Disclosure Standards 3014
Part II: Interpretive Guidance 3015
ASC 210-20: Offsetting 3015
ASC 210-20-45-9
Assurance That a Right of Setoff Is Enforceable in a Bankruptcy under FASB Interpretation No. 39 3016

PART I: GENERAL GUIDANCE

ASC 210-10: OVERALL

OVERVIEW

The distinction between current and noncurrent assets and liabilities in a classified balance sheet is an important feature of financial reporting. There is considerable interest in the liquidity of the reporting enterprise, and the separate classification of current assets and liabilities is an important aspect of liquidity analysis.

BACKGROUND

In the ordinary course of business, there is a continuing circulation of capital within the current assets. For example, a manufacturer expends cash for materials, labor, and factory overhead that are converted into finished inventory. At the point of sale, inventory usually is converted into trade receivables and, on collection of receivables, is converted back to cash. The average time elapsing between expenditure of cash and receiving the cash back from the collection of the trade receivable is called the *operating cycle*. One year is used as a basis for segregating current assets in the usual case where more than one operating cycle occurs within a year. When the operating cycle is longer than one year, as with the lumber, tobacco, and distillery businesses, the operating cycle is used for segregating current assets. *In the event that a business clearly has no operating cycle, the one-year rule is used* (ASC 210-10-45-3).

Frequently, businesses have a *natural business year*, at the end of which the company's activity, inventory, and trade receivables are at their lowest point. This is often the point in time selected as the end of the entity's accounting period for financial reporting purposes.

BASIC DEFINITIONS

Current Assets

Resources that are expected to be realized in cash, sold, or consumed during the next year (or longer operating cycle) are classified as current assets. Current assets are sometimes called circulating or working assets; cash that is restricted as to withdrawal or use for other than current operations is not classified as a current asset (ASC 210-10-45-4).

PRACTICE NOTE: This definition of current assets demonstrates the importance of professional judgment in determining the proper treatment of certain items. The words "expected to be realized" indicate that management intent is important. The same item could be a current asset for one company and not a current asset for another company due to differences in management intent.

The primary types of current assets are cash, cash equivalents, secondary cash resources, receivables, inventories, and prepaid expenses (ASC 210-10-45-1).

Cash and Cash Equivalents

Includes cash and cash equivalents, such as cash on deposit, cash awaiting deposit, and other cash funds that are available for current operations. *Cash Equivalents* consist of short-term, highly liquid investments that are (*a*) readily convertible to known amounts of cash and (*b*) so near their maturities that they present insignificant risk of changes in value because of changes in interest rates.

Secondary Cash Resources

A common type of secondary cash resources is marketable securities that are available for current operations.

Receivables

Include trade accounts, notes, and acceptances receivable, as well as receivables from officers and employees, if collectible in the ordinary course of business within one year.

Inventories

Include merchandise, raw materials, work in process, finished goods, operating supplies, and ordinary maintenance material and parts.

Prepaid Expenses

Include prepaid insurance, interest, taxes, advertising, unused royalties, current paid advertising not received, and operating supplies. Prepaid expenses, unlike other current assets, are not expected to be converted into cash; but, if they had not been paid in advance, they would require the use of current assets during the operating cycle.

Asset valuation allowances for losses, such as those for receivables and investments, are deducted from the assets or groups of assets to which the allowances relate. (ASC 210-10-45-13).

Current Liabilities

Current liabilities are obligations for which repayment is expected to require the use of current assets or the creation of other current liabilities.

http://www.pbookshop.com

PRACTICE POINTER: The definition of current liabilities is based on the asset category from which the liability is expected to be retired rather than on a specific period of time. As a practical matter, however, most current liabilities are expected to be retired during the period of time encompassed by the definition of current assets. Care should be taken, however, to identify instances where liabilities that are due in the near future should be classified as noncurrent because they will not require the use of current assets. Examples are short-term obligations expected to be refinanced that meet certain specified criteria and noncurrent liabilities that are near their maturity but that will be paid from noncurrent assets (e.g., bond sinking funds).

There are several common types of current liabilities (ASC 210-10-45-8):

Payables from Operations

Include items that have entered the operating cycle, which include trade payables and accrued liabilities such as wages and taxes.

Debt Maturities

Include amounts expected to be liquidated during the current operating cycle, such as short-term notes and the currently maturing portion of long-term debt.

Revenue Received in Advance

Includes collections received in advance of services, for example, prepaid subscriptions and other deferred revenues. This type of current liability is typically liquidated by means other than the payment of cash (e.g., delivery of products, provision of services).

Other Accruals

Include estimates of accrued amounts that are expected to be required to cover expenditures within the year for known obligations (*a*) when the amount can be determined only approximately (provision for accrued bonuses payable) or (*b*) when the specific person(s) to whom payment will be made is (are) unascertainable (provision for warranty of a product) (ASC 210-10-45-6).

Working Capital and Related Ratios

Working capital is the excess of current assets over current liabilities, and it is often used as a measure of the liquidity of an enterprise (ASC 210-10-05-5).

Changes in Each Element of Working Capital

The changes in each element of working capital are the increases or decreases in each current asset and current liability over the amounts in the preceding year.

http://www.pbookshop.com

Illustration of Determining Working Capital

	20X8	*20X9*	*Working Capital Increase or (Decrease)*
Current Assets:			
Cash	$10,000	$ 15,000	$ 5,000
Accounts receivable, net	25,000	35,000	10,000
Inventory	50,000	60,000	10,000
Prepaid expenses	1,000	500	(500)
Total current assets	$86,000	$110,500	$ 24,500
Current Liabilities:			
Accounts payable	$10,000	$ 15,000	$ (5,000)
Notes payable-current	20,000	15,000	5,000
Accrued expenses	1,000	1,500	(500)
Total current liabilities	$31,000	$ 31,500	$ (500)
Net working capital	$55,000	$ 79,000	
Increase in working capital			$24,000

The *current ratio*, or *working capital ratio*, is a measure of current position and is useful in analyzing short-term credit. The current ratio is computed by dividing the total current assets by the total current liabilities.

Illustration of Current Ratio

	20X8	*20X9*
Current assets	$86,000	$110,500
Current liabilities	(31,000)	(31,500)
Working capital	$55,000	$79,000
Current ratio (86 ÷ 31), (110.5 ÷ 31.5)	2.8:1	3.5:1

The *acid-test* or *quick ratio* is determined by dividing those assets typically closest to cash by total current liabilities. The assets used to calculate this ratio consist of only the most liquid assets, typically cash, receivables, and marketable securities.

PRACTICE POINTER: Only receivables and securities *convertible into cash* are included; restricted cash and securities are excluded.

Illustration of Acid-Test Ratio

	20X8	*20X9*
Cash	$10,000	$15,000
Receivables, net	25,000	35,000
Total *quick* assets	$35,000	$50,000
Total current liabilities	$31,000	$31,500
Acid-test ratio (35 ÷ 31), (50 ÷ 31.5)	1.1:1	1.6:1

PRACTICE POINTER: Inventory is excluded from the numerator in calculating the quick/acid-test ratio. Whether the current or quick/acid-test ratio is a better measure of liquidity may depend on the accounting method used for inventory. Where the LIFO inventory method is used, the current asset amount of inventory consists of the oldest costs and may not be a fair representation of the current value of the inventory. This would make the acid test/quick ratio the preferred liquidity measure. On the other hand, if the FIFO inventory method is used, the current asset amount of inventory represents an amount closer to the current cost, making the current ratio a more logical measure of liquidity.

RECEIVABLES

Accounts receivable are reported in the financial statements at net realizable value. Net realizable value is equal to the gross amount of receivables less an estimated allowance for uncollectible accounts.

Two common procedures of accounting for uncollectible accounts are (1) the direct write-off method and (2) the allowance method.

Direct Write-Off Method

This method delays the recognition of bad debt expense until a specific account is determined to be uncollectible. The conceptual weaknesses of the direct write-off method are:

- Bad debt expense may not be recognized in the same reporting period as the related sale.
- Accounts receivable are overstated, because no attempt is made to account for the unknown bad debts included therein.

Ordinarily, the direct write-off method is not considered U.S. GAAP, because it results in a mismatching of revenues and expenses (i.e., expenses are recognized in a later period than the revenue to which they relate), overstating the amount of assets and understating the amount of expense. The method may be acceptable in situations where uncollectible accounts are immaterial in amount.

http://www.pbookshop.com

Allowance Method

The allowance method recognizes an estimate of uncollectible accounts each period, even though the specific individual accounts that will not be collected cannot be specifically identified at that time. Estimates of uncollectible accounts usually are made as a percentage of credit sales or ending receivables. This method is consistent with ASC 450 (Contingencies), as explained below.

Under ASC 450, a contingency exists if, at the date of the financial statements, an enterprise does not expect to collect the full amount of its accounts receivable. Under this circumstance, an accrual for a loss contingency must be recognized, if both of the following conditions exist:

- It is *probable* that as of the date of the financial statements an asset has been impaired or a liability incurred, based on information available before the issuance of the financial statements.
- The amount of the loss can be *estimated reasonably*.

If both of the above conditions are met, an accrual for the estimated amount of uncollectible receivables is made even though the specific uncollectible receivables cannot be identified at the time of the accrual. An enterprise may base its estimate of uncollectible receivables on its prior experience, the experience of other enterprises in the same industry, the debtor's ability to pay, or an appraisal of current economic conditions.

PRACTICE NOTE: Estimates of uncollectible amounts are usually made in the aggregate for all credit sales rather than being based on individual accounts. A predictable percentage of credit sales or outstanding accounts receivable are common approaches used to estimate uncollectibles for a reporting period.

Significant uncertainty may exist in the ultimate collection of receivables if an enterprise is unable to estimate reasonably the amount that is uncollectible. If a significant uncertainty exists in the ultimate collection of the receivables, the installment sales method, cost-recovery method, or some other method of revenue recognition may be used. In the event that both of the above conditions for accrual are not met and a loss contingency is at least *reasonably possible*, certain financial statement disclosures are required by ASC 450.

Illustration of Accounting for Uncollectible Accounts by the Allowance Method

AMB Co. estimates uncollectible accounts at 1% of credit sales. For the current year, credit sales totaled $1,000,000. The year-end balances in accounts receivable and the unadjusted allowance for uncollectible accounts are $250,000 and $15,000, respectively.

The entry to record uncollectible accounts ($1,000,000 × 1% = $10,000) is as follows:

Bad debt expense	10,000	
Allowance for uncollectible accounts		10,000

The balance sheet includes accounts receivable of $250,000, allowance for uncollectible accounts of $25,000 ($15,000 + $10,000), and net accounts receivable of $225,000 ($250,000 - $25,000).

When a specific uncollectible account is written off (e.g., $2,100), the following entry is required:

Allowance for uncollectible accounts	2,100	
Accounts receivable (specific account)		2,100

This entry has no effect on the amount of net accounts receivable, because both the receivables balance and the allowance balance are reduced by the same amount.

If the estimate of uncollectibles is based on the ending balance of accounts receivable, the same procedure is followed, except that the existing balance in the allowance would require consideration. For example, if uncollectible accounts were estimated at 9% of the ending balance in accounts receivable, the bad debt expense for the year would be $7,500, computed as follows:

Required allowance ($250,000 × 9%)	$22,500
Balance before adjustment	(15,000)
Required adjustment	$ 7,500

The balance sheet includes accounts receivable of $250,000, an allowance of $22,500, and a net receivables amount of $227,500.

A variation on the previous method is to "age" accounts receivable, a procedure that provides for recognizing an increasing percentage as uncollectible as accounts become increasingly delinquent. For example, applying this procedure to the $250,000 receivables balance above might result in the following:

	Within 30 Days	*30 Days Overdue*	*60 Days Overdue*	*Past 60 Days Overdue*
Accounts receivable balance	$120,000	$50,000	$50,000	$30,000
Uncollectible %	2%	7%	12%	25%
Uncollectible balance	$2,400	$3,500	$6,000	$7,500

The total uncollectible balance is $19,400, ($2,400 + $3,500 + $6,000 + $7,500), resulting in the recognition of bad debt expense of $4,400, assuming a previous allowance balance of $15,000 ($19,400 - $15,000 = $4,400).

Discounted Notes Receivable

Discounted notes receivable arise when the holder endorses the note (with or without recourse) to a third party and receives a sum of cash. The difference between the amount of cash received by the holder and the maturity value of the note is called the discount. If the note is discounted with recourse, the assignor remains contingently liable for the ultimate payment of the note when it becomes due. If the note is discounted without recourse, the assignor assumes no further liability.

The account "discounted notes receivable" is a contra account, which is deducted from the related receivables for financial statement purposes. The following is the procedure for computing the proceeds of a discounted note:

1. Compute the total maturity value of the note, including interest due at maturity.
2. Compute the discount amount (the maturity value of the note multiplied by the discount rate for the time involved).
3. The difference between the two amounts (1, less 2) equals the proceeds of the note.

Illustration of Discounted Notes Receivable

A $1,000 90-day 10% note is discounted at a bank at 8% when 60 days are remaining to maturity.

Maturity—$1,000 + ($1,000 × .10 × 90/360)	$1,025.00
Discount—$1,025 × .08 × 60/360	(13.67)
Proceeds of note	$1,011.33

http://www.pbookshop.com

Factoring

Factoring is a process by which a company converts its receivables into immediate cash by assigning them to a factor either with or without recourse. *With recourse* means that the assignee can return the receivable to the company and get back the funds paid if the receivable is uncollectible. *Without recourse* means that the assignee assumes the risk of losses on collections. Under factoring arrangements, the customer may or may not be notified.

Pledging

Pledging is the process whereby the company uses existing accounts receivable as collateral for a loan. The company retains title to the receivables but pledges that it will use the proceeds to pay the loan.

CASH SURRENDER VALUE OF LIFE INSURANCE

The proceeds of a life insurance policy usually provide some degree of financial security to one or more beneficiaries named in the policy. Upon death of the insured, the insurance company pays the beneficiary the face amount of the policy, less any outstanding indebtedness.

Insurable Interest

An owner of an insurance interest in life insurance need only exist at the time the policy is issued, while an insurable interest in property insurance must exist at the time of a loss. An insurable interest is a test of financial relationship. A husband may insure the life of his wife, an employer the life of an employee, a creditor the life of a debtor, and a partner the life of a copartner.

An investment in a life insurance policy is accounted for at the amount that can be realized by the owner of the policy as of the date of its statement of financial position. Generally, the amount that can be realized from a life insurance policy is the amount of its *cash surrender value*. The increase in the cash surrender value of an insurance policy for a particular period is recorded by the owner of the policy and the cash surrender value is included as an asset in its statement of financial position. The insurance expense for the same period is the difference between the total amount of premium paid and the amount of increase in the cash surrender value of the policy.

Illustration of Insurable Interest

An enterprise is the owner and sole beneficiary of a $200,000 life insurance policy on its president. The annual premium is $16,000. The policy is starting its fourth year, and the schedule of cash values indicates that at the end of the fourth year the cash value increases $25 per thousand. The enterprise pays the $16,000 premium, and the journal entry to record the transaction is as follows:

Life insurance expense—officers	11,000	
Cash surrender value—life insurance policy (200 × $25)	5,000	
Cash		16,000

The cash surrender value of a life insurance policy is classified either as a current or noncurrent asset in the policy owner's statement of financial position, depending upon the intentions of the policy owner. If the policy owner intends to surrender the policy to the insurer for its cash value within its normal operating cycle, the cash surrender value is classified as a current asset in the statement of financial position. If there is no intention of collecting the policy's cash value within the normal operating cycle of the policy owner, the cash surrender value is classified as a noncurrent asset in the statement of financial position.

LIABILITY CLASSIFICATION ISSUES

ASC 480 more clearly defines the distinction between liabilities and equity. ASC 480 also establishes standards for issuers of financial instruments with characteristics of both liabilities and equity related to the classification and measurement of those instruments.

Current Obligations Expected to Be Refinanced

ASC 210 establishes U.S. GAAP for classifying a short-term obligation that is expected to be refinanced into a long-term liability or stockholders' equity. ASC 210 applies only to those companies that issue classified balance sheets (ASC 210-10-15-3). ASC 470 provides guidance on when a short-term obligation can be excluded from current liabilities and classified as non-current.

Callable Obligations

ASC 470 establishes U.S. GAAP for the current/noncurrent classification in the debtor's balance sheet of obligations that are payable on demand or callable by the creditor.

Compensated Absences

For guidance regarding the proper accrual of the liability for employees' compensated absences, see ASC 420.

OFFSETTING ASSETS AND LIABILITIES—GENERAL

Offsetting is the display of a recognized asset and a recognized liability as one net amount in a financial statement. If the amount of the recognized asset is the same as the amount of the recognized liability, then the net or combined amount of both is zero, and, as a result, no amount would appear in the financial statement. If the two amounts are not the same, the net amount of the two items that have been offset is presented in the financial statement and classified in the manner of the larger item.

ASC 210-20 discusses the general principle of offsetting in the balance sheet in the context of income tax amounts and provides the following guidance:

- Offsetting assets and liabilities in the balance sheet is acceptable only where a right of setoff exists.
- This includes offsetting cash or other assets against a tax liability or other amounts owed to governments that are not, by their terms, designated specifically for the payment of taxes.
- The only exception to this general principle occurs when it is clear that a purchase of securities that are acceptable for the payment of taxes is in substance an advance payment of taxes that are payable in the relatively near future.

The general principle of financial reporting, which holds that offsetting assets and liabilities is improper except where a right of setoff exists, usually is considered in the context of unconditional receivables from and payables to another party. ASC 210 extends this general principle to *conditional* amounts recognized for contracts under which the amounts to be received or paid or the items to be exchanged depend on future interest rates, future exchange rates, future commodity prices, or other factors.

Four criteria that must be met for the right of setoff to exist (ASC 210-20-45-1):

1. Each party owes the other party specific amounts.
2. The reporting party has the right to set off the amount payable, by contract or other agreement, with the amount receivable from the other party.
3. The reporting party intends to set off.
4. The right of setoff is enforceable at law.

http://www.pbookshop.com

OBSERVATIONS: The importance of managerial intent is apparent in the third criterion, which states that the reporting party *intends* to set off its payable and receivable. When all of these conditions are met, the reporting entity has a valid right of setoff and may present the net amount of the payable or receivable in the balance sheet.

Generally, debts may be set off if they exist between mutual debtors, each acting in its capacity as both debtor and creditor. State laws and the U.S. Bankruptcy Code may impose restrictions on or prohibitions against the right of set off in bankruptcy under certain circumstances.

Illustration of Offsetting Assets and Liabilities

The offsetting of assets and liabilities is an important issue to consider when determining financial statement presentation of current assets and current liabilities. Any time items are set off, information that would otherwise be available is lost. In addition, important financial statement relationships may be altered when assets and liabilities are set off. Consider the following example:

Current Assets	
Receivable from M Co.	$100
Other assets	400
	$500
Current Liabilities	
Payable to M Co.	$ 75
Other liabilities	175
	$250
Current ratio (500/250)	2:1

Now, consider the same situation, except the $75 payable to M Co. is offset against the $100 receivable from M Co.:

Current Assets	
Net receivable from M Co. ($100 - $75)	$25
Other assets	400
	$425
Current Liabilities	
Other liabilities	$175
Current ratio (425/175)	2.4:1

When offsetting is applied, the individual amounts of the receivable and payable are not presented, and only the net amount of $25 is present in the balance sheet. Further, the current ratio is significantly altered by the offsetting activity. This is a simple example, but it illustrates the impact of offsetting, and thus its importance as a financial statement reporting issue.

An exception to the general offsetting rule exists for derivative contracts executed with the same counterparty under a master netting agreement. A master netting agreement is a contractual agreement entered into by two parties

http://www.pbookshop.com

to multiple contracts that provides for the net settlement of all contracts covered by the agreement in the event of default under any one contract. For such derivative contracts, assets and liabilities may be offset and presented as a net amount even if the reporting entity does not meet the requirement in ASC 210 that the reporting entity has the intent to net settle. Offsetting derivative assets and liabilities under this exception is an election and the reporting entity must apply the election consistently.

Many sources of authoritative accounting standards specify accounting treatments that result in offsetting or in a balance sheet presentation that has an effect similar to offsetting. ASC 210 is not intended to modify the accounting treatment in any of those particular circumstances.

OFFSETTING OF DERIVATIVES, PURCHASE AND REPURCHASE AGREEMENTS, AND SECURITIES LENDING TRANSACTIONS

ASC 210 provides specific guidance as to when payables under repurchase agreements can be offset with receivables under reverse repurchase agreements. These criteria are (ASC 210-20-45-11):

1. The agreements are executed with the same counterparty.
2. The agreements have the same settlement date, set forth at inception.
3. The agreements are executed in accordance with a master netting arrangement.
4. The securities under the agreements exist in "book entry" form and can be transferred only by means of entries in the records of the transfer system operator or securities custodian.
5. The agreements will be settled on a securities transfer system that operates in the manner described below, and the enterprise must have associated banking arrangements in place as described below. Cash settlements for securities transferred are made under established banking arrangements that provide that the enterprise will need available cash on deposit only for any net amounts that are due at the end of the business day. It must be *probable* that the associated banking arrangements will provide sufficient *daylight overdraft or other intraday credit* at the settlement date for each of the parties.
6. The enterprise intends to use the same account at the clearing bank (or other financial institution) to settle its receivable (i.e., cash inflow from the reverse purchasing agreement) and its payable (i.e., cash outflow to settle the offsetting repurchase agreement).

If these six criteria are met, the enterprise has the option to offset. That choice must be applied consistently.

The third criterion refers to a "master netting arrangement." A master netting arrangement exists if the reporting entity has multiple contracts, whether for the same type of conditional or exchange contract or for different types of contracts, with a single counterparty that are subject to a contractual agreement that provides for the net settlement of all contracts through a single payment in a single currency in the event of default on or termination of any one contract (ASC 210).

The fourth criterion refers to "book entry" form. ASC 210 considers this a key element because it provides control over the securities. The controlling record for a "book entry" security is maintained by the transfer system operator. A securities custodian that has a security account with the transfer system operation may maintain "subsidiary" records of "book entry" securities and may transfer the securities within its subsidiary records; however, a security cannot be traded from the account of that custodian to a new custodian without a "book entry" transfer of the security over the securities transfer system. This form of accounting record facilitates repurchase and reverse repurchase agreement transactions on securities transfer systems.

For a transfer system for repurchase and reverse repurchase agreements to meet the fifth criterion, cash transfers must be initiated by the owner of record of the securities notifying its securities custodian to transfer those securities to the counterparty to the arrangement. Under associated banking arrangements, each party to a same-day settlement of both a repurchase agreement and a reverse repurchase agreement would be obligated to pay a gross amount of cash for the securities transferred from its counterparty, but the party would be able to reduce that gross obligation by notifying its securities custodian to transfer other securities to that counterparty the same day (ASC 210-20-45-14).

In the fifth criterion, the term *probable* has the same definition as in ASC 450, meaning that a transaction or event is more likely to occur than not. The phrase "daylight overdraft or other intraday credit" refers to the feature of the banking arrangement that permits transactions to be completed during the day when insufficient cash is on deposit, provided there is sufficient cash to cover the net cash requirement at the end of the day.

ASC 210 requirements apply to recognized derivatives accounted for in accordance with Topic 815, including bifurcated embedded derivatives, repurchase agreements and reverse repurchase agreements, and securities borrowing and securities lending transactions that are offset in accordance with either Topics 210 or 815. These requirements are also applicable for recognized derivative instruments accounted for in accordance with Topic 815 that are subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are offset in accordance with Topic 210 or 815 (ASC 210-250-2).

DISCLOSURE STANDARDS

Current assets and current liabilities must be identified clearly in the financial statements, and the basis for determining the stated amounts must be disclosed fully (ASC 210-10-05-5). The following are the common disclosures that are required for current assets and current liabilities in the financial statements or in notes thereto:

- Classification of inventories and the method used (e.g., FIFO, LIFO, average cost)
- Restrictions on current assets

- Current portions of long-term obligations
- Description of accounting policies relating to current assets and current liabilities
- Accounts receivable and notes receivable from officers, employees, or affiliated companies, if material, must be reported separately in the financial statements (ASC 310-10-45-13).

The above disclosure requirements apply to both of the following:

a. Recognized financial instruments and derivative instruments that are offset.

b. Recognized financial instruments and derivative instruments that are subject to an enforceable master netting arrangement or similar agreement. (ASC 210-20-50-1)

Disclosure is required of information to enable users of an entity's financial statements to evaluate the effect or potential effect of netting arrangements on its financial position. This includes the effort or potential effect of rights of offset associated with the entity's recognized assets and liabilities. (ASC 210-20-50-2) To meet this objective, the entity must disclose at the end of the reporting period the following quantitative information:

1. The gross amounts of those recognized assets and liabilities.
2. The amounts offset to determine the net amounts presented in the statement of financial position.
3. The net amounts presented in the statement of financial position.
4. The amounts subject to an enforceable master netting arrangement or similar arrangement:
   a. The amounts related to recognized financial instruments and other derivative instruments that either management makes a policy election not to offset or do not meet some of the guidance in ASC 210-20-45 or 815-10-45.
   b. The amounts related to financial collateral, including cash collateral.
5. The net amounts after deducting the amounts in (4) from the amounts in (3). (ASC 210-20-50-3)

The above information is required in a tabular form, separately for assets and liabilities unless another format is more appropriate. (ASC 210-20-50-4) A description of the rights of offset associated with an entity's recognized assets and liabilities subject to an enforceable master netting arrangement or similar agreement is required. (ASC 210-20-50-5) If the information above is presented in more than one note to the financial statements, cross-references between notes is required. (ASC 210-20-50-6)

http://www.pbookshop.com

ASC 310-10-05-5, 05-7; 25-3, 25-6, 25-8; 25-13; 30-7; 35-41 through 35-43, 35-46 through 35-49; 45-2, through 45-3; 50-2 through 50-11; ASC 310-20-15-3; 50-1; ASC 460-10-35-3; 45-1; ASC 460-605-25-7; ASC 825-10-35-1 through 35-3; ASC 835-30-15-1; ASC 860-20-50-5; ASC 860-50-15-3; ASC 860-50-40-2, 40-6; ASC 860-942-15-2 through 15-3; ASC 942-210-45-1 through 45-2; ASC 942-305-05-2; 45-1; 50-1; ASC 942-310-15-2; ASC 942-320-50-4; ASC 942-325-25-1 through 25-3; 35-1 through 35-4; ASC 942-360-45-2; ASC 942-405-25-1 through 25-4; 35-1; 45-1 through 45-4; 50-1; ASC 942-470-45-1 through 45-2; 50-2 through 50-3; ASC 942-505-50-1H through 50-7; ASC 942-825-50-1 through 50-2; ASC 944-320-50-1; ASC 948-10-15-3; 50-2 through 50-5

Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others 18,021

ASC 310-10-25-7; 35-52

Difference between Initial Investment and Principal Amount of Loans in a Purchased Credit Card Portfolio 18,024

ASC 310-10-05-9; ASC 815-15-55-9, 55-10

Application of the AICPA Notice to Practitioners Regarding Acquisition, Development, and Construction Arrangements to Acquisition of an Operating Property 18,025

ASC 310-10-50-18; 310-30-05-2 through 05-3; 15-1 through 15-4, 15-6 through 15-10; 25-1; 30-1; 35-2 through 35-3, 35-5 through 35-6, 35-8 through 35-15; 40-1; 45-1; 50-1 through 50-3; 55-2, 55-5 through 55-29; 60-3

Accounting for Certain Loans or Debt Securities in a Transfer 18,027

ASC 310-10-35-2, 35-4, 35-6, 35-8, 35-15, 35-19, 35-25, 35-27, 35-34 through 35-36, 35-38; 55-1 through 55-6; 310-40-50-4; 310-45-20-60-3

Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio 18,031

ASC 310-20: Nonrefundable Fees and Other Costs 18,032

ASC 310-20-05-3; 35-4, 35-6, 50-4

Amortization Period for Net Deferred Credit Card Origination Costs 18,032

ASC 310-20-05-4; 25-18; 35-8

Accounting for Individual Credit Card Acquisitions 18,033

ASC 310-20-35-11

Creditor's Accounting for a Modification or an Exchange of Debt Instruments 18,035

ASC 310-30: Loans and Debt Securities Acquired with Deteriorated Credit Quality 18,036

ASC-310-30-35-13, 40-1 through 40-2; 310-40-15-11

Effect of a Loan Modification When the Loan Is Part of a Pool That Is Accounted for as a Single Asset 18,036

ASC 310-40: Troubled Debt Restructurings by Creditors 18,037

ASC 310-40-15-3; 55-4; 470-60-15-3; 55-15

Classification of Debt Restructurings by Debtors and Creditors 18,037

ASC 310-40-40-1

Substituted Debtors in a Troubled Debt Restructuring 18,037

ASC 310-40-40-6, 55-1, 55-10A; ASC 310-10-50-11, 50-35; ASC 270-10-50-1; ASC 360-50-4

Reclassifications of Collateralized Mortgage Loans upon a Troubled Debt Restructuring 18,038

ASC 310-40-40-6A, 40-7; 55-12

Valuation of Repossessed Real Estate 18,039

Illustration of Valuation of Foreclosed Real Estate 18,040

ASC 310-40-40-6 through 40-7B; ASC 310-10-40-1A

Troubled Debt Restructurings by Creditors (ASC 310-40): Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure 18,041

ASC 310-40-40-8A, 40-9

Accounting for Conversion of a Loan into a Debt Security in a Debt Restructuring 18,043

Illustration of the Conversion of a Loan into a Debt Security 18,044

ASC 310-40-40-10; 35-11; 55-13 through 55-15

Determination of Cost Basis for Foreclosed Assets under FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, and the Measurement of Cumulative Losses Previously Recognized under Paragraph 37 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* 18,046

ASC 310-40-50-5; S50-1; S99-1

Applicability of the Disclosures Required by FASB Statement No. 114 When a Loan Is Restructured in a Troubled Debt Restructuring into Two (or More) Loans 18,047

Illustration of Required Disclosure Requirements When a Loan Is Restructured in a Troubled Debt Restructuring into Two (or More) Loans 18,048

ASC 310-40-55-6 through 55-10

Use of Zero Coupon Bonds in a Troubled Debt Restructuring 18,048

http://www.pbookshop.com

PART I: GENERAL GUIDANCE

FUTURE IMPACT OF ASU 2016-13: FINANCIAL INSTRUMENTS—CREDIT LOSSES

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. This update creates a new ASC 326, *Financial Instruments—Credit Losses*. Because the update is not effective until 2020 or later, coverage in this edition is limited to notifications of the future impact of ASU 2016-13. That update will be fully implemented in the 2020 *GAAP Guide*. Chapter 23, *ASC 326—Financial Instruments—Credit Losses*, will include the primary coverage of ASC 326, and the impact of ASU 2016-13 on other chapters will be incorporated, as appropriate.

Current GAAP require what is referred to as an incurred loss methodology for recognizing credit losses. This approach delays recognition until it is *probable* that a loss has been incurred. Both financial institutions and users of their financial statement expressed concern that this approach restricts the entity's ability to record credit losses that are expected, but that do not yet meet the probable threshold.

The primary objective of ASU 2016-13 is to provide information that is more decision-useful about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity. The update will replace the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses. It requires consideration of a broader range of reasonable and supportable information to support estimates of credit losses. ASU 2016-13 affects entities that hold financial assets and net investments in leases that are not accounted for at fair value through net income. This includes loans, debt securities, trade receivables, net investments in leases, off-balance-sheet credit exposures, reinsurance receivables, and any other financial assets that include the contractual right to receive cash and that are not specifically excluded from the scope of the update.

A more extensive future impact statement regarding ASU 2016-13 can be found at the beginning of Chapter 23, *ASC 326—Financial Instruments—Credit Losses*.

ASC 310-10: OVERALL

OVERVIEW

Receivables may arise from credit sales, loans, and other transactions. Receivables may be in the form of loans, notes, and other types of financial instruments and may be originated by an entity or purchase from another entity. (ASC 310-10-05-4) Accounts receivable are reported at their net realizable value for the purposes of U.S. GAAP. Net realizable value is equal to the total amount of the receivables less an estimated allowance for uncollectible accounts. U.S. GAAP also addresses how allowances for credit losses related to certain loans should be determined, including how to recognize and measure loan impairment and how to measure income on impaired loans.

In addition to providing general guidance on accounting for receivables, ASC 310 includes accounting for the following:

- Nonrefundable fees and other costs
- Loans and debt securities acquired with deteriorated credit quality
- Troubled debt restructurings by creditors (ASC 310-10-05-1)

BACKGROUND

A loan is impaired if, based on current information and events, it is probable that the creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement, including both the contractual interest and the principal receivable. For further discussion of troubled debt restructurings from the perspective of the debtor, see the coverage of ASC 470-60 (Troubled Debt Restructurings by Debtors).

Debt may be restructured for a variety of reasons. A restructuring of debt is considered a troubled debt restructuring (TDR) if the creditor, for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise consider. The concession may stem from an agreement between the creditor and the debtor, or it may be imposed by law or court (ASC Glossary).

GENERAL GUIDANCE ON RECEIVABLES

Receivables may arise from credit sales, loans, or other transactions. They may be in the form of loans, notes, and other types of financial instruments and may be originated by an entity or purchased from another entity. (ASC 310-10-05-4)

ASC 310 applies to a broad range of financial instruments and transactions, including trade accounts receivable, loans, loan syndications, factoring arrangements, standby letters of credit, and financing receivables. It does not apply to mortgage banking activities or to a contract that is required to be accounted for as a derivative instrument under ASC 815-10. (ASC 310-10-15-2 and 3)

Recognition

For the purposes of U.S. GAAP, accounts receivable are reported at their net realizable value. Net realizable value is equal to the total amount of the receivables less an estimated allowance for uncollectible accounts.

Under ASC 450, an accrual for a loss contingency must be charged to income if both of the following conditions are met:

- It is *probable* that as of the date of the financial statements an enterprise does not expect to collect the full amount of its accounts receivable, based on information available before the actual issuance of the financial statements, and
- The amount of loss contingency (uncollectible receivables) can be *reasonably estimated*.

If both of these conditions are met, an accrual for the estimated amount of uncollectible receivables must be made even if the uncollectible receivables cannot be identified specifically (ASC 310-10-35-9). An enterprise may base its estimate of uncollectible receivables on its prior experience, the experience of other enterprises in the same industry, the debtor's ability to pay, and/or an appraisal of current economic conditions (ASC 310-10-35-10).

Transfers of receivables under factoring arrangements that meet sale criteria are accounted for by the factor as purchases of receivables. Factoring commissions under these arrangements are recognized over the period of the loan contract. That period begins when a finance company or an entity with financing activities including trade receivables funds a customer's credit and ends when the customer's account is settled. (ASC 310-10-25-3)

Regarding loan syndications and loan participants, each lender accounts for the amount it is owed by the borrower. Repayments by the borrower may be made to a lead lender that then distributes the collections to the other lenders in the syndicate. In this situation, the lead lender is simply functioning as a servicer and does not recognize the aggregate loan as an asset. (ASC 310-10-25-4)

When an entity purchases a credit card portfolio that includes the cardholder relationships at an amount that exceeds the sum of the amounts due under the credit card receivables, the premium between the amount paid and the sum of

the balances of the credit card loans at the date of purchase is allocated between the cardholder relationships and the loans acquired. The premium relating to cardholder relationships represents an identifiable intangible asset that is accounted for in accordance with ASC 350. (ASC 310-10-25-7)

Initial Measurement

When a note is received solely for cash and no other rights or privilege is exchanged, the presumption is that the present value at issuance is measured by the cash proceeds exchanged. If cash or some other rights or privileges are exchanged for a note, the value of the rights or privileges is given accounting recognition in accordance with ASC 835-30-25-6. (ASC 310-10-30-2)

Notes exchanged for property, goods, or services are valued and accounted for at the present value of the consideration exchanged between the contracting parties at the date of the transaction in a manner similar to that followed for a cash transaction. (ASC 310-10-30-3) The established exchange price of property, goods, or services acquired for a note may generally be used to establish the present value of the note. If interest is not stated, the stated amount is unreasonable, or the stated face amount of the note is materially different from the current cash price for the same or similar items or from the fair value of the note, the note, the sales price, and the cost of the property, goods, or services exchanged for the note are recorded at the fair value of the property, goods or services or at an amount that reasonably approximates the fair value of the note, whichever is more clearly determinable. In the absence of established exchange prices of the property, goods, or services or evidence of the fair value of the note, the present value of a note that stipulates either no interest or an interest rate that is clearly unreasonable is determined by discounting all future payments on the notes using an imputed rate of interest as described in ASC 835-30. (ASC 310-10-2 through 6)

Loan Impairment

A *loan* is defined as "a contractual right to receive money on demand or on fixed or determinable dates that is recognized as an asset in the creditor's statement of financial position." U.S. GAAP addresses how allowances for credit losses related to certain loans should be determined (ASC Glossary).

The following provide an overview of U.S. GAAP for loan impairment:

- It is usually difficult to identify a single event that led to a particular loan being uncollectible. The general concept in U.S. GAAP is that impairment of receivable is recognized when, based on available evidence, it is probable that a loss has been incurred based on both past events and conditions existing at the date of the financial statements.
- Losses are not recognized before it is probable that they have been incurred, even though it may be probable based on past experience that losses will be incurred in the future. It is not appropriate to consider possible or expected future trends that may lead to additional losses.

- U.S. GAAP does not permit the establishment of allowances that are not supported by appropriate analyses.
- The threshold for recognition of impairment is the same whether the creditor has many loans or has only one loan. (ASC 310-10-35-4)

PRACTICE POINTER: U.S. GAAP does not specify how a creditor should identify loans that are to be evaluated for collectibility. A creditor may apply its normal loan review procedures in making that judgment. Guidance for this decision is found in the AICPA's Audit Procedure Study *Auditing the Allowance for Credit Losses of Banks* and includes the following items:

- Materiality criterion
- Regulatory reports of examination
- Internally generated listings such as "watch lists," past due reports, overdraft listings, and listings of loans to insiders
- Management reports of total loan amounts by borrower
- Historical loss experience by type of loan
- Loan files lacking current financial data related to borrowers and guarantors
- Borrowers experiencing problems such as operating losses, marginal working capital, inadequate cash flow, or business interruptions
- Loans secured by collateral that is not readily marketable or that is subject to deterioration in realizable value
- Loans to borrowers in industries or countries experiencing economic instability
- Loan documentation and compliance exception reports

ASC 310 ties accounting for an impairment of a loan directly to the criteria established in ASC 450 (Contingencies) for recognizing a loss contingency. A recognition of a loss is required when both of the following conditions are met:

- Information available before the financial statements are issued or are available to be issued indicates that it is probable that an asset has been impaired at the date of the financial statements.
- The amount of the loss can be reasonably estimated. (ASC 310-10-35-8)

A loan is not considered impaired based on an insignificant delay or insignificant shortfall in amount of payments. Whether the loss can be reasonably estimated normally depends on the experience of the entity, information about the ability of individual debtors to pay, and appraisal of the receivable in light of the current economic environment. (ASC 310-10-35-10)

PRACTICE NOTE: Use of the term *probable* in ASC 310 is consistent with its use in ASC 450. ASC 450 indicates a range of probability that must be considered in the decision to accrue a loss contingency, including *probable*, *reasonably possible*, and *remote*. Virtual certainty is not required before a loss can be accrued. While ASC 310 changes the wording of ASC 450 as it relates to loan impairments that require accrual, it does not change the overall intent of applying the guidance related to loss contingencies.

http://www.pbookshop.com

Measuring the impairment of a loan requires judgment and estimates, and the eventual outcome may differ from those estimates. Creditors have wide latitude in developing measures that are practical in their circumstances. (ASC 310-10-35-20)

Some impaired loans have risk characteristics that are unique to an individual borrower which leads to evaluation on a loan-by-loan basis. Others have risk characteristics in common with other impaired loans in which case the creditor may aggregate those loans in measuring impairment. In aggregating loans, factors to consider included historical statistics such as average recovery period and average amount recovered, along with a composite effective interest rate in measuring impairment. (ASC 310-10-35-21)

Following are brief descriptions, which are expanded in more depth in the ASC, how this general principle is applied:

- Impairment generally is based on the present value of expected future cash flows discounted at the loan's effective interest rate. As a practical matter, a creditor may measure impairment based on a loan's observable market price or on the fair value of the collateral if the loan is collateral dependent. (ASC 310-10-35-22)
- If the fair value of the collateral is used to measure impairment of a collateral-dependent loan and repayment or satisfaction of the loan is dependent on the sale of the collateral, the fair value of the collateral is adjusted for costs to sell. (ASC 310-10-23)
- For measuring impairment on a loan-by-loan basis, the creditor shall consider estimated costs to sell, on a discounted basis, if the costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan. (ASC 310-10-35-24)
- If a creditor bases loan impairment on a present value amount, the creditor shall calculate the present value amount based on an estimate of the expected future cash flows of the impaired loan, discounted at the loan's effective interest rate. (ASC 310-10-35-25)
- If the creditor bases its measurement of loan impairment on a present value amount, the estimates of expected future cash flows shall be the creditor's best estimate based on reasonable and supportable assumptions and projections. All available evidence, including costs to sell if those costs are expected to reduce the cash flows available, are considered in developing the estimate of expected future cash flows. (ASC 310-10-35-26)
- A creditor shall consider all available information reflecting past events and current conditions when developing the estimate of expected future cash flows. This includes existing environmental factors, such as existing industry, geographical, economic, and political factors that are relevant to the collectability of the loan. (ASC 310-10-35-27)
- If the loan's contractual rate varies based on changes in an independent factor, such as an index or rate, that loan's effective interest rate may be calculated based on the factor as it changes over the life of the loan or may be fixed at the rate in effect at the date the loan meets the impairment criteria. (ASC 310-10-35-28)

http://www.pbookshop.com

After the initial measurement of impairment, if there is a significant change in the amount or timing of an impaired loan's expected future cash flows, or if actual cash flows are significantly different from the cash flows previously projected, recalculation of the impairment and adjustment of the valuation allowance is required. (ASC 310-10-35-37)

PRACTICE POINTER: ASC 310-10-35 provides specific guidance on the subsequent measurement of the following specific types of receivables:

- Financial assets subject to prepayment
- Standby commitments to purchase loans
- Loans and trade receivables not held for sale
- Nonmortgage loans held for sale
- Loans not previously held for sale
- Amortization of discount or premium on notes
- Premium allocated to loans purchase in a credit card portfolio
- Hedged portfolios of loans

Presentation Matters

Loan or trade receivables may be presented on the balance sheet as aggregate amounts. Receivables held for sale shall be in a separate balance sheet category. Major categories of loans or trade receivables shall be presented either in the balance sheet or in notes to the financial statements. (ASC 310-45-2)

The change in present value from one reporting period to the next may result not only from the passage of time but also from changes in estimates of the timing or amount of expected future cash flows. If impairment is based on the present value of expected future cash flows, the entire change in present value may be presented as bad-debt expense. Alternatively, the creditor may report the change in present value attributable to the passage of time as interest income. (ASC 310-10-45-5)

Current assets are cash and other assets expected to be realized in cash, sold, or consumed during the normal operating cycle of the business. This includes:

- Trade accounts, notes, and acceptances receivable
- Receivables from officers, employees, affiliates, and others, if collectible in the ordinary course of business within one year
- Installment or deferred accounts and notes receivable if they conform generally to normal trade practices and terms within the business. (ASC 310-10-45-9)

Cash receipts from returns on loans and other debt instruments, and equity securities are classified in the statement of cash flows as operating activities. Cash flows from purchases, sales, and maturities of available-for-sale securities

are classified as investing activities and reported gross in the statement of cash flows. (ASC 310-10-45-10)

Disclosures

The summary of significant accounting policies shall include the following:

- The basis for accounting for loans and trade receivables;
- The method used in determining the lower of cost or fair value of nonmortgage loan held for sale;
- The classification and method of accounting for interest-only strips loans, and other receivables, or retained interest in securitizations that can be contractually prepaid or otherwise settled in a way that the holder would not recover substantially all of the recorded investment; and
- The method for recognizing interest income on loan and trade receivables, including a statement about the entity's policy for treatment of related fees and costs, including the method of amortizing net deferred fees or costs. (ASC 310-10-50-2)

If major categories of loans or trade receivables are not presented separately in the balance sheet, they shall be disclosed in notes to the financial statements. (ASC 310-10-50-3)

The allowance for credit losses (i.e., allowance for doubtful accounts) and any unearned income, any unamortized premiums and discounts, and any net unamortized deferred fees and costs shall be disclosed in the financial statements. (ASC 310-10-50-4) The policy for charging off uncollectible trade accounts receivable that have a contractual maturity of one year or less and arose from the sale of goods or services shall be disclosed. (ASC 310-10-50-4a)

PRACTICE POINTER: ASC 310-10-50-3 through 35 include a wide range of disclosures required for different aspects of receivables and loans in specific circumstances. These include assets serving as collateral, nonaccrual and past due financing receivables, accounting policies for off-balance-sheet credit exposures, foreclosed and repossessed assets, allowance for credit losses related to financing receivables, impaired loans, loss contingencies, risks and uncertainties, fair value disclosures, credit quality information, modifications, loans in process of foreclosure.

NONREFUNDABLE FEES AND OTHER COSTS

Please refer to *Part II: Interpretive Guidance* in this chapter for coverage of this ASC subtopic.

LOANS AND DEBT SECURITIES ACQUIRED WITH DETERIORATED CREDIT QUALITY

Please refer to *Part II: Interpretive Guidance* in this chapter for coverage of this ASC subtopic.

TROUBLED DEBT RESTRUCTURINGS BY CREDITORS

A troubled debt restructuring is one in which the creditor grants the debtor certain concessions that would not normally be considered. The concessions are made because of the debtor's financial difficulty, and the creditor's objective is to maximize recovery of its investment. Troubled debt restructurings are often the result of legal proceedings or of negotiation between the parties (ASC 310-40-15-5, 6).

Troubled debt restructurings include situations in which (ASC 310-40-15-9):

- The creditor accepts a third-party receivable or other asset(s) of the debtor, in lieu of the receivable from the debtor.
- The creditor accepts an equity interest in the debtor in lieu of the receivable. (This is not to be confused with convertible securities, which are *not* troubled debt restructurings.)
- The creditor accepts modification of the terms of the debt, including but not limited to:
  - — Reduction in the stated interest,
  - — Extension of maturity at an interest rate below the current market rate,
  - — Reduction in face amount of the debt, and
  - — Reduction in accrued interest.

The reductions mentioned in the bulleted items above can be either absolute or contingent.

For the purposes of ASC 310-40, troubled debt restructurings do not include the following (ASC 310-40-15-11):

- Changes in lease agreements;
- Employment-related agreements, such as deferred compensation contracts or pension plans;
- A debtor's failure to pay trade accounts that do not involve a restructure agreement; and
- A creditor's legal action to collect accounts that do not involve a restructure agreement.

A troubled debt restructuring by a debtor in bankruptcy proceedings is permitted under ASC 310 provided that the restructuring does *not* constitute a *general restatement* of the debtor's liabilities (ASC 310-40-15-10). ASC 310 requires that a creditor account for all loans that are restructured as part of a TDR involving a modification of terms as an impaired loan.

Not all debt restructuring is considered troubled, even though the debtor is in financial difficulty. Circumstances in which the restructuring is *not* troubled include (ASC 310-40-15-12):

- The debtor satisfies the debt by giving assets or equity with a fair value that at least equals either:
  - — The creditor's recorded receivable, or
  - — The debtor's carrying amount of the payable.

http://www.pbookshop.com

- The creditor reduces the interest rate primarily in response to changes in market rates.
- In exchange for the debtor's debt, the debtor issues new debt securities that have an effective interest rate that is at or near the current market interest rate of debt with similar maturity dates and interest rates issued by non-troubled debtors.

PRACTICE NOTE: If the debtor can obtain funds at current market rates and conditions, this provides evidence that the restructuring is not a troubled debt restructuring.

A receivable or payable, referred simply as debt, represents a contractual right to receive money or a contractual obligation to pay money on demand or on fixed or determinable dates that is already included as an asset or liability in the creditor's or debtor's balance sheet at the time of the restructuring. (ASC 310-40-15-4A)

A restructuring is considered a troubled debt restructuring (TDR) if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. A concession is usually granted by the creditor in an attempt to protect as much of its investment as possible. (ASC 310-40-15-5)

Generally, a debtor that can obtain funds from sources other than the existing creditor at market interest rates at or near those rates for non-troubled debt is *not* involved in a TDR. A TDR may include, but is not limited to, the following:

- Transfers from the debtor to the creditor of receivables from third parties, real estate, or other assets to satisfy fully or partially a debt.
- Issuance or other granting of an equity interest to the creditor by the debtor to satisfy fully or partially a debt unless the equity interest is granted pursuant to existing terms for converting the debt into an equity interest.
- Modification of terms of a debt, such as:
  - — Reduction of the stated interest rate for the remaining original life of the debt.
  - — Extension of the maturity date or dates of a stated interest rate lower than the current market rate for new debt with similar risk.
  - — Reduction of the face amount or maturity amount of the debt as stated in the instrument or other agreement.
  - — Reduction of accrued interest. (ASC 310-40-15-9)

In determining whether a restructuring is a TDR, the creditor must separately conclude that *both* of the following exists:

- The restructuring constitutes a concession.
- The debtor is experiencing financial difficulty.

Granting a Concession

The following additional guidance is provided to assist creditors in determining whether it has granted a concession. If the debtor does not otherwise have access to funds at a below market rate or debt with similar risk characteristics as the restructuring debt, the restructuring is considered to be at a below-market rate and may indicate that the creditor has granted a concession. In that circumstance, the creditor should consider all aspects of the restructuring to determine if it has made a concession. (ASC 310-40-15-15)

A temporary or permanent increase in the contractual interest rate as a result of a restructuring does not preclude the restructuring from being considered a concession because the new contractual interest rate on the restructured may still be below the market interest rate for new debt with similar risk characteristics. In this situation, the creditor should consider all aspects of the restructuring to determine whether a concession has been granted. (ASC 310-40-15-16)

A restructuring that results in an insignificant delay in payment is not considered a concession. The creditor should consider various factors in assessing whether a restructuring that results in a delay in payment is insignificant. (ASC 310-40-15-17)

http://www.pbookshop.com

Assessing Financial Difficulty

If a decision is made that the creditor has made a concession, a separate assessment must be made whether the debtor is experiencing financial difficulties to determine whether the restructuring constitutes a TDR.

The following should be considered in making this judgment:

- The debtor is currently in payment default on any if its debt.
- The probability that the debtor will be in payment default on any of its debt in the foreseeable future without the modification.
- The debtor has declared or is in the process of declaring bankruptcy.
- There is substantial doubt as to whether the debtor will continue to be a going concern.
- The debtor has securities that have been delisted, are in the process of being delisted, or are under threat of being delisted from an exchange.
- On the basis of estimates and projections that only encompass the debtor's current capabilities, the creditor forecasts that the debtor's entity-specific cash flows will be insufficient to service any of its debt in accordance with the contractual terms of the existing agreement for the foreseeable future.
- Without the current modification, the debtor cannot obtain funds from sources other than the existing creditors at an effective interest rate equal to the market rate for similar debt for a non-troubled debtor. (ASC 310-40-15-20)

Further guidance to assist the creditor in assessing whether a debtor is experiencing financial difficulties include the following. Payment default is not a necessary criterion for determining that a debtor is having financial difficulties. A creditor should evaluate whether it is probable that the debtor will be in payment default on any of its debt in the foreseeable future without the current modification in its debt.

Transfer of Asset(s)

When the creditor receives assets as full settlement of a receivable, they are accounted for at their fair value at the time of the restructuring. The fair value of the receivable satisfied can be used if it is more clearly determinable than the fair value of the asset or equity acquired. In partial payments the creditor *must* use the fair value of the asset or equity received (ASC 310-40-35-6).

The excess of the recorded receivable over the fair value of the assets received (less cost to sell if a long-lived asset is received) is recognized as a loss (ASC 310-40-40-3). The creditor accounts for these assets as if they were acquired for cash (ASC 310-40-40-5).

Illustration of Transfer of Assets

A debtor owes $20,000, including accrued interest. The creditor accepts land valued at $17,000 and carried on the debtor's books at its $12,000 cost, in full payment.

Under U.S. GAAP, the debtor recognizes two gains: $5,000 ($17,000 – $12,000) on the transfer of the assets, and $3,000 ($20,000 – $17,000) on the extinguishment of debt.

The creditor recognizes a loss of $3,000 ($20,000 – $17,000).

Transfer of Equity Interest

The creditor records the receipt of an equity interest as any other asset by recording the investment at its fair value and recognizing a loss equal to the difference between the fair value of the equity interest and the amount of the receivable (ASC 310-40-40-3).

Illustration of Transfer of Equity Interest

A debtor grants an equity interest valued at $10,000, consisting of 500 shares of $15 par value stock, to retire a payable of $12,000. Given these facts, the debtor records the issuance of the stock at $10,000 ($7,500 par value and $2,500 additional paid-in capital) and a gain on the extinguishment of debt of $2,000 ($12,000 – $10,000). The creditor records an investment asset of $10,000 and an ordinary loss of $2,000 ($12,000 – $10,000) on the TDR.

PRACTICE POINTER: Determining the fair value of an equity interest of a debtor company involved in a troubled debt restructuring may be difficult. In many cases, the company's stock will not be publicly traded, and there may be no recent stock transactions that would be helpful. Even if a recent market price were available, consider whether that price reflects the financially troubled status of the company that exists at the time the troubled debt restructuring takes place.

Modification of Terms

A creditor in a TDR involving a modification of terms accounts for the restructured loan at the present value of expected future cash flows discounted at the loan's contractual interest rate, the loan's observable market price, or the fair value of collateral if the loan is collateral-dependent.

PRACTICE NOTE: A loan is impaired if it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. A loan whose terms are modified in a TDR will have already been identified as impaired. A loan is considered collateral-dependent if repayment is expected to be provided solely by the underlying collateral.

Illustration of Modification of Terms

A debtor has a loan to a creditor, details of which are as follows:

Principal	$10,000
Accrued interest	500
Total	$10,500

They agree on a restructuring in which the total future cash payments, both principal and interest, are $8,000. The present value of these payments is $7,500.

Under U.S. GAAP, the debtor recognizes a gain of $2,500 ($10,500 – $8,000) at the time of the restructuring, and all future payments are specified as principal payments. Under U.S. GAAP, the creditor recognizes a loss of $3,000 ($10,500 – $7,500).

Combination of Types

When a restructuring involves combinations of asset or equity transfers and modification of terms, the creditor reduces the recorded investment by the fair value of assets received less cost to sell, including an equity interest in the debtor. Thereafter, the creditor accounts for the TDR in accordance with ASC 310 (ASC 310-40-35-7).

Related Issues

Legal fees and other direct costs resulting from a TDR are expensed by the creditor when incurred (ASC 310-40-25-1).

A receivable obtained by a creditor from the sale of assets previously obtained in a TDR is accounted for in accordance with ASC 835-30 (Interest—Imputation of Interest), regardless of whether the assets were obtained in satisfaction of a receivable to which ASC 835-30 was not intended to apply (ASC 310-40-40-8).

For creditors, a troubled debt restructuring may involve substituting debt of another business enterprise, individual, or governmental unit for that of a

http://www.pbookshop.com

troubled debtor. That kind of restructuring should be accounted for according to its substance (ASC 310-40-25-2).

CREDITOR DISCLOSURE REQUIREMENTS FOR TROUBLED DEBT RESTRUCTURINGS

The creditor shall disclose the following regarding troubled debt restructurings (ASC 310-40-50-1):

1. As of the date of each statement of financial position presented, the total recorded investment in the impaired loans at the end of each period, as well as (*a*) the amount of the recorded investment for which there is a related allowance for credit losses, and the amount of that allowance; and (*b*) the amount of the recorded investment for which there is no related allowance for credit losses
2. The creditor's policy for recognizing interest income on impaired loans, including how cash receipts are recorded
3. For each period for which results of operations are presented, the average recorded investment in the impaired loans during each period; the related amount of interest income recognized during the time within that period that the loans were impaired; and, if practicable, the amount of interest income recognized (cash-basis method of accounting) during the time within that period that the loans were impaired
4. Amount(s) of any commitment(s) to lend additional funds to any debtor who is a party to a restructuring

OTHER CLASSIFICATION AND DISCLOSURE ISSUES

ASC 230-10-45-11 states that cash flows from purchases, sales, and maturities of available-for-sale debt securities are classified as cash flows from investment activities and reported gross in the statement of cash flows. ASC 230-10-45-21 states that some loans are similar to debt securities in a trading account in that they are originated or purchased specifically for resale and are held for short periods of time. (ASC 310-10-45-11)

ASC 825-10-50 provides guidance on the required disclosure of fair value of certain assets and liabilities. ASC 825-10-50 explains that, for trade receivables and payables, no disclosure is required if the trade receivable or payable is due in one year or less. (ASC 310-10-50-26)

PART II: INTERPRETIVE GUIDANCE

ASC 310-10: OVERALL

IMPORTANT NOTICE: See the discussion of the Future Impact of ASU 2016-13: *Financial Instruments—Credit Losses*, in Part I above.

http://www.pbookshop.com

ASC 310-10-05-9; 15-5; 25-15 through 25-30; 35-55 through 35-61; 40-3 through 40-5; 45-15; ASC 360-10-35-3, 35-9 Purpose and Scope of AcSEC Practice Bulletins and Procedures for Their Issuance

BACKGROUND

The AICPA issued Practice Bulletins to disseminate the views of the AICPA Accounting Standards Executive Committee (AcSEC) (now known as the Financial Reporting Executive Committee) on narrow financial accounting and reporting issues. AcSEC was a senior technical body of the AICPA authorized to represent the AICPA on matters that addressed accounting and financial reporting unique to specific industries. Practice Bulletins addressed issues that were not addressed and are not expected to be addressed by either the FASB or the Governmental Accounting Standards Board (GASB).

ACCOUNTING GUIDANCE

Before 1987, when AcSEC began to issue Practice Bulletins, similar guidance was provided in "Notices to Practitioners," which were published in either *The CPA Letter* or the *Journal of Accountancy*. Unlike Notices to Practitioners, which are not numbered for retrievability, Practice Bulletins are numbered and designed to convey information that will enhance the quality and comparability of financial statements.

Drafts of proposed Practice Bulletins, which have been discussed at AcSEC open meetings, are available to the public as part of the meeting's agenda. However, Practice Bulletins have not been exposed for public comment, and their issuance is not subject to public hearings.

A Practice Bulletin is issued if both of the following conditions are met: (*a*) two-thirds or more of AcSEC's members vote to issue the proposed Bulletin, and (*b*) after reviewing the proposed Bulletin, the FASB and GASB indicate that neither plans to address the particular issue.

Most of the Notices to Practitioners that preceded the issuance of Practice Bulletins have been superseded. Three Notices to Practitioners continue to be in effect, however, and are discussed in the appendix to PB-1, "Purpose and Scope of AcSEC Practice Bulletins and Procedures for Their Issuance." The following is a brief discussion of the three Notices to Practitioners that were not superseded.

ACRS Lives and U.S. GAAP

In most cases, the number of years specified by the ACRS for recovery deductions will not bear any reasonable resemblance to the asset's useful life. In these cases, ACRS recovery deductions cannot be used as the depreciation expense amount for financial reporting purposes. Rather, depreciation for financial reporting purposes should be based on the asset's useful life.

Accounting by Colleges and Universities for Compensated Absences

Note: The following discussion pertains solely to private (nonpublic) colleges and universities.

When ASC 710, *Compensation—General*, and ASC 420, *Exit or Disposal Cost Obligations* were issued, there was some discussion as to whether the guidance in ASC

710 would apply to colleges and universities. The FASB decided *not* to exempt colleges and universities from the provisions of that standard. A Notice to Practitioners was issued to assist colleges and universities in applying that guidance. The essential conclusions of the Notice were as follows:

- In recognizing the liability, and the associated charge, for compensated absences in the current and prior years, the unrestricted current fund is to be used (use of the plant fund is specifically prohibited).
- In some cases, the liability for compensated absences might be recoverable from future state and federal grants and contracts for funded research. A receivable, and the associated revenue, can be recognized to offset a portion of the liability only in limited situations. More specifically, a receivable can be recognized only if it meets the definition of an *asset* in Statement of Financial Accounting Concepts No. 6 (Elements of Financial Statements of Business Enterprises). In evaluating the receivable, the college or university should consider the measurability and collectibility of the receivable and the institution's legal right to it.
- The reduction in the unrestricted current fund balance caused by recognizing the liability for compensated absences may be reduced by interfund transfers. These interfund transfers may be recognized only if (*a*) unrestricted assets are available for permanent transfer and (*b*) payment (or other settlement) to the unrestricted current fund is expected within a reasonable period.

ADC Arrangements

This Notice to Practitioners addresses the funding provided by financial institutions for real estate acquisition, development, and construction (ADC). In some cases, financial institutions enter into ADC agreements where the institution has essentially the same risks and rewards as an investor or a joint venture participant. In these cases, treating the ADC funding as a loan would not be appropriate.

The notice applies only to ADC arrangements in which a financial institution is expected to receive some or all of the residual profit. Expected residual profit is the amount of funds the lender is expected to receive—whether these funds are referred to as interest, as fees, or as an equity kicker—above a customary amount of interest and fees normally received for providing comparable financing.

The profit participation between the lender and the developer is not always part of the mortgage loan agreement. Therefore, the auditor should be cognizant that such side agreements may exist and should design the audit to detect such profit participation agreements between the lender and the developer.

PRACTICE POINTER: A side agreement may exist to provide the lender with a profit participation in ADC loans. This side agreement may not be referred to in the mortgage agreement between the lender and the developer. The auditor should specifically ask the lender to confirm whether it is party to a profit participation agreement on a particular loan.

A number of characteristics, in addition to the sharing of the expected residual profit, indicate that the ADC arrangement is more akin to an investment or a joint venture than to a loan. These characteristics are as follows:

- The financial institution provides all, or substantially all, of the funds necessary to acquire, develop, and construct the project. The developer has title but little or no equity investment in the project.
- The financial institution rolls into the loan any commitment and/or origination fees.
- The financial institution adds to the loan balance all, or substantially all, interest and fees during the term of the loan.
- The financial institution's only security for the loan is the ADC project. There is no recourse to other assets of the borrower. Also, the borrower does not guarantee the debt.
- The financial institution recovers its investment in one of three ways: (*a*) the project is completed and sold to an independent third party, (*b*) the borrower obtains refinancing from another source, or (*c*) the project is completed and placed in service, and cash flows are sufficient to fund the repayment of principal and interest.
- Foreclosure during the development period due to delinquency is unlikely, because the borrower is not required to make any payments during this period.

In some cases, even though a lender is expected to participate in the residual profit from the project, the facts and circumstances of the borrowing arrangement are consistent with a loan. The following characteristics of an ADC arrangement are consistent with a loan:

- The lender's participation in the expected residual profit is less than 50%.
- The borrower has a substantial equity investment in the project, not funded by the lender. This equity investment can be either in the form of cash or in the form of the contribution of land to the project.
- Either (*a*) the lender has recourse to other substantial, tangible assets of the borrower, which have not already been pledged under other loans, or (*b*) the borrower has secured an irrevocable letter of credit from a creditworthy, independent third party for substantially all of the loan balance and for the entire term of the loan.
- A take-out commitment for the entire amount of the loan has been secured from a creditworthy, independent third party. If the take-out commitment is conditional, the conditions should be reasonable and their attainment should be probable.

Some ADC loans contain personal guarantees from the borrower or from a third party, but such guarantees are rarely sufficient to support classifying an ADC arrangement as a loan.

In evaluating the substance of a personal guarantee, the following factors should be considered: (1) the ability of the guarantor to perform under the guarantee, (2) the practicality of enforcing the guarantee in the applicable juris-

http://www.pbookshop.com

diction, and (3) a demonstrated intent on the part of the lender to enforce the guarantee. Factors that might indicate the ability to perform under the guarantee include placing liquid assets in escrow, pledging marketable securities, and obtaining irrevocable letters of credit from a creditworthy, independent third party.

In the absence of the support discussed above for a guarantee, a guarantor's financial statements should be evaluated. In evaluating a guarantor's financial statements, an auditor should consider both the guarantor's liquidity and net worth. A guarantee has little substance if it is supported only by assets already pledged as security for other debt. Also, guarantees made by a guarantor on other projects should be considered.

If a lender expects to receive more than 50% of the residual profit from a project, the lender should account for the income or loss from the arrangement as a real estate investment. The guidance in ASC 970, Real Estate-General, ASC 360, Property Plant and Equipment, and ASC 976, Real Estate-Retail Land should be followed.

If a lender expects to receive less than 50% of the residual profit from a project, an ADC arrangement should be accounted for as a loan or as a joint venture, depending on the applicable circumstances. If an ADC arrangement is classified as a loan, interest and fees accounted for as a receivable may be recognized as income if they are recoverable. In assessing the recoverability of loan amounts and accrued interest, the guidance in both ASC 974, Real Estate-Real Estate Investment Trusts, and the guidance in ASC 942 (Audit and Accounting Guide, *Banks and Savings Institutions*) might be useful. If an ADC arrangement is classified as a joint venture, the primary accounting guidance may be found in ASC 970 and in ASC 835-20, Interest-Capitalization.

For balance sheet reporting purposes, ADC arrangements classified as investments in real estate or as joint ventures should be combined and reported separately from ADC arrangements accounted for as loans.

In some cases, a lender's share of the expected residual profit is sold before a project is completed. The applicable accounting in those cases hinges on whether the ADC arrangement was treated as a loan, as an investment in real estate, or as a joint venture. If an ADC arrangement was treated as a loan, proceeds received from a sale of the expected residual profit should be recognized as additional interest income over the remaining term of the loan. If an ADC arrangement was treated as a real estate investment or a joint venture, any gain to be recognized upon sale of the expected residual profit is determined based on the guidance ASC 976.

The accounting treatment of an ADC project should be periodically reassessed. For example, an ADC arrangement originally classified as an investment or as a joint venture might subsequently be classified as a loan if a lender is not expected to receive more than 50% of the residual profit and if the risk to the lender has decreased significantly. It is important to note that a change in accounting for an ADC arrangement depends on a change in the facts that were relied upon when the ADC arrangement was initially classified. The absence of, or a reduced participation in, a residual profit is not sufficient to change the categorization of an ADC arrangement. In addition, it is possible for an ADC arrangement initially classified as a loan to be reclassified as a real estate investment or a joint venture. A lender may take on additional risks and rewards of ownership by releasing collateral to support a guarantee and by increasing its percentage of profit participation. An improvement in a project's economic prospects does not justify a change in how an ADC arrangement is categorized. A change in classification is expected to be rare and should be supported by adequate documentation.

Finally, regardless of the accounting treatment for an ADC arrangement, it is necessary to continually assess the collectibility of principal, accrued interest, and fees. Also, ADC financing often entails a heightened risk of related-party transactions. An auditor needs to design the audit accordingly.

ASC 310-10-05-5, 05-7; 25-3, 25-6, 25-8; 25-13; 30-7; 35-41 through 35-43, 35-46 through 35-49; 45-2, through 45-3; 50-2 through 50-11; ASC 310-20-15-3; 50-1; ASC 460-10-35-3; 45-1; ASC 460-605-25-7; ASC 825-10-35-1 through 35-3; ASC 835-30-15-1; ASC 860-20-50-5; ASC 860-50-15-3; ASC 860-50-40-2, 40-6; ASC 860-942-15-2 through 15-3; ASC 942-210-45-1 through 45-2; ASC 942-305-05-2; 45-1; 50-1; ASC 942-310-15-2; ASC 942-320-50-4; ASC 942-325-25-1 through 25-3; 35-1 through 35-4; ASC 942-360-45-2; ASC 942-405-25-1 through 25-4; 35-1; 45-1 through 45-4; 50-1; ASC 942-470-45-1 through 45-2; 50-2 through 50-3; ASC 942-505-50-1H through 50-7; ASC 942-825-50-1 through 50-2; ASC 944-320-50-1; ASC 948-10-15-3; 50-2 through 50-5 Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others

BACKGROUND

This guidance was issued to reduce the variability among financial institutions (including entities with trade receivables) in accounting for similar transactions. It provides accounting guidance for entities that lend to or finance the activities of other parties, including entities that simply extend normal trade credit to customers (i.e., accounts receivable). The guidance does *not* apply to entities that carry loans and trade receivables at fair value, with changes in fair value flowing through the current period's income statement. Examples of such entities include: investment companies, broker-dealers in securities, and employee benefit plans.

PRACTICE NOTE: This guidance applies to all entities that lend to or finance the activities of their customers or other parties, even if an entity is not considered to be a finance company. Therefore, the guidance on the recognition, measurement, and disclosure of loans and trade receivables, credit losses, and other items, applies to manufacturers, retailers, and other non-financial entities. Also, more specific guidance is provided for finance companies.

---

http://www.pbookshop.com

PART I: GENERAL GUIDANCE

ASC 480-10: OVERALL

OVERVIEW

ASC 480 more clearly defines the distinction between liabilities and equity. The approach taken is to specifically define liabilities and require that all other financial instruments be classified as equity in the balance sheet. The FASB states that ASC 480 is generally consistent with its definitions of the various elements of the statement of financial position (balance sheet), income statement, and statement of cash flows.

ASC 480 establishes standards for issuers of financial instruments with characteristics of both liabilities and equity related to the classification and measurement of those instruments. It requires the issuer to classify a financial instrument as a liability, or asset in some cases, which was previously classified as equity. The classification standards are generally consistent with the definition of liabilities in FASB Concepts Statement No. 6 and with the FASB's proposal to revise that definition to encompass certain obligations that a reporting entity can or must settle by issuing its own equity shares.

LIABILITIES AND EQUITY

Distinction between Liabilities and Equity

ASC 480 requires an issuer to classify the following instruments as liabilities, or assets in certain circumstances:

- A financial instrument issued in the form of shares that is mandatorily redeemable in that it embodies an unconditional obligation that requires the issuer to redeem the shares by transferring the entity's assets at a specified or determinable date(s) or upon an event that is certain to occur.
- A financial instrument other than an outstanding share that, at its inception, embodies an obligation to repurchase the issuer's equity shares, or is indexed to such an obligation, and that requires or may require the issuer to settle the obligation by transferring assets (ASC 480-10-25-8).
- A financial instrument other than an outstanding share that embodies an unconditional obligation that the issuer must or may settle by issuing a variable number of equity shares if, at inception, the monetary value of the obligation is based solely or predominantly on any of the following (ASC 480-10-25-14):
  - A fixed monetary amount known at inception (e.g., a payable to be settled with a variable number of the issuer's equity shares).
  - Variations in something other than the fair value of the issuer's equity shares (e.g., a financial instrument indexed to the S&P 500 and settle-able with a variable number of the issuer's equity shares).

  - Variables inversely related to changes in the fair value of the issuer's equity shares (e.g., a written put option that could be net share settled).

ASC 480 applies to issuers' classification and measurement of freestanding financial instruments, including those that comprise more than one option or forward contract. It does not apply to features that are embedded in a financial instrument that is not a derivative in its entirety. In applying the classification provisions of ASC 480, nonsubstantive or minimal features are to be disregarded.

Required Disclosures

Issuers of financial instruments are required to disclose the nature and terms of the financial instruments and the rights and obligations embodied in those instruments. That disclosure shall include information about any settlement alternatives in the contract and identify the entity that controls the settlement alternatives (ASC 480-10-50-1).

For all outstanding financial instruments within the scope of ASC 480, and the settlement alternative(s), the following information is required to be disclosed by issuers (ASC 480-10-50-2):

- The amount that would be paid, or the number of shares that would be issued and their fair value, determined under the conditions specified in the contract if the settlement were to occur at the reporting date.
- How changes in the fair value of the issuer's equity shares would affect those settlement amounts.
- The maximum amount that the issuer could be required to pay to redeem the instrument by physical settlement, if applicable.
- The maximum number of shares that could be required to be issued, if applicable.
- That a contract does not limit the amount that the issuer could be required to pay or the number of shares that the issuer could be required to issue, if applicable.
- For a forward contract or an option indexed to the issuer's equity shares, the forward price or option strike price, the number of the issuer's shares to which the contract is indexed, and the settlement date(s) of the contract.

Mandatorily Redeemable Financial Instruments—Applicability and Implementation

The classification, measurement, and disclosure guidance in subtopic ASC 480-10 does not apply to mandatorily redeemable financial instruments that meet both of the following: (1) they are issued by nonpublic entities *that are not registered with the SEC*, and (2) they are mandatorily redeemable but not on fixed dates for fixed amounts, or if the amount due is not tied to an interest rate index, currency index, or other external index (ASC 480-10-15-7A).

In addition, ASC 480's guidance does not apply to mandatorily redeemable noncontrol- ling interests if the interest would not be classified as a liability by

http://www.pbookshop.com

through 45-9, 50-1, 55-1 through 55-33, 55-35 through 55-38; ASC 460-10-60-11 (formerly SOP 93-6), or related guidance. However, according to ASC 480-10-15-8, the guidance in ASC 480-10-05-1 through 05-6, 10-1, 15-3 through 15-5, 15-7 through 15-8, 25-1 through 25-2. 25-4 through 25-15, 30-1 through 30-5, 30-7, 35-1, 35-3 through 35-5, 45-1 through 45-4, 50-1 through 50-4, 55-1 through 55-12, 55-14 through 55-28, 55-34 through 55-41, 55-64; ASC 835-10-60-13. But other applicable guidance under Subtopic 718-40 continues to apply to ESOP shares that are mandatorily redeemable or freestanding under agreements to repurchase shares.

ACCOUNTING GUIDANCE

Question: Does the guidance in Subtopic 480-10 apply to mandatorily redeemable ESOP shares or freestanding agreements to repurchase ESOP shares?

Answer: No. The guidance in Subtopic 480-10 does *not* apply to mandatorily redeemable ESOP shares or freestanding agreements to repurchase those shares, that are accounted for under the guidance in Topic 718-40 until they are redeemed or under the guidance in Subtopic 505-50. Nevertheless, freestanding financial instruments issued under a share-based compensation arrangement that are no longer subject to the guidance in Topic 718 or Subtopic 505-50, would be accounted for under the guidance in Subtopic 480-10, for example, when a mandatorily redeemable share is issued as a result of an employee's exercise of an employee share option.

ASC 480-10-25-9, 25-13, 55-33 Issuer's Accounting under FASB Statement No. 150 for Freestanding Warrants and Other Similar Instruments on Shares That Are Redeemable

BACKGROUND

This guidance applies to freestanding financial instruments that are *not* outstanding shares, such as warrants. They are issued with an obligation to repurchase the issuer's equity shares and require or may require settlement by a transfer of assets. Such financial instruments, therefore, are accounted for as liabilities under the guidance in ASC 480-10-25-9 through 25-12. In ASC 480-10-55-29 through 55-32, 40-42 through 40-52, there is an example of a warrant that may be put to the issuer at a fixed price immediately after the warrant has been exercised. Constituents have raised the following question.

QUESTION

Does the timing of the redemption feature or the redemption price, which may be at fair value or a fixed amount, affect whether the guidance in ASC 480-10-25-9 through 25-12 should be applied to warrants for shares that can be put to the issuer?

ACCOUNTING GUIDANCE

Because freestanding warrants and other similar instruments on shares that are puttable or mandatorily redeemable include obligations to transfer assets, they should be accounted for as liabilities (under the guidance in ASC 480-10-25-9 through 25-12) regardless of when they are redeemed or their redemption price.

The phrase "requires or may require" is used in ASC 480-10-25-9 through 25-12 to refer to financial instruments under which an issuer is conditionally or unconditionally obligated to transfer assets. For puttable shares, the issuer would be *conditionally* obligated to transfer assets if the warrant is exercised and the shares are put to the issuer. In the case of mandatorily redeemable shares, the issuer would be *conditionally* obligated to transfer assets if the holder exercises the warrant. In both cases, the warrant should be accounted for as a liability.

ASC 480-10-45-2A through 45-2B Accounting for Mandatorily Redeemable Shares Requiring Redemption by Payment of an Amount That Differs from the Book Value of Those Shares, under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*

Question: Some companies have outstanding shares, all of which are subject to mandatory redemption on the occurrence of events that are certain to occur. Assume that on the date of adoption, the redemption price of the shares is more than their book value. On the date of adoption, the company would recognize a liability for the redemption price of the shares that are subject to mandatory redemption, reclassifying the amounts previously classified as equity. Any difference between the redemption price on the date of adoption and the amounts previously recognized in equity is reported in income as a cumulative effect transition adjustment loss. The redemption price may be a fixed amount or may vary based on specified conditions. How should the cumulative transition adjustment and subsequent adjustment to reflect changes in the redemption price of the shares be reported if they exceed the company's equity balance?

Answer: The cumulative adjustment amount and any subsequent adjustments to it should be reported as an excess of liabilities over assets (i.e., as a deficit). If the redemption price of the mandatorily redeemable shares is less than the book value of those shares, the excess of that book value over the liability reported for the mandatorily redeemable shares should be reported as an excess of assets over liability (i.e., as equity).

For example, assume that Company X adopts the guidance in ASC 480 when both the fair value and redemption value of the mandatorily redeemable shares is $20 million and the book value of those shares is $15 million of which $10 million is paid-in capital. On the date that guidance is adopted, the company would recognize a liability of $20 million by transferring $15 million from equity and recognizing a cumulative transition adjustment loss of $5 million. Assume further that net income attributable to the mandatorily redeemable share is $1 million for the year and the fair value of the shares at the end of the year is $21.2 million. No cash dividends are paid. The following is the presentation in the statement of financial position at the end of the year, assuming assets of $26 million and other liabilities of $10 million (all numbers in millions):

Assets	$26,000
Liabilities other than shares	$10,000
Shares subject to mandatory redemption	21,200
Total liabilities	$31,200
Excess of liabilities over assets	(5,200)
Total	$26,000

http://www.pbookshop.com

ASC 480-10-S45-5; S99-4 Sponsor's Balance Sheet Classification of Capital Stock with a Put Option Held by an Employee Stock Ownership Plan

BACKGROUND

Federal income tax regulations require employer securities held by an ESOP to have a put option, referred to as a liquidity put, allowing the employee to demand redemption if the securities are not readily marketable. The employer may have the option to satisfy the demand for redemption with cash, marketable securities, or both. Under the provisions of some ESOPs, the ESOP may substitute for the employer in redeeming the employees' shares.

Companies may also issue to their ESOPs convertible preferred stock, which is convertible into the company's common stock. Such stock is not publicly traded and therefore has a put option. The holder generally has the option of when to convert the stock, but under the terms of some convertible stock the issuer/employer is permitted to convert the shares. In some cases, the stock is converted or put to the employer when there is a takeover attempt or a merger. The convertible stock may have the following features:

- It has a "floor put" feature that guarantees the participant a minimum value, and is exercised if the convertible is "out of the money." The employer may have the option of redeeming the stock for cash, giving the participant common stock that would be issuable on conversion plus additional shares, or giving the participant common stock that would be issuable on conversion plus cash. The participant may have the option of receiving cash, common shares, or a combination of both.
- After a certain period of time, the employer may have the option to call the stock at a stipulated price. The ESOP can hold callable stock if it provides for a reasonable period of time after calling for the stock to be converted to common shares instead of cash, if participants so desire.
- The convertible stock can be held only by the ESOP and is automatically converted to common stock when distributed to participants leaving the plan. However, a floor put feature enables participants to require the trustee to put the convertible stock even before it has been distributed to participants if the convertible stock is "out of the money."

SEC Staff Accounting Series Release (ASR) 268 (Presentation in Financial Statements of "Redeemable Preferred Stocks") requires public companies to classify mandatorily redeemable preferred stock or stock whose redemption is outside the issuer's control outside of stockholders' equity.

In a leveraged ESOP, the employer records the ESOP's debt as a liability. The liability is offset by a contra-equity account referred to as "unearned ESOP shares," which is recorded as a debit in equity. (Before the issuance of ASC 718-40 (Employers' Accounting for Employee Stock Ownership Plans), such an account was referred to as *loan to ESOP or deferred* compensation.) When the employer issues stock to the ESOP, this contra-equity account is credited and there is no effect on equity.

http://www.pbookshop.com

ACCOUNTING ISSUES

- Under what circumstances should all or a portion of convertible preferred stock with put options held by an ESOP be classified outside of equity?
- If convertible preferred stock with put options issued to a leveraged ESOP is classified outside of stockholders' equity, should the contra-equity account, unearned ESOP shares, be classified in the same manner?

ACCOUNTING GUIDANCE

- Publicly held companies should classify convertible preferred stock issued to ESOPs in accordance with the provisions of ASR-268, which requires that mandatorily redeemable preferred stock be classified as a separate item between liabilities and equity, commonly referred to as the "mezzanine."
- A proportional amount of the contra-equity account in the employer's balance sheet should be similarly classified.

  For example, if $7,500,000 of $10,000,000 of preferred stock issued to an ESOP is convertible and therefore is classified outside of stockholders' equity, 75% of the balance of the contra-equity account would be classified in the same manner. Thus, if the remaining ESOP debt is $8,000,000, 75% (or $6,000,000) of the contra-equity account, unearned ESOP shares, would be classified outside of stockholders' equity.

PRACTICE POINTER: Under the guidance in ASC 460-10-55-5, a put option issued by an ESOP may be a guarantee. If a put is a guarantee that is not accounted for under the provisions of ASC 815-10-15, the ESOP sponsor's obligations under that guarantee would be reported as a liability under U.S. GAAP; the sponsor would be required to recognize a liability for the fair value of the put at its inception and provide the disclosures specified in ASC 460. The requirement in ASC 460 that a put be recognized as a liability at its inception and the requirement to disclose additional information change the sponsor's reporting and, therefore, partially nullify the guidance above.

ASC 480-10 provides guidance to issuers on the classification and measurement of financial instruments with characteristics of both liabilities and equity, except for mandatorily redeemable financial instruments of nonpublic entities. Financial instruments under the scope of ASC 480-10 should be classified as liabilities or, in some cases, as assets. Because ESOP shares with embedded repurchase features or freestanding instruments to repurchase ESOP shares are covered under the guidance in ASC 718-40 (Employers' Accounting for Employee Stock Ownership Plans) and related guidance, the guidance in ASC 480-10 does not apply to those shares. However, the requirement in the SEC's ASR-268 that ESOP shares be reported in temporary equity continues to apply.

Step 2: Assess whether the monetary value of any freestanding components are collectively predominant over the collective monetary value of any other component obligations. If so, the entire financial instrument is accounted for under the guidance in ASC 480-10-25-14. If not, the financial instrument is not included under the scope of ASC 480-10.

For example, Company X issues a puttable warrant to Investor Y. The warrant allows Investor Y to purchase one equity share at a strike price of $10 at a specified date. The put feature allows Investor Y to put the warrant back to Company X on that date at $2, and can be settled in fractional shares. If the share price on the settlement date exceeds $12, Investor Y would be expected to exercise the warrant and obligate Company X to issue a fixed number of shares in exchange for a fixed amount of cash. The monetary value of the shares varies directly with changes in the share price above $12. If the share price is equal to or less than $12, Investor Y would most likely put the warrant back to Company X, obligating it to issue a variable number of shares with a fixed monetary value (known at inception) of $2. Thus, at inception, the number of shares that the puttable warrant obligates Company X to issue can vary, and the financial instrument must be examined as described previously. The facts and circumstances are used to make a judgment whether the monetary value of the obligation to issue a number of shares that varies is predominantly based on a fixed monetary amount that is known at inception and, if so, it is a liability under the guidance in ASC 480-10-25-14.

In the previous example, if Company X's share price is well below the $10 exercise price of the warrant at inception, the warrant has a short life, and Company X's stock is determined to have low volatility, the circumstances would suggest that the monetary value of the obligation to issue shares is based predominantly on a fixed monetary amount known at inception and the instrument should be classified as a liability.

ASC 480-10-55-53 through 55-61; ASC 460-10-60-6 Majority Owner's Accounting for a Transaction in the Shares of a Consolidated Subsidiary and a Derivative Indexed to the Noncontrolling Interest in That Subsidiary

PRACTICE NOTE: The guidance in ASC 810-10-65-1, which was issued in December 2007, establishes accounting and reporting standards for a *noncontrolling* interest in a subsidiary and changes the term *minority interest* to *noncontrolling interest*. It does not affect the guidance in this Issue.

BACKGROUND

This Issue addresses the accounting for a scenario in which a parent company has a controlling interest in 80% of a subsidiary's equity shares and an unrelated entity has a noncontrolling interest in 20% of the equity shares. At acquisition of its 20% noncontrolling interest, the noncontrolling interest holder and the holder of the controlling interest in the subsidiary enter into a derivative contract that is indexed to the subsidiary's equity shares. The form of the derivative may be structured as follows:

- *Derivative 1* The parent has a forward contract to *purchase* the 20% noncontrolling interest at a fixed price at a specified future date.
- *Derivative 2* The parent has a call option to *purchase* the 20% noncontrolling interest at a fixed price at a specified future date and the holder of the noncontrolling interest has a put option to *sell* its 20% interest to the parent at the fixed price of the call option.
- *Derivative 3* The parent and the holder of the noncontrolling interest enter into an arrangement referred to as a *total return swap*, which has the following characteristics:
  - The parent agrees to pay the owner of the noncontrolling interest an amount based on the London Interbank Offered Rate (LIBOR) plus an agreed spread and, at the termination date, an amount equal to the net depreciation, if any, of the fair value of the 20% interest since the inception of the swap.

The holder of the noncontrolling interest will pay the parent an amount equal to the dividends received on its 20% interest and, at the termination date, an amount equal to the net appreciation, if any, of the 20% interest since the inception of the swap. The net change in the fair value of the 20% noncontrolling interest at the termination date may be determined based on an appraisal or based on the sales price of the stock. The following guidance applies only to the derivatives discussed above. Further, at the inception of the derivative instrument, the parent company must be the holder of the majority interest of the subsidiary's outstanding common stock and the subsidiary must be consolidated in the parent's financial statements.

ACCOUNTING ISSUES

- How should an entity that is the holder of an 80% controlling interest in a subsidiary account for an arrangement in which it enters separately into a derivative transaction with the holder of the 20% noncontrolling interest in the subsidiary at the time the noncontrolling interest holder purchases its interest in the subsidiary?
- How should an entity that acquires an 80% controlling interest in a subsidiary account for an arrangement in which it enters separately into a derivative with the seller (the 20% noncontrolling interest holder) at the same time as it acquires a controlling interest in the entity?
- How should an entity that sells a 20% noncontrolling interest in its 100% owned subsidiary to an unrelated party account for an arrangement in which the majority owner and the holder of the noncontrolling interest enter into the type of derivative transaction described above?

ACCOUNTING GUIDANCE

1. ASC 480-10 provides guidance for issuers on the classification and measurement of financial instruments with the characteristics of both liabilities and equity. Financial instruments under the scope of ASC 480 must be classified as liabilities, or as assets in some situations. Freestanding financial instruments under the scope of ASC 480 are *not* permitted to be combined with other freestanding derivatives unless the combina-

http://www.ebookshop.com

tion is required under the guidance in ASC 815 and its related guidance. A parent of a subsidiary that has entered into a forward purchase contract with the terms of Derivative 1 is required to account for the transaction as a financing and to consolidate 100% of the subsidiary. Because the parent must settle the contract by a physical repurchase of the noncontrolling interest's shares in exchange for cash, the parent should recognize the forward purchase contract as a liability that is initially measured at its present value. The amount of the noncontrolling interest should be reduced by a corresponding amount. Subsequent accruals to the amount of the contract and amounts paid or to be paid to the contract holders, if any, should be accounted for as interest cost.

2. A financial instrument with the terms of Derivative 2 should be accounted for based on one of the following three methods, subject to how the contract was issued:

   — *Issued as a single freestanding instrument.* Account for the entire contract initially as a liability, or as an asset under some circumstances, and measure initially and subsequently at fair value.

   — *Issued as two separate freestanding instruments—a written put option and a purchased call option.* Initially classify (a) a written put option as a liability that is measured at fair value under the guidance in ASC 480, and (b) the purchased call option under the guidance in ASC 815-40-25-4 and ASC 815-40-55-13, as (1) a liability or as an asset if the contract requires net cash settlement or the *counterparty* can choose to settle the contract in net cash, net shares, or a physical settlement in shares; or (2) as equity if physical settlement in shares or net share settlement is required, or the *entity* can choose settlement in either net cash, physical shares, or net share settlement in its own shares, assuming all the criteria in ASC 815-10-25-7 through 25-35 and ASC 815-40-55-2 through 55-6 have been met.

3. Regardless of how Derivative 2 was issued, the noncontrolling interest should be accounted for separately from the derivative instrument. If, however, the written put option and the purchased call option are embedded in the noncontrolling interest's shares and they are not mandatorily redeemable, the freestanding instrument should be accounted for as a financing in accordance with the guidance in ASC 480-10-55-59 and the parent should consolidate 100% of the subsidiary. In that case, the stated yield earned under the combined derivative instrument and the noncontrolling interest would be allocated to interest expense. That is, the financing would be accreted to the strike price of the forward or option until settlement. The parent would not recognize a gain or loss on the sale of the noncontrolling interest at the inception of the derivative instrument. A total return swap with the terms of Derivative 3 above should be indexed to an obligation to repurchase the issuer's shares. Because the issuer may be required to transfer assets to settle the obligation, the total return swap should be accounted for as a liability, or as an asset under some circumstances, that is measured initially and subsequently at fair value. The noncontrolling interest should be accounted for separately from the total return swap.

4. Under the guidance in ASC 480-10, a freestanding financial instrument is not permitted to be combined with another freestanding financial instrument, unless the combination is required under the guidance in ASC 815. Therefore, freestanding derivatives under the guidance in ASC 480-10 should not be combined with a noncontrolling interest.

5. The parent retains the risks and rewards of ownership in the noncontrolling interest during the period in which the derivative instrument is in effect, even though another party is the noncontrolling interest's legal owner.

6. The counterparty to the derivative is financing the noncontrolling interest. Therefore, the requirement that the parent account for a purchased noncontrolling interest and a related derivative on a combined basis as a financing results in a presentation of the substance of the transaction.

PRACTICE POINTER: The combined instrument is *not* a derivative under the scope of ASC 815. The FASB's Derivatives Implementation Group reached a similar conclusion on the combination of two instruments that meet the following criteria:

a. The transactions are entered into intentionally at the same time,
b. The transactions are with the same counterparty (or structured through an intermediary),
c. The transactions are related to the same risk, and
d. No economic reason or business purpose exists to induce the parties to structure the transactions separately rather than as a single transaction.

ASC 480-10-S99-3A Classification and Measurement of Redeemable Securities

The SEC Observer stated the views of the SEC staff about the application of Accounting Series Release (ASR) No. 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks."*

SCOPE

Under the guidance in ASR 268, SEC registrants are required to classify outside permanent equity redeemable preferred securities that can be redeemed (*a*) at a fixed or determinable price on a fixed or determinable date, (*b*) at the holder's option, or (*c*) when an event occurs that is not completely under the issuer's control. The SEC staff believes that the above guidance can be applied by analogy to other equity instruments, such as common stock, derivatives instruments, noncontrolling interests if the redemption feature is not considered to be a freestanding option under the scope of ASC 480-10, equity securities held by and employee stock ownership plan with terms allowing an employee to put the securities to the sponsor for cash or other assets, and redeemable instruments classified in equity granted under a share-based payment arrangement with employees as discussed in ASC 718-10-S99.

http://www.ipbookshop.com

The guidance in ASR 268 does *not* apply to the following instruments:

- Freestanding financial instruments that are classified as assets or liabilities under the guidance in ASC 480-10 or other GAAP;
- Freestanding derivative instruments classified in stockholders' equity under the guidance in ASC 815-40, which applies to embedded derivatives indexed to, and potentially settled in, a company's own stock.
- Equity instruments subject to registration payment arrangements as defined in ASC 825-20-15-3;
- Share-based payment awards;
- Convertible debt instruments that contain an equity component that is classified separately. A convertible debt instrument may be required to be separated into a liability and an equity component under other GAAP. A convertible debt instrument that is not redeemable at the balance sheet date, but that may become redeemable based on the passage of time or the occurrence of an event is not considered to be redeemable at the balance sheet date;
- Certain redemptions that occur as a result of a liquidation event. However, deemed liquidation events under which a holder is required or permitted to redeem only one or more equity instruments of a specific class for cash or other assets would require the application of ASR 268;
- Certain redemptions covered by proceeds from insurance, for example, an equity instrument that becomes redeemable on the holder's or disability

CLASSIFICATION

PRACTICE NOTE: ASC 480 provides guidance for issuers on the classification and measurement of financial instruments with the characteristics of both liabilities and equity. Financial instruments under the scope of ASC 480 must be classified as liabilities, or as assets in some situations, because they represent an issuer's obligations.

SEC OBSERVER COMMENT

The SEC Observer clarified the SEC staff's position regarding the interaction of the staff's guidance on this announcement with the guidance in ASC 480 when accounting for *conditionally* redeemable preferred shares. The guidance in ASC 480 does *not* apply to the accounting for such shares if they are conditionally redeemable at a holder's option or when an uncertain event *not* under the issuer's control occurs, because there is no unconditional obligation to redeem the shares by a transfer of assets at a specified or determinable date or when a certain event occurs. The condition is resolved when an uncertain event occurs. Once it becomes certain that such an event will occur, the shares should be accounted for under the provisions of ASC 480, which requires that the shares be measured at fair value and reclassified as a liability. As a result, stockholders' equity would be reduced by an equivalent amount with no gain or loss recognition. The reclassification is similar to a redemption of shares by issuing debt. As in the redemption of preferred shares discussed in ASC 260-10-99S-2 ("The Effect on the Calculation of Earnings per Share for the Redemption or Induced Conversion of Preferred Stock"), when calculating earnings per share, the difference between the fair value of the liability and the carrying amount of the preferred debt at reclassification should be deducted from or added to net earnings available to common shareholders.

The SEC staff believes that an issuer of a redeemable equity security should evaluate separately all the events that could trigger redemption if some of the security's redemption features are not under the issuer's control. A security should be classified outside of permanent equity if *any* event not under the issuer's sole control, regardless of the probability of occurrence, could trigger its redemption. Although a change in classification is not required if an event occurs that would cause a potential ordinary liquidation that would require cash payment only if the company is totally liquidated, the occurrence of events that could cause the redemption of one or more particular classes or types of equity securities would require that those securities be classified outside of permanent equity. The classification of equity securities whose redemption is not solely under the issuer's control should be based on the individual facts and circumstances.

For example, the SEC Observer noted that a redeemable security with a provision that requires the issuer to obtain the approval of the board of directors to call the security may not necessarily be under the issuer's control, because the board of directors may be controlled by the holders of the particular redeemable security. In contrast, classification in permanent equity would continue to be appropriate in a situation in which a preferred stock agreement includes a provision stating that the issuer's decision to sell all or substantially all of the company's assets and a subsequent distribution to common stockholders triggers redemption of the preferred equity security, because the decision to sell all or substantially all of the issuer's assets is solely under the issuer's control. That is, a distribution to common stockholders cannot be *triggered* or required by the preferred stock holders as a result of their representation on the board of directors.

One exception to the requirement in this announcement that should *not* be analogized to other transactions occurs when there is a provision that the equity securities become redeemable as a result of the holder's death or disability. Under that circumstance, the redemption of the securities would be funded by the proceeds of an insurance policy that is in force and that the issuer intends to and is able to maintain in force. Consequently, the securities continue to be classified in permanent equity.

MEASUREMENT

The SEC staff believes the *initial* amount of a redeemable equity security included in temporary equity in accordance with the guidance in ASR 268 should be its fair value on the issue date, except in the following circumstances:

- *Share-based payment arrangements with employees.* Measure the initial amount recognized in temporary equity based on the instrument's re-

http://www.pbookshop.com

demption provisions and the proportion of consideration received as employee services.

- *Employee stock ownership plans.* If the cash redemption option is related only to a market value guarantee feature, a registrant's accounting policy for temporary equity may be to present (a) the amount of the total guaranteed market value of the equity securities, or (b) the maximum cash obligation based on the fair value of the underlying equity securities at the balance sheet date.
- *Noncontrolling interests.* Present in temporary equity the initial carrying amount of a noncontrolling interest in accordance with the guidance in ASC 805-20-30.
- *Convertible debt instruments that include a separately classified equity component.* Present an amount in temporary equity only if the instrument is currently redeemable or convertible at the issuance date for cash or other assets. If a portion of a component classified as equity is included in temporary equity, present the amount of cash or other assets that would be paid to a holder on conversion or redemption at the issuance date in excess of the component classified as a liability on the issuance date.
- *Host equity contracts.* Present in temporary equity the initial carrying amount of the host contract in accordance with the guidance in ASC 815-15-30.
- *Preferred stock with a beneficial conversion feature or that is issued with other instruments.* Include in temporary equity the total amount allocated to the instrument in accordance with the guidance in ASC 470-20 *less* the amount of the beneficial conversion feature recognized at the issuance date.

The following are the views of the SEC staff about the *subsequent measurement* of a redeemable equity instrument subject to the requirements of ASR 268:

- The amount of securities currently redeemable at a holder's option should be adjusted to their maximum redemption amount at each balance sheet date. If the maximum amount is contingent on an index or similar variable, the amount in temporary equity should be calculated based on the existing conditions at the balance sheet date, such as the instrument's current fair value. At each balance sheet date, the amount of dividends *not* currently declared or paid but that will be paid under the redemption features or if their ultimate payment is *not* under the registrant's control should be included. If an instrument is not currently redeemable, an adjustment is unnecessary if it is not probable that the instrument will become redeemable, such as when redemption will occur only based on the passage of time.
- If it is probable that an equity instrument will become redeemable, the SEC staff will not object if either of the following accounting methods are applied consistently for securities that will become redeemable at a future *determinable* date but whose redemption amount is *variable* (e.g., they are redeemable at fair value):

a. Accrete changes in the redemption value from the date of issuance or when redemption becomes probable (if later) to the security's earliest redemption date using an appropriate method, usually the interest method. Changes in redemption value are considered to be changes in accounting estimates and accounted for, and disclosed, in accordance with the guidance in ASC 250.

b. Recognize changes in the redemption value (for example, fair value) immediately as they occur and adjust the security's carrying amount to equal the redemption value at the end of each reporting period. Under this method, the end of the reporting period would be viewed as if it were also the security's redemption date.

The following is additional guidance provided by the SEC staff on subsequent measurement under the following circumstances:

- *Share based payment arrangements with employees.* At each balance sheet date, base the amount included in temporary equity on the instrument's redemption provisions considering the proportion of consideration received in the form of employee services (the pattern of recognition of compensation cost in accordance with the guidance in ASC 718).
- *Employee stock ownership plans.* If a cash redemption obligation is related only to a market value guarantee feature, a registrant's accounting policy for temporary equity may be to present (a) the amount of the total guaranteed market value of the equity securities, or (b) the maximum cash obligation based on the fair value of the underlying equity securities at the balance sheet date.
- *Noncontrolling interests.* Determine the adjustment of the carrying amount in temporary equity after attributing the subsidiary's net income or a loss according to the guidance in ASC 810-10.
- *Convertible debt instruments that include a separately classified equity component.* Present an amount in temporary equity only if the instrument is currently redeemable or convertible at the issuance date for cash or other assets. If a portion of a component classified as equity is included in temporary equity, present the amount of cash or other assets that would be paid to a holder on conversion or redemption at the issuance date in excess of the component classified as a liability on the issuance date.
- *Fair value option.* Redeemable equity instruments included in temporary equity in accordance with the requirements in ASR 268 should not be measured at fair value through earnings instead of applying the SEC staff's measurement guidance. Also see the guidance in ASC 825-10-15-5(f), which prohibits the use of the fair value option for financial instruments that are wholly or partially classified in stockholder's equity, including temporary equity.

The SEC staff believes that regardless of which of the above accounting methods is used to account for a redeemable equity security, that security's carrying amount should be reduced only to the extent that the registrant had

http://www.pbookshop.com

previously increased the security's carrying amount as a result of the application of the guidance in this Topic.

The SEC staff expects registrants to apply the accounting method selected consistently and to disclose the selected policy in the notes to the financial statements. In addition, registrants that elect to accrete changes in redemption value over the period from the date of issuance to the earliest redemption date should disclose the security's redemption value as if it were redeemable.

RECLASSIFICATION INTO PERMANENT EQUITY

If temporary classification of a redeemable equity security is no longer required, its carrying amount should be reclassified from temporary to permanent equity at the date of the occurrence of the event causing reclassification. Prior financial statements should *not* be adjusted. The SEC staff also believes that reversal of previously recorded adjustments to the security's carrying amount would be inappropriate when a reclassification occurs.

DECONSOLIDATION OF A SUBSIDIARY

An entity that deconsolidates a subsidiary recognizes a gain or loss on that transaction in net income based on the measurement guidance in ASC 810-10-40-5. The carrying amount of a noncontrolling interest, if any, in the former subsidiary affects that gain or loss calculation. The SEC staff believes that because adjustments to a noncontrolling interest's carrying amount from the application of the guidance in this SEC staff announcement have not entered into the determination of the entity's net income, the noncontrolling interest's carrying amount should likewise *not* include any adjustments made to the noncontrolling interest as a result of the application of the guidance in this SEC staff announcement. Previous adjustments to the noncontrolling interest's carrying amount from the application of the guidance in this SEC staff announcement should be eliminated by recording a credit to the parent entity's equity.

EARNINGS PER SHARE

Preferred Securities Issued by a Parent or Single Reporting Entity

Increases or decreases in the carrying amount of a redeemable security should be treated like dividends on nonredeemable stock by charging retained earnings, or if no retained earnings exist, by charging paid-in capital, regardless of the method used to account for the security or whether the security is redeemable at a fixed price or at fair value. In calculating earnings per share and the ratio of earnings to combined fixed charges and preferred stock dividends, income available to common stockholders should be reduced or increased as a result of increases or decreases in a preferred security's carrying amount. Guidance related to the accounting at the date of a redemption or induced conversion of a preferred equity security may be found in ASC 260-10-S99-2 ("The Effect on the Calculation of Earnings per Share for the Redemption or Induced Conversion of Preferred Stock")

Common Securities Issued by a Parent or a Single Reporting Entity

Increases or decreases in the carrying amount of a redeemable security should be treated like dividends on nonredeemable stock by charging retained earnings, or if no retained earnings exist, by charging paid-in capital, regardless of the method used to account for the security or whether the security is redeemable at a fixed price or at fair value. But those increases or decreases in a redeemable common stock's carrying amount should *not* affect income available for common stock holders. The SEC staff believes that in so far as a common shareholder has a contractual right to receive an amount other than the fair value of those shares at redemption, a common shareholder has, in substance, received a different distribution than the other common shareholders. Entities whose capital structures include a class of common stock with dividend rates that differ from those of another class of common shareholders but without senior rights, are required to calculate their earnings per share based on the two-class method discussed in ASC 260-10-45-59A. As a result, increases or decreases in the carrying amount of a class of common stock that is redeemable at other than fair value should be considered in the calculation of earnings per share using the two-class method. In footnote 8 of this Topic, the SEC staff states that if a common security is redeemable at other than fair value, it is acceptable to allocate earnings under the two-class method using one of the following two methods:

- Treat the total periodic adjustment to the security's carrying amount as a result of the application of the guidance in this Topic like an actual dividend, or
- Treat like an actual dividend only the portion of the periodic adjustment to the security's carrying amount as a result of the application of the guidance in this Topic that represents a redemption in excess of fair value.

The SEC staff does not expect the two-class method to be used in the calculation of earnings per share if a class of common stock is redeemable at fair value, because the dividend distribution to those shareholders does not differ from that made to other common shareholders. The SEC staff believe that common stock redeemable based on a specified formula is considered redeemable at fair value if the formula is intended to equal or reasonably approximate fair value. However, a formula based only on a fixed multiple of earnings or a similar measure would *not* qualify.

The SEC staff also believe that likewise, the two-class method need *not* be used if share-based payment awards in the form of common shares or options or common shares granted to employees are redeemable at fair value. However, the two-class method may still apply to such share-based payment awards under the guidance in ASC 260-10-45-59A and ASC 260-10-45-60, 45-60A through 45-68, 55-24 through 55-30, 55-71 through 55-75 (*Participating Securities and the Two-Class Method under Statement No. 128*).

Noncontrolling Interests

In accordance with the guidance in ASC 810-10-45-23, (a) changes in a parent's ownership interest accounted for by the equity method while a parent retains control of the subsidiary and (b) an adjustment to a noncontrolling interest as a result of the application of the guidance in this SEC staff announcement, have no effect on net income or comprehensive income in the consolidated financial statements. Instead, such adjustments are accounted for like a repurchase of a noncontrolling interest, although they may be recognized in retained earnings

http://www.pbookshop.com

Uncertain Tax Positions 46,027
- Scope 46,027
- Recognition 46,028
- Measurement 46,028
- Effect of ASC 740 on Evaluation of Deferred Tax Assets 46,029
- Subsequent Recognition 46,029
- Derecognition 46,029
- Treatment of Interest and Penalties 46,029
- Financial Statement Classification 46,030
- Disclosure Requirements 46,030
- Implementation Guidance 46,031
  - *Illustration—Measuring Benefit of a Tax Position* 46,031
  - *Illustration—Measurement when Uncertainty Exists Surrounding the Timing of Tax Deductibility* 46,032

ASC 740-20: Intraperiod Tax Allocation 46,033

Intraperiod Tax Allocation 46,033

ASC 740-30: Other Considerations or Special Areas 46,034

Income Taxes in Special Areas 46,034

ASC 740-270: Interim Reporting 46,035

Accounting for Income Taxes in Interim Periods 46,035
- *Illustration of Quarterly Income Tax Calculation* 46,036

Important Notice for 2019 46,036

Part II: Interpretive Guidance 46,037

ASC 740-10: Overall 46,037

ASC 740-10-25-9
- Definition of *Settlement* in FASB Interpretation No. 48 46,037

ASC 740-10-25-34, 50-4, 55-2 through 55-6, 55-15 through 55-22, 55-25, 55-40 through 55-41, 55-48, 55-59 through 55-65, 55-79 through 55-80, 55-163 through 55-164, 55-168 through 55-169, 55-213 through 55-216; ASC 740-20-55-1 through 55-7; ASC 942-740-35-1 through 35-3; ASC 942-852-55-2 through 55-6; ASC 855-10-60-2
- A Guide to Implementation of ASC 740 on Income Taxes 46,039
  - *Illustration of Change in Tax Status* 46,042
  - *Illustration of Multiple Tax Planning Strategies* 46,043

ASC 740-10-25-39 through 25-40, 30-14
- Accounting for Tax Credits Related to Dividend Payments in Accordance with ASC 740 46,044

ASC 740-10-25-41
- Measurement in the Consolidated Financial Statements of a Parent of the Tax Effects Related to the Operations of a Foreign Subsidiary That Receives Tax Credits Related to Dividend Payments 46,046

ASC 740-10-25-43; ASC 840-30-35-48 through 35-52
- Tax Reform Act of 1986: Issues Related to the Alternative Minimum Tax 46,047

ASC 740-10-25-48
- Effect of a Retroactive Change in Enacted Tax Rates That Is Included in Income from Continuing Operations 46,048
  - *Illustration Using Guidance in ASC 740-10-25-48* 46,049

http://www.pbookshop.com

ASC 740-10-25-50 through 25-55, 35-5, 45-22 through 45-24, S25-1, S99-3, 55-171 through 55-191, 55-199 through 55-201, 55-203 through 55-204, 55-76
- Accounting for Acquired Temporary Differences in Certain Purchase Transactions That Are Not Accounted for as Business Combinations 46,050
  - *Illustrations of the Guidance on Accounting for Temporary Differences in Certain Purchases That Are Not Accounted for as Business Combinations* 46,052

ASC 740-10-45-10A through 45-13, 65-3; ASC 210-10-15-3, 65-3
- Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists 46,054

ASC 740-10-45-21; ASC 740-20-45-11
- Accounting by a Company for the Income Tax Effects of Transactions among or with Its Shareholders under ASC 740 46,056

ASC 740-10-45-18, 25-47
- Adjustment Due to Effect of a Change in Tax Laws or Rates 46,058

ASC 740-10-55-26, 55-140 through 55-144, 15-4, 05-5
- Application of ASC 740 to a State Tax Based on the Greater of a Franchise Tax or an Income Tax 46,059
  - *Illustration of the Calculation of Texas State Tax and Deferred Tax Liability* 46,060

ASC 740-10-55-27 through 55-30, 55-146 through 55-148
- Application of ASC 740, Income Taxes, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004 46,061

ASC 740-10-55-50, 25-31
- Temporary Differences Related to LIFO Inventory and Tax-to-Tax Differences 46,061

ASC 740-10-55-51
- Income Tax Consequences of Issuing Convertible Debt with a Beneficial Conversion Feature 46,062

ASC 740-10-55-53, 25-31
- Intraperiod Tax Allocation of the Tax Effect of Pretax Income from Continuing Operations 46,063

ASC 740-10-55-69, 55-70, 55-71
- Classification of Payment Made to IRS to Retain Fiscal Year 46,064

ASC 740-10-55-73 through 55-74, 15-4
- Accounting for Tax Effects of Dividends in France in Accordance with ASC 740 46,065

ASC 740-30: Other Considerations or Special Areas 46,066

ASC 740-30-25-10
- Recognition of Deferred Tax Assets for a Parent Company's Excess Tax Basis in the Stock of a Subsidiary That Is Accounted for as a Discontinued Operation 46,066

ASC 740-270: Interim Reporting 46,067

ASC 740-270-55-51
- Accounting in Interim Periods for Changes in Income Tax Rates 46,067

PART I: GENERAL GUIDANCE

OVERVIEW

The tax consequences of many transactions recognized in the financial statements are included in determining income taxes currently payable in the same accounting period. Sometimes, however, tax laws differ from the recognition and measurement requirements of financial reporting standards. Differences arise between the tax bases of assets or liabilities and their reported amounts in the financial statements. These differences are called *temporary differences* and they give rise to deferred tax assets and liabilities.

Temporary differences ordinarily reverse when the related asset is recovered or the related liability is settled. A *deferred tax liability* or *deferred tax asset* represents the increase or decrease in taxes payable or refundable in future years as a result of temporary differences and carryforwards at the end of the current year.

The objectives of accounting for income taxes are to recognize:

- The amount of taxes payable or refundable for the current year.
- The deferred tax liabilities and assets that result from future tax consequences of events that have been recognized in the enterprise's financial statements or tax returns.

BACKGROUND

Accounting for income taxes is strongly influenced by the fact that some transactions are treated differently for financial reporting purposes and for income tax purposes. Other transactions are treated the same way in financial reporting and for income tax purposes, but in different accounting periods. Differences in timing are referred to as temporary differences and are reconciled in the financial statements by the recognition of deferred tax assets and liabilities.

For several decades, deferred tax assets and liabilities were recognized in the financial statements by the deferred method which placed primarily emphasis on determining net income by matching of revenues and expenses. Income tax expense was determined by applying the current tax rate to pretax accounting income. Any differences between the resulting expense and the amount of income taxes payable in the current period were adjustments to deferred income taxes. The deferred method focused first on the income statement, and adjustment to balance sheet elements were determined by the measurement of income tax expense.

The Financial Accounting Standards Board significantly changed this approach when it changed accounting for income taxes to the asset/liability method, frequently referred to as simply the liability method. The liability method places primary emphasis on the valuation of the elements of the balance sheet—deferred tax assets and liabilities. The amount of income tax expense currently payable or refundable, plus or minus the changes in deferred tax assets and liabilities, is the amount of income tax expense recognized in the income statement for a financial reporting period. The liability method focuses first on the balance sheet, and the amount of income tax expense is determined by changes in the elements of the balance sheet.

ASC 740-10: OVERALL

THE ASSET/LIABILITY METHOD

ASC 740 requires income taxes to be accounted for by the asset/liability method. Its main effects on financial statements include the following:

- Emphasis is on the recognition and measurement of deferred tax assets and liabilities. Deferred income tax expense is determined residually (i.e., as the difference between the beginning and required ending balances in deferred tax assets and liabilities for the period).
- Deferred tax asset and liability amounts are remeasured when tax rates change to approximate more closely the amounts at which those assets and liabilities will be realized or settled.
- Deferred tax assets are recognized for operating loss and other carryforwards. Deferred tax assets are subject to reduction by a valuation allowance if evidence indicates that it is *more likely than not* that some or all of the deferred tax assets will not be realized. Determining this valuation allowance is similar to accounting for reductions in receivables to net realizable value.
- Disclosure requirements result in the presentation of a significant amount of information in the notes to the financial statements.

PRACTICE NOTE: The asset/liability method is commonly referred to as the liability method, although it results in both deferred tax assets and deferred tax liabilities.

GENERAL PROVISIONS OF ASC 740

Scope

ASC 740 requires what traditionally has been referred to as "comprehensive income tax allocation," as opposed to partial allocation or nonallocation. This means that the income tax effects of all revenues, expenses, gains, losses, and other events that create differences between the tax bases of assets and liabilities and their amounts for financial reporting are required to be recognized (ASC 740-10-05-1).

ASC 740 is applicable to:

- Domestic federal income taxes and foreign, state, and local taxes based on income (ASC 740-10-15-3).
- An enterprise's domestic and foreign operations that are consolidated, combined, or accounted for by the equity method. ASC 740 provides guidance for determining the tax bases of assets and liabilities for financial reporting purposes (ASC 740-10-15-3).
- Foreign enterprises in preparing financial statements in accordance with U.S. GAAP. (ASC 740-10-15-2).

ASC 740 does not apply to the following transactions/activities (ASC 740-10-15-4):

http://www.pbookshop.com

1. A franchise tax to the extent it is based on capital and there is no additional tax based on income.
2. A withholding tax for the benefit of recipients of a dividend.

Three important financial statement issues are specifically set aside and not covered by ASC 740:

1. Accounting for the investment tax credit (ITC)
2. Accounting for income taxes in interim periods
3. Discounting deferred income taxes

Accounting for the ITC and accounting for income taxes in interim periods are covered by other authoritative pronouncements. Discounting of deferred income taxes is not permitted.

Basic Principles of the Asset/Liability Method

The objectives of accounting for income taxes are identified in terms of elements of the balance sheet (ASC 740-10-10-1):

- To recognize the amount of taxes payable or refundable for the current year
- To recognize the deferred tax assets and liabilities for the future tax consequences of events that have been recognized in the financial statements or in tax returns

This emphasis on the balance sheet is consistent with the liability method of accounting for income taxes incorporated ASC 740.

Accounting for income taxes under ASC 740 is based on the following basic principles at the date of the financial statements:

- A tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current and prior years.
- A deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carryforwards. (ASC 740-10-25-2)

PRACTICE POINTER: The reader is encouraged to consult ASC 740-10-25-2 for exceptions to these basic requirements in certain specialized situations (e.g., foreign subsidiaries or corporate joint ventures, undistributed earnings of a domestic subsidiary or corporate joint venture that is essentially permanent in duration, bad debt reserves of U.S. savings and loan associations, policyholders' surplus of stock life insurance entities, deposits in statutory reserve funds by U.S. steamship entities, leveraged leases, goodwill for which amortization is not deductible for tax purposes, inventory in the buyer's tax jurisdiction where the carrying value as reported in the consolidated financial statements as a result of an intra-entity transfer of inventory from one tax-paying

component to another tax-paying component of the same consolidated group, assets and liabilities remeasured from the local currency into the functional currency using historical exchange rates and that result from changes in exchange rates or indexing for tax purposes. Many of these include certain specific time parameters for application.

Temporary Differences

Deferred tax assets and liabilities that result from temporary differences are based on the assumption that assets and liabilities in an entity's balance sheet eventually will be realized or settled at their recorded amounts (ASC 740-10-25-20).

The following categories of temporary differences refer to events that result in differences between the tax bases of assets and liabilities and their reported amounts in the financial statements (ASC 740-10-25-20):

- Revenues or gains that are taxable after they are recognized in accounting income (e.g., receivables from installment sales)
- Expenses or losses that are deductible for tax purposes after they are recognized in accounting income (e.g., a product warranty liability)
- Revenues or gains that are taxable before they are recognized in accounting income (e.g., subscriptions received in advance)
- Expenses or losses that are deductible for tax purposes before they are recognized in accounting income (e.g., depreciation expense)
- A reduction in the tax basis of depreciable assets because of tax credit
- Investment tax credits accounted for by the deferred method
- An increase in the tax basis of assets because of indexing when the local currency is the functional currency
- Business combinations accounted for by not-for-profit entities by the acquisition method
- Intra-entity transfers of an asset other than inventory

Taxable and Deductible Temporary Differences

Temporary differences that will result in taxable amounts in future years when the related asset or liability is recovered or settled are referred to as *taxable temporary differences*. Temporary differences that will result in deductible amounts in future years are referred to as *deductible temporary differences*. (ASC 740-10-25-23). Table 46-1 provides examples of some of the more common taxable and deductible temporary differences.

Temporary differences include some items that do not appear in the company's balance sheet. For example, a company may expense organization costs when they are incurred but recognize them as a tax deduction in a later year. Between the two events, no balance-sheet item exists for this type of temporary difference (ASC 740-10-25-25, 26).

http://www.pbookshop.com

The identification of temporary differences may require significant professional judgment. Similar items may be temporary differences in one instance and not in another. For example, the excess of the cash surrender value of life insurance over premiums paid is a temporary difference and results in deferred taxes if the cash surrender value is expected to be recovered by surrendering the policy, but it is not a temporary difference and does not result in deferred taxes if the asset is expected to be recovered upon the death of the insured (ASC 740-10-25-30). Management intent and professional judgment are important factors in making the appropriate determination of the nature of assets and liabilities of this type.

PRACTICE POINTER: Developing a system for identifying and tracking the amounts of all temporary differences and carryforwards is an important implementation issue for ASC 740. Theoretically, differences should be identified by comparing items and amounts in the entity's balance sheets for accounting purposes and for tax purposes. Many companies do not maintain tax-basis balance sheets, though this may be the most logical way to identify and track temporary differences in relatively complex situations.

Table 46-1: Examples of Taxable and Deductible Temporary Differences

Nature of Temporary Difference	*Explanation*	*Deferred Tax*
	Taxable Temporary Differences	
Depreciable assets	Use of modified accelerated cost recovery system (MACRS) for tax purposes and straight-line for accounting purposes makes the tax basis of the asset less than the accounting basis	Liability, to be paid as MACRS deduction becomes less than straight-line depreciation
Installment sale receivable	Sales recognized for accounting purposes at transaction date and deferred for tax purposes until collection, resulting in a difference between the tax and accounting basis of the installment receivable	Liability, to be paid when the sale is recognized for tax purposes
	Deductible Temporary Differences	
Warranty liability	Expense recognized on accrual basis for accounting purposes and on cash basis for tax purposes, resulting in a liability that is recognized for financial reporting purposes but has a zero basis for tax purposes	Asset, to be recovered when deduction is recognized for tax purposes
Accounts receivable allowance for doubtful accounts	Expense recognized on an accrual basis for accounting purposes and deferred for tax purposes	Asset, to be recovered when uncollectible account is written off for tax purposes

Certain differences between the tax basis and the accounting basis of assets and liabilities will not result in taxable or deductible amounts in future years, and no deferred tax asset or liability should be recognized (ASC 740-10-05-9). These differences are often referred to as permanent differences, although that term is not used in ASC 740.

Recognizing and Measuring Deferred Tax Assets and Liabilities

The emphasis placed on the balance sheet by the asset/liability method of accounting for income taxes is evident from the focus on the recognition of deferred tax liabilities and assets. The change in these liabilities and assets is combined with the income taxes currently payable or refundable to determine income tax expense (ASC 740-10-30-3).

Five steps are required to complete the annual computation of deferred tax liabilities and assets (ASC 740-10-30-5):

1. Identify the types and amounts of existing temporary differences and the nature and amount of each type of operating loss and tax credit carryforward and the remaining length of the carryforward period.
2. Measure the total deferred tax liability for taxable temporary differences using the applicable tax rate.
3. Measure the total deferred tax asset for deductible temporary differences and operating loss carryforwards using the applicable tax rate.
4. Measure deferred tax assets for each type of tax credit carryforward.
5. Reduce deferred tax assets by a valuation allowance if it is more likely than not that some or all of the deferred tax assets will not be realized.

Valuation Allowance and Tax-Planning Strategies

A basic requirement is to reduce the measurement of deferred tax assets not expected to be realized (ASC 740-10-30-16) All available evidence is considered to determine whether a valuation allowance for deferred tax assets is needed and, if so, at what amount (ASC 740-10-30-17).

Determining the need for and calculating the amount of the valuation allowance involves the following steps at the end of each accounting period:

http://www.pbookshop.com

1. Determine the amount of the deferred tax asset recognized on each deductible temporary difference, operating loss, and tax credit carryforward. (These are not offset by the deferred tax liability on taxable temporary differences.)
2. Assess the sources of future taxable income which may be available to recognize the deductible differences and carryforwards by considering the following (ASC 740-10-30-18):
   a. Taxable income in prior carryback year(s) if carryback is permitted under tax law
   b. Future reversals of existing taxable temporary differences
   c. Tax planning strategies that would make income available at appropriate times in the future that would otherwise not be available
   d. Future taxable income exclusive of reversing differences and carryforwards

PRACTICE POINTER: The four sources of future taxable income (listed above) are organized differently here than in ASC 740 in order to emphasize the implementation of the standard. In identifying income to support the recognition of deferred tax assets (and thereby supporting a case that an allowance is not required), a logical approach is to consider sources of income in order from the most objective to the least objective. Income in prior carryback years is most objective, followed by the income from the reversal of taxable temporary differences, income resulting from tax planning strategies, and finally, future income from other sources.

3. Based on all available evidence, make a judgment concerning the realizability of the deferred tax asset.
4. Record the amount of the valuation allowance, or change in the valuation allowance (the example below assumes that the allowance is being recorded for the first time or is being increased for $100,000).

Income tax expense	$100,000	
Allowance to reduce deferred tax asset to lower recoverable value		$100,000

PRACTICE NOTE: ASC 740 relaxes the criteria for recognizing deferred tax assets by requiring the recognition of deferred tax assets for all deductible temporary differences and all operating loss and tax credit carryforwards. An important adjunct to this provision, however, is the requirement to determine the need for, and amount of, a valuation allowance to reduce the deferred tax asset to its realizable value. The valuation allowance aspects of U.S. GAAP require significant judgment on the part of accountants and auditors of financial statements. A valuation allowance is required if it is more likely than not that some or all of the deferred tax assets will not be realized. *More likely than not* is defined as a likelihood of more than 50%.

Applicable Tax Rate

Reference to the applicable tax rate is made in the four steps identified above. The *applicable tax rate* is that rate expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized based on enacted tax law. If the entity's taxable income is low enough to make the graduated tax rates a significant factor, the entity uses the average graduated tax rate applicable to the amount of estimated annual taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized (ASC 740-10-10-3). For example, if a company has taxable temporary differences of $20,000 that are expected to reverse in a year when no other income is expected, the applicable tax rate under current tax law is 15% and the deferred tax liability is:

$$\$20{,}000 \times 15\% = \$3{,}000$$

If the taxable temporary differences total $60,000, graduated tax rates become a factor (the tax rate changes at $50,000); deferred taxes are $10,000:

$50,000 × 15%	=	$ 7,500
$10,000 × 25%	=	2,500
		$10,000

The average applicable tax rate is 16.67%.

$$\$10{,}000/\$60{,}000 = 16.67\%$$

PRACTICE POINTER: Determining the applicable tax rate may be relatively straightforward, or it may require careful analysis and professional judgment. When an entity has been consistently profitable at sufficiently high levels that graduated tax rates are not a significant factor, use the single flat tax rate at which all income is used to compute the amount of deferred taxes on cumulative temporary differences. If a company experiences intermittent tax loss and tax income years, or if the company is consistently profitable at a level low enough that the graduated tax rates are a significant factor, greater judgment is required to determine the applicable tax rate.

Deferred tax assets and liabilities are remeasured at the end of each accounting period and adjusted for changes in the amounts of cumulative temporary differences and for changes in the applicable income tax rate, as well as for other changes in the tax law (ASC 740-10-35-4). As a result of this procedure, the deferred tax provision is a combination of two elements:

1. The change in deferred taxes because of the change in the amounts of temporary differences
2. The change in deferred taxes because of a change in the tax rate caused by new enacted rates or a change in the applicability of graduated tax rates (or other changes in the tax law)

Treating the change in income tax rates in this manner is consistent with accounting for a change in estimate under ASC 250 (Accounting Changes and Error Corrections).

http://www.pbookshop.com

Tax Planning Strategies

Consideration of tax planning strategies is required by ASC 740. Tax planning strategies are an important part of determining the need for, and the amount of, the valuation allowance for deferred tax assets. Tax-planning strategies are actions that (ASC 740-10-30-19):

- Are prudent and feasible
- The entity might not ordinarily take, but *would* take to prevent an operating loss or tax credit carryforward from expiring before it is used
- Would result in the realization of deferred tax assets

Examples include actions the entity could take to accelerate taxable income to utilize expiring carryforwards, to change the character of taxable or deductible amounts from ordinary income or loss to capital gain or loss, and to switch from tax-exempt to taxable investments.

Negative Evidence

Negative evidence, such as cumulative losses in recent years, supports a conclusion that a valuation allowance is necessary. Other examples of negative evidence are (ASC 740-10-30-21):

- A history of operating loss or tax credit carryforwards expiring before they are used
- Losses expected in early future years (by a presently profitable entity)
- Unsettled circumstances that, if unfavorably resolved, would adversely affect future operations and profit levels on a continuing basis in future years
- A carryback or carryforward period that is so short that it significantly limits the probability of realizing deferred tax assets

Positive Evidence

Positive evidence supports a conclusion that a valuation allowance is *not required.* Examples of positive evidence are (ASC 740-10-30-22):

- Existing contracts or firm sales backlog that will produce more than enough taxable income to realize the deferred tax asset based on existing sales prices and cost structures
- An excess of appreciated asset value over the tax basis of the entity's net assets in an amount sufficient to realize the deferred tax asset
- A strong earnings history exclusive of the loss that created the future deductible amount, coupled with evidence indicating that the loss is an aberration rather than a continuing condition (e.g., an unusual or infrequent item)

PRACTICE POINTER: Projecting the reversal of temporary differences for each future year individually is commonly referred to as "scheduling." Does ASC 740 require scheduling? On the one hand, the requirement to recognize deferred tax assets and liabilities for all taxable and deductible temporary differences, as

well as for all carryforwards, seems to diminish or eliminate the need to schedule. Also, using a flat tax rate in determining the amount of deferred tax assets and liabilities, as described earlier, diminishes the need to schedule individual future years. On the other hand, scheduling may help determine the need for, and amount of, a valuation allowance, including the consideration of tax-planning strategies. To determine the availability of taxable income in the appropriate years—to take advantage of deferred tax assets and to make the judgments concerning the valuation allowance—projecting taxable income from known or estimated sources by year, or scheduling, may still be important.

Professional judgment is required in considering the relative impact of negative and positive evidence to determine the need for, and amount of, the valuation allowance for deferred tax assets. The weight given the effect of negative and positive evidence should be commensurate with the extent to which it can be objectively verified. The more negative evidence exists, the more positive evidence is needed to conclude that a valuation allowance is not required (ASC 740-10-30-23).

The effect of a change in the valuation allowance that results from a change in circumstances, which in turn causes a change in judgment about the realizability of the related deferred tax asset, is included in income from continuing operations with limited exceptions (ASC 740-10-42-20).

SPECIALIZED APPLICATIONS OF ASC 740

Several specialized applications of ASC 740 are summarized briefly below.

Change in Tax Status

An enterprise's tax status may change from nontaxable to taxable or taxable to nontaxable. A deferred tax liability or asset is recognized for temporary differences at the date that a nontaxable enterprise becomes a taxable enterprise. An existing deferred tax liability or asset is eliminated at the date an enterprise becomes a nontaxable enterprise (ASC 740-10-25-32).

Reclassification of Certain Tax Effects

PRACTICE POINTER: The following amendments to the ASC are effective for all entities for fiscal years beginning after December 15, 2018, and for interim periods within those fiscal years.

ASU 2018-02, Income Statement—Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income, deals with the reclassification of certain tax effects from accumulated other comprehensive income that results from the Tax Cuts and Jobs Act of 2017. This amendment allows a reclassification from accumulated other comprehensive income to retained earnings from stranded tax effects resulting from this Act. See Chapter 5, *ASC 220—Comprehensive Income,* of the 2019 *GAAP Guide* for more coverage of this topic.

---

http://www.pbookshop.com

realized tax benefits that exceed the previously recognized deferred tax asset for those instruments are recognized as paid-in capital (ASC 718-740-35-3).

The amount deductible on the employer's tax return may be less than the cumulative compensation cost recognized for financial reporting purposes. The write-off of a deferred tax asset related to that deficiency, net of any related valuation allowance, is first offset to the extent of any remaining additional paid-in capital from excess tax benefits from previous awards accounted for in accordance with the requirements under previous U.S. GAAP. Any remaining balance of the write-off of a deferred tax asset related to a tax deficiency shall be recognized in the income statement (ASC 718-740-35-5; 718-740-45-04).

PRACTICE NOTE: The special applications discussed in this section illustrate the pervasive nature of accounting for income taxes. Income tax considerations affect many parts of the financial statements and many kinds of business transactions. This dimension of accounting for income taxes makes ASC 740 a very important pronouncement and accounts, at least partially, for the long and difficult process of making the transition from the deferred method to the asset/liability method.

Leveraged Leases

For the specific requirements for accounting for income taxes related to leveraged leases, see Subtopic 842-50.

FINANCIAL STATEMENT PRESENTATION AND DISCLOSURE ISSUES

ASC 740 requires deferred tax assets and liabilities to be presented in a classified balance sheet as noncurrent amounts (ASC 740-10-45-4).

PRACTICE NOTE: This represents a departure from past practice in which deferred tax assets and liabilities were presented in net current and net noncurrent amounts. As part of the FASB's simplification project, the previous requirement to separate deferred tax assets and liabilities into current and noncurrent amounts has been eliminated. For public business entities, this new presentation is effective for financial statements issued for annual periods beginning after December 15, 2016, and interim periods within those annual periods. For all other entities, the effective date is for financial statements issued for annual periods beginning after December 15, 2017, and for interim periods within annual periods beginning after December 15, 2018. Earlier application is permitted for all entities as of the beginning of an interim or annual reporting period. The change required may be accounted for either prospectively or retroactively with appropriate disclosure of the nature of the change and whether prior period information has been retrospectively adjusted.

For a particular tax-paying component of an entity and within a particular tax jurisdiction, all deferred tax liabilities and assets shall be offset and presented as a single noncurrent amount. However, an entity shall not offset deferred tax liabilities and assets attributable to different tax-paying components of the entity or to different tax jurisdictions (ASC 740-10-45-6).

Disclosures

The following components of the net deferred tax liability or asset recognized in an enterprise's balance sheet must be disclosed (ASC 740-10-50-2):

- The total of all deferred tax liabilities for taxable temporary differences
- The total of all deferred tax assets for deductible temporary differences and loss and tax credit carryforwards
- The total valuation allowance recognized for deferred tax assets
- The net change during the year in the total valuation allowance

Disclosure of significant components of income tax expense attributable to continuing operations for each year presented is required in the financial statements or related notes (ASC 740-10-50-9):

- Current tax expense or benefit
- Deferred tax expense or benefit
- Investment tax credit
- Government grants (to the extent recognized as reductions in income tax expense)
- Tax benefits of operating loss carryforwards
- Tax expense that results from allocating tax benefits
- Adjustments to a deferred tax liability or asset for enacted changes in tax laws or rates or for a change in the tax status of the enterprise
- Adjustments of the beginning balance of the valuation allowance because of a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in the future

---

PRACTICE NOTE: The effect of two unique features of the asset/liability method can be seen in the disclosure requirements listed above. The seventh item requires disclosure of the amount of the adjustment to deferred tax assets and liabilities for enacted changes in tax laws or rates. The eighth item requires disclosure of the amount of the adjustment of the beginning balance of the valuation allowance on deferred tax assets made as a result of a change in judgment about the realizability of that item.

The amount of income tax expense or benefit allocated to continuing operations and amounts separately allocated to other items shall be disclosed for each year for which those items are presented.

Several distinctions are made in the disclosures required by public enterprises and those required by nonpublic enterprises. The two most significant ones are summarized as follows (ASC 740-10-50-6, 8, 12, 13):

http://www.pbookshop.com

	Public/Nonpublic Company Disclosures	
	Public	*Nonpublic*
Temporary Differences and Carryforwards	Approximation of tax effect of each type	Description of types
Statutory Reconciliation	Reconciliation in percentages or dollars	Description of major reconciling items

Companies with operating loss and tax credit carryforwards must disclose the amount and expiration dates. Disclosure is also required for any portion of the valuation allowance for deferred tax assets for which subsequently recognized tax benefits will be credited directly to contributed equity (ASC 740-10-50-3).

An entity that is a member of a group that files a consolidated tax return must disclose the following in its separately issued financial statements (ASC 740-10-50-17):

- The aggregate amount of current and deferred tax expense for each statement of earnings presented and the amount of any tax-related balances due to or from affiliates as of the date of each statement of financial position presented
- The principal provisions of the method by which the consolidated amount of current and deferred tax expense is allocated to members of the group and the nature and effect of any changes in that method during the year

Illustration of Major Provisions of ASC 740

This illustration considers Power Company for three consecutive years, with the objective of preparing the year-end income tax accrual and income tax information for the company's financial statements. Power Company's first year of operations is 20X8. During that year, the company reported $160,000 of pretax accounting income. Permanent and temporary differences are combined with pretax financial income to derive taxable income, as follows:

Pretax financial income	$160,000
Permanent difference:	
Interest on municipal securities	(5,000)
Pretax financial income subject to tax	$155,000
Temporary differences:	
Depreciation	(28,000)
Warranties	10,000
Revenue received in advance	7,000
Taxable income	$144,000

The $5,000 interest on municipal securities represents nontaxable income, and the $28,000 depreciation temporary difference represents the excess of accelerated write-off for tax purposes over straight-line depreciation for financial reporting purposes. Warranties are expensed at the time of sale on an estimated basis, but are deductible for income tax purposes only when paid. In 20X8, $10,000 more was accrued than paid. Revenue received in advance is taxable at the time received, but is deferred for financial reporting purposes until earned. In 20X8, $7,000 was received that was not earned by year-end. Depreciation is a *taxable temporary difference* that reduces current tax payable and gives rise to a deferred tax liability. The warranties and revenue received in advance are *deductible temporary differences* that increase current tax payable and give rise to deferred tax assets.

Exhibit A presents analyses that facilitate the preparation of the year-end tax accrual, as well as information for the financial statements. Similar analyses are used for each of the three years in this Illustration. The analysis in the upper portion of Exhibit A "rolls forward" the amount of the temporary differences from the beginning to the end of the year. Because 20X8 is the first year for Power Company, the beginning balances are all zero. The change column includes the amounts used in the earlier calculation to determine taxable income from pretax accounting income. The numbers without parentheses are deductible temporary differences; those in parentheses are taxable temporary differences. The company is in a net taxable temporary difference position at the end of the year because the net amount of temporary differences is $(11,000), due to the large amount of the depreciation difference.

http://www.pbookshop.com

EXHIBIT A: Analysis of Cumulative Temporary Differences and Deferred Taxes, 20X8

Cumulative Temporary Differences (TD)

	Beginning Balance 20X8	*Change*	*Ending Balance 20X8*
Deductible TD:			
Warranties	0	$ 10,000	$ 10,000
Revenue received in advance	0	7,000	7,000
(Taxable) TD:			
Depreciation	0	(28,000)	(28,000)
	0	$(11,000)	$(11,000)

Deferred Income Taxes

	Beginning Balance @—%	*Ending Balance @34%*	*Change*
Assets:			
Warranties	0	$3,400	$ 3,400
Revenue receivedin advance	0	2,380	2,380
(Liabilities):			
Depreciation	0	(9,520)	(9,520)
	0	$(3,740)	$(3,740)

PART I: GENERAL GUIDANCE

ASC 835-10: OVERALL

OVERVIEW

Under certain conditions, interest is capitalized as part of the acquisition cost of an asset. Interest is capitalized only during the period of time required to complete and prepare the asset for its intended use, which may be either *sale or use within the business*. Capitalization of interest is based on the principle that a better measure of acquisition cost is achieved when certain interest costs are capitalized. This results in a better matching of revenue and costs in future periods.

Business transactions may involve the exchange of cash or other assets for a note or other instrument. When the interest rate on the instrument is consistent with the market rate at the time of the transaction, the face amount of the instrument is assumed to be equal to the value of the other asset(s) exchanged. An interest rate that is different from the prevailing market rate, however, implies that the face amount of the instrument may not equal the value of the other asset(s) exchanged. In this case, it may be necessary to impute interest that is not stated as part of the instrument, or to recognize interest at a rate other than that stated in the instrument.

BACKGROUND

The basis of accounting for depreciable fixed assets is cost, including all normal expenditures of readying an asset for use are capitalized as part of acquisition cost. Unnecessary expenditures that do not add to the utility of the asset should be charged to expense.

ASC 835 covers the promulgated U.S. GAAP on the capitalization of interest costs on certain qualifying assets that are undergoing activities to prepare them for their intended use. ASC 835 requires that the same materiality tests applied by regular U.S. GAAP be applied to the materiality of capitalizing interest cost.

ASC 835 applies to the capitalization of interest cost on equity funds, loans, and advances made by investors to certain investees that are accounted for by the equity method as described in ASC 323 (Investments—Equity Method and Joint Ventures).

ASC 835 provides special treatment in capitalizing interest costs on qualifying assets that are acquired with (*a*) the proceeds of tax-exempt borrowings and (*b*) gifts or grants that are restricted for the sole purpose of acquiring a specific asset.

PRACTICE POINTER: The basis of capitalizing certain interest costs is that the cost of an asset should include all costs necessary to bring the asset to the condition and location for its intended use. The requirements of ASC 835 to capitalize interest cost may result in a lack of comparability among reporting entities, depending on their method of financing major asset acquisitions. For example, Company A and Company B both acquire an identical asset for $10 million that requires three years to complete for its intended use. Company A pays cash, and at the end of three years, the total cost of the asset is $10 million. In addition, assume that Company A also had net income of $2 million a year for each of the three years and had no interest expense. Assume also that Company B had $1.5 million net income for each of the three years after deducting $500,000 of interest expense per year. If Company B qualifies for capitalized interest costs under ASC 835, it would reflect $2 million per year net income and not show any interest expense. On the balance sheet of Company B at the end of three years, the identical asset would appear at a cost of $11.5 million. Future depreciation charges will vary between the two companies by a total of $1.5 million. Although the interest cost may be necessary to Company B, it does not add to the utility of the asset.

ASC 835 is also the main source of U.S. GAAP on imputing interest on receivables and payables. However, ASC 835 guidance does not apply under the following conditions (ASC 835-30-15-3):

1. Payables that arise in the ordinary course of business and are due in approximately one year or less.
2. Amounts do not require repayment in the future, but rather will be applied to the purchase price of the property, goods, or services to which they relate rather than requiring a transfer of cash, except for amounts promised in a contract with a customer.
3. Amounts represent security or retainage deposits.
4. Amounts arise in the ordinary course of business of a lending institution.
5. Amounts arise from transactions between a parent and its subsidiaries, or between subsidiaries of a common parent.
6. The interest rate is affected by the tax attributes or legal restrictions prescribed by a governmental agency.
7. The application of the present value measurement (valuation) techniques to estimates of contractual or other obligations assumed in connection with the sale of property, goods or services.
8. Receivables, contract assets, and contract liabilities in contracts with customers.

Receivables and payables that are not specifically excluded from the provisions of ASC 835 and that are contractual rights to receive or pay money at a fixed or determinable date must be recorded at their present value if (*a*) the interest rate is not stated or (*b*) the stated interest rate is unreasonable (ASC 310-10-30-6).

PRACTICE NOTE: This is an application of the basic principle of substance over form in that the substance of the instrument (interest-bearing), rather than the form of the instrument (noninterest-bearing or bearing interest at an unreasonable rate), becomes the basis for recording.

---

http://www.pbookshop.com

ASC 835-20: CAPITALIZATION OF INTEREST

QUALIFYING ASSETS

Acquisition Period

In concept, interest cost must be capitalized for all assets that require an *acquisition period* to get them ready for their intended use (ASC 835-20-15-2). *Acquisition period* is defined as the period commencing with the first expenditure for a qualifying asset and ending when the asset is substantially complete and ready for its intended use. Thus, before interest costs can be capitalized, expenditures must have been made for the qualifying asset, providing an investment base on which to compute interest, and activities that are required to get the asset ready for its intended use must actually be in progress.

The usual rules of materiality embodied in U.S. GAAP must be followed in determining the materiality for the capitalization of interest costs. Thus, in applying the provisions of ASC 835, all the usual materiality tests used in applying other promulgated U.S. GAAP should also be used in determining the materiality for capitalization of interest costs.

Intended Use

Capitalization of interest cost is applicable for assets that require an acquisition period to prepare them for their intended use. Assets to which capitalized interest must be allocated include both (1) assets acquired for a company's own use, (2) assets intended for sale or lease that are acquired as discrete projects in the ordinary course of business, and (3) certain of an investor's investments in an investee accounted for under the equity method (ASC 835-20-15-5). Thus, inventory items that require a long time to produce, such as a real estate development, qualify for capitalization of interest costs. However, interest costs are not capitalized for inventories that are routinely produced in large quantities on a repetitive basis (ASC 835-20-15-6).

http://www.pbookshop.com

PRACTICE POINTER: The FASB concluded that the benefit of capitalizing interest costs on inventories that are routinely produced in large quantities does not justify the cost. Thus, interest costs should not be capitalized for inventories that are routinely produced in large quantities.

Capitalization of interest cost is not permitted (*a*) for assets that are ready for their intended use or that are actually being used in the earning activities of a business and (*b*) for assets that are not being used in the earning activities of a business and that are not undergoing the activities required to get them ready for use (ASC 835-20-15-6).

COMPUTING INTEREST COST TO BE CAPITALIZED

The amount of interest cost that may be capitalized for any accounting period may not exceed the actual interest cost (from any source) that is incurred by an enterprise during that same accounting period (ASC 835-20-30-6). In addition to interest paid and/or accrued on debt instruments, interest imputed in accordance with ASC 835-30 (Imputation of Interest) and interest recognized on finance leases in accordance with ASC 842 (Leases) are available for capitalization. ASC 835 specifically prohibits imputing interest costs on any equity funds. In consolidated financial statements, this limitation on the maximum amount of interest cost that may be capitalized in a period should be applied on a consolidated basis.

PRACTICE NOTE: ASC 715 (Compensation—Retirement Benefits) requires that the interest cost component of net periodic pension cost shall not be considered to be interest for purposes of applying ASC 835.

Similarly, the interest cost component of postretirement benefit cost shall not be considered interest for purposes of applying ASC 835.

PRACTICE POINTER: A logical starting point for applying ASC 835 and related pronouncements is to determine the total amount of interest that was incurred and that is available for capitalization as a cost of a qualifying asset. If a company incurs little or no qualifying interest on debt instruments, interest imputed in accordance with ASC 835-30, or interest on finance leases, the requirement to capitalize interest may not be effective, even though the company may have invested in assets that would otherwise require interest capitalization.

Average Accumulated Investment

To compute the amount of interest cost to be capitalized for a particular accounting period, the average accumulated investment in a qualifying asset during that period must be determined. To determine the average accumulated investment, each expenditure must be *weighted* for the time it was outstanding during the particular accounting period.

Illustration of Computing Average Accumulated Investment

In the acquisition of a qualifying asset, a calendar year company expends $225,000 on January 1, 20X8; $360,000 on March 1, 20X8; and $180,000 on November 1, 20X8. The average accumulated investment for 20X8 is computed as follows:

Amount of Expenditure	*Period from Expenditure to End of Year*	*Average Investment*
$225,000	12 months (12/12)	$225,000
360,000	10 months (10/12)	300,000
180,000	2 months (2/12)	30,000
$765,000		$555,000

Identification of Interest Rates

If a specific borrowing is made to acquire the qualifying asset, the interest rate incurred on that borrowing may be used to determine the amount of interest costs to be capitalized. That interest rate is applied to the average accumulated investment for the period to calculate the amount of capitalized interest cost on the qualifying asset. Capitalized interest cost on average accumulated investments in excess of the amount of the specific borrowing is calculated by the use of the weighted-average interest rate incurred on other borrowings outstanding during the period (ASC 835-20-30-3).

If no specific borrowing is made to acquire the qualifying asset, the weighted-average interest rate incurred on other borrowings outstanding during the period is used to determine the amount of interest cost to be capitalized. The weighted-average interest rate is applied to the average accumulated investment for the period to calculate the amount of capitalized interest cost on the qualifying asset. Judgment may be required to identify and select the appropriate specific borrowings that should be used in determining the weighted-average interest rate. The objective should be to obtain a reasonable cost of financing for the qualifying asset that could have been avoided if the asset had not been acquired (ASC 835-20-30-4).

PRACTICE POINTER: In determining the weighted average interest rate for purposes of capitalizing interest, take care not to overlook interest that is available for capitalization even though it has another specific purpose. For example, a company might have interest on mortgage debt on buildings and plant assets. Unless that interest already is being capitalized into a different asset under ASC 835, it is available for capitalization despite the fact that it was incurred specifically to finance the acquisition of a different asset.

Progress payments received from the buyer of a qualifying asset are deducted in the computation of the average amount of accumulated expenditures during a period. Nonetheless, the determination of the average amount of accumulated expenditures for a period may be reasonably estimated (ASC 835-20-30-5).

Illustration of Calculating Weighted-Average Interest Rate

A company has the following three debt issues outstanding during a year in which interest must be capitalized as part of the cost of plant assets:

$1,000,000 par value, 8% interest rate

$1,500,000 par value, 9% interest rate

$1,200,000 par value, 10% interest rate

The weighted-average interest rate is computed as follows:

$1,000,000 × 8%	=	$80,000
1,500,000 × 9%	=	135,000
1,800,000 × 10%	=	180,000
$4,300,000	=	$395,000
$395,000/$4,300,000	=	9.19%

Interest available for capitalization is $395,000. Assuming none of the debt issues relates directly to the asset for which interest is being capitalized, interest is charged to the cost of the asset at a 9.19% interest rate applied to the average investment made on the asset during the year. If, instead, one of the debt issues relates directly to the asset for which interest is being capitalized, interest may be charged at the interest rate applicable to that debt issue on the investment equal to the amount of that debt. Interest on any remaining investment is calculated at the weighted-average interest rate for the remaining debt.

Capitalization Period

The interest capitalization period starts when three conditions are met (ASC 835-20-25-3):

1. Expenditures have occurred.
2. Activities necessary to prepare the asset (including administrative activities before construction) have begun.
3. Interest cost has been incurred.

Interest is not capitalized during delays or interruptions initially by the entity, except for brief interruptions, that occur during the acquisition of the qualifying asset. However, interest continues to be capitalized during externally imposed delays or interruptions (e.g., strikes) (ASC 835-20-25-4).

When the qualifying asset is substantially complete and ready for its intended use, the capitalization of interest ceases. The qualifying asset may be completed in independent parts (i.e., the parts can be used separately from the rest of the project, like units in a condominium) or in dependent parts (i.e., parts that, although complete, cannot be used until other parts are finished, like subassemblies of a machine). Interest capitalization ceases for an independent part when it is substantially complete and ready for its intended use. For dependent parts of a qualifying asset, however, interest capitalization does not stop until all dependent parts are substantially complete and ready for their intended use (ASC 835-20-25-5).

SPECIAL APPLICATIONS

Equity Method Investments

An investor's qualifying assets, for the purposes of capitalizing interest costs under ASC 835, include equity funds, loans, and advances made to investees accounted for by the equity method. Thus, an investor must capitalize interest costs on such qualifying assets if, during that period, the investee is undergoing activities necessary to start its planned principal operations and such activities include the use of funds to acquire qualifying assets for its operations. The investor does not capitalize any interest costs on or after the date that the investee actually begins its planned principal operations.

http://www.pbookshop.com

For the purposes of applying the above guidance, the term *investor* means both the parent company and all consolidated subsidiaries. Thus, all qualifying assets of a parent company and its consolidated subsidiaries that appear in the consolidated balance sheet are subject to the interest capitalization provisions of ASC 835. Capitalization of interest cost in the investee's separate financial statements is unaffected by this guidance.

Capitalized interest costs on an investment accounted for by the equity method are included in the carrying amount of the investment. Up to the date on which the planned principal operations of the investee begin, the investor's carrying amount of the investment, which includes capitalized interest costs (if any), may exceed the underlying equity in the investment. If the investor cannot relate the excess carrying amount of the investment to specific identifiable assets of the investee, the difference is considered goodwill (ASC 323-10-35-34).

Any interest cost capitalized is not changed in restating financial statements of prior periods. Thus, if an unconsolidated investee is subsequently consolidated in the investor's financial statements as a result of increased ownership or a voluntary change by the reporting entity, interest costs capitalized are not changed if restatement of financial statements is necessary.

Tax-Exempt Borrowings and Gifts and Grants

Under the provisions of ASC 835, capitalized interest cost for a qualifying asset is determined by applying either a specific interest rate or a weighted-average interest rate to the average accumulated expenditures during a particular period for the qualifying asset. An underlying premise in ASC 835 is that borrowings usually cannot be identified with specific qualifying assets. The financing policies of most enterprises are planned to meet general funding objectives, and the identification of specific borrowings with specific assets is considered highly subjective.

U.S. GAAP concludes that different circumstances are involved in the acquisition of a qualifying asset with tax-exempt borrowings, such as industrial revenue bonds and pollution control bonds. The tax-exempt borrowings, temporary interest income on unused funds, and construction expenditures for the qualifying asset are so integrated that they must be accounted for as a single transaction (ASC 835-20-30-10). Thus, capitalization of interest cost for any portion of a qualifying asset that is acquired with tax-exempt borrowings is required, as follows (ASC 835-20-30-11).

Capitalization Period

Interest cost is capitalized from the date of the tax-exempt borrowings to the date that the qualifying asset is ready for its intended use.

Amount of Capitalized Interest Cost

The amount of capitalized interest cost allowable is equal to the total actual interest cost on the tax-exempt borrowing, less any interest income earned on temporary investments of the tax exempt funds. The net cost of interest on the tax-exempt borrowing is capitalized and added to the acquisition cost of the related qualifying asset (ASC 835-20-30-11).

External Restriction Requirement

The above guidance only applies when the qualifying asset is financed by tax-exempt borrowing, in which the use of the borrowed funds is restricted to acquiring the assets or servicing the related debt. The restriction must be *external*, that is, imposed by law, contract, or other authority outside the enterprise that borrows the funds. This guidance does not permit the capitalization of interest cost on any portion of a qualifying asset that is acquired with a gift or grant that is restricted to the acquisition of the specified qualifying asset. Restricted interest income on temporary investment of funds is considered an addition to the restricted gift or grant.

PRACTICE POINTER: No interest cost should be capitalized on qualifying assets acquired by restricted gifts or grants, because there is no economic cost of financing involved in acquiring an asset with a gift or grant. In addition, any interest earned on temporary investment of funds from a gift or grant is, in substance, part of the gift or grant.

Disposition of Capitalized Interest

If capitalized interest costs are added to the overall cost of an asset, the total cost of the asset, including capitalized interest, may exceed the net realizable or other lower value of the asset that is required by U.S. GAAP. In this event, ASC 835 requires that the provision to reduce the asset cost to the lower value required by U.S. GAAP be increased. Thus, the total asset cost, including capitalized interest, less the provision, will equal the lower value for the asset that is required by U.S. GAAP (ASC 835-20-25-7).

Capitalized interest costs become an integral part of the acquisition costs of an asset and should be accounted for as such in the event of disposal of the asset (ASC 835-20-40-1).

DISCLOSURE REQUIREMENTS

The total amount of interest costs incurred and charged to expense during the period and the amount of interest costs, if any, which has been capitalized during the period, should be disclosed in the financial statements or notes thereto (ASC 835-20-50-1).

Illustration of the Application of ASC 835

On January 1, 20X8, Poll Powerhouse borrowed $300,000 from its bank at an annual rate of 12%. The principal amount plus interest is due on January 1, 20Y0. The funds from this loan are specifically designated for the construction of a new plant facility. On February 1, 20X8, Poll paid $15,000 for architects' fees and for fees for filing a project application with the state government.

http://www.pbookshop.com

On March 1, 20X8, Poll received state approval for the project and began construction. The following summarizes the costs incurred on this project.

20X8	
February 1 (architects' and filing fees)	$ 15,000
April 1	150,000
September 1	60,000
20X9	
January 1	1,000
March 1	360,000
November 1	180,000
Total Project Cost	$766,000

The $1,000 is a miscellaneous cost and was expensed in 20X9, since it was determined by Poll to be immaterial.

The following schedule summarizes the additional borrowings of Poll as of December 31, 20X9:

Borrowing Date	*Amount*	*Maturity Date*	*Annual Interest Rate*
Mar. 1, 20X8	$1,000,000	Feb. 28, 20Y0	13%
Oct. 1, 20X9	$ 500,000	Sept. 30, 20Y1	14%

From February 1, 20X9, to March 31, 20X9, a major strike of construction workers occurred, halting all construction activity during this period.

In August 20X9, Poll voluntarily halted construction for the entire month because the chief executive officer did not want construction to continue without her supervision during her scheduled vacation.

Calculation of Interest

Poll's new plant facility is a qualifying asset under the provisions of ASC 835 and is subject to interest capitalization. The interest capitalization period begins on the first date that an expenditure is made by Poll, which was for architects' fees, February 1, 20X8.

To compute the interest capitalization for 20X8, the average accumulated expenditures for 20X8 are first calculated as follows:

Amount of Expenditure	*Period from Expenditure to End of Year*	*Average Investment*
$ 15,000	11 months (11/12)	$ 13,750
150,000	9 months (9/12)	112,500
60,000	4 months (4/12)	20,000
$225,000		$146,250

Next, the average investment amounts are multiplied by the interest rate on the borrowing (12%). This rate is used because Poll has specifically associated the borrowing with the construction of the new plant facility, and the average accumulated investment ($146,250) does not exceed the amount of the borrowing ($300,000). Therefore, the interest capitalized for 20X8 is computed as follows:

Average accumulated investment	$146,250
Interest rate	12%
Capitalizable interest cost—20X8	$17,550

Since Poll incurred $144,333 of interest costs [($300,000 × 12%) + ($1,000,000 × 13% × 10/12)], the full $17,550 must be capitalized.

The investment in the asset for 20X8 ($225,000 + $17,550 capitalized interest = $242,550) is included as part of the base to compute 20X9 capitalizable interest cost. One further adjustment is necessary to calculate the average accumulated expenditures for 20X9. The plant facility was completed on December 31, 20X9, but there were two interruptions in construction in 20X9. Interest is capitalized during delays or interruptions that are externally imposed, or during delays inherent in acquiring the qualifying asset. However, interest is not capitalized during delays or interruptions that are caused internally by an enterprise, unless they are brief. Thus, in this problem, interest capitalization continues during the externally imposed strike. However, interest capitalization ceases during August 20X9, because the CEO's vacation is a voluntary interruption.

http://www.pbookshop.com

The average accumulated investment for 20X9 is computed as follows:

Amount of Expenditure	*Period from Expenditure to End of Year, Less One Month of Interruption*	*Average Investment*
$242,550	11 months (11/12)	$222,338
360,000	9 months (9/12)	270,000
180,000	2 months (2/12)	30,000
$782,550		$522,338

Note: The $180,000 was expended on November 1, 20X9, after the interruption, so no adjustment need be made to the average expenditure of $30,000 for the interruption.

The $1,000 miscellaneous cost is not included, since Poll decided that this amount was immaterial and expensed it.

If the average accumulated investment for the qualifying asset exceeds the amount of the specific borrowing made to construct the asset, the capitalization rate applicable to the excess is the weighted-average interest rate incurred on other borrowings. In this problem, the computation of the excess investment over the original loan amount is as follows:

Average investment through December 31, 20X9	$522,338
Less: Amount of original loan	300,000
Excess investment	$222,338

Thus, in 20X9, interest on $222,338 of the $522,338 average investment is capitalized using the weighted-average borrowing rate, whereas interest on the balance of $300,000 is capitalized using the interest rate on the original loan made specifically to acquire the qualifying asset. The weighted-average rate on the other borrowings is computed as follows:

Amount	Weighted Amount	Rate	Annual Interest
$1,000,000	$1,000,000	13%	$130,000
500,000	125,000 (3 mos.)	14%	$17,500
$1,500,000	$1,125,000		$147,500

$$\frac{\$147{,}500}{\$1{,}125{,}000} = 13.11\% \text{ weighted-average interest rate.}$$

The interest cost to be capitalized for 20X9 is computed as follows:

$300,000	×	12.00%	=	$36,000
222,338	×	13.11%	=	29,149
$522,338				$65,149

Since Poll incurred $183,500 [($300,000 × 12%) + ($1,000,000 × 13%) + ($500,000 × 14% × 3/12)] of interest, the full $65,149 is capitalizable as part of the acquisition cost of the asset in 20X9.

The total interest capitalized on the asset is $82,699 ($17,550 in 20X8 plus $65,149 in 20X9). The total asset cost at the end of 20X9 is as follows:

Expenditures other than interest	$765,000
Interest cost capitalized	$82,699
	$847,699

PRACTICE NOTE: In this illustration, interest capitalized in 20X9 was based on an investment amount from 20X8 that included the amount of interest capitalized in 20X8. The authors have not found specific authoritative guidance that supports the inclusion of previously capitalized interest in the investment base, but believes this is consistent with the inclusion of interest in other situations and is logical in the circumstances.

ASC 835-30: IMPUTATION OF INTEREST

CIRCUMSTANCES REQUIRING IMPUTED INTEREST

A note issued or received in a noncash transaction contains two elements to be valued: (1) the principal amount for the property, goods, or services exchanged and (2) an interest factor for the use of funds over the period of the note. These types of notes must be recorded at their present value. Any difference between the face amount of the note and its present value is a discount or premium that is amortized over the life of the note.

PRACTICE POINTER: The interest rate on a note that results from a business transaction entered into at arm's length is generally presumed to be fair. If no interest is stated or if the interest stated appears unreasonable, however, record the substance of the transaction. Further, if rights or privileges are attached to the note, evaluate them separately.

For example, a beer distributor lends $5,000 for two years at no interest to a customer who wishes to purchase bar equipment. There is a tacit agreement that the customer will buy the distributor's products. In this event, a present value must be established for the note receivable, and the difference between the face of the note ($5,000) and its present value must be considered an additional cost of doing business for the beer distributor.

Circumstances requiring interest to be imputed as specified in ASC 835 are summarized in Figure 56-1.

The present value techniques used in ASC 835 should not be applied to estimates of a contractual property or other obligations that are assumed in connection with a sale of property, goods, or services such as an estimated warranty for product performance.

PRACTICE NOTE: Interest that is imputed on certain receivables and payables in accordance with ASC 835-30 is eligible for capitalization under the provisions of ASC 835-20 (Capitalization of Interest).

APPLYING ASC 835-30 PRINCIPLES

Determining Present Value

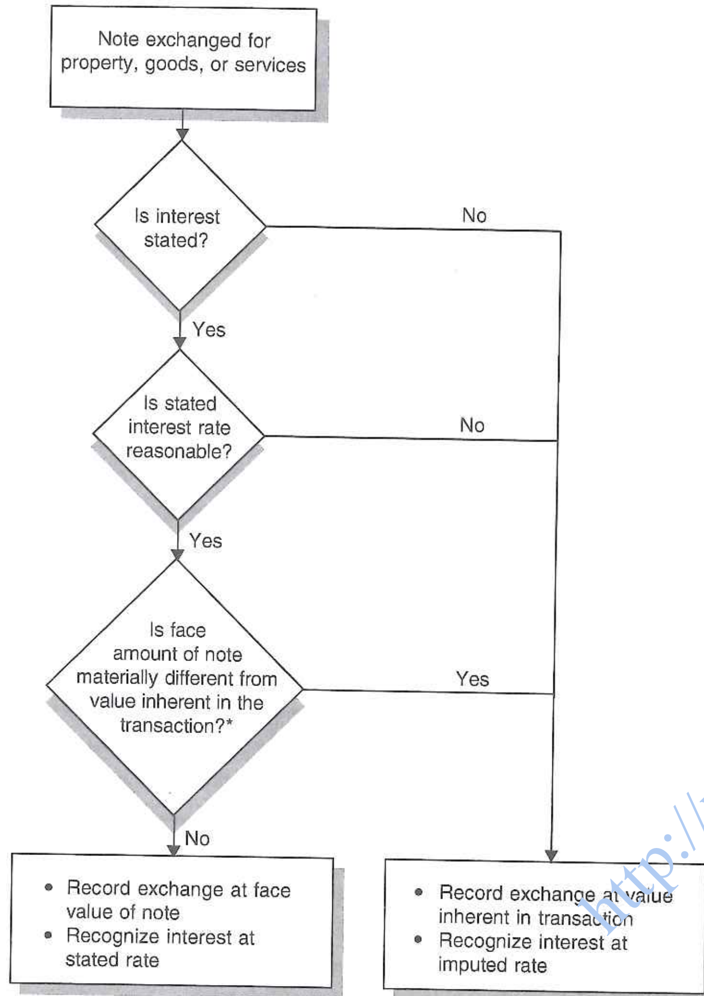
There is no predetermined formula for determining an appropriate interest rate. *However, the objective is to approximate what the rate would have been, using the same terms and conditions, if it had been negotiated by an independent lender*. The following factors should be considered (ASC 835-30-25-12):

- Credit rating of the borrower
- Restrictive covenants or collateral involved
- Prevailing market rates
- Rate at which the debtor can borrow funds

The appropriate interest rate depends on a combination of the above factors.

http://www.pbookshop.com

Figure 56-1: Circumstances Indicating a Need to Impute Interest



* Value inherent in transaction is the fair value of the property, goods, or services or the market value of the note, whichever is more readily determinable.

PRACTICE POINTER: In determining an appropriate interest rate for purposes of imputing interest for the purchaser in a transaction, a starting point might be the most recent borrowing rate. The more recent the borrowing, the more appropriate that rate may be. Even if the borrowing rate is recent, however, give consideration to the impact that the additional debt from the earlier borrowing would likely have on the company's next borrowing. The size of the transaction for which interest is being imputed relative to other outstanding debt also may be an important factor in determining an appropriate rate.

Discount and Premium

The difference between the present value and the face amount of the receivable or the payable represents the amount of premium or discount. A discount exists if the present value of the total cash flow of the note (face amount plus stated interest), using the appropriate rate of interest, is *less* than the face amount of the note. A premium exists if the present value of the total proceeds of the note (face amount plus stated interest), using the appropriate rate of interest, is *more* than the face amount of the note.

The premium or discount is amortized over the life of the note as interest expense or income, using a constant rate on any outstanding balance (ASC 835-30-35-2). This method is called the *interest method* and is illustrated at the end of this chapter.

The premium or discount that arises from the use of present values on cash and noncash transactions is inseparable from the related asset or liability. Therefore, premiums and discounts are added to or deducted from their related asset or liability in the balance sheet. Similarly, debt issuance costs related to a note must be reported in the balance sheet as a direct deduction from the face amount of that note. The discount, premium, or debt issuance costs resulting from imputing interest are not classified as deferred charges or credits (ASC 835-30-45-1A).

http://www.pbookshop.com

Disclosure

A description of the receivable or payable, the effective interest rate, and the face amount of the note should be disclosed in the financial statements or notes thereto. The amortization of a discount or premium must be reported as interest expense in the case of liabilities or as interest income in the case of assets. The amortization of debt issuance costs must also be reported as interest expense (ASC 835-30-45-2, 3).

Illustration of Interest Imputed and Accounted for on a Noninterest-Bearing Note

A manufacturer sells a machine for $10,000 and accepts a $10,000 note receivable bearing no interest for five years; 10% is an appropriate interest rate. The initial journal entry would be:

Note receivable	10,000.00	
Sales (present value at 10%)		6,209.00
Unamortized discount on note		3,791.00

The manufacturer records the note at its face amount but records the sale at the present value of the note because that is the value of the note today. The difference between the face amount of the note and its present value is recorded as *unamortized discount on note.*

The *interest method* is used to produce a constant rate, which is applied to any outstanding balance. In the above example, the present value of $6,209 was recorded for the $10,000 sale using the appropriate interest rate of 10% for the five-year term of the note. The difference between the $10,000 sale and its present value of $6,209 is $3,791, which was recorded as unamortized discount on note. The 10% rate, when applied to each annual outstanding balance for the same five years, will result in amortization of the discount on the note, as follows:

Fair Value

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (ASC Glossary).

For the manufacturer or dealer, fair value usually is the normal selling price less trade or volume discounts. Fair value may be less than the normal selling price, however, and sometimes less than the cost of the property.

For others, fair value usually is cost less trade or volume discounts. Fair value may be less than cost, however, especially in circumstances in which a long period elapses between the acquisition of the property by the lessor and the inception of a lease.

Finance Lease

A finance lease meets one or more of the following conditions for the lessee: transfers ownership to the lessee at the end of the lease term, grants the lessee an option to purchase that is likely to be exercised, has a lease term for the majority of the remaining economic life of the asset, or has minimum lease payments and a residual value guarantee such that the present value of the sum of the payments is greater than or equal to substantially all of the fair value of the asset (ASC 842-10-25-2).

Incremental Borrowing Rate

The lessee's incremental borrowing rate is the rate of interest that the lessee would have had to pay at the inception of the lease to borrow the funds, on similar terms, to purchase the leased property (ASC Glossary).

Initial Direct Costs

Initial direct costs are the incremental lease costs that would not have been incurred if the lease had not been obtained (ASC Glossary).

Lease

A lease is a contract conveying the right to control the use of the identified property, plant, or equipment for a period of time in exchange for consideration (ASC Glossary).

Lease Inception

The lease inception is the earlier of the date of the lease agreement or written, executed commitment that sets forth all of the principal provisions of the transaction (ASC Glossary).

Lease Modification

A lease modification is a change to contract terms and conditions that changes the lease scope or consideration (ASC Glossary).

Lease Receivable

The lessor has a lease receivable measured on a discounted basis for its right to receive lease payments from a sales-type or direct financing lease plus any residual value guarantee (ASC Glossary).

Lease Term

The lease term includes all of the following (ASC Glossary):

- The noncancelable term.
- The period covered by an extension option that is reasonably certain to be exercised.
- The period covered by a termination option that is reasonably certain not to be exercised.
- The period covered by an option to extend or not to terminate in which the lessor controls the option.

Leveraged Lease

For the lessor, a leveraged lease is a lease that commenced before the effective date of ACS 842 and was classified as a leveraged lease in accordance with ASC 840 (ASC Glossary).

Market Participants

Market participants are buyers and sellers with the following characteristics (ASC Glossary):

- They are independent, non-related parties.
- They are knowledgeable and have a reasonable understanding of the asset or liability and transaction using information that is readily available and that is obtained through any customary due diligence efforts.
- They are able to enter into the transaction.
- They are willing to enter into the transaction.

Minimum Lease Payments

Minimum lease payments are the payments the lessee is obligated to or can be required to make on the leased property except for contingent rentals, any lessee guarantees of the lessor's debt, and the lessee's obligation to pay executory costs.

In leases with a bargain purchase option, minimum lease payments are only required to include the minimum rental payments over the lease term and the bargain purchase option payment. Otherwise, minimum lease payments include all of the following:

- Minimum rental payments over the lease term.
- Any residual value guarantee. If the lessor can require the lessee to purchase the property at lease termination, the purchase amount is considered a lessee residual value guarantee. If the lessee agrees to make up any deficiency below a stated residual value amount, the minimum lease payments should include the stated residual value, not an estimate of the deficiency.

http://www.pbookshop.com

- Any payment the lessee must make or can be required to make upon failing to renew or extend the lease at the end of its term.
- Payments made before the beginning of the lease term using the same interest rate used to discount lease payments during the lease term.
- Fees paid by the lessee to owners of a special-purpose entity for structuring the lease transaction.

Lease payments dependent on an existing index or rate should be included in minimum lease payments based on the index or rate at lease inception. Lease payments dependent on a factor directly related to the future, such as sales volume, are considered contingent rentals and are excluded from minimum lease payments (ASC Glossary).

Net Investment in the Lease

The net investment in the lease is the sum of the lease receivable and the unguaranteed residual asset, net of any deferred selling profit in a direct financing lease (ASC Glossary).

Operating Lease

An operating lease is any lease other than a finance lease for a lessee and any lease other than a sales-type lease or direct financing lease for a lessor.

Penalty

The term *penalty* refers to any outside factor or provision of the lease agreement that does or can impose on the lessee the requirement to disburse cash, incur or assume a liability, perform services, surrender or transfer an asset or rights to an asset or otherwise forego an economic benefit, or suffer an economic detriment (ASC Glossary).

Rate Implicit in the Lease

The implicit interest rate in the lease is the rate that, at a given date, causes the aggregate present value of the lease payments plus the amount a lessor can expect from the underlying asset at the end of the lease term to equal the fair value of the underlying asset less any realizable investment tax credit that was retained plus any deferred initial direct costs of the lessor (ASC Glossary).

Related Parties

Related parties include (ASC Glossary):

- Entity affiliates.
- Entities for which investments in their equity securities are required to be accounted for by the equity method by the investing entity.
- Trusts for the benefit of employees.

- The entity's principal owners and management and their immediate families.
- Other parties the entity may deal with if one party has control or significant influence over the management or operating policies of the other party.
- Other parties that have control or significant influence over the management or operating policies or have an ownership interest in one of the transacting parties.

Residual Value Guarantee

A residual value guarantee is a guarantee made to the lessor regarding the minimum value of an underlying asset when it is returned at the end of a lease (ASC Glossary).

Sales-Type Lease

A sales-type lease is a type of finance lease that meets one or more of the following criteria: transfers ownership to the lessee at the end of the lease term, grants the lessee an option to purchase that is likely to be exercised, has a lease term for the majority of the remaining economic life of the asset, or has minimum lease payments and a residual value guarantee such that the present value of the sum of the payments is greater than or equal to substantially all of the fair value of the asset (ASC 842-10-25-2).

Separately identifying sales-type and direct financing leases is an accounting issue for the lessor only, who accounts for the two types of finance leases differently, as described later in this chapter. Both types of leases are treated as a finance lease by the lessee.

Selling Profit or Selling Loss

At the commencement date, selling profit or selling loss equals (ASC Glossary):

- The lower of the fair value of the underlying asset or the sum of the lease receivable and any lease payments prepaid by the lessee, minus
- The carrying amount of the underlying asset net of any unguaranteed residual asset, minus
- Any deferred initial direct costs of the lessor.

Short-Term Lease

A short-term lease has a term of 12 months or less and no option to purchase that is reasonably certain to be exercised (ASC Glossary).

Unguaranteed Residual Asset

An unguaranteed residual asset is the discounted amount a lessor expects to derive from the underlying asset at the end of the lease term that is not guaranteed by either the lessee or a third party unrelated to the lessor (ASC Glossary).

http://www.pbookshop.com

Variable Lease Payments

Variable lease payments are those that vary due to changes in facts or circumstances other than the passage of time occurring after the commencement date (ASC Glossary).

LEASE CLASSIFICATION

Lease components are classified separately at the commencement date of the lease. Lease classifications are not reassessed unless the contract is modified but a separate contract is not created, or, for the lessee, if the lease term or assessment of whether the lessee is reasonably certain to exercise an option to purchase the asset changes (ASC 842-10-25-1).

If one or more of the following criteria is present at the inception of a lease, it is classified as a finance lease by the lessee and a sales-type lease by the lessor (ASC 842-10-25-2):

1. Ownership of the asset is transferred to the lessee by the end of the lease term.
2. The lease contains an option to purchase the asset that the lessee is reasonably certain to exercise.
3. The lease term is for the majority of the remaining economic life of the asset. If the lease term begins near the end of the economic life of the asset, this criterion does not apply.
4. The present value of the lease payments plus any residual value guaranteed by the lessee not reflected in the lease payments equals or exceeds substantially all of the fair value of the asset.
5. The asset is specialized such that it is not expected to have an alternative use to the lessor at the end of the lease term.

If none of the criteria above are met, the lease is classified as an operating lease by the lessee and either an operating lease or direct financing lease by the lessor. The lessor classifies the lease as an operating lease unless the following two criteria are met, in which case the lessor classifies the lease as a direct financing lease (ASC 842-10-25-3):

1. The present value of the lease payments plus any residual value guaranteed by the lessee not reflected in the lease payments and/or any other third party unrelated to the lessor equals or exceeds substantially all of the fair value of the asset.
2. It is probable the lessor will collect the lease payments plus any residual value guarantee.

In assessing the above criteria, there are some reasonable thresholds that could be applied. Seventy-five percent or more could be considered the majority of the economic life of the asset; likewise, if a lease begins during the last 25 percent, it could be considered to be near the end of the economic life of the asset. When comparing the payment amounts to the fair value of the asset, 90 percent could be considered to be substantially all of the fair value of the asset (ASC 842-10-55-2). Sometimes it is not practicable for an entity to determine the fair

value of an asset; in these circumstances, a lease should be classified without using the criterion comparing the lease payments to the asset's fair value (ASC 842-10-55-3). The fair value calculated should exclude any investment tax credits retained and expected to be realized by the lessor (ASC 842-10-55-8).

A lessor uses the rate implicit in the lease to assess the present value of the lease payments and residual value guarantees. It should be assumed that initial direct costs are not deferred if the fair value of the asset is different from its carrying amount at the lease commencement date (ASC 842-10-25-4).

When determining if ownership of the asset is transferred at the end of the lease term, an option to purchase the asset does not satisfy this criterion. Examples of situations where ownership is transferred include leases where the lessor delivers documents releasing and transferring ownership of the asset to the lessee provided the lessee performs in accordance with the lease terms or leases where the lessee pays a nominal amount to transfer ownership of the asset (ASC 842-10-55-4 through 55-6).

To assess whether an asset has an alternative use at the end of the lease term, an entity should consider whether there are substantive, enforceable contractual restrictions preventing the asset from having an alternative use to the lessor. The lessor should also consider whether there are practical limitations such as significant economic losses or unique design specifications that would prevent the lessor from being able to redirect use of the asset (ASC 842-10-55-7).

If a lease is acquired through a business combination or acquisition by a not-for-profit entity, the lease classification should remain the same unless there is a lease modification not accounted for as a separate contract (ASC 842-10-55-11).

Related Party Leases

Related party leases should be classified and accounted for as if the parties were unrelated (ASC 842-10-55-12).

PRACTICE NOTE: Specific financial statement disclosures pertaining to related parties are required by ASC 850 (Related Party Disclosures).

Leases Involving Governmental Units

Leases with governmental units often lack fair values, have indeterminable economic lives, and cannot provide for transfer of ownership. These special provisions usually prevent their classification as any other than operating leases (ASC 842-10-55-13).

Leases involving governmental units, however, are subject to the same criteria as any other lease unless all of the following conditions exist; and in that event, these leases are classified as operating leases (ASC 842-10-55-13):

- A governmental unit or authority owns the leased property.
- The leased property is operated by or on behalf of a governmental unit or authority and is part of a larger facility, such as an airport.

http://www.pbookshop.com

- The leased property cannot be moved to another location because it is a permanent structure or part of a permanent structure.
- The governmental unit or authority can terminate the lease agreement at any time under the terms of the lease agreement, existing statutes, or regulations.
- Ownership is not transferred to the lessee and the lessee cannot purchase the leased property.
- Equivalent property in the same area as the leased property cannot be purchased or leased from anyone else.

Lease Modifications

A lease modification should be accounted for as a separate contract if both of the following conditions apply:

- The modification grants the lessee an additional right of use not included in the original lease.
- The lease payments increase proportionally with the standalone price of the additional right of use, given the circumstances of the original contract.

If a lease modification does not require that it be accounted for as a separate contract, then reassessment of the lease classification should be as of the effective date of the modification given the facts and circumstances at that date (ASC 842-10-25-8, 9).

If, before expiration of the lease term, a change in a lease occurs as a result of a refunding by the lessor of tax-exempt debt, it should be accounted for in the same manner as any other lease modification (ASC 842-10-55-16).

When considering whether a master lease agreement should be treated as a lease modification, if the lessee is allowed to use additional assets during the lease term but is not required to do so, the lessee taking control over any such additional asset should be accounted for as a lease modification (ASC 842-10-55-18). If, however, the master lease agreement states additional assets the lessee will gain control over during the lease term, the separate lease components should be identified and consideration in the contract should be allocated across those components (ASC 842-10-55-17).

Lessees

Lessees should reallocate the remaining consideration in a contract and remeasure the lease liability using a discount rate determined at the effective date of the lease modification if a contract modification does any of the following (ASC 842-10-25-11):

- Grants the lessee an additional right of use not included in the original contract.
- Extends or reduces the term of an existing lease other than through exercising a contractual option in the lease.
- Changes only the consideration in the contract.
- Fully or partially terminates an existing lease.

If one of the first three changes has occurred, the lessee recognizes the amount of change in the lease liability from the remeasurement as an adjustment to the corresponding right-of-use asset. If the change was full or partial termination of an existing lease, the lessee decreases the carrying amount of the right-of-use asset proportionately to the change in the lease and any difference in that change and the reduction of the lease liability should be recognized as a gain or loss at the modification date (ASC 842-10-25-12, 13).

If the lease modification changes a finance lease to an operating lease, any difference in the carrying amount of the right-of-use asset after recording the adjustment and the amount that would have occurred if operating right-of-use asset measurement guidance had been used should be accounted for in the same manner as a rent prepayment or lease incentive (ASC 842-10-25-14).

Lessors

http://www.pbookshop.com

If an operating lease is modified and not accounted for as a separate contract, the lessor should treat this as termination of the existing lease and creation of a new lease commencing on the effective date of the modification. If the modified lease is an operating lease, the lessor should include any prepaid or accrued lease rentals relating to the original lease as part of the lease payments in the modified lease. If the modified lease is a direct financing or sales-type lease, the lessor should derecognize any deferred rent liability or accrued rent asset and adjust the selling profit or loss as needed (ASC 842-10-25-15).

If a direct financing lease is modified and not accounted for as a separate contract, the lessor should account for the modified lease as follows (ASC 842-10-25-16):

- If the modified lease is a direct financing lease, adjust the discount rate so the initial net investment in the modified lease equals the carrying amount of the net investment in the original lease prior to the modification.
- If the modified lease is a sales-type lease, use the guidance in ASC 842-30. To calculate selling profit or loss, the fair value of the asset is its fair value at the modification date and its carrying amount is the carrying amount of the net investment in the original lease prior to the modification.
- If the modified lease is an operating lease, the carrying amount is the carrying amount of the net investment in the original lease prior to the modification.

If a sales-type lease is modified and not accounted for as a separate contract, the lessor should account for the modified lease as follows (ASC 842-10-25-17):

- If the modified lease is a direct financing or sales-type lease, adjust the discount rate so the initial net investment in the modified lease equals the carrying amount of the net investment in the original lease prior to the modification.

- If the modified lease is an operating lease, the carrying amount is the carrying amount of the net investment in the original lease prior to the modification.

Contract Combinations

An entity can consider two or more contracts entered into near the same time, at least one of which is a lease, as a single transaction if any of the following apply (ASC 842-10-25-19):

- The contracts are negotiated as a package with the same commercial objectives.
- The consideration in one contract depends on the price or performance of the other contract.
- The contractual rights to use underlying assets are a single lease component.

MEASUREMENT OF A LEASE

Lease Term and Purchase Options

An entity initially determines the lease term as the noncancelable period of the lease along with periods covered by an option to extend the lease if the lessee is reasonably certain to exercise the option or the option right is controlled by the lessor, and periods covered by an option to terminate if the lessee is reasonably certain not to exercise the option or the option right is controlled by the lessor (ASC 842-10-30-1). If there is a fiscal funding clause in the lease and the possibility of it being exercised is more than remote, the lease term should only include periods for which funding is reasonably certain (ASC 842-10-55-27).

All factors creating an economic incentive for the lessee should be considered when determining the lease term. These factors may include comparing the contractual terms for the optional periods with current market rates, significant leasehold improvements expected when the option becomes exercisable, costs of terminating the lease and signing a new lease, and the importance of the asset to the lessee's operations (ASC 842-10-55-26).

The lease term begins at the commencement date and includes any rent-free periods provided to the lessee (ASC 842-10-55-25). In the case of a master lease agreement covering several underlying assets, there may be multiple commencement dates if the assets are made available for use on different dates (ASC 842-10-55-22). The noncancelable period is defined as the period during which the contract is enforceable. If the lessee and lessor both have the right to terminate the lease without permission from the other party and without significant penalty, the lease is no longer enforceable (ASC 842-10-55-23).

In some contracts, the lessee may have possession or control over an asset prior to making lease payments. The timing of when lease payments begin does not affect the commencement date of the lease (ASC 842-10-55-20). If an entity has a building or ground lease, the right to use the asset is the same during any construction period as it is after construction so any lease costs or income

associated with the lease incurred or earned during a construction period should be recognized according to the guidance for lessees and lessors (ASC 842-10-55-21).

The lessee should only reassess the lease term or option to purchase the asset if one of the following occurs (ASC 842-10-35-1):

- A significant event or change in circumstances occurs that directly affects the lessee's probability of exercising an option to extend or terminate the lease or purchase the asset.
- An event is written into the contract requiring the lessee to exercise or not exercise an option to extend or terminate the lease.
- The lessee exercises an option it was previously determined it would not be reasonably certain of exercising.
- The lessee does not exercise an option it was previously determined it would be reasonably certain of exercising.

Significant events that might cause a lessee to reassess the lease term or option to purchase the asset could include construction of significant leasehold improvements, significant modification or customization of the asset, making a business decision directly relevant to the lessee's ability to exercise an option, or subleasing the asset beyond the exercise date of the option. Market factors would generally not qualify as a significant event that would require reassessment of the lease term or purchase option (ASC 842-10-55-28, 29).

The lessor should only reassess the lease term or lessee option to purchase the underlying asset if the lease is modified and not accounted for as a separate contract (ASC 842-10-35-3).

Measurement of Lease Payments

As of the commencement date, lease payments consist of the following (ASC 842-10-30-5):

- Fixed payments less any lease incentives paid or payable to the lessee.
- Variable payments that depend on an index or rate and measured at that index or rate at the commencement date.
- The exercise price of an option to purchase the asset if purchase is reasonably certain.
- Penalties for lease termination if reflected in the lease term.
- Fees paid to owners of a special-purpose entity for structuring the transaction.
- For the lessee, probable residual value guarantees.

Payments that are in substance fixed payments are treated as fixed payments. In substance fixed payments may appear to be variable but are not, for example, if the lessee has a choice about which of two sets of payments to make but is required to make at least one set of payments (ASC 842-10-55-31). Lease incentives included in the lease payments include payments made to or on behalf

http://www.pbookshop.com

of the lessee and losses the lessor incurs by assuming a lessee's pre-existing lease with a third party (ASC 842-10-55-30).

The lessee includes a residual value guarantee in its lease payments if the lessor has the right to require the lessee to purchase the asset at the end of the lease term. However, if there is a lease provision requiring the lessee to pay a residual value deficiency if there is damage, extraordinary wear and tear, or excessive usage, this does not constitute a residual value guarantee. If a lessee obtains a residual value guarantee from a third party, it should not reduce the lessee's calculation of lease payments unless the lessor releases the lessee from its obligation (ASC 842-10-55-34 through 55-36).

Lease payments do not include (ASC 842-10-30-6):

- Any other variable lease payments.
- Lessee guarantee of the lessor's debt.
- Amounts allocated to nonlease components.

Obligations to return an asset to its original condition at the end of the lease term if modified by the lessee generally would not be considered lease payments and would instead be accounted for following the guidance in ASC 410 (Asset Retirement and Environmental Obligations). However, costs incurred from lease requirements to dismantle and remove an asset at the end of the lease term would generally qualify as lease payments (ASC 842-10-55-37).

Indemnification clauses that indemnify lessors for tax benefits that may be lost if tax law changes would generally qualify as variable lease payments (ASC 842-10-55-38).

Lease payments should be remeasured by the lessee if (ASC 842-10-35-4):

- The lease is modified and not accounted for as a separate contract.
- A contingency related to the variable lease payments is resolved such that those payments are now considered lease payments.
- There is a change in: lease term, the assessment of the probability of the lessee exercising an option to purchase the underlying asset, or the amounts probable of being owed by the lessee under residual value guarantees.

A lessor should not remeasure lease payments unless the lease is modified and not accounted for as a separate contract (ASC 842-10-35-6).

Initial Direct Costs

A lessee or lessor's initial direct costs may include commissions or payments made to encourage an existing tenant to terminate its lease (ASC 842-10-30-9). Costs that would be incurred whether or not the lease was obtained are not initial direct costs; examples of these costs are fixed employee salaries, general overhead expenses, advertising, and tax and legal expenses incurred prior to obtaining the lease (ASC 842-10-30-10).

ASC 842-20: LESSEE

LESSEE

Asset and Liability Recognition

The lessee recognizes a right-of-use asset and a lease liability at the commencement date of the lease (ASC 842-20-25-1).

Short-Term Leases

For short-term leases, the lessee can elect not to apply the recognition requirements in ASC 842-20. This accounting policy election can be made by class of underlying asset. If elected, lease payments are recognized in profit and loss on a straight-line basis over the lease term. Variable lease payments are recognized in the period in which the obligation for those payments occurs or becomes probable (ASC 842-20-25-2, ASC 842-20-55-1).

If the lease changes and the lease term is extended by more than 12 months from the end of the prior lease term or the lessee becomes reasonably certain of exercising an option to purchase, the lease is no longer a short-term lease. The date of this change in circumstance serves as the effective commencement date in this instance (ASC 842-20-25-3).

Finance Leases

Unless the following costs are included in the carrying amount of another asset, the lessee should recognize in profit and loss (ASC 842-20-25-5):

- Amortization of the right-of-use asset.
- Interest on the lease liability.
- Variable lease payments not included in the lease liability.
- Any impairment of the right-of-use asset.

Operating Leases

Unless the following costs are included in the carrying amount of another asset, the lessee should recognize in profit and loss (ASC 842-20-25-6):

- Single lease costs allocating the remaining cost of the lease over the remaining lease term on a straight-line basis unless there is another method more representative of the benefit expected from the right to use the asset.
- Variable lease payments not included in the lease liability.
- Any impairment of the right-of-use asset.

If the right-of-use asset is determined to be impaired, the single lease costs should be calculated by adding: (1) amortization of the remaining asset after impairment on a straight-line, or other more representative basis; and (2) increase of the lease liability in the amount that produces a constant discount rate over each remaining period of the lease term on the remaining liability balance (ASC 842-20-25-7).

http://www.pbookshop.com

For operating leases without impairment, the remaining cost throughout the lease term consists of (ASC 842-20-25-8):

- The total lease payments, paid and future, reflective of any remeasurement or lease modification adjustment; plus
- Total initial direct costs attributable to the lease; less
- The periodic lease costs recognized in prior periods.

Lessee Measurement

The lessee measures both a lease liability and a right-of-use asset.

Lease Liability

At the commencement date, the lease liability is the present value of the lease payments to be paid using the discount rate for the lease at commencement. The rate implicit in the lease should be used if it is readily determinable; otherwise, the lessee's incremental borrowing rate should be used. If the entity is not public, it may elect to use a risk-free discount rate for a period comparable with the lease term for all of its leases (ASC 842-20-30-1 through 30-3). The lease liability should continue to be measured in the same manner for an operating lease unless the rate has changed since commencement (ASC 842-20-35-3).

After the commencement date of a finance lease, the lessee measures the lease liability by decreasing the carrying amount by any lease payments made and increasing the carrying amount by interest on the lease liability. The interest is the amount producing a constant periodic discount rate on the remaining lease liability and is recognized in the entity's profit and loss (ASC 842-20-35-1).

If lease payments are remeasured after lease commencement, the entity should recognize the remeasurement as an adjustment to the right-of-use asset, with any additional adjustment required after the asset's carrying amount is zero reflected in the entity's profit or loss (ASC 842-20-35-4). The discount rate should be adjusted in these situations to reflect the remaining lease payments over the lease term at the date of remeasurement unless the remeasurement occurred due to a change in (ASC 842-20-35-5):

- Lease term.
- The assessment of whether the lessee will exercise a purchase option.
- Amount probable of being owed under a residual value guarantee.
- Lease payments due to resolution of a contingency upon which variable lease payments are based.

Right-of-Use Asset

At lease commencement, the right-of-use asset consists of (ASC 842-20-30-5):

- The amount of the initial measurement of the lease liability.
- Any lease payments paid to the lessor on or before the commencement date less any lease incentives received.
- Any initial direct costs incurred.

After the commencement date of a finance lease, the lessee measures the right-of-use asset at cost less any accumulated amortization and impairment losses (ASC 842-20-35-1).

After the commencement date of an operating lease, if the right-of-use asset has not been impaired, it is measured at the amount of the lease liability, adjusted for (ASC 842-20-35-3):

- Prepaid or accrued lease payments.
- The remaining balance of any lease incentives received and not yet recognized in the lease cost.
- Unamortized initial direct costs.
- Impairment of the right-of-use asset.

Right-of-use assets for finance leases should be amortized on a straight-line basis unless there is another systematic basis more representative of the lease. If the lease liability is remeasured and the right-of-use asset adjusted, amortization should be adjusted from the date of remeasurement forward (ASC 842-20-35-7). The amortization term should be from the commencement date to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term unless the lessee is expected to exercise a purchase option, in which case amortization should extend to the end of the useful life of the underlying asset (ASC 842-20-35-8).

If a right-of-use asset may be impaired, use the guidance in ASC 360-10-35 (Property, Plant, and Equipment) to determine if the asset is impaired and to recognize any impairment loss. If it is determined that a right-of-use asset is impaired, it should be measured at its carrying amount after impairment less any accumulated amortization (ASC 842-20-35-10).

Leasehold Improvements

The amortization term for any leasehold improvements should end with the earlier of the useful life of the improvements or the lease term, unless the lessee is expected to exercise a purchase option, in which case amortization should extend to the end of the useful life of the improvements (ASC 845-20-35-12).

Subleases

If the original lessee is not relieved of its primary obligation under the original lease, it becomes a sublessor and accounts for the sublease as follows (ASC 842-20-35-14):

- If the sublease is an operating lease, continue accounting for the original lease in the same manner. If the lease cost for the sublease term exceeds the expected sublease income, this indicates the carrying amount of the right-of-use asset may not be recoverable.
- If the original lease was a financing lease and the sublease is a sales-type or direct financing lease, derecognize the original right-of-use asset and continue to account for the lease liability in the same manner as the original lease. Evaluate the investment in the sublease for impairment.

http://www.pbookshop.com