

This Update to *Intermediate Accounting* contains discussions of key accounting standards and other issues that have arisen since the publication of *Intermediate Accounting, 14th Edition*, by Kieso, Weygandt, and Warfield. The Update consists of the following three elements: (1) **Completed Projects** provide the latest information about new accounting standards promulgated since the textbook was published; (2) **Proposed Projects** address contemporary issues being debated by accounting professionals and standard-setters, which may result in new accounting standards; and (3) **International Developments** discuss recent activity in the international accounting area.

Contents

Completed Projects

Comprehensive Income (UP-2). Relates to Chapter 4, Income Statement.

Securities Repurchases (UP-9). Discusses new rules for repurchase agreements (Chapter 7, Cash and Receivables), in response to the controversial **Lehman Brothers'** Repo 105 transactions.

Optional Step in Goodwill Impairment Testing (UP-13). Addresses new rules related to goodwill impairment testing (Chapter 12, Intangible Assets).

Troubled Debt Restructurings (UP-15). New rules on when a debt restructuring is "troubled" (Appendix A of Chapter 14, Long-Term Liabilities).

Fair Value Measurement (UP-16). Discusses updated fair value measurement and disclosure guidance (Appendix C of Chapter 17, Investments).

Proposed Projects

Offsetting (UP-18). Proposed new guidance on offsetting (or netting) of financial assets and liabilities (Chapters 7, Cash and Receivables; 13, Current Liabilities; and 17, Investments).

Financial Instruments (UP-20). Summarizes the FASB's project on financial instruments, which is a joint project with the IASB (Chapters 7, Cash and Receivables; 14, Long-Term Liabilities; and 17, Investments).

Revenue Recognition (UP-27). Discusses the FASB's joint project with the IASB on revenue (Chapter 18, Revenue Recognition).

Leases (UP-31). Summarizes the FASB's joint project with the IASB on leases (Chapter 21, Accounting for Leases).

International Developments

International Accounting Convergence (UP-35). Update on the SEC's work plan for the consideration of IFRS for use by public companies in the United States.

Other Projects (UP-38). Recent accounting developments in IFRS, including joint projects with the FASB (comprehensive income, fair value, financial instruments, revenue recognition, and leases) and the recent amendment to *IAS 19* (Employee Benefits).

COMPLETED PROJECTS

COMPREHENSIVE INCOME

The discussion in this section provides an introduction to the new standard on comprehensive income reporting. Replacement pages for pages 181–184 in the textbook are provided in the next section.

What Has Changed?

The FASB recently changed the rule governing the reporting of comprehensive income [Accounting Standards Update 2011-05, Comprehensive Income (Topic 220): *Presentation of Comprehensive Income*]. In brief, under the new rules, companies now have the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income (one statement approach) or in two separate but consecutive statements (two statement approach).

Under previous GAAP (issued in 1997), companies could present other comprehensive income and its components in financial statements in one of three ways. In addition to the one statement or the two statement approach, a third presentation option was to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. As indicated in *Intermediate Accounting*, most companies used the stockholders' equity approach; the new comprehensive income reporting rules eliminate this option.

In addition, GAAP allowed companies to present reclassification adjustments in the notes to the financial statements. Under the new rules, reclassification adjustments must be presented on the face of comprehensive income reports.

The new guidance does not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. The amendments do not change the option for an entity to present components of other comprehensive income either net of related tax effects or before related tax effects, with one amount shown for the aggregate income tax expense or benefit related to the total of other comprehensive income items. In both cases, the tax effect for each component must be disclosed in the notes to the financial statements or presented in the statement that includes other comprehensive income. The amendments do not affect how earnings per share is calculated or presented.

Why Change?

According to the FASB, the new rules are needed to improve the comparability, consistency, and transparency of financial reporting, and to increase the prominence of items reported in other comprehensive income. To increase the prominence of items reported in other comprehensive income and to facilitate convergence of GAAP and International Financial Reporting Standards (IFRS), the FASB eliminated the option to present components of other comprehensive income as part of the statement of changes in stockholders' equity. IFRS does not have this option. Removing certain presentation options will make it easier to compare statements of comprehensive income prepared using GAAP with those prepared using IFRS.

Summary

The FASB and IASB have been working on projects that will potentially increase the number of items that may be reported in other comprehensive income (e.g., financial instruments and pensions projects discussed later in this Update, as well as the volume and significance of items currently reported in other comprehensive income). Thus, the Boards worked jointly on a limited-scope project to develop common requirements for the presentation of other comprehensive income in GAAP and IFRS. The new comprehensive income presentation rules will be effective in 2012.

8 LEARNING OBJECTIVE

Explain how to report other comprehensive income.

The following discussion reflects the most recent accounting standards concerning comprehensive income. It should replace pages 181–184 in Chapter 4 of Intermediate Accounting, 14th Edition. Replacement homework material is also included.

Comprehensive Income

Companies generally include in income all revenues, expenses, and gains and losses recognized during the period. These items are classified within the income statement so that financial statement readers can better understand the significance of various components of net income. Changes in accounting principles and corrections of errors are excluded from the calculation of net income because their effects relate to prior periods.

In recent years, there is an increased use of fair values for measuring assets and liabilities. Furthermore, possible reporting of gains and losses related to changes in fair value have placed a strain on income reporting. Because fair values are continually changing, some argue that recognizing these gains and losses in net income is misleading. The FASB agrees and has identified a limited number of transactions that should be recorded directly to stockholders equity. One example is unrealized gains and losses on available-for-sale securities.²¹ These gains and losses are excluded from net income, thereby reducing volatility in net income due to fluctuations in fair value. At the same time, disclosure of the potential gain or loss is provided.

Companies include these items that bypass the income statement in a measure called comprehensive income. **Comprehensive income** includes all changes in equity during a period *except* those resulting from investments by owners and distributions to owners. Comprehensive income, therefore, includes the following: all revenues and gains, expenses and losses reported in net income, and all gains and losses that bypass net income but affect stockholders' equity. These items—non-owner changes in equity that bypass the income statement—are referred to as **other comprehensive income**.

Companies must display the components of other comprehensive income in one of two ways: (1) a single continuous statement (**one statement approach**) or (2) two separate, but consecutive statements of net income and other comprehensive income (**two statement approach**). The one statement approach is often referred to as the comprehensive income statement. The two statement approach uses the traditional term income statement for the first statement and the comprehensive income statement for the second statement. **[8]**

Under either approach, companies display each component of net income and each component of other comprehensive income. In addition, net income and comprehensive income are reported. Companies are not required to report earnings per share information related to comprehensive income.²²

We illustrate these two alternatives in the next two sections. In each case, assume that V. Gill Inc. reports the following information for 2012: sales revenue \$800,000; cost

²¹We further discuss available-for-sale securities in Chapter 17. Additional examples of other comprehensive items are translation gains and losses on foreign currency, unrealized gains and losses on certain hedging transactions, and adjustments related to pensions. Corrections of errors and changes in accounting principles are not considered other comprehensive income items.

²²A company must display the components of other comprehensive income either (1) net of related tax effects, or (2) before related tax effects, with one amount shown for the aggregate amount of tax related to the total amount of other comprehensive income. Both alternatives must show each component of other comprehensive income, net of related taxes either in the face of the statement or in the notes.

of goods sold \$600,000; operating expenses \$90,000; and an unrealized holding gain on available-for-sale securities of \$30,000, net of tax.

One Statement Approach

In this approach, the traditional net income is a subtotal, with total comprehensive income shown as a final total. The combined statement has the advantage of not requiring the creation of a new financial statement. However, burying net income as a subtotal on the statement is a disadvantage. Illustration 4-19 shows the one statement format for V. Gill.

V. GILL INC.	
STATEMENT OF COMPREHENSIVE INCOME	
FOR THE YEAR ENDED DECEMBER 31, 2012	
Sales revenue	\$800,000
Cost of goods sold	<u>600,000</u>
Gross profit	200,000
Operating expenses	<u>90,000</u>
Net Income	110,000
Other comprehensive income	
Unrealized holding gain, net of tax	<u>30,000</u>
Comprehensive Income	<u><u>\$140,000</u></u>

ILLUSTRATION 4-19
One Statement Format:
Comprehensive Income

Two-Statement Approach

Illustration 4-20 shows the two statement format based on the above information for V. Gill. Reporting comprehensive income in a separate statement indicates that the gains and losses identified as other comprehensive income have the same status as traditional gains and losses.²³

V. GILL INC.	
INCOME STATEMENT	
FOR THE YEAR ENDED DECEMBER 31, 2012	
Sales revenue	\$800,000
Cost of goods sold	<u>600,000</u>
Gross profit	200,000
Operating expenses	<u>90,000</u>
Net income	<u><u>\$110,000</u></u>

V. GILL INC.	
COMPREHENSIVE INCOME STATEMENT	
FOR THE YEAR ENDED DECEMBER 31, 2012	
Net income	\$110,000
Other comprehensive income	
Unrealized holding gain, net of tax	<u>30,000</u>
Comprehensive income	<u><u>\$140,000</u></u>

ILLUSTRATION 4-20
Two Statement Format:
Comprehensive Income

Statement of Stockholders' Equity

In addition to a comprehensive income statement, companies also present a **statement of stockholders' equity** (often referred to as statement of changes in stockholders' equity). This statement reports the changes in each stockholder's equity account and in total

²³Companies are not required to present net income at the beginning of the second statement because net income is reported in the first statement. In that situation, the second statement is referred to as the other comprehensive income statement.

stockholders' equity during the year. Companies often prepare **in columnar form** the statement of stockholders' equity. In this format, they use columns for each account and for total stockholders' equity. Stockholders' equity is generally comprised of contributed capital (common and preferred stock and additional paid-in capital), retained earnings, and the accumulated balances in other comprehensive income. The statement reports the change in each stockholders' equity account and in total equity for the period. The following items are disclosed in this statement.

1. Contributions (issuances of shares) and distributions (dividends) to owners.
2. Reconciliation of the carrying amount of each component of stockholders' equity from the beginning to the end of the period.

To illustrate, assume the same information for V. Gill (on pages UP-4 and UP-5). The company has the following stockholder equity account balances at the beginning of 2012: Common Stock \$300,000; Retained Earnings \$50,000; and Accumulated Other Comprehensive Income \$60,000. No changes in the Common Stock account occurred during the year. Illustration 4-21 shows a statement of stockholders' equity for V. Gill.

ILLUSTRATION 4-21
Presentation of Comprehensive Income in Stockholders' Equity Statement

V. GILL INC.				
STATEMENT OF STOCKHOLDERS' EQUITY				
FOR THE YEAR ENDED DECEMBER 31, 2012				
	<u>Total</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Income</u>	<u>Common Stock</u>
Beginning balance	\$410,000	\$ 50,000	\$60,000	\$300,000
Net income	110,000	110,000		
Other comprehensive income				
Unrealized holding gain, net of tax	30,000		30,000	
Ending balance	<u>\$550,000</u>	<u>\$160,000</u>	<u>\$90,000</u>	<u>\$300,000</u>

Balance Sheet Presentation

Regardless of the display format used, V. Gill reports the **accumulated other comprehensive income** of \$90,000 in the stockholders' equity section of the balance sheet as follows.

ILLUSTRATION 4-22
Presentation of Accumulated Other Comprehensive Income in the Balance Sheet

V. GILL INC.	
BALANCE SHEET	
AS OF DECEMBER 31, 2012	
(STOCKHOLDERS' EQUITY SECTION)	
Stockholders' equity	
Common stock	\$300,000
Retained earnings	160,000
Accumulated other comprehensive income	<u>90,000</u>
Total stockholders' equity	<u>\$550,000</u>

By providing information on the components of comprehensive income, as well as accumulated other comprehensive income, the company communicates information about all changes in net assets. With this information, users will better understand the quality of the company's earnings.

SUMMARY OF LEARNING OBJECTIVE

8 Explain how to report other comprehensive income. Companies report the components of other comprehensive income in one of two ways: (1) a single statement of comprehensive income (one statement format) or (2) in a second statement (two statement format).

QUESTION

34. What are the two ways that other comprehensive income may be displayed (reported)?

BRIEF EXERCISE

8 **BE4-11** On January 1, 2012, Richards Inc. had cash and common stock of \$60,000. At that date, the company had no other asset, liability, or equity balances. On January 2, 2012, it purchased for cash \$20,000 of equity securities that it classified as available-for-sale. It received cash dividends of \$3,000 during the year on these securities. In addition, it has an unrealized holding gain on these securities of \$4,000 net of tax. Determine the following amounts for 2012: (a) net income; (b) comprehensive income; (c) other comprehensive income; and (d) accumulated other comprehensive income (end of 2012).

EXERCISES

8 **E4-14 (Comprehensive Income)** Armstrong Corporation reported the following for 2012: net sales \$1,200,000; cost of goods sold \$720,000; selling and administrative expenses \$320,000; and an unrealized holding gain on available-for-sale securities \$15,000.

Instructions

Prepare a statement of comprehensive income, using (a) the one statement format, and (b) the two statement format. (Ignore income taxes and earnings per share.)

8 **E4-15 (Comprehensive Income)** Bryant Co. reports the following information for 2012: sales revenue \$750,000; cost of goods sold \$500,000; operating expenses \$80,000; and an unrealized holding loss on available-for-sale securities for 2012 of \$50,000. It declared and paid a cash dividend of \$10,000 in 2012.

Bryant Co. has January 1, 2012, balances in common stock \$350,000; accumulated other comprehensive income \$80,000; and retained earnings \$90,000. It issued no stock during 2012.

Instructions

Prepare a statement of stockholders' equity.

8 **E4-16 (Various Reporting Formats)** The following information was taken from the records of Gibson Inc. for the year 2012: income tax applicable to income from continuing operations \$119,000; income tax applicable to loss on discontinued operations \$25,500; income tax applicable to extraordinary gain \$32,300; income tax applicable to extraordinary loss \$20,400; and an unrealized holding gain on available-for-sale securities \$15,000.

Extraordinary gain	\$ 95,000	Cash dividends declared	\$ 150,000
Loss on discontinued operations	75,000	Retained earnings January 1, 2012	600,000
Administrative expenses	240,000	Cost of goods sold	850,000
Rent revenue	40,000	Selling expenses	300,000
Extraordinary loss	60,000	Sales revenue	1,700,000

Shares outstanding during 2012 were 100,000.

Instructions

- (a) Prepare a multiple-step income statement.
- (b) Prepare a statement of comprehensive income for 2012, using the one statement format.
- (c) Prepare a retained earnings statement for 2012.

CONCEPTS FOR ANALYSIS

CA4-9 (Comprehensive Income) Willie Nelson, Jr., controller for Jenkins Corporation, is preparing the company's financial statements at year-end. Currently, Nelson is focusing on the income statement and determining the format for reporting comprehensive income. During the year, the company earned net income of \$400,000 and had unrealized gains on available-for-sale securities of \$15,000. In the previous year, net income was \$410,000, and the company had no unrealized gains or losses.

Instructions

- (a) Show how income and comprehensive income will be reported on a comparative basis for the current and prior years, using the two statement format.
- (b) Show how income and comprehensive income will be reported on a comparative basis for the current and prior years, using the one statement format.
- (c) Which format should Nelson recommend?

SECURITIES REPURCHASES (REPO 105)

In this section, we discuss the recent accounting standards update for repurchase agreements (as discussed in Chapter 7, *Cash and Receivables*), in response to the controversial **Lehman Brothers'** Repo 105 transactions. A revised footnote 15 (page 389) in Chapter 7 is provided.

Background

On September 15, 2008, **Lehman Brothers** filed for bankruptcy—the largest in U.S. history. Lehman was a victim of the 2008 financial crisis that even today continues to affect global markets. Lehman's bankruptcy was an important event in this crisis because it was the fourth largest investment bank in the country. Its downfall raised serious questions about the valuations of financial instruments in other financial institutions' balance sheets.

Many reasons are given for Lehman's demise, such as too much leverage, toxic assets, poor management, excessive risk strategies, and loss of investor confidence. However, Lehman also used accounting devices that led to less-than-accurate accounting and misleading financial statements. As a result, the FASB recently issued a new standard that addresses the accounting and reporting for the types of financial transactions used by Lehman.

The Main Issue

In a number of business situations, companies must determine whether a transaction should be accounted for as a sale or a borrowing. For example, if a company sells a product in one period and agrees to buy it back in the next period, has the company sold the product? As indicated in Chapters 8 and 18 of *Intermediate Accounting*, in most cases, the economic substance of these sales with buybacks (repurchase agreements) are that the seller retains the risk of ownership. In other words, if the seller has an obligation to take back merchandise subsequent to the sale, it is appropriate to account for the transaction as a borrowing. The issue is important from a financial reporting perspective. If the transaction is a borrowing, cash is increased and a liability is reported, which increases a company's leverage (e.g., its debt to equity ratio). Conversely, if the transaction is a sale, assets are increased, no additional debt is reported, and the company may use its cash to reduce existing debt (reducing its debt to equity ratio). In addition, revenue is increased.

Many of the same issues surfaced with **Lehman Brothers** and its use of repurchase agreements for financial assets, often referred to as "repos." A repo is a two-step transaction that is often used to obtain short-term funding. In the first step, Lehman (often referred to as the transferor) transfers securities or other assets to a counterparty (e.g., **Barclays Bank**) in exchange for cash. Lehman agrees to reacquire the transferred assets at a future date for an amount equal to the cash exchanged plus a charge similar to interest. In the second stage, Lehman pays Barclays the original cash amount plus the interest, and Barclays returns the originally transferred assets. In this case, the repo is accounted for as a loan by Lehman. Lehman executed many of these types of transactions between 2000 and 2008.

However, Lehman developed another type of repo called Repo 105. Lehman accounted for its Repo 105 transactions as sales. By carefully structuring the Repo 105 to get around the GAAP rules for repos, it was able to derecognize the assets transferred and to use the cash received to pay down other liabilities. As a result of this accounting, Lehman reported lower assets and liabilities (and lower leverage) even though it had an obligation to repurchase the assets. Lehman used Repo 105 transactions because management believed that its leverage was too high and that it would be penalized in the marketplace. At the same time, many questioned whether the accounting (and the lack of disclosure) used by Lehman, which allowed it to report lower leverage, was in accordance with GAAP.

GAAP and Repos

As discussed in Chapter 7 of *Intermediate Accounting*, the accounting for a repurchase agreement is addressed in the accounting rules for securitizations and other transfers of financial assets and collateral. These rules (FASB ASC 860-40) indicate that the degree of control that the transferor has over the asset determines whether a transferred asset is properly accounted for as a sale or a borrowing.

If the transferor retains control over the asset, it recognizes the asset on its balance sheet. If the transferor surrenders control, those assets are accounted for as a sale and derecognized. A transferor surrenders control over a transferred asset—and therefore may treat the transaction as a sale—only if (see Illustration 7-22 on page 389):

- (a) The transferred **assets have been isolated from the transferor**, put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership;
- (b) The **transferee has the right to pledge or exchange the assets** it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange the asset and provides more than a trivial benefit to the transferor; and
- (c) The **transferor does not maintain effective control over the transferred assets** through either (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity, or (2) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call.

In summary, the FASB concludes that if the above three conditions are met, the seller has surrendered control of the assets to the buyer and that the transfer can be recorded as a sale (assets and liabilities derecognized and gain or loss recorded in income). **If any of the criteria are not met, the transfer is recorded as a borrowing, with assets and liabilities still on the books.¹ The typical repo transaction is reported as a borrowing.**

Concerns about Repo 105

Repo 105 derives its name from the fact that Lehman transferred at least \$105 in assets to its counterparty for every \$100 in cash it received. In other words, Lehman took a haircut on the deal. The deal did not make sense unless Lehman had the motive of reducing its leverage from this transaction. Lehman then argued that because it gave its counterparties \$105 in assets for \$100 in cash, that it is giving up control because it may not have the resources to repurchase the assets transferred. In other words, Lehman and its auditors concluded that in a Repo 105 transaction Lehman **did not obtain cash or other collateral in these transactions sufficient to fund “substantially all” of the cost of replacing the assets** it had transferred to its counterparties. That is, Lehman did not maintain effective control over the transferred assets, and sale accounting can be applied.

Many believe that the Lehman Repo 105 transactions do not meet the GAAP requirements for sale treatment. Those critical of Lehman’s accounting for the Repo 105 transactions were concerned that (1) Lehman was obligated contractually to repurchase the Repo 105 assets (violating paragraph (c) above) and (2) Lehman was not able to obtain a “true sale at law” opinion from a U.S. law firm but only from a U.K. law firm (raising questions about the whether the provisions in paragraph (a) above were met).

These critics also assert that the transactions lacked a business purpose or economic substance. Rather, these critics note that Lehman entered into these transactions in order

¹These provisions are analogous to rules governing sales with buyback agreements. If the risk and rewards are transferred because the product can be returned, recognition of the revenue is deferred until the obligation related to the return privilege expires.

to “window dress” its balance sheet through Repo 105. In other words, it reported lower liabilities by not recording the obligation to return the purchased assets in the next period.

Did Lehman Violate GAAP?

Following extensive analysis, a federal court concluded that Lehman’s accounting for Repo 105 transactions were in accordance with GAAP.² First, although Lehman’s alleged contractual obligation to repurchase the transferred Repo 105 assets initially might be thought to violate GAAP’s requirements, the court concluded otherwise.

Rather, under the Repo 105 terms, the court noted that Lehman **did not obtain cash or other collateral in these transactions sufficient to fund “substantially all” of the cost of replacing the assets** it had transferred to its counterparties. That is, Lehman did not maintain effective control over the transferred assets, and sale accounting can be applied.

Second, the fact that Lehman allegedly was unable to obtain a “true sale at law” opinion from a U.S.-based law firm does not call into question the conclusion of a U.K.-based law firm that the transactions were, in fact, true sales at law under U.K. law. Nothing in GAAP requires the true sale at law opinion to be based on U.S. law.

Finally, nothing in GAAP suggests that the business purpose of a transfer has any bearing on whether it should be treated as a sale or as a financing. Rather, the guiding principle is whether the transferor has retained control over the asset. Thus, an allegation that Lehman had less-expensive means of obtaining financing says nothing about whether its accounting treatment of the Repo 105 transactions was consistent with GAAP.

In summary, the court concluded that the Lehman Repo 105 was accounted for in accordance with GAAP—as a sale of the assets.

Observations

While the court concluded that Lehman’s accounting for the Repo 105 transactions technically complied with GAAP, it did not agree that Lehman’s *financial statements* complied with GAAP. That is, GAAP recognizes that technical compliance with accounting rules may lead to misleading financial statements. As a result, GAAP imposes an overall requirement that the statements as a whole accurately reflect the financial status of the company.

The broader concern with the use of Repo 105 was that the financial statements were misleading because the Repo 105 transactions temporarily and artificially lowered the company’s reported leverage at the end of each reporting period. Specifically, under Repo 105, Lehman used the cash it received to pay down other liabilities. As a consequence, the Repo 105 transactions reduced the amounts of Lehman’s net assets while leaving its tangible equity capital unchanged, resulting in lower reported leverage. For example, Lehman hid \$39 billion at the end of the fourth quarter of 2007, \$49 billion in the first quarter of 2008, and \$50 billion in the second quarter of 2008.

However, Lehman was obligated to, and did, repurchase the assets from the Repo 105 counterparties in the days after each quarter ended. This increased its net assets without any change to tangible equity capital, resulting in increases in leverage. This repetitive, temporary, and undisclosed reduction of leverage at the end of each quarter allowed Lehman to portray its leverage more favorably than its financial position warranted, a circumstance that resulted in the published balance sheet for that quarter being inconsistent with GAAP’s overall requirement of fair presentation.

²Opinion of UNITED STATES DISTRICT COURT, SOUTHERN DISTRICT OF NEW YORK; Re: LEHMAN BROTHERS SECURITIES AND ERISA LITIGATION (Document 09 MD 2017 (LAK), July 27, 2011).

New GAAP Requirements

Although Lehman was cited for misrepresenting its financial statements, the conclusion that its accounting for Repo 105 was in accordance with GAAP raises issues about the rules governing transfers like those in Repo 105. The FASB responded to these concerns in a recent standards update [Accounting Standards Update 2011-03, Transfers and Servicing (Topic 860): *Reconsideration of Effective Control for Repurchase Agreements* (April 2011)]. The new rules retain the control criterion but remove the requirement that the transferor has the ability to repurchase or redeem financial assets on substantially the same terms, even in the event of default by the transferee. The Board concluded that this criterion is not a determining factor of effective control. The amendments also eliminate the requirement to demonstrate that the transferor possesses adequate collateral to fund substantially all the cost of purchasing replacement financial assets. Eliminating the transferor's ability criterion from the assessment of effective control will block the use of repurchase agreements similar to Repo 105. These new rules should improve the accounting for repos and other similar transactions.³

Evaluation of the detailed provisions of the control criterion in repurchase situations is beyond the scope of intermediate accounting. For instructors who wish to discuss the Repo 105 structure, they can provide students the discussion in this Update. In addition, the following text can be added to footnote 15 (page 387) in Chapter 7 of *Intermediate Accounting*:

In response to the use of repurchase agreements by some financial institutions during the financial crisis (e.g., **Lehman Brothers'** Repo 105) to "window-dress" their balance sheets and show lower leverage, the FASB also recently issued new guidance on transfers of assets in repurchase agreements [Accounting Standards Update 2011-03, Transfers and Servicing (Topic 860): *Reconsideration of Effective Control for Repurchase Agreements* (April 2011)]. The new rules tighten the requirements for meeting the control criterion, which raises the bar for companies to be able to assert sale accounting in a repurchase agreement.

³The IASB's derecognition guidance is provided under IAS 39, "Financial Instruments: Recognition and Measurement." The consideration of a transferor's ability to repurchase or redeem financial assets transferred on substantially agreed terms, even in the event of default by the transferee, is not required under IFRS. The amendments in this Update improve convergence by eliminating from GAAP the need to consider this criterion.

OPTIONAL STEP IN GOODWILL IMPAIRMENT TESTING

The discussion in this section addresses a recent standards update related to goodwill impairment testing. A new footnote is provided to insert on page 679 of Chapter 12 (Intangible Assets).

The FASB has issued an accounting standard [(Accounting Standards Update, Intangibles—Goodwill and Other (Topic 350): *Testing Goodwill for Impairment*), September 2011] which introduces an optional step in the goodwill impairment evaluation process. Under these new rules, companies may perform an optional **qualitative** assessment to determine whether it is more likely than not (i.e., a likelihood of more than 50 percent) that the fair value of its reporting unit is less than its carrying amount. If the qualitative assessment indicates the fair value of the reporting unit is not likely to be less than the carrying value, the company need not continue with the two-step impairment test.

Qualitative Assessment Factors

The new guidance includes examples of events and circumstances that a company should consider in evaluating whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. The events and circumstances include the following:

- Macroeconomic conditions such as a deterioration in general economic conditions, limitations on accessing capital, fluctuations in foreign exchange rates, or other developments in equity and credit markets.
- Industry and market considerations such as a deterioration in the environment in which a company operates, an increased competitive environment, a decline (both absolute and relative to its peers) in market-dependent multiples or metrics, a change in the market for a company's products or services, or a regulatory or political development.
- Cost factors such as increases in raw materials, labor, or other costs that have a negative effect on earnings.
- Overall financial performance such as negative or declining cash flows or a decline in actual or planned revenue or earnings.
- Other relevant company-specific events such as changes in management, key personnel, strategy, or customers; contemplation of bankruptcy; or litigation.
- Events affecting a reporting unit such as a change in the carrying amount of its net assets, a more-likely-than-not expectation of selling or disposing all (or a portion of) a reporting unit, the testing for recoverability of a significant asset group within a reporting unit, or recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit.
- If applicable, a sustained decrease (both absolute and relative to its peers) in share price.

Evaluation Process

None of these factors, by themselves, indicate that Step 1 of the goodwill impairment test should or should not be performed. Rather, a company must consider the significance of each of these events or circumstances to the estimated fair value of its reporting unit. Also, a company should consider positive and mitigating events and circumstances that may affect its determination of whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If a company determines (after assessing these factors) that it is more likely than not that the fair value of a reporting unit

is greater than its carrying amount, it need not to do any further testing. Given the subjective nature of this qualitative assessment, companies must document the rationale for their conclusions about whether the existence of one or more factors makes it more likely than not that the fair value of a reporting unit is less than its carrying amount.

Summary

A number of preparers had complained about the complexity and cost of performing the two-step goodwill impairment test. In particular, private companies found that it was difficult and time-consuming to determine the fair value of reporting units at each annual reporting date (Step 1). In situations where it is more likely than not that the reporting unit carrying value is less than the fair value (and hence goodwill is not impaired), introduction of the qualitative assessment should reduce both the cost and complexity of performing the goodwill impairment test. Instructors may add the following footnote as indicated to the discussion in Chapter 12 (page 679) of *Intermediate Accounting* (footnote 10 then becomes footnote 10b):

“. . . Kohlbuy determines that the fair value of Pritt Division is \$2,800,000. **Because the fair value of the division exceeds the carrying amount of the net assets, Kohlbuy does not recognize any impairment.**^{10a}”

^{10a}Under a recent Accounting Standards Update, Intangibles—Goodwill and Other (Topic 350): *Testing Goodwill for Impairment* (September 2011), the FASB gives companies the option to perform a qualitative assessment to determine whether it is more likely than not (i.e., a likelihood of more than 50 percent) that the fair value of its reporting unit is less than its carrying amount.

Examples of events and circumstances to be evaluated include but are not limited to (1) deterioration in the environment in which a company operates, an increased competitive environment, a decline (both absolute and relative to its peers) in market-dependent multiples or metrics, a change in the market for a company’s products or services, or a regulatory or political development; (2) cost factors such as increases in raw materials, labor, or other costs that have a negative effect on earnings; and (3) overall financial performance such as negative or declining cash flows or a decline in actual or planned revenue or earnings.

If the qualitative assessment indicates that the fair value of the reporting unit is more likely than not to be greater than the carrying value, the company need not continue with the two-step impairment test. As a result, introduction of the qualitative assessment should reduce both the cost and complexity of performing the goodwill impairment test.

TRoubLED DEBT RESTRUCTURINGS

In this section, we explain the new rules on when a debt restructuring is “troubled.” A replacement footnote is provided for footnote 15 on page 811 in Chapter 14.

As indicated in Appendix 14A in *Intermediate Accounting*, a troubled debt restructuring (TDR) occurs when a 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.” Given the recent financial crisis, the volume of TDRs has increased and concern is expressed that the criteria for determining a TDR are not being applied consistently. For example, a financial institution like **Wells Fargo** may agree to restructure a debt to defer interest or principal payment, extend the maturity, or request additional collateral on an existing loan. Diversity in practice has resulted where some companies may consider these transactions as evidence of a TDR and others may not. As a result, the FASB issued Accounting Standards Update 2011-02, Receivables (Topic 310): *A Creditor’s Determination of Whether a Restructuring Is a Troubled Debt Restructuring*, to help determine when a trouble debt restructuring occurs.

Implications of New Rule

The new rule provides additional guidance for determining whether a TDR has occurred by clarifying when the creditor has granted a concession and whether the debtor is experiencing financial difficulty. As a result of this rule, creditors will likely determine that more restructurings are troubled debt restructurings. Because GAAP requires specific impairment-measurement methods and additional disclosure for TDRs, this rule will lead to increases in loan losses and related increases in receivable allowances (reductions in book value of the receivables). This rule will have its biggest impact on financial institutions, notably banks.

Guidance

The guidance provided in the new rule is extremely technical and beyond the scope of *Intermediate Accounting*. In essence, the guidance helps a creditor determine when a customer is experiencing financial difficulty even if it has not defaulted on the loan. It also specifies that if a borrower cannot access funds at a market rate for a new loan, then a modification at a below-market rate is a concession. In both cases, this may lead to the loan being classified as a trouble debt restructuring.

Update to Textbook

The text of footnote 15 (page 811) in Chapter 14 should be replaced with the following:

¹⁵Recently, the FASB issued Accounting Standards Update 2011-02, Receivables (Topic 310): *A Creditor’s Determination of Whether a Restructuring Is a Troubled Debt Restructuring*, to help determine when a trouble debt restructuring (TDR) occurs. The new rule provides additional guidance for determining whether a TDR has occurred by clarifying when the creditor has granted a concession and whether the debtor is experiencing financial difficulty. As a result of this rule, creditors will likely determine that more restructurings are troubled debt restructurings, which will lead to more losses on receivables being reported.

FAIR VALUE MEASUREMENT

The discussion in this section relates to updated fair value measurement and disclosure guidance (a joint project with the IASB). This material supplements the discussion in Appendix C of Chapter 17 (Investments).

In 2011, the FASB issued Accounting Standards Update 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS*. At the same time, the IASB issued a nearly identical standard on the same subject. This standard is the culmination of over five years of deliberation on this subject and represents a major convergence effort on the part of the two Boards. This standard helps address the issues surrounding the use of fair values in financial statements and is a step forward in helping to solve problems that arose in the 2008 global credit crisis.

These new requirements do not change the guidance on when to use fair values but instead provide guidance on how fair value should be applied if presently required or permitted by other financial reporting standards.

For GAAP, these new requirements update existing requirements on fair value measurement and disclosure. A major benefit of the new requirements is to provide a better definitional structure of what is meant by fair value and an understanding of how fair values should be measured and disclosed. For the most part, this standard will not change current practice, except in the areas of disclosures about the assumptions used in fair value measurements.

The new guidelines require enhanced disclosures with special emphasis on Level 3 measurements. These disclosures are as follows.

- 1.** Quantitative information about significant unobservable inputs used for all Level 3 measurements.
- 2.** A qualitative discussion about the sensitivity of recurring Level 3 measurements to changes in the unobservable inputs disclosed, including interrelationships between inputs.
- 3.** A description of the company's valuation process.
- 4.** Any transfers between Levels 1 and 2 of the fair value hierarchy.
- 5.** Information about nonfinancial assets measured at fair value at amounts that differ from its highest and best use.
- 6.** The proper hierarchy classification for items that are not recognized on the balance sheet but are disclosed in the notes to the financial statements.

A typical disclosure is as follows.

(\$ in millions)	Fair Value at 12/31/2012	Valuation Technique(s)	Unobservable Input	Range (Weighted-Average)
Residential mortgage-backed securities	125	Discounted cash flow	Constant prepayment rate Probability of default Loss severity	3.5%–5.5% (4.5%) 5%–50% (10%) 40%–100% (60%)
Collateralized debt obligations	35	Consensus pricing	Offered quotes Comparability adjustments (%)	20–45 –10%–+15% (+5%)
Direct venture capital investments: Health care	53	Discounted cash flow	Weighted-average cost of capital Long-term revenue growth rate Long-term pretax operating margin Discount for lack of marketability ^a Control premium ^a	7%–16% (12.1%) 2%–5% (4.2%) 3%–20% (10.3%) 5%–20% (17%) 10%–30% (20%)
		Market-comparable companies	EBITDA multiple ^b Revenue multiple ^b Discount for lack of marketability ^a Control premium ^a	6.5–12 (9.5) 1.0–3.0 (2.0) 5%–20% (10%) 10%–20% (12%)
Credit contracts	38	Option model	Annualized volatility of credit ^c Counterparty credit risk ^d Own credit risk ^d	10%–20% 0.5%–3.5% 0.3%–2.0%

^aRepresents amounts used when the reporting entity has determined that market participants would take into account these premiums and discounts when pricing the investments.
^bRepresents amounts used when the reporting entity has determined that market participants would use such multiples when pricing the investments.
^cRepresents the range of the volatility curves used in the valuation analysis that the reporting entity has determined market participants would use when pricing the contracts.
^dRepresents the range of the credit default swap spread curves used in the valuation analysis that the reporting entity has determined market participants would use when pricing the contracts.
(Note: For liabilities, a similar table should be presented.)

Quantitative Information about Level 3 Fair Value Measurements

An important positive development of this fair value document is the convergence of fair value requirements for both GAAP and IFRS. As the former chair of the IASB noted, this “marks the completion of a major convergence project and is a fundamentally important element of our joint response to the global crisis. The result is clearer and more consistent guidance on measuring fair value, where its use is already required.”

PROPOSED PROJECTS

OFFSETTING

In this section, we discuss the FASB's proposed new guidance on offsetting (or netting) of financial assets and liabilities. This discussion is relevant to discussions in Chapters 7 (Cash and Receivables), 13 (Current Liabilities), and 17 (Investments).

Background

Why are accounts payable not offset against cash on the balance sheet? Or, why is long-term debt used to finance equipment not netted against the equipment on the balance sheet? The rationale: Offsetting of recognized assets and recognized liabilities detracts from the ability of users to understand the transactions and conditions that have occurred and to assess the company's future cash flows. In other words, providing information on assets, liabilities, and stockholders' equity helps users to compute rates of return and evaluate capital structure. As a result, the FASB does not permit the reporting of summary accounts alone (e.g., total assets, net assets, and total liabilities). Instead, companies should report and classify individual items in sufficient detail to permit users to assess the amounts, timing, and uncertainty of future cash flows.

As indicated in *Intermediate Accounting*, the objective of financial reporting requires providing information about the economic resources (assets) and the claims against these resources (liabilities). Netting assets and liabilities limits a user's ability to assess the future economic benefits and obligations. It therefore becomes difficult to assess a company's financial strengths and weakness. In short, offsetting hides the existence of assets and liabilities, making it difficult to evaluate liquidity, solvency, and financial flexibility.

Present Direction

To be consistent with the objective of financial reporting, the FASB presently restricts the use of offsetting to a very limited set of circumstances. The transaction in which offsetting generally takes place occurs in the derivative area.

The issue is whether companies with derivative transactions, which are subject to a master netting agreement, can present the derivatives on a net basis. Under GAAP, companies are now permitted to net the asset and liability related to these types of contracts. Others, particularly in the international arena, favor a gross approach where both the asset and liability are reported on the balance sheet and not netted together.

Proposal

A recent exposure draft requires that a company offset a recognized financial asset and a recognized financial liability if a company (1) has an unconditional right of offset and (2) intends to either settle the asset and liability on a net basis or realize that asset and settle the liability simultaneously. The right of offset must be legally enforceable in all circumstances. Due to the nature of most master netting arrangements, the conditions for offsetting would no longer be met for most U.S. companies. As a result, balance sheets (particularly for financial institutions) would be substantially larger as the gross asset and gross liability of the derivative transaction would have to be reported.

The exposure draft also requires additional disclosures related to the right of offset. Proposed offsetting disclosures are designed to:

- 1.** Provide information about rights of set-off and related arrangements (such as collateral arrangements) associated with the entity's financial assets and financial liabilities to enable users of its financial statements to understand the effect of those rights and arrangements on the entity's financial position;
- 2.** Indicate that netting applies only to instruments under an enforceable master netting agreement or similar arrangement (e.g., derivatives, sale and repurchase agreements, reverse sale and repurchase agreements, securities lending arrangements); and
- 3.** Clarify that an entity need not provide the required disclosures if the entity "has no qualifying assets or liabilities that are subject to a right of set-off (other than collateral agreements) at the reporting date."

Specific proposed disclosures include:

- (a)** The gross amounts of financial assets and financial liabilities;
- (b)** The amounts of financial assets and financial liabilities offset in the statement of financial position;
- (c)** The net amount after taking in account (a) and (b) (which should be the same as the amounts reported in the statement of financial position);
- (d)** The effect of rights of set-off that are only enforceable and exercisable in bankruptcy, default, or insolvency of either party not taken into account in arriving at the amounts presented in the statement of financial position (including collateral); and
- (e)** The net exposure after taking into account the effect of items (b) and (d).

In addition, where conditional rights of offset exist, but the amounts are still reported gross, the net amounts will have to be disclosed.

FINANCIAL INSTRUMENTS

This section contains a summary of the FASB's project on financial instruments, which is a joint project with the IASB. This discussion relates to discussions of loans and impairments in Chapter 7 (Cash and Receivables), financial liabilities in Chapter 14 (Long-Term Liabilities), and investments in Chapter 17 (Investments).

Background

As discussed in *Intermediate Accounting*, a **financial instrument** is cash, an equity investment of another company, or a contractual right to receive cash from (or obligation to pay cash to) another party (e.g., loans, receivables, and bonds). The accounting for cash is relatively straightforward and is discussed in Chapter 7. The accounting and reporting for equity and debt investments, as discussed in the opening story of Chapter 17, is extremely contentious, particularly in light of the credit crisis in the latter part of 2008.

Some users of financial statements support a single measurement—fair value—for all financial instruments. They view fair value as more relevant than other measurements in helping investors assess the effect of current economic events on the future cash flows of the asset. In addition, they believe that the use of a single method promotes consistency in valuation and reporting on the financial asset, thereby improving the usefulness of the financial statements. Others disagree. They note that many investments are not held for sale but rather for the income they will generate over the life of the investment. They believe cost-based information (referred to as *amortized cost*) provides the most relevant information for predicting future cash flows in these cases. Others express concern that using fair value information to measure financial assets is unreliable when markets for the investments are not functioning in an ordinary fashion.

The FASB is working on a project to improve and simplify the accounting for financial instruments. The Board is examining the comments received on an exposure draft it issued in 2010. It hopes to issue a final standard on the classification and measurement of financial instruments in late 2011. A final standard on hedging will not be issued until 2012. The discussion in the following sections reflects decisions made at the time this Update is going to press. These decisions may be changed in the final standard.

Classification and Measurement—A Closer Look

The proposed guidance applies to financial assets and liabilities, including loans and receivables, investments in debt and equity securities, and the debt issued by a company. The general measurement principle is either fair value or amortized cost.¹ If a company has both a business strategy whose objective is to hold assets in order to collect contractual cash flows and the contractual terms of the financial asset provides specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding, then the company should use amortized cost. If the criteria for measurement at amortized cost are not met, then the financial instruments are valued and accounted for at fair value.

Where unrealized gains and losses on fair value financial assets are recorded depends on the business strategy for holding those securities. If the securities are held for trading, then gains and losses are recorded in income (FV-NI). Gains and losses on

¹At initial recognition, the fair value of a financial instrument is normally the transaction price. In certain circumstances, a company is required to evaluate whether the consideration given or received at initial recognition for a financial instrument that is not otherwise required to be initially measured at fair value (e.g., a transaction cost such as a brokerage fee) indicates that an element other than the financial instrument is included in the transaction.

financial assets not held for trading are recorded in other comprehensive income (FV-OCI). There is no fair value option for financial assets.

Classification of financial liabilities is based on the characteristics of the financial liability, and the business strategy criterion is different from that used for financial assets. Reporting of changes in fair value of a financial liability through the comprehensive income category is not permitted, but a fair value option is available for financial liabilities (only in certain limited circumstances).² The illustration below provides a summary of the proposed model.

Measurement Classification	Business Strategy Criterion	Characteristics of Instrument (Applies to):
Fair Value through Net Income (measure at fair value with gains and losses recorded in income)	Does not meet the business model test (not held-for-collection)	Debt assets, equity assets, and liabilities
Fair Value through Other Comprehensive Income (measure at fair value with gains and losses recorded in other comprehensive income)	Held for special reasons (e.g., hedging)	Debt assets and equity assets
Amortized Cost	Held for collection of contractual cash flows (held-for-collection)	Only debt assets and liabilities

Summary of the Proposed Classification and Measurement Model

As indicated, the proposed model uses both the asset characteristics and the company's business strategy to determine the accounting. The proposed model is similar to the current model, which is based on management intent (held-to-maturity, trading, and available-for-sale). However, as discussed in the following sections, the proposal is more general in that it applies to most financial assets and liabilities. Therefore, more financial instruments are measured at fair value, compared to the current model.³

Application of the Model—Financial Assets

Characteristics of the Instrument Criterion

As indicated above, the proposed model classifies financial assets based on the characteristics of the financial instrument and the entity's business strategy for managing the instruments. Debt instruments are characterized by contractual payments on specified dates of principal and interest on the principal amount outstanding. As a result, only debt instruments have the characteristics that permit use of amortized cost as the measurement approach if the company's strategy is to hold the security for collection of the contractual cash flows.

For example, if **JPMorgan Chase** makes a loan to **IBM**, it will receive contractual cash flows of interest over the life of the loan and repayment of the principal at maturity. If it is Chase's strategy to hold this loan in order to receive these cash flows over the life of the loan, it has a held-for-collection strategy and it will measure the loan at amortized cost.

In applying the model, the characteristics criterion is applied first. **Financial assets that do not meet the characteristics criterion are measured at fair value.** Such financial

²One major area not yet addressed is the presentation and disclosure requirements. The Board has indicated that it would like disclosures to provide more information about the underlying risk of financial instruments.

³The IASB has already issued its classification and measurement guidance in *IFRS 9*; its provisions are similar to the FASB's proposal. The IASB has indicated it will expose the FASB's final classification and measurement proposals to its constituents to improve convergence between GAAP and IFRS.

assets are then classified based on the company's business strategy (discussed in the next section) used to manage the assets and are accounted for at fair value, either through net income or other comprehensive income.⁴

Equity assets do not meet the characteristics criterion. The Board has tentatively decided that **most investments in equity securities not accounted for under the equity method should be classified and measured at fair value with any gain or loss recorded in net income.**⁵

Business Strategy Criterion

After assessing the financial instruments' characteristics criterion, companies classify debt assets based on how the instruments are managed. The business strategy criterion is applied at a company or a business unit level (higher level of aggregation), rather than on management's intent for individual financial instruments (as is the case under current guidance). For example, a bank like **Wells Fargo**, with separate commercial and investment banking units, may classify the same or similar assets held in those divisions differently if the business strategy differs. The commercial banking unit's strategy may be to make loans and collect contractual interest and principal payments. The investment banking unit's strategy may be to generate profits by actively buying and selling securities. The commercial banking unit's loans are classified and measured at amortized cost, while the investment banking unit's securities are classified and measured at fair value and gains and losses affect net income.

Amortized Cost Category. Debt assets are classified and measured at amortized cost if all of the following conditions are met:

- The company's business strategy, at origination or acquisition of the assets, is to manage them through customer financing or lending activities. These activities primarily focus on the collection of substantially all of the contractual cash flows from the borrower.
- The holder of the instrument has the ability to manage credit risk by negotiating any potential adjustment of contractual cash flows with the counterparty in the event of a potential credit loss. Sales or settlements are limited to circumstances that minimize losses due to deteriorating credit.
- The financial assets are not held for sale at acquisition.

Thus, for a company like **JPMorgan Chase**, the primary strategy for its lending business is to fulfill financing needs of customers and generate interest income. JPMorgan generally engages in this business activity by lending with a long-term view and an expectation of the collection of principal at maturity. In this case, accounting for its loans at amortized costs provides the most useful information on its lending activities.

⁴The characteristics criterion is applied at the individual asset level. The business strategy criterion, however, is assessed at a higher level in the organization. The FASB also clarified that companies can classify identical or similar financial instruments differently, depending on their business strategy for managing the instruments.

⁵A practicability exception is provided for investments in nonmarketable equity securities held by nonpublic entities. Under the exception, these securities are measured at cost, less any other-than-temporary impairment, with upward and downward adjustments to the carrying value when information about a change in price becomes observable. The impairment model for nonmarketable securities is based on assessment of qualitative factors (or impairment indicators). Companies assess the impairment indicators to determine whether it is more likely than not that the investment is impaired and, if so, an impairment loss is recognized in earnings equal to the difference between the investment's carrying value and its fair value.

Under current GAAP, selling investments accounted for at amortized cost (held-to-maturity) could “taint” the entire portfolio as to management’s intent. In that case, the entire portfolio may have to be reported at fair value. Under the proposed rules, selling an amortized-cost debt asset before maturity does not “taint” other financial assets classified and measured at amortized cost. However, if the level of sales becomes significant, a company must determine whether its business strategy for newly originated or acquired debt assets is to hold the assets for the collection of substantially all of the contractual cash flows.

When assets originally classified and measured at amortized cost are identified for sale, the assets continue to be classified and measured at amortized cost (less impairment). The impairment amount, equal to the difference between the assets’ amortized cost and fair value, is recognized immediately in earnings.⁶

Other Comprehensive Income Category. Debt assets are classified and measured at FV-OCI (fair value with gains and losses recorded in other comprehensive income) if (1) the financial assets are not held for sale at acquisition *and* (2) the financial assets are issued or acquired in as part of a business strategy to invest the cash for one of the following reasons:

- Maximize total return by collecting contractual cash flows or selling the asset.
- Manage the interest rate or liquidity risk of the entity by either holding or selling the asset (e.g., a derivative used for hedging).

For example, say a company such as **Ford** buys corporate bonds as an investment. It does not intend to engage in trading but may sell the bonds prior to maturity to meet its capital or liquidity needs. Its business strategy is therefore to invest and maximize returns. Under these circumstances, this bond investment is measured at FV-OCI. Or, a company like **Home Depot** may purchase or sell investments to manage its exposure to market shifts, economic cycles, interest rate risk, liquidity risk, capital needs, and other risks (e.g., hedging). It accounts for these investments at FV-OCI.⁷

FV-NI Category. Debt assets that meet either of the following conditions are classified and measured at FV-NI:

1. The financial assets are held for sale at acquisition; or
2. The financial assets are actively managed and monitored internally on a fair value basis but do not qualify for the FV-OCI category. This category includes assets held for trading, as is the case under current GAAP.

Application of the Model—Financial Liabilities

Under the proposed model, financial liabilities are classified and measured based on the same characteristics criterion as financial assets. However, a different business strategy criterion is used for financial liabilities.

The Board decided that a financial liability meeting the characteristics criterion is classified and measured at amortized cost except when the financial liability is (1) held for settlement or transfer at acquisition, (2) at issuance or inception and the company has the ability and means to transact at the liability’s fair value, or (3) a short sale. If the

⁶Generally, an individual holder of debt securities such as corporate bonds does not have the ability to manage credit risk by negotiating any potential adjustment of contractual cash flows with the counterparty in the event of a potential credit loss. As a result, **most debt securities would not be eligible for classification and measurement at amortized cost.**

⁷Thus, equity assets used in some hedging strategies are accounted for at fair value with gains and losses recorded in other comprehensive income.

financial liability meets any of the above conditions, it is classified and measured at fair value and gains and losses are recorded in net income.⁸ As indicated earlier, there is no FV-OCI category for liabilities.

Equity Method Investments

The FASB has tentatively decided to retain the current guidance for determining whether an investment in equity securities should be accounted for by the equity method. The FASB also tentatively decided that a **fair value option should not be permitted for equity method investments**.

Impairment of equity method investments is based on qualitative factors (or impairment indicators) that a company applies to determine whether the investment is impaired (i.e., whether fair value is less than carrying value). If so, an impairment charge is recognized in earnings to write down the carrying value to its fair value. The same impairment model is used for both marketable and nonmarketable equity method investments. Previously recognized impairment losses on equity method investments are not reversed.

Impairment

A significant accounting weakness revealed during the financial crisis relates to the accounting for loan losses (or allowance for doubtful accounts). The concern is that existing GAAP results in allowances for loan loss that tend to be at their lowest level when they are most needed at the beginning of a downward-trending economic cycle (the “too little, too late” concern). Therefore, the FASB is now working to develop a standard that ensures that the allowance for loan loss balance is sufficient to cover all estimated credit losses for the remaining life of an instrument.

The FASB indicates in its proposal that a company should recognize in net income an impairment when it does not expect to collect all contractual amounts due for originated financial assets or all amounts originally expected to be collected for purchased financial assets. Furthermore, the FASB indicates that it is inappropriate to allocate (defer) an impairment loss over the life of a financial asset. In other words, if a company does not expect to collect all amounts due, a loss exists and should be recognized immediately. Many oppose this conservative approach to impairment.

In response to concerns about the impairment approach described above, the FASB is working with the IASB on another approach. This approach is called the “three-bucket” approach and is described as follows.

Bucket 1. Financial assets evaluated collectively for impairment that do not meet the criteria for Buckets 2 or 3. That is, this bucket includes loans that have suffered changes in credit loss expectations as a result of macroeconomic events that are not specific to either a group of loans or a specific loan.

Bucket 2. Debt instruments affected by the occurrence of events that indicate possible future defaults. However, the specific debt instruments in danger of default have not yet been identified.

Bucket 3. Debt instruments for which information is available that specifically identifies that credit losses are expected to, or have, occurred on individual debt instruments.

⁸The Board clarified that core deposit liabilities and an entity’s own plain-vanilla debt would be generally classified and measured at amortized cost based on the entity’s business strategy for those financial liabilities. In this case, the FASB responded to constituent feedback to scale back the requirement that most liabilities be measured at fair value. The FASB also decided that some convertible debt instruments that are not required to be separated into liability and equity components under other GAAP guidance should be measured at amortized cost in their entirety. This is similar to the accounting under IFRS.

The allowance balance for debt instruments in Buckets 2 and 3 are estimates of remaining lifetime expected losses. This model has gained support because the allowance balance captures three different phases of deterioration in credit quality. In addition, in contrast to current GAAP, which is based on an “incurred loss” model, estimated loan losses are recognized earlier. That is, GAAP generally only records loan losses on loans in Bucket 1 of the proposed model.

Below is a summary of decisions reached on impairment issues **prior to development of the “three-bucket” approach. These issues may be reconsidered by the Boards at future meetings if deemed necessary.**

- **Uncollectibility.** A financial asset is considered uncollectible if the company has no reasonable expectation of recovery. Therefore, a company writes off a financial asset or part of a financial asset in the period in which the company has no reasonable expectation of recovery of the financial asset (or part of the financial asset). A write-off is defined as “a direct reduction of the amortized cost of a financial asset resulting from uncollectibility.”
- **Estimating expected losses.** A company should use the best available and supportable information at the date of estimation (historical, current, and forecasted) to estimate expected losses. Expected losses should be estimated with the objective of an expected value. An expected value identifies possible outcomes (or a representative sample of the possible outcomes), estimates the likelihood of each outcome, and calculates a probability weighted-average. Expected losses should be measured as all shortfalls in cash flows (both principal and interest) on a discounted basis. That is, the measurement of expected losses should reflect the effect of discounting.
- **Unwinding the discounting of expected credit losses.** The effect of unwinding the discounting of expected credit losses (through amortization) should be included in bad debt expense on the statement of comprehensive income.
- **Interest income recognition.** Interest income should be determined by applying the effective-interest rate to an amortized cost balance that is not reduced for credit impairment.

In summary, the Boards agree on the general conceptual elements of the three-bucket approach. They will continue to deliberate this model and plan to address the following issues in future meetings: (1) an approach for Bucket 1 with an overall objective of recognizing an impairment allowance equal to 12 months’ worth of expected losses based on initial expectations plus the full amount of any changes in expected credit losses, and (2) clear and well-defined indicators and criteria for when to transfer debt instruments among Buckets 1, 2, and 3.

Fair Value Option

In a significant change from current GAAP, the FASB has decided to eliminate the fair value option for financial assets. The Board also tentatively decided not to allow an unconditional fair value option for financial liabilities.

Instead, the Board decided to permit a conditional fair value option for hybrid financial liabilities to allow companies to avoid bifurcation and separate measurement of an embedded derivative from the host contract. The Board has indicated it may revisit its tentative conclusion on the fair value option for financial assets. Eliminating the fair value option is a significant departure by the FASB from its earlier view that the use of fair value measurements should be expanded. The Board reasoned that a fair value option reduces comparability and should be allowed only in limited circumstances.

Other Issues

The Board has made a number of other tentative decisions in the financial instruments project:

- Reclassification between categories is not permitted, even when there is a change in business strategy, because reclassifications reduce comparability and consistency between companies.
- Changes in fair value that have been recognized in OCI are recognized in net income (i.e., recycled) when these gains or losses are realized, either through sales or settlements.

Hedge Accounting

The FASB's objective for the hedge accounting project is to improve, simplify, and bring about convergence of the financial reporting requirements for hedging activities. In December 2010, the IASB published an exposure draft on hedge accounting, for which the comment period ended in March 2011. The FASB has not begun redeliberations on hedge accounting. However, the FASB has participated in the IASB's discussion of the feedback received on the IASB exposure draft and will consider the feedback during its reexamination. A final standard on hedge accounting is not expected until 2012.

REVENUE RECOGNITION

The discussion in this section addresses the FASB's joint project with the IASB on revenue, which is addressed in Chapter 18 (Revenue Recognition).

Background

Most revenue transactions pose few problems for revenue recognition. This is because, in many cases, the transaction is initiated and completed at the same time. However, not all transactions are that simple. For example, consider a customer who enters into a mobile phone contract with a company such as **Verizon**. The customer is often provided with a package that may include a handset, free minutes of talk time, data downloads, and text-messaging service. In addition, some providers will bundle that with a fixed-line broadband service. At the same time, customers may pay for these services in a variety of ways, possibly receiving a discount on the handset and then paying higher prices for connection fees and so forth. In some cases, depending on the package purchased, the company may provide free applications in subsequent periods. How, then, should the various pieces of this sale be reported by Verizon? The answer is not obvious.

It is therefore not surprising that a recent survey of financial executives noted that the revenue recognition process is increasingly more complex to manage, more prone to error, and more material to financial statements compared to any other area in financial reporting. The report went on to note that revenue recognition is a top fraud risk and that regardless of the accounting rules followed (GAAP or IFRS), the risk of errors and inaccuracies in revenue reporting is significant.¹

Indeed, both the FASB and the IASB indicate that the present state of reporting for revenue is unsatisfactory. IFRS is criticized because it lacks guidance in a number of areas. For example, IFRS has one basic standard on revenue recognition—*IAS 18*—plus some limited guidance related to certain minor topics. In contrast, GAAP has numerous standards related to revenue recognition (by some counts, well over 100), but many believe the standards are often inconsistent with one another. Thus, the accounting for revenues provides a most fitting contrast of the principles-based (IFRS) and rules-based (GAAP) approaches. While both sides have their advocates, the FASB and IASB recognize a number of deficiencies in this area.²

Unfortunately, inappropriate recognition of revenue can occur in any industry. Products that are sold to distributors for resale pose different risks than products or services that are sold directly to customers. Sales in high-technology industries, where rapid product obsolescence is a significant issue, pose different risks than sales of inventory with a longer life, such as farm or construction equipment, automobiles, trucks, and appliances.³ As a consequence, restatements for improper revenue recognition are relatively common and can lead to significant share price adjustments.

¹See www.prweb.com/releases/RecognitionRevenue/IFRS/prweb1648994.htm.

²See, for example, "Preliminary Views on Revenue Recognition in Contracts with Customers," *IASB/FASB Discussion Paper* (December 19, 2008). Some of the problems noted are that GAAP has so many standards that at times they are inconsistent with each other in applying basic principles. In addition, even with the many standards, no guidance is provided for service transactions. Conversely, IFRS has a lack of guidance in certain fundamental areas such as multiple-deliverable arrangements, which are becoming increasingly common. In addition, there is inconsistency in applying revenue recognition principles to long-term contracts versus other elements of revenue recognition.

³Adapted from American Institute of Certified Public Accountants, Inc., *Audit Issues in Revenue Recognition* (New York: AICPA, 1999).

As a result, in June 2010 the FASB and the IASB issued an exposure draft on revenue recognition entitled *Revenue from Contracts with Customers*. The Boards received many comments on this exposure draft and have reached decisions on many of the issues related to the revenue recognition model. However, some parts of the model need further clarification. As a result, the Boards issued a revised exposure draft on this subject. Major changes are incorporated into this revised exposure draft; the material presented here reflects these changes. It is likely that the new exposure draft will become a final standard in early 2012.

Revenue Recognition Model

The revenue recognition model proposed is a significant change from the present model of how revenue is recognized. The new model adopts an asset-liability approach, which is consistent with the Conceptual Framework approach to recognition. The Boards believe a contract-based model that measures changes in contract assets and liabilities is conceptually correct and will lead to a consistent approach to recognize revenue.

As indicated in the textbook, the revenue recognition model presently used is to recognize revenue (1) when it is realized or realizable, and (2) when it is earned. In the exposure draft, the revenue recognition model is different. It requires a company to recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration that it receives, or expects to receive, in exchange for those goods or services. To apply this principle, a company:

1. Identifies the contract(s) with customers.
2. Identifies the separate performance obligations in the contract.
3. Determines the transaction price.
4. Allocates the transaction price to the separate performance obligations.
5. Recognizes revenue when the company satisfies each performance obligation.

Identifying the Contract(s) with Customers

A contract is defined as an agreement between two or more parties that creates enforceable rights or obligations. Criteria are provided in the exposure draft to assess whether a contract has occurred between a company and its customers. In some cases, there may be multiple contracts related to a transaction, and segmentation may or may not occur depending on the circumstances.

Identifying the Separate Performance Obligations in the Contract

A performance obligation is a promise in a contract with a customer to transfer a good or service to the customer. In some cases, a company promises a bundle of goods or services. These goods or services should be accounted for separately only if certain conditions are met.

Determining the Transaction Price

Transaction price is the amount of consideration a company receives, or expects to receive, in exchange for transferring goods or services to a customer. If the consideration is uncertain, the company must estimate the amount. The approaches followed to estimate this amount are either (1) a weighted-average amount of possible payments or (2) the most likely amount.

A second guideline is that companies should not consider credit risk in the measurement of the transaction price. As a result, companies should recognize revenue for the full contract price. If a credit risk exists, companies should recognize the expected impairment loss from its contracts with customers. The loss should be reported as a contra-revenue item on the income statement.

A third guideline is that companies should consider the time value of money if the contract includes a significant financing element. As a practical help, if the financing is less than one year, a company does not have to consider the time value of money.

Allocating the Transaction Price to the Separate Performance Obligations

Companies should allocate to each separate performance obligation the amount of consideration the company expects to receive in exchange for satisfying that performance obligation. In general, the allocation is based on the relative standalone selling price of each service or good. If one of the standalone prices of a good or service is difficult to estimate, a residual approach is used. In a residual approach, companies take the total consideration and subtract the standalone value of goods or services that have a high degree of certainty. The remaining amount is then allocated to the remaining good or service.

Recognizing Revenue When the Company Satisfies Each Performance Obligation

The final step is the recognition of the revenue. A company should recognize revenue when it satisfies a performance obligation. This occurs by transferring the goods or services to the customer, which is when the customer obtains control of the promised good or service. The customer obtains control of a good or service when the customer has the ability to direct the use of, and receive the benefit from, the good or service.

Indicators that the customer has obtained control of a good are:

1. The customer has an unconditional obligation to pay.
2. The customer has legal title.
3. The customer has physical possession.
4. The customer has the risks and rewards of ownership of the goods.

The recognition criteria for services is less straightforward, fairly complex, and beyond our discussion here. It should be noted that if the goods and services are separate performance obligations, the company should account for them separately. Otherwise, the company should account for the bundle of goods and services as a service.

Other Issues

In addition to developing the basic revenue recognition model, the exposure draft also addresses the following related issues.

1. Warranties
2. Onerous contract
3. Costs of obtaining contract

Warranties

A warranty is sometimes sold separately from the product. For example as indicated in Chapter 13 (page 740) of *Intermediate Accounting*, when you purchase a television set, you are entitled to a manufacturer's warranty. You also will undoubtedly be offered an extended warranty on the product at an additional cost. In this case, the seller should recognize separately the sale of the television with the manufacturer's warranty, and the sale of the extended warranty.

If a customer does not have the option to purchase a warranty separately from the company, then the company should account for the warranty using the expense warranty approach (discussed in Chapter 13, page 739). The textbook treatment is essentially consistent with the treatment of warranties developed in the exposure draft.

Onerous Contract

An onerous contract is a contract in which the unavoidable costs of meeting the obligations under it exceed the economic benefits expected to be received under it (taken from *IFRS 37*). In this case, a company should recognize a liability and related expense for the costs that exceed benefits.

Costs of Obtaining Contract

The exposure draft indicates that a company should recognize an asset for the incremental costs of obtaining a contract that the company expects to recover. These costs should then be amortized on a systematic basis over the life of the good or service to which it relates.

Summary

Revenue is a significant number to users of financial statements in assessing a company's performance and prospects. However, revenue recognition requirements under GAAP differ from those in IFRS, and most believe that both sets of requirements need to be improved. The proposed revenue accounting guidance is intended to improve financial reporting by clarifying the principles for recognizing revenue and creating a converged revenue recognition standard that companies can apply consistently across various industries and capital markets.

LEASES

In this section, we summarize the FASB's joint project with the IASB on leases, which is addressed in Chapter 21 (Accounting for Leases).

Background

As discussed in Chapter 21 of *Intermediate Accounting*, leasing is an important source of financing. The existing rules for leases require lessees to classify their leases as either capital leases or operating leases. However, these existing rules are criticized for failing to meet the needs of users of financial statements because they do not provide a faithful representation of leasing transactions. In other words, (1) relevant information about rights and obligations that meet the definitions of assets and liabilities are omitted, and (2) existing rules lead to a lack of comparability and undue complexity because of the sharp bright-line distinction between capital leases and operating leases. As a result, many financial statement users adjust the amounts presented in the statement of financial position to reflect the assets and liabilities arising from operating leases.

In response to these criticisms of lease accounting, the FASB and IASB are working on a joint project to develop a new approach to lease accounting. At the time of this Update, the Boards are planning to issue a revised lease accounting proposal for both lessees and lessors.

Proposed Framework

The general framework adopted by the Boards is that a lease represents the “right-of-use” of an asset. Under this model, a lessee in a lease arrangement recognizes an asset representing its right to use an underlying asset during the lease term and a liability representing its obligation to make lease payments during the lease term. Lessors recognize a right to receive lease payments and a residual asset at the commencement of the lease.

Lessee Accounting

Under the current proposals, lessees apply a single accounting approach for all leases. This accounting approach requires a lessee to:

- Initially recognize a liability to make lease payments and a right-of-use asset, both measured at the present value of the lease payments.
- Subsequently measure the liability to make lease payments using the effective-interest method.
- Amortize the right-of-use asset on a systematic basis that reflects the pattern of use of the asset.

In essence, the proposed model eliminates (except for short-term leases) the distinction between operating and capital leases. That is, leases are no longer evaluated based on criteria that address whether ownership of the asset has been transferred to the lessee. Rather than accounting for the whole asset, **the proposed model focuses on the part of the asset for which the lease conveys the right of use.** In some cases, this is the whole asset. In other situations, only part of the asset is leased.

Lessor Accounting

For lessors, the Boards propose that a lessor should apply a “receivable and residual” accounting approach as follows.

- The lessor recognizes a right to receive lease payments and a residual asset at the date of the commencement of the lease.

- The lessor initially measures the right to receive lease payments at the sum of the present value of the lease payments, discounted using the rate the lessor charges the lessee.
- The lessor initially measures the residual asset as an allocation of the carrying amount of the underlying asset and would subsequently measure the residual asset by accreting it over the lease term using the rate the lessor charges the lessee.

In situations where the cost of the asset is less than the payments to be received (e.g., a sales-type lease), the lessor accounts for the lease according to whether the profit on the transfer is reasonably assured or not:

- If profit on the right-of-use asset transferred to the lessee is reasonably assured, the lessor recognizes that profit at the date of the commencement of the lease. The profit is measured as the difference between (a) the carrying amount of the underlying asset and (b) the sum of the initial measurement of the right to receive lease payments and the residual asset.
- If profit on the right-of-use asset transferred to the lessee is not reasonably assured, the lessor defers recognition of the profit. In that case, the lessor initially measures the residual asset as the difference between the carrying amount of the underlying asset and the right to receive lease payments. The lessor subsequently accretes the residual asset, using a constant rate of return. Thus, the profit on the transfer is recognized over the life of the lease.

Illustration of Proposed Model

The following example is used to compare the proposed rules to existing GAAP. Assume that Lessor A owns a two-story building with a fair value of \$2,000,000. The building has a 30-year life with zero residual value. Lessor A plans to lease the building to a tenant on a five-year, nonrenewable lease, with annual payments of \$165,000 at the beginning of the year. Lessee B leases the building for the first five-year lease term. Lessee B's incremental borrowing rate is 8 percent.

Analysis—Current GAAP. This lease would most assuredly be classified as an operating lease by the lessee because (1) there is no transfer of ownership, nor is there a bargain-purchase option; (2) the lease term is less than 75 percent of the asset useful life ($5 \div 30 = 16.67\%$); and (3) the present value of the lease payments is less than 90 percent of the fair value of the asset [$\$711,501.45 (\$165,000 \times 4.31213) \div \$2,000,000 = 36\%$]. Thus, under current GAAP, this lease is accounted for as an operating lease (no asset or liability related to the lease is reported on the lessee's balance sheet). The lessee records lease expense for each payment made, and the lessor records lease revenue and continues to report the building on its balance sheet.

Analysis—Proposed Model. Under the proposed lease model, rather than evaluating the lease based on the whole asset, the lessee and lessor analyze the "right of use" asset. That is, the lease conveys to the lessee the right to use the building for five years in exchange for payments of \$165,000 each year. Thus, the lessee makes the following entry at inception of the lease.

Right-of-Use Asset ($\$165,000 \times 4.31213$)	711,501	
Lease Liability		711,501

During the lease term, the lessee accounts for the lease liability similar to current capital lease guidance, using effective-interest amortization. The right-of-use asset is accounted for as a limited-life intangible asset (likely with straight-line amortization).

At lease inception, the lessor records a receivable for the payments to be received and derecognizes the portion of the asset transferred to the lessee. Any profit (or loss) arising from the difference between lease receivable and the carrying value of the derecognized portion of the asset is recognized at inception (if reasonably assured). Note that under

current GAAP, initial gross profit recognized is based on the sale of the entire asset, not just the part of the asset leased. Thus, the new approach results in lower initial profits on leases with these features.

Other Issues

The proposed model abandons criteria designed to assess transfer of ownership of leased assets. However, the model still requires evaluation of some of the same lease characteristics as existing GAAP. Two significant areas of judgment addressed in the proposal relate to (1) the lease term and (2) the discount rate.

Lease Term

The lease term is defined, for both lessees and lessors, as follows.

- The lease term is the noncancelable period for which the lessee has contracted with the lessor to lease the underlying asset, together with any options to extend or terminate the lease when there is a significant economic incentive for a company to exercise an option to extend the lease, or for a company not to exercise an option to terminate the lease.
- A lessee and a lessor should reassess the lease term only when there is a significant change in relevant factors such that the lessee would then either have, or no longer have, a significant economic incentive to exercise any options to extend or terminate the lease.

Discount Rate

The discount rate to be used by lessees and lessors should be as follows.

- The lessee should use the rate the lessor charges the lessee when that rate is available; otherwise, the lessee would use its incremental borrowing rate.
- The lessor would use the rate the lessor charges the lessee.

The rate the lessor charges the lessee could be the lessee's incremental borrowing rate, the rate implicit in the lease, or, for property leases, the yield on the property. When more than one indicator of the rate that the lessor charges the lessee is available, the rate implicit in the lease should be used.

The lease term and discount rate provisions are similar to those in existing GAAP. As a result, some of the same difficult subjective judgments will be required to implement the proposed lease accounting model.

Summary

Since 2006, the FASB and IASB have been working to develop improved accounting guidance for leases. The proposed "right-of-use" model shows promise to result in the reporting of more relevant and representationally faithful information about leasing arrangements. As summarized below, early analysis of the potential impact of the proposed leasing rules indicates significant effects.

A quick look at the current leasing market and some possible effects of the proposed rules:

- **\$600 billion.** Annual volume of leased equipment.
- **70%.** Volume of real estate leases as a percentage of all leases held by U.S. public companies.
- **\$1.3 trillion.** Amount of operating lease payments that U.S. public companies will bring back on balance sheets as capital leases under the proposed rule.
- **7%.** Potential first-year average increase in lease expense for a 3-year lease.
- **21%.** Potential first-year average increase in lease expense for a 10-year lease.

Source: Equipment Leasing and Finance Association, 2009; PricewaterhouseCoopers and Rotterdam School of Management, 2009.

Leasing Statistics and
Accounting Impacts

UP-34 Update to Intermediate Accounting, 14th Edition

As indicated, over \$1 trillion of operating leases will come on-balance-sheet if the rules are adopted. In addition, there will be a significant negative impact on lessee income statements in the early years of leases. As the following shows, the frontloading of lease expenses will be felt by lessees in several industries.

**Lease Expense Impacts—
By Industry Sector**

Sector	Typical Lease Term (Years)	First-Year % Increase Prompted by New Rules*	Cumulative % Increase Through Peak Year*
Airline	17	26%	128%/yr. 9
Automotive fleet	3	4	N/A
Banking	10	21	64%/yr. 5
Copier/office equipment	3	7	7%/yr. 3
Industrial-equipment manufacturers	5	11	17%/yr. 2
Health-care equipment	5	11	17%/yr. 2
Information technology	3	7	7%/yr. 2
Rail	22	26	200%/yr. 12
Real estate	10	21	64%/yr. 5
Trucking	7	16	33%/yr. 4

*As compared with the straight-line method of accounting.
Source: Equipment Leasing and Finance Association, 2009.

Given these effects—increased reported debt and lower income—as a consequence of these proposed rules, it is not surprising that the FASB (and IASB) are continuing to receive numerous comments on its proposed lease-accounting rules. It appears that 2012 will be the earliest that a new leasing standard will be issued.

INTERNATIONAL DEVELOPMENTS

INTERNATIONAL ACCOUNTING CONVERGENCE

The following discussion addresses the current status of the SEC's work plan for the consideration of IFRS for use by public companies in the United States. This discussion supplements the *IFRS Insights* in Chapter 1 (pages 32–40).

As indicated in the textbook, the SEC recognizes that the establishment of a single, widely accepted set of high-quality accounting standards benefits both global capital markets and U.S. investors. U.S. investors will make better-informed investment decisions if they obtain high-quality financial information from U.S. companies that are more comparable to the presently available information from non-U.S. companies operating in the same industry or line of business. Thus, the SEC appears committed to move to IFRS, assuming that certain conditions are met. These conditions are spelled out in a document, referred to as the “**Roadmap**,” and in a policy statement issued by the SEC in early 2010.

The FASB and the IASB have been working diligently to (1) make their existing financial reporting standards fully compatible as soon as is practicable, and (2) coordinate their future work programs to ensure that once achieved, compatibility is maintained. This process is referred to as convergence, and the Boards have made significant progress in developing high-quality converged standards. However, much work needs to be done. As discussed in the *IFRS Insights* for Chapters 17, 18, and 21 and in this Update, the Boards have identified the issuance of converged standards on financial instruments (investments), revenue, and leases as a key milestone in the convergence process.

SEC Staff Paper on Incorporation of IFRS

The SEC has monitored the convergence process through a staff Work Plan, which considers specific areas and factors relevant to a commission determination as to whether, when, and how the current financial reporting system for U.S. companies should be transitioned to a system incorporating International Financial Reporting Standards (IFRS). Execution of the Work Plan (which addresses such areas as independence of standard-setting, investor understanding of IFRS, and auditor readiness), combined with the completion of the convergence projects of the FASB and the IASB according to their current work plan, will position the SEC to make a decision on required use of IFRS by U.S. issuers. After reviewing the progress related to the Work Plan studies, the SEC still plans to decide by the end of 2011 whether to mandate the use of IFRS for U.S. companies. It is likely that not all companies would be required immediately to change to IFRS, but there would be a transition period in which this would be accomplished.

With respect to this transition, the SEC staff recently issued a staff paper, which explores an approach for incorporating IFRS into the U.S. financial reporting system.¹ The approach to incorporation is an “endorsement approach,” which is similar to the approaches used in other countries to incorporate IFRS into their financial reporting systems. That is, rather than *adopting* IFRS at a point in time (sometimes referred to as a “big bang”), the endorsement approach specifies that the FASB and IASB continue their convergence efforts (over a 5–7-year **transition period**) to align GAAP and IFRS. As a

¹SEC Staff Paper, “Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers: Exploring a Possible Method of Incorporation” (May 26, 2011), available at www.sec.gov.

result, these converged standards (which are also IFRS) will be incorporated into GAAP. **At the end of this period, a U.S. company that is compliant with GAAP would also be compliant with IFRS.** Following the transition period, there would be an **ongoing endorsement period** of IFRS by the FASB to determine if newly issued IFRS will become part of GAAP.

Transition Period

In the transition period, the FASB and SEC will execute a transition plan for evaluating IFRS for incorporation into GAAP. The transition plan groups IFRS into one of three categories:

- 1. IFRS subject to current active convergence projects.** The FASB and IASB first target completion of active projects (e.g., financial instruments, revenue recognition, and leases) in 2011 or 2012. If successfully completed through the Boards' joint deliberations, these projects would be incorporated into GAAP and IFRS relatively soon and would have little effect on the transition plan.
- 2. IFRS included on the IASB's current standard-setting agenda.** The FASB next evaluates other standards that the IASB is likely to issue in the near term to determine the magnitude of proposed changes to IFRS and the potential differences from GAAP. Once these standards are finalized by the IASB, the FASB will review the individual standards to determine how best to incorporate the standards into GAAP.
- 3. All other existing IFRS not subject to current standard-setting and areas not addressed by IFRS.** The FASB would next assess the standards not subject to current standard-setting plans for potential incorporation into GAAP. To minimize the cost of incorporation, the staff paper suggests that prospective application of new requirements will be permitted whenever possible after giving consideration to comparability, reliability, cost and benefit, and other relevant factors. An example of a modification to IFRS is the possible continuation of some existing GAAP requirements that have no specific IFRS counterparts (e.g., guidance for insurance, oil and gas, and broadcasting industries). These accounting rules will remain in force in GAAP only until the IASB develops corresponding requirements, at which time the U.S.-specific requirements would be rescinded.

Thus, in the transition period, the FASB will continue to work with the IASB in a convergence process to develop converged standards and to evaluate other existing IFRS for incorporation in GAAP.

Ongoing Endorsement Period

After the transition period, the FASB will continue to have an active role in international standard-setting to assist in the development and promotion of high-quality, globally accepted accounting standards and to endorse new IFRS into GAAP. This role would differ considerably from the FASB's current standard-setting role and responsibilities. Most significantly, the FASB would participate along with other constituents in the IASB's process for developing IFRS rather than serving as the principal body responsible for developing new accounting standards or modifying existing standards in GAAP.

However, in the ongoing endorsement process, the FASB would retain the authority to modify or add to the requirements of newly issued IFRS. For example, the FASB may find it necessary to make changes such as (1) prescribing additional disclosure requirements, (2) prescribing which alternative accounting treatment permitted by IFRS on a particular issue should be used by U.S. issuers to achieve greater consistency in U.S. practice, or (3) setting requirements compatible with IFRS on issues it does not specifically address.

Note that under the endorsement approach, **the SEC maintains its oversight of the FASB as the designated U.S. standard-setter**. In exercising that oversight, the SEC staff could issue guidance similar to its process for issuing staff accounting bulletins, although the staff expects that these occurrences would be rare. Additionally, the SEC would continue to be actively engaged in the international standard-setting process and likely would need to broaden its activities with respect to the IASB and its governance body.

Summary

Incorporation of IFRS through the endorsement approach works toward the goal of a single set of high-quality, globally accepted accounting standards, while doing so in a practical manner and in a way that minimizes both the cost and effort needed to incorporate IFRS into the U.S. financial reporting system. The framework provides for a gradual implementation of IFRS, which could reduce adoption costs in comparison to those involved from an approach of incorporating IFRS all at once (adoption or a big bang). It also would align the United States with other jurisdictions by retaining the national standard-setter's authority to establish accounting standards (e.g., the FASB in the United States). Importantly, this IFRS incorporation approach retains GAAP as the basis of financial reporting for U.S. issuers. This avoids the complexities and costs associated with changing the many references to GAAP in U.S. laws and contracts.

The SEC held a roundtable in July 2011 to obtain feedback on the staff paper; there was general support for the endorsement approach. The SEC staff is expected to issue additional reports in the near future covering topics such as consistency in the application of IFRS among companies in various jurisdictions currently applying IFRS and significant differences between IFRS and GAAP. Information gathered from these activities is intended to help inform the SEC's decision in late 2011 on adoption of IFRS in the United States.

OTHER PROJECTS

Throughout *Intermediate Accounting*, **IFRS Insights** identify and explain important differences between GAAP and IFRS. As indicated in the Update discussions above, several of the recent changes are the result of joint projects of the FASB and IASB. In this regard, the converged standards for comprehensive income and fair value measurement have been adopted by the IASB. In addition, the FASB and IASB are working to develop converged standards for financial instruments, revenue recognition, and leases. Thus, the Update discussions for those projects are also relevant to IFRS and can be used to complement the related discussion in the *IFRS Insights* for those topics.

Amendments to IAS 19 (Employee Benefits)

The following section summarizes the recent amendment to IAS 19 (Employee Benefits). While the Boards have not been working on this project together, the FASB is expected to revisit the accounting rules for benefit plans and likely will work to develop standards similar to those issued by the IASB. This discussion relates to the material in Chapter 20.

Background

The accounting for pensions and other postretirement benefit plans is a challenging area for accounting standard-setters. In particular, defined benefit plans—which entail company promises to pay uncertain benefits in the future—give rise to large and uncertain costs for many companies, and estimating these costs can be complex. Given the numerous estimates and judgments inherent in measuring the impact of defined benefit plans on companies' financial position and performance, it is difficult to meet the goal of providing investors and creditors the most useful information on the company's commitments resulting from those plans and the potential impact of the performance of those plans.

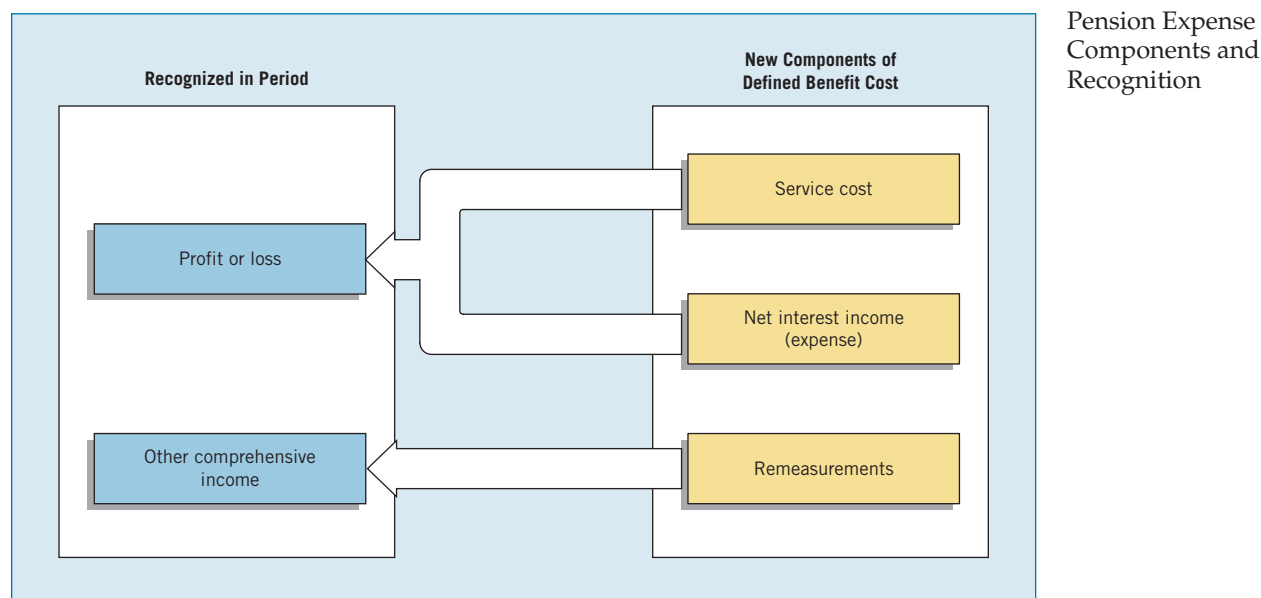
One of the key issues in the accounting for defined benefit plans relates to deferred recognition of gains and losses arising from remeasurements. Prior to the amendments to *IAS 19*, options in the standards allowed (1) gains and losses to be recognized either in income or stockholders' equity (OCI) and (2) gains and losses to be recognized in the period when they occurred or they could be deferred. As a result of these options, it is difficult to compare companies with similar obligations. The option to defer recognition of some changes could prevent users from gaining a clear picture of the gains and losses that arose in the current period. In addition, the funded status of the plan (reflecting the net of pension assets and liabilities) was not reported in the statement of financial position.

New Measurement and Recognition Guidance

The recent amendments to *IAS 19* address these issues by removing deferral options and prescribing presentation of pension assets and liabilities. First, companies must report any deficit or surplus in a plan (funded status) on their statement of financial position (similar to GAAP). With respect to removal of deferrals, the amendments remove from *IAS 19* the option allowing companies to defer some gains and losses that arise from defined benefit plans (the "corridor approach"). As a result, companies must recognize these changes as they occur. In addition, the amendments eliminate options for presenting gains and losses. Rather, pension expense elements arising from service and

finance costs are recorded in income and remeasurements (of the pension asset and liability) are recorded in OCI.¹

The components of pension expense and their recognition are summarized in the following figure.



As indicated, the change in the net defined benefit liability or asset is disaggregated into the following components:

- **Service cost**—the additional liability that arises from employees providing service during the period;
- **Net interest**—the interest expense on the net defined benefit liability or interest income on the net defined benefit asset; and
- **Remeasurements**—other changes in the value of the defined benefit obligation, such as changes in estimates; amendments (amendments for prior service are recognized immediately); and other changes in the value of plan assets. Amounts recorded in OCI are not “recycled” to income via amortization in subsequent periods.

An important difference is the substitution of a single net interest component for the expected return on assets and interest costs on the defined benefit liability. Thus, the net defined benefit liability or asset is equivalent to an amount owed to or from the plan (similar to a receivable or payable). The IASB decided on this approach because an underfunded plan will result in interest expense and an overfunded plan will result in interest income, reflecting the financing effect of the amount owed to or from the plan.

Note that under the prior IFRS, a pension liability could result in net finance income if the expected return on plan assets exceeded the interest cost on the defined benefit obligation. In addition, the returns on assets with higher risk were reflected in income (with a higher expected return and lower pension expense), while the costs of taking that risk (unexpected gains and losses) were reflected in OCI. The IASB believes the

¹The IASB’s improvements to the recognition requirements will align IFRS with the requirement in GAAP to recognize the funded status of the defined benefit plan on a company’s statement of financial position. The IASB, together with the FASB, also recently introduced amendments to how items in other comprehensive income (OCI) are presented, enabling users to identify differences in the accounting for period-to-period changes across financial statements prepared under IFRS and GAAP.

approach in the amended *IAS 19* is simpler, more understandable, and better represents the underlying economics of the change attributable to the passage of time. Indeed, the FASB indicates it will consider the *IAS 19* amendments when it restarts its project on pensions and other postemployment benefits. In the next section, we discuss some recent developments under GAAP that suggest some companies are moving toward IFRS in their accounting for pensions and other postemployment benefits.

GAAP Developments

Recently, some prominent U.S. companies have changed the way they account for unrealized gains and losses on their pension and other postretirement benefit plans. For example, **Verizon Communications Inc.**, **AT&T Inc.**, and **Honeywell International Inc.** revised past financial statements retroactively under the accounting change to recognize the losses as if they occurred in the prior years. For Verizon, its losses totaled \$22 billion; AT&T, \$17 billion; and Honeywell, \$5.5 billion.

Given the significance of these adjustments, it is not surprising that there are questions about whether the newly adopted approach is the result of new accounting rules or simply an accounting choice by these companies within existing GAAP. In the sections that follow, we discuss the authoritative literature on pension plan gains and losses, and we explain why the recent changes are in accordance with existing GAAP (no new rules yet). We also explain some likely changes in the accounting for pension and other postemployment benefits that are on the horizon.

Recent Developments

So what about the recent significant adjustments to pension amounts reported by major companies? In brief, these adjustments are not the result of new GAAP (although the IASB and FASB have been exploring changes in pensions and other postemployment benefit accounting, as discussed earlier). Rather, these recent adjustments are the result of companies changing their accounting policies regarding the treatment of gains and losses in their pension and other postretirement benefit plans.

What's GAAP? As discussed in Chapter 20 of *Intermediate Accounting*, companies are not required to recognize actuarial (liability) gains and losses or the unrealized asset gains and losses in pension expense. Rather, the standards (*FASB ASC 715*) recognize the long-term nature of the benefit arrangement and the likelihood that over time gains and losses from changes in the values of plan assets and the benefit obligation may be offset by losses and gains in those amounts in subsequent periods. As a result, companies may defer these unrealized gains and losses in other comprehensive income. Depending on the size of the net deferred gain or loss, a portion of that amount is recognized in net income in future periods through "corridor" amortization.

While in the past just about all companies used corridor amortization to recognize gains and losses in income, GAAP (*FASB ASC 715-30-35-15*) indicates that "immediate recognition of gains and losses as a component of net periodic pension cost is permitted if that method is applied consistently, and is applied to all gains and losses on both plan assets and obligations." That is, companies have had the option to immediately recognize gains and losses in income, as long as they do it consistently.²

²Rather than full recognition of gains and losses, some companies have chosen to recognize only gains and losses outside the 10 percent corridor. Another accounting policy election that companies can make in this area (see footnote 13 on page 1223 in Chapter 20 of *Intermediate Accounting*) is the use of the "fair value" of plan assets measured at year-end, rather than a "calculated value." Use of the calculated value, which is based on a 3–5-year moving-average of asset fair values, helps smooth out the impact of unrealized gains and losses in the pension plan.

In past economic cycles, such as during the late 1990s' technology bubble, employers accumulated sizable gains that were amortized into income in future periods. However, in the current economic environment, most employers have sizable accumulated losses that have not yet been recognized in income. As reported in a 2010 PricewaterhouseCoopers study, 45 of 49 large U.S. public companies had unamortized net losses in 2008, with the median company's unamortized losses equal to 34.2 percent of plan obligations.

Implications. The examples of Verizon, AT&T, and Honeywell are the result of these companies changing their accounting policy related to recognition of gains and losses. That is, in response to a very tough market for pension assets, combined with low discount rates for their liabilities, these and other companies had significant unrealized losses in their benefit plans. By changing their accounting method from corridor amortization to more immediate recognition, companies are able to get these losses behind them. As discussed in Chapter 22 of *Intermediate Accounting*, a change like this is implemented through retrospective application.

Recall that under retrospective application, companies record the cumulative effect of the change in the opening balances of the earliest period presented, and adjust the financial statements for each prior period presented to reflect the effects of applying the new accounting principle. For example, in making the change, **AT&T** revised its 2008 financial statements to show \$25.4 billion in benefits expense for pension plans and other retirement costs instead of the \$500 million it reported at the time. The \$24.9 billion difference represents the 2008 impact of a large loss in (pension) asset value. Thus, the losses are assigned to the past statements.

AT&T justified the change because it cleans up past income statements and eliminates losses recognized in future amortization. So, the company believes it has a more rational basis for projecting earnings in the future. According to an AT&T official, clarity is improved because "everyone can understand where the gains and losses that get recognized in our income statement at the end of each year are tied to real economic events," and "you see it in our results that year instead of it being reflected over many years in the future."³

On the Horizon

Whether more U.S. companies elect benefit plan accounting policies that result in more immediate recognition of gains and losses remains to be seen. Some believe that such a trend is on the horizon. In addition to gaining the benefit of putting losses behind them, some companies may change in anticipation of changes in accounting standards that will require more immediate recognition of benefit plan gains and losses.

For example, as discussed in the prior section, the IASB recently issued an amendment to its accounting standard for pensions and other postemployment benefits (*IAS 19, "Employee Benefits"*), which eliminates the option to defer the recognition of gains and losses. This project is part of the Memorandum of Understanding (MoU) between the IASB and the FASB. While the Boards have had different timelines for work on this project—with the IASB issuing new rules ahead of the FASB—the FASB is expected to revisit the accounting rules for benefit plans and likely will work to develop standards similar to those issued by the IASB. Such an approach will further support international convergence. Thus, the recent accounting policy changes adopted by U.S. companies in this area may be anticipating adoption of the IASB rules. We will keep instructors abreast of any changes in pension and other postretirement benefit accounting in future Updates.

³In evaluating the costs and benefits of this accounting choice, companies also consider the effect of immediate recognition of gains and losses on the volatility of income in future periods under the new rule. These effects might not be so bad if the company is scaling back its defined benefit plan. Such a trend had been under way in recent years.