FASB/IASB Update – Part I

Tom Linsmeier
FASB Member
August 3, 2014

The views expressed in this presentation are those of the presenter. Official positions of the FASB are reached only after extensive due process and deliberations.
Agenda

- Revenue from contracts with customers: Joint
  - Conceptual framework: IASB
  - Conceptual framework: FASB
  - Disclosure framework and financial performance reporting projects: FASB
  - Disclosure initiative: IASB
  - Rate-regulated accounting: IASB
- Private company issues: FASB
- Post-issuance reviews: FASB
Revenue Recognition: Joint Project
Background

- U.S. GAAP comprised broad revenue concepts and detailed guidance for industries and transactions
- IFRS had different principles and were difficult to understand and apply to transactions other than simple ones. IFRS had limited guidance on important topics such as revenue recognition for multiple-element arrangements
- Disclosures under U.S. GAAP & IFRS were inadequate for users of financial statements
Improvements

- **Topic 606 / IFRS 15:**
  - Provides a robust framework for addressing revenue recognition issues
  - Improves comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets
  - Simplifies the preparation of financial statements by reducing the amount of guidance to which entities must refer
  - Enhances disclosures to help users of financial statements better understand the nature, amount, timing, and uncertainty of revenue
Extensive due process

December 2008
Discussion Paper
Preliminary Views on Revenue Recognition in Contracts with Customers
211 comment letters

June 2010
Exposure Draft
Revenue from Contracts with Customers
974 comment letters
Roundtables

November 2011
Revised Exposure Draft
Re-exposure of Revenue from Contracts with Customers
358 comment letters
Roundtables

May 2014
Final Standard
Topic 606 / IFRS 15 Revenue from Contracts with Customers
Scope

- All contracts with customers, except
  - Lease contracts
  - Insurance contracts
  - Financial instruments
  - Guarantees
  - Non-monetary exchanges between entities in the same line of business to facilitate sales to customers

- Sales/Transfers of nonfinancial assets outside of the entity’s ordinary activities (Subtopic 610-20)
  - Recognition and measurement guidance
# Five steps to apply Standard

Recognize revenue to depict the transfer of goods or services in an amount that reflects the consideration to which the entity expects to be entitled.

<table>
<thead>
<tr>
<th>Step</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Identify the contract(s) with a customer</td>
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<tr>
<td>2</td>
<td>Identify the performance obligations in the contract</td>
</tr>
<tr>
<td>3</td>
<td>Determine the transaction price</td>
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<td>4</td>
<td>Allocate the transaction price to the performance obligations in the contract</td>
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<tr>
<td>5</td>
<td>Recognize revenue when (or as) the entity satisfies a performance obligation</td>
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</table>
Step 1: Identify the contract(s)

Objective: To identify the bundle of contractual rights and obligations to which an entity would apply the revenue model

- Existence of a contract
- Combine contracts
- Contract modifications
Step 1: Identify the contract(s)

Existence of a contract

- Must meet specified criteria to apply the model
- Key criterion: Collectibility threshold – to apply model must be probable of collecting consideration to which the entity will be entitled; otherwise, recognize revenue when performance obligation is satisfied and cash is collected

Combine contracts

- Negotiated as a package
- Consideration in contracts is linked
- Goods or services form one performance obligation

Contract modifications

- Separate contract if add distinct goods/services at standalone selling price
- If do not treat as separate contract, prospective treatment if remaining goods/services distinct; otherwise, cumulative catch-up
Objective: To identify the promised goods or services that are distinct and should be accounted for separately

Promise to transfer a distinct good or service

Customer can benefit from good or service
- On its own
- Together with other readily available goods or services (including goods/services previously acquired from entity)

Promised good or service is separable from other promises
- No significant service of integrating the good/service
- Good/service does not significantly modify or customize another good or service in the contract
- Good/service is not highly dependent on or interrelated with other goods or services
Step 3: Determine transaction price (TP)

**Objective:** To determine amount of consideration to which an entity expects to be entitled in exchange for promised goods or services

- **Variable consideration:**
  - Estimate using:
    - Expected value
    - Most likely amount but ‘constrained’

- **Significant financing:**
  - Adjust consideration if timing provides customer or entity with significant benefit of financing

- **Non-cash consideration:**
  - Measure at fair value unless cannot be reasonably estimated

- **Consideration payable to customer:**
  - Reduction of the TP unless in exchange for a distinct good or service
Step 3: Constraining variable consideration

Include estimate of variable consideration in the transaction price only if it is *probable* that a significant revenue reversal will not occur when the uncertainty is resolved.

For licenses of intellectual property, include sales or usage-based royalties in the transaction price when the sales or usage occurs.

Update the transaction price at each reporting date.
Step 4: Allocate the transaction price

**Objective:** To allocate to each performance obligation the amount to which the entity expects to be entitled

**Relative standalone selling price basis**

- estimate selling prices if not observable
- residual estimation techniques may be appropriate in certain situations

**Discounts & contingent amounts allocated entirely to specific performance obligation if specified criteria met.**
An entity satisfies a performance obligation over time if one of the following criteria is met:

- The customer simultaneously receives and consumes the benefits provided by the entity’s performance as the entity performs
- The entity’s performance creates or enhances an asset that the customer controls as the asset is created or enhanced
- The entity’s performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date
Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation

- If a performance obligation is not satisfied over time, an entity satisfies the performance obligation at a point in time. To determine the point in time at which control transfers, consider the following indicators:
  - Present right to payment
  - Legal title
  - Physical possession
  - Risks and rewards of ownership
  - Customer acceptance
Contract costs – if no other guidance applies

**Incremental costs of obtaining a contract**

Recognize as an asset if:
- Incremental
- Expect to recover

*For example:* Selling commissions

Practical expedient: May recognize as an expense when incurred if the amortization period is one year or less

**Costs to fulfill a contract**

Recognize as an asset if:
- Relate directly to a contract
- Generate or enhance resources of the entity that will be used to satisfy performance obligations in the future
- Expect to recover

*For example:* Pre-contract or setup costs
Implementation guidance

- Performance obligations satisfied over time
- Methods for measuring progress
- Sale with a right of return
- Warranties
- Principal versus agent considerations
- Customer options for additional goods or services
- Customers’ unexercised rights
- Nonrefundable upfront fees
- Licensing
- Repurchase agreements
- Consignment arrangements
- Bill-and-hold arrangements
- Customer acceptance
- Disclosure of disaggregated revenue
Implementation guidance: Licenses

Step 2: Identify the performance obligation(s)

Is the license distinct?

No

Account for bundle of goods and services

Yes

Apply criteria to determine whether nature of entity’s promise in granting license is to provide:

- a right to **access** the entity’s intellectual property as it exists throughout the license period (i.e., a performance obligation satisfied over time); or

- a right to **use** the entity’s intellectual property as it exists at the point in time at which the license is granted (i.e., a performance obligation satisfied at a point in time)
Disclosure requirements

**Disclosure objective:** To enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

- **Clarifications and refinements to disclosure requirements**
  - Disaggregation of revenue
  - Information about contract balances
  - Transaction price allocated to remaining performance obligations
  - Interim requirements
## Transition, effective date and early application

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<tbody>
<tr>
<td>Cumulative catch-up</td>
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<td>Contracts under new standard</td>
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<td>Contracts restated</td>
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## Cumulative effect at date of application

<table>
<thead>
<tr>
<th>Contracts not restated</th>
<th>Cumulative catch-up</th>
<th>Existing* and new contracts under new standard</th>
<th>Existing and new contracts presented under legacy IFRS/US GAAP</th>
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</table>

*contracts not completed in prior years as determined under legacy revenue guidance

- **Effective date, annual reporting periods beginning:**
  - IFRS – on or after 1 January 2017, early application permitted
  - US GAAP – after 15 December 2016, one year deferral for nonpublic entities, early application not permitted
Transition Resource Group

- Responsible for informing the FASB and the IASB about potential issues that could arise when implementing the new standard
- Group will solicit, analyze, and discuss stakeholder issues that apply to common transactions that could reasonably create diversity in practice
- In addition to providing a forum to discuss the application of the requirements, the transition group will provide information that will help the Boards determine what, if any, action will be needed to resolve that diversity
- The group itself will not issue guidance
Conceptual Framework: FASB
Conceptual Framework

Historical Objective

Conceptual framework undertaken— “with the expectation that it would articulate definitions and concepts that would diminish the need for and details in standards; it was to be the ‘relief’ from the so-called ‘firefighting’ [approach] for which the FASB’s predecessors had been criticized.” (Kirk–1988)

The alternative to conceptual based standards is ad-hoc answers to issues, which continues to be a significant cause of the complexity in our accounting standards.
Never the intention to start with a clean sheet of paper & develop a new conceptual framework

- Try to address deficiencies
- Try to clarify & improve understanding
- Make amendments that experience in application have suggested are necessary
## Conceptual Framework

### Areas to potentially address:

<table>
<thead>
<tr>
<th>Elements of Financial Statements</th>
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<tr>
<td>Recognition</td>
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<tr>
<td>Derecognition</td>
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<tr>
<td>Measurement</td>
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<tr>
<td>Reporting Entity</td>
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<tr>
<td>Presentation (research project in progress)</td>
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<tr>
<td>Disclosure (project in progress; ED issued Mar. 2014)</td>
</tr>
</tbody>
</table>
Conceptual Framework

**What issues should be given priority?**

Possible basis for prioritization:

- Framework deficiencies
- Issues that have been impediments to revolving standard-setting issues (MOU projects)
- Issues that seem precedential to resolving other framework issues
Foundational: Conceptual Framework

Added to the research agenda

Staff identified 3 significant deficiencies in current framework

- Lack of presentation concepts
- Lack of concepts for selecting measurement methods
- Deficiencies in the definition of elements, especially liabilities
Disclosure Framework Project: FASB
Objective:

- Improve the effectiveness of disclosures in notes to financial statements by clearly communicating the information most important to users of those statements.

Are financial statements a vehicle for communications with investors? Or are they more of a compliance exercise?
Phase I: Board’s Decision Process


Issues Addressed in the Board’s Decision Process:

- Purpose of the notes
- General limitations
  - Relevance
  - Costs
  - Certain information oriented toward the future
- Information that could be appropriate for inclusion in notes
- Considerations for interim reporting
Phase II: Entity’s Decision Process

Field Study:
- Designed to test the ability of entities to exercise discretion over which disclosures they provide in the notes

Participant Profiles:
- Assigned Materiality or Entity-Specific Relevance

<table>
<thead>
<tr>
<th>Materiality</th>
<th>Entity-Specific Relevance</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public Business Entities</td>
<td>5</td>
<td>4</td>
</tr>
<tr>
<td>Private Business Entities</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Not-For-Profit Entities</td>
<td>7</td>
<td>4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>14</strong></td>
<td><strong>9</strong></td>
</tr>
</tbody>
</table>

Outreach Efforts:
- Included calls and site visits with participants, participants’ auditors, national office representatives, the PCAOB, and a securities attorney
Entity’s Decision Process

Field Study Provided Insights On:

- Effectiveness of notes after applying discretion criteria
- Effectiveness of different criteria in removing disclosures that are not decision useful
- Ease with which the criteria was understood and applied
- Costs of the reporting system on the entity’s ability to exercise discretion
Field Study Results

More guidance around discretion facilitates more qualitative considerations

Preparers thought notes were generally more effective after applying their assigned discretion criterion

The word “materiality” has a strong quantitative connotation in practice

Obstacles in the financial reporting system discourage the application of discretion
Field Study Results

- Costs identified by participants:
  - Auditor objections
  - Auditor communication of disclosure omissions to the audit committee
  - SEC comment letters
  - Time required to make and adequately document judgments
  - Changes to internal controls
  - Education process to complete the exercise
Disclosure Framework – Next Steps

- Analyze comment letters regarding the Board’s Decision Process
- Utilize field study results and other feedback to develop changes to the Codification that promote the use of discretion
  - Expose changes to several Topics’ disclosure sections
- Address disclosures for interim periods
- Address accounting policies
Financial Performance Reporting: FASB Research Project
A New Project about Presentation

FASB directed staff to perform research on a financial statement presentation (FSP) project in January 2014.

Previous FSP project was jointly undertaken with the IASB and had a very broad and comprehensive objective.

This research project has a narrower objective and is more focused on the performance statement.

Following the research phase, goal is to activate a project on FASB’s agenda.
Objective of the research project

**Primary objective**
The primary objective is to evaluate ways the FASB might improve the relevance of information presented in the performance statement.

Two focus areas for the performance statement:
(1) a framework for determining a measure of operating performance
(2) distinguishing between recurring and nonrecurring or infrequently occurring items

The project was renamed to better reflect this new objective
# Scope of the research project

<table>
<thead>
<tr>
<th>Improvement areas</th>
<th>Performance reporting</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Priority focus areas</strong></td>
<td></td>
</tr>
<tr>
<td>A measure of operating performance</td>
<td>✔</td>
</tr>
<tr>
<td>Non-recurring or infrequent items</td>
<td>✔</td>
</tr>
<tr>
<td><strong>Areas where related improvements may also be considered</strong></td>
<td></td>
</tr>
<tr>
<td>Transparency of remeasurements</td>
<td>✔</td>
</tr>
<tr>
<td>Additional disaggregation in the performance statement</td>
<td>✔</td>
</tr>
<tr>
<td>Related changes to segment reporting</td>
<td>✔</td>
</tr>
<tr>
<td>Linkages across the primary statements</td>
<td>✔</td>
</tr>
</tbody>
</table>
Areas unlikely to be addressed

The following areas are unlikely to be pursued in this project:

- Direct Cash Flow Statement
- Cost of Goods Sold
- Earnings per Share
- Other Comprehensive Income
Private Company Issues: FASB
Private Company Council (PCC) . . . Structure

- FAF oversight
  - Identifies, deliberates & votes on proposed GAAP alternatives for private companies

- Advisory body to FASB
  - Private company practitioners (4), users (3), preparers (3)
PCC... Process

- PCC Agenda Decision
- PCC deliberation of staff analysis and vote*
- FASB endorsement
- FASB final endorsement
- PCC re-deliberates and votes*
- Exposure Draft
- FASB issues final Guidance

*FASB participates in deliberations
PCC... Agenda Process

- Identification of potential GAAP alternatives
- Pre-agenda research on potential modification
- Staff analysis - Private Company Decision Making Framework
- PCC vote on agenda topics (Super-majority)
Private Company Decision-Making Framework (PCDMF)
PCDMF... *Fundamentals*

- **Assist in user-relevance and cost-benefit evaluations for private companies under the existing conceptual framework**
- **Intended to facilitate decisions & drive consistency**
- **Fundamental approach retains or improves information relevant to typical users**
- **Reduce cost & complexity, but not adversely affecting reporting of relevant information**
Identify & provide alternatives based on differential factors

- Number of users and access to management
- Investment strategies of primary users
- Ownership & capital structure
- Accounting resources
- Learning about new guidance
Private Company Decision-Making Framework

Tool for PCC and FASB

Where guidance differ between public & private (modules)

- Recognition & Measurement
- Display (Presentation)
- Disclosures
- Effective Date
- Transition Method

Apply to PCC look-back projects & ongoing FASB projects
Organizations Affected

Scope of PCDMF

- Public business entities, not-for-profits & employee benefit plans excluded from the scope

- FASB determine if guidance will apply to organizations outside of the scope
  - And if so, whether the alternative should be required or an option
Final Alternatives
Goodwill... Problem?

Stakeholder Concerns

Limited benefits to users:
Users disregard goodwill & impairment losses in financial condition & operating performance

Cost & complexity of current goodwill impairment test
Goodwill... Solution

<table>
<thead>
<tr>
<th>Current U.S. GAAP</th>
<th>Final Alternative</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ Do not amortize goodwill</td>
<td>▪ Amortize goodwill over 10 years or less</td>
</tr>
<tr>
<td>▪ Test for impairment at least annually or more frequently</td>
<td>▪ Test for impairment upon triggering event</td>
</tr>
<tr>
<td>▪ Goodwill impairment test</td>
<td>▪ Goodwill impairment test</td>
</tr>
<tr>
<td>- At reporting unit level</td>
<td>- At entity level or reporting unit level</td>
</tr>
<tr>
<td>- Two-step test</td>
<td>- One-step test</td>
</tr>
<tr>
<td>- Optional qualitative assessment</td>
<td>- Optional qualitative assessment</td>
</tr>
</tbody>
</table>
Goodwill. . . Benefits of Alternative

- Significant cost savings for many private companies that carry goodwill on their balance sheets.
- Amortization reduces likelihood of impairments, private companies will test goodwill for impairment less frequently.
## Interest Rate Swaps . . . Problem?

### Stakeholder Concerns

1. Difficult to obtain fixed-rate borrowing
2. Must enter into swaps to economically convert variable-rate to fixed-rate borrowing
3. Lack expertise to comply with hedge accounting
4. Question relevance/cost of determining & presenting fair value of swap for converting to fixed-rate borrowing
# Interest Rate Swaps

<table>
<thead>
<tr>
<th>Impact of interest rate swap</th>
<th>Current GAAP</th>
<th>PCC Alternative</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No hedge accounting</td>
<td>Hedge accounting</td>
</tr>
<tr>
<td>Income statement</td>
<td>Volatility in interest expense as result of changes in FV</td>
<td>Interest expense approximates fixed rate debt</td>
</tr>
<tr>
<td>Balance sheet</td>
<td>Asset or liability at <strong>fair value</strong></td>
<td>Asset or liability at <strong>fair value</strong></td>
</tr>
<tr>
<td>Other comprehensive income</td>
<td>No impact</td>
<td>Includes changes in fair value of effective portion of hedge</td>
</tr>
</tbody>
</table>
Interest Rate Swaps . . . Solution

Simplified Hedge Accounting Approach

Practical expedient: removes consideration of nonperformance risk in measure; no longer requires contemporaneous documentation.

Reduces income statement volatility; provides relevant information for lenders/investors.

Less costly & complex.
Common-Control Leasing . . . Arrangements

Typical private company arrangement:

- Owner
  - 100% Interest
  - Leases Land & Building
  - Pays Rent

- Manufacturing Company
  - 100% Interest
  - Debt

- Leasing Company
  - 100% Interest
  - Mortgage

- Bank
  - Bank
Lessees may elect alternative not to apply VIE guidance when certain conditions are met.

- Not require VIE disclosures – instead require specific information on Lessor entity.

Important Note – Not meeting the criteria above does not automatically result in consolidation.
Common-Control Leasing . . . Solution

The “VIE Alternative” . . .

Reducing costs & complexity for private company lessees by not having to apply VIE guidance in situations where consolidation is unlikely

Useful lessor-related information for users of private company financial statements
Current Projects
Identifiable Intangible Assets . . . Problem?

Business Combinations

- Requirement for separate recognition & measurement of certain identifiable intangible assets from goodwill does not provide users with decision-useful information.

- Cost & complexity:
  - Estimating fair value of certain assets, including some identifiable intangible assets, e.g. customer relationships and non-compete agreements.
At April 29 meeting, PCC discussed various alternatives, including:

- Recognizing & measuring only intangible assets capable of being sold or licensed independently
- Alternatives focusing solely on types of customer related intangibles and non-compete arrangements that may not warrant recognition separately from goodwill
PCC . . . Other Issues

- **Development stage entities**
  - Resulted in FASB issuing guidance eliminating DSEs

- **Stock-based compensation**
  - Research currently being done for future agenda decision

- **Definition of public business entity (Phase 2)**
  - On PCC agenda; Project aims to eliminate multiple definitions in Codification
PCC... Advising on FASB Projects

- Revenue Recognition
- Leases
- Accounting for Financial Instruments
- Going Concern
- Disclosure Framework
- Definition of a Public Business Entity
- Government Assistance
- Reporting Discontinued Operations
Post-implementation Reviews:
FASB
PIR Objectives

Determine whether standard is accomplishing stated purpose
  • Is decision-useful information being reported?
  • Is the standard operational?

Evaluate implementation & continuing costs and related benefits

Provide feedback to improve standard-setting process
Completed FASB PIRs

- FIN 48, *Accounting for income tax uncertainty* (Jan 2012)
- FAS 131, *Segment disclosures* (Jan 2013)
- FAS 109, *Income taxes* (November 2013)
- FAS 157, *Fair Value Measurements* (February 2014)
FASB PIRs in Progress

FAS 160, *Noncontrolling Interests in Consolidated Financial Statements*

FAS 123(R), *Share-Based Payment*
Questions?

Copies of these slides will be available tomorrow on the FASB homepage at www.fasb.org