with a regulatory agency within 45 days following the end of each fiscal quarter.

How should the MLP compute EPU for the first quarter?

Analysis

To compute EPU for the first quarter, the GP should determine the amount of available cash that will be distributed to the GP and LPs for the quarter.

The MLP should reduce (or increase) net income (or loss) by that amount in computing undistributed earnings that will be allocated to the GP (including the distribution rights of the embedded IDRs) and LPs.

32.5.3 EPU – common control transaction

When assets and liabilities comprising a business are transferred between reporting entities under common control, ASC 805-50-45-2 through 45-5 require that financial statements of the receiving entity be presented as though the transfer occurred at the beginning of the period. Financial statements for prior years should also be retrospectively adjusted to furnish comparative information. Questions arise related to the application of the two-class method when MLPs are formed through a “drop-down” of assets and liabilities from an entity that is under common control. We believe there are different methods that may be acceptable based on the reporting entity’s facts and circumstances. One commonly-used method is to allocate earnings related to the transferred assets and liabilities for periods prior to the drop-down to the GP.

32.6 Conversion of a corporation into a partnership

A partnership may be formed from an existing operation and may be the result of one of the following:

- *Conversion or reorganization*

  An existing corporation transfers substantially all of its business into a partnership and liquidates the corporation. Existing shareholders exchange their shares for units in the partnership.

- *Spin-off or roll out*

  An existing corporation places assets into a limited partnership and distributes the partnership units to the shareholders.

- *Carve-out or drop-down*

  An existing corporation carves out a portion of its operations and places them in a partnership. Some or substantially all of the partnership units are sold to new investors.

  Some transactions may include features of both a spin-off and a carve-out.

- *Rollup*

  Formation of a partnership could also be in the form of a rollup. A rollup does not involve the conversion of a corporation to a partnership. It is the merger of several existing limited partnerships, or limited partnership interests, into one larger limited partnership. Generally, a rollup is done for efficiency or liquidity purposes.

There may be situations when rollup transactions qualify as a business combination that will require a new basis of accounting for the acquired assets and liabilities. Examples include a rollup in which the general partner of the new MLP was also the general partner of all of the predecessor limited partnerships and no cash was involved in the transaction; or a transaction in which the general partner of the new MLP was the general partner of some, but not all, of the predecessor limited partnerships.

The basis of accounting for a new LP will generally depend on the structure of the transaction. Once the partnership is formed, it should adhere to the financial statement reporting requirements for partnerships. Comparative financial statements for prior periods are the financial statements of the predecessor company. The new LP may present pro forma information for prior periods (as though the reporting entity had operated in partnership form - required in the initial registration statement for partnership units) as supplementary information, but that information cannot replace the predecessor entity's financial statements as the principal comparative financial information. The presentation in the footnotes of the supplemental information should be sufficient and clear to prevent any information from being misleading if users were to rely solely on the comparative statements.

Newly-formed LLCs that are not partnerships and that constitute a new reporting entity would fall within the scope of an accounting change and are subject to ASC 250. ASC 250 requires retrospective application for all years presented following the presentation of the new LLC reporting entity. For further detail on accounting changes, see FSP 30.

32.6.1 Tax considerations of the new entity

Taxes payable (currently or deferred) generally will not appear on the opening balance sheet of a carved-out or spun-off entity as such taxes remain the liability of the general partner/sponsor.

If, in a conversion, the new reporting entity will not be deemed an association taxable as a corporation, it should eliminate deferred tax balances in the first financial statements following conversion to partnership form. As noted in TX 8.3, a deferred tax liability or asset should be eliminated at the date the entity ceases to be taxable by including the reversal in income from continuing operations as a current provision for income taxes.

The reporting entity may continue to need some provision for current taxes. In addition to tax liabilities that arise (e.g., recapture or capital gains) on partnership formation, some jurisdictions assess taxes on a partnership as if the entity were a corporation. Under current tax law, Congress allowed MLPs to annually elect to retain their partnership tax status in exchange for a 3.5 percent gross revenue tax. The MLP should consider appropriate presentation and disclosure of the gross revenue tax in its financial statements. This would include

(1) recognition as current tax expense and (2) a description as to the nature of the tax (its qualifications under the current tax law).

32.7 Smaller reporting companies that are LPs

Smaller reporting companies (SRCs) are subject to S-X Article 8. If an LP is an SRC, it should include the balance sheet of the general partners within its financial statements in the following circumstances:

- If the general partner of the SRC is a corporation, it should disclose the audited balance sheet of that corporation as of the end of its most recently completed fiscal year. The SRC should deduct receivables, other than trade receivables, from affiliates of the general partner from the equity of the general partner. When an affiliate has committed to increase or maintain the general partner's capital, the SRC should also present the audited balance sheet of that affiliate.

- If the general partner of the SRC is a partnership itself, it should file an audited balance sheet of that partnership as of the end of its most recently completed fiscal year.

- If the general partner of the SRC is a natural person, it should include a recent balance sheet as supplemental information, although there is no requirement for this statement to be audited. The SRC should carry the assets and liabilities of the general partner at estimated fair value, with provisions for estimated income taxes on unrealized gains. The SRC should also disclose the net worth of the person in a registration statement. If there is more than one person as general partner, the SRC can present their net worth, as determined from the balance sheets, individually or in the aggregate.

32.8 Considerations for private companies

32.8.1 Comparative financial statements

Non-SEC registrants are not subject to the guidance in Regulation S-X, which requires multiple years of financial statements; however, ASC 272-10-45-7 encourages comparative statements for private LLCs. If the nonpublic partnership or LLC voluntarily presents multiple years, amounts should be comparable with the most recent year shown in accordance with ASC 205-10-45, disclosing any exceptions to comparability.

Similarly, partnerships that are formed from corporations but do not file with the SEC are not required to present the pro forma comparative statements.

32.8.2 Basis of accounting

Partnerships and LLCs that do not file with the SEC are not subject to certain disclosure requirements. For example, financial statements prepared on a different basis of accounting than U.S. GAAP do not require a reconciliation of

U.S. GAAP- to tax-basis. U.S. GAAP-basis statements would not be needed within the financial statements (that is a specific SEC requirement).

32.8.3 SEC filers that may not comply with SEC requirements

A partnership that files with the SEC in connection with the sale of a portion of its interest to the public files an annual report on Form 10-K in the year the registration statement becomes effective. However, in subsequent years, the partnership may be exempt from such requirements if it meets Section 15(d) of the Securities Exchange Act of 1934 by having fewer than 300 individuals hold the securities of the partnership at the beginning of the fiscal year. Partnerships in this situation should nonetheless consider providing the SEC required disclosures even if they have no requirement to file financial statements with the SEC.

Appendices

Appendix A: Professional literature

The PwC guides provide in-depth accounting and financial reporting guidance for various topics, as outlined in the preface to this guide. The PwC guides summarize the applicable accounting literature, including relevant references to and excerpts from the FASB's Accounting Standards Codification (the Codification). They also provide our insights and perspectives, interpretative and application guidance, illustrative examples, and discussion on emerging practice issues. The PwC guides supplement the authoritative accounting literature. This appendix provides further information on authoritative U.S. generally accepted accounting principles and technical references used throughout this guide.

Professional literature

The Codification is the primary source of authoritative U.S. financial accounting and reporting standards (U.S. GAAP) for nongovernmental reporting entities (hereinafter referred to as "reporting entities"). Additionally, guidance issued by the SEC is a source of authoritative guidance for SEC registrants.

Updates and amendments to the Codification arising out of the FASB's standard-setting processes are communicated through *Accounting Standards Updates* (ASUs). The Codification is updated concurrent with the release of a new ASU, or shortly thereafter. PwC has developed a *FASB Accounting Standards Codification Quick Reference Guide* which is available on CFOdirect. The quick reference guide explains the structure of the Codification, including examples of the citation format, how new authoritative guidance will be released and incorporated into the Codification, and where to locate other PwC information and resources on the Codification. The quick reference guide also includes listings of the Codification's "Topics" and "Sections" and a list of frequently referenced accounting standards and the corresponding Codification Topics where they now primarily reside.

In the absence of guidance for a transaction or event within a source of authoritative U.S. GAAP (i.e., the Codification and SEC guidance), a reporting entity should first consider accounting principles for similar transactions or events within a source of authoritative U.S. GAAP for that reporting entity and then consider non-authoritative guidance from other sources. Sources of non-authoritative accounting guidance and literature include:

- FASB Concepts Statements
- AICPA Issues Papers
- International Financial Reporting Standards issued by the International Accounting Standards Board

- Pronouncements of other professional associations or regulatory agencies
- Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids
- PwC accounting and financial reporting guides
- Accounting textbooks, guides, handbooks, and articles
- Practices that are widely recognized and prevalent either generally or in the industry

While other professional literature can be considered when the Codification does not cover a certain type of transaction or event, we do not expect this to occur frequently in practice.

SEC guidance

The content contained in the SEC sections of the FASB's Codification is provided for convenience and relates only to SEC registrants. The SEC sections do not contain the entire population of SEC rules, regulations, interpretative releases, and staff guidance. Also, there is typically a lag between when SEC guidance is issued and when it is reflected in the SEC sections of the Codification. Therefore, reference should be made to the actual documents published by the SEC and SEC Staff when addressing matters related to public reporting entities.

Appendix B: Technical references and abbreviations

The following tables provide a list of the technical references and definitions for the abbreviations and acronymns used within this guide.

Technical references

AICPA AU 420.17	*Consistency of Application of Generally Accepted Accounting Principles*
AICPA AU-C 570	*The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*
AICPA Audit and Accounting Guide, *Valuation of Privately-Held-Company Equity Securities Issued as Compensation*	Chapter 14 - *Accounting and Disclosures*
ASC 205	Accounting Standards Codification 205, *Presentation of Financial Statements*
ASC 205-20	Accounting Standards Codification 205, *Presentation of Financial Statements – Discontinued Operations*
ASC 210	Accounting Standards Codification 210, *Balance Sheet*
ASC 220	Accounting Standards Codification 220, *Comprehensive Income*
ASC 225	Accounting Standards Codification 225, *Income Statement*
ASC 230	Accounting Standards Codification 230, *Statement of Cash Flows*
ASC 250	Accounting Standards Codification 250, *Accounting Changes and Error Corrections*
ASC 260	Accounting Standards Codification 260, *Earnings Per Share*
ASC 270	Accounting Standards Codification 270, *Interim Reporting*

Technical references	
ASC 272	Accounting Standards Codification 272, *Limited Liability Entities*
ASC 275	Accounting Standards Codification 275, *Risks and Uncertainties*
ASC 280	Accounting Standards Codification 280, *Segment Reporting*
ASC 310	Accounting Standards Codification 310, *Receivables*
ASC 320	Accounting Standards Codification 320, *Investments – Debt and Equity Securities*
ASC 323	Accounting Standards Codification 323, *Investments – Equity Method and Joint Venture*
ASC 330	Accounting Standards Codification 330, *Inventory*
ASC 340	Accounting Standards Codification 340, *Other Assets and Deferred Costs*
ASC 350	Accounting Standards Codification 350, *Intangibles – Goodwill and Other*
ASC 360	Accounting Standards Codification 360, *Property, Plant, and Equipment*
ASC 405	Accounting Standards Codification 405, *Liabilities*
ASC 410	Accounting Standards Codification 410, *Asset Retirement and Environmental Obligations*
ASC 420	Accounting Standards Codification 420, *Exit or Disposal Cost Obligations*
ASC 440	Accounting Standards Codification 440, *Commitments*
ASC 450	Accounting Standards Codification 450, *Contingencies*
ASC 460	Accounting Standards Codification 460, *Guarantees*
ASC 470	Accounting Standards Codification 470, *Debt*

Technical references	
ASC 480	Accounting Standards Codification 480, *Distinguishing Liabilities from Equity*
ASC 505	Accounting Standards Codification 505, *Equity*
ASC 605	Accounting Standards Codification 605, *Revenue Recognition – General*
ASC 710	Accounting Standards Codification 710, *Compensation – General*
ASC 712	Accounting Standards Codification 712, *Compensation – Nonretirement Postemployment Benefits*
ASC 715	Accounting Standards Codification 715, *Compensation – Retirement Benefits*
ASC 718	Accounting Standards Codification 718, *Compensation – Stock Compensation*
ASC 720	Accounting Standards Codification 720, *Other Expenses*
ASC 730	Accounting Standards Codification 730, *Research and Development*
ASC 740	Accounting Standards Codification 740, *Income Taxes*
ASC 805	Accounting Standards Codification 805, *Business Combinations*
ASC 808	Accounting Standards Codification 808, *Collaborative Arrangements*
ASC 810	Accounting Standards Codification 810, *Consolidation*
ASC 815	Accounting Standards Codification 815, *Derivatives and Hedging*
ASC 820	Accounting Standards Codification 820, *Fair Value Measurements*
ASC 825	Accounting Standards Codification 825, *Financial Instruments*
ASC 830	Accounting Standards Codification 830, *Foreign Currency Matters*

Technical references	
ASC 835	Accounting Standards Codification 835, *Interest*
ASC 840	Accounting Standards Codification 840, *Leases*
ASC 845	Accounting Standards Codification 845, *Nonmonetary Transactions*
ASC 850	Accounting Standards Codification 850, *Related Party Disclosures*
ASC 852	Accounting Standards Codification 852, *Reorganizations*
ASC 855	Accounting Standards Codification 855, *Subsequent Events*
ASC 860	Accounting Standards Codification 860, *Transfers and Servicing*
ASC 910	Accounting Standards Codification 910, *Contractors – Construction*
ASC 912	Accounting Standards Codification 912, *Contractors – Federal Government*
ASC 942	Accounting Standards Codification 942, *Financial Services – Depository and Lending*
ASC 946	Accounting Standards Codification 946, *Financial Services – Investment Companies*
ASC 952	Accounting Standards Codification 952, *Franchisors*
ASC 985	Accounting Standards Codification 985, *Software*
ASR 268	Accounting Series Release 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks"*
ASU 2013-02	Accounting Standards Update 2013-02, *Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*

Technical references

ASU 2013-11	Accounting Standards Update 2013-11, *Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists*
ASU 2014-02	Accounting Standards Update 2014-02, *Accounting for Goodwill*
ASU 2014-03	Accounting Standards Update 2014-03, *Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps—Simplified Hedge Accounting Approach*
ASU 2014-07	Accounting Standards Update 2014-07, *Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements*
ASU 2014-08	Accounting Standards Update 2014-08, *Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity*
ASU 2014-09	Accounting Standards Update 2014-09, *Revenue from Contracts with Customers*
ASU 2014-10	Accounting Standards Update 2014-10, *Elimination of Certain Financial Reporting Requirements, Including an Amendment to Variable Interest Entities Guidance in Topic 810, Consolidation*
ASU 2014-11	Accounting Standards Update 2014-11, *Transfers and Servicing (Topic 860) Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures*
ASU 2014-15	Accounting Standards Update 2014-15, *Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*
CON 5	FASB Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*
CON 6	FASB Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*

Technical references	
FRP 202	SEC Financial Reporting Policy 202: *Reporting Cash Flow*
FRP 211	SEC Financial Reporting Policy 211: *Redeemable Preferred Stocks*
FRP 213	Financial Reporting Policy 213: *Separate Financial Statements*
FRP 405	SEC Financial Reporting Policy 405: *Limited Partnerships*
PCAOB AS 6	PCAOB Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*
PCAOB AU 341	PCAOB Interim Auditing Standard 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*
PCAOB AU 623	PCAOB Interim Auditing Standard 623, *Special Reports*
SAB 74	SEC Staff Accounting Bulletin 74: *Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period*
SAB 99	SEC Staff Accounting Bulletin 99: *Materiality*
SAB Topic 1.B	Staff Accounting Bulletin Topic 1.B: *Allocation Of Expenses And Related Disclosure In Financial Statements Of Subsidiaries, Divisions Or Lesser Business Components Of Another Entity*
SAB Topic 3.A	Staff Accounting Bulletin Topic 3.A: *Convertible Securities*
SAB Topic 3.C	Staff Accounting Bulletin Topic 3.C: *Redeemable Preferred Stock*
SAB Topic 4.C	Staff Accounting Bulletin Topic 4.C: *Change in Capital Structure*
SAB Topic 4.E	Staff Accounting Bulletin Topic 4.E: *Receivables from Sale of Stock*
SAB Topic 4.F	Staff Accounting Bulletin Topic 4.F: *Limited Partnerships*

Technical references	
SAB Topic 4.G	Staff Accounting Bulletin Topic 4.G: *Notes and Other Receivables from Affiliates*
SAB Topic 5.F	Staff Accounting Bulletin Topic 5.F: *Accounting Changes Not Retroactively Applied Due to Immateriality*
SAB Topic 5.M	Staff Accounting Bulletin Topic 5.M: *Other than Temporary Impairment of Certain Investments in Equity Securities*
SAB Topic 5.P	Staff Accounting Bulletin Topic 5.P: *Restructuring Charges*
SAB Topic 5.Y	Staff Accounting Bulletin Topic 5.Y: *Accounting and Disclosures Relating to Loss Contingencies*
SAB Topic 5.Z	Staff Accounting Bulletin Topic 5.Z: *Accounting and Disclosure Regarding Discontinued Operations*
SAB Topic 6.B	Staff Accounting Bulletin Topic 6.B : *Income or Loss Applicable to Common Stock*
SAB Topic 6.G.2.b	Staff Accounting Bulletin Topic 6.G.2.b: *Reporting Requirements for Accounting Changes*
SAB Topic 6.H.2	Staff Accounting Bulletin Topic 6.H.2: *Classification of Short-term Obligations – Debt Related to Long-Term Projects*
SAB Topic 6.I	Staff Accounting Bulletin Topic 6.I: *Improved Disclosure of Income Tax Expense*
SAB Topic 6.I.2	Staff Accounting Bulletin Topic 6.I.2: *Taxes of Investee Company*
SAB Topic 6.I.3	Staff Accounting Bulletin Topic 6.I.3: *Net of Tax Presentation*
SAB Topic 11.B	Staff Accounting Bulletin Topic 11.B: *Depreciation and Depletion Excluded from Cost of Sales*
SAB Topic 11.C	Staff Accounting Bulletin Topic 11.C: *Tax Holidays*
SAB Topic 11.E	Staff Accounting Bulletin Topic 11.E: *Chronological Ordering of Data*

Technical references	
SAB Topic 11.F	Staff Accounting Bulletin Topic 11.F: *LIFO Liquidations*
SAB Topic 13.A	Staff Accounting Bulletin Topic 13.A: *Selected Revenue Recognition Issues*
SAB Topic 14	Staff Accounting Bulletin Topic 14: *Share-Based Payment*
SEC FRM 2500	SEC Financial Reporting Manual 2500, *Guarantors of Securities*
SEC FRM 2810	SEC Financial Reporting Manual 2810, *Parent-only Financial Statements (Condensed)*
SEC Regulation S-K	Regulation S-K, *Nonfinancial Statement Disclosures*
S-K 302(a)	*Regulation S-K, Item 302(a)*
SEC Regulation S-X	Regulation S-X, *Financial Statement Requirements*
S-X 1-02	Rule 1-02: *Definition of terms used in Regulation S-X*
S-X 3-01	Rule 3-01: *Consolidated balance sheets*
S-X 3-02	Rule 3-02: *Consolidated statements of income and changes in financial position*
S-X 3-04	Rule 3-04: *Changes in stockholders' equity*
S-X 3-10	Rule 3-10: *Financial statements of guarantors and issuers of guaranteed securities registered for being registered*
S-X 3A-01	Rule 3A-01: *Application of Rules 3A-01 to 3A-05*
S-X 3A-02	Rule 3A-02: *Consolidated financial statements of the registrant and its subsidiaries*
S-X 3A-03	Rule 3A-03: *Statement as to principles of consolidation or combination followed*
S-X 3A-04	Rule 3A-04: *Intercompany items and transactions*

Technical references	
S-X 4-01	Rule 4-01: *Form, order, and terminology*
S-X 4-02	Rule 4-02: *Items not material*
S-X 4-06	Rule 4-06: *Inapplicable captions and omission of unrequired or inapplicable financial statements*
S-X 4-07	Rule 4-07: *Discount on shares*
S-X 4-08	Rule 4-08: *General notes to financial statements*
S-X 5-02	Rule 5-02: *Balance sheets*
S-X 5-03	Rule 5-03: *Income statements*
S-X 5-04	Rule 5-04:*What schedules are to be filed*
S-X 9-03	Rule 9-03: *Balance sheets*
S-X 10-01	Rule 10-01: *Interim financial*
S-X 11-01(d)	Rule 11-01(d): *Presentation requirements*
S-X 12-04	Rule 12-04: *Condensed financial information of registrant*
S-X Article 3	*General Instructions as to financial statements*
S-X Article 4	*Rules of general application*
S-X Article 5	*Commercial and industrial companies*
S-X Article 8	*Financial statements of smaller reporting companies*

Abbreviation / Acronym	Definition
AAERs	Accounting and Auditing Enforcement Releases
ABO	Accumulated Benefit Obligation
AFS	Available for Sale
AMT	Alternative Minimum Tax

Abbreviation / Acronym	Definition
AOCI	Accumulated Other Comprehensive Income
APBO	Accumulated Postretirement Benefit Obligation
APIC	Additional Paid in Capital
ARO	Asset Retirement Obligation
ARS	Auction Rate Securities
ASRs	Accounting Series Releases
BCF	Beneficial Conversion Features
BESP	Best estimate of selling price
CMBS	Collateralized Mortgage-Backed Securities
CODM	Chief Operating Decision Maker
CPI	Consumer Price Index
CTA	Cumulative Translation Adjustment
CWIP	Construction work in progress
DAC	Deferred Acquisition Cost
DIG	Derivatives Implementation Group
DPP	Deferred Purchase Price
DTA	Deferred Tax Asset
EBITDA	Earnings Before Interest, Tax, Depreciation, and Amortization
EITF	Emerging Issues Task Force
EPS	Earnings Per Share
EPU	Earnings Per Unit
ESOPs	Employee Stock Ownership Plans
ESPP	Employee Stock Purchase Plan
ETF	Exchange-Traded Funds
FDIC	Federal Deposit Insurance Corporation

Abbreviation / Acronym	Definition
FIFO	First-in First-Out
FRRs	Financial Reporting Releases
FVO	Fair Value Option
GP Interest	General Partner Interest
HTM	Held-to-maturity
IDR	Incentive Distribution Rights
IPR&D	In-process Research and Development
ISDA	International Swaps and Derivatives Association
LCM	Lower-of-Cost-or-Market
LLC	Limited Liability Company
LP	Limited Partnership
MAC	Material Adverse Change
MAE	Material Adverse Effect
MD&A	Management Discussion & Analysis
MLP	Master Limited Partnership
MRV	Market-Related Value
NAV	Net Asset Value
NCI	Noncontrolling Interest
NFPs	Not-for-profit Entities
NOL	Net Operating Loss
NRV	Net Realizable Value
OCI	Other Comprehensive Income
OPEB	Other Postretirement Benefits
OTTI	Other-Than-Temporary Impairments
PBO	Projected Benefit Obligation

Abbreviation / Acronym	Definition
PIK	Paid-in-Kind
POC	Percentage-of-Completion
PP&E	Property, Plant, and Equipment
SAB Topics	Staff Accounting Bulletin Topics
SAC	Subjective Accounting Clauses
SAR	Stock-Appreciation Rights
SG&A	Selling, General and Administrative
SRC	Smaller Reporting Company
VIE	Variable Interest Entity
VOE	Voting Interest Entity
VRDO	Variable Rate Demand Obligation
VSOE	Vendor Specific Objective Evidence

Appendix C: Key terms

The following table provides definitions for key terms used within this guide.

Term	Definition
Accounting change	A change in an accounting principle, an accounting estimate, or the reporting entity. The correction of an error is not an accounting change.
Accumulated benefit obligation	The actuarial present value of benefits (whether vested or nonvested) attributed, generally by the pension benefit formula, to employee service rendered before a specified date and based on employee service and compensation (if applicable) before that date. The accumulated benefit obligation differs from the projected benefit obligation in that it does not make an assumption about future compensation levels.
Accumulated postretirement benefit obligation	The actuarial present value as of a particular date of all future benefits attributed to an employee's service rendered to that date, assuming the plan continues in effect and that all assumptions about future events are fulfilled.
Acquisition date	The date on which the acquirer obtains control of the acquiree.
Active market	A market in which transactions take place with sufficient frequency and volume to provide pricing information on an ongoing basis.
Actuarial gain or loss	A change in the value of either the benefit obligation (projected benefit obligation for pension plans or accumulated postretirement benefit obligation for other postretirement benefit plans) or the plan assets, resulting from experience different from that assumed or from a change in an actuarial assumption, or the consequence of a decision to temporarily deviate from the other postretirement benefit substantive plan. Gains or losses that are not recognized in net periodic pension cost or net periodic postretirement benefit cost when they arise are recognized in other comprehensive income. Those gains or losses are subsequently recognized as a component of net periodic pension cost or net periodic postretirement benefit cost.
Affiliate	A party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with a reporting entity.

Term	Definition
Antidilution	An effect which would increase the amount of EPS, either by lowering the share count or increasing earnings.
Asset group	An asset group is the unit of accounting for a long-lived asset(s) to be held and used, which represents the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities.
Asset retirement obligation	The estimated obligation related to a tangible, long-lived asset's retirement, such as an environmental remediation liability.
Available for sale	Investments in debt securities and equity securities that have readily determinable fair values not classified as either trading securities or as held-to-maturity securities.
Bank overdraft	Checks honored by the bank that exceed the amount of cash available in the reporting entity's account
Basic earnings per share	The amount of earnings for the period available to each share of common stock outstanding during the reporting period.
Beneficial conversion feature	A nondetachable conversion feature that is in-the-money at the commitment date.
Beneficial interest	A right to receive all or a portion of specified cash inflows received by a trust or other entity, including, but not limited to, all of the following: □ Senior and subordinated shares of interest, principal, or other cash inflows to be passed-through or paid-through □ Premiums due to guarantors □ Commercial paper obligations □ Residual interests, whether in the form of debt or equity
Book overdraft	Outstanding checks in excess of funds on deposit.
Business combination	A transaction or other event in which an acquirer obtains control of one or more businesses.
Callable obligation	An obligation is callable at a given date if the creditor has the right at that date to demand, or to give notice of its intention to demand, repayment of the obligation owed to it by the debtor.

Term	Definition
Carryback	A deduction or credit that cannot be utilized on the tax return during a year that may be carried back to reduce taxable income or taxes payable in a prior year. An operating loss carryback is an excess of tax deductions over gross income in a year; a tax credit carryback is the amount by which tax credits available for utilization exceed statutory limitations.
Carryforward	A deduction or credit that cannot be utilized on the tax return during a year that may be carried forward to reduce taxable income or taxes payable in a future year. An operating loss carryforward is an excess of tax deductions over gross income in a year; a tax credit carryforward is the amount by which tax credits available for utilization exceed statutory limitations.
Carve-out	A separate financial statement of a division or business unit that is derived from (or carved-out) of a larger parent entity.
Cash	Cash includes currency on hand and demand deposits with banks or other financial institutions. Cash also includes other kinds of accounts that have the general characteristics of demand deposits in that the customer may deposit additional funds at any time and also effectively may withdraw funds at any time without prior notice or penalty.
Cash conversion feature	A feature within an instrument that permits cash settlement.
Cash equivalent	Short-term, highly liquid investments that have both of the following characteristics: □ Readily convertible to known amounts of cash □ So near their maturity that they present insignificant risk of changes in value because of changes in interest rates Generally, only investments with original maturities of three months or less qualify under that definition. Original maturity means original maturity to the reporting entity holding the investment.
Cash flow hedge	A hedge of the exposure to variability in the cash flows of a recognized asset or liability, or of a forecasted transaction, that is attributable to a particular risk.

Term	Definition
Change in accounting estimate	A change that has the effect of adjusting the carrying amount of an existing asset or liability or altering the subsequent accounting for existing or future assets or liabilities. A change in accounting estimate is a necessary consequence of the assessment, in conjunction with the periodic presentation of financial statements, of the present status and expected future benefits and obligations associated with assets and liabilities. Changes in accounting estimates result from new information.
Change in accounting principle	A change from one generally accepted accounting principle to another generally accepted accounting principle or when the accounting principle formerly used is no longer generally accepted. A change in the method of applying an accounting principle is also considered a change in accounting principle.
Chief Operating Decision Maker (CODM)	The individual or individuals responsible for allocating resources and assessing performance.
Collaborative arrangement	A contractual arrangement that involves a joint operating activity. These arrangements involve two (or more) parties that meet both of the following requirements: □ They are active participants in the activity □ They are exposed to significant risks and rewards dependent on the commercial success of the activity
Collateral	Personal or real property in which a security interest has been given.
Common control	Reporting entities or businesses that are controlled by the same parent entity.
Common stock	A stock that is subordinate to all other stock of the issuer. Also called common shares.
Compensating balance arrangement	A minimum balance that must be maintained in an account to offset a portion of the cost that a lender faces when extending a loan or credit to an individual or reporting entity.
Completed-contract method	An accounting method under which revenue recognition is postponed until a contract is completed.

Term	Definition
Component of an entity	A component of a reporting entity comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the reporting entity. A component of a reporting entity may be a reportable segment or an operating segment, a reporting unit, a subsidiary, or an asset group.
Comprehensive income	The change in equity (net assets) of a reporting entity during a period from transactions and other events and circumstances from nonowner sources. Comprehensive income comprises both of the following: □ All components of net income □ All components of other comprehensive income
Conduit debt security	Certain limited-obligation revenue bonds, certificates of participation, or similar debt instruments issued by a state or local governmental entity for the express purpose of providing financing for a specific third party (the conduit bond obligor) that is not a part of the state or local government's financial reporting entity.
Contingency	An existing condition, situation, or set of circumstances involving uncertainty as to possible gain (gain contingency) or loss (loss contingency) to a reporting entity that will ultimately be resolved when one or more future events occur or fail to occur.
Contingent consideration	Usually an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met.
Contingent rental	The increases or decreases in lease payments that result from changes occurring after lease inception in the factors (other than the passage of time) on which lease payments are based, excluding any escalation of minimum lease payments relating to increases in construction or acquisition cost of the leased property or for increases in some measure of cost or value during the construction or pre-construction period. The term "contingent rentals" contemplates an uncertainty about future changes in the factors on which lease payments are based.

Term	Definition
Contingent stock agreement	An agreement to issue common stock (usually in connection with a business combination) that is dependent on the satisfaction of certain conditions.
Contingently convertible instrument	An instrument that has embedded conversion features that are contingently convertible or exercisable based on either of the following: □ A market price trigger □ Multiple contingencies, if one of the contingencies is a market price trigger and the instrument can be converted or share settled based on meeting the specified market condition Examples of contingently convertible instruments include contingently convertible debt and contingently convertible preferred stock.
Contingently issuable share	A share issuable for little or no cash consideration upon the satisfaction of certain conditions pursuant to a contingent stock agreement. Also called "contingently issuable stock."
Continuing cash flow (Continuing involvement)	With regard to segments (ASC 280), cash inflows or outflows that are generated by the ongoing reporting entity and are associated with activities involving a disposed component. With regard to transfers of financial assets (ASC 860), any involvement with the transferred financial assets that permits the transferor to receive cash flows or other benefits that arise from the transferred financial assets or that obligates the transferor to provide additional cash flows or other assets to any party related to the transfer.
Controlling financial interest	The portion of equity (net assets) in a subsidiary which is attributable, directly or indirectly, to a parent.
Conversion rate	The ratio of the number of common shares issuable upon conversion to a unit of a convertible security. For example, $100 face value of debt convertible into 5 shares of common stock would have a conversion ratio of 5:1. Also called "conversion ratio."
Convertible security	A security that is convertible into another security based on a conversion rate. For example, convertible preferred stock that is convertible into common stock on a two-for-one basis (two shares of common for each share of preferred).

Term	Definition
Cost method	A method of accounting for an equity investment, when the investor does not have the ability to exercise significant influence (typically below 20% ownership), where companies carry their investment at cost, recognize dividends when received, and only recognize gains or losses after selling the securities. The cost method may only be used for investments in securities that are nonmarketable or do not have readily convertible fair values.
Credit derivative	A derivative instrument that has both of the following characteristics: □ One or more of its underlyings are related to the credit risk of a specified entity (or a group of entities) or an index based on the credit risk of a group of entities □ It exposes the seller to potential loss from credit-risk-related events specified in the contract. Examples of credit derivatives include, but are not limited to, credit default swaps, credit spread options, and credit index products.
Cumulative effect of an accounting change	An accounting adjustment to the carrying amounts of assets and liabilities as of the beginning of the first period presented due to a change in accounting principle.
Deferred tax asset	The deferred tax consequence attributable to a deductible temporary difference or carryforward measured using the applicable enacted tax rate and provisions of the enacted tax law. A deferred tax asset is reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.
Deferred tax expense (or benefit)	The change during the year in a reporting entity's deferred tax liabilities and assets.
Deferred tax liability	The deferred tax consequence attributable to a taxable temporary difference measured using the applicable enacted tax rate and provisions of the enacted tax law.

Term	Definition
Defined benefit plan	A plan that provides participants with a determinable benefit based on a formula provided for in the plan. Types of plans may include health and welfare plans, pension plans, and postretirement plans.
Defined contribution plan	A plan that provides an individual account for each participant and provides benefits that are based on all of the following: amounts contributed to the participant's account by the employer or employee; investment experience; and any forfeitures allocated to the account, less any administrative expenses charged to the plan. Types of plans may include health and welfare plans and postretirement plans.
Derivative instrument	A financial instrument or other contract with all of the following characteristics: an underlying, notional amount, and payment provision; an initial net investment; and net settlement.
Diluted earnings per share	The amount of earnings for the period available to each share of common stock outstanding during the period and to each share that would have been outstanding, assuming the issuance of common shares for all dilutive instruments outstanding during the reporting period.
Dilution	A reduction in EPS resulting from the assumption that convertible securities were converted, that options or warrants were exercised, or that other shares were issued upon the satisfaction of certain conditions.
Discontinued operation	Disposal of a component or group of components that meet the requirements of ASC 205-20.
Discount (on debt issuance)	The difference between the net proceeds, after expense, received upon issuance of debt and the amount repayable at its maturity.
Disposal group	Assets to be disposed of together as a group in a single transaction and liabilities directly associated with those assets that will be transferred in the transaction. May include a discontinued operation, along with other assets and liabilities that are not part of the discontinued operation.
Dividends in kind	Dividends paid in a form other than cash.
Economic hedge	Transactions that serve to mitigate cash flow or fair value risks, but that are not designated as hedging transactions for financial reporting purposes.

Term	Definition
Effective interest rate	The rate of return implicit in the loan; that is, the contractual interest rate adjusted for any net deferred loan fees or costs, premium, or discount existing at the origination or acquisition of the loan.
Effectiveness	The extent to which the hedging instrument offsets the changes in fair value or cash flows of the hedged item.
Embedded derivative	Implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by a contract in a manner similar to a derivative instrument.
Employee stock ownership plan	A plan that is a stock bonus plan, or combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock.
Employee stock purchase plan	A plan designed to promote employee stock ownership by providing employees with a convenient means (usually through a payroll deduction) to acquire a company's shares.
Equity method	A method of accounting for an equity investment, when the investor has the ability to exercise significant influence (typically between 20 percent-50 percent), where reporting entities adjust the investment amount each period for changes in the investee's net assets and record earnings of the investee equivalent to their percentage ownership.
Expected return on plan assets	For defined benefit plans, the expected return on plan assets is determined based on the expected long-term rate of return on plan assets and the market-related value of plan assets.
Expected term	A requisite service period, typically associated with stock-based compensation.
Expected volatility	A variable in option pricing formula showing the extent to which the return of the underlying asset will fluctuate between now and the option's expiration.

Term	Definition
Extraordinary item	An event or transaction that is distinguished by its unusual nature and by the infrequency of its occurrence. Thus, both of the following criteria should be met to classify an event or transaction as an extraordinary item: □ The underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the reporting entity, taking into account the environment in which the reporting entity operates. □ The underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the reporting entity operates.
Fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
Fair value hedge	A hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment that are attributable to a particular risk.
Fair value hierarchy	A three level hierarchy that distinguishes the inputs and assumptions used in a fair value estimate.
Financial instrument	Cash, evidence of an ownership interest in an entity, or a contract that both: □ Imposes on one entity a contractual obligation either to deliver cash or another financial instrument to a second entity or to exchange other financial instruments on potentially unfavorable terms with the second entity □ Conveys to that second entity a contractual right either to receive cash or another financial instrument from the first entity or to exchange other financial instruments on potentially favorable terms with the first entity

Term	Definition
Financial statements are available to be issued	Financial statements are considered available to be issued when they are complete in a form and format that complies with GAAP and all approvals necessary for issuance have been obtained, for example, from management, the board of directors, and/or significant shareholders.
Financial statements are issued	Financial statements are considered issued when they are widely distributed to shareholders and other financial statement users for general use and reliance in a form and format that complies with GAAP. (SEC registrants also are required to consider the guidance in ASC 855-10-S99-2.)
Financing receivable	A financing arrangement that has both of the following characteristics: □ It represents a contractual right to receive money on demand or on a fixed or determinable date □ It is recognized as an asset in the reporting entity's statement of financial position See ASC 310-10-55-13 through 55-15 for more information on the definition of financing receivable, including a list of items that are excluded from the definition (e.g., debt securities).
Foreign currency	A currency other than the functional currency of the reporting entity being referred to.
Foreign currency translation	The process of expressing in the reporting currency of the reporting entity those amounts that are denominated or measured in a different currency.
Forfeiture	The loss of rights to unvested stock-based compensation awards.
Forward exchange contract	An agreement between two parties to exchange different currencies at a specified exchange rate at an agreed-upon future date.
Freestanding contract	A freestanding contract is entered into either: □ Separate and apart from any of the reporting entity's other financial instruments or equity transactions □ In conjunction with some other transaction and is legally detachable and separately exercisable

<table>
<tr><th>Term</th><th>Definition</th></tr>
<tr><td>Functional currency</td><td>The currency of the primary economic environment in which the reporting entity operates; normally, that is the currency of the environment in which a reporting entity primarily generates and expends cash.</td></tr>
<tr><td>Gain or loss (component of net periodic pension cost)</td><td>The sum of the difference between the actual return on plan assets and the expected return on plan assets and the amortization of the net gain or loss recognized in accumulated other comprehensive income.</td></tr>
<tr><td>General partnership</td><td>An association in which each partner has unlimited liability.</td></tr>
<tr><td>Grant date</td><td>The date at which an employer and an employee reach a mutual understanding of the key terms and conditions of a share-based payment award. The grant date for an award of equity instruments is the date that an employee begins to benefit from, or be adversely affected by, subsequent changes in the price of the employer’s equity shares.</td></tr>
<tr><td>Gross margin</td><td>The excess of sales over cost of goods sold. Gross margin does not consider all operating expenses.</td></tr>
<tr><td>Held-for-sale</td><td>A long-lived asset (disposal group) to be sold that meets the following criteria:
□ Management commits to a plan to sell the asset
□ The asset is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets
□ An active program to locate a buyer and other actions required to complete the plan to sell the asset have been initiated
□ The sale of the asset is probable, and transfer of the asset is expected to be completed within one year
□ The asset is being actively marketed for sale at a price that is reasonable in relation to its current fair value
□ It is unlikely that significant changes to the plan will be made or that the plan will be withdrawn</td></tr>
<tr><td>Held-to-maturity</td><td>A security which a reporting entity has the positive intent and ability to hold until the instrument’s maturity.</td></tr>
</table>

Term	Definition
Highly inflationary economy	An economy which has had cumulative inflation of approximately 100 percent or more over three years.
Hybrid instrument	A contract that embodies both an embedded derivative and a host contract.
Income tax	Domestic and foreign federal (national), state, and local (including franchise) tax based on income.
Indefinite reinvestment	An assertion on the part of a company to reinvest foreign earnings without repatriation.
Input	An assumption that market participants would use when pricing the asset or liability, including assumptions about risk, such as the following: □ The risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) □ The risk inherent in the inputs to the valuation technique
Interest cost (component of net periodic pension cost)	The amount recognized in a period determined as the increase in the projected benefit obligation due to the passage of time.
In-the-money	An option for which the common stock during the period exceeds the exercise price.
Joint and several liability	Where liability is joint and several, any party deemed liable is potentially responsible for all of the associated costs. This scheme of liability means that any responsible party can potentially be liable for the entire cost of a liability, notwithstanding that the party is responsible for only a portion of it.
Joint venture	A reporting entity owned and operated by a small group of entities (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group. The purpose of a joint venture frequently is to share risks and rewards in developing a new market, product, or technology, to combine complementary technological knowledge; or to pool resources in developing production or other facilities. A joint venture also usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors.

Term	Definition
Level 1 input	Quoted price (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date.
Level 2 input	An input other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
Level 3 input	An unobservable input for the asset or liability.
Limited partnership	An association in which one or more general partners have unlimited liability and one or more limited partners have limited liability.
Line-of-credit arrangement (or revolving debt arrangement)	An agreement that provides the borrower with the option to make multiple borrowings up to a specified maximum amount, to repay portions of previous borrowings, and to then reborrow under the same contract. May include both amounts drawn by the debtor (a debt instrument) and a commitment by the creditor to make additional amounts available to the debtor under predefined terms (a loan commitment).
Mandatorily redeemable financial instrument	Any of various financial instruments issued in the form of shares that embody an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur.
Margin deposit	Security deposit by a customer with a broker, or the governing clearing house, for each futures or options contract as support for fulfilling the contract.
Marketable security	A highly liquid security that can be readily converted into cash.
Master limited partnership	A type of limited partnership that is publicly traded.
Master netting arrangement	An agreement which states that a reporting entity has the right to set off the amounts owed from its derivatives with a counterparty that is enforceable by law.
Measurement period (for business combinations)	A period of time after a business combination in which a reporting entity is permitted to finalize the accounting for certain valuations.

Term	Definition
Mezzanine equity	A temporary equity classification for an instrument that is redeemable or may become redeemable at a fixed or determinable price on a fixed or determinable date, at the option of the holder, or upon the occurrence of an event that is not solely within the control of the issuer.
Milestone method	A method of recognizing revenue for long-term contracts. It is based on the premise that a task associated with a long-term contract, when completed, provides management with a reliable indicator of progress-to-completion on those contracts.
Multi-employer plan	A pension or postretirement benefit plan to which two or more unrelated employers contribute, usually pursuant to one or more collective-bargaining agreements. A characteristic of multi-employer plans is that assets contributed by one participating 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.
Net periodic pension cost	The amount recognized in an employer's financial statements as the cost of a pension plan for a period. The term "net periodic pension cost" is used instead of "net pension expense" because part of the cost recognized in a period may be capitalized with other costs as part of an asset such as inventory.
Noncontrolling interest	The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent.
Observable input	An input that is developed using market data, such as publicly available information about actual events or transactions, and that reflects the assumptions that market participants would use when pricing the asset or liability.
Operating segment	A component of a public reporting entity that has all of the following characteristics: □ It engages in business activities from which it may earn revenues and incur expenses □ Its operating results are regularly reviewed by the chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance □ Its discrete financial information is available

Term	Definition
Other comprehensive income	Revenues, expenses, gains, and losses that under GAAP are included in comprehensive income but excluded from net income.
Other postemployment benefit	A benefit, other than special or contractual termination benefits, that is provided by an employer to former or inactive employees after employment but before retirement including benefits provided to beneficiaries and covered dependents.
Out-of-period adjustment	An adjustment made in an accounting period resulting from misstatements in a previous period.
Participating right	The ability to block the actions through which a reporting entity exercises the power to direct the activities of a VIE that most significantly impact the VIE's economic performance. Alternatively, the ability of limited partners to participate in certain financial and operating decisions of limited partnerships that are made in the ordinary course of business.
Participating security	With regard to EPS calculations, a security that may participate in undistributed earnings with common stock, whether that participation is conditioned upon the occurrence of a specified event or not. The form of such participation does not have to be a dividend—that is, any form of participation in undistributed earnings would constitute participation by that security, regardless of whether the payment to the security holder was referred to as a dividend.
Participation right	A purchaser's right under a participating contract to receive future dividends.
Pass-through entity	A business structure that is used to reduce the effects of double taxation in which the reporting entity doesn't pay income taxes at the corporate level. Instead, corporate income is allocated among the owners, and income taxes are only levied at the individual owners' level.
Percentage-of-completion method	A method under which the amount of revenue recognized (based on the sales value) at the time a sale is recognized is measured by the relationship of costs already incurred to the total of costs already incurred and future costs expected to be incurred.

Term	Definition
Performance condition	With regard to stock-based compensation, a condition affecting the vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award that relates to both of the following: □ An employee's rendering service for a specified (either explicitly or implicitly) period of time □ Achieving a specified performance target that is defined solely by reference to the employer's own operations (or activities)
Permanent equity	Equity instruments that do not qualify for temporary, or mezzanine, equity classification.
Plan asset	An asset—usually a stock, bond, or other investment (except certain insurance contracts)—that has been segregated and restricted (usually in a trust) to be used for postretirement benefits. The amount of plan assets includes amounts contributed by the employer, and by plan participants for a contributory plan, and amounts earned from investing the contributions, less benefits, income taxes, and other expenses incurred.
Plan curtailment	An event that significantly reduces the expected years of future service of present employees or eliminates for a significant number of employees the accrual of defined benefits for some or all of their future services.
Portfolio segment	The level at which a reporting entity develops and documents a systematic methodology to determine its allowance for credit losses.
Preferred dividend	Dividend on preferred stock usually at a specified rate stated in dollars per share or as a percentage of par value.
Preferred stock	A security that has preferential rights compared to common stock.
Premium (on debt issuance)	The excess of the net proceeds, after expense, received upon issuance of debt over the amount repayable at its maturity.
Primary beneficiary	A reporting entity that consolidates a variable interest entity (VIE).

Term	Definition
Prior service cost	The cost of benefit improvements attributable to plan participants' prior service pursuant to a plan amendment or a plan initiation that provides benefits in exchange for plan participants' prior service.
Probable	Future event or events that are likely to occur.
Projected benefit obligation	The actuarial present value as of a date of all benefits attributed by the pension benefit formula to employee service rendered before that date. The projected benefit obligation is measured using assumptions as to future compensation levels if the pension benefit formula is based on those future compensation levels.
Purchased call option	A contract that allows the reporting entity to buy a specified quantity of its own stock from the issuer of the contract at a fixed price for a given period.
Push down accounting	Use of the acquiring entity's basis of accounting in the preparation of the acquired entity's financial statements.
Rabbi trust	Grantor trusts generally set up to fund compensation for a select group of management or highly paid executives. To qualify as a rabbi trust for income tax purposes, the terms of the trust agreement should explicitly state that the assets of the trust are available to satisfy the claims of general creditors in the event of bankruptcy of the employer.
Reasonably estimable	An amount whose level of certainty will not impair the integrity of the reporting entity's financial statements.
Reasonably possible	The chance of the future event or events occurring is more than remote but less than likely.
Reclassification	A change in classification of an amount from a prior period from one acceptable financial statement caption to another acceptable caption for comparability purposes.
Redeemable preferred stock	An instrument that is issued in the form of shares and permits the issuer to redeem the instrument on a specified or determinable date (or dates) or upon the occurrence of a future event.

Term	Definition
Related party	Includes: □ Affiliates of the reporting entity □ Entities for which investments in their equity securities would be required, absent the election of the fair value option under ASC 825, to be accounted for using the equity method □ Trusts for the benefit of employees, such as pension and profit-sharing trusts, that are managed by or under the trusteeship of management □ Principal owners of the reporting entity and members of their immediate families □ Management of the reporting entity and members of their immediate families □ Other parties with which the reporting entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests □ Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests
Remote	The chance of the future event(s) occurring is slight.
Reportable segment	An operating segment reported in a reporting entity's financial statements.
Reporting currency	The currency in which a reporting entity prepares its financial statements.
Reporting unit	The level of reporting at which goodwill is tested for impairment. A reporting unit is an operating segment or one level below an operating segment (also known as a component).

Term	Definition
Repurchase agreement (or "repo")	An agreement under which the transferor (repurchase party) transfers a security to a transferee (repurchase counterparty or reverse party) in exchange for cash and concurrently agrees to reacquire that security at a future date for an amount equal to the cash exchanged plus a stipulated interest factor. Instead of cash, other securities or letters of credit may be exchanged. Some repurchase agreements call for repurchase of securities that need not be identical to the securities transferred.
Restatement	The process of revising previously-issued financial statements to reflect the correction of an error.
Restricted stock unit	Compensation offered by an employer to an employee in the form of company stock. The employee does not receive the stock immediately, but instead receives it according to a vesting plan and distribution schedule after achieving required performance milestones or upon remaining with the employer for a particular length of time.
Restructuring	A program that is planned and controlled by management, and materially changes either the scope of a business undertaken by a reporting entity, or the manner in which that business is conducted.
Retainage	Amounts that are owed between two entities in a long term contract, but typically not paid until the contract has been completed.
Retrospective application	The application of a different accounting principle to one or more previously-issued financial statements, or to the balance sheet at the beginning of the current period, as if that principle had always been used, or a change to financial statements of prior accounting periods to present the financial statements of a new reporting entity as if it had existed in those prior years.
Revised financial statement	Financial statement revised only for either of the following conditions: □ Correction of an error □ Retrospective application of GAAP
Revolving debt	See Line-of-Credit Arrangement.

Term	Definition
Right of setoff	A legal right, by contract or otherwise, to discharge all or a portion of an obligation owed to another party by applying against the obligation an amount that the other party owes.
Securitization	The process by which financial assets are transformed into securities.
Service cost (component of net periodic pension cost or component of periodic post-retirement benefit)	The actuarial present value of benefits attributed to services rendered by employees during the period (the portion of the expected postretirement benefit obligation attributed to service in the period).
Servicing asset	A contract to service financial assets under which the benefits of servicing are expected to more than adequately compensate the servicer for performing the servicing, either: □ Undertaken in conjunction with selling or securitizing the financial assets being serviced □ Purchased or assumed separately
Servicing liability	A contract to service financial assets under which the estimated future revenues from contractually specified servicing fees, late charges, and other ancillary revenues (benefits of servicing) are not expected to adequately compensate the servicer for performing the servicing.
Share lending agreement	The act of loaning a share, which requires the borrower to put up collateral, and the title and the ownership is also transferred to the borrower.
Spin-off	The transfer of assets that constitute a business by an entity (the spinnor) into a new legal spun-off entity (the spinnee), followed by a distribution of the shares of the spinnee to its shareholders, without the surrender by the shareholders of any stock of the spinnor.
Statutory tax rate	The tax rate specified by the law of a taxing jurisdiction.
Stock appreciation right	An award entitling employees to receive cash, stock, or a combination of cash and stock in an amount equivalent to any excess of the fair value of a stated number of shares of the employer's stock over a stated price.

Term	Definition
Stock dividend	An issuance by a corporation of its own common shares to its common shareholders without consideration.
Stock option	A contract that gives the holder the right, but not the obligation, either to purchase (to call) or to sell (to put) a certain number of shares at a predetermined price for a specified period of time.
Stock split	An issuance by a corporation of its own common shares to its common stockholders without consideration.
Subjective acceleration clause	A provision in a debt agreement that states that the creditor may accelerate the scheduled maturities of the obligation under conditions that are not objectively determinable (for example, if the debtor fails to maintain satisfactory operations or if a material adverse change occurs).
Subsequent event	An event or transaction that occurs after the balance sheet date but before financial statements are issued or are available to be issued. There are two types of subsequent events: □ Type 1 — Events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements (that is, recognized subsequent events) □ Type 2 — Events that provide evidence about conditions that did not exist at the date of the balance sheet but arose subsequent to that date (that is, nonrecognized subsequent events)

Term	Definition
Tax position	A position in a previously filed tax return or a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets and liabilities for interim or annual periods. A tax position can result in a permanent reduction of 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 term "tax position" also encompasses, but is not limited to: □ A decision not to file a tax return □ An allocation or a shift of income between jurisdictions □ The characterization of income or a decision to exclude reporting taxable income in a tax return □ A decision to classify a transaction, entity, or other position in a tax return as tax exempt □ A reporting entity's status, including its status as a pass-through entity or a tax-exempt not-for-profit entity
Temporary difference	A difference between the tax basis of an asset or liability computed for tax positions, and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively.
Temporary equity	See Mezzanine equity.
Trading	Securities that are bought and held principally for the purpose of selling them in the near term and therefore held for only a short period of time. Generally reflects active and frequent buying and selling, and trading securities are generally used with the objective of generating profits on short-term differences in price.
Transaction gain or loss	Gains or losses that result from a change in exchange rates between the functional currency and the currency in which a foreign currency transaction is denominated. They represent an increase or decrease in both of the following: □ The actual functional currency cash flows realized upon settlement of foreign currency transactions □ The expected functional currency cash flows on unsettled foreign currency transactions

Term	Definition
Transfer	The conveyance of a noncash financial asset by and to someone other than the issuer of that financial asset. A transfer includes the following: □ Selling a receivable □ Putting a receivable into a securitization trust □ Posting a receivable as collateral A transfer excludes the following: □ The origination of a receivable □ Settlement of a receivable □ The restructuring of a receivable into a security in a troubled debt restructuring
Translation adjustment	An adjustment that results from the process of translating financial statements from the reporting entity's functional currency into the reporting currency.
Troubled debt restructuring	A restructuring in which the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider.
Two-class method	An earnings allocation formula that determines EPS for each class of common stock and participating security according to dividends declared (or accumulated) and participating rights in undistributed earnings.
Uncertain tax position	A tax position taken that may be challenged and ultimately disallowed in whole or in part.
Unobservable input	An input for which market data is not available and that is developed using the best information available about the assumptions that market participants would use when pricing the asset or liability.
Unrecognized tax benefit	The difference between a tax position taken or expected to be taken in a tax return and the benefit recognized.
Valuation allowance	The portion of a deferred tax asset for which it is more likely than not that a tax benefit will not be realized.

Term	Definition
Variable interest entity (VIE)	An entity that by design possesses the following characteristics: ▫ The equity investment at risk is not sufficient for the entity to finance its activities without additional subordinated financial support ▫ As a group, the holders of equity investment at risk do not possess: o The power, through voting rights or similar rights, to direct the activities that most significantly impact the entity's economic performance o The obligation to absorb expected losses or the right to receive the expected residual returns of the entity o Symmetry between voting rights and economic interests and where substantially all of the entity's activities either involve or are conducted on behalf of an investor with disproportionately fewer voting rights (e.g., structures with nonsubstantive voting rights)
Variable rate demand obligation	A debt instrument that the investor can put (or demand repayment) on short notice. Upon an investor's exercise of a put, a remarketing agent will resell the debt to another investor to obtain the funds to honor the put (i.e., to repay the investor). If the remarketing agent fails to sell the debt, the funds to pay the investor who exercised the put will often be obtained through a liquidity facility issued by a financial institution.
Variation margin	With regard to derivatives, an amount that is required to be paid or received periodically as dictated by the clearing member and/or clearing house.
Vest	To earn the rights to. A share-based payment award becomes vested at the date that the employee's right to receive or retain shares, other instruments, or cash under the award is no longer contingent on satisfaction of either a service condition or a performance condition. Market conditions are not vesting conditions.
Warrant	A security that gives the holder the right to purchase shares of common stock in accordance with the terms of the instrument, usually upon payment of a specified amount.

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