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Financial statement presentation

Partially updated March 2024

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About the Financial statement presentation guide

PwC is pleased to offer our *Financial statement presentation* guide. This guide serves as a compendium of many of today's presentation and disclosure requirements included in US GAAP, including relevant references to and excerpts from the FASB's Accounting Standards Codification (the Codification). It also provides our insights and perspectives, interpretative and application guidance, illustrative examples, and discussion on emerging practice issues.

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

Appropriate financial statement presentation and disclosure is key to achieving the objectives of financial reporting, including providing decision-useful information to investors, lenders, creditors, and other stakeholders. This guide has been prepared to support practitioners in the preparation of their financial statements. It should be used in combination with a thorough analysis of the relevant facts and circumstances, review of the authoritative accounting literature, and appropriate professional and technical advice.

The guidance in this guide is applicable to reporting entities that are going concerns and addresses financial statement presentation and disclosure related to the core financial statements. As a result, the following areas are not addressed in this guide:

- Management Discussion and Analysis (MD&A)
- Regulation S-K reporting

PwC's Bankruptcies and liquidations guide addresses the presentation and disclosure requirements applicable to entities reporting on a liquidation basis.

References to US GAAP

Definitions, full paragraphs, and excerpts from the FASB's Accounting Standards Codification are clearly labeled. In some instances, guidance was cited with minor editorial modification to flow in the context of the PwC Guide. The remaining text is PwC's original content.

References to other PwC guidance

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

- *Bankruptcies and liquidations (BLG)*
- *Business combinations and noncontrolling interests (BCG)*

- *Carve-out financial statements (CO)*
- *Consolidation (CG)*
- *Crypto assets (CA)*
- *Derivative and hedging (DH)*
- *Equity method investments and joint ventures (EM)*
- *Fair value measurements (FV)*
- *Financing transactions (FG)*
- *Foreign currency (FX)*
- *Income taxes (TX)*
- *Inventory (IV)*
- *Leases (LG)*
- *Loans and investments (LI)*
- *Not-for-profit entities (NP)*
- *Property, plant, equipment and other assets (PPE)*
- *Revenue from contracts with customers (RR)*
- *Software costs (SW)*
- *Stock-based compensation (SC)*
- *Transfers and servicing of financial assets (TS)*
- *Utilities and power companies (UP)*

Summary of significant changes

The following is a summary of recent noteworthy revisions to the guide. Additional updates may be made to future versions to keep pace with significant developments.

Revisions made in March 2024

FSP 25, *Segment reporting*

- Content in **FSP 25.2** and **FSP 25.7** was moved to **FSP 25.2A** and **FSP 25.7A** respectively, and content on the application of segment reporting after adoption of ASU 2023-07, *Segment Reporting (Topic 280): Improvements to Reportable Segment Disclosures,* was added to FSP 25.2 and 25.7. The case study previously in FSP 25.7.10 was moved to FSP 25.8 and updated to reflect the adoption of ASU 2023-07 as well.

FSP 6, *Statement of cash flows*

- **FSP 6.2** was updated to include a summary of recently-issued FASB guidance that affects the statement of cash flows.
- **FSP 6.5.2** was updated to clarify guidance on the definition of cash equivalents.
- **FSP 6.5.3** was updated to clarify guidance on the presentation and disclosure of amounts generally described as restricted cash or restricted cash equivalents.
- **FSP 6.6** was updated to clarify examples of net reporting in the statement of cash flows.
- Information on common cash flow classification issues previously included in **FSP 6.9** was moved to **FSP 6.8.**
- **FSP 6.8.2** was updated to clarify guidance when a centralized treasury function is used.
- **FSP 6.8.5.4** was updated to clarify guidance on the classification of cash flows associated with derivatives used in net investment hedges.
- **FSP 6.8.5.5** now includes guidance on the classification of cash flows associated with settled-to-market contracts.
- **Example FSP 6-11** was added to illustrate the cash flow presentation of payments to repay debt with an insignificant coupon; **Example FSP 6-12** was added to illustrate the cash flow presentation of payments to repay debt with a bifurcated feature resulting in an insignificant coupon on the debt host. Following examples were renumbered.
- **FSP 6.8.8.3** was updated to include guidance on the cash flow presentation of restructuring of a term loan syndication.
- **FSP 6.8.12** was updated to clarify guidance on the classification of cash flows related to sold receivables when the reporting entity continues to provide account servicing of sold receivables.
- **FSP 6.8.16.1** and **6.8.16.3** were updated to include guidance on the classification of payments for prepaid rent on a finance lease.
- **FSP 6.9.20** was updated to clarify guidance on the classification of cash flows arising from business combinations and acquired IPR&D in an asset acquisition.
- Information on supplementary cash flow information is now included in **FSP 6.9**. Guidance on noncash investing and financing activities previously included in **FSP 6.8** is now included in **FSP 6.9.2**. As a result, subsequent sections have been renumbered. In addition, **FSP 6.9.1** now includes discussion of supplemental disclosure of interest and income taxes paid.
- **FSP 6.10** was updated to clarify guidance on the presentation of cash and cash equivalents included in assets held for sale in the statement of cash flows.

Revisions made in January 2024

FSP 6, *Statement of cash flows*

- FSP 6.9.18 and FSP 6.9.19 were updated to include guidance from **LG 9.2.3** and **LG 9.3.3.**

FSP 14, *Leases*

- Content from LG 9 on presentation and disclosure under ASC 842 (except for LG 9.2.3 and LG 9.3.3) was moved to FSP 14, and content from ASC 840 was removed as ASC 842 is effective for all entities.

Revisions made in September 2023

FSP 10, *Equity method investments & joint venture entities*

- **FSP 10.8** was added to discuss disclosure requirements for newly-formed joint venture entities upon adoption of ASU 2023-05.

Revisions made in June 2023

FSP 10, *Equity method investments*

- **FSP 10.4.1.9** was updated to discuss investments in tax credit entities after adoption of ASU 2023-02, including the broader application of the proportional amortization method. Guidance related to accounting for investments in tax credit entities prior to the adoption of ASU 2023-02 was moved to **FSP 10.4.1.9A**. Disclosure requirements under ASU 2023-02 are included in FSP 16.5.4.

Revisions made in April 2023

FSP 8, *Other assets*

- The guidance on disclosure requirements for troubled debt restructurings in **FSP 8.3.1.2** was clarified.

- **FSP 8.4.2** added a disclosure requirement for net losses related to accrued firm purchase commitments.

- **FSP 8.5.1** was updated to clarify guidance on disclosure requirements related to cooperative advertising arrangements when advertising payments occur after the recognition of revenue related to those costs.

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Chapter 1: General presentation and disclosure requirements—updated December 2021

1.1 Financial statement presentation and disclosure requirements

This chapter introduces the general concepts of financial statement presentation and disclosure that underlie the detailed guidance that is covered in the remaining chapters of this guide.

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

ASC 205-10-45-1A

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

a. Financial position at the end of the period

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

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

d. Cash flows during the period

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

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

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

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

1.1.1 Reporting periods

Comparative financial statements provide historical context for a reporting entity's financial performance and enable users to identify trends or other relationships. Comparative periods should be presented on a consistent basis with any changes disclosed as a change in accounting policy or correction of an error (see FSP 30).

Figure FSP 1-1 depicts the reporting periods required by the SEC for financial statements of public companies.

Figure FSP 1-1

Audited financial statement requirements for public companies

Statement	Reporting periods required	Reference
Balance sheet	As of the end of each of the two most recent fiscal years	S-X 3-01(a)
Statement of comprehensive income	For the three most recent fiscal years	S-X 3-02(a)
Statement of cash flows	For the three most recent fiscal years	S-X 3-02(a)
Statement of changes in stockholders' equity	Present in a separate statement or in the footnotes for each period a statement of comprehensive income is presented	S-X 3-04

Qualifying Emerging Growth Companies, as defined in the Jumpstart Our Business Startups (JOBS) Act, and Smaller Reporting Companies, as defined in S-K 10(f), are permitted to omit the earliest year income statement and statements of comprehensive income, cash flows, and changes in stockholders' equity in an initial public offering. Additionally, S-X, Article 8 notes that for annual financial statements, a Smaller Reporting Company should file an audited balance sheet as of the end of each of the two most recent fiscal years, and audited statements of income, cash flows, and changes in stockholders' equity for each of the last two fiscal years.

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

ASC 205-10-45-2

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

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

1.1.2 Chronological ordering of data

The SEC staff has indicated no preference as to the order in which data is presented in the financial statements (e.g., whether the most current fiscal period should be displayed as the first or last column in the income statement). However, it has stated that data presented in tabular form should read consistently from left to right in the same chronological order throughout the filing. Numerical data included in the footnotes should also follow the same ordering pattern (see SAB Topic 11.E).

1.1.3 Basis of presentation

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

In practice, some reporting entities choose to provide a "Basis of Presentation," or similarly-titled footnote to disclose that the financial statements are presented in accordance with US GAAP. Other reporting entities choose to include this information in a "Significant Accounting Policies" footnote, as described in FSP 1.1.4.

1.1.4 Disclosure of accounting policies

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

ASC 235-10-50-3

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

a. A selection from existing acceptable alternatives

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

c. Unusual or innovative applications of GAAP.

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

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

1.1.5 Use of estimates

ASC 275, *Risks and Uncertainties,* requires reporting entities to disclose that the preparation of financial statements in accordance with US GAAP requires the use of management's estimates.

ASC 275-10-50-4

Financial statements shall include an explanation that the preparation of financial statements in conformity with generally accepted accounting principles (GAAP) requires the use of management's estimates.

Refer to FSP 24 for further discussion.

1.2 Enhancing disclosure effectiveness

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

Reporting entities can enhance the format and organization of the footnotes to help focus users on the most decision-useful information. Footnote disclosures should include (1) clarity about relevant policies and significant transactions, and (2) organization that eases navigation. Reporting entities should consider employing best practices such as:

- Using plain English to describe industry and entity-specific policies
- Eliminating overly technical references
- Grouping related data together and avoiding duplication
- Using tabular formats
- Cross-referencing information from the face of the primary statements to the related footnote or between footnotes

In addition, within established rules and legal requirements, we encourage reporting entities to exercise well-reasoned judgment to determine which disclosures are most relevant to their financial statement users. Extensive footnote disclosure requirements impose costs on both reporting entities and investors. The costs to reporting entities include preparing and analyzing information, maintaining internal controls, and audit costs. Investors indirectly bear these costs as well as the cost of the time needed to assess data presented in the footnotes to determine whether it is relevant for their decision-making.

Chapter 2: Balance sheet—updated September 2022

2.1 Balance sheet overview

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

This chapter details general balance sheet presentation requirements. It includes an example of a balance sheet of a commercial company that illustrates the requirements of S-X 5-02, which calls for the presentation of a classified balance sheet as discussed in FSP 2.3.4. This chapter also addresses balance sheet offsetting, the presentation of a noncontrolling interest (NCI) in unconsolidated subsidiaries, and considerations for private companies.

2.2 Balance sheet scope and relevant guidance

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

Commercial and industrial companies that are SEC registrants are generally subject to S-X Article 5, and should also comply with the guidance regarding presentation of the balance sheet in SAB Topic 11.E (codified in ASC 205-10-S99-9) and Article 3 and Article 4 within Regulation S-X:

- S-X Article 5 provides for the presentation of the balance sheet and notes additional schedules that may be required.

- SAB Topic 11.E provides guidance on the chronological ordering of financial data.

- Article 3 provides general instructions applicable to all registrants. In particular, S-X 3-01 stipulates that the registrant and its subsidiaries should file a consolidated balance sheet as of the end of each of the two most recent fiscal years.

- Article 4 (S-X 4-01 through S-X 4-03) provides general application rules regarding the form and order of the balance sheet and other statements.

Reporting entities subject to other SEC regulations include registered investment companies and business development companies (Article 6), employee stock purchase, savings and similar plans (Article 6A), insurance companies (Article 7), smaller reporting companies (Article 8), bank holding companies (Article 9), and brokers and dealers when filing Form X-17A-5. While Article 5 requires a classified balance sheet, no other articles within S-X contain this requirement. Reporting entities subject to the articles referred to above should refer to the applicable S-X guidance to determine their requirements.

2.2.1 Sample balance sheets

Figure FSP 2-1 is an illustrative balance sheet prepared based on the following conventions:

- Captions not required by SEC rules, but either required by US GAAP or often included in a typical presentation are in regular font.

- Captions required by S-X 5-02 are in **bold** font.

- If S-X 5-02 provides an option to include information in a footnote rather than on the face of the balance sheet, the caption is in regular font.

Detailed presentation and disclosure requirements are addressed in FSP 2.3.3. For each balance sheet caption, the last column of Figure FSP 2-1 includes a reference to the relevant FSP guide chapter where more information can be found. The captions included on a balance sheet may vary based on each reporting entity's facts. Further, certain required captions may not be applicable to all reporting entities.

Figure FSP 2-1

Sample consolidated balance sheets under S-X 5-02

FSP Corp
Consolidated Balance Sheets
December 31, 20X2 and 20X1

Assets	**December 31, 20X2**	**December 31, 20X1**	**FSP guide chapter reference**
	(in millions $, except per share data)	(in millions $, except per share data)	
Current assets			
Cash and cash equivalents	$xxx	$xxx	FSP 6.5
Restricted cash[1]	xxx	xxx	FSP 6.5
Marketable securities at fair value (amortized cost of $xxx in 20X2 and $xxx in 20X1)[2]	xxx	xxx	FSP 9.4
Accounts receivable[3], **net of allowance for doubtful accounts** of $xx and $xx[4]	xxx	xxx	FSP 8.3
Notes receivable[3], **net of allowance for doubtful accounts** of $xx and $xx[4]	xxx	xxx	FSP 8.3
Net investment in leased property[5]	xxx	xxx	FSP 14.4A
Inventories	xxx	xxx	FSP 8.4
Prepaid expenses	xxx	xxx	FSP 8.5
Contract assets	xxx	xxx	FSP 33.3
Other current assets	xxx	xxx	FSP 8
Total current assets	xxx	xxx	
Debt and equity securities	xxx	xxx	FSP 9.4
Securities of related parties	xxx	xxx	FSP 26.3
Net investment in leased property, noncurrent[5]	xxx	xxx	FSP 14.4A
Indebtedness of related parties, noncurrent	xxx	xxx	FSP 26.3
Other investments	xxx	xxx	FSP 9.4
Investments in unconsolidated subsidiaries	xxx	xxx	FSP 10.3
Derivative assets	xxx	xxx	FSP 19.3
Deferred income tax assets, noncurrent[6]	xxx	xxx	FSP 16.2
Property, plant, and equipment, net of accumulated depreciation, depletion, and amortization of $xx and $xx[7]	xxx	xxx	FSP 8.6
Intangible assets, net of accumulated amortization of $xx and $xx	xxx	xxx	FSP 8.8
Goodwill[8]	xxx	xxx	FSP 8.9
Other assets	xxx	xxx	FSP 8
Total assets	$xxx	$xxx	

Liabilities, redeemable preferred stock, and stockholders' equity	December 31, 20X2	December 31, 20X1	FSP guide chapter reference
	(in millions $, except per share data)	(in millions $, except per share data)	
Current liabilities			
Accounts and notes payable[9]	$xxx	$xxx	FSP 11.3
Current portion of long-term debt	xxx	xxx	FSP 12
Current portion of obligations under capital leases	xxx	xxx	FSP 14.3A
Income taxes	xxx	xxx	FSP 16.2
Derivative liabilities	xxx	xxx	FSP 19.3
Deferred credits, current[6]	xxx	xxx	FSP 16.3
Dividends payable	xxx	xxx	FSP 5.11
Contract liabilities[5]	xxx	xxx	FSP 33.3
Other current liabilities	xxx	xxx	FSP 11
Total current liabilities	xxx	xxx	
Bonds, mortgages and other long-term debt, including capitalized leases Less: Unamortized discount and issuance costs	xxx	xxx	FSP 12/ FSP 14
Indebtedness to related parties – noncurrent	xxx	xxx	FSP 26.3
Noncurrent portion of obligations under capital leases	xxx	xxx	FSP 14.3A
Notes payable, noncurrent[9]	xxx	xxx	FSP 11
Long-term debt	xxx	xxx	FSP 12
Employee benefit plan obligation	xxx	xxx	FSP 13
Deferred credits, noncurrent[6]	xxx	xxx	FSP 16.2
Deferred tax liabilities, noncurrent[6]	xxx	xxx	FSP 16.2
Other liabilities	xxx	xxx	FSP 11
Total liabilities	xxx	xxx	
Commitments and contingent liabilities[10]			FSP 23
Redeemable preferred stock[11] Class D - subject to redemption ($0.01 par value; authorized – xxxx shares; issued and outstanding – xxx and xxx shares)	xxx	xxx	FSP 5.6.3
Stockholders' equity			
Non-redeemable preferred stock Class C ($0.01 par value; authorized – xxxx shares; issued and outstanding – xxx and xxx shares)	xxx	xxx	FSP 5.6
Common stock – Class A ($0.01 par value; authorized – xxxx shares; issued and outstanding – xxx and xxx shares)	xxx	xxx	FSP 5.5
Treasury stock, at cost (xxx and xxx shares held)	(xxx)	(xxx)	FSP 5.9
Additional paid-in capital[12]	xxx	xxx	FSP 5.10
Accumulated other comprehensive income[13]	xxx	xxx	FSP 4
Retained earnings[14]	xxx	xxx	FSP 5.8
Total stockholders' equity attributable to FSP Corp stockholders	xxx	xxx	
Noncontrolling interests in consolidated subsidiaries	xxx	xxx	FSP 5.3.1/ FSP 18
Total stockholders' equity	xxx	xxx	
Total liabilities, redeemable preferred stock, and equity	$xxx	$xxx	

See Notes to the Consolidated Financial Statements

1 S-X 5-02(1) requires segregation on the balance sheet of funds legally restricted as to withdrawal, including compensating balances. The provisions of any restrictions should be described in a note to the financial statements.

2 ASC 825-10-45-1A requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables) on the balance sheet or in the footnotes. See FSP 9.4.

3 The caption in S-X 5-02 is “accounts and notes receivable.” This balance sheet assumes that each account is material and is included individually. S-X 5-02 requires separate captions for amounts receivable from (1) customers (trade), (2) related parties, (3) underwriters, promoters, and employees (other than related parties) that arose in other than the ordinary course of business, and (4) others.

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

5 If leasing is a significant part of the lessor’s business activities (as measured by revenue, net income, or assets), the lessor should disclose the components that make up its net investment in sales-type or direct financing leases under ASC 840. See FSP 14.4.3.2A for more details.

See LG 9.3 for presentation and disclosure requirements for a lessor under ASC 842.

6 S-X 5-02 requires separate captions for (1) deferred income taxes, (2) deferred tax credits, and (3) material items of deferred income. ASC 740 requires a reporting entity to net all deferred tax assets and liabilities by tax paying component for each jurisdiction, along with any related valuation allowance, and classify each tax paying component’s net deferred tax balance as noncurrent.

7 S-X 5-02(14) requires the amount of accumulated depreciation, depletion, and amortization of property, plant, and equipment to be presented separately in the balance sheet or in a note. Per ASC 840-30-50-1(a) assets recorded under capital leases may be combined with owned assets, and are often included in the Property, Plant, and Equipment line item. Refer FSP 14.1 for the ASC 842 presentation and disclosure requirements.

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

9 The caption in S-X 5-02 is “accounts and notes payable.” This balance sheet assumes that each account is material and is included individually. S-X 5-02 does require separate captions for amounts payable to (1) banks for borrowings; (2) factors or other financial institutions for borrowings; (3) holders of commercial paper; (4) trade creditors; (5) related parties; (6) underwriters, promoters, and employees (other than related parties); and (7) others. Amounts applicable to (1), (2), and (3) may be stated separately on the balance sheet or in a footnote.

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

11 If applicable, S-X 5-02 requires separate presentation for each issue of redeemable preferred stock (also known as “mezzanine equity” or temporary equity). Determining whether certain instruments are required to be classified as mezzanine equity is discussed in FG 7 and presentation and disclosure of mezzanine equity is discussed in FSP 5.6.3.1.

12 In accordance with S-X 5-02, additional paid-in capital may be combined with the stock caption to which it applies, if appropriate.

13 Caption required by S-X 5-02 and ASC 220-10-45-14.

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

2.3 General presentation requirements

The rules that govern balance sheet presentation are intended to aid comparability between reporting entities. Among other areas, reporting entities should consider the number of reporting periods presented, as well as chronology. While most reporting entities present the balance sheet in order of liquidity (i.e., starting with the most liquid asset, which is cash for most companies), there is no specific ordering requirement within US GAAP. Certain assets may be presented with more prominence depending on their relative importance to the industry (e.g., property, plant, and equipment in the public utilities industry).

Reporting entities should also consider whether individually significant account balances may warrant further disaggregation, classified balance sheet requirements, and the impact of the entity's operating cycle on classification.

2.3.1 Reporting periods

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

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

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

2.3.2 Chronology

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

2.3.3 Individually significant account balances

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

- Current assets with amounts greater than 5% of total current assets.

- Any other assets with amounts in excess of 5% of total assets that are not properly classified in one of the existing asset captions.

- The aggregate amount of notes receivable, if it exceeds 10% of total receivables.

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

- Current liabilities with amounts greater than 5% of total current liabilities.

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

- Any other liabilities with amounts in excess of 5% of total liabilities that are not properly classified in one of the existing liability captions.

2.3.4 Classified balance sheet

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

The ASC Master Glossary defines current assets and current liabilities.

Definitions from ASC Master Glossary

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

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

ASC 210-10-45 provides further guidance on what is included in current assets and current liabilities. The FASB guidance and the SEC guidance are aligned on what is considered current and bases that classification on the reporting entity's operating cycle.

2.3.4.1 Operating cycle

Reporting entities generally use a 12-month cycle when determining whether classification should be current or noncurrent. However, the classification should align with the business' operating cycle, which could be more, but not less, than 12 months.

The ASC Master Glossary defines operating cycle.

Definition from ASC Master Glossary

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

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

Figure FSP 2-2
How to determine time period for current classification

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

Once the reporting entity determines its operating cycle, it should analyze each asset and liability to determine whether the amounts should be classified as current, noncurrent, or divided between current and noncurrent.

Certain financial statement captions or account balances, such as deferred income taxes (FSP 16.2), may have their own specific guidance with respect to classification as current or noncurrent that does not necessarily align with the operating cycle determination.

Not all assets and liabilities will have a current and noncurrent allocation. For example, although a portion of property, plant, and equipment and intangible assets will typically be depreciated or amortized during a reporting entity's operating cycle, the amount represents an allocation of the asset cost to operating expenses rather than an amount that is directly realized in cash or through consumption of the asset during the operating cycle; therefore, the entire asset should be classified as noncurrent.

2.4 Balance sheet offsetting

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

ASC 210-20-45-1 provides guidance on the right of setoff of all balances. The right of setoff for derivatives and repurchase/reverse repurchase and stock lending agreements are subject to different offsetting requirements as discussed in FSP 19 and FSP 22, respectively.

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

ASC 210-20-45-1

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

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

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

c. The reporting party intends to set off.

d. The right of setoff is enforceable at law.

Three of these criteria are objectively determinable. An asset and liability should be offset under a legal right of setoff only when they represent amounts due to and from the same party. In addition, a reporting entity should consider discussion with its legal counsel to evaluate legal enforceability of setoff rights.

In assessing whether amounts qualify for net reporting, determining the intent of the reporting party may require judgment. ASC 210-20-45-5 notes that historical precedent is an indicator to consider in evaluating intent of the reporting entity. If the reporting entity has executed a settlement by offsetting balances with the other party in prior transactions, it may be appropriate to expect a similar offset in the future, provided the reporting entity asserts its intention to offset the balances. Generally, a reporting entity cannot present an asset and liability with another party net if the reporting entity does not intend to offset, even if all other criteria are met. The ASC 210-20 offsetting guidance relates to presentation only; its scope does not extend to derecognition of assets and liabilities. For example, presenting an asset and liability of equal value net on the balance sheet does not result in the derecognition of the contractual right and obligation. Therefore, reporting entities should include the gross amounts in disclosure, despite the amounts being all or partially eliminated from presentation on the balance sheet. Further, the offsetting guidance does not permit a reporting entity to record or disclose that debt or a note payable has been extinguished through the presence of a debt service fund or similar collateral arrangement.

2.5 Noncontrolling interests

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

In some circumstances, reporting entities will classify NCI outside of stockholders' equity, either as a mezzanine instrument or as a liability. See BCG 2.6.6 and ASC 480-10-S99-3A for a discussion of circumstances that may require these alternative classifications. In these circumstances, reporting entities are required to make additional disclosures, similar to those for redeemable preferred stock. Refer to FSP 5.6.3 for presentation and disclosure requirements for redeemable preferred stock.

2.6 Considerations for private companies

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

Other notable differences are:

- The SEC requirement in S-X 3-01(a) that comparative statements be presented is not required for private companies. Refer to FSP 2.3.1 for more information.

- S-X 5-02 quantitative thresholds for determining which balances should be separately presented on the face of the balance sheet do not apply to private companies.

Chapter 3: Income statement – updated November 2022

3.1 Income statement overview

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

3.2 Income statement scope and relevant guidance

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

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

Presentation

- ASC 205, *Presentation of Financial Statements*
- ASC 225, *Income Statement*
- ASC 235, *Notes to Financial Statements*

Revenues

- ASC 606, *Revenue from contracts with customers*
- ASC 610-20, *Gains and losses from the derecognition of nonfinancial assets*

Expenses

- ASC 720, *Other Expenses*
- ASC 326, *Financial Instruments—Credit Losses*

SEC

- Regulation S-X Article 3, S-X Article 4, and S-X Article 5

- SAB Topic 1.B, *Allocation Of Expenses And Related Disclosure In Financial Statements Of Subsidiaries, Divisions Or Lesser Business Components Of Another Entity* (codified in ASC 220-10-S99-3)
- SAB Topic 5.P*, Restructuring Charges* (codified in ASC 420-10-S99-2)

Note about ongoing standard setting

The FASB has an active project related to the disaggregation of income statement expenses. Financial statement preparers and other users of this publication are therefore encouraged to monitor the status of the project, and if finalized, evaluate the effective date of the new guidance and the implementation on presentation and disclosure.

3.3 Format of the income statement

ASC 205, *Presentation of Financial Statements,* and ASC 225, *Income Statement*, provide the baseline authoritative guidance for presentation of the income statement for all US GAAP reporting entities. The income statement can be presented in a "one-step" or "two-step" format. In a "one-step" format, revenues and gains are grouped together, and expenses and losses are grouped together. These amounts are then totaled to show net income or loss. In a "two-step" format, subtotals are used to show decision-useful line items such as gross margin and operating income separately from non-operating income and net income or loss. Many commercial and industrial reporting entities use a "two-step" format.

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

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

Sample income statement

The captions included in an income statement will vary across reporting entities based on what is applicable to each entity's business. Figure FSP 3-1 is a sample income statement that includes the line items required by S-X 5-03 (in **bold** font) and other commonly used captions. Line items that are not applicable to a reporting entity need not be presented. If S-X 5-03 indicates the placement of the detailed information is optional, the caption is in regular font. Additionally, US GAAP requires certain disclosures, which can generally be presented in the footnotes or on the face of the income statement.

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

Figure FSP 3-1
Sample consolidated "two-step" income statement

FSP Corp
Consolidated Statements of Operations
For the years ended December 31, 20X3, 20X2, and 20X1

	20X3	20X2	20X1	FSP chapter or section reference
	In millions $, except per share data	In millions $, except per share data	In millions $, except per share data	
Net sales	**$xxx**	**$xxx**	**$xxx**	**FSP 33**
Cost of sales	**(xxx)**	**(xxx)**	**(xxx)**	**FSP 3.5**
Gross profit	xxx	xxx	xxx	FSP 3.5
Other operating expenses	**xxx**	**xxx**	**xxx**	**FSP 3.6**
Selling, general, & administrative expenses	**(xxx)**	**xxx**	**(xxx)**	**FSP 3.6**
Provision for doubtful accounts and notes	**(xxx)**	**(xxx)**	**(xxx)**	**FSP 3.6.2**
Depreciation expense[1]	(xxx)	(xxx)	(xxx)	FSP 3.6.3
Impairment loss[2]	—	(xxx)	—	FSP 3.6.5
Restructuring expense[3]	(xxx)	(xxx)	—	FSP 3.6.9
Other general expenses	**(xxx)**	**(xxx)**	**(xxx)**	**FSP 3.6.13**
Non-operating income	**xxx**	**xxx**	**xxx**	**FSP 3.7**
Interest and amortization of debt discount and expense	**(xxx)**	**(xxx)**	**(xxx)**	**FSP 3.7.3 / FSP 12**
Non-operating expenses	**(xxx)**	**(xxx)**	**(xxx)**	**FSP 3.7**
Income (loss) from continuing operations before income tax expense	**xxx**	**xxx**	**(xxx)**	**FSP 3.8.1**
Income tax expense	**(xxx)**	**(xxx)**	**(xxx)**	**FSP 3.8.2 / FSP 16**
Equity in earnings of unconsolidated entities	**xxx**	**xxx**	**(xxx)**	**FSP 3.8.3 / FSP 10**
Income (loss) from continuing operations	**xxx**	**xxx**	**(xxx)**	**FSP 3.8.4**

[1] Reporting entities may choose to present depreciation expense separately in the income statement to fulfill the requirements of ASC 360-10. Refer to FSP 3.6.3 for further details.

[2] Reporting entities may choose to present impairment loss separately in the income statement to fulfill the requirements of ASC 360-10. Refer to FSP 3.6.5 for further details.

[3] Reporting entities may choose to present exit or disposal activities covered by ASC 420-10 separately within continuing operations as long as those activities do not involve a discontinued operation. Refer to FSP 3.6.9 for further details.

	20X3	20X2	20X1	FSP chapter or section reference
	In millions $, except per share data	In millions $, except per share data	In millions $, except per share data	
Discontinued operations	**—**	**xxx**	**—**	**FSP 3.8.5 / FSP 27**
Income (loss) before cumulative effects of changes in accounting principles	**xxx**	**xxx**	**(xxx)**	**FSP 3.8.6**
Cumulative effects of changes in accounting principles	**—**	**xxx**	**—**	**FSP 3.8.6 / FSP 30**
Net income (loss)	**xxx**	**xxx**	**(xxx)**	**FSP 3.8.7**
Less: Net income (loss) attributable to noncontrolling interests	**xxx**	**(xxx)**	**(xxx)**	**FSP 3.8.8 / FSP 18**
Net income (loss) attributable to parent	**$xxx**	**$(xxx)**	**$(xxx)**	**FSP 18**
Net income (loss) attributable to entity per common share—basic				**FSP 3.8.9 / FSP 7**
Continuing operations	xxx	xxx	xxx	FSP 3.8.9 / FSP 7
Discontinued operations	N/A	xxx	N/A	FSP 3.8.9 / FSP 7
Net income (loss)	xxx	xxx	xxx	FSP 3.8.9 / FSP 7
Net income (loss) attributable to entity per common share – diluted				**FSP 3.8.9/ FSP 7**
Continuing operations	xxx	xxx	xxx	FSP 3.8.9 / FSP 7
Discontinued operations	N/A	xxx	N/A	FSP 3.8.9 / FSP 7
Net income (loss)	xxx	xxx	xxx	FSP 3.8.9 / FSP 7

See Notes to the Consolidated Financial Statements.

3.4 General presentation and disclosure requirements

ASC 225 is the primary guidance that provides the requirements for information included in the income statement. This includes ASC 225-10-S45 and ASC 225-10-S99, which capture the guidance also included in Articles 3, 4, and 5 of Regulation S-X. For purposes of this guide, we have focused on commercial and industrial companies, which are subject to Article 5. Reporting entities subject to other SEC regulations include registered investment companies (Article 6), employee stock purchase, savings, and similar plans (Article 6A), insurance companies (Article 7), smaller reporting companies

(Article 8), bank holding companies (Article 9) and brokers and dealers that file Form X-17A-5, which are not addressed in this guide.

Reporting periods

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

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

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

3.5 Cost of sales

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

Although cost of sales is often one of the more material income statement line items, there are minimal associated presentation and disclosure requirements. However, as previously discussed, the costs and expenses related to each revenue category must be reflected separately in the income statement.

3.6 Operating expenses

As indicated in Figure FSP 3-1, S-X 5-03 requires registrants to separately identify certain operating expense line items if they are material. In practice, many reporting entities will separately identify selling, general, and administrative costs (SG&A) as a single line item, but other operating costs may be separately identified in a manner that differs from the named line items prescribed by S-X 5-03. This section discusses many of the common operating expenses that reporting entities may separately identify in the income statement. This assessment will depend on materiality, and what is deemed to be most useful to a reporting entity's financial statement users.

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

expense (excluding those related to product manufacturing), and any other costs of selling product or administrating the business.

3.6.1 Advertising expense

Advertising costs are generally presented as part of selling, general, and administrative (SG&A) expenses in a reporting entity's income statement. As discussed in ASC 720-35-25-1, a reporting entity can elect an accounting policy to either expense advertising costs the first time the advertising takes place or expense them as they are incurred. The accounting policy selected from these two alternatives must be applied consistently to similar kinds of advertising activities. ASC 720-35-50-1 requires that disclosures include, at a minimum:

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

3.6.2 Provision for doubtful accounts and notes (ASC 326)

The presentation and disclosure requirements of ASC 326, *Financial Instruments—Credit Losses,* are discussed in LI 12. See FSP 3.6.2A for the related disclosure requirements prior to adoption of ASC 326.

3.6.2A Provision for doubtful accounts and notes (ASC 310) before adoption of ASC 326

Provision for doubtful accounts and notes is the current period expense associated with losses from normal credit sales (See FSP 8 for balance sheet disclosure requirements).

These provisions are generally grouped within SG&A. However, if they are material, they should be presented separately on the face of the income statement as an operating expense. Although the SEC requires a rollforward of the doubtful accounts and notes to be included in the filing as part of the Regulation S-X, Rule 12-09 "valuation and qualifying accounts" schedule (Schedule II), some reporting entities include such disclosures as part of the footnotes to the financial statements.

3.6.2.1A Bad debt expense (ASC 310) before adoption of ASC 326

Reporting entities may have flexibility as to how they present bad debt expense (i.e., expense associated with changes in the provision for receivables). ASC 310-10-45-5 provides classification guidance for reporting entities that apply a present value of expected future cash flows technique.

Excerpt from ASC 310-10-45-5

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

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

3.6.2.2A Impaired loans (ASC 310) prior to the adoption of ASC 326

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

ASC 310-10-45-6

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

3.6.3 Depreciation and amortization of long-lived assets

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

Where depreciation and amortization is classified in the statement of operations depends on the related asset's function. For example, the depreciation of a manufacturer's factory and production equipment would likely be considered fixed overhead and capitalized as part of inventory costs, while the depreciation of corporate headquarters would typically be considered part of general and administrative expense. ASC 730-10-25-2 states that depreciation of capitalized equipment or facilities that are acquired or constructed for research and development activities should be considered research and development costs. See FSP 3.6.4 for considerations related to intangible assets and goodwill.

Not all depreciation of manufacturing productive assets can be absorbed into inventory. The allocation of indirect costs (e.g., fixed production overheads) should be based on normal capacity, which is defined in ASC 330-10-30-3.

Excerpt from ASC 330-10-30-3

Normal capacity refers to a range of production levels. Normal capacity is the production expected to be achieved over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. Some variation in production levels from period to period is expected and establishes the range of normal capacity.

The reporting entity should apply judgment in determining whether a production level is within the range of normal capacity considering various business- and industry-specific factors. Any unallocated fixed cost overheads, including depreciation expense, are considered period costs and should be charged to earnings in the current period.

Some reporting entities choose to report all depreciation and amortization directly charged to earnings as a separate line item in the statement of operations rather than include it in the related line items by

function (e.g., cost of sales, selling and marketing, general and administrative). When some or all of the depreciation and amortization related to the manufacturing of products or the services provided by a reporting entity are excluded from the cost of sales line item, SAB Topic 11.B, *Depreciation And Depletion Excluded From Cost Of Sales* (codified in ASC 220-10-S99-8) provides guidance that the description of the line item should reflect this exclusion (e.g., "Cost of sales (exclusive of items shown separately below)" or "Cost of sales (exclusive of depreciation shown separately below)").

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

3.6.3.1 Amortization of-right-of use assets

Amortization expense may result from lease transactions that are accounted for under ASC 842. The amortization of a right-of-use asset should be presented in accordance with ASC 842-20-45-4 and may differ depending on whether the lease is a finance lease or an operating lease. The requirements of ASC 842 are covered in PwC's *Leases* guide.

3.6.4 Amortization of intangibles

Like the depreciation or amortization of tangible long-lived assets, the amortization of intangibles may be included in operating expenses or cost of sales, depending on the use of the asset.

For example, a reporting entity that provides security monitoring services may have an acquired customer-relationship intangible asset. Classification of amortization of the intangible asset in selling, general, and administrative expense may be most consistent with the nature of the asset because the intangible asset is not typically associated with providing the service to customers. On the other hand, a reporting entity may have a patent intangible asset that is used in the production of its products. In this case, classification of the amortization for the patent in costs of sales (or as an inventory cost that is eventually recorded as cost of sales) may be most consistent with the nature of the asset. If not included in cost of sales, the reporting entity should follow the guidance in SAB Topic 11.B (as discussed in FSP 3.6.3.

See FSP 8.8 for presentation and disclosure requirements for intangibles.

3.6.4.1 Amortization of favorable and unfavorable contracts (intangibles)

We generally believe the subsequent amortization of a favorable or unfavorable revenue contract should be recognized within the income statement as contra-revenue or revenue, respectively.

See BCG 4.3.3.5 for further discussion on the initial recognition and measurement of acquired contracts in a business combination.

3.6.5 Impairment of long-lived assets and goodwill

Impairments of long-lived assets may be included within operating income based on the function of the associated asset or presented separately in the income statement. The aggregate amount of goodwill impairment losses should be presented as a separate line item on the income statement within continuing operations unless a goodwill impairment is associated with a discontinued operation. See FSP 8.6 and FSP 8.9 for presentation and disclosure requirements for impairments related to long-lived assets and goodwill, respectively.

3.6.6 *Gains or losses on sales of businesses*

Some reporting entities present gains or losses resulting from sales of businesses (that do not qualify as discontinued operations) within operating income in a "two-step" income statement, in accordance with ASC 360-10-45-5. Others report such items as non-operating gains or losses. The SEC has accepted both approaches. In a "one-step" income statement format, gains or losses from the sale of businesses (that do not qualify as discontinued operations) should be reported as "other general expenses."

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

3.6.7 *Research and development expense*

Many reporting entities, especially those in certain industries (e.g., biotechnology), incur significant research and development expenses. ASC 730 requires reporting entities to expense research and development costs as they are incurred. It also requires certain disclosures, as discussed in ASC 730-10-50-1.

Excerpt from ASC 730-10-50-1

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

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

ASC 730 requires disclosure of research and development arrangements that are accounted for as a contract to perform research and development for others.

ASC 730-20-50-1

An entity that under the provisions of this Subtopic accounts for its obligation under a research and development arrangement as a contract to perform research and development for others shall disclose both of the following:

a. The terms of significant arrangements under the research and development arrangement (including royalty arrangements, purchase provisions, license agreements, and commitments to provide additional funding) as of the date of each balance sheet presented

b. The amount of compensation earned and costs incurred under such contracts for each period for which an income statement is presented.

Reporting entities that receive reimbursements of research and development expenses from another party may question whether those reimbursements should be treated as revenue or an offset to expense. The SEC staff has acknowledged that, in some cases, a reporting entity may be able to

support more than one conclusion based on the existing accounting literature. Reporting entities should evaluate the facts and circumstances of each arrangement, apply reasonable judgment consistently, and disclose the method of accounting used as well as the reason(s) that the chosen method is appropriate.

ASC 730 does not require any specific disclosure regarding research and development arrangements that are accounted for as liabilities. Although other accounting literature may require additional disclosure for such obligations (e.g., ASC 440 and ASC 850), we believe that, at a minimum, a reporting entity should disclose when the obligation is to be repaid and the interest rate used in recording the liability. Additionally, the amounts of, and accounting for, any loans or advances by the reporting entity to other parties (including to any partnerships formed in connection with the research and development arrangement) should be disclosed.

3.6.8 Collaborative arrangements

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

Reporting entities should evaluate payments related to collaborative arrangements based on the nature and contractual terms of the arrangement as well as the nature of the reporting entity's business operations. If there is other guidance that is applicable to payments in collaborative arrangements, reporting entities should follow that guidance (e.g., guidance on customer payments in ASC 606-10) for determining the income statement classification. If the payments are not in the scope of other guidance, or if there is no appropriate analogy, reporting entities should make a consistently-applied accounting policy election, and should consider disclosure of that policy election.

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

ASC 808-10-50-1

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

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

b. Its rights and obligations under the collaborative arrangements

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

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

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

3.6.8.1 Collaborative arrangements with partners outside the scope of ASC 606

ASC 808 precludes entities from presenting transactions with collaborative partners outside the scope of ASC 606 with revenue that is subject to ASC 606; however, ASC 808 does not prescribe any specific presentation for these transactions. Similar to the underlying accounting framework, ASC 808 permits entities to present transactions based on analogy to other authoritative guidance, or a reasonable, rational, and consistently applied policy election, if there is no appropriate analogy. We believe there will be instances when it will be acceptable to present transactions in the scope of ASC 808 as revenue; however, these amounts cannot be included with revenue in the scope of ASC 606. Refer to RR 2.4.1 for further discussion about collaborative arrangements.

3.6.9 Restructuring expense

ASC 420-10-S99-2 (SAB Topic 5.P, *Restructuring Charges*) requires reporting entities to present restructuring charges as a component of income from continuing operations, separately disclosed if material. Reporting entities are also permitted to separately present, in income from continuing operations, exit or disposal activities covered by ASC 420, *Exit or Disposal Cost Obligations*, that are not discontinued operations. For more detail on presentation and disclosure of restructuring expenses, see FSP 11.

3.6.10 Nonmonetary transactions

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

3.6.11 Gains or losses on insurance claims

The classification of insurance proceeds in the income statement depends on the nature of the insurance claim. ASC 410-30-45-4 requires credits arising from recoveries of environmental losses to be classified in the same line items as the related loss. ASC 220-30-45-1 indicates that reporting entities have a choice in how to classify business interruption insurance recoveries as long as the classification is not contrary to other US GAAP. However, income statement classification guidance is not provided for many other types of claims (including involuntary conversions). Judgment should be applied to determine what presentation is most meaningful. Once a recovery meets the requisite recognition threshold (see FSP 23.5), it should be recognized in the income statement. In particular, if the insurance recoveries relate to property damage, the proceeds should not be recorded as a reduction of the cost to rebuild or replace the insured asset. Business interruption insurance recoveries, even if based in part on lost revenue, should not be presented as revenue from contracts with customers as they would not meet the definition of revenue within ASC 606.

3.6.12 Foreign currency transaction gains/losses

Foreign currency transaction gains/losses result from a change in exchange rates between the functional currency and the currency in which a foreign currency transaction is denominated. See FSP 21.3.1 for discussion of presentation and disclosure considerations related to foreign currency.

3.6.13 Other general expenses

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

3.6.14 Gains or losses from sale of long-lived assets

ASC 360-10-45-5

A gain or loss recognized on the sale of a long-lived asset (disposal group) that is not a discontinued operation shall be included in income from continuing operations before income taxes in the income statement of a business entity. If a subtotal such as income from operations in presented, it shall include the amounts of those gains or losses.

In certain circumstances, S-X 5-03(6) indicates other material items should be presented as "other general expenses." See FSP 8.6 for further presentation and disclosure guidance on long-lived assets and FSP 3.6.6 for further information on gains or losses on the sale of a business.

3.6.15 Consideration received from a vendor

ASC 705-20 addresses accounting by a customer (including a reseller) for certain consideration received from a vendor (e.g., supplier or manufacturer). The consideration received could be cash, a credit, or some other form of incentive (e.g., a coupon or voucher) that reduces the amount owed. The accounting model in ASC 705-20 largely mirrors the model in ASC 606 for vendors that make payments to customers (see RR 4) in that consideration received from a vendor is generally accounted for as a reduction of the purchase price of the goods or services acquired from the vendor. Consideration that is contingent upon meeting a milestone, such as a cumulative level of purchases, is recognized when the amounts are probable and can be reasonably estimated based on a systematic and rational allocation to the underlying transactions.

ASC 705-20 describes three exceptions to that general model:

- Consideration received in exchange for a distinct good or service
- Reimbursement of costs incurred by the reporting entity to sell the vendor's products
- Reimbursement of sales incentives offered by the vendor to end customers

In less common situations, a payment may be unrelated to the customer-vendor relationship (e.g., the resolution of a separate commercial dispute) and subject to other guidance, such as the guidance for contingent gains (see FSP 23.5.)

Distinct good or service

If payments are received in exchange for a distinct good or service that the reporting entity transfers to the vendor, the reporting entity should recognize the payment as revenue, assuming the goods or services are an output of the reporting entity's ordinary activities. In other words, the reporting entity should account for the sale the same way it accounts for sales to other customers. The assessment of

whether a good or service is distinct is a two-pronged test: the good or service must be both (1) capable of being distinct and (2) separately identifiable. See RR 3.4.

If the amount of consideration received from the vendor exceeds the standalone selling price of the distinct good or service that the reporting entity transfers to the vendor, the reporting entity should account for the excess amount pursuant to the general principle for vendor consideration (i.e., as a reduction of the purchase price of the goods or services acquired from the vendor). See RR 5.2 for guidance on the determination of the standalone selling price.

Reimbursement of costs

A reporting entity may report reimbursement of costs incurred to sell the vendor’s products (e.g., cooperative advertising) as a reduction of that cost in its income statement. However, the consideration must be for reimbursement of specific, incremental, identifiable costs incurred by the reporting entity to sell the vendor's products. If the amount of consideration received from the vendor exceeds the costs being reimbursed, the reporting entity should account for the excess amount as a reduction of the purchase price of the goods or services acquired from the vendor.

Reimbursement of sales incentives

In some cases, a vendor provides consideration to resellers to reimburse them for sales incentives (e.g., rebates or coupons) offered to end customers to stimulate consumer demand for the vendor’s products. The reseller may in turn reduce the price paid by the end consumer at the point of sale and will later receive reimbursement from the vendor. In other scenarios, the end customer may interact directly with the vendor to claim sales incentives for products purchased from a reseller (e.g., mail-in rebate). In both scenarios, the reseller generally has no control over which consumers receive or choose to apply these incentives. Effectively, the reseller is acting as the vendor’s agent when it provides the incentives to end consumers. Therefore, the reseller should recognize reimbursements for vendor’s sales incentives that meet the criteria in ASC 705-20-25-7 as revenue.

ASC 705-20-25-7

For purposes of this guidance, the phrase vendor's sales incentive offered directly to consumers is limited to a vendor's incentive that meets all the following criteria:

a. The incentive can be tendered by a consumer at resellers that accept manufacturer’s incentives in partial payment of the price charged by the reseller for the vendor's product.

b. The reseller receives a direct reimbursement from the vendor (or a clearinghouse authorized by the vendor) based on the face amount of the incentive.

c. Terms of reimbursement to the reseller for the vendor's sales incentive offered to the consumer must not be influenced by or negotiated in conjunction with any other incentive arrangements between the vendor and the reseller but, rather, may be determined only by the terms of the incentive offered to consumers.

d. The reseller is subject to an agency relationship with the vendor, whether expressed or implied, in the sales incentive transaction between the vendor and the consumer.

If the criteria in ASC 705-20-25-7 are not met, the reseller should account for the consideration as a reduction of the purchase price of the goods or services acquired from the vendor.

Example FSP 3-1, Example FSP 3-2, and Example FSP 3-3 illustrate the accounting for consideration received from a vendor.

EXAMPLE FSP 3-1

Consideration received from a vendor – no distinct good or service provided

FSP Corp enters into a supply contract with Water Company to purchase water bottles for $100,000. Water Company provides FSP Corp with $10,000 to ensure that its products receive prominent placement on store shelves (that is, it pays a slotting fee).

How should FSP Corp account for the $10,000 payment from Water Company?

Analysis

FSP Corp should recognize the consideration received as a reduction of the purchase price of the water bottles because it has not provided a distinct good or service to Water Company in exchange for this fee. Also, the consideration is not a reimbursement of specific, incremental, and identifiable costs incurred by FSP Corp to sell the vendor's products. Assuming the water bottles are initially held in inventory by FSP Corp prior to their eventual sale, the cost of the inventory would be reduced by $10,000 on a per unit basis such that cost of sales will be reduced when recognized in FSP Corp's income statement.

EXAMPLE FSP 3-2

Cooperative advertising – costs are specific, incremental, and identifiable

FSP Corp enters into a supplier agreement with Toy Company to purchase toys to sell through its website. Toy Company has also committed to reimburse 50% of FSP Corp's advertising costs related to toys purchased from Toy Company. FSP Corp will contract directly with the advertising agencies and pay for the total cost of the campaign. FSP Corp is required to provide Toy Company with the associated proof of payment for advertisements that feature Toy Company's products. FSP Corp's expenses for these advertisements are $2,000, and it expects to receive $1,000 from Toy Company.

How should the advertising costs reimbursed by Toy Company be recorded by FSP Corp?

Analysis

FSP Corp would likely conclude in this fact pattern that the reimbursement relates to specific, incremental, and identifiable costs incurred in selling Toy Company's products. FSP Corp should therefore recognize the $1,000 received from Toy Company as a reduction of advertising costs in its income statement.

EXAMPLE FSP 3-3

Cooperative advertising – costs are not specific, incremental, and identifiable

FSP Corp enters into a supplier agreement with Toy Company to purchase board games to sell through its website. The agreement also includes payment of an advertising allowance of $1,000 to FSP Corp by Toy Company. FSP Corp has discretion over the use of the allowance, and it is not required to provide Toy Company with supporting documentation of how the allowance was utilized.

How should the $1,000 advertising allowance be recorded by FSP Corp?

Analysis

FSP Corp would likely conclude in this fact pattern that the reimbursement does not relate to specific, incremental, and identifiable costs incurred in selling Toy Company's products. FSP Corp should therefore recognize $1,000 as a reduction of the cost of its purchases from Toy Company and, using a systematic and rational allocation approach, recognize a corresponding reduction in costs of sales when the related products are sold.

3.6.16 Unusual or infrequently occurring items

ASC 220-20 provides guidance on the presentation of unusual or infrequently occurring items on the income statement.

ASC 220-20-45-1

A material event or transaction that an entity considers to be of an unusual nature or of a type that indicates infrequency of occurrence or both shall be reported as a separate component of income from continuing operations. The nature and financial effects of each event or transaction shall be presented as a separate component of income from continuing operations or, alternatively, disclosed in notes to financial statements. Gains or losses of a similar nature that are not individually material shall be aggregated. Such items shall not be reported on the face of the income statement net of income taxes. Similarly, the EPS effects of those items shall not be presented on the face of the income statement.

The definitions of "unusual nature" and "infrequency of occurrence" are included in the FASB Codification Master Glossary. "Unusual nature" means that the event possesses a high degree of abnormality and is clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the company. "Infrequent" means that the event should not be reasonably expected to recur in the foreseeable future. Both of those characteristics are, therefore, highly dependent on the environment in which a company operates.

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

3.7 Non-operating income and expenses

S-X 5-03(7) and (9) prescribe separate income statement line item captions for non-operating income and non-operating expense. Many SEC registrants prefer to show one line item for non-operating income and expense on a net basis. Generally, the combination of non-operating income and expense is permissible as long as the individual amounts are not significant, with the exception that interest expense and amortization of debt discount must be presented on the face of the income statement (refer to FSP 3.7.3). Note that it is not the net balance that determines materiality, but the offsetting gross amounts.

3.7.1 Non-operating income

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

3.7.2 Non-operating expenses

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

3.7.3 Interest expense and amortization of debt discount

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

3.8 Other presentation requirements

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

3.8.1 Income or loss before income tax expense

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

3.8.2 Income tax expense

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

3.8.3 *Equity in earnings of unconsolidated entities*

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

3.8.4 *Income or loss from continuing operations*

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

3.8.5 *Discontinued operations*

A disposal that meets the requirements under ASC 205-20 is reported as discontinued operations on the face of the income statement. This is also consistent with the requirements of S-X 5-03. See FSP 27 for further guidance on presentation and disclosure guidance for discontinued operations.

3.8.6 *Cumulative effects of changes in accounting principles*

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

3.8.7 *Net income or net loss*

S-X 5-03 requires that net income or net loss be presented on the face of the financial statements. ASC 220 includes guidance on what comprises net income.

ASC 220-10-45-7A

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

a. Investment companies

b. Insurance entities

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

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

3.8.8 *Net income attributable to noncontrolling interests*

S-X 5-03 requires a parent company that has control of a reporting entity to record consolidated revenues, expenses, gains, losses, net income (loss), and other comprehensive income (loss). For more on presentation and disclosure requirements associated with noncontrolling interests, see FSP 18.

3.8.9 *Earnings per share data*

Reporting entities with simple capital structures (i.e., those reporting entities with only one class of common stock outstanding and no equity instruments outstanding, such as stock options) must present basic per-share amounts for income from continuing operations and for net income on the face of the income statement as required by Regulation S-X, Rule 5-03. All other reporting entities must present basic and diluted per-share amounts on the face of the income statement for income from continuing operations and for net income with equal prominence. See FSP 7 for further discussion of the EPS presentation requirements.

3.9 *Allocation of expenses to subsidiaries or carve-out entities*

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

Circumstances may arise that require separate financial statements for these businesses (sometimes referred to as "carve-out" financial statements), or may require financial statements for subsidiaries of the reporting entity. For further discussion of carve-out financial statements, see PwC's *Carve-out financial statements* guide. See FSP 17.6 and BCG 10.1 for discussion of pushdown accounting.

3.9.1 *Presentation considerations*

ASC 220-10-S99-3 (SAB Topic 1.B, *Allocation of Expenses and Related Disclosure in Financial Statements of Subsidiaries, Divisions or Lesser Business Components of Another Entity*) provides guidance to registrants regarding the allocation of costs incurred by a parent on behalf of a carve-out entity in the carve-out financial statements. However, the guidance is also useful for any separate financial statement reporting of businesses/subsidiaries, not just carve-out financial statements.

ASC 220-10-S99-3 emphasizes the importance of presenting operating results that reflect all of the "costs of doing business" despite the fact that some of the costs may not have been allocated historically to the carve-out entity. These expenses include, but are not necessarily limited to, the following:

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

Often, a reasonable method of allocating common expenses to the subsidiary (e.g., incremental or proportional cost allocation) must be chosen because specific identification of expenses is not practicable. In these situations, SEC FRM 7210 states that reporting entities should include an explanation in the footnotes of the allocation method used, together with management's assertion that the method is reasonable. Disclosures should be made of what expenses would have been on a standalone basis, if materially different. Although ASC 220-10-S99-3requires a reasonable estimate of expenses incurred on behalf of a subsidiary to be reflected in the financial statements, changes to actual amounts on the basis of expected future results is prohibited in the historical financial statements.

Example FSP 3-4 illustrates the allocation of costs and expenses to a subsidiary.

EXAMPLE FSP 3-4

Allocation of costs and expenses to a subsidiary

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

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

Analysis

FSP Corp will need to obtain carve-out financial statements from Company Y for historical financial information. These financial statements need to include all of the appropriate revenues, expenses, assets, and liabilities related to the acquired business, even though Company Y may not have maintained separate accounting records for Product A. This would include an appropriate allocation of selling and marketing expenses (even though Company Y's sales force and marketing department was not acquired by FSP Corp), together with other costs such as overhead expenses in accordance with ASC 220-10-S99-3 as this reflects all "the costs of doing business" associated with Product A.

3.9.2 Disclosure considerations

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

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

statements to include disclosure of any intercompany profits or losses resulting from transactions with related parties that are not eliminated.

ASC 220-10-S99-3 also requires additional disclosures of expense allocations from parents to subsidiaries regarding income taxes as follows:

ASC 220-10-S99-3, Question 3

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

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

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

ASC 220-10-S99-3 also requires specific disclosure related to financing arrangements between a parent and a subsidiary.

ASC 220-10-S99-3, Question 4

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

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

3.10 Accounting for government assistance

3.10.1 Government assistance to not-for-profit entities

Accounting and presentation of government grants to not-for-profit entities within the scope of ASC 958 is addressed within NP 12.2.

3.10.2 Government assistance to business entities

A business entity may receive government assistance that provides financial assistance for certain eligible expenditures—for example, federal disaster assistance. Government assistance could take the form of tax credits, cash grants, or grants of other assets. There is no specific guidance in US GAAP that addresses the recognition and measurement of government assistance received by a business entity. Thus, determining the proper accounting treatment will depend on an analysis of the nature of the assistance and the conditions on which it is predicated.

A reporting entity should first assess whether the arrangement with the government is in the scope of specific US GAAP, such as:

- Arrangements when the government is a customer (i.e., exchange transactions) are in the scope of ASC 606.
- Assistance in the form of a tax credit may be subject to ASC 740, *Income Taxes*. Refer to TX 1.2.4 for guidance on determining when a credit is subject to ASC 740.
- Assistance in the form of a below-market rate loan is accounted for under ASC 470, *Debt*. ASC 835-30, *Imputation of interest*, provides guidance for imputing interest when financing is provided or obtained at other-than-market terms. However, ASC 835-30-15-3(e) excludes from the scope of this guidance "transactions where interest rates are affected by the tax attributed or legal restrictions prescribed by a governmental agency (for example, industrial revenue bonds, tax exempt obligations, government guaranteed obligations, income tax settlements)." Thus, a reporting entity would not need to impute interest on a loan from the government with a below-market interest rate.

ASC 105, *Generally Accepted Accounting Principles*, describes the framework for developing an accounting policy when no guidance exists in US GAAP for a particular transaction. Specifically, ASC 105-10-05-2 instructs reporting entities to first look for guidance for a similar transaction or event within US GAAP and apply that guidance by analogy. If no guidance for similar transactions is identified, a reporting entity may consider nonauthoritative guidance from other sources (for example, guidance issued by other standard-setters).

ASC 958-605 contains the US GAAP on grant accounting, including guidance on evaluating whether government grants are exchange or nonexchange transactions. However, ASC 958-605 excludes from its scope transfers of assets from governments to business entities. As a result, forms of government assistance provided to business entities would not be in the scope of ASC 958-605, but it may be applied by analogy under ASC 105-10-05-2. Alternatively, IFRS includes a specific standard, IAS 20, *Accounting for Government Grants and Disclosures of Government Assistance*, that reporting entities may also analogize to. As illustrated in Figure FSP 3-2, ASC 958-605 and IAS 20 differ in a few key areas when it comes to accounting for government grants.

Figure FSP 3-2

Differences between ASC 958-605 and IAS 20

Description	ASC 958-605	IAS 20
Recognition when conditions are present	When the conditions have been substantially met	When there is reasonable assurance that the entity will comply with the conditions and that the grant will be received
Timing and pattern of recognition	When grant is awarded or, if conditional, immediately once the condition is substantially met Recipients should also consider whether grantor-imposed restrictions exist.	Using a systematic basis over the periods in which the entity recognizes the related expenses or losses that the grants are intended to compensate When the grant becomes receivable if it compensates for expenses or losses already incurred
Presentation of grant income	Grant income is presented on a gross basis (i.e., grant revenue or other income)	May be reported separately as "other income" or deducted from the related expense

With regard to the evaluation of conditions, IAS 20 does not define "reasonable assurance" but it is generally considered to be similar to the notion of "probable" as used in ASC 450, *Contingencies*. ASC 958-605, however, does not permit an entity to consider probability or intent in evaluating whether a condition has been or will be achieved; instead, under ASC 958-605, grant income is recognized only when the condition has been substantially met.

3.10.3 Disclosure of government assistance

ASC 832, *Government Assistance,* requires business entities that account for transactions with a government by applying a grant or contribution model by analogy to disclose information about government assistance recorded during the period. ASC 832 is effective for all entities for annual reporting periods beginning after December 15, 2021.

ASC 832 outlines the disclosure requirements for certain transactions with a government. For purposes of applying ASC 832, ASC 832-10-15-5 describes entities that are considered a government.

ASC 832-10-15-5

Transactions with a government, as used in this Topic, include assistance that is administered by domestic, foreign, local (for example, city, town, county, and municipal), regional (for example, state, provincial, and territorial), and national (federal) governments and entities related to those governments. Examples of entities related to governments include departments, independent agencies, boards, commissions, and component units. Government assistance also can be administered by intergovernmental organizations and other types of organizations such as nongovernmental organizations or government-sponsored enterprises that have authority from a government to administer assistance on its behalf.

The disclosure requirements in ASC 832 apply to transactions with a government that are accounted for by analogizing to a grant or contribution accounting model (e.g., ASC 958-605, IAS 20).

If the accounting for a transaction is specified in the scope of other US GAAP, it is not subject to the disclosure requirements in ASC 832. This would include:

- tax credits accounted for under ASC 740;
- gain contingencies accounted for under ASC 450;
- revenue transactions accounted for under ASC 606; and
- below-market loans or forgivable loans accounted for under ASC 470.

For transactions that are not in the scope of other US GAAP, a reporting entity should assess its accounting policy for that transaction to determine whether it is in the scope of ASC 832. Judgment may be required in the assessment of whether a reporting entity is analogizing to a grant or contribution accounting model.

If a transaction is in the scope of other US GAAP, reporting entities should apply the disclosure requirements within that guidance. Reporting entities should also consider the requirement in ASC 235 to disclose significant accounting policies (refer to FSP 1.1.4) for government assistance transactions that are determined to not be in the scope of ASC 832.

ASC 832-10-50-3 requires business entities to provide disclosures for annual periods that provide information about government assistance that will enable a user to better assess the overall nature of the transaction and its impact on the financial statements.

ASC 832-10-50-3

An entity shall disclose the following about government assistance transactions:

a. The nature of the transactions, including a general description of the transactions and the form in which the assistance has been received (for example, cash or other assets)

b. The accounting policies used to account for the transactions as required by paragraph 235-10-50-1

c. The line items on the balance sheet and income statement that are affected by the transactions, and the amounts applicable to each financial statement line item in the current reporting period.

As discussed in ASC 832-10-50-4, business entities should also disclose information about the significant terms and conditions of a government assistance transaction. Such disclosures may include the following:

- The duration of the agreement
- Commitments made by both the reporting entity and the government
- Provisions for recapturing government assistance, including the conditions under which recapture is allowed
- Other contingencies

There may be instances when an organization is prohibited by the government from disclosing certain information required by ASC 832-10-50-1 through ASC 832-10-50-4. In these circumstances, ASC 832-10-50-5 requires reporting entities to disclose a description of the general nature of the arrangement and indicate that the specific omitted disclosures are legally prohibited from being disclosed.

Note about ongoing standard setting

The FASB has an active project related to the accounting for government grants by business entities. Financial statement preparers and other users of this publication are therefore encouraged to monitor the status of the project, and if finalized, evaluate the effective date of the new guidance and the implementation on presentation and disclosure.

3.11 Income statement considerations for private companies

The majority of presentation and disclosure requirements discussed in this chapter are applicable to both public and private companies.

Requirements included in Figure FSP 3-3 apply only to SEC registrants.

Figure FSP 3-3

Presentation and disclosure requirements applicable only to SEC registrants

Description	Reference	Section
The various line items that, if applicable, should appear on the face of the income statements	S-X 4-01(a); S-X 5-03	FSP 3.3
Requirement to present three-year comparative income statement	S-X 3-02(a)	FSP 3.4
Requirement to separately report, under the heading operating income/expense any material amounts not included in the caption "costs and expenses applicable to sales and revenues"	S-X 5-03(3)	FSP 3.5
Requirement to present separate financial statement line items based on thresholds – including sales/revenues and corresponding cost of sales	S-X 5-03(1); S-X 5-03(2); S-X 4-02	FSP 33.2.1
Requirement to separately disclose receivables resulting from long-term contracts	S-X 5-02 (3)(c)	FSP 33.4.6
Requirement to state that depreciation, depletion, and amortization is excluded from cost of sales or presented as a separate line item if elected to not present such amounts in cost of sales	SAB Topic 11.B (codified in ASC 220-10-S99-8)	FSP 3.6.3

Description	Reference	Section
Requirement to disclose selected quarterly financial data for each full quarter within the two most recent fiscal years in the annual reports on Form 10-K	S-K 302(a)(1)	FSP 3.6.3
Requirement to report as "other general expenses" gains or losses from the sale of long-lived assets reported under ASC 360-10-45-5	S-X 5-03(6)	FSP 3.6.14
Requirement to include items not normally included under the caption "selling, general, and administrative expenses" under the caption "other general expenses"	S-X 5-03(6)	FSP 3.6.13
Requirement to present separate income statement line item captions for non-operating income and non-operating expense	S-X 5-03(7) and (9)	FSP 3.7
Requirement to present all interest expense in the caption for interest expense	S-X 5-03(8)	FSP 3.7
Requirement to state separately, in the income statement or in a footnote, amounts earned from (a) dividends, (b) interest on securities, (c) profits on securities (net of losses), and (d) miscellaneous other income	S-X 5-03(7)	FSP 3.7.1
Requirement to disclose the amounts earned from transactions in securities of related parties (if applicable)	S-X 4-08 (k)	FSP 3.7.1
Requirement to state separately, in the income statement or in a footnote, amounts of losses on securities (net of profits) and miscellaneous income deductions	S-X 5-03(9)	FSP 3.7.2
Requirement to present interest expense and amortization of debt discount on the face of the income statement	S-X 5-03(8)	FSP 3.7.3
Requirement to only include taxes based on income under the caption "income tax expense"	S-X 5-03(11)	FSP 3.8.2
Requirement to present specific earnings per share captions on the face of the income statement	S-X 5-03(b) 20	FSP 3.8.9

Chapter 4: Reporting comprehensive income—updated November 2019

4.1 Chapter overview

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

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

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

The disclosure guidance in this chapter applies to annual reporting periods. Interim disclosure requirements for comprehensive income are addressed in FSP 29.

4.2 Scope and relevant guidance

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

In accordance with ASC 220-10-15-3, ASC 220 applies to all reporting entities except for not-for-profit organizations that follow ASC 958-205, *Not-for-Profit Entities*. Certain investment companies, defined benefit plans, and other employee benefit plans that are exempt from the requirement to provide a statement of cash flows under ASC 230-10-15-4 are not exempt from the requirements of ASC 220 to provide a statement of comprehensive income. However, these entities typically do not have items of OCI. A reporting entity that does not have items of OCI in any period presented does not need to present comprehensive income.

4.3 Components of comprehensive income

Comprehensive income includes net income and OCI. OCI consists of revenues, expenses, gains, and losses to be included in comprehensive income but excluded from net income.

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

ASC 220-10-45-10A lists the components of OCI. These include:

- Currency translation adjustments
- Gains or losses on net investment hedges
- Gains and losses on derivatives qualifying as cash flow hedges,
- For fair value or cash flow hedges, the difference between the initial value of an "excluded component" of the hedging instrument and the current fair value of such component, to the extent not recognized in earnings,

- Unrealized holding gains or losses on available for sale debt securities (this does not include accrued interest, writeoffs, or the allowance for credit losses).

- Gains and losses associated with pensions or other postretirement benefits (to the extent not recognized as a component of net periodic pension cost),

- Changes in the fair value of FVO-elected liabilities attributable to instrument-specific credit risk (aka – own credit adjustments).

ASC 220-10-45-10B lists items that are *not* considered OCI. These include:

- Changes in equity resulting from investments by or distributions to owners

- Items required to be reported as direct adjustments to additional paid-in capital (APIC), retained earnings, and certain other non-income equity accounts (e.g., reductions of stockholders' equity related to employee stock ownership plans, recognition of tax benefits related to deductible temporary differences and carryforwards arising from a quasi-reorganization (as defined in ASC 852-20) , and net cash settlements of own share transactions).

4.3.1 Displaying the tax effects of OCI components

As discussed in ASC 220-10-45-11, each component of OCI should be reported either (1) net of related tax effects, or (2) before related tax effects with one amount shown for the aggregate income tax effect of all OCI items. A reporting entity should disclose the income tax effect of each component of OCI, including reclassification adjustments, either on the face of the statement in which those components are displayed or in the footnotes. ASC 220-10-55-7 through ASC 220-10-55-8B provides examples of the alternative formats for disclosing the tax effects of the components of OCI.

4.3.2 New guidance

ASU 2017-07

In March 2017, the FASB issued ASU 2017-07, *Compensation—Retirement Benefits (Topic 715), Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*. The new guidance changes how employers that sponsor defined benefit pension or other postretirement benefit plans present the net periodic benefit cost in the income statement. Additionally, significant pension cost or other postretirement benefit cost components reclassified out of AOCI are no longer required to be disclosed parenthetically provided they are presented separately on the income statement. See Figure FSP 4-8 for an example of such disclosure.

ASU 2017-07 was effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those years. For all other entities, the guidance is effective for fiscal years beginning after December 15, 2018 and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted as of the beginning of an annual reporting period for which financial statements have not been issued or made available for issuance. See FSP 13.3.

ASU 2018-02

In February 2018, the FASB issued ASU 2018-02, *Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income*. ASU 2018-02 permits a company to reclassify disproportionate tax effects in AOCI caused by the Tax Cuts and Jobs Act of 2017 (the 2017 Act) to

retained earnings. The FASB refers to these disproportionate tax effects as “stranded tax effects.” Only the stranded tax effects resulting from the 2017 Act are eligible for reclassification. The reclassification amount should include the effect of the change in the US federal corporate income tax rate on the gross deferred tax amounts and related valuation allowances, if any, at the date of enactment of the law (December 22, 2017) related to items remaining in AOCI. In addition, reporting entities may choose to include in their reclassification other income tax effects related to the application of the 2017 Act on items remaining in AOCI.

ASU 2018-02 is effective for all entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted, including adoption in any interim period. Refer to FSP 16.2 for further discussion.

ASU 2018-03

In February 2018, the FASB issued ASU 2018-03, *Technical Corrections and Improvements to Financial Instruments—Overall (Subtopic 825-10), Recognition and Measurement of Financial Assets and Financial Liabilities*. ASU 2018-03 introduced amendments to clarify certain aspects of the guidance issued in ASU 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*. ASU 2018-03 clarifies that when the fair value option is elected for a financial liability, the guidance in ASC 825-10-45-5 should be applied, regardless of whether the fair value option was elected under either ASC 815-15, *Derivatives and Hedging—Embedded Derivatives*, or ASC 825-10, *Financial Instruments—Overall*. Under this guidance, entities present the portion of the total change in the fair value of the liability that results from a change in the instrument-specific credit risk separately in other comprehensive income.

In addition, ASU 2018-03 clarifies that for foreign currency-denominated financial liabilities for which the entity has elected the fair value option, the amount of the change in fair value that relates to instrument-specific credit risk first should be measured in the currency of denomination when presented separately from the total change in fair value of the financial liability. Both components of the change in fair value of the liability should then be remeasured into the functional currency of the reporting entity using end-of-period spot rates. The remeasurement of the change in fair value of the instrument-specific credit risk should be presented in accumulated other comprehensive income.

ASU 2018-03 was effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years beginning after June 15, 2018. For all other entities, the guidance is effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019 (the same as the effective date for ASU 2016-01). Early adoption is permitted as long as ASU 2016-01 has also been adopted.

ASU 2018-09

In July 2018, the FASB issued ASU 2018-09, *Codification Improvements*. ASU 2018-09 clarifies the guidance in ASC 220-10-45-10B by removing the generic phrase “taxes not payable in cash” and adding guidance that is specific to certain quasi-reorganizations. This was done to clarify that while the guidance no longer applies to bankruptcy organizations, it is applicable to quasi-organizations.

The amendment introduced by ASU 2018-09 was effective for public business entities for annual periods beginning after December 15, 2018, and interim periods within those years. For all other entities, the guidance is effective for annual period beginning after December 15, 2019 and interim periods within annual periods beginning after December 15, 2020.

4.4 Presenting comprehensive income

ASC 220 provides a definition of comprehensive income.

Definition from ASC 220-10-20

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

a. All components of net income

b. All components of other comprehensive income.

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

Total comprehensive income per share should not be disclosed on the face of the financial statements. See FSP 7.3.3.

Figure FSP 4-1 illustrates the reporting requirements of each format.

Figure FSP 4-1
Formats for the presentation of comprehensive income

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

Question FSP 4-1 addresses whether a change in format for the presentation of comprehensive income is a change in accounting principle.

Question FSP 4-1

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

PwC response

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

Question FSP 4-2 addresses whether an entity may use one format for the presentation of comprehensive income for interim reporting and another format for annual reporting.

Question FSP 4-2

Is it possible to use a single statement format for interim reporting and a two-statement format for annual reporting?

PwC response

Yes. Some reporting entities elect to provide the minimum information required for interim reporting and only present total comprehensive income in a single statement format. However, because of the additional annual reporting requirements, an entity may prefer to use a two statement format at year end. Because both formats provide the same information, there is no requirement to use the same format in interim and annual periods.

4.4.1 Presenting comprehensive income attributable to noncontrolling interest

A reporting entity is required by ASC 220-10-45-5 to separately present net income and comprehensive income attributable to its parent and any noncontrolling interest (NCI) on the face of the financial statements. This would include the statement of comprehensive income and statement of income (if presented as two separate statements).

4.4.2 Sample single statement of comprehensive income

Figure FSP 4-2 illustrates the presentation of comprehensive income in a single statement.

As discussed in ASC 220-10-45-14A through ASC 220-10-45-17B, reporting entities are permitted to present reclassifications from AOCI either on the face of the statement of comprehensive income or within the footnotes. See FSP 4.5 for further information. Figure FSP 4-2 presents the “net changes” for each component of OCI as depicted in ASC 220-10-55-7 and ASC 220-10-55-8 assuming reclassifications are disclosed elsewhere. Comparative statements are not shown for simplicity. See Figure FSP 4-3 for example statements that reflect reclassifications from AOCI.

Figure FSP 4-2

Sample consolidated single statement of comprehensive income

FSP Corp **Consolidated Statement of Comprehensive Income** **Year ended December 31, 20X7** **In millions $, except per share data**		
Revenues		$1,400
Costs of goods sold		(500)
Selling, general and administrative		(20)
Gain on sale of securities		340
Income before tax		1,220
Income tax expense		(320)
Equity in earnings of unconsolidated investee, after tax		100
Net income		$1,000
Less: net income attributable to the noncontrolling interest		(100)
Net income attributable to FSP Corp stockholders		$900
Earnings per share		
Basic and diluted	$1.25	
Other comprehensive loss, net of tax:		
Change in foreign currency translation adjustments		80
Change in unrealized gains related to available-for-sale debt securities		11
Equity in unrealized losses on available-for-sale debt securities of unconsolidated investee		(8)
Change in unrealized gains on cash flow hedges		15
Change in prior service cost and unrecognized loss for defined benefit pension plans		(150)
Change in fair value attributable to instrument-specific credit risk of liabilities measured at fair value under the fair value option		5
Other comprehensive loss		(47)
Comprehensive income		$953[1]
Less: comprehensive income attributable to the noncontrolling interest[2]		(220)[3]
Comprehensive income attributable to FSP Corp stockholders		$733

[1] Represents net income of $1,000 less other comprehensive loss of $47.

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

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

4.4.3 Sample statement of comprehensive income (that follows the income statement)

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

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

As discussed in ASC 220-10-45-14A through ASC 220-10-45-17B, reporting entities can present reclassifications from AOCI either on the face of the statement of comprehensive income or within the footnotes. See FSP 4.5 for further information. Figure FSP 4-3 segregates the reclassifications out of AOCI from other changes relative to that component of OCI. Refer to ASC 220-10-55-9 for an additional illustration. See Figure FSP 4-2 for an illustration of a net presentation of OCI and AOCI in the statement of comprehensive income.

Figure FSP 4-3

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

FSP Corp
Consolidated Statement of Comprehensive Income
Year ended December 31, 20X7
In millions $

Net income		$1,000
Other comprehensive loss, net of tax:		
Change in foreign currency translation adjustments		80
Net changes related to available-for-sale debt securities:		
Unrealized gains during period	13	
Reclassifications of losses to net income	(2)	11
Equity in unrealized losses on available-for-sale debt securities of unconsolidated investee		(8)
Change in unrealized gains/losses on cash flow hedges:		
Unrealized gains during period	43	
Reclassifications of losses to net income	(28)	15
Change in fair value attributable to instrument-specific credit risk of liabilities measured at fair value under the fair value option		5

FSP Corp
Consolidated Statement of Comprehensive Income
Year ended December 31, 20X7
In millions $

Changes in defined benefit pension plans:		
Prior service cost arising during period	(160)	
Net loss arising during period	(10)	
Less: amortization of prior service cost included in net periodic pension cost	20	(150)
Other comprehensive loss		(47)
Comprehensive income		$953
Less: comprehensive income attributable to the noncontrolling interest		(220)[1]
Comprehensive income attributable to FSP Corp stockholders		$733

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

4.5 Accumulated other comprehensive income and reclassification adjustments

As discussed in ASC 220-10-45-14 through ASC 220-10-45-14A, reporting entities should display AOCI separate from retained earnings and additional paid-in capital on the balance sheet. Changes in the components of AOCI should be presented separately in the statement of changes in stockholders' equity or in the footnotes. If the changes in AOCI are presented in the footnotes, the reporting entity should provide the information for each period for which a statement of stockholders' equity is presented (i.e., three years for public reporting entities).

Other guidance (e.g., ASC 715, *Compensation—Retirement Benefits*) dictates how and when amounts should be recorded into AOCI and subsequently included in net income. ASC 220 dictates how amounts should be recorded when they are reclassified out of AOCI and into net income. Sometimes this is referred to as "recycling" AOCI.

4.5.1 Methodology for determining reclassification adjustments

Because an event that requires reclassification of amounts out of AOCI can occur at any date within a reporting period, a reporting entity needs to make a policy decision regarding whether to determine reclassification adjustments by either (1) reporting the net change from the beginning to the end of the period (i.e., effectively freezing amounts reported within the prior period's reported OCI balances) or (2) using an approach that conceptually includes the intra-period activity within the reclassified amount.

Figure FSP 4-4 illustrates the alternative reclassification methods. In this illustration, a reporting entity holds AFS debt securities, which it marks-to-market each reporting period, reporting unrealized gains or losses in OCI. The securities appreciated by $30 in 20X6, but appreciated another $20 before being sold in 20X7.

Figure FSP 4-4
Reclassification methods

	Method 1: Freeze prior period OCI and reclassify		Method 2: Include intra-period activity	
	20X6	20X7	20X6	20X7
Net income	$500	$550	$500	$550
Unrealized gain on debt securities	30	0	30	20
Less: reclassification adjustment		**(30)**		**(50)**
OCI	30	(30)	30	(30)
Comprehensive income	$530	$520	$530	$520

The methodology chosen is a policy decision that should be applied consistently and disclosed if material to the financial statements.

4.5.2 *Types of reclassification adjustments*

Figure FSP 4-5 lists types of AOCI reclassification adjustments, along with references to the relevant guidance within the Codification that address the accounting for the reclassification. Figure FSP 4-5 also indicates the applicable FSP section where the presentation of the reclassification adjustments in the income statement is discussed.

Figure FSP 4-5
Types of reclassification adjustments with Codification and guide references

Reclassifications out of AOCI	Codification reference	Section
Release of cumulative translation adjustments	ASC 830-30-40-1 through ASC 830-30-40-4	FSP 21.4.1.1
Realized gains and losses on derivative instruments that qualify as cash flow hedges	ASC 815-30-35-38 through ASC 815-30-35-41	FSP 19.5.4.2, D 12.4.4.1, D 12.4.4.3
The difference between the initial value of an “excluded component” of the hedging instrument in a cash flow or fair value hedge and the current fair value of such component, to the extent recognized in earnings	ASC 815-30-50-2	D 12.4.4.1, D 12.4.4.3

Reclassifications out of AOCI	Codification reference	Section
Gains and losses on net investment hedges reclassified from cumulative translation adjustment to earnings	ASC 815-10-50-4CCC(b)	D 12.4.4.4
Realized gains and losses on available-for-sale debt securities	ASC 320-10-40-2	FSP 9.3
Pension and other postretirement benefits items amortized into net income	ASC 715-30-35-24 (pension) ASC 715-60-35-29 (OPEB)	FSP 13.3.6.5
Changes in fair value attributable to instrument-specific credit risk of liabilities for which the fair value option is elected	ASC 825-10-45-5	FV 8.1
Stranded tax effects from the Tax Cuts and Jobs Act of 2017 (upon adoption of ASU 2018-02)	ASC 220-10-45-12A	FSP 16.2

4.5.3 Objectives of disclosures and presentation of reclassification adjustments

ASC 220-10-45-17 requires reporting entities to aggregate the information about amounts reclassified from AOCI into net income that is presented throughout the financial statements and to provide a roadmap to the related disclosures.

Reporting entities have two distinct disclosure requirements with respect to reporting AOCI. Both of these requirements can be met through disclosure on the face of the financial statements or in the notes.

First, ASC 220-10-45-14A requires reporting entities to present the changes *in each component* of AOCI, showing separately the amount of OCI impacted by current period activity and the amount of current period reclassifications out of AOCI. This can be done either before tax or after tax for each component, either in the relevant statement or in the notes.

Separately, ASC 220-10-45-17 through ASC 220-10-45-17B requires a reporting entity to provide additional information about the effects of significant reclassification adjustments on net income when those reclassifications (1) are significant and (2) occur in their entirety in that period. This may be done on the face of the income statement (see FSP 4.5.5) or in the notes (see FSP 4.5.6).

This disclosure requires identification of which line item(s) of the income statement are affected by the reclassification.

4.5.4 Presenting reclassification adjustments

As discussed in ASC 220-10-45-17, a reporting entity is required to present the amount reclassified from each component of AOCI based on its source component of OCI (e.g., foreign currency, realized gains/losses and other-than-temporary impairment on available-for-sale debt securities, and realized gains/losses on cash flow hedges). Reporting entities are also required to provide the income statement line item affected by the reclassification (e.g., interest income or interest expense), unless

the component is not required to be reclassified in its entirety. With the exception of certain pension and other postretirement benefit costs (see FSP 4.3.2) and certain insurance adjustments, this disclosure is required for all components. Finally, the disclosure should include amounts attributable to NCI. See FSP 4.5.5 for further information.

A reporting entity can present this information either (1) parenthetically on the face of the financial statements, if certain criteria are met (see FSP 4.5.5) or (2) in a single footnote (see FSP 4.5.6). Therefore, for all components of OCI, a reporting entity may either present a gross display on the face of the financial statements (i.e., reclassification adjustments by component, presented separately from other changes in the AOCI balance) or a net display with disclosure of the gross change in the footnotes. With both options, a reporting entity can present these amounts either before tax or net of tax; however, the presentation should be consistent in each reporting period.

Figure FSP 4-6 illustrates the options for presenting reclassifications out of AOCI.

Figure FSP 4-6

Options for presenting amounts reclassified out of each component of AOCI

Presentation of reclassifications out of AOCI	Requirements of presentation
Parenthetically on the face of the financial statement in which net income is presented This presentation election can only be made if the two requirements outlined in FSP 4.5.5 are met.	□ Present parenthetically by component of AOCI the effect of significant reclassification amounts on the respective line items of net income □ Present parenthetically the aggregate tax effect of all "significant reclassifications" on the income tax benefit or expense line item in the statement presenting net income □ If applicable, present amounts of reclassifications attributable to NCI; see FSP 4.5.7
Within a single footnote A reporting entity can elect this option or may be required to follow this guidance if the requirements outlined in FSP 4.5.5 are not met.	□ Present significant reclassification amounts by component of AOCI □ Provide a subtotal of each component of comprehensive income that corresponds to the components presented on the face of the financial statement in which comprehensive income is presented □ Identify each income statement line item affected by each "significant reclassification amount" for reclassifications to net income in their entirety □ Provide a cross-reference to the footnote for any significant reclassification amount not made to net income in its entirety □ Present amounts either before tax or net of tax, as long as the reporting entity complies

Presentation of reclassifications out of AOCI	Requirements of presentation
	with requirements of ASC 220-10-45-12 related to the presentation of the income tax effects on other comprehensive income □ If applicable, present amounts of reclassifications attributable to NCI; see FSP 4.5.7

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

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

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

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

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

4.5.5.1 *Sample disclosure– reclassification adjustments in AOCI included in statement of income*

Figure FSP 4-7 illustrates how a reporting entity may comply with the disclosure requirements in ASC 220-10-45-14 through ASC 220-10-45-17B when it elects to provide the required information for reclassification adjustments parenthetically on the face of the income statement. The first part of Figure FSP 4-7 illustrates the option to comply with ASC 220-10-45-17 through ASC 220-10-45-17B (the impact of reclassification on income statement line items) by presenting parenthetical disclosures on the face of the income statement. A separate footnote was used to comply with the requirements of ASC 220-10-45-14A, (the impact of reclassifications on components of AOCI), as illustrated in the second part of Figure FSP 4-7. Comparative information is not shown for simplicity.

Figure FSP 4-7

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

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

FSP Corp
Consolidated Income Statement
For the year ended December 31, 20X7

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

Note X: Changes in accumulated other comprehensive income by component

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

	Gains and losses on cash flow hedges	Unrealized gains and losses on available-for-sale debt securities	Total
Beginning balance, January 1, 20X7	$(5,000)	$8,000	$3,000
Other comprehensive income before reclassifications	7,000	8,000	15,000
Amounts reclassified from accumulated other comprehensive income	(2,250)	(3,000)	(5,250)
Net current-period other comprehensive income	4,750	5,000	9,750
Ending balance, December 31, 20X7	$(250)	$13,000	$12,750

When a reporting entity provides parenthetical disclosure on the income statement, as required, it shows the effect of the reclassifications upon income tax expense parenthetically as well. However, in the note showing changes in AOCI, all data presented is already net of tax (which is permitted, but not required). The example in Figure FSP 4-7 assumes a tax rate of 25%, which will enable the reader to agree the after-tax figures in the note to the pre-tax information provided in the income statement.

4.5.6 *Presenting reclassifications in a footnote*

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

Other reporting entities may not meet the requirements discussed in FSP 4.5.5 to present reclassified amounts on the face of the financials. This could occur when a reporting entity has a reclassification adjustment that is initially capitalized (and, therefore, the reporting entity has not reclassified the total amount in its entirety), or when it is unable to identify the impacts on the income statement line items. Instead, the reporting entity will present the information in the footnotes and cross-reference to the other applicable notes.

One common example of when a reporting entity may not meet the requirements discussed in FSP 4.5.5 to present reclassified amounts on the face of the financials is when it has a defined benefit pension plan and capitalizes a portion of the service cost component of net periodic pension cost in inventory. In this instance, the amount reclassified from AOCI during a period is not recognized in net income until the inventory is sold. Therefore, the reporting entity is not able to present reclassification adjustments on the face of the financials. Instead, it should disclose all of its reclassification adjustments in a single footnote (see Figure FSP 4-8). In that note, the income statement line item affected only needs to be shown for components reclassified to net income in their entirety. Other components, such as net periodic pension cost, should be cross-referenced to the related footnote (e.g., the pension footnote).

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

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

4.5.6.1 *Sample disclosure – Footnote displaying changes in AOCI*

Figure FSP 4-8 illustrates how a reporting entity may comply with the disclosure requirements in ASC 220-10-45-14 through ASC 220-10-45-17B when it elects to provide the required information in a single footnote. The first table in the figure demonstrates how the reporting entity complied with ASC 220-10-45-14A, while the second table demonstrates how the reporting entity complied with ASC 220-10-45-17 through ASC 220-10-45-17B. Comparative information is not shown for simplicity.

Figure FSP 4-8

Sample disclosure: Reclassification adjustments in AOCI by component – single footnote presentation

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

Excerpt from ASC 220-10-55-15

	Gains and losses on cash flow hedges	Unrealized gains and losses on available-for-sale debt securities	Defined benefit pension items	Foreign currency items	Changes in fair value attributable to instrument-specific credit risk	Total
Beginning balance, January 1, 20X7	$(1,200)	$1,000	$(8,800)	$1,300	500	$(7,200)
Other comprehensive income before reclassifications	3,000	2,500	(3,000)	1,000	200	3,700
Amounts reclassified from accumulated other comprehensive income	(750)	(1,500)	4,500	-	(100)	2,150
Net current-period other comprehensive income	2,250	1,000	1,500	1,000	100	5,850
Ending balance, December 31, 20X7	$1,050	$2,000	$(7,300)	$2,300	600	$(1,350)

ASC 220 includes an illustration of the income statement line items affected by the reclassifications out of accumulated other comprehensive income:

Excerpt from ASC 220-10-55-17E

Reclassifications out of accumulated other comprehensive income[a]
For the period ended December 31, 20X1

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

Excerpt from ASC 220-10-55-17E

Reclassifications out of accumulated other comprehensive income[a]
For the period ended December 31, 20X1

Details about accumulated other comprehensive income components	Amount reclassified from accumulated other comprehensive income	Affected line item in the statement where income is presented
	1,500	Tax (expense) or benefit
	$(4,500)	Refer to pension footnote
Total reclassification for the period	$(2,250)	Net of tax

a Amounts in parentheses indicate debits to profit/loss.

b These accumulated other comprehensive income components are components of net periodic pernsion cost (see pension note for additional details).

4.5.7 *Presenting reclassifications attributable to noncontrolling interest*

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

In practice, many reporting entities present the tax impact of NCI below the tax expense/benefit line for each component. Additionally, the total reclassifications in the rollforward of AOCI would be presented net of tax and inclusive of NCI, as shown in Figure FSP 4-8.

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

As noted in FSP 4.3.1, each component of OCI should be reported either (1) net of related tax effects or (2) before related tax effects with one amount shown for the aggregate income tax expense or benefit related to the total OCI items.

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

Backward tracing could result in using different tax rates for different components of AOCI if the reclassified items relate to different tax jurisdictions. It could also result in items being reclassified using different tax rates than when the items were originally recorded in AOCI (e.g., when there have been changes in the valuation allowance). This result is consistent with the FASB's desire to simplify AOCI accounting, although it may seem different from the objective of OCI reclassification to prevent double counting in comprehensive income. For further considerations surrounding presentation and disclosure of income taxes, see FSP 16.

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

4.6 OCI in spin-off transactions

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

Question FSP 4-3 addresses the presentation of AOCI attributable to the assets and liabilities of the subsidiary post spin.

Question FSP 4-3

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

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

PwC response

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

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

4.7 Considerations for private companies

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

Chapter 5: Stockholders' equity—updated May 2022

5.1 Stockholders' equity overview

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

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

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

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

New guidance

In August 2020, the FASB issued ASU 2020-06, *Debt—Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging—Contracts in Entity's Own Equity (Subtopic 815-40)*. The ASU simplifies the accounting for certain financial instruments with characteristics of liabilities and equity. The ASU reduces the number of accounting models for convertible debt and convertible preferred stock instruments and makes certain disclosure amendments to improve the information provided to users. In addition, the ASU amends the derivative guidance for the "own stock" scope exception (see FG 5) and certain aspects of the EPS guidance (see FSP 7).

For public business entities that meet the definition of an SEC filer, excluding entities eligible to be smaller reporting companies as defined by the SEC, the guidance is effective for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. The one-time determination of whether an entity is eligible to be a smaller reporting company is based on an entity's most recent determination as of August 5, 2020, in accordance with SEC regulations. For all other entities, the guidance is effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted, but no earlier than fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. The ASU also specifies that an entity must adopt the guidance as of the beginning of its annual fiscal year and is not permitted to adopt the guidance in an interim period, other than the first interim period of their fiscal year.

Guidance in this chapter has been updated to reflect the new ASU and impacted sections are denoted with "after adoption of ASU 2020-06" and "before adoption of ASU 2020-06."

5.2 Scope and relevant guidance

ASC 505, *Equity*, ASC 815-40, *Contracts in an Entity's Own Equity,* S-X 3-04, and S-X 5-02 are the primary sources for the presentation and disclosure requirements related to stockholders' equity accounts. ASC 810-10 addresses the presentation and disclosure requirements of noncontrolling interests. In addition, for SEC registrants, FRP 211 (SEC Accounting Series Release No. 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks"* ("ASR 268")), codified in ASC

480-10-S99, requires certain securities to be presented outside of permanent equity on the balance sheet.

Other relevant guidance for SEC registrants includes:

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

5.3 *Presentation of changes in stockholders' equity*

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

While footnote disclosure is permitted, the most common presentation is as a separate statement of changes in stockholders' equity. Reporting entities typically present the information about changes in stockholders' equity in a columnar format, but it is not required.

Figure FSP 5-1 shows an example statement of changes in stockholders' equity in columnar format.

Figure FSP 5-1

Example consolidated statement of changes in stockholders' equity

FSP Corp
Consolidated statement of changes in stockholders' equity
For the year ended December 31, 20X2 (in millions $, except per share data)

	Common shares	Amnt	Preferred shares	Amnt	APIC	Retained earnings	AOCI	Total FSP Corp stockholders' equity	Noncontrolling interests	Total equity
Balance at December 31, 20X1	xx	$xx	xx	$xx	$xx	$xx	$xx	$xx	$xx	$xx
Net income						xx		xx	xx	xx
Other comprehensive income, net							xx	xx	xx	xx
Stock-based compensation	xx	xx			xx			xx		xx
Common stock issued	xx	xx			xx			xx		xx
Retirement of common shares	(xx)	(xx)			(xx)	(xx)		(xx)		(xx)
Cash dividends declared ($x.xx per share)						(xx)		(xx)		(xx)
Stock dividends declared	xx	xx			xx	(xx)				

FSP Corp
Consolidated statement of changes in stockholders' equity
For the year ended December 31, 20X2 (in millions $, except per share data)

	Common shares	Amnt	Preferred shares	Amnt	APIC	Retained earnings	AOCI	Total FSP Corp stockholders' equity	Noncontrolling interests	Total equity
Conversion of preferred shares into common shares	xx	xx	(xx)	(xx)						
Purchase of shares from noncontrolling interests					(xx)		xx[1]	(xx)	(xx)	(xx)
Balance at December 31, 20X2	xx	$xx	xx	$xx	$xx	$xx	$xx	$xx	$xx	$xx

See Notes to Consolidated Financial Statements

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

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

For SEC registrants, S-X 3-04 calls for disclosure of dividends per share and in the aggregate for each class of shares.

5.3.1 *Noncontrolling interests*

The statement of changes in stockholders' equity should distinguish equity attributable to the parent from equity attributable to noncontrolling interests. As discussed in ASC 810-10-50-1A(c), it should present the noncontrolling interests' portion of each component of stockholders' equity.

ASC 810-10-50-1A(c)

Either in the consolidated statement of changes in equity, if presented, or in the notes to consolidated financial statements, a reconciliation at the beginning and the end of the period of the carrying amount of total equity (net assets), equity (net assets) attributable to the parent, and equity (net assets) attributable to the noncontrolling interest. That reconciliation shall separately disclose all of the following:

1. Net income

2. Transactions with owners acting in their capacity as owners, showing separately contributions from and distributions to owners

3. Each component of other comprehensive income.

ASC 810-10-50-1A(d) requires reporting entities to disclose in the footnotes a separate schedule that shows the effects of any changes in a parent's ownership interest in a subsidiary on the equity attributable to the parent. The schedule is only required in periods when a parent's ownership interest in a subsidiary changes. ASC 810-10-55-4M provides an illustration of this disclosure.

Question FSP 5-1

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

PwC response

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

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

5.4 Disclosures for all classes of securities

A reporting entity is required to explain the pertinent rights and privileges of all outstanding classes of securities.

ASC 505-10-50-3 and ASC 505-10-50-3A include the following examples of information that should be summarized within the financial statements:

- Dividend and liquidation preferences
- Participation rights
- Call prices and dates
- Sinking-fund requirements
- Unusual voting rights
- Significant terms of contracts to issue additional shares
- Terms that may change conversion or exercise prices (excluding standard antidilution provisions)
- Conversion or exercise prices and pertinent dates
- Number of shares issued upon conversion, exercise, or satisfaction of required conditions during the most recent annual fiscal period and any subsequent interim period presented
- Actual changes to conversion or exercise prices that occur during the reporting period (excluding changes due to standard antidilution provisions)

- For a financial instrument with a down round feature that has been triggered during the reporting period and for which an entity has recognized the effect in accordance with ASC 260-10-25-1 (i.e., treated as a dividend and as a reduction of income available to common stockholders in basic earnings per share), an entity should disclose the fact that the feature has been triggered and the value of the related effect.

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

See FSP 5.7 for information on disclosures required for contracts in an entity's own equity (e.g., warrants).

5.5 Common stock

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

5.5.1 Balance sheet presentation

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

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

5.5.2 Disclosure

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

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

5.6 Preferred stock

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

The balance sheet presentation of preferred stock depends on whether it is (1) perpetual or non-redeemable (FSP 5.6.2.1), (2) mandatorily redeemable (FSP 5.6.3.1), or (3) contingently redeemable (FSP 5.6.3.1). The determination of how to classify redeemable preferred stock is addressed in FG 7.

5.6.1 Disclosure – updated January 2024

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

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

- Aggregate or per-share amounts at which the preferred stock is called or is subject to redemption through sinking-fund operations or otherwise
- Aggregate and per-share amounts of cumulative preferred dividends in arrears

5.6.2 Perpetual preferred stock (no redemption provisions)

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

5.6.2.1 Balance sheet presentation

Absent any conversion or exchange provisions, preferred stock is generally classified in equity. However, reporting entities should consider whether substantive redemption features exist, in which case it may be classified outside of equity (e.g., mezzanine equity), or as a liability. See FG 7.3.

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

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

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

5.6.3 *Redeemable preferred stock*

Preferred stock may have redemption features in which the preferred shares may be exchanged for cash. Preferred stock that is redeemable at the option of the issuer (i.e., the issuer has a call option) would follow the same presentation and disclosure requirements as perpetual preferred stock (see FSP 5.6.2.1). Preferred stock may also have a mandatory redemption feature or a redemption feature outside of the control of the issuer.

5.6.3.1 *Balance sheet presentation*

A public reporting entity should state on the face of the balance sheet the following for each issue of redeemable preferred stock in accordance with S-X 5-02 (27).

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

If a reporting entity has multiple issues of such instruments outstanding, it may combine the amounts on the face of the balance sheet if appropriate disclosure is included in the footnotes.

Mandatorily redeemable

ASC 480-10-25-4 requires reporting entities to present mandatorily redeemable preferred stock that does not contain a conversion option as a liability on the balance sheet. Financial instruments in the scope of ASC 480 should be presented as liabilities on the balance sheet, and not as items in the mezzanine section (i.e., not between the liabilities section and the equity section in the balance sheet).

ASC 480-10-45-2 addresses the presentation of payments to holders of such instruments (e.g., dividends on the "equity" shares) as well as the presentation by entities that do not have other "equity" instruments.

ASC 480-10-45-2

Entities that have no equity instruments outstanding but have financial instruments issued in the form of shares, all of which are mandatorily redeemable financial instruments required to be classified as liabilities, shall describe those instruments as shares subject to mandatory redemption in statements of financial position to distinguish those instruments from other liabilities. Similarly, payments to holders of such instruments and related accruals shall be presented separately from payments to and interest due to other creditors in statements of cash flows and income.

Redeemable outside control of the issuer

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

Reporting entities should present redeemable securities that are classified as mezzanine equity separate from stockholders' equity accounts that are classified as permanent equity (e.g., non-redeemable preferred, common stock, and retained earnings). ASR 268, codified in ASC 480-10-S99-1, specifically prohibits the use of the term "stockholders' equity" as a caption to present the combined total of all equity securities and redeemable preferred stock.

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

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

5.6.3.2 Disclosure

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

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

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

- A description of the accounting treatment for any difference between the carrying value and redemption amount

ASR 268, codified in ASC 480-10-S99-1, requires the following presentation/disclosure for public companies with redeemable equity instruments that are classified outside of permanent equity:

Excerpt from FRP 211.03

ASR 268:

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

FRP 211.04

ASR 268:

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

As noted in the excerpt, FRP 211.03 indicates that changes in redeemable preferred stock are required to be disclosed in a separate note. However, we believe that presentation of redeemable securities within the statement of changes in stockholders' equity is permitted provided the statement is appropriately titled. If disclosed in the statement of changes in stockholders' equity, the redeemable preferred stock should be excluded from total stockholders' equity, and clearly delineated. Typically this is accomplished through the use of a " black line." We believe either alternative is appropriate.

Mandatorily redeemable

In addition to the disclosures in FSP 5.4, reporting entities that issue mandatorily redeemable securities classified as liabilities, pursuant to ASC 480-10-25, are required to provide the following disclosures in accordance with ASC 480-10-50:

- Nature and terms of the financial instrument

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

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

- Amount that would be paid, or the number of shares that would be issued and their fair value, determined based on the conditions in the contract if the settlement were to occur at the balance sheet date

- How changes in the fair value of the issuer's equity shares would impact the settlement amounts (see ASC 480-10-50-2(b) for example disclosure)

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

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

5.6.4 Convertible preferred stock

Convertible preferred stock is equity that is convertible into common stock. It may be contingently convertible (e.g., convertible at the option of the issuer, upon an initial public offering, or when reaching a target stock price) or mandatorily convertible. Refer to FG 7.3 to determine if convertible preferred stock should be classified in permanent or mezzanine equity.

5.6.4.1 Balance sheet presentation

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

Convertible preferred stock classified in mezzanine equity should follow the guidance discussed in FSP 5.6.3.1 for presentation requirements.

5.6.4.2 Disclosure—after adoption of ASU 2020-06

Reporting entities are required to include disclosures noted in FSP 5.4 for all convertible preferred stock. ASC 505-10-50-12 establishes disclosure objectives for convertible preferred stock in order for stakeholders to better understand the detailed disclosure requirements.

ASC 505-10-50-12

The objective of the disclosure about convertible preferred stock is to provide users of financial statements with:

a. Information about the terms and features of convertible preferred stock

b. An understanding of how those instruments have been reported in an entity's statement of financial position and statement of financial performance

c. Information about events, conditions, and circumstances that can affect how to assess the amount or timing of an entity's future cash flows related to those instruments.

Reporting entities should explain the pertinent rights and privileges of each convertible preferred stock instrument outstanding. ASC 505-10-50-13 provides a list of requirements for convertible preferred stock.

ASC 505-10-50-13

To comply with the general disclosure requirements of paragraph 505-10-50-3, an entity shall explain the pertinent rights and privileges of each outstanding instrument, including, but not limited to, the following information:

a. Number of shares issued and par value

b. Dividends

c. Conversion or exercise prices or rates and number of shares into which the instrument is potentially convertible

d. Pertinent dates, such as conversion date(s)

e. Parties that control the conversion rights

f. Manner of settlement upon conversion and any alternative settlement methods, such as cash, shares, or a combination of cash and shares

g. Terms that may change conversion or exercise prices, number of shares to be issued, or other conversion rights and the timing of those rights (excluding standard antidilution provisions)

h. Liquidation preference required by paragraph 505-10-50-4 and unusual voting rights

i. Other material terms and features of the instrument that are not listed above.

For contingently convertible instruments, incremental disclosures are required. Reporting entities should disclose information about events or changes in circumstances that would adjust or change the contingency or would cause the contingency to be met in accordance with ASC 505-10-50-14. In addition, information on whether the shares that would be issued if converted are included in diluted EPS and the reasons why or why not should be disclosed. Other information that is helpful to understand the nature of contingencies and potential impact of conversion should also be disclosed.

Further, in accordance with ASC 505-10-50-15, reporting entities should disclose the amount of dividends declared for each period for which a statement of financial performance is presented, in addition to the existing disclosures required by ASC 505-10-50-5.

ASC 505-10-50-16 provides additional information reporting entities should disclose as of the date of the latest statement of financial position presented.

ASC 505-10-50-16

An entity shall disclose the following information as of the date of the latest statement of financial position presented:

a. Changes to conversion or exercise prices that occur during the reporting period other than changes due to standard antidilution provisions

b. Events or changes in circumstances that occur during the reporting period that cause conversion contingencies to be met or conversion terms to be significantly changed

c. Number of shares issued upon conversion, exercise, or satisfaction of required conditions during the reporting period.

5.6.4.2A Disclosure—before adoption of ASU 2020-06

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

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

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

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

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

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

Excerpt from ASC 505-10-50-7

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

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

5.6.4.3 Contingently convertible preferred stock with related derivatives—after adoption of ASU 2020-06

In accordance with ASC 505-10-50-17, the disclosures in ASC 815 are also required for a conversion option that is accounted for as a derivative. ASC 505-10-50-18 requires reporting entities to disclose the following information about derivative transactions entered into in connection with the issuance of convertible preferred stock, regardless of whether the derivative transactions are accounted for as assets, liabilities, or equity instruments:

- The terms of the derivative transactions (including terms of settlement)

- How those derivative transactions relate to the convertible preferred stock

- Number of shares underlying the derivative transactions
- Reason for entering into those derivative transactions

5.6.4.3A *Contingently convertible preferred stock with related derivatives—before adoption of ASU 2020-06*

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

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

For additional information related to disclosures of derivatives, see FSP 19.

5.6.4.4A *Discount on contingently convertible preferred stock—before adoption of ASU 2020-06*

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

5.7 Contracts in an entity's own equity

A reporting entity may enter into an equity-linked contract to issue shares, repurchase shares, or raise financing at a reduced rate. Warrants, forward repurchase contracts, and convertible debt are all examples of equity-linked contracts. An equity-linked contract may be classified in its entirety as equity or a liability (or asset), or may be separated into components that are separately classified. See FG 5 for information on determining whether an equity-linked contract should be separated and how contracts in an entity's own stock should be classified.

If a contract in an entity's own stock meets the requirements for liability (or asset) classification, it is likely to meet the definition of a derivative in ASC 815. In that case, the presentation and disclosure requirements for derivatives discussed in FSP 19 should also be considered.

5.7.1 *Disclosure—after adoption of ASU 2020-06*

The guidance in ASC 815-40-50-1A establishes disclosure objectives in order for stakeholders to better understand the detailed disclosure requirements related to contracts in an entity's own equity.

ASC 815-40-50-1A

The disclosure guidance in this Section should help a user of financial statements understand the following:

a. Information about the terms and features of contracts in an entity's own equity within the scope of this Subtopic

b. How those instruments have been reflected in the issuer's statement of financial position and statement of financial performance

c. Information about events, conditions, and circumstances that can affect how to assess the amount or timing of an entity's future cash flows but has not yet been reflected in the financial statements.

Contracts in an entity's own equity, for which the disclosure guidance in ASC 815-40-50 is applicable, are described in ASC 815-40-50-2.

ASC 815-40-50-2

The disclosure guidance in this Subtopic applies to freestanding instruments that are potentially indexed to, and potentially settled in, an entity's own equity, regardless of whether the contract meets the criteria to qualify for the scope exception in Sections 815-40-15 and 815-40-25. Some contracts that are classified as assets or liabilities meet the definition of a derivative instrument under the provisions of Subtopic 815-10. The related disclosures that are required by Sections 815-10-50, 815-25-50, 815-30-50, and 815-35-50 also are required for those contracts. Equity-classified contracts under the provisions of this Subtopic are not required to provide the disclosures required by Section 505-10-50, other than those described in paragraph 815-40-50-5.

A reporting entity is required to disclose its accounting for a contract indexed to its own shares (i.e., as equity or a liability/asset). ASC 815-40-50-5 provides guidance on how to comply with the requirements in ASC 505-10-50 for contracts in an entity's own equity.

ASC 815-40-50-5

The disclosures required by Section 505-10-50 apply to all contracts within the scope of this Subtopic as follows:

a. In the case of an option or forward contract indexed to the issuer's equity, the pertinent information to be disclosed under Section 505-10-50 about the contract includes all of the following:

   1. The forward rate

   2. The option strike price

   3. The number of issuer's shares to which the contract is indexed

   4. The settlement date or dates of the contract

5. The issuer's accounting for the contract (that is, as an asset, liability, or equity).

b. If the terms of the contract provide settlement alternatives, those settlement alternatives shall be disclosed under Section 505-10-50, including all of the following:

   1. Who controls the settlement alternatives and a description of those alternatives

   2. The maximum number of shares that could be required to be issued to net share settle a contract, if applicable. Paragraph 505-10-50-3 requires additional disclosures for actual issuances and settlements that occurred during the accounting period.

c. If a contract does not have a fixed or determinable maximum number of shares that may be required to be issued, the fact that a potentially infinite number of shares could be required to be issued to settle the contract shall be disclosed under Section 505-10-50.

d. For each settlement alternative, 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 and how changes in the fair value of the issuer's equity shares affect those settlement amounts (for example, the issuer is obligated to issue an additional X shares or pay an additional Y dollars in cash for each $1 decrease in the fair value of one share) shall be disclosed under Section 505-10-50. (For some issuers, a tabular format may provide the most concise and informative presentation of these data.)

e. The disclosures required by paragraph 505-10-50-11 shall be made for any equity instrument in the scope of this Subtopic that is (or would be if the issuer were a public entity) classified as temporary equity. (That paragraph applies to redeemable stock issued by nonpublic entities, regardless of whether the private entity chooses to classify those securities as temporary equity.)

f. The disclosures required by paragraph 505-10-50-18 also shall be made for an equity-classified contract within the scope of this Subtopic that is entered into in connection with the issuance of convertible preferred stock.

5.7.1A Disclosure-before adoption of ASU 2020-06

A reporting entity is required to disclose its accounting for a contract indexed to its own shares (i.e., as equity or a liability/asset). ASC 815-40-50-5 provides guidance on how to comply with the requirements in ASC 505-10-50 for contracts in an entity's own equity.

ASC 815-40-50-5

The disclosures required by Section 505-10-50 apply to all contracts within the scope of this Subtopic as follows:

a. In the case of an option or forward contract indexed to the issuer's equity, the pertinent information to be disclosed under Section 505-10-50 about the contract includes all of the following:

   1. The forward rate

2. The option strike price

3. The number of issuer's shares to which the contract is indexed

4. The settlement date or dates of the contract

5. The issuer's accounting for the contract (that is, as an asset, liability, or equity).

b. If the terms of the contract provide settlement alternatives, those settlement alternatives shall be disclosed under Section 505-10-50, including both of the following:

   1. Who controls the settlement alternatives

   2. The maximum number of shares that could be required to be issued to net share settle a contract, if applicable. Paragraph 505-10-50-3 requires additional disclosures for actual issuances and settlements that occurred during the accounting period.

c. If a contract does not have a fixed or determinable maximum number of shares that may be required to be issued, the fact that a potentially infinite number of shares could be required to be issued to settle the contract shall be disclosed under Section 505-10-50.

d. A contract's current fair value for each settlement alternative (denominated, as relevant, in monetary amounts or quantities of shares) and how changes in the price of the issuer's equity instruments affect those settlement amounts (for example, the issuer is obligated to issue an additional X shares or pay an additional Y dollars in cash for each $1 decrease in stock price) shall be disclosed under Section 505-10-50. (For some issuers, a tabular format may provide the most concise and informative presentation of these data.)

e. The disclosures required by paragraph 505-10-50-11 shall be made for any equity instrument in the scope of this Subtopic that is (or would be if the issuer were a public entity) classified as temporary equity. (That paragraph applies to redeemable stock issued by nonpublic entities, regardless of whether the private entity chooses to classify those securities as temporary equity.)

5.7.2 Disclosure-modifications or exchanges of equity-classified written call options

New guidance

In May 2021, the FASB issued ASU 2021-04, *Earnings Per Share (Topic 260), Debt—Modifications and Extinguishments (Subtopic 470-50), Compensation—Stock Compensation (Topic 718), and Derivatives and Hedging—Contracts in Entity's Own Equity (Subtopic 815-40)*. The ASU clarifies the guidance related to an issuer's accounting for modifications or exchanges of freestanding equity-classified written call options (for example, warrants) that remain equity-classified after modification or exchange. The amendments in the ASU are effective for all entities for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. Early adoption is permitted for all entities, including adoption in an interim period. If an entity elects early adoption in an interim period, the guidance should be applied as of the beginning of the fiscal year that includes that interim period.

ASC 815-40-50-6 summarizes the disclosure requirements related to an issuer's accounting for modifications or exchanges of freestanding equity-classified written call options.

ASC 815-40-50-6

For a freestanding equity-classified written call option modified or exchanged during any of the periods presented and for which an entity has recognized the effect in accordance with paragraph 815-40-35-17, an entity shall disclose the following:

a. Information about the nature of the modification or exchange transaction (see paragraph 815-40-35-15)

b. The amount of the effect of the modification or exchange (see paragraph 815-40-35-16)

c. The manner in which the effect of the modification or exchange has been recognized (see paragraph 815-40-35-17).

See FG 8.3 for further information on the accounting for such modifications or exchanges.

5.7.3 Reclassification

If upon the reassessment of a contract in its own equity, a reporting entity determines that the contract should be reclassified into (or out of) equity, the reporting entity should disclose the reclassification, the reason for the reclassification, and the effect on the financial statements.

See FG 5.7 (after adoption of ASU 2020-06) or FG 5.7A (before adoption of ASU 2020-06) for information on the reassessment and reclassification of contracts in an entity's own equity.

5.8 Retained earnings

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

5.8.1 Restrictions on retained earnings

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

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

- The most significant restrictions on the payment of dividends, including their sources, their pertinent provisions, and the amount of retained earnings or net income restricted or free of such restrictions

- The amount of consolidated retained earnings that represents undistributed earnings of 50% or less-owned entities accounted for by the equity method

- The nature of any restrictions on the ability of consolidated and unconsolidated subsidiaries to transfer funds to the parent, and the amounts of such restricted net assets

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

Figure FSP 5-2 is an example footnote disclosure of a restriction on retained earnings.

Figure FSP 5-2
Example disclosure — retained earnings restrictions

Note D — At December 31, 20X1, consolidated retained earnings was restricted in the amount of $3,500,000, representing the cost of 170,000 shares of common stock held in the treasury.

5.8.1.1 Restrictions on retained earnings in loan agreements

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

Figure FSP 5-3 is an example footnote disclosure of a restriction on retained earnings in a loan agreement.

Figure FSP 5-3
Example disclosure — restriction on retained earnings in a loan agreement

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

5.8.1.2 Subsidiary restrictions on retained earnings

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

- A domestic subsidiary with a noncontrolling interest that capitalizes retained earnings by declaring a stock dividend

- Subsidiaries that capitalize retained earnings by transfers to common stock in order to gain tax or other advantages

- A foreign subsidiary that is required by statute to establish a legal reserve for the protection of creditors
- Debt covenant requirements that restrict a subsidiary's ability to transfer funds to the parent
- Regulated subsidiaries, such as broker dealers and insurance companies, that need to keep capital levels at certain amounts or have regulators approve dividends

5.8.2 *Appropriations on retained earnings*

Retained earnings may be appropriated by:

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

ASC 505-10-45-3 permits presentation of an appropriation of retained earnings if it clearly identified within stockholders' equity on the balance sheet. A reporting entity should not transfer any part of the appropriation to net income, nor should it charge costs or losses directly to an appropriation of retained earnings.

5.9 *Treasury stock*

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

5.9.1 *Balance sheet presentation*

As discussed in ASC 505-30, *Treasury Stock*, a reporting entity that repurchases its shares may account for the shares as treasury stock or retire them. If the treasury stock is not retired upon its reacquisition, the reporting entity may present it on the balance sheet as a reduction from common stock, additional paid-in capital (APIC), or retained earnings. If a reporting entity retires the share, it should follow the guidance in ASC 505-30-30-7 to ASC 505-30-30-10, which govern the retirement of treasury stock, including the accounting for the amount paid to repurchase the shares in excess of the par or stated value. See FG 9.4 for information on the accounting for share retirement.

5.9.2 *Disclosure*

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

- Basis at which it is carried
- Number of shares
- Commitments to repurchase capital stock

- Restrictions imposed by state law
- Reasons for acquisition

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

See FG 9.3 for accounting considerations related to treasury stock.

5.9.3 *Parent's presentation of a subsidiary investment in a parent*

A consolidated subsidiary may hold an investment in its parent company's common stock. In consolidation, the presentation guidance in ASC 810-10-45-5 requires that such shares not be treated as outstanding shares. Rather, such shares would be eliminated and reflected as treasury shares in the consolidated financial statements. The treatment of intercompany dividend payments in consolidation would eliminate dividend income at the subsidiary against dividends paid by the parent.

If a noncontrolling interest is present at the subsidiary that owns an interest in the parent, a question arises regarding how the parent should allocate income or loss to the noncontrolling interest. The answer will depend on how the subsidiary accounts for the investment in the parent, as detailed in FSP 5.9.4. If the subsidiary accounts for its parent's shares as investment, the noncontrolling interest holder will reflect its proportionate share of the subsidiary-owned parent shares' dividend income (if any). If the subsidiary accounts for its investment as contra-equity, no additional income or loss attribution to the noncontrolling interest would be required.

The attribution of income or loss to the noncontrolling interest should also consider the accounting for equity investments as required by ASC 321-10-35-1, which requires all equity investments to be measured at fair value with changes in fair value recognized in net income. However, companies may choose to reflect equity investments with no readily determinable fair value at cost minus impairment, plus or minus changes in value resulting from observable price changes. If the subsidiary accounts for its ownership of parent shares as an investment, the income or loss attribution to the noncontrolling interest holder would include its proportionate interest in any measurement changes associated with the subsidiary's parent's shares.

5.9.4 *Subsidiary's presentation of an investment in its parent*

A subsidiary may hold an investment in its parent company's common stock. The manner in which the subsidiary presents its investment in the parent company's common stock in the standalone subsidiary financial statements will depend on whether the parent company is deemed to have substance.

If the parent company's only significant asset is its investment in the subsidiary, then the parent company would not be considered substantive and the subsidiary would present its investment in its parent as a reduction of the subsidiary's stockholders' equity balance. This substance-based presentation approach treats the subsidiary's investment in the parent company as treasury stock. If the parent's only asset is the investment in the subsidiary, there is no distinction between the

subsidiary directly acquiring its own shares or indirectly acquiring shares through the acquisition of an interest in its parent. When a subsidiary's investment in the stock of its parent is classified as a reduction to stockholders' equity, any dividends received from the parent should be recorded as a capital contribution.

If the parent company has other significant assets in addition to its investment in its subsidiary, the subsidiary may account for its interest in the parent as either an investment or as contra equity, similar to treasury stock. See LI 2 for information on the accounting for equity investments and FG 9 for information on the accounting for treasury stock. The subsidiary should also disclose the nature of the related party transaction.

5.10 Additional paid-in capital

Additional paid-in capital (APIC, or sometimes referred to as capital in excess of par value) is the excess amount paid by an investor over the par value of a stock issue. In addition, contributions from an investor, such as cash or property that do not result in the issuance of new shares, are normally reflected in APIC as the par value of outstanding shares has not changed. APIC may be shown as a separate caption in the equity section of the balance sheet or combined with the related stock caption.

5.10.1 Notes received for common stock

A reporting entity may receive a note, rather than cash, as a contribution to its equity. The note may be for the sale of common stock or a contribution to paid-in capital. The question arises as to whether the note should be presented as a receivable or as contra-equity. The predominant practice is to present the note receivable as contra-equity. ASC 505-10-45-2 indicates that reporting the note as an asset is generally not appropriate, except in very limited circumstances when there is substantial evidence of intent and ability to pay in a reasonably short time period.

For nonpublic entities, evidence of intent and ability to pay in a reasonably short period may include circumstances when the notes are secured by irrevocable letters of credit or other liquid collateral, have a stated maturity in a short time period, or when the notes are collected prior to issuance of the financial statements. SAB Topic 4.E (codified in ASC 310-10-S99-2) indicates that the SEC would permit recording such a note as an asset only if the note is collected prior to issuance of the financial statements.

For other transactions with shareholders, see FG 4.5.

5.11 Dividends

Dividends are distributions to owners or stockholders. They may be paid in cash, stock, or as dividends in kind.

Cash dividends declared are generally reported as a deduction from retained earnings. As depicted in Figure FSP 5-1, dividends declared or paid are normally presented in the statement of stockholders' equity at the amount per share, and in total for each class of shares as required by S-X 3-04. In the absence of retained earnings, cash dividends should generally be charged to APIC. This treatment is supported by analogy to SAB Topic 3.C (codified in ASC 480-10-S99-2), which requires accretion of redeemable preferred stock to be charged to APIC in the absence of retained earnings.

A parent company may declare a dividend from other than its accumulated earnings (e.g., from APIC, unrecorded increases in value of the company, or retained earnings resulting from parent's equity in undistributed earnings of a subsidiary). Laws in many jurisdictions have restrictions on declaring dividends from other than a reporting entity's accumulated profits. Accordingly, whenever dividends are declared from other than a parent company's retained earnings, the reporting entity should consider obtaining an opinion of counsel as to the legality of the declaration. A reporting entity may also wish to record a dividend as an addition to accumulated deficit. The legal character of a dividend as a charge to accumulated deficit instead of APIC may be followed for accounting purposes when the dividend is not a legal return of capital.

5.11.1 Stock dividends

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

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

Further, as noted in FSP 5.5, S-X 5-02 requires disclosure of the number of shares issued and outstanding on the face of the balance sheet. When a stock dividend has been declared, but not issued at the balance sheet date, the sum of the number of shares declared as a stock dividend and the total number of shares outstanding should usually be disclosed on the face of the balance sheet. When there are multiple classes of shares, it may be appropriate to disclose this information in the footnotes.

Figure FSP 5-4 illustrates two versions of this presentation on the balance sheet.

Figure FSP 5-4

Example balance sheet presentation — shares declared as a stock dividend and not issued

	December 31, 20X1
Common stock — $10 par; authorized 200,000 shares; issued and outstanding 105,000 shares (including 5,000 shares declared as a stock dividend on December 29, 20X1, and issued on January 15, 20X2)	$1,050,000

Or

	December 31, 20X1	
	Shares	**Amount**
Common stock — $10 par; authorized 200,000 shares		
Issued and outstanding	100,000 shares	$1,000,000
Issued on January 15, 20X2 as a stock dividend	5,000 shares	50,000
	105,000 shares	$1,050,000

5.11.1.1 Stock dividend declared but not paid

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

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

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

5.11.2 Unpaid dividends

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

5.11.3 Liquidating dividends

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

Figure FSP 5-5 is an example of a footnote to disclose liquidating dividends.

Figure FSP 5-5
Sample disclosure for a liquidating dividend — deducting from capital balance

Note X — Cash dividends paid during the year 20X1 equaled $1.00 per share on the $3.00 par value common stock, of which $0.30 represented a liquidating dividend paid from APIC.

5.11.4 *Stockholders' rights plans ("poison pill" takeover defenses)*

To discourage unfriendly takeover attempts, reporting entities may adopt plans under which rights are granted to existing stockholders that convert to common stock upon the occurrence of certain events, such as the accumulation of a significant percentage of the reporting entity's outstanding shares by a single stockholder. These plans are sometimes referred to as "poison pill" takeover defenses and have the characteristics of a dividend. Reporting entities with poison pill takeover defenses should disclose in their footnotes the terms of the plans, including events that cause conversion, the potentially dilutive nature of the plan, and call provisions, if any. Accounting for these plans is addressed in FG 8.5.

5.11.4.1 *Earnings capitalized in prior years*

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

5.11.4.2 *Fractional shares*

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

5.12 *Stock splits*

ASC 505-20-20 defines a stock split.

Definition from ASC 505-20-20

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

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

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

5.12.1 *Differentiation between stock dividends and stock splits*

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

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

5.13 Stock dividend and stock split

Refer to FSP 28.5.2 for guidance on the balance sheet presentation of capital structure changes due to a stock dividend, stock split, or reverse split after the balance sheet date. Since stock dividends and stock splits should be given retroactive recognition in computing earnings per share (ASC 260-10-55-12 and FSP 7.6), they are also given retroactive recognition in computing dividends per share. When dividends per share are presented on other than the historical basis, as a result of retroactive recognition, reporting entities should disclose the basis of presentation in the footnotes.

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

Often in an IPO, outstanding debt or preferred stock will automatically convert into common stock either upon the effective date or completion (i.e., closing) of the IPO. Such conversions typically have a significant impact on an entity's capital structure. The conversion of securities on either the effective date or closing date of an IPO, however, cannot be reflected in the historical balance sheet. The security should instead be classified according to its nature in the historical balance sheet at such date. If the impact of the conversion results in a material reduction of earnings per share (excluding the effects of the offering), the IPO filing should include pro forma financial statements prepared under Regulation S-X Article 11 to give effect to the assumed conversion of the security on either the effective date or the closing date. This unaudited pro forma balance sheet should not give effect to the proceeds of the offering. In addition, pro forma information reflecting the change in capitalization should not be presented on the face of the audited historical financial statements.

5.15 Considerations for private companies

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

In addition, ASC 505-10-50-11 requires that all reporting entities disclose the amount of redemption requirements for all issues of stock that are redeemable at fixed or determinable prices on fixed or determinable dates in each of the five years following the date of the latest balance sheet presented. In

contrast, S-X 5-02 requires this disclosure for all redeemable preferred stock issued by SEC registrants.

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

- S-X 3-04 requires inclusion of dividends per share in the statement of changes in stockholders' equity (or in the footnotes if there is not a separate statement).

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

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

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

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

  - Title

  - Carrying amount

  - Redemption amount

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

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

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

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

Chapter 6: Statement of cash flows—updated March 2024

6.1 Statement of cash flows—overview

This chapter discusses the concepts that guide classification within the statement of cash flows. Proper presentation begins with understanding what qualifies as cash and cash equivalents, including restricted cash and cash equivalents, and what does not. From there, classifying cash flows as operating, investing, or financing can often be a challenge, especially for cash flows related to non-recurring transactions. A further challenge exists in determining what is and what is not a cash flow; noncash activities and the foreign currency effects on cash introduce additional complexity. The following sections explore these topics and provide examples and considerations that will offer financial statement preparers and users insight into appropriate presentation of the statement of cash flows in accordance with US GAAP.

6.2 Statement of cash flows—scope and relevant guidance

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

- FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting*
- ASC 320, *Investments — Debt and Equity Securities*
- ASC 350-40, *Internal-Use Software*
- ASC 350-60 *Intangibles – Goodwill and Other – Crypto Assets*
- ASC 815, *Derivatives and Hedging*
- ASC 830, *Foreign Currency Matters*

In addition, certain reporting entities should consider industry-specific guidance as follows:

- ASC 920-230, *Entertainment-Broadcasters*
- ASC 926-230, *Entertainment-Films*
- ASC 942-230, *Financial Services-Depository and Lending*
- ASC 946-230, *Financial Services-Investment Companies*
- ASC 958-230, *Not-for-Profit Entities*
- ASC 970-230, *Real Estate-General*
- ASC 978-230, *Real Estate-Time Sharing Activities*

ASC 230 requires a statement of cash flows as part of a full set of financial statements for all reporting entities, except as noted below. The statement of cash flows is a primary financial statement and is required for each period for which an income statement (or statement of activities for not-for-profits) is presented. The statement of cash flows is also required to be presented in guarantor condensed

consolidating information and parent company-only financial statements that include a balance sheet and an income statement. There are no exclusions for specific industries or different types of reporting entities except for:

- An investment company as defined in ASC 946 that also meets the following conditions:
  - Substantially all of the assets of the reporting entity are carried at fair value and are classified as Level 1 or Level 2 under ASC 820, *Fair Value Measurement*, or are measured using the practical expedient in ASC 820-10-35-59 and are always redeemable in the near term
  - The reporting entity has little or no debt (based on the average debt outstanding during the period) relative to average total assets
  - The reporting entity provides a statement of changes in net assets
- A common trust fund, variable annuity account, or similar fund maintained by a bank, insurance entity, or other entity in its capacity as a trustee, administrator, or guardian for the collective investment and reinvestment of moneys for a beneficiary
- A defined benefit or defined contribution postretirement plan

New guidance

ASU 2023-06

In October 2023, the FASB issued ASU 2023-06, *Disclosure Improvements: Codification Amendments in Response to the SEC's Disclosure Update and Simplification Initiative*. The ASU affects a variety of topics in the Codification, including ASC 230. It adds ASC 230-10-50-9, which requires the reporting entity to disclose its accounting policy for where cash flows associated with derivative instruments and their related gains and losses are presented. Consistent with the accounting policy disclosure requirements in ASC 235-10-50-1 through 235-10-50-2, the disclosure applies to annual reporting periods and the interim reporting period in which the reporting entity changes its accounting policies since the end of its preceding fiscal year.

For all entities subject to the SEC's existing disclosure requirements and for entities required to file or furnish financial statements with or to the SEC in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer, the amendments are effective and applicable to financial statements issued after the date that the SEC's removal of the related guidance from Regulation S-X or Regulation S-K becomes effective. For all other entities, the amendments are effective two years after that date. Early adoption is prohibited. For all entities, if by June 30, 2027, the SEC has not removed the applicable requirement from Regulation S-X or Regulation S-K, the pending content of the related amendment will be removed from the Codification and will not become effective for any entity.

The ASU should be applied prospectively.

ASU 2023-08

In December 2023, the FASB issued ASU 2023-08, *Intangibles – Goodwill and Other – Crypto Assets (Subtopic 350-60): Accounting for and Disclosure of Crypto Assets*. The cash flow presentation of in-

scope crypto assets will generally follow the existing guidance in ASC 230. However, if crypto assets are received as noncash consideration in the ordinary course of business (e.g., settlement of receivables) and then "nearly immediately" converted into cash, the ASU specifically requires that the cash received be classified as an operating activity in the statement of cash flows. The ASU defines "nearly immediately" as a short period of time that is expected to be within hours or a few days, rather than weeks.

The ASU is effective for all entities for fiscal years beginning after December 15, 2024, including interim periods within those fiscal years. Early adoption is permitted for both interim and annual financial statements that have not yet been issued (or made available for issuance).

6.3 Cash basis method of reporting

Reporting activity in the statement of cash flows is predicated on the cash method of accounting rather than the accrual method used for other financial statements. Accordingly, all debits and credits to a bank account that has the general characteristics of a deposit account, whether restricted or unrestricted, as well as those instruments determined to be cash equivalents, generally should be reported as cash outflows and cash inflows. FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting*, explains:

Excerpt from FASB Concepts Statement No. 8

Reporting cash flows involves no estimates or allocations and few judgments except regarding classification in cash flow statements.

CON 8 further indicates that cash flows should be recognized when they occur. Accordingly, reporting entities should generally only report cash flows that actually affected cash and cash equivalents (see FSP 6.9.2.1 for a discussion of constructive receipts and disbursements). Cash and cash equivalents may be found in multiple financial statement line items, such as cash and cash equivalents as well as amounts generally described as restricted cash or restricted cash equivalents. A statement of cash flows should not reflect cash flows that could have happened or are expected to happen.

Question FSP 6-1 addresses the reporting of an acquisition of a long-lived asset prior to the remittance of payment.

Question FSP 6-1

How should a reporting entity report the acquisition of a long-lived asset in the financial statements if it has not remitted payment at the end of the reporting period?

PwC response

Prior to remittance of payment, the acquisition of a long-lived asset is a noncash investing activity. The reporting entity's statement of cash flows should not include an investing outflow for the acquisition of the long-lived asset. Payable amounts for the purchase of long-lived assets are not included in the reconciliation of net income to cash flows from operating activities. When the payable is paid, that amount is classified as an investing cash outflow. The fact that the reporting entity has sufficient cash to settle the accounts payable on the balance sheet date or expects to pay the accounts payable shortly after the balance sheet date is irrelevant.

6.4 Format of the statement of cash flows

ASC 230 allows a reporting entity to prepare and present its statement of cash flows using either the direct or indirect method (see FSP 6.4.2), though ASC 230-10-45-25 encourages using the direct method.

6.4.1 Sample statement of cash flows

Figure FSP 6-1 is an illustrative cash flow statement prepared using the indirect method. It reflects certain captions required by ASC 230 (bolded) and other common captions. Not all captions are applicable to all reporting entities. In addition, some captions may be reflected in other classification categories depending on facts and circumstances.

Presentation and disclosure requirements are addressed in the relevant sections of this chapter and cross referenced in the last column of the figure. Not all items discussed within this chapter are presented in the figure.

Figure FSP 6-1

Sample consolidated statement of cash flows

FSP Corp
Consolidated Statement of Cash Flows
For the years ended 20X3, 20X2, and 20X1

	20X3	**20X2**	**20X1**	**Section reference**
	in millions $	in millions $	in millions $	
Cash flows from operating activities:				
Net income	$xxx	$xxx	$xxx	FSP 6.4.2
Adjustments to reconcile net income to net cash provided by (used in) operating activities:				
Accretion (amortization) of discount (premium) on issued debt securities	xxx	xxx	xxx	FSP 6.8.6
(Gain) loss on extinguishment of debt	xxx	xxx	xxx	FSP 6.8.7 / FSP 6.8.8
Depreciation and amortization	xxx	xxx	xxx	FSP 6.7.3
Amortization of debt issue costs	xxx	xxx	xxx	FSP 6.7.3
Share-based incentive compensation	xxx	xxx	xxx	FSP 6.7.3
Impairment of assets	xxx	xxx	xxx	FSP 6.7.3
Provision for bad debt expense	xxx	xxx	xxx	FSP 6.7.3
Inventory obsolescence impairment	xxx	xxx	xxx	FSP 6.7.3

	20X3	20X2	20X1	Section reference
Deferred taxes	xxx	xxx	xxx	FSP 6.7.3
Noncash provisions for exit costs	xxx	xxx	xxx	FSP 6.7.3
Loss (gain) on disposal of property and equipment	xxx	xxx	xxx	FSP 6.7.3
(Income) loss from equity method investments, net of dividends received	xxx	xxx	xxx	FSP 6.8.3
Foreign currency transactions	xxx	xxx	xxx	FSP 6.11
Changes in operating assets and liabilities, net of effects of businesses acquired:				
Decrease (increase) in trade receivables	xxx	xxx	xxx	FSP 6.4.2
Cash received on sale of accounts receivable	xxx	xxx	xxx	FSP 6.4.2
Decrease (increase) in inventories	xxx	xxx	xxx	FSP 6.4.2
Decrease (increase) in other assets, net	xxx	xxx	xxx	FSP 6.4.2
Increase (decrease) in operating accounts payable	xxx	xxx	xxx	FSP 6.4.2
Increase (decrease) in accrued liabilities	xxx	xxx	xxx	FSP 6.4.2
Increase (decrease) in income taxes payable	xxx	xxx	xxx	FSP 6.4.2
Increase (decrease) in other liabilities, net	xxx	xxx	xxx	FSP 6.4.2
Net cash provided by (used in) operating activities	xxx	xxx	xxx	FSP 6.7.3
Cash flows from investing activities:				
Acquisition [sale] of equity securities*	xxx	xxx	xxx	FSP 6.7.1
Acquisition [proceeds from sale] of property, plant, and equipment*	xxx	xxx	xxx	FSP 6.8.13
Acquisition [sale] of a business, net of cash and cash equivalents acquired [or sold]*	xxx	xxx	xxx	FSP 6.8.20
Impact to cash resulting from initial consolidation [deconsolidation]*	xxx	xxx	xxx	FSP 6.7.1

	20X3	20X2	20X1	Section reference
Contributions and advances to joint ventures	xxx	xxx	xxx	FSP 6.8.4
Subsequent collections of receivables sold, and of receivables reacquired	xxx	xxx	xxx	FSP 6.8.12
Net cash provided by (used in) investing activities	xxx	xxx	xxx	FSP 6.7.1
Cash flows from financing activities:				
Bank overdrafts	xxx	xxx	xxx	FSP 6.5.1.1
Payment of contingent consideration	xxx	xxx	xxx	FSP 6.8.20
Proceeds from debt	xxx	xxx	xxx	FSP 6.7.2
Repayments of debt	xxx	xxx	xxx	FSP 6.7.2
Payments of debt issue costs	xxx	xxx	xxx	FSP 6.7.2
Dividends paid	xxx	xxx	xxx	FSP 6.7.2
Net payments of short-term borrowings	xxx	xxx	xxx	FSP 6.7.2
Repurchases of equity securities	xxx	xxx	xxx	FSP 6.7.2
Acquisition of common stock for tax withholding obligations	xxx	xxx	xxx	FSP 6.8.18
Distributions to noncontrolling interests	xxx	xxx	xxx	FSP 6.8.19
Principal payments under capital lease obligations	xxx	xxx	xxx	FSP 6.7.2
Net activity from derivatives with an other-than-insignificant financing element	xxx	xxx	xxx	FSP 6.8.5
Net cash provided by (used in) financing activities	xxx	xxx	xxx	FSP 6.7.2
Effect of exchange rate changes on cash, cash equivalents and restricted cash	xxx	xxx	xxx	FSP 6.11
Cash, cash equivalents, and restricted cash:				
Net change during the period	xxx	xxx	xxx	FSP 6.5
Balance, beginning of period	xxx	xxx	xxx	FSP 6.5
Balance, end of period	$xxx	$xxx	$xxx	FSP 6.5

	20X3	20X2	20X1	Section reference
Supplemental cash flow information:				
Cash paid for interest, net of amounts capitalized	$xxx	$xxx	$xxx	FSP 6.9.1
Cash paid for income taxes	xxx	xxx	xxx	FSP 6.9.1
Noncash investing and financing activity*	xxx	xxx	xxx	FSP 6.9.2
Reconciliation of cash, cash equivalents, and restricted cash reported in the statement of financial position				
Cash and cash equivalents	xxx	xxx	xxx	FSP 6.5
Restricted cash	xxx	xxx	xxx	FSP 6.5.3
Restricted cash included in other long-term assets	xxx	xxx	xxx	FSP 6.5.3
Total cash, cash equivalents, and restricted cash shown in the statement of cash flows	xxx	xxx	xxx	

* These line items generally should be presented gross; however, for ease of reference in Figure FSP 6-1, the inflows and outflows are reflected in the sample statement on one line.

6.4.2 *Direct versus indirect method*

As discussed in ASC 230-10-45-28, cash flows related to operating activities may be presented in one of two ways — the direct method or the indirect method. The presentation of investing and financing activities are identical under the direct and indirect methods. Although the presentation of operating cash flows differs between the two methods, both methods result in the same amount of net cash flows from operations. While ASC 230-10-45-25 encourages the use of the direct method, the large majority of reporting entities elect to use the indirect method. The concepts underlying classification within ASC 230 were conceived and explained solely from the perspective of the direct method. While the indirect method represents an alternative presentation model, it is not an alternative classification methodology. Accordingly, even when a reporting entity is using the indirect method, it should consider the direct method framework when evaluating the proper classification of a cash flow.

As discussed in ASC 230-10-45-25, the direct method requires the presentation of major types of gross cash receipts and gross cash payments and their arithmetic sum, which represents the net cash flow from operating activities. At a minimum, the following types of operating receipts and disbursements are required in a direct method presentation:

- Cash collected from customers, including lessees, licensees, etc.
- Interest and dividends received (except for return of capital)
- Other operating cash receipts, if any

- Cash paid to employees and other suppliers of goods or services, including suppliers of insurance, advertising, etc.
- Interest paid
- Income taxes paid
- Other operating cash payments, if any

To illustrate how operating cash flows (prepared on the cash basis of accounting) relate to net income (prepared on the accrual method of accounting), as discussed in ASC 230-10-45-28, the direct method also requires a reconciliation of net income to net cash flows from operating activities. Net income, including earnings attributable to the controlling and noncontrolling interests, is the starting point to reconcile cash flows from operating activities. The reconciliation removes the effects of the following:

- All deferrals of past operating cash receipts and payments, and all accruals of expected future operating cash receipts and payments (e.g., changes during the period in receivables and payables pertaining to operating activities)
- All items included in net income that do not affect operating cash receipts and payments (e.g., all items for which cash effects are related to investing or financing activities (e.g., depreciation, amortization, gains or losses on dispositions of long-lived assets, and foreign currency gains and losses from the retirement of foreign denominated debt))
- Adjustments for noncash items in the reconciliation of net income to net cash flows from operating activities, which may include items such as:
  - Depreciation and amortization relating to fixed assets, definite-lived intangible assets, capital leases, premiums, or discounts on debt (including debt issuance costs)
  - Lessee's amortization of right-of-use assets (see FSP 6.8.16.1)
  - Provisions for bad debts and inventory
  - Share-based incentive compensation
  - Deferred income taxes
  - Impairment losses
  - Unrealized foreign currency transaction gains or losses
- Adjustments for cash flows from investing and financing activities recognized in net income *adjusted to arrive at cash flows from operating activities may include items such as:*
  - Gains or losses from the sale of long-lived assets or businesses
  - Gains or losses from the settlement of asset retirement obligations
  - Gains or losses from the extinguishment of debt
  - Realized foreign currency transaction gains or losses related to investing or financing activities

As discussed in ASC 230-10-45-25 and ASC 230-10-45-28, when the indirect method is used, a reporting entity does not report the gross cash receipts and gross payments required by the direct method. Instead, only the reconciliation of net income to net operating activities, as described above, is reported.

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

Although ASC 230 encourages the use of the direct method, a reporting entity can change from the indirect to the direct method (or vice versa) retrospectively. This retrospective change in the presentation of the statement of cash flows would not be considered a discretionary accounting change and would not require an assessment of preferability.

Even when a reporting entity is using the indirect method, the direct method may be helpful in evaluating the proper classification of cash flows. Example FSP 6-1 illustrates how a reporting entity can use the direct method to isolate cash flows from operations to ensure that the presentation under the indirect method of cash flows from operations is the same.

EXAMPLE FSP 6-1

Foreign currency cash flows in operating and financing cash flows

FSP Corp is a US dollar functional currency entity with two Euro-denominated liabilities: a €1,000 account payable due in 30 days and a €100,000 long-term note due in 3 years that may be repaid at any time, in any increment. At the beginning of the quarter, the spot rate for Euros was $1.20 per €1. The account payable was remeasured at the beginning of the quarter at $1,200 and the long-term note at $120,000. FSP Corp has $50,000 of cash and cash equivalents on the balance sheet at the beginning of the quarter.

A week later, when the spot rate for Euros is $1.15 per €1, FSP Corp pays the €1,000 account payable and settles €40,000 of the note payable. When preparing its financial statements at the end of the quarter, the exchange rate for remeasurement of the remaining €60,000 of long-term note payable is $1.10 per €1. FSP Corp records the following journal entries.

Journal Entry #1

Dr. Accounts payable	$1,200	
Cr. Foreign exchange gains and losses		$50
Cr. Cash		$1,150

To settle the outstanding account payable (foreign exchange gains of $50 (€1,000 x ($1.20-$1.15)) and cash of $1,150 (€1,000 x $1.15)

Journal Entry #2

Dr. Note payable	$48,000	
Cr. Foreign exchange gains and losses		$2,000
Cr. Cash		$46,000

To partially repay the long-term note payable (foreign exchange gains of $2,000 (€40,000 x ($1.20-$1.15)) and cash of $46,000 (€40,000 x $1.15)

Journal Entry #3

Dr. Note payable	$6,000	
Cr. Foreign exchange gains and losses		$6,000

To record the foreign exchange gain on the remeasurement of the outstanding debt of $6,000 (€60,000($1.20-$1.10))*

Ignoring interest and taxes, what is the treatment in the cash flow statement for these three journal entries under the direct and indirect methods?

Analysis

Treatment on the cash flow statement:

	Direct method
Cash flows from operations	
Settlement of accounts payable	$(1,150)
Net cash flows from operating activities	$(1,150)
Cash flows from investing activities	
None	
Net cash flows from investing activities	$ 0
Cash flows from financing activities	
Repayment of notes payable	$(46,000)
Net cash flows from financing activities	$(46,000)
Total change in cash for the quarter	$(47,150)
Cash, cash equivalents, and restricted cash at beginning of the quarter	50,000
Cash, cash equivalents, and restricted cash at end of the quarter	$ 2,850

	Indirect method
Cash flows from operations	
Net income	$ 8,050
Adjustment for non-cash activities:	
Unrealized foreign exchange gains	(6,000)
Adjustment for investing and financing activities recognized in net income:	
Foreign exchange gain on retirement of long-term debt	(2,000)
Change in operating assets and liabilities:	
Change accounts payable	(1,200)
Net cash flows from operating activities	$(1,150)
Cash flows from investing activities	
None	
Net cash flows from investing activities	$ 0
Cash flows from financing activities	
Repayment of notes payable	$(46,000)
Net cash flows from financing activities	$(46,000)
Total change in cash for the quarter	$(47,150)
Cash, cash equivalents, and restricted cash at beginning of the quarter	50,000
Cash, cash equivalents, and restricted cash at end of the quarter	$ 2,850

A common error when preparing the cash flow statement is to present the repayment of €40,000 of the note payable as an outflow of $48,000 (the amount of the debt repayment remeasured to US dollars at the beginning of the period). This results in the foreign exchange gain on the retirement of debt being included in cash flows from operations. In this example, reporting the foreign exchange gain in operations (rather than financing) would have resulted in $850 of net cash inflows from operations, rather than the $1,150 net outflow from operating activities. See FSP 6.11 for further discussion of foreign currency cash flows.

6.4.3 *Cash flow performance measures prohibited*

Whether a reporting entity uses the direct or indirect method to present its operating cash flows, ASC 230-10-45-3 prohibits disclosure of cash flow per share or any component of cash flow per share.

6.5 Cash, cash equivalents, and restricted cash

The statement of cash flows must detail changes in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents for the period. The beginning and ending balance of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents shown on the statement of cash flows should agree to the sum of the amounts on the balance sheet.

6.5.1 Definition of cash

Cash includes cash on hand (e.g., petty cash) and demand deposits with financial institutions.

ASC 230 defines cash as follows.

ASC 230-10-20 Glossary

Cash: Consistent with common usage, cash includes not only currency on hand but demand deposits with banks or other financial institutions. Cash also includes other kinds of accounts that have the general characteristics of demand deposits in that the customer may deposit additional funds at any time and also effectively may withdraw funds at any time without prior notice or penalty. All charges and credits to those accounts are cash receipts or payments to both the entity owning the account and the bank holding it. For example, a bank's granting of a loan by crediting the proceeds to a customer's demand deposit account is a cash payment by the bank and a cash receipt of the customer when the entry is made.

6.5.1.1 Bank overdrafts

Bank overdrafts occur when a bank honors disbursements in excess of funds on deposit in a reporting entity's account. Such a feature is commonly referred to as overdraft protection. Accordingly, bank overdrafts represent short-term loans from the bank and should be classified as debt on the balance sheet and financing cash flows in the statement of cash flows, as discussed in the non-authoritative guidance included in section 1300.15 of the AICPA Technical Questions and Answers.

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

ASC 210, *Balance Sheet*, indicates that a reporting entity's cash account at a bank is not considered an amount owed to the reporting entity for purposes of determining whether a right of offset exists. Accordingly, the ASC 210 offset model cannot be utilized to offset a bank account in a deposit position against another bank account with the same bank that is in an overdraft position. Notwithstanding the guidance in ASC 210, some reporting entities have concluded that the contractual terms of their

notional pooling arrangements preclude individual bank accounts within the arrangement from being considered separate accounts because contractually it functions as one account. In such circumstances, the reporting entity should aggregate all bank accounts that are subject to the notional pooling arrangement into a single balance on its balance sheet and combine these balances when assessing if there is a bank overdraft. However, when a subsidiary that participates in the notional pooling arrangement prepares its financial statements on a standalone basis, the presentation of the subsidiary's bank accounts should reflect the facts and circumstances of the individual subsidiary without consideration of its parent's conclusions regarding the notional pooling arrangement at the consolidated level.

6.5.1.2 Book overdrafts

Non-authoritative guidance included in section 1100.08 of the AICPA Technical Questions and Answers indicates that outstanding checks should be accounted for as a reduction of cash. Book overdrafts are created when the sum of outstanding checks related to a specific bank account is in excess of funds on deposit (including deposits in transit) for that bank account. Unlike a bank overdraft, there is no cash flow impact from a book overdraft. Book overdrafts related to a specific bank account should not be offset against other cash or cash equivalent accounts (including time deposits, certificates of deposit, money market funds, and similar temporary investments). In practice, most preparers reflect book overdrafts as a liability on the balance sheet.

However, a reporting entity may have a contractual banking arrangement whereby the unit of account is the contractual arrangement, not the individual bank account subject to the arrangement (see FSP 6.5.1.1). In such circumstances, the reporting entity should assess the combined balance on deposit for presentation within its balance sheet.

Question FSP 6-2 addresses the presentation of changes in book overdrafts within the statement of cash flows.

Question FSP 6-2

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

PwC response

A book overdraft is not reflected in the statement of cash flows because it only represents the reinstatement of accounts payable and does not result in cash changing hands or credit being extended by a financial institution. Thus, this activity does not represent "proceeds from short-term borrowings" as described in ASC 230-10-45-14 and is not a financing activity.

However, assuming that cash has been reduced for outstanding checks based on the non-authoritative AICPA guidance discussed above, if a zero balance account is linked to a bank overdraft credit facility and checks presented for payment are immediately payable under the credit facility, the "book" overdraft would be, in substance, a "bank" overdraft. This is because the bank can turn presented checks into legal liabilities without further action by the payor. In that case, changes in the overdraft would be classified as financing activities in the statement of cash flows and the overdraft would be presented as debt on the balance sheet.

6.5.1.3 *Checks written but not released*

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

6.5.2 *Definition of cash equivalents*

ASC 230 defines cash equivalents.

ASC 230-10-20 Glossary

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

a. Readily convertible to known amounts of cash

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

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

The definition presumes that all cash equivalents have two attributes: they must be (1) short-term and (2) highly liquid. The definition then provides two characteristics that elaborate on the required attributes. In practice, reporting entities sometimes place singular focus on the maturity characteristic (short-term), while overlooking the readily convertible characteristic (highly liquid). While the FASB's definition elaborates on the maturity characteristic, this does not diminish the requirement for a cash equivalent to be readily convertible to known amounts of cash.

We believe that the following attributes may demonstrate that an instrument is highly liquid:

- Redeemable upon demand without significant penalty from an issuer subject to government or regulatory oversight such as a bank or financial institution

- Traded on an established market

- Convertible to known amounts of cash within normal processing time without significant penalty

Both characteristics included in the definition of cash equivalents must be met for an investment to be considered a cash equivalent. Accordingly, an investment with a maturity of less than three months that is not readily convertible to known amounts of cash is not a cash equivalent. Similarly, an investment that is readily convertible into a known amount of cash, but that has a maturity greater than three months, is also not a cash equivalent. We believe, however, that a liquid instrument with a stated maturity of greater than three months but puttable to the issuer of the instrument at a fixed

amount within three months can be considered a cash equivalent because the put feature creates an effective maturity date within three months.

In its deliberations of ASU 2016-18, *Restricted Cash,* the EITF considered whether restricted cash could be a cash equivalent. Although the EITF did not conclude, the Basis for Conclusions provides a helpful way to think about the interaction between restricted cash and the definition of cash equivalents.

Excerpt from BC9 in ASU 2016-18

... only those financial instruments that first meet the definition of cash or cash equivalents before considering the restrictions that exist in a separate provision outside those financial instruments should be included in the ... total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents on the statement of cash flows.

For an example of how slight degradations to liquidity can impact the ability to classify an investment as a cash equivalent, see FSP 6.5.2.2 regarding an SEC rule that impacts the classification of certain money market funds as cash equivalents.

6.5.2.1 Credit card and debit card payments in transit to a merchant

Some reporting entities include cash in transit from credit and debit payment processors in cash and cash equivalents while others include these amounts in accounts receivable. There is diversity in practice over the classification of payments from credit card and debit card processors which settle shortly after the reporting date. Reporting entities should consistently apply and disclose the treatment of such payments.

6.5.2.2 Money market funds

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

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

- A fund's policies include a provision that requires the weighted average maturity of the fund's securities holdings not to exceed 90 days
- The investor has the ability to redeem the fund's shares daily in accordance with its cash management policy
- The fund's investment attributes are consistent with the investment attributes of an SEC-registered money market fund

An SEC rule mandates the use of a floating net asset value (NAV) for institutional prime money market funds. The SEC notes that under normal circumstances, qualifying money market funds with floating

NAVs are reported as cash equivalents. However, if credit or liquidity issues arise, including the increased potential for the enactment of liquidity fees or redemption gates, investors need to assess the validity of accounting for such money market funds as cash equivalents under such conditions.

6.5.2.3 *Reassessment of money market funds as cash equivalents*

If there are (1) increased credit and liquidity concerns associated with the money market fund, especially if there is a significant decline in net asset value, or (2) there are significant liquidity fees or redemption gates put in place, a money market fund may no longer have the attributes to be considered a cash equivalent. This analysis should be performed at each reporting period. If a money market fund no longer qualifies as a cash equivalent due to such analysis, we believe the corresponding outflow of cash equivalents within the statement of cash flows should be reflected as an investing activity.

Question FSP 6-3 addresses the presentation of a change in the classification of a money market fund.

Question FSP 6-3

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

PwC response

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

6.5.2.4 *Auction rate securities and variable rate demand notes*

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

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

6.5.2.5 *Accounting policy defining cash equivalents*

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

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

Question FSP 6-4 addresses whether overnight repurchase agreements are considered cash equivalents.

Question FSP 6-4

Are overnight repurchase (lending) agreements with financial institutions cash equivalents?

PwC response

Yes. Despite being not redeemable on demand or prior to maturity, an overnight reverse repurchase transaction matures the next day and thus is readily convertible to known amounts of cash, similar to a demand deposit bank account or a treasury bill that trades with one-day settlement (both of which are generally considered cash equivalents).

6.5.3 Restricted cash and restricted cash equivalents

ASC 230 does not define restricted cash or restricted cash equivalents. However, ASC 210-10-45 contains some limited guidance on the balance sheet classification of items that are restricted as to withdrawal or usage. Further, the SEC has some limited guidance on restricted cash (see FSP 6.5.3.4).

In its deliberations of ASU 2016-18, the EITF noted that the definition of restricted cash or restricted cash equivalents has not been a significant source of diversity in practice. As a result, due to the breadth of potential restrictions, it decided not to provide a formal definition, and instead, allow a reporting entity to continue to use its own definition.

While not defined, we believe restricted cash and restricted cash equivalents should generally include any cash or cash equivalent that is legally restricted as to withdrawal or usage. Classification of additional amounts as restricted beyond those that are legally restricted should be subject to a reporting entity's accounting policy. Consistent with the views of most EITF members, we generally do not think that self-imposed designations should be presented as restricted cash or restricted cash unless an entity has an existing policy to do so.

6.5.3.1 Legal restrictions on cash and cash equivalents

Generally, the fact that a reporting entity maintains a separate bank account for funds it owes to a third party does not require the cash or cash equivalents to be restricted on the balance sheet. For example, if the reporting entity is named as the party that has the legal right to deposit into and withdraw from the deposit account (as opposed to being the entity for which the cash or cash equivalent is held), the separate bank account is a matter of internal recordkeeping and is not a legally-segregated cash balance.

If the reporting entity can access the cash or cash equivalents without any legal or contractual consequence (i.e., there is no requirement that the specific cash or cash equivalent be set aside for remittance), the cash or cash equivalent is likely not legally restricted. Even if the entity has a liability for the amount of cash it needs to remit to a customer, it is possible that the entity could raise cash to pay its customer in another way. For example, assuming an entity collects $100 to be remitted to a

customer, it may be able to deploy that $100 for its other operations and then draw $100 from a line of credit and repay the customer, without regard for where the cash was sourced.

6.5.3.2 Compensating balances

Some borrowing arrangements contain compensating balance requirements. Given the lack of definitive guidance related to compensating balances and restricted cash, determining when compensating balances are restricted cash can be challenging. If a compensating balance arrangement legally restricts the use of cash, such amounts should be considered restricted cash. See FSP 6.5.3 for further discussion of this general principle.

Cash that cannot be withdrawn due to compensating balance arrangements should be classified as a noncurrent asset if it relates to the noncurrent portion of the debt that causes its restriction.

Compensating balance arrangements that do not legally restrict the use of cash should be disclosed in the footnotes.

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

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

Excerpt from SEC FRP 203.02.b

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

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

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

Compensating balances related to future credit availability

Some borrowing arrangements do not prohibit the withdrawal of compensating balances, but as a practical matter; future credit availability may be dependent on the maintenance of such balances. Accordingly, reporting entities should disclose this fact (for example, "the compensating balances may be withdrawn, but the availability of short-term lines of credit is dependent upon the maintenance of such compensating balances"). If the borrower is not prohibited from withdrawing the compensating balance and using such funds in current operations, it could be appropriate to include such amounts in the cash and cash equivalent caption depending on the reporting entity's policy for defining restricted cash.

Related parties

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

6.5.3.3 Change in accounting policy on restricted cash and restricted cash equivalents

Any change to a reporting entity's policy for determining restricted cash and restricted cash equivalents must be evaluated as a change in accounting principle subject to a conclusion that the new principle is preferable.

6.5.3.4 Balance sheet presentation of restricted cash and restricted cash equivalents

Restricted cash and restricted cash equivalents are usually presented separately on the face of the balance sheet, or within other assets or similar line items. S-X 5-02(1) requires separate disclosure of the cash and cash items that are restricted as to withdrawal or usage.

The provisions of any restrictions should be described in a footnote. Restrictions may include legally restricted deposits held as compensating balances against short-term borrowing arrangements, contracts entered into with others, or company statements of intention with regard to particular deposits; however, time deposits and short-term certificates of deposit are not generally included in legally restricted deposits. When compensating balance arrangements exist but are not agreements that legally restrict the use of cash amounts shown on the balance sheet, describe in the footnotes these arrangements and the amount involved, if determinable, for the most recent audited balance sheet and for any subsequent unaudited balance sheet. Compensating balances that are maintained under an agreement to assure future credit availability should be disclosed in the footnotes along with the amount and terms of such agreement.

6.5.3.5 Cash flow presentation of restricted cash and restricted cash equivalents

Reporting entities are required to present the change in the cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents balances during the period in the statement of cash flows.

ASC 230 does not define restricted cash or restricted cash equivalents; instead, it refers to "amounts generally described as" restricted cash or restricted cash equivalents. By referring to restricted cash

more broadly, the FASB intended it to encompass all amounts generally described as restricted cash or restricted cash equivalent accounts, regardless of their classification on the balance sheet.

In other words, amounts generally described as restricted cash or restricted cash equivalents are included on the statement of cash flows along with cash and cash equivalents. As a result, a transfer between restricted and unrestricted cash or cash equivalent accounts is not reported as a cash flow. All cash receipts/payments with third parties directly to/from restricted cash or restricted cash equivalent accounts are classified as an operating, investing, or financing cash flow based on the nature of the transaction.

In its deliberations of ASU 2016-18, the EITF considered concerns raised by some comment letter respondents that including restricted and unrestricted cash or cash equivalent balances together in the statement of cash flows could mislead financial statement users about how much cash is available for an entity's operations. The respondents noted that restricted cash or cash equivalents are fundamentally different from unrestricted cash or cash equivalents and may not be available to satisfy general obligations. However, the EITF thought that information about the liquidity of the amounts included in the statement of cash flows is best obtained from the balance sheet, and that the additional required disclosures about the nature of restrictions on cash should mitigate those concerns.

Example FSP 6-2 illustrates how a reporting entity should reflect the proceeds of a debt offering held in escrow by a bank in the statement of cash flows.

EXAMPLE FSP 6-2

Restricted use financing

FSP Corp issues debt in a $100 million bond offering, and, per the bond agreement, the proceeds are distributed to an escrow account that FSP Corp records as restricted cash. The proceeds from the offering are directly transferred from the investor to the trustee-controlled escrow account and FSP Corp never receives the cash from the bond offering in its general cash account. Per the bond agreement, the trustee is instructed to use $40 million of the proceeds to repay FSP Corp's existing debt, while the remaining $60 million will be held in the restricted escrow account until FSP Corp incurs qualifying construction expenditures. At that time, the trustee will make distributions to FSP Corp's general cash account for reimbursement of these incurred costs.

How should this arrangement be reflected in FSP Corp's statement of cash flows?

Analysis

The cash flow statement should reflect a financing inflow of $100 million. Although it is restricted cash, it is part of the change in cash, cash equivalents, and restricted cash. Repayment of the $40 million existing debt is a $40 million financing outflow. When the $60 million is used for construction expenditures, it will be reflected as an investing outflow if it is for the payment of infrastructure, such as PP&E. When the $100 million bond is ultimately repaid, it will be reflected as a financing outflow.

6.5.3.6 Disclosure of restricted cash and restricted cash equivalents

Reporting entities are required to disclose (1) the nature of restrictions on cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents and (2) how the statement of cash flows reconciles to the balance sheet when the balance sheet includes more than one

line item of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. A reporting entity should also consider the significance of amounts generally described as restricted cash or restricted cash equivalents and whether its definition should be disclosed as a significant accounting policy pursuant to ASC 235-10-50.

Nature of restrictions

ASC 230-10-50-7 requires a reporting entity to disclose information about the nature of restrictions on its cash and cash equivalents but does not provide additional detail on what is required to be included in the disclosure. This disclosure could be similar to those already required by S-X 5-02(1) for public companies. While the guidance does not detail what is meant by the "nature of restrictions," it notes items such as the expected duration of the restriction, its purpose and terms, and the amount of cash subject to the restriction. These should not be considered a checklist of items to be disclosed. Reporting entities have flexibility to disclose relevant information about the nature of the restrictions based on their facts.

Reconciliation of the statement of cash flows to the balance sheet

If cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents are presented in multiple line items on the balance sheet, reporting entities are required to present on the face of the statement of cash flows or disclose in the footnotes (in either a narrative or tabular format) a reconciliation of the total amount in the cash flow statement to the amounts presented in the balance sheet. The total should sum to the end-of-period total amount of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents shown on the statement of cash flows. This is consistent with the requirement in ASC 230-10-50-8 for cash and cash equivalents to agree to similarly-titled line items on the balance sheet.

6.6 Gross and net cash flows

Generally, information about the gross amounts of cash receipts and cash payments during a period is more relevant than information about the net amounts of cash receipts and payments. Accordingly, ASC 230 emphasizes gross, rather than net, cash flows. However, netting cash flows in certain circumstances (e.g., receipts and repayments of certain short-term borrowings, certain hedges and items being hedged, and certain cash receipts and cash payments of banks, savings institutions, and credit unions) is permitted. As discussed in ASC 230-10-45-8 and ASC 230-10-45-9, items that qualify for net reporting must have quick turnover, occur in large volumes, and have short maturities (i.e., less than 90 days).

Examples that typically qualify for net reporting include:

- Cash receipts and payments pertaining to trading investments and activities, classified within operating activities
- Cash receipts and disbursements on behalf of customers (e.g., customer demand deposits of a bank and customer accounts payable of a broker-dealer)
- Debt (asset or liability) that has an original maturity of three months or less

  Items that are due on demand are considered to have maturities of three months or less even though they may remain outstanding for longer periods.

- Net borrowings under a revolving line of credit if the credit arrangement requires the borrower to (1) enter into a series of individual notes having a maturity of 90 days or less and (2) repay on maturity of individual notes

  However, it would not be appropriate to present the net change for a revolving line of credit that utilizes notes with a term of more than three months.

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

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

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

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

6.7 Classification of cash flows

ASC 230 identifies three classes of cash flows—investing, financing, and operating—and requires a reporting entity to classify each discrete cash receipt and cash payment (or identifiable sources or uses therein) in one of these three classes. The classification is based on the nature of the cash flow, without regard to whether a cash flow stems from another item (hereafter referred to as the "nature principle"). A cash flow is first evaluated to determine if it meets either the definition of an investing or financing cash flow. If a cash flow does not meet the definition of an investing activity or a financing activity, the cash flow is classified as an operating activity. Cash flows from operating activities are generally the cash effects of events that enter into the determination of net income. However, see FSP 6.7.3 for a discussion of events that enter into the determination of net income that are not classified as operating cash flows.

The definitions of the activity classes within ASC 230, combined with its waterfall model, results in a bias toward classifying cash flows as operating activities. When determining the appropriate classification, the FASB acknowledged that, in some situations, a reasonable case can be made for alternative classifications.

6.7.1 *Investing activities*

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

Following the principles in ASC 230-10-45, the following items should be classified as investing activities:

- Gross cash receipts or cash payments resulting from the acquisition or sale of debt securities (classified as available-for-sale or held-to-maturity) or equity securities of other reporting entities

  However, interest income or dividend income received in cash on such investment securities is an operating cash inflow. Investments accounted for as trading securities under ASC 320-10, when there is a stated intent to buy and sell securities with the objective of generating trading profits, should be classified as operating activities rather than investing activities.

- Distributions received from equity method investees that are deemed a return of investment (see FSP 6.8.3)

- Cash flows from purchases and sales of property, plant, and equipment and other productive assets, including business combinations (see FSP 6.8.13 and FSP 6.8.20) and successful sale-leaseback transactions

  Even though the gain or loss associated with a disposition could theoretically represent a separately identifiable source or use of cash, ASC 230-10-45-12(c) precludes such bifurcation.

- Insurance proceeds directly attributable to casualty losses related to productive assets (see FSP 6.8.21)

- Proceeds from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies (see FSP 6.8.22)

- Cash outflows and inflows associated with reverse repurchase agreements (see Question FSP 6-4)

- Cash outflows and inflows resulting from originations, acquisitions, and sales of loans originally classified as loans held for investment

  Cash flows from these loans should continue to be classified as cash flows from investing activities, even if the reporting entity subsequently reclassifies the loans as held for sale (this is a concept known as symmetry).

- Cash flows resulting from the purchase of receivables from third parties and related collections

- Cash collected subsequent to sales of financial assets from the seller/transferor's interest in sold trade receivables, commonly referred to as a holdback or deferred purchase price (see FSP 6.8.12)

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

6.7.2 *Financing activities*

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

Following the principles in ASC 230-10-45, the following items should be classified as financing activities:

- Payments for debt issue costs (e.g., third-party costs)
- Payments for debt prepayment or debt extinguishment costs (see FSP 6.8.7)
- Proceeds from failed sale-leaseback transactions
- Proceeds from issuing debt
- Payments on seller-financed debt related to the purchase of property, plant, and equipment and other productive assets

  The incurrence of that debt is a noncash financing transaction.
- Stock issuance proceeds, net of stock issuance costs
- Cash dividends and purchases of treasury stock
- Cash activity related to stock subscriptions receivable
- If a reporting entity has a "bank overdraft" at year end, the change in bank overdrafts during the period (see FSP 6.5.1.1)
- Cash proceeds received as collateral under a securities lending program and subsequent repayment of the cash, because the cash received is considered a borrowing
- Cash inflows and outflows associated with repurchase agreements, including transactions accounted for as securitized borrowings

  Net presentation for these cash flows may be permitted.

6.7.3 *Operating activities*

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

ASC 230 defines operating activities.

Excerpt from ASC 230-10-20

Cash flows from operating are generally the cash effects of transactions and other events that enter into the determination of net income.

Following the principles in ASC 230-10-45-16 to ASC 230-10-45-17, the following items should be classified as operating activities:

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

- Interest and dividend receipts related to investments in other reporting entities or deposits with financial institutions (i.e., returns on investment)

  Interest income is considered received when the bank posts the entry to a reporting entity's account. (See FSP 6.8.3 for further discussion of equity method investments.)

- Payments to vendors for inventory or services (including cash expenditures for advertising)

- Payments on short-term or long-term credit extended by the supplier or its affiliate finance subsidiary for the purchase of inventory or other goods and services

  In contrast, payments on credit extended by an entity other than the supplier or its affiliate finance subsidiary are normally a financing activity (see FSP 6.8.10).

- Payments to creditors for interest

- Insurance proceeds related to operating activities (e.g., inventory losses or business interruption) (see FSP 6.8.21)

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

- Payments to governments for taxes

- Payments made to settle an asset retirement obligation

- Cash receipts and cash payments resulting from acquisitions and sales of loans originally classified as loans held for sale

  Cash flows should continue to be classified as operating activities, even if the reporting entity subsequently reclassifies the loans to be held for long-term investment.

- Restructuring payments, including severance

- Cash contributions made to employee benefit plans

- Payments for capitalized implementation costs incurred in a cloud computing arrangement that is a service contract

  ASC 350-40-45-3 requires an entity to classify payments for capitalized implementation costs in the statement of cash flows in the same manner as payments made for fees associated with the hosting element, which would typically be operating cash flows.

Figure FSP 6-2 includes common transactions that enter into the determination of net income, but generally are not classified as operating cash flows.

Figure FSP 6-2
Common transactions that enter into the determination of net income, but generally are not classified as operating cash flows

Description	FSP section
Foreign currency transactions	FSP 6.11
Gains and losses on the disposal of property, plant, and equipment, and other productive assets	FSP 6.8.13
Gains and losses on the sales of debt and equity investments	FSP 6.7.1
Derivative transactions	FSP 6.8.5
Debt extinguishment costs	FSP 6.8.7
Discounts on debt instruments with coupon interest rates that are significant in relation to the effective interest rate of the debt	FSP 6.8.6
Specified portions of contingent consideration settlements made soon after the acquisition	FSP 6.8.20

6.8 Common classification issues

6.8.1 Cash flows with aspects of more than one class

Certain cash receipts and payments may have aspects of more than one class of cash flow. ASC 230 recognizes that the most appropriate classification of an item may not always be clear. ASC 230 provides the following guidance for classifying cash flows that have aspects of more than one class of cash flows:

- *Apply specific US GAAP addressing the statement of cash flow classification (if any)*

  A reporting entity should first apply specific guidance in US GAAP addressing statement of cash flow classification to classify a discrete cash flow. For example, specific guidance in ASC 230-10-45-21C requires settlements of corporate owned life insurance to be reflected entirely as investing cash flows. In addition, there is specific guidance in ASC 230-10-45-15(b) that states that the payment for settlement of a zero coupon bond should be bifurcated between financing and operating cash flows. Therefore, the cash flow classification of these items would follow this guidance.

- *Bifurcate*

  Bifurcate discrete cash flows into separately identifiable sources or uses on the basis of the nature of the underlying cash flows, and then classify each separately identifiable source or use as either investing, financing, or operating. Judgment may be necessary to determine how and when cash flows should be bifurcated, as well as to estimate the amount of each separately identifiable source or use. In making these determinations, a reporting entity should look to the application of other US GAAP. For example, when a reporting entity makes a quarterly payment on amortizing debt, it uses ASC 835, *Interest*, to determine the portion of the payment that relates to interest expense (which enters into the determination of net income) and the portion related to principal. For purposes of the statement of cash flows, the different natures of these separately identifiable uses cause the interest expense portion to be classified as operating and the principal portion to be classified as financing. We generally believe the application of other US GAAP will be indicative of when and how cash flows should be bifurcated. See Example FSP 6-3 for an illustration of the bifurcation of a single cash flow.

- *Predominant activity*

  When a discrete cash flow has aspects of more than one class of cash flows, but it cannot be further bifurcated (see Example FSP 6-4), the appropriate classification should depend on the nature of the expected predominant activity.

Example FSP 6-3 illustrates the cash flow presentation of payments for equipment when it is uncertain if they will be either sold or rented.

EXAMPLE FSP 6-3

Classification of equipment purchases when the equipment is either sold or rented to customers

FSP Corp recently developed a new patented process to detect certain chemicals in waste water. Starting nine months ago, FSP Corp began marketing their product to municipalities and corporate entities that manage waste water. FSP Corp charges a fee each time its patented process is used to analyze a sample. Its commercial process is dependent on a proprietary sampling device, installed at the customer's location, which collects samples that are then sent to FSP Corp for analysis. FSP Corp sells or rents (under an operating lease) the sampling device at cost, as the economics of their business is based solely on the fee charged to analyze a sample. Said differently, FSP Corp is indifferent between selling and renting sampling devices, and will therefore accommodate a customer's individual preference.

Since inception, of the 1,000 sampling devices acquired by municipalities, 500 have been rented and 500 have been sold. Of the 500 sampling devices acquired by corporate customers, 100 have been rented and 400 have been sold. In total, 40% of the devices have been rented and 60% have been sold. FSP Corp expects future sales/rentals to be consistent with their recent history. The sampling devices are manufactured and assembled for FSP Corp by a third party, which delivers new sampling devices once a month. FSP Corp usually keeps a three-month supply of sampling devices on hand.

What is the appropriate classification in the statement of cash flows for the purchase of 100 sampling devices from the third-party manufacturer?

Analysis

Based on the inception-to-date statistics for all customers and the fact that FSP Corp expects future sales/rentals to be consistent with their recent history, the cost of 40% of the devices should be classified as investing (representing the devices that will be carried as long-lived assets and rented to customers) and the cost of 60% of the devices should be classified as operating (representing the devices carried as inventory that will be sold to customers).

By analogy to ASC 230-10-45-12(e), if a sampling device that was originally considered a long-lived asset is instead sold to a customer (i.e., the transaction did not follow original expectations), the sales proceeds should be classified in the same manner as the original purchase, as an investing inflow. Correspondingly, if a sampling device that was originally considered inventory is transferred to long-lived assets and rented to customers, any salvage proceeds received at the end of the device's productive life should be classified as operating, as an operating outflow was recorded upon the purchase of the item. These subsequent balance sheet reclassifications of carrying amounts between inventory and long-lived assets are noncash activities. As a result, it would be inappropriate to adjust the cash flow classification as a result of the balance sheet reclassifications. Going forward, FSP Corp should continue to analyze how sampling devices are deployed, and modify the allocations between operating and investing, as appropriate.

Example FSP 6-4 illustrates the predominance principle.

EXAMPLE FSP 6-4

Classification of equipment purchases when the equipment is rented and later sold

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

What is the appropriate classification in the statement of cash flows for the purchase of the appliances?

Analysis

Cash flows associated with purchasing an appliance to be used to rent to customers would be classified as investing. Cash flows associated with purchasing an appliance to sell to customers would be classified as operating. Since FSP Corp plans to both rent and sell each appliance, the cash flow to purchase the appliance has aspects of both operating and investing activities. Accordingly, FSP Corp would need to determine the nature of the activity that is likely to be the predominant source of cash flows in order to determine how the cash flow for the purchase of the appliances should be classified.

For example, assume FSP Corp expects to rent the new appliances for only a short period of time before selling them. In this fact pattern, the amount of cash flows that it expects to receive from rental income is relatively small compared to the proceeds that it expects to receive from the sale of the appliances. In such circumstances, the appliances would appear to have the nature of an inventory item, and accordingly the cash flows related to the purchase and sale of the appliances should be classified as operating activities.

If, however, FSP Corp expects to rent the new appliances for a longer period of time before selling them, and the amount of cash flows that it expects to receive from rental income as compared to the proceeds received from the sale of the appliances is relatively large, then the appliances have the nature of a long-lived asset. In this case, the cash flows related to the purchase and sale of the appliances should be classified as investing activities.

Application of this predominance principle could have applicability to a wide range of fact patterns. For example, upon disposition of a business, a reporting entity may have historically classified the net proceeds (i.e., gross proceeds, net of transaction costs paid at closing) as an investing inflow. Given that there is no specific guidance related to the classification of transaction costs, application of ASC 230 seems to suggest that the gross proceeds should be classified as an investing inflow, while the transaction costs should be classified as an operating outflow. Accordingly, reporting entities should thoughtfully consider how this aspect of ASC 230 impacts their statement of cash flows.

6.8.2 Subsidiary cash flows when part of centralized treasury function

Many large entities use centralized treasury functions in which subsidiaries' excess cash balances are swept into a cash pool. When the centralized account is under the parent's name, it demonstrates that the parent has legal title to the funds. In addition, subsidiaries may need to notify or obtain permission from the parent when accessing the funds in the cash pool. This kind of arrangement results in due to/from parent in each subsidiary's standalone financial statements. In such circumstances, the intercompany net due to/from parent is, in substance, the subsidiary's cash account. As a result, changes in the due to/from parent account should be reflected as actual cash flows in the subsidiary's standalone statement of cash flows.

- If a subsidiary's balance sheet shows a net due-from-parent, an appropriate classification in the subsidiary's statement of cash flows would be investing, as this balance is akin to making a loan, as contemplated by ASC 230-10-45-12(a) and ASC 230-10-45-13(a).

- If a subsidiary's balance sheet reflects a net due-to-parent, the appropriate classification in the subsidiary's statement of cash flows would be financing, as this balance is similar to issuing debt.

- Alternatively, both a parent and its subsidiaries could classify the cash flow activity associated with due-from-parent and due-to-parent accounts as financing activities based on the consolidating statement of cash flows example included in ASC 830-230-55-2.

For a subsidiary to classify funds in the cash pool as cash and cash equivalents in its standalone financial statements, the subsidiary needs to have control over the funds through legal title and autonomy to access the funds.

6.8.3 Distributions from equity method investees

ASC 230 indicates that cash flows that represent a "return *on* investment" are operating and those representing a "return *of* investment" are investing, and ASC 230-10-45-21D requires that a reporting entity elect an accounting policy to classify distributions received from equity method investees using either the cumulative earnings approach or the nature of distributions approach. This election must be made on an entity-wide basis for all equity method investments. However, as explained below, certain facts and circumstances may require a reporting entity to utilize both methods for different investments.

As discussed in paragraph BC30 of the Basis for Conclusions of ASU 2016-15, *Statement of Cash Flow Classification of Certain Cash Receipts and Cash Payments*, neither method is appropriate for an equity method investment measured using the fair value option, but further guidance is not provided. By analogy to the inherent nature of a derivative (see FSP 6.8.5), we believe that all distributions received from an equity method investment measured using the fair value option should be classified as investing.

The methodologies to determine if a distribution, or a portion of a distribution, from an equity investee is a return on investment or a return of investment are as follows.

- *Cumulative earnings approach*

  The cumulative earnings approach is predicated on the rebuttable presumption that distributions received from equity method investees represent "returns on investment," which ASC 230 indicates are operating, and differentiates between returns on investment and returns of investment by comparing cumulative distributions received by a reporting entity, less distributions received in prior periods that were deemed returns of investment, to its cumulative share of equity earnings (as adjusted for basis differences). When cumulative distributions less distributions received in prior periods that were deemed returns of investment are in excess of cumulative equity earnings, such excess should be considered a return of investment and classified as investing cash flows.

- *Nature of the distribution approach*

  Under the nature of distribution approach, distributions received are classified as either a return on investment or a return of investment on the basis of the nature of the activity or activities of the investee that generated the distribution, when such information is available.

If a reporting entity that elected to apply the nature of the distribution approach is no longer able to obtain the information needed to apply that approach to distributions received from an individual equity method investee, the reporting entity should report a change in accounting principle on a retrospective basis by applying the cumulative earnings approach for that investee. In such situations, an entity should disclose that a change in accounting principle has occurred with respect to the affected investees due to the lack of available information.

Because the nature of distribution approach does not include a presumption that distributions are returns on investment, investors will need to understand the facts and circumstances for each distribution to determine the proper classification. This will require the investor to obtain information about the nature of distributions received from investees, but ASC 230 contains no description of the information needed to make such an assessment. What constitutes sufficient information to apply the nature of distribution approach is a matter of judgment. The process used by investors to determine classification should be systematic, rational, and applied consistently from period to period.

Example FSP 6-5 and Example FSP 6-6 demonstrate the determination of a return of investment versus return on investment using the cumulative earnings approach.

EXAMPLE FSP 6-5

Return of investment versus return on investment under the cumulative earnings approach

FSP Corp is a calendar year-end SEC registrant with a 20% equity investment in a joint venture, EM Company. The initial cash investment by FSP Corp on January 1, 20X1 for the 20% interest is $25,000. The investment is accounted for as an equity method investment, and there is no basis difference between FSP Corp's equity investment and the underlying equity of EM Company.

FSP Corp's share of EM Company's income/loss) and the related share of dividend distributions for the last four years are as follows:

	Share of net income/(loss)	Share of dividend distributions
12/31/20X1	$(2,000)	$1,000
12/31/20X2	$(1,000)	$1,000
12/31/20X3	$5,000	$3,000
12/31/20X4	$6,000	$3,000

How should the distributions be classified in the statement of cash flows for each of these periods?

Analysis

If the investor's inception-to-date distributions are greater than the investor's inception-to-date earnings, the presumption is that the equity method investee utilized a portion of the funds initially invested to pay all, or a portion of, the cash distributions. As noted above, FSP Corp received distributions of $1,000 for the years ended December 31, 20X1 and December 31, 20X2 when EM Company incurred net losses. As such, FSP Corp would conclude that EM Company paid the distributions from its capital balance, which would be considered a return of investment and classified as an investing inflow within FSP Corp's statement of cash flows.

For the year ended December 31, 20X3, the distribution received by FSP Corp would be allocated between return on investment and return of investment because, even though FSP's Corp inception-to-date distribution exceeded its inception-to-date earnings, for the first time FSP Corp's inception-to-date earnings were positive and therefore eligible to be considered as a portion of the 20X3 distributions. For the year ended December 31, 20X4, FSP Corp's inception-to-date earnings exceeded the inception-to-date distributions adjusted for prior period distributions that were previously deemed returns of investment, and therefore the entire 20X4 distribution would be considered a return on investment and classified as an operating activity within FSP Corp's statement of cash flows.

EM Company's historical retained earnings balance prior to FSP Corp's investment of $25,000 is not relevant for purposes of determining the classification of the distribution in FSP Corp's statement of cash flows. FSP Corp should only consider EM Company's earnings for purposes of the cumulative earnings approach beginning when FSP Corp made its investment in EM Company.

The following table summarizes the impact to FSP Corp:

End of period	FSP Corp's 20% share of EM Company's annual net income/(loss)	FSP Corp's share of EM Company's cumulative earnings since investment inception	FSP Corp's 20% share of dividend distribution	Statement of cash flows classification	
				Operating	Investing
12/31/20X1	$(2,000)	$(2,000)	$1,000		$1,000
12/31/20X2	$(1,000)	$(3,000)	$1,000		$1,000
12/31/20X3	$ 5,000	$ 2,000	$3,000	$2,000	$1,000
12/31/20X4	$ 6,000	$ 8,000	$3,000	$3,000	

EXAMPLE FSP 6-6

Return of investment versus return on investment during interim periods under the cumulative earnings approach

FSP Corp receives a dividend from its equity method investee during an interim period. Based upon an analysis of inception-to-date distributions compared to inception-to-date earnings, it would appear the dividend received in the interim period should be considered a return of investment and classified as an investing inflow by the reporting entity. However, when forecasted earnings for the entire fiscal year are considered, inception-to-date earnings are expected to be greater than inception-to-date distributions. Thus, the dividend exceeds the investee's current quarterly earnings (and the inception-to-date earnings) but does not exceed forecasted annual earnings.

How should the reporting entity classify the cash dividend received in its interim period statement of cash flows?

Analysis

We believe that it is acceptable for a reporting entity to consider the investee's forecasted annual earnings in classifying dividends as either a return on or return of investment under the cumulative earnings approach. We also believe it is acceptable to analyze dividends received on a quarter-by-quarter basis without consideration of the investee's forecasted earnings. The approach followed should be disclosed and consistently applied in all periods for similar investments.

6.8.4 *Contributions and advances to joint ventures*

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

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

6.8.5 *Derivatives*

Generally, cash flows related to a derivative, whether over-the-counter or centrally-cleared, should be classified according to their nature, which is that of an investing activity. However, ASC 230-10-45-27

indicates that a reporting entity may elect an accounting policy to classify the cash flows from derivatives designated in a qualifying fair value or cash flow hedging relationship in the same category as the cash flows from the hedged items, provided there is no other-than-insignificant financing element (see FSP 6.8.5.5), and this treatment is disclosed. Refer to FSP 6.8.5.3 and 6.8.5.4 for discussions of the cash flow classification of derivatives used in economic hedges and net investment hedges, respectively.

Even under a policy to classify the cash flows from derivatives designated in a qualifying hedging relationship in the same category as the cash flows from the hedged items, reporting entities may treat cash payments and receipts on collateral as investing cash flows when the collateral account is in an asset position, and as financing cash flows when the collateral account is in a liability position. Example FSP 6-7 illustrates this treatment in the statement of cash flows.

EXAMPLE FSP 6-7

Cash flows presentation on the movement of derivative collateral.

FSP Corp and its counterparty (broker) post and receive collateral each month for the entire fair value of an over-the-counter derivative contract. The derivative's trade date is August 5, 20X1. At the end of the first month, the contract is a $100 liability to FSP Corp, and it posts collateral of $100 with the broker. The following month the derivative's liability increases to $125, then in the subsequent month, the liability becomes smaller. In November the derivative contract becomes an asset of $25, and in December the asset falls in value to $15.

Below are the transactions on a monthly basis and the treatment of the corresponding cash flows related to collateral, based on the changes in fair value of the derivative.

Date	Fair value of the derivative asset or (liability)	Collateral cash received	Collateral cash paid	Collateral asset / Due from broker balance	Collateral liability / Due to broker balance	Investing or financing cash flow
8/05/X1	0					
8/30/X1	($100)		($100)	$100		$100 Investing outflow
9/30/X1	($125)		($25)	$125		$25 Investing outflow
10/31/X1	($55)	$70		$55		$70 Investing inflow
11/30/X1	$25	$80		0	$25	$55 Investing inflow and $25 Financing inflow
12/31/X1	$15		($10)		$15	$10 Financing outflow

As highlighted above, in November, when the derivative moves from a liability to an asset, the collateral account moves from an asset to a liability, as the broker has repaid all $125 of collateral that had been paid by FSP Corp and paid an additional $25 to satisfy the collateral exposure FSP Corp has

to the broker for the derivative asset. In November the $80 received is a combination of a $55 investing inflow and a $25 financing inflow representing the extinguishment of the collateral asset/due from broker and creation of a collateral liability/due to broker.

6.8.5.1 *Centrally-cleared derivatives*

Certain central clearing parties, including the London Clearing House (LCH) and Chicago Mercantile Exchange (CME), have implemented rules so that a variation margin payment is legally considered a settlement payment, as opposed to the posting of collateral. For these contracts (referred to as "settled-to-market" or STM contracts), the derivative contract, variation margin, and interest on the cumulative variation margin (referred to as "price alignment interest," PAI, or "price alignment," PA) are viewed as a single unit of account.

For STM contracts, if a derivative does not have an "other-than-insignificant" financing element, we understand that the SEC staff would not object to a registrant continuing to report variation margin payments and "derivative settlements" in different categories in the statement of cash flows. This is based on a view that ASC 230 would support concluding that variation margin payments are separately identifiable sources and uses of cash flows that are distinguishable from "other derivative cash flows." This view acknowledges that in this circumstance, the unit of account for balance sheet purposes is not determinative of the presentation of separately identifiable cash flows. We also understand that the SEC staff would not object to classifying all of the payments related to an STM contract as a single unit of account reported within the same classification in the statement of cash flows.

Question FSP 6-5 addresses the classification of a qualifying hedging instrument in the statement of cash flows.

Question FSP 6-5

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

PwC response

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

6.8.5.2 *After hedge termination*

When an individual hedge relationship is discontinued because the hedged item has been settled, or will no longer occur, any cash flows from the derivative instrument subsequent to the date hedge accounting is discontinued should be classified in accordance with a derivative's nature as an investing activity. The cash flows should be classified as an investing activity because there are no cash flows from the hedged item for the classification of the derivative's cash flows to follow. If only the derivative

is settled or closed out, and the hedged item will continue to be accounted for, the derivative settlement cash flows should be classified according to the reporting entity's policy for derivative settlements (i.e., as either investing cash flows or by following the classification of the hedged item).

In some instances, a cash flow resulting from the termination of a hedging instrument may be viewed as occurring simultaneously with discontinuance and disposal of the hedged item – not subsequent to the discontinuance. In that case, the derivative settlement should also be classified according to the reporting entity's policy for derivative settlement.

6.8.5.3 *Derivatives used in economic hedges*

Reporting entities frequently enter into derivative transactions for hedging purposes, but do not elect to apply the hedge accounting rules in ASC 815. Such transactions are commonly referred to as "economic hedges." The literature does not specifically afford reporting entities the ability to elect an accounting policy to reflect classification of the cash flows of the economic hedge with cash flow classification of the hedged items (as ASC 230-10-45-27 permits mimicking the classification of the hedged item for designated fair value and cash flow accounting hedges). We believe that a literal application of the nature principle (see FSP 6.8.1), combined with other guidance in ASC 230 pertaining to classifying cash flows related to derivatives, would lead a reporting entity to classify the cash flows related to an economic hedge as investing. However, we note that the predominant practice is to classify these derivative cash flows according to the classification of cash flows of the economic "hedged item" when the reporting entity has a policy to do so under ASC 230-10-45-27. We have also observed this practice when reporting entities only have economic hedges. This practice has been acknowledged by regulators. Accordingly, we do not object to a reporting entity electing a policy to classify cash flows related to economic hedges following the classification of cash flows of the economic hedged items consistent with their policy for derivatives designated in hedge accounting relationships, assuming the practice is consistently applied and clearly disclosed.

Example FSP 6-8 illustrates an economic hedge.

EXAMPLE FSP 6-8

Cash flows related to an economic hedge

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

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

Analysis

The cash flows from the economic hedged item (oil production) would be reflected in operating cash flows. We believe FSP Corp may also classify the derivatives' cash flows as operating, if it has elected

an accounting policy to classify hedging cash flows in the same category in the statement of cash flows as the category for the cash flows from hedged items. Absent such a policy decision, the nature of a derivative is an investing activity. The changes in fair value of the derivative from period-to-period that are recognized in earnings represent a noncash adjustment in the reconciliation of net income to operating cash flows under the indirect method. These adjustments are separate from the actual cash settlements, classified as investing or operating, discussed in this example.

6.8.5.4 Derivatives used in net investment hedges

Reporting entities with global operations frequently hedge the investment made in their foreign subsidiaries with net investment hedges. Example FSP 6-9 illustrates the classification of cash received from the settlement of derivatives accounted for as a net investment hedge.

EXAMPLE FSP 6-9

Classifying cash flows from settlement of a net investment hedge

FSP Corp, a US parent company, enters into a foreign currency forward exchange contract to sell British pounds (GBP) and receive US dollars, and designates the forward exchange contract as a net investment hedge of its British subsidiary whose functional currency is the British pound. Under the spot method for hedges of net investments, the portion of the changes in the fair value of the forward exchange contract attributable to changes in the prevailing USD/GBP spot rate, are recorded in the cumulative translation adjustment (CTA) account, which is a component of OCI, and will remain there until the investment in the subsidiary is sold or substantially liquidated in accordance with ASC 830, *Foreign Currency Matters*. Any change in fair value of the excluded component is recognized in earnings or is deferred to CTA and systematically amortized to earnings. At the expiration of the forward exchange contract, FSP Corp receives $2 million from the counterparty.

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

Analysis

The cash received from settlement of the net investment hedge should be classified as an investing activity in the statement of cash flows. Investing classification is appropriate as the hedged item is the investment in a foreign subsidiary and the cash paid or received from acquiring or selling the subsidiary would typically be classified as investing under ASC 230-10-45. Additionally, ASC 230-10-45-27 further supports an investing classification as the FASB believed that the purchase or sale of a forward contract is an investing activity. Therefore, the $2 million received from the settlement of the net investment hedge should be classified as an investing inflow.

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

When employing cross currency swaps rather than forward contracts, under the spot method, the periodic settlements of the swaps are frequently recorded as interest income or expense in the income statement representing the amortization to earnings of the derivative's excluded component. Generally, cash flows on cross currency swaps used to hedge a net investment are classified (1) as

investing cash flows, consistent with a derivative's nature, or (2) consistent with the nature of the hedged item (depending on the entity's policy election under ASC 230-10-45). However, in certain circumstances, reporting entities have presented periodic settlements of cross currency swaps (both outflows and inflows) as operating cash flows under the concept that a derivative that relates to a specified debt instrument approximates an economic interest in foreign-denominated debt. Under this view, the periodic settlements on the cross currency swap are reported with the interest on the related debt instrument as operating cash flows.

Notwithstanding the cash flow treatment of the periodic swap settlements, the cash flows from sales or liquidation of the subsidiary will be investing cash flows.

6.8.5.5 Derivatives with financing elements

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

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

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

For STM contracts, since variation margin and interest received or paid on the cumulative variation margin amount are considered part of a single unit of account, if a derivative has an "other-than-insignificant" financing element, cash flows associated with variation margin, price alignment, and price alignment interest must also be reported as financing activities.

Example FSP 6-10 illustrates the classification of cash flows associated with acquired forward contracts.

EXAMPLE FSP 6-10

Classifying cash flows associated with acquired derivatives

FSP Corp uses its common stock to acquire another company in a transaction accounted for as a business combination under ASC 805. At the acquisition date, the acquired company held derivatives

in the form of physically settled commodity forward contracts originated by the acquired company. Based on the difference between market prices at the date of the acquisition and the historical terms of the acquired forward contracts, all of the forward contracts are in a liability position, and they all are deemed to contain an "other-than-insignificant" financing element.

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

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

Analysis

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

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

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

6.8.6 Discounts and premiums on debt instruments

When a debt instrument is issued at a discount, the cash proceeds received (i.e., face value of the debt instrument less the discount) is classified as a financing inflow for the issuer. The classification of subsequent payments related to debt issued at a discount can vary.

6.8.6.1 Zero coupon debt instruments and other deeply-discounted debt instruments

The cash received upon issuance of a zero coupon debt instrument is classified as a financing inflow and the discount accretion in subsequent periods is included as a positive adjustment in the reconciliation of net income to operating cash flows under the indirect method of presentation.

ASC 230 requires that cash payments for the settlement of zero-coupon debt instruments, or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing, be allocated between financing and operating as follows:

- Operating: the portion of the cash payment attributable to accreted interest on the debt discount
- Financing: the portion of the cash payment attributable to the proceeds received at issuance

ASU 2016-15 introduced the concept of an insignificant coupon when compared to the effective rate of the debt instrument. During deliberations of ASU 2016-15, the EITF was concerned that if the scope was not expanded beyond zero-coupon debt instruments, there could be reduced comparability with the classification of economically similar instruments, such as a deeply discounted debt instrument with a *near* zero-coupon interest rate. As such, ASC 230-10-45-17 includes debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing but does not define what is meant by "insignificant in relation to the effective interest rate of the borrowing" so preparers will need to apply judgment in making this determination. In practice, we have seen reporting entities define insignificant as amounts that are less than 10%. We would view a coupon rate to be insignificant if this rate was less than 10% of the effective rate on the instrument (e.g., a 0.25% coupon rate where the effective rate of the instrument was 2.501% or higher).

The guidance in ASC 230-10-45-17 for zero-coupon debt instruments or those with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing should not be applied to other debt instruments issued at a discount when the coupon is not insignificant. Therefore, the entire cash outflow associated with the settlement of debt issued at a discount should be reflected as a financing outflow.

Example FSP 6-11 illustrates the cash flow classification of repayment of a debt issued at a discount with an insignificant coupon and Example FSP 6-12 illustrates the cash flow classification of repayment of a debt with a bifurcated feature resulting in an insignificant coupon on the debt host.

EXAMPLE FSP 6-11

Statement of cash flow classification of repayment of debt issued at a discount and with an insignificant coupon

FSP Corp issued 0.5% debt with a par value of $1,000. Cash proceeds received at issuance were $780. The debt matures in seven years and is callable at par by FSP Corp after the fifth year. At the time of issuance, FSP Corp also issued term debt at par with a coupon and effective interest rate of a 5.68%. After comparing the contractual coupon rate of 0.5% to the effective rate of 5.68%, FSP Corp concluded that the coupon rate is insignificant in relation to the effective rate of the bond (0.5%/5.68% = 8.8%, which is less than 10% of the effective rate and is therefore considered insignificant).

Five years after issuance, FSP Corp exercised its call option to prepay the debt and paid the issuer $1,000.

How should FSP Corp classify the payments in its statement of cash flows?

Analysis

Since FSP Corp determined that the bond is deeply discounted with an insignificant coupon, it would classify an outflow of $780 as a financing activity (because that is the portion of the consideration paid to settle the amounts attributable to the proceeds received at issuance). The $220 difference between the $1,000 extinguishment price and the $780 initial proceeds would be classified as an operating activity because that is the amount associated with the cash paid for accreted interest on the debt discount.

EXAMPLE FSP 6-12

Statement of cash flow classification of repayment of debt with a bifurcated feature and an insignificant coupon

FSP Corp issued 6% debt with a par value of $1,000. FSP Corp determined that the debt included an embedded derivative that required bifurcation. Cash proceeds received at issuance were $1,000 and the debt matures in one year. At the time of issuance, FSP Corp allocated $400 to the bifurcated component and $600 ($1,000 par value less $400 discount) to the debt host liability, resulting in a 76.7% effective interest rate. After comparing the contractual coupon rate of 6% to the effective rate of 76.7%, FSP Corp concluded that the coupon rate is insignificant in relation to the effective rate of the bond (6%/76.7% = 7.8%, which is less than 10% of the effective rate and is therefore insignificant).

At the maturity date, the embedded feature had expired and FSP Corp repaid the debt for $1,000.

How should FSP Corp classify the payments in its statement of cash flows?

Analysis

Since FSP Corp determined that the bond is deeply discounted with an insignificant coupon, it would classify an outflow of $600 as a financing activity (because that is the portion of the consideration paid to settle the amounts attributable to the proceeds received at issuance). The $400 difference between the $1,000 allocated to the extinguishment price and the $600 would be classified as an operating activity because that is the amount associated with the cash paid for accreted interest on the debt discount.

6.8.6.2 *Payment in kind interest (PIK notes)*

The terms of debt instruments may permit or require the borrower to satisfy interest payments on the debt by issuing additional paid-in-kind (PIK) notes having identical terms as the original debt instead of paying in cash. We believe that a PIK note is in substance the same as a zero coupon bond. That is, in both a PIK note and a zero coupon bond, the interest due on the original principal amount of debt is accrued and added to the debt balance. Therefore, we believe the guidance for zero coupon bonds should be followed for payments made to extinguish PIK notes as well. For example, if debt with a $100 principal amount was issued at par and the issuer satisfied $15 of interest by issuing additional notes, the borrower would pay $115 at maturity. On the extinguishment date, when the borrower pays $115 in cash to settle the debt, the $100 representing the original amount of proceeds received at issuance would be classified as a financing outflow, and the remaining $15 attributable to accreted interest would be classified as an operating cash outflow.

6.8.6.3 *Debt issued at a premium*

Consistent with the conclusion in ASU 2016-15 concerning debt discounts associated with debt instruments with coupon interest rates that are not insignificant in relation to the effective interest rate of the debt, we believe that it would be acceptable for the proceeds from debt issued at a premium to be reflected as a financing inflow. Premium amortization in subsequent periods is included as a reduction of net income in the reconciliation of net income to operating cash flows. When the debt is repaid, it would be acceptable for the entire cash outflow to be classified as a financing outflow.

Alternatively, it would also be acceptable to treat the contractual coupon cash flows paid in excess of the effective rate recognized as a financing outflow representing the repayment of the initial proceeds of the debt in excess of the contractual principal. A third approach has also been observed in practice in which the issuer splits the initial proceeds into an operating inflow for the initial proceeds in excess of the contractual principal due (i.e., the premium on the debt) and classifies the contractual principal of the debt as an inflow from financing activities. Subsequently, all contractual cash coupon payments are classified as operating outflows. While this technique results in the same cash flow classifications as the alternative approach in the aggregate across all cash flow periods, it does so by having earlier operating cash flows in the period of debt issuance and less operating cash flows in the subsequent periods.

To illustrate, assume a debt issuance of $1,000 principal has a stated coupon of 4%. The effective market rate is 3% and the initial proceeds are $1,100. The three approaches for classification in the cash flow statement of the borrowing, interest, and repayment cash flows over the life of the debt are:

- Approach 1: The initial proceeds of $1,100 would be classified as financing inflows. The $40 coupon payments would be classified as operating outflows (interest). Finally, the $1,000 payment to retire the debt at its maturity would be classified as a financing outflow.

- Approach 2: The initial proceeds of $1,100 would be classified as financing inflows. The contractual coupons would be split into operating outflows for the effective rate of interest and financing outflows for the excess of the coupon paid above the recognized interest expense as partial repayments on the outstanding debt balance. Finally, the $1,000 payment to retire the debt at its maturity would be classified as a financing outflow.

- Approach 3: The initial proceeds of $1,100 would be split into a $100 operating inflow as receipt of interest in exchange for agreeing to make coupon payments that are greater than market rates, and $1,000 for contractual principal due as a financing inflow. The entirety of the $40 coupon payments would be subsequently classified as operating outflows for interest. Finally, the $1,000 payment to retire the debt at its maturity would be classified as a financing outflow.

6.8.7 Debt extinguishment costs

ASC 230 requires that cash payments for debt prepayment or other debt extinguishment costs, including third-party costs, premiums paid, and other fees paid to lenders that are directly related to the debt prepayment or extinguishment, be classified as financing activities in the statement of cash flows. The Basis for Conclusions in ASU 2016-15 stated that some members of the EITF noted that this was appropriate because such costs are associated with the extinguishment of the debt principal and because many view these costs as being similar to debt issue costs, which are also classified as financing outflows.

6.8.8 Debt restructurings accounted for under ASC 470-50

A debt restructuring is accounted for as either a modification or as an extinguishment. The statement of cash flows classification of cash exchanged in a debt restructuring depends on the accounting for the restructuring, the counterparties involved, and the nature of the payments being made. See FG 3 for a detailed discussion of accounting for modifications and extinguishments as well as accounting for modifications to lines of credit and revolving debt arrangements.

The treatment of unamortized fees or principal that remains outstanding is not addressed, as there is no cash flow effect. If they are expensed in the period, however, they will be a reconciling item between net income and cash flow from operations.

6.8.8.1 *Term debt modifications*

In connection with a restructuring of term debt accounted for as a modification, companies may incur creditor fees and fees to other parties. Creditor fees incurred in these situations are capitalized as a debt discount and amortized. According to ASC 230-10-45-17(d), when a discount is repaid for debt instruments with coupon interest rates that are not insignificant in relation to the effective interest rate of the debt, the repayment of that discount should be a financing cash outflow. In a modification, the creditor fees paid on the modification date are capitalized as a debt discount. Therefore, the borrower is paying that portion of the discount on the modification date. By analogy to ASC 230-10-45-15(g), we believe that it is acceptable to classify all creditor fees incurred in conjunction with a debt restructuring accounted for as a modification as financing cash outflows.

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

6.8.8.2 *Term debt extinguishments*

As required in ASC 230-10-45-15(g), all fees incurred in conjunction with a debt restructuring that is accounted for as an extinguishment under ASC 470-50 (irrespective of whether the fees are paid to creditors or third parties) should follow the same classification as discussed in FSP 6.8.7 for debt extinguishment payments costs, which are financing outflows.

6.8.8.3 *Restructuring of a term loan syndication*

Syndicated loans involve multiple lenders and a single borrower. While the terms of the loan may be identical or virtually identical with each lender, they are legally separate loans between the borrower and each syndicate lender. When determining the treatment in the statement of cash flows when the proceeds from a new term loan syndication are used to repay an existing term loan syndication and there are lenders that roll over from the existing loan syndicate to the new loan syndicate, each loan should be analyzed separately.

The reporting entity must assess each lender to determine if it is a new lender (i.e., did not hold debt in the original syndicate), exiting lender (i.e., does not hold debt in the new syndicate), or rollover lender (i.e., holds debt in both the original and new syndicate). Additionally, the reporting entity must assess whether the debt held by the rollover lenders is accounted for as an extinguishment or a modification of the debt on a lender-by-lender basis, as discussed in FG 3.6.

Amounts paid to or received from new and exiting lenders

In all cases, proceeds received from new lenders (net of lender fees) are financing inflows and amounts paid to exiting lenders (including any lender fees) are financing outflows (assuming the debt does not have an insignificant coupon, as discussed in FSP 6.8.6).

Amounts paid to or received from rollover lenders

The presentation for rollover lenders is more complicated and depends on the form of the transaction and the accounting for each lender.

- **Cash is exchanged on a gross basis**

  In certain circumstances, a reporting entity receives proceeds for the entire amount of the lending provided by the new debt syndicate and repays the entire amount owed to the existing debt syndicate. That is, each lender (including rollover lenders) gives the reporting entity cash equal to the lender's entire portion of the new debt syndicate, and each lender receives full payment equal to the lender's entire portion of the existing debt syndicate. In this scenario, we believe the reporting entity should follow the form of the transaction and reflect the entire amount repaid and the entire amount of new proceeds received separately as a cash outflow and inflow from financing activities, respectively.

  Alternatively, if a particular lender's restructuring was accounted for as a modification based on the guidance in ASC 470-50-40, the reporting entity can elect to present only the *net change* for that particular lender. In this case, only the net cash received or paid, representing the net change in principal balance of the debt for that lender, would be reflected in the cash flow statement. This alternative election is a policy choice that should be applied consistently. See Example FSP 6-13 for an illustration of this scenario. Such net presentation is not permitted if the lender's restructuring is accounted for as an extinguishment based on the guidance in ASC 470-50-40.

- **Cash is exchanged only for principal balance changes less lender fees**

  In certain circumstances, the rollover lenders would give the reporting entity cash only if their principal balance less lender fees in the new syndicate increased and would receive money only if their principal in the new syndicate decreased or they are receiving a lender fee. In this scenario, the reporting entity must present the cash receipts or repayments as financing inflows or outflows, respectively, based on the actual cash exchanged with each lender.

  Third-party fees

  The cash flow presentation for third-party fees (e.g., legal fees) incurred in the transaction are assessed separately from cash flows exchanged with lenders because payments are made to different parties. As discussed in FG 3.6.1, third-party fees are allocated to each lender using a rational approach to determine the accounting for such fees. The cash flow classification for these fees depends on the type of lender as follows:

Lender type	Cash flow classification of third-party fees
New lender	Financing
Exiting lender	Financing
Rollover lender accounted for as a modification	Operating
Rollover lender accounted for as an extinguishment	Financing

□ **Reporting entity uses a transfer agent to facilitate the cash flows**

A reporting entity may engage a transfer agent (often an investment bank) to assist in a debt restructuring. In these cases, the transfer agent collects the proceeds from the new debt issuance and repays the original debt on the reporting entity's behalf. Typically, the reporting entity receives only the net difference between the proceeds received and the amounts paid. In these circumstances, the reporting entity should apply the constructive receipts and disbursement guidance discussed in FSP 6.9.2.1. Therefore, all cash that the transfer agent receives or pays on behalf of the reporting entity should be reflected in the cash flow statement as if it was received or paid by the reporting entity.

Example FSP 6-13 illustrates classification of the restructuring of a term loan syndication on the statement of cash flows. This example uses the same facts as in Example FG 3-7 in PwC's Financing transactions guide.

EXAMPLE FSP 6-13

Statement of cash flow classification of the restructuring of a term loan syndication

FG Corp had a syndicated loan arrangement aggregating to $52 million. FG Corp needs additional financing and replaces its original syndicated loan arrangement with a new syndicated loan arrangement aggregating to $100 million. There are $4 million dollars in lender fees. Therefore, the net proceeds received from the new debt are $96 million. There are also $1 million of third-party costs.

The transaction is structured such that FG Corp receives $96 million in cash proceeds from the new debt. FG Corp uses $52 million of those proceeds to immediately repay the entire amount of existing debt and uses $1 million to pay third-party costs.

There are three lenders in the original syndication that also are lenders in the new syndication. Each of the loans with these rollover lenders is accounted for as a modification.

The following table summarizes changes to the syndicated loan on a lender-by-lender basis as well as the fees and costs allocated to each lender.

Bank	Balance of original syndication	Balance of new syndication	Principal change	Lender fees	Third-party costs
A	$5,000,000	$5,000,000	-	$200,000	$50,000
B	$20,000,000	$30,000,000	$10,000,000	$1,200,000	$300,000
C	-	$60,000,000	$60,000,000	$2,400,000	$600,000
D	$12,000,000	$5,000,000	$(7,000,000)	$200,000	$50,000
E	$15,000,000	-	$(15,000,000)	-	-
Total	**$52,000,000**	**$100,000,000**	**$48,000,000**	**$4,000,000**	**$1,000,000**

How should the transaction be reflected on the statement of cash flows?

Analysis

Amounts paid to or received from lenders are analyzed separately from third-party costs because third-party costs are paid to parties other than the lender.

Amounts paid to or received from lenders

Since the structure of the transaction was such that FG Corp received proceeds of $96 million (new principal less lender fees) in cash and used $52 million of those proceeds to pay off the existing debt at the same time, the presentation depends on FG Corp's policy election (as described above):

- **Follow the form of the transaction**

  Under this approach, FG Corp presents a financing inflow for $96 million (proceeds received) and a financing outflow for the $52 million used to repay the original debt. This presentation does not require a lender-by-lender assessment.

- **Present the net change by lender**

  FG Corp can follow this approach for all the rollover lenders because each is accounted for as a modification. Under this approach, FG Corp reviews the net change for each rollover lender.

  If the rollover lender's principal balance has increased, a financing inflow is reflected for the principal change less any lender fees paid.

  If the rollover lender's principal balance has decreased, a financing outflow is reflected for the principal decrease plus lender fees.

  If the rollover lender's principal balance has not changed but a lender fee was paid, we believe this fee should be a financing outflow.

Any new or exiting lender would reflect financing inflows and outflows based on amounts paid/received as illustrated in the table below.

Lender	Financing inflow	Financing outflow
A: Rollover lender (modification)		($200,000)
B: Rollover lender (modification)	$8,800,000	
C: New lender	$57,600,000	
D: Rollover lender (modification)		($7,200,000)
E: Exiting lender		($15,000,000)
Totals	**$66,400,000**	**($22,400,000)**

Third-party fees

Third-party fees are presented based on the accounting for each lender and the amounts allocated. These amounts are not netted against the amounts paid to or received from the lenders under either presentation above. This was assessed as follows.

Lender	Financing outflow	Operating outflow
A: Rollover lender (modification)		($50,000)
B: Rollover lender (modification)		($300,000)
C: New lender	($600,000)	-
D: Rollover lender (modification)		($50,000)
E. Exiting lender (no third-party costs were allocated to the original loan)		
Total	**($600,000)**	**($400,000)**

6.8.8.4 Modifications to line of credit and revolving debt arrangements

Third-party and creditor fees incurred in connection with a modification to a line of credit or revolving debt arrangement are considered to be associated with the new arrangement and should therefore be capitalized. We believe the classification of these costs in the statement of cash flows depends on the purpose of the line of credit. Will it be drawn upon, or is it more like “insurance” that enables the entity to access cash should it be needed?

- *If the reporting entity does not intend to draw down on the line*: All third-party and creditor fees should be classified as operating activities because the entity does not expect them to be related to a borrowing.

- *If the reporting entity intends to draw down on the line*: The fees are costs to issue debt in the future and should be classified as financing outflows.

6.8.8.5 Troubled debt restructurings

A troubled debt restructuring (TDR) can occur in a variety of ways including delivering assets or equity to fully or partially settle the debt and modifying the debt terms. In certain situations, a gain is recognized, and if there are ongoing debt service payments, the carrying value of the debt is set at the undiscounted future cash flow amount. In these cases, all ongoing debt service payments reduce the carrying value of the debt, and no interest expense is recognized going forward. See FG 3.3 for further details on TDRs.

Some of the key cash flow considerations relating to TDRs include the following.

- Any delivery of equity or assets to partially or fully settle debt should be reported as noncash investing or financing activities, as appropriate.

- Costs incurred with third parties directly related to the restructuring (including legal fees) generally should be classified in operating; however, any direct costs associated with the issuance of equity securities in partial or full settlement of the debt should be reflected as financing outflows.

- Any fees paid to the lender should be classified as a financing outflow.

- When debt is modified in a troubled debt restructuring, presentation of the subsequent cash payments made post restructuring depends on whether there was a gain recorded from the modification of terms.

- *Gain recognized*

  All ongoing debt payments should be reflected as financing outflows. This includes any contractual interest payments since, for accounting purposes, all payments are treated as reductions to the carrying value of the debt instead of interest expense.

- *No gain recognized*

  Ongoing debt payments should be reflected in a manner consistent with non-troubled debt. Interest payments should be reflected as operating outflows while principal repayments should be reflected as financing outflows.

6.8.9 Structured payables

Under structured payable programs, the reporting entity arranges for its vendors to have the option to factor their receivables (i.e., the reporting entity's payables) to a bank. The balance sheet classification of the reporting entity's payable depends on the economic substance of the arrangement. See FSP 11.3.1.5 for additional discussion of balance sheet classification of structured payables arrangements, including related disclosure requirements.

If the economic substance of the trade payables has changed as a consequence of implementing a structured vendor payable program, an in-substance refinancing will be deemed to have occurred. As a

result, the affected trade payable balances should be reclassified to debt on the reporting entity's balance sheet. In this circumstance, the SEC staff's position (which is consistent with the view expressed concerning floor plan financing programs discussed in FSP 6.8.10) is that a reporting entity's statement of cash flows should reflect (impute) an operating cash outflow and financing cash inflow related to the affected trade payable balances. A financing cash outflow should be reflected upon payment to the bank and settlement of the obligation.

6.8.10 Floor plan financing programs

Reporting entities often finance the purchase of their inventory by engaging in floor plan financing arrangements with lenders that are not affiliated with the manufacturer of the inventory. When these arrangements are with the manufacturer, the arrangements are long-term accounts payable that are operating cash flows when settled. In an arrangement that is not with the manufacturer, an unaffiliated lender pays the manufacturer of the inventory directly and is then repaid by the reporting entity according to the terms negotiated between the reporting entity and the lender, which are usually much longer than normal trade payables.

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

However, the SEC staff has expressed the view that the lack of symmetry in such floor financing programs does not depict the substance of the transaction because the lender effectively acts as the reporting entity's agent. To remedy the asymmetry, the SEC staff believes that the reporting entity should report (impute) an operating cash outflow and a financing cash inflow upon receipt of the inventory, even though neither cash flow occurred. Application of this approach to other situations requires judgment. Reporting entities should scrutinize their non-cash operating activities for situations similar to those created by the use of third-party floor plan financing arrangements. See FSP 6.9.2.1 for a discussion of constructive receipt and constructive disbursement.

6.8.11 Liabilities settled through paying agents

In some circumstances, a reporting entity may engage a financial institution to operate solely as a paying agent by entering into arrangements that allow for the financial institution to make payments on its behalf, and in some instances, allow it to participate in a rebates or "rewards" programs for transaction volume generation. See FSP 11.3.1.6 for further discussion of these arrangements.

With regard to classification of this type of arrangement in the statement of cash flows, reporting entities should follow the guidance in FSP 6.8.9 for structured payables.

6.8.12 Sales of receivables

Reporting entities sometimes sell or factor trade receivables to banks or asset-backed commercial paper conduits, frequently under revolving financing arrangements, to accelerate cash inflows. Sellers may not receive the entire purchase price in cash at the transfer date. Rather, the seller may receive

only a portion of the purchase price (which is classified as operating in the statement of cash flows), with the difference consisting of a receivable from the bank or conduit. The repayment of that receivable is typically contingent on the subsequent collections of the underlying trade receivables sold. This deferred payment arrangement, a receivable from the bank or facility representing a beneficial interest in the transferred trade receivables, is commonly referred to as the "deferred purchase price," or "DPP."

ASC 230 requires that a transferor's beneficial interest obtained upon sale in a securitization of financial assets be disclosed as a noncash activity, and any subsequent cash receipts from payments on a transferor's beneficial interests in securitized trade receivables to be classified as cash inflows from investing activities when the trade receivable is derecognized upon transfer. Subsequent cash receipts, occurring after receipt of proceeds of the initial sale of receivables, cannot be attributed to the receivable because the receivable is no longer on the balance sheet. Instead, the subsequent cash receipts are considered an investing relationship with the bank or conduit.

Pursuant to replacement or unwinding of these accounts receivable programs, or through other transactions, the original seller of the accounts receivable balances may reacquire some of its own previously sold receivables. Just as the subsequent collections on any sold receivables after the initial sale are treated as an investing cash flow, the subsequent collections on any receivables reacquired would continue to be of an investing nature and included as cash inflows from investing activities; they would not revert back to an operating activity. The nature of these collections on reacquired receivables do not change to that of an operating cash flow due to the repurchase transaction.

Entities regularly continue to provide account servicing of the sold receivables and collect cash on behalf of the purchaser. Sometimes this cash is deposited into the purchaser's bank account and is not a cash flow of the seller of the receivables; other times this cash is collected and retained by the seller until remitted to further receivables are purchased.

- When this cash is deposited into the accounts of the seller, if this cash collection is not used to satisfy DPP, then it represents cash collected on the behalf of another, and the cash flow is classified as a financing inflow.

- When remitted to the seller at a later date, this is a financing outflow.

- When used to purchase further receivables, we believe that the reporting entity should present a financing outflow and an operating inflow for the sale of new receivables, provided that the reduction of the liability is consummate with the sale of the new receivables.

Example FSP 6-14 illustrates the statement of cash flows classification of receivables sold.

EXAMPLE FSP 6-14

Cash flow classification of receivables sold

FSP Corp sells its trade receivables into a revolving structure with a 90% advance rate applied to each receivable transfer, with monthly payments out of the collections account to the conduit and the selling company on the 15th of each month (the Payment Date). The structure was set up in a prior period and receivables have been transferred previously and funded in accordance with the terms of the receivables purchase agreement. The conduit has reached its funding limit under the agreement; therefore, going forward, the only source of cash to pay for receivables sold each day are collections on

receivables previously sold to the conduit. Collections received on a daily basis can be used to pay for receivables transferred that same day after withholding amounts needed to pay the conduit at the upcoming Payment Date. This set-side, and any amounts remaining after payment to the transferor for that day's new receivables, is deposited into an off-balance sheet collections account and held in trust until the next Payment Date. Since trade receivables are non-interest bearing, the purchase price of each receivable under these programs typically incorporates a discount from the receivable's face amount. For simplicity, this example assumes a purchase price equal to face.

The following table summarizes the activity during the 30-day period preceding a Payment Date:

Day	**Cash collections on prior A/R** **a**	**New transfers (face)** **b**	**Cash consideration** **c**	**DPP consideration** **b - c**	**Trust fund collections account** **a - c**	
16	$0	$50,000	$0	$50,000	$0	
17	$100,000	$120,000	$96,000	$24,000	$4,000 *	
18	$200,000	$10,000	$9,000	$1,000	$191,000	
19	$0	$140,000	$0	$140,000	$0	
[for simplicity, assume no additional activity takes place between the 20th of the month and the ensuing Payment Date on the 15th]						
Total	*$300,000*	*$320,000*	*$105,000*	*$215,000*	*$195,000*	
[on the 15th, the $195,000 in the collections account is disbursed and allocated as follows]						
15	$0	$0	$191,000	($191,000)	($191,000)	Seller
					($4,000)	Conduit
		Grand total	*$296,000*	*$24,000*	*$0*	

*$4,000 for estimated payments to fund interest and fees payable to the conduit for the monthly period preceding the Payment Date

How should these transactions be reflected on the statement of cash flows?

Analysis

In our view, an appropriate basis of presentation would treat each day's collective activity as the unit of analysis. Under this approach, each day's cash collections released to the seller (i.e., reinvested) would be allocated between operating and investing inflows. Cash received would first considered to be payment for that day's transfers of new receivables (subject to the applicable "advance rate") and would be considered an operating inflow. Any excess that day would be deemed to be a repayment of the DPP, and an investing inflow. Any increase in the DPP (representing the excess of the transferred receivables' purchase price over cash received) would be recorded and disclosed as a non-cash investing activity based on the fair value of DPP received.

The following table illustrates the application of this approach, based on the stipulated daily activity. All amounts exclude consideration of discounts and anticipated losses.

Day		Operating inflow	Investing inflow	Noncash investing disclosure
16		$0	$0	$50,000
17		$96,000	$0	$24,000
18		$9,000	$0	$1,000
19		$0	$0	$140,000
...				
	Total Month 1	*$105,000*	*$0*	*$215,000*
15		$0	$191,000	$0
	Total Month 2	*$0*	*$191,000*	*$0*
	Grand total	$105,000	$191,000	$215,000

The presentation in the statement of cash flows aligns with the legal form of the exchanges that take place daily between the seller and the conduit, and at the monthly settlement date. Each day serves as the unit of analysis. In this example, a substantial portion of the cash received by the seller for the period consists of a payout from the collections account at the Payment Date ($191,000). Consistent with the terms of the receivables purchase agreement, this receipt represents a return of a portion of the seller's DPP – an investing cash inflow.

6.8.13 Property, plant, and equipment

As discussed in ASC 230-10-45-13(c), payments made soon before, soon after, or at the time of purchase to acquire property, plant, and equipment and other productive assets should be classified as cash outflows for investing activities. Such amounts should include interest payments and sales taxes capitalized as part of the cost of the acquired assets. If a purchase of property, plant, and equipment and other productive assets is solely funded by issuing debt directly to the seller, it is a noncash financing transaction. Subsequent payments of principal on such debt are financing cash outflows.

Purchases of property, plant, and equipment that have not been paid for during the period (i.e., liabilities exist in accounts payable or accrued liabilities to pay for the purchase) represent noncash activities, as discussed in ASC 230-10-50-4. As such, they should generally be excluded from the relevant statement of cash flows line items (i.e., the change in accounts payable or accrued liabilities lines in the operating category, and purchases of property, plant, and equipment in the investing category). Such noncash activity should be separately disclosed as discussed in ASC 230-10-50-3. Refer to Example FSP 6-15 for more information.

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

Real estate is generally considered a productive asset and cash payments to acquire such real estate are classified as investing cash outflows. However, if real estate is purchased by a developer to be subdivided, improved, and sold in individual lots, the cash payments to purchase the real estate and the related cash receipts from sale of the real estate should be classified as operating activities. Thus, the nature of the cash flows is similar to inventory in other businesses.

6.8.14 Contributions in aid of construction agreements

Utilities and pipeline operators often enter into arrangements to provide a municipality or plant with a commodity, such as high voltage electricity or natural gas. This requires the construction of infrastructure to deliver the commodity to the entity's location, such as a high tension lines or a pipeline extension. Arrangements known as contributions in aid of construction (CIAC) dictate the amount of funds to be provided by the customer to the utility. An AICPA task force described the arrangements as follows.

Contributions in aid of construction (CIAC) represents an amount of money or other property contributed to a regulated utility to ensure that the appropriate parties are paying for the costs of utility infrastructure and that the price of utility service is economical and fair for all customers, including those that are not parties to the requested additional infrastructure. Specifically, CIAC is contributed by a customer that requests an uneconomic connection based on projected consumption and regulator-established utility rates. The CIAC, which is computed using a methodology set by the regulator, is paid up-front and covers the uneconomic portion of the utility's investment on a dollar-for-dollar basis (no margin for the utility). The amount of the CIAC payment is not subject to negotiation between the utility and the customer; rather, the amount is prescribed by regulation. The utility maintains ownership, has full control over and is responsible for operating and maintaining the connection along with the larger distribution network.

The activity under the CIAC will result in the utility having a productive asset albeit at a low cost basis since it was able to construct the asset using the customer's funding. Therefore, the cash receipts from the customer should be presented in the statement of cash flows as inflows from investing activities and the expenditures to construct the asset should be presented as outflow from investing activities.

Alternatively, the cash receipts under the CIAC could be classified as cash inflows from financing activities as they are recognized as liabilities and the construction disbursements up to the amount of the recognized liability classified as cash outflows from financing activities, with any disbursements in excess of the liability classified as outflows from investing activities.

Question UP 12-2 describes how CIAC agreements are distinguished from construction advances. Unlike a CIAC agreement, construction advances must be repaid to the third party by the reporting entity. Construction advances are classified as cash flows from financing activities when received and repaid, while the disbursements for construction would be classified as cash flows from investing activities.

6.8.15 *Planned major maintenance*

There are two acceptable methods of accounting for planned major maintenance: direct expensing and deferral. While these methods impact the income statement and balance sheet differently, we believe that the nature of expenditures related to planned major maintenance requires these cash flows to be classified as operating in the statement of cash flows, regardless of which accounting method the entity uses. This view is consistent with comments issued by the SEC staff.

6.8.16 *Presenting cash flows for changes in lease-related accounts - lessees*

The following subsections address how a lessee should present cash payments for finance and operating leases in the statement of cash flows.

6.8.16.1 *Finance leases*

A lessee should classify cash payments with respect to finance leases as follows.

- Cash payments for the principal portion of the lease liability arising from a finance lease should be classified as financing activities.

- Cash payments for the interest portion of the lease liability arising from a finance lease should follow the guidance in ASC 230. These amounts would generally be classified as operating activities.

- Variable lease payments and short-term lease payments not included in the lease liability should be classified as operating activities.

- Payments for prepaid rent for a finance lease are investing activities because these payments are made to acquire a productive right-of-use asset and are made before any finance lease liability is recorded. However, given the lack of specific guidance in ASC 230 or ASC 842 related to lease prepayments, we believe that it is also acceptable to classify these payments in financing, similar to the payment of principal on a finance lease.

6.8.16.2 *Operating leases*

A lessee should generally classify cash payments arising from operating leases within operating activities. The exception to this relates to lease payments associated with the cost to bring another asset to the condition and location necessary for its intended use that are capitalized as part of the cost of the asset. For example, certain lease payments incurred while building property, plant, or equipment would be capitalized and should be classified as investing activities rather than operating.

Under ASC 842, if a lessee is using the indirect method, both a right-of-use asset and lease liability are recorded as separate line items on the balance sheet for operating leases. The combined change of the two accounts will generally equal the difference between the straight-line lease expense and the cash paid for leases. Questions have arisen as to whether a single line presentation in the reconciliation to net income is appropriate with the two line items on the balance sheet. ASC 842 does not explicitly address this question. Additionally, the general statement of cash flow guidance in ASC 230 provides limited guidance on applying the indirect method. However, ASC 230 does suggest that the reconciliation of net income to operating cash flows should separately report all major classes of reconciling items. Therefore, we believe that the changes in right-of-use assets and lease liabilities

arising from lease expense should be reported separately. This is consistent with the balance sheet presentation. One way to present this is to separately present the amortization of the right-of-use asset as a non-cash adjustment from net income and the change in the lease liability due to cash payments as a change in operating assets and liabilities.

We are also aware of another view of presenting a single line item in the reconciliation similar to how it was presented under ASC 840. Given the lack of guidance in this area and that the leases standard does not require the separate presentation of the expense in the income statement, we believe a single-line presentation in the reconciliation would be acceptable.

6.8.16.3 Payments and reimbursements for leasehold improvements

As discussed in LG 3.3.4.2, when a lessee pays for an improvement to the leased property, it must determine whether the improvement is a lessee asset or a lessor asset.

In the statement of cash flows, payments made by a lessee for lessee assets are reflected as investing activities. If the lessor reimburses the lessee for lessee assets, the reimbursement is treated as a lease incentive and the statement of cash flow presentation is the same as any other lease payment. For example, a lease incentive received for an operating lease would be an operating activity.

If a lessee pays for a lessor asset, the payment is accounted for as prepaid rent. If the lessor reimburses the lessee for the lessor asset, it is recorded as a reduction to the prepaid rent. For payments made by a lessee that are accounted for as prepaid rent, we believe that the statement of cash flows presentation will depend on the expected lease classification at commencement. As discussed in FSP 6.8.16.1, if there is clear evidence that the lease would be classified as a finance lease, payments for prepaid rent may be investing activities because these payments are made to acquire a productive right-of-use asset and are made before any finance lease liability is recorded. Alternatively, given the lack of specific guidance in ASC 230 or ASC 842 related to lease prepayments, payments for prepaid rent may be financing activities, similar to the payment of principal on a finance lease. Otherwise, the prepayment should be reflected in the operating section of the statement of cash flows. After the commencement date, any payments made by a lessee and any subsequent reimbursement by the lessor should follow the classification of any other lease payments in the statement of cash flows

6.8.16.4 Noncash transactions

As discussed in FSP 14.2.4, ASC 842 requires certain quantitative disclosures. One such disclosure relates to supplemental noncash information on lease liabilities arising from obtaining right-of-use assets. Furthermore, ASC 230 requires disclosure of all non-cash investing and financing transactions. We believe that all noncash transactions related to adjustments to the lease liability or right-of-use asset should be disclosed as noncash transactions. This includes all noncash changes related to any modification or reassessment events (even when there is a decrease to the right-of-use asset). We believe that disclosing each type of noncash event is the most transparent disclosure, however, we would not object to presenting all changes in one non-cash line item.

6.8.17 Presenting cash flows – lessors

A lessor is required to classify cash receipts from all lease payments, regardless of lease classification, as operating activities unless the lessor is within the scope of ASC 942, *Financial Services – Depository and Lending*. A lessor within the scope of ASC 942 should follow the guidance in ASC 942-

230-45-4, which requires classification of principal payments received under sales-type leases and direct financing leases within investing activities.

6.8.17.1 *Payments for assets under construction*

When a lessor constructs an asset that it will ultimately lease, questions arise as to how the cash payments for construction should be presented in the statement of cashflows. We believe the presentation depends on the expected lease classification at lease commencement. If there is clear evidence that the lease will be classified a sales-type lease, the lessor should accumulate the construction costs as inventory, and the cash outflows should be reflected in the operating section of the statement of cash flows. Otherwise, the lessor should accumulate the construction costs as property, plant, and equipment, and reflect the cash outflows in the investing section of the statement of cash flows. This cash flow model is consistent with the lessee model for payments and reimbursements for leasehold improvements in FSP 6.8.16.3.

6.8.18 *Stock compensation*

ASC 230 requires that upon the settlement or exercise of stock-based compensation awards, income taxes payable is reduced (or deferred taxes are adjusted, subject to normal valuation allowance considerations) for the tax effect of the deductions generated, and any windfalls or shortfalls are recorded in the income statement. Furthermore, ASC 230 requires that all tax-related cash flows resulting from share-based payments be reported as operating activities in the statement of cash flows.

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

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

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

Stock-based compensation plans may permit shares to be withheld by a reporting entity/grantor in exchange for agreeing to fund a grantee's tax obligation. When the reporting entity/grantor pays the

withholding taxes to the appropriate taxing jurisdiction, ASC 230 requires that the cash payment be presented as a financing outflow in the statement of cash flows.

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

6.8.19 Cash flows related to noncontrolling interests

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

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

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

6.8.20 Business combinations and asset acquisitions

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

- *Business combinations*

  Cash flows from sales and for purchases of productive assets, including the acquisition or sale of a business, are presented as investing activities if made soon before (e.g., within three months), soon after (e.g., within three months), or at the acquisition date. Payments not made soon after the acquisition date in a business combination are akin to seller-provided financing and therefore should be classified as a financing outflow in the statement of cash flows.

  In an acquisition, the unit of account is the acquired business, and therefore the individual changes in assets and liabilities that occur on the acquisition date in the consolidated financial statements are not reflected on the individual line items in the statement of cash flows. Rather, the statement of cash flows should reflect, as a single line item, cash paid to purchase a business. This line item should be net of any cash acquired. Occasionally, the cash acquired can be greater than the cash paid and can result in a net cash inflow. Since the nature of the transaction is the acquisition of a business, we believe that a net cash inflow would still be presented within the investing section.

The noncash effects of a business combination, including any noncash consideration included in the purchase consideration and the significant assets and liabilities of the acquirer, are required to be disclosed. Consideration that is not expected to be paid soon after the acquisition date would be considered a noncash financing activity at the acquisition date and a cash outflow from financing activities when paid (see FSP 6.9.2). Subsequent to the acquisition of a business, cash flows of the newly acquired business are combined with those of the consolidated entity and presented within operating, investing, and financing activities as appropriate.

- *Transaction costs*

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

- *Contingent consideration*

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

ASC 230-10-45-13 through ASC 230-10-45-17 indicates that the classification of contingent consideration in the statement of cash flows depends on the timing and amount of the payment and should be reflected as follows:

Timing of payment after the acquisition date	Amount	Classification
Soon after the acquisition date (e.g., within three months)	All payments related to contingent consideration made soon after the acquisition date, including amounts related to fair value remeasurements	All payments should be classified as investing cash outflows.
Three or more months after the acquisition date	Liability is settled at an amount equal to or less than the acquisition date fair value (plus or minus measurement period adjustments)	The cash payment is akin to seller-provided financing and therefore should be classified as a financing outflow in the statement of cash flows.
	Liability is settled at an amount greater than the acquisition date fair value (plus or minus	The portion of the payment in excess of the acquisition date fair value (plus or minus measurement period adjustments) should be classified as an operating outflow, because this portion of the

	measurement period adjustments)	payment impacts net income. The remaining amount should be classified as a financing outflow. When determining whether a liability is settled at an amount greater than the acquisition date fair value, reporting entities should include all payments made to satisfy the contingent consideration, including payments made soon after the acquisition and classified as investing cash outflows.

While the suggested threshold of three months or less is not included in the codification, it was the period suggested by some members of the EITF (referenced in the Basis for Conclusions of ASU 2016-15).

□ *Working capital adjustments*

A working capital adjustment is typically included in a purchase and sale agreement as a means of agreeing on the amount of working capital that existed, and was thus acquired, as of the acquisition date. The subsequent determination of working capital that existed as of the acquisition date does not relate to future events or conditions. Accordingly, payments or receipts for changes in provisional amounts for working capital are recognized as an adjustment of consideration transferred by the acquirer in its acquisition accounting if the changes occur during the measurement period. Payments or receipts for changes in provisional amounts for working capital that occur outside of the measurement period should be recognized in current period earnings.

□ *Pushdown accounting*

When pushdown accounting is not applied to the financial statements of a subsidiary as a result of a business combination, cash flows should only be reported by the entity actually involved in the cash transactions. When pushdown accounting has been elected, there may be alternatives in how to present the cash flows in the financial statements of the subsidiary. In all cases, appropriate disclosure of the form of the transaction and the resulting cash flows should be made.

□ *Acquired IPR&D in an asset acquisition*

In accordance with ASC 730-10-25-2(c), intangible assets used in research and developmental activities that are acquired in an asset acquisition should be expensed at the acquisition date if there is no alternative future use in other R&D projects or otherwise. Cash flows related to the acquisition of such in-process research and development (IPR&D) assets require consideration of the nature of the underlying cash flow in determining its classification. In general, a reporting entity should classify the cash outflow based on what is likely to be the predominant use of cash in accordance with ASC 230-10-45-22A. On the one hand, such assets are considered intangible assets (productive assets) that have no useful life. On the other hand, expenditures for such assets are immediately recognized as research and development expenses in the income statement. Given that the nature of this cash flow has aspects of more than one class of cash flows as well as the lack of authoritative guidance in this area, we believe that classification in either operating or investing

activities is acceptable. Reporting entities should consistently apply their classification conclusion to similar transactions.

- *Debt extinguished in conjunction with a business combination*

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

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

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

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

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

  If an acquirer legally assumes debt, we believe it is appropriate to record the debt at fair value on the acquirer's balance sheet as a liability assumed in the acquisition. The debt would therefore be included net in the "acquisition of a business, net of cash acquired" line in investing activities, rather than as a financing inflow. Any subsequent payments related to the debt would be classified as a financing cash outflow, as discussed in FSP 6.8.7, since the debt is the legal obligation of the acquirer at the time the debt is extinguished.

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

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

6.8.20.1 *Carve-out financial statements*

Preparing the statement of cash flows for a carve-out reporting entity can be challenging. CO 6.4 explains some of the specific considerations, such as distinguishing the bank accounts and intercompany accounts that form the basis for the transactions in the statement of cash flows of the carve-out reporting entity. Determining the equity amounts requires judgment. As discussed in CO 4.4, the parent investment shown in the statement of changes in equity should be reconcilable to the financing section of the cash flow statement for the carve-out reporting entity.

6.8.21 *Cash flow presentation of insurance claim proceeds*

ASC 230 requires that cash proceeds received from the settlement of insurance claims (with the exception of proceeds received from corporate-owned life insurance policies and bank-owned life insurance policies, discussed in FSP 6.8.22) be classified on the basis of the related insurance coverage. In other words, the classification should be made based on the nature of the loss. For example, insurance proceeds related to damage of equipment are investing inflows while proceeds related to business interruption are operating inflows.

6.8.22 *Cash flow presentation of life insurance proceeds*

Life insurance policies are purchased for a variety of purposes, including funding the cost of providing employee benefits and protecting against the financial consequences of the loss of key persons. These types of policies are generally known as corporate-owned life insurance and bank-owned life insurance. ASC 230-10-45-21C requires that cash proceeds received from the settlement of corporate-owned life insurance policies and bank-owned life insurance policies be classified as investing cash inflows. Payments for premiums on corporate-owned policies may be classified as cash outflows for investing activities, operating activities, or a combination of investing and operating activities.

6.9 *Supplementary cash flow information*

In addition to the presentation of cash flows, ASC 230 requires supplementary cash flow information, which includes disclosure of interest and income taxes paid as well as noncash investing and financing activities.

6.9.1 *Interest and income taxes paid*

As discussed in ASC 230-10-50-2, when the indirect method is used, amounts of interest paid (net of amounts capitalized) and income taxes paid during the period must be disclosed, either on the face of the statement of cash flows or in the footnotes.

Questions have arisen as to whether cash flows that result from the sale or purchase of transferable credits (received from or paid to third parties) should be included in the supplemental income taxes paid disclosure. Given the lack of explicit guidance in this area and pending any further guidance, we believe a reporting entity can choose to either include or exclude these third-party amounts when determining the amount of income taxes paid to disclose. If these amounts are included, the reporting entity should transparently disclose the amounts that relate to the sale or purchase of transferable credits.

6.9.2 Noncash investing and financing activities

ASC 230 requires separate disclosure of all investing or financing activities that do not result in cash flows. This disclosure may be in a narrative or tabular format. The noncash activities may be included on the same page as the statement of cash flows, in a separate footnote, or in other footnotes, as appropriate.

Following the principles in ASC 230-10-50-3 through 50-6, the following are noncash investing and financing transactions:

- Converting debt to equity
- Acquiring productive assets by assuming directly related liabilities
- Obtaining a right-of-use asset in exchange for a lease liability
- Obtaining a beneficial interest as consideration for transferring financial assets (excluding cash), including the transferor's trade receivables (commonly referred to as a holdback or deferred purchase price)
- Obtaining a building or investment asset as a gift
- Exchanging noncash assets or liabilities for other noncash assets or liabilities

Other examples include:

- Issuing stock in connection with a stock compensation plan where no cash payment is required
- Acquiring a business through the issuance of stock
- Acquiring productive assets not yet paid for

  ASC 230-10-45-13(c) indicates that payments at the time of purchase *or soon before or after purchase* to acquire plant, property, or equipment and other productive assets are investing activities. This phrase does not mean that cash flows can be reflected in a statement of cash flows before they occur. The words "or soon before or after purchase" are intended to highlight that some payments made subsequent to the acquisition of a long-lived asset should be classified as investing (e.g., payments made shortly after acquisition of the long-lived asset according to normal trade terms), while other payments made subsequent to the acquisition of a long-lived asset should be classified as financing (e.g., payments for which the timing is not consistent with normal trade terms, which may indicate that the long-lived asset was acquired with debt financing). Determining if the payment terms received by a reporting entity are consistent with the trade terms the seller normally makes available to its other customers is an important consideration when evaluating if seller financing was provided.

Separately, reporting entities may undertake transactions in which cash is received or disbursed on its behalf by another entity. ASC 230 does not address these situations. As explained in FSP 6.9.2.1, we believe a reporting entity may be able to recognize those cash flows as if they had received or disbursed the cash from its bank account under a constructive receipt and disbursement concept.

Example FSP 6-15 and Example FSP 6-16 demonstrate the identification and presentation of noncash investing and financing activities.

EXAMPLE FSP 6-15

Noncash investing or financing activity — purchased equipment not yet paid for

On December 20, 20X1, FSP Corp purchases and takes title to equipment costing $100, and accordingly debits property, plant, and equipment and credits accounts payable. As of December 31, 20X1, FSP Corp has not yet made cash payment to settle the accounts payable.

How should the equipment acquisition be reflected in FSP Corp's December 31, 20X1 statement of cash flows?

Analysis

Until FSP Corp has made a cash payment related to the equipment, the equipment acquisition is a noncash activity that should not be reflected in the statement of cash flows. Understanding if FSP Corp's equipment acquisition is a noncash investing or financing activity requires an understanding of the words "soon before or after purchase" and evaluation of whether seller financing was provided. Regardless, it would be incorrect to include a $100 investing outflow and a corresponding $100 operating inflow (created by the increase in accounts payable as a reconciling item using the indirect method of presentation) in FSP Corp's December 31, 20X1 statement of cash flows because neither of those cash flows occurred.

EXAMPLE FSP 6-16

Noncash investing and financing activity — equipment partially financed by a note

FSP Corp acquires computer equipment for $100 cash and a $400 installment note payable to the seller. Providing installment notes payable to its customers is not a normal trade term for the seller.

How should the $100 cash payment be recorded in the statement of cash flows? How should the $400 installment note payable to the seller be reflected?

Analysis

The $100 cash payment should be reported as an investing activity outflow and included with purchases of property, plant, and equipment. The noncash investing and financing transaction of $400 should be disclosed.

The subsequent principal payments on the debt should be classified as financing cash outflows, whereas the payments of interest on the debt should be classified as operating cash flows.

Alternatively, if the $400 was borrowed from a third-party lender who agrees to disburse the funds either to the buyer or the seller at the direction of the buyer, the loan would be a financing cash inflow and the full purchase price of the equipment would be an investing cash outflow.

6.9.2.1 *Constructive receipts and disbursements*

Numerous processes and protocols have developed in which financial institutions or other entities act as *quasi*-agents on behalf of reporting entities in regard to transfers of cash. Thus, a reporting entity may have certain transactions that do not result in an exchange of currency or an entry into its cash account, but for which the same economic results are obtained as if an exchange of currency or an entry into its cash account had occurred. In these situations, the question arises as to whether the transactions should be reflected as a noncash activity or if the reporting entity should gross up its statement of cash flows to reflect that cash was constructively received and disbursed.

If an arrangement is made whereby a cash disbursement is made by a third party (e.g., a financial institution) on behalf of the reporting entity to satisfy the reporting entity's obligation to another party (e.g., a vendor), we believe the substance of the transactions and its constructive cash flows should be reported in the statement of cash flows. Therefore, a reporting entity should include cash flows received or paid by a third party on behalf of the reporting entity as though the transaction took place through the bank accounts of the reporting entity.

For example, assume a reporting entity engages a transfer agent to assist in the simultaneous borrowing under a new loan with Lender B and the payoff and retirement of an existing loan with Lender A. The new debt proceeds from Lender B are sent to the transfer agent, and from the transfer agent to Lender A. Neither the new loan proceeds nor the old loan payoff enter or leave the reporting entity's bank account. In this situation, the reporting entity should gross up its statement of cash flows to reflect that cash was constructively received from Lender B (a financing inflow) through the reporting entity's agent, and then this same cash was constructively disbursed to Lender A in the form of principal and interest (a financing outflow and operating outflow).

Another example of constructive receipt and disbursement is when a reporting entity obtains financing from a bank which is immediately used to pay a vendor payable. If the reporting entity instructs the bank to pay the vendor directly on its behalf, the reporting entity should reflect a financing inflow for the receipt of the debt proceeds and an operating outflow for the payment of the vendor payable.

Judgment is required when determining if constructive receipt and disbursement is appropriate.

6.10 Discontinued operations

ASC 205-20-50-5B(c) requires reporting entities to present in the statement of cash flows or disclose in a footnote either (1) total operating and investing cash flows for discontinued operations, or (2) depreciation, amortization, capital expenditures, and significant noncash operating and investing activities related to discontinued operations.

While the guidance does not require presentation or disclosure of cash flow information from discontinued operations related to financing activities, a reporting entity is not precluded from presenting or disclosing such information. Similarly, we do not believe a reporting entity would be precluded from providing information about operating or investing activities for discontinued operations that is incremental to the requirements of ASC 205-20-50-5B(c) (e.g., line item detail). In both alternatives, the operating, investing, and financing activities totals for the reporting entity do not change by having discontinued operations.

If a reporting entity separately discloses cash flows pertaining to discontinued operations, it should identify the respective categories (operating, investing, and financing). Including all cash flows from

discontinued operations separate from the continuing operation cash flows, without separating the amounts into their respective categories (e.g., reflecting the entire net change as part of operating cash flows), is unacceptable. Doing so violates the provisions of ASC 230-10-45-24, which states, in part, "A statement of cash flows for a period shall report net cash provided or used by operating, investing, and financing activities…."

Questions have arisen about the proper presentation of cash receipts from the sale of a discontinued operation when a reporting entity elects to separate its cash flows from discontinued operations from its cash flows from continuing operations. We believe it is acceptable to present the cash inflow as either continuing-investing or discontinued-investing as long as such presentation is applied consistently and is accompanied by transparent disclosure. However, we believe the more intuitive treatment is to classify such sales proceeds as discontinued-investing cash flows.

The cash and cash equivalents line item on the balance sheet may not include all of a reporting entity's cash and cash equivalents if the reporting entity has a disposal group with cash and cash equivalents included within the assets held for sale caption (regardless of whether or not the disposal group meets the criteria to be presented as discontinued operations). We believe the cash and cash equivalents included in assets held for sale should be included in the beginning and ending balances of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents in the statement of cash flows and reconciled to the respective balance sheet line items (either on the face of the statement of cash flows or in the footnotes, similar to the guidance in ASC 230-10-50-8).

6.11 Foreign currency cash flows

A reporting entity with operations in foreign countries or with foreign currency transactions must report the reporting currency equivalent of foreign currency cash flows using the exchange rates in effect at the time of the cash flows. If the pattern of cash flows and exchange rates are relatively consistent throughout the period, the reporting entity may use an average exchange rate for translation, as the cash flow results would not be significantly different from the result if actual exchange rates on the day of the cash flows were used. However, if the pattern of cash flows is not consistent or the exchange rates are volatile, a simple average of the rates at the beginning and end of the period may not yield an appropriately-weighted average exchange rate, especially for large and infrequent investing and financing transactions. In such circumstances, the rate in effect at the time of the transaction should be disclosed.

Specific requirements for the presentation of foreign currency activities on the statement of cash flows are as follows:

- Foreign currency transaction gains and losses reported on the income statement should be reflected as a reconciling item from net income to cash flows from operating activities
- The effect of exchange rate changes on cash and cash equivalents denominated in currencies other than the reporting currency should be a separate line item as part of the reconciliation of the change in cash equivalents during the period
- The effect of exchange rate changes on cash and cash equivalents reflected in the statement of cash flows is not a "plug." It is a balancing amount and may be proven using the following formula:

The net cash flow activity for the period measured in the functional currency *multiplied by* the difference between the exchange rates used in translating functional currency cash flows and the exchange rate at year end.	+	The fluctuation in the exchange rates from the beginning of the year to the end of the year *multiplied by* the beginning cash balance denominated in currencies other than the reporting currency.

See Step 3 in Example FSP 6-17 for further illustration of how to calculate this number.

6.11.1 *Presenting the cash flows of foreign operations*

When preparing the statement of cash flows for a reporting entity with foreign operations, the reporting entity should perform the following steps:

- Step 1: The statement of cash flows for each distinct and separable operation should be prepared on a standalone basis in its respective functional currency.
- Step 2: The statement of cash flows for each distinct and separable operation that is a foreign entity (as defined in ASC 830) should be translated into the reporting entity's reporting currency.
- Step 3: The reporting entity should prepare a consolidating statement of cash flows using the individually translated statements of cash flows for each distinct and separable operation. The effect of exchange rate changes on cash and cash equivalents denominated in currencies other than the reporting currency should be calculated for each distinct and separable operation.

Example FSP 6-17 illustrates the preparation of a statement of cash flows for a reporting entity with foreign operations. ASC 830-230-55 also includes an example of how to calculate the effect of exchange rate changes on cash.

EXAMPLE FSP 6-17

Statement of cash flows for a foreign subsidiary

FSP Corp is located in the US and has one wholly-owned subsidiary, Britain Limited (Britain).

Britain is not an extension of FSP Corp, and its functional currency is the British pound (GBP). The reporting currency for FSP Corp is the US dollar (USD). The year-end for FSP Corp is December 31, 20X2.

The British pound to US dollar exchange rates are as follows:

Code	Description	GBP to USD
B	Current rate, beginning of year	GBP 1 = USD 1.45
E	Current rate, end of year	GBP 1 = USD 1.55
A	Average rate for the year	GBP 1 = USD 1.50
R	Rate in effect at time of transaction	GBP 1 = USD Varies

Significant transactions during the year include the following:

- Britain sold a piece of equipment with a net book value of 20,000 *GBP and received proceeds of 10,000 GBP. The exchange rate on the date of the transaction was GBP 1 = USD 1.46.*
- Britain made *one property, plant, and equipment purchase for 155,000 GBP. The exchange rate on the date of purchase was GBP 1 = USD 1.47.*
- Britain *paid cash dividends of 100,000 GBP. The exchange rate on the date of the dividend was GBP 1 = USD 1.54.*
- Britain has *a bank note denominated in US dollars. There were no payments or additional borrowings on the bank note. As a result of movements in the exchange rate, a transaction gain of 26,000 GBP was recorded at December 31, 20X2.*
- Britain has an intercompany note den*ominated in US dollars. There were no payments or additional borrowings on the intercompany note. As a result of movements in the exchange rate, a transaction gain of 9,000 GBP was recorded at December 31, 20X2.*

The GBP to USD exchange rate is deemed to not have significantly fluctuated throughout the period.

The balance sheet for Britain in GBP as of December 31, 20X1 and December 31, 20X2 is as follows:

	Functional currency (GBP)		
	12/31/20X1	**12/31/20X2**	**Change**
Assets			
Cash and cash equivalents	256,000	457,000	201,000
Accounts receivable	225,000	250,000	25,000
Inventory	478,000	500,000	22,000
Property, plant and equipment, net	1,000,000	1,050,000	50,000
Total assets	1,959,000	2,257,000	298,000
Liabilities			
Accounts payable	300,000	340,000	40,000
Accrued expenses	120,000	190,000	70,000
Debt, denominated in USD	413,000	387,000	(26,000)
Debt, denominated in GBP	50,000	50,000	–
Debt, intercompany	138,000	129,000	(9,000)
Deferred income taxes	100,000	80,000	(20,000)
Total liabilities	1,121,000	1,176,000	55,000
Stockholders' equity			
Common stock	500,000	500,000	–
Retained earnings	338,000	581,000	243,000
Total stockholders' equity	838,000	1,081,000	243,000
Total liabilities and stockholders' equity	1,959,000	2,257,000	298,000

The income statement and changes in retained earnings for Britain in GBP for the year ended December 31, 20X2 is as follows:

	Functional currency (GBP) 12/31/20X2
Revenue	2,000,000
Cost and expenses	
Cost of sales	1,000,000
Selling and administrative expenses	341,000
Interest expense	86,000
Depreciation	85,000
Loss on sale of equipment	10,000
Foreign currency transaction gain	(35,000)
Total costs and expenses	1,487,000
Income before income taxes	513,000
Current	190,000
Deferred	(20,000)
Total provision for income taxes	170,000
Net income	343,000
Retained earnings, beginning	338,000
Net income	343,000
Cash dividends	(100,000)
Retained earnings, ending	581,000

How should FSP Corp prepare Britain's statement of cash flows as of December 31, 20X2 in US dollars?

Analysis

Step 1:

FSP Corp would prepare the statement of cash flows in Britain's functional currency (GBP) based on the changes in assets, liabilities, and stockholders' equity noted. Refer to the table in Step 2 for an illustration.

The transaction gain created by the USD denominated debt balances would be reflected in the reconciliation of net income to operating cash flows.

Step 2:

FSP Corp would translate the functional currency statement of cash flows into the reporting currency, USD.

	Step 1			Step 2
	GBP 12/31/20X2	Code	Exchange Rate	USD 12/31/20X2
Cash flows from operating activities				
Net Income	343,000	A	GBP 1 = USD 1.50	514,500
Adjustments to reconcile net income to net cash provided by operating activities				
Depreciation	85,000	A	GBP 1 = USD 1.50	127,500
(Gain) loss on sale of equipment	10,000	R	GBP 1 = USD 1.46	14,600
(Gain) loss on foreign currency exchange rates	(35,000)	A	GBP 1 = USD 1.50	(52,500)
Deferred income taxes	(20,000)	A	GBP 1 = USD 1.50	(30,000)
Change in operating assets and liabilities				
Accounts receivable	(25,000)	A	GBP 1 = USD 1.50	(37,500)
Inventory	(22,000)	A	GBP 1 = USD 1.50	(33,000)
Accounts payable	40,000	A	GBP 1 = USD 1.50	60,000
Accrued expenses	70,000	A	GBP 1 = USD 1.50	105,000
Net cash provided by operating activities	446,000			668,600
Cash flows from investing activities				
Proceeds from sale of equipment	10,000	R	GBP 1 = USD 1.46	14,600
Purchases of property, plant and equipment	(155,000)	R	GBP 1 = USD 1.47	(227,850)
Net cash used in investing activities	(145,000)			(213,250)
Cash flows from financing activities				
Payment of dividends	(100,000)	R	GBP 1 = USD 1.54	(154,000)
Net cash used in financing activities	(100,000)			(154,000)
Effect of exchange rate changes on cash	—			35,800
Change in cash	201,000			337,150
Cash, beginning of the year	256,000	B	GBP 1 = USD 1.45	371,200
Cash, end of the year	457,000	E	GBP 1 = USD 1.55	708,350

Because the pattern of cash flows and the GBP to USD exchange rate has not significantly fluctuated throughout the year, an average exchange rate can be used to translate most of the cash flows from operating activities (Tickmark A in the example above). For specific transactions such as dividends, significant purchases, and dispositions of equipment, the rate in effect at the time of transaction should be used (Tickmark R).

Step 3:

Upon consolidating the statement of cash flows of each distinct and separable operation, FSP Corp should record elimination entries for the reporting currency equivalent of intercompany transactions. Since the information for FSP Corp's US operations has not been provided in this example, the consolidating statement of cash flows for FSP Corp is not presented. However, the effect of exchange rate changes on cash held by Britain is presented below.

When a reporting entity holds cash and cash equivalents in a currency other than the reporting currency, the resulting transaction gains and losses and translation adjustments are not cash flows but should instead be reported within the effect of foreign currency exchange rates on cash and cash equivalents.

Calculation of effect of exchange rate changes on cash

	Code	Calculation	Result
Effect on beginning cash balance			
Beginning cash balance in local currency		256,000	
Net change in exchange rate during the year	(E - B)	0.10	
Effect on beginning cash balance			25,600
Effect from operating activities during the year			
Cash provided by operating activities in local currency		446,000	
Year-end exchange rate	E	1.55	
Operating cash flows based on year-end exchange rate		691,300	
Operating cash flows reported in the statement of cash flows		668,600	
Effect from operating activities during the year			22,700
Effect from investing activities during the year			
Cash provided by investing activities in local currency		(145,000)	
Year-end exchange rate	E	1.55	
Investing cash flows based on year-end exchange rate		(224,750)	
Investing cash flows reported in the statement of cash flows		(213,250)	
Effect from investing activities during the year			(11,500)
Effect from financing activities during the year			
Cash provided by financing activities in local currency		(100,000)	
Year-end exchange rate	E	1.55	
Financing cash flows based on year-end exchange rate		(155,000)	
Financing cash flows reported in the statement of cash flows		(154,000)	
Effect from financing activities during the year			(1,000)
Effect of exchange rate changes on cash			35,800

6.12 Considerations for private companies

The requirements of ASC 230 apply equally to SEC registrants and private companies.

Figure FSP 6-3 summarizes the presentation and disclosure items discussed in this chapter that are only required for SEC registrants.

Figure FSP 6-3

Presentation and disclosure requirements applicable only to SEC registrants

Description	Reference	Section
Compensating balances must be segregated on the balance sheet	SEC FRP 203.02.b	FSP 6.5.3.2
Restricted cash disclosure requirement	S-X 5-02(1)	FSP 6.5.3.6

Based on the guidance in ASC 210-10-45-4, we believe private companies may present cash and restricted cash together in one caption on the balance sheet, provided: (1) the legally-restricted cash relates to a current asset or liability (for example, a short-term borrowing), and (2) there is disclosure of the restricted amounts in the footnotes. If the restricted cash does not relate to a liability classified as current, it should be a noncurrent asset.

Chapter 7:
Earnings per share—updated November 2021

7.1 Earnings per share overview

Earnings per share (EPS) measures the performance of an entity over a reporting period. This chapter highlights key provisions for the computation, presentation, and disclosure of EPS.

The chapter explains several methodologies used in computing EPS. It also highlights some of the key considerations in determining how to include particular instruments and transactions, including financing transactions and stock-based compensation awards, in EPS.

The chapter also includes sample computations of both basic and diluted EPS.

New guidance

In August 2020, the FASB issued ASU 2020-06, Debt - Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging - Contracts in Entity's Own Equity (Subtopic 815-40). The ASU simplifies the accounting for certain financial instruments with characteristics of liabilities and equity. The FASB reduced the number of accounting models for convertible debt and convertible preferred stock instruments and made certain disclosure amendments to improve the information provided to users. In addition, the FASB amended the derivative guidance for the "own stock" scope exception and certain aspects of the EPS guidance.

For public business entities that meet the definition of an SEC filer, excluding entities eligible to be smaller reporting companies as defined by the SEC, the guidance is effective for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. The one-time determination of whether an entity is eligible to be a smaller reporting company is based on an entity's most recent determination as of August 5, 2020, in accordance with SEC regulations. For all other entities, the guidance is effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted, but no earlier than fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. The FASB also specified that an entity must adopt the guidance as of the beginning of its annual fiscal year and is not permitted to adopt the guidance in an interim period, other than the first interim period of their fiscal year.

The guidance in this chapter has been updated to reflect ASU 2020-06 and impacted sections are denoted with "after adoption of ASU 2020-06" or "before adoption of ASU 2020-06."

7.2 EPS—scope and relevant guidance

ASC 260, *Earnings Per Share*, requires the presentation of EPS for all entities that have publicly traded common stock or potential common stock (e.g., options or warrants). A public market includes a stock exchange (domestic or foreign) or over-the-counter markets. This would include circumstances when securities are quoted only locally or regionally.

Presentation of EPS is also required for a reporting entity that has made a filing or is in the process of filing with a regulatory agency in preparation for the sale of securities in a public market.

Private companies may elect to report EPS provided they comply with the guidance in ASC 260.

ASC 260-10-15-3 states that the presentation of EPS is not required for investment companies that comply with the requirements of ASC 946, *Financial Services—Investment Companies*, or in the financial statements of wholly-owned subsidiaries.

SAB 98 provides incremental EPS guidance for SEC registrants in the following areas:

- Carve-out entities – SAB Topic 1.B
- Convertible securities – SAB Topic 3.A
- Nominal issuances – SAB Topic 4.D
- Income or loss applicable to common stock – SAB Topic 6.B
- Quarterly per share results – SAB Topic 6.G

7.3 Types of EPS computations

ASC 260-10 requires the reporting of both basic and diluted EPS for each reporting period.

7.3.1 Basic EPS

Basic EPS is computed by dividing income available to common stockholders by the number of weighted average common shares outstanding during the period.

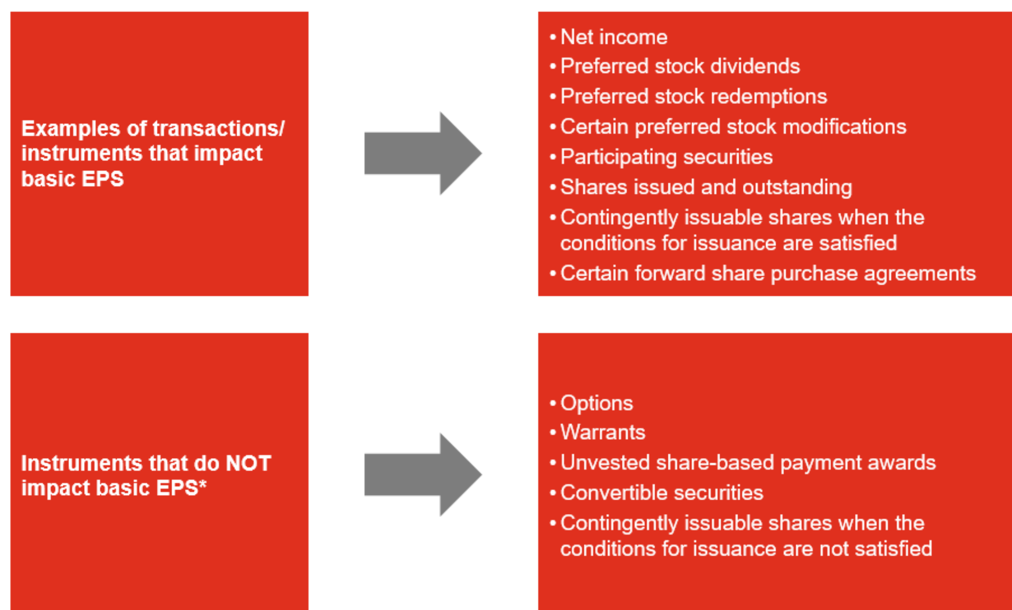
Definition from ASC 260-10-20

Basic Earnings Per Share: The amount of earnings for the period available to each share of common stock outstanding during the reporting period.

Figure FSP 7-1 provides a summary of basic EPS.

Figure FSP 7-1

Summary of basic EPS



* Presumes the securities are not considered participating securities

See FSP 7.4 for further discussion of basic EPS.

7.3.2 *Diluted EPS*

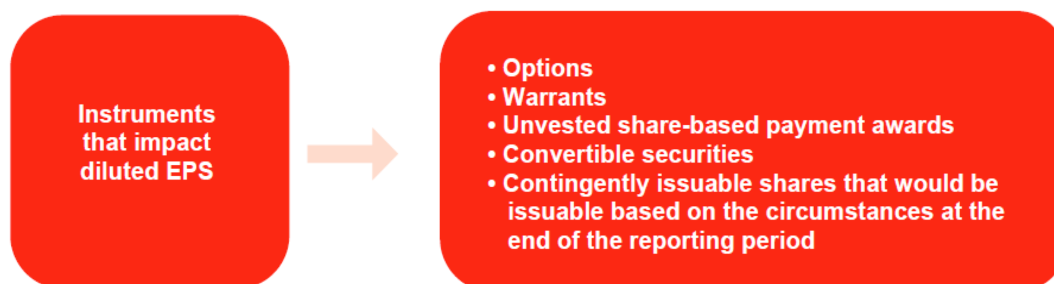
Diluted EPS is computed by dividing income available to common stockholders, adjusted for the effects of the presumed issuance of potential common shares, by the number of (1) weighted average common shares outstanding, *plus* (2) potentially issuable shares, such as those that result from the conversion of a convertible instrument or exercise of a warrant.

Definition from ASC 260-10-20

Diluted Earnings Per Share: The amount of earnings for the period available to each share of common stock outstanding during the reporting period and to each share that would have been outstanding assuming the issuance of common shares for all dilutive potential common shares outstanding during the reporting period.

In other words, diluted EPS is basic EPS adjusted for the hypothetical effect of potentially dilutive securities. Figure FSP 7-2 provides a summary of diluted EPS.

Figure FSP 7-2
Summary of diluted EPS



See FSP 7.5 for further discussion of diluted EPS.

7.3.3 Presentation of basic and diluted EPS

EPS should be presented for income from continuing operations, if applicable, and for net income on the income statement. Reporting entities should present EPS for each class of common stock for all periods for which an income statement is presented.

Reporting entities with outstanding potential common stock should present diluted EPS for net income and income from continuing operations, if applicable, with equal prominence on the face of the income statement. If the reporting entity reports diluted EPS data in one period, it should report it for all periods presented, even if the amounts are the same as basic EPS. If basic and diluted EPS are the same amount for all periods, dual presentation can be accomplished in one line. If the reporting entity elects to present a single statement of comprehensive income, EPS should be presented after net income and before other comprehensive income (OCI). The presentation of basic and diluted EPS for a participating security, other than common stock, is not required but is not precluded.

In ASC 220-10-S99-5 (SAB Topic 6.B), the SEC staff requires that income or loss available to common stockholders be presented on the income statement when it is materially different from reported net income or loss. While ASC 220-10-S99-5 acknowledges that a materiality assessment consists of quantitative and qualitative factors, it highlights that for differences of less than 10%, the staff would generally not insist on disclosure on the income statement. See Figure FSP 7-3 for examples of adjustments which can create differences between net income and income available to common stockholders.

The terms “basic EPS” and “diluted EPS” are used in ASC 260 to identify EPS data to be presented. However, ASC 260-10-45-4 notes they are not required captions in the income statement; terms such as “earnings per common share” and “earnings per common share—assuming dilution,” respectively, are acceptable alternatives.

A reporting entity that reports a discontinued operation should present basic and diluted EPS amounts for that line item either on the income statement or in the notes. However, if disclosure of these amounts in the notes is elected, basic and diluted EPS for continuing operations, and for net income, must still be presented on the income statement. ASC 260-10-55-49 illustrates the presentation of the captions on the income statement.

7.3.3.1 *Other per-share performance measures*

ASC 220-20-45-1 precludes disclosure of the EPS effects of individual events or transactions on the face of the income statement. Therefore, the EPS impact of restructurings, charges subject to ASC 420, *Exit or Disposal Cost Obligations*, impairments, or similar items, may not be presented on the face of the income statement. Reporting entities may disclose such EPS effects in the footnotes.

ASC 230-10-45-3 prohibits presentation of cash flow per share. Similarly, SEC FRP 202.04 notes that per share data other than that relating to net income, net assets, and dividends should be avoided in reporting financial results.

If the reporting entity chooses to report per-share amounts not required by ASC 260, such amounts should be computed in accordance with ASC 260 and presented only in the notes (i.e., not on the face of the financial statements) and labelled as pretax or net-of-tax.

7.3.4 *Disclosure related to EPS—updated May 2022*

ASC 260-10-50-1 requires a reporting entity to disclose the following for each period for which an income statement is presented:

- For basic and diluted EPS, a reconciliation of the numerator and denominator for income from continuing operations. The reconciliation should include the individual income and share amount effects of all securities that affect EPS. ASC 260-10-55-51 provides an example of this presentation.
- The effect of preferred dividends on income available to common stockholders in computing basic EPS
- Securities that were anti-dilutive for diluted EPS for the period(s) presented but which could potentially dilute EPS in the future (the concept of anti-dilution is addressed in FSP 7.5.1). Full disclosure of the key terms and conditions of these securities is required even if not included in diluted EPS in the current period. Generally, we believe disclosure of the terms and conditions of the securities should be detailed enough to allow the reader to gain insight to the potentially dilutive impact to basic EPS in the future.

A reporting entity should provide a description of any subsequent event that occurs after the end of the most recent balance sheet, but before issuance of the financial statements, that will materially change the number of common shares or potential common shares outstanding. Examples of those events may include:

- the issuance or acquisition of common shares
- the resolution of a contingency under a contingent stock agreement
- the conversion or exercise of potential common shares outstanding at the end of the period into common shares

In certain SEC filings, there may be requirements to provide pro forma EPS for these and other events, as discussed in FSP 7.7.

If changes in common stock resulting from stock dividends or stock splits occur after the close of the period, but before the financial statements are issued, the computations of basic and diluted EPS shall be adjusted retroactively for all periods presented to reflect that change in capital structure. If per-share computations reflect such changes, that fact should be disclosed. In certain circumstances, pro forma EPS may be required as further discussed in FSP 7.6.1.

ASC 505, *Equity*, requires reporting entities to disclose participation rights on its outstanding securities (see ASC 505-10-50-3). After adoption of ASU 2020-06, in order to comply with the general disclosure requirements in ASC 505-10-50-3, an entity shall explain the pertinent rights and privileges of each outstanding instrument in accordance with ASC 505-10-50-13. See FSP 7.4.2 for details.

7.4 Basic EPS

Basic EPS is computed as:

$$\frac{\textit{Income available to parent company common stockholders (the "numerator")}}{\textit{Weighted average number of common shares outstanding (the "denominator")}}$$

The numerator may be impacted by transactions with preferred stockholders (dividends, accretion, repurchases, etc.) and by the required allocation of income to other classes of securities with participation rights.

The denominator may be impacted by share issuances and repurchases, as well as certain forward share purchase agreements, vested restricted stock awards, and certain contingent share arrangements.

7.4.1 Numerator

As discussed in ASC 260-10-45-10, the starting point for the calculation of the numerator is income from continuing operations and net income (after allocation of income to noncontrolling interests under ASC 260-10-45-11A, if applicable). The reporting entity adjusts these amounts by deducting (1) dividends declared in the period on preferred stock (whether or not paid), and (2) cumulative dividends on preferred stock (whether or not declared), regardless of the form of payment of the dividends (e.g., cash, stock, or other assets).

When a dividend on preferred stock is paid in another class of stock, the reporting entity should record the fair value of the shares issued as a charge (debit) to retained earnings. See FG 7.7.1 for further information. As discussed in ASC 260-10-45-12, dividends declared on preferred stock that are payable in the reporting entity's common shares should be deducted from earnings available to common shareholders when computing earnings per share. Accordingly, an adjustment to net income for preferred stock dividends is required regardless of the form of the payment (whether the dividend is paid in cash, other assets, common shares, or additional preferred shares of the same or another class).

As discussed in ASC 260-10-45-11, when there is a loss from continuing operations or net loss, the adjustment for preferred dividends will increase the loss. Preferred dividends that are cumulative only if earned should be deducted only to the extent they are earned.

In addition, the reporting entity should deduct any amount of undistributed earnings allocated to participating securities from the numerator. See FSP 7.4.2 for details.

Figure FSP 7-3 illustrates a number of other adjustments to arrive at the numerator for basic EPS.

Figure FSP 7-3

Possible adjustments made in computing income available to common stockholders for basic EPS after adoption of ASU 2020-06

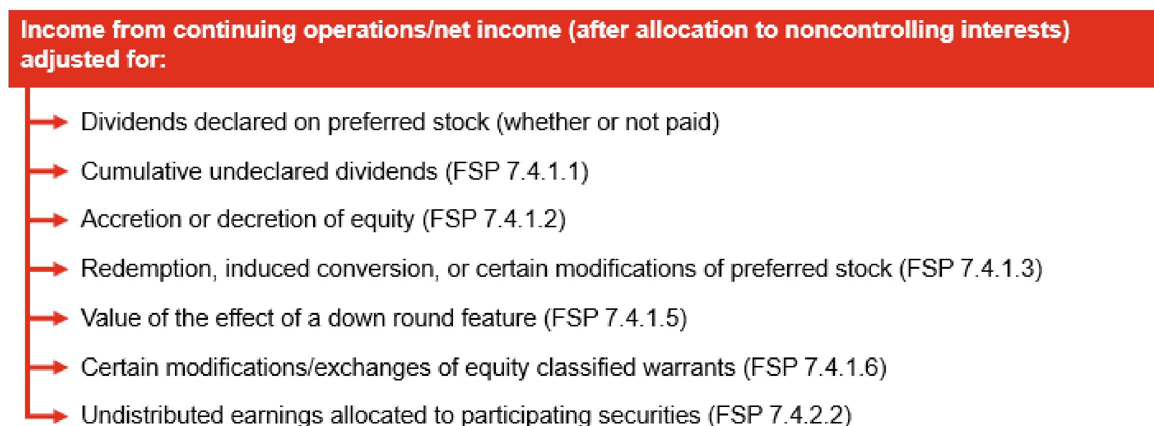
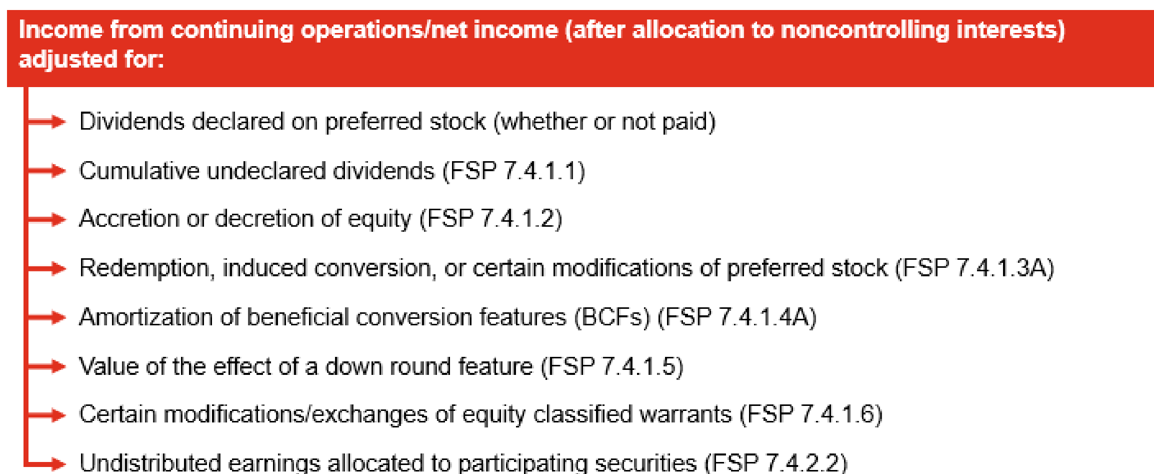


Figure FSP 7-3A

Possible adjustments made in computing income available to common stockholders for basic EPS before adoption of ASU 2020-06



7.4.1.1 Adjustments for cumulative undeclared dividends

A reporting entity may not be required to record undeclared dividends on cumulative preferred stock in its accounting records (i.e., on the balance sheet or statement of stockholders' equity). However, the absence of accounting for undeclared dividends on cumulative preferred stock does not change the

requirement to include the cumulative undeclared dividends in the EPS computation as discussed in ASC 260-10-45-11.

There are two common situations when the accounting for the cumulative undeclared preferred dividends would differ from the EPS treatment. In these instances, the reporting entity is not required to record the accumulated undeclared dividends in its balance sheet but should still deduct the cumulative undeclared dividends from the EPS numerator.

- *Perpetual cumulative preferred stock*

  Because there are no redemption features in perpetual preferred stock, the perpetual cumulative preferred stock is classified within permanent equity (see FSP 5.6.2). As such, no dividend entry is recorded on the balance sheet or the statement of stockholders' equity for any undeclared dividends.

- *Contingently redeemable cumulative preferred stock*

  Typically, the redemption price of contingently redeemable preferred stock includes any cumulative dividends. However, because contingently redeemable preferred stock is not accreted to its redemption value unless it is probable of becoming redeemable (e.g., the contingent event is probable of occurring), when the contingent event is not probable of occurring, there is no entry to record the accretion of the cumulative dividend. In such cases, reporting entities should disclose why redemption of the security is not probable. When redemption becomes probable, the cumulative undeclared dividends would increase the mezzanine equity carrying value. Only dividends declared are reported as dividends payable.

If the reporting entity subsequently declares preferred dividends that accumulated over prior periods, it should only reduce the numerator by the dividends related to the current period, as the amounts related to the prior periods would have already been included in the EPS computations of the prior periods.

7.4.1.2 Adjustments for accretion or decretion of equity

The accretion or decretion of equity, such as mezzanine equity, should be considered in the calculation of the numerator.

The impact of accretion or decretion on the computation of EPS may vary depending on whether the mezzanine equity is common stock, preferred stock, or a noncontrolling interest in a subsidiary.

Impact of mezzanine equity in the form of common stock

ASC 480-10-S99-3A requires common stock reported as mezzanine equity that is redeemable at an amount other than fair value to be treated as having a right to distributions that differs from other common stockholders. As such, changes in the mezzanine carrying amount generally impact income available to common stockholders.

ASC 480-10-S99-3A, paragraph 21 (FN 17), provides two acceptable approaches for allocating earnings to a common security that is redeemable at other than fair value. A reporting entity should make an accounting policy election to either:

- Treat the entire adjustment to the security's carrying amount as being akin to a dividend, or
- Treat the portion of the periodic adjustment to the security's carrying amount that reflects a redemption price in excess of the security's fair value as being akin to a dividend.

The impact may result in either an increase or decrease in income available to common stockholders. However, under either approach, increases cannot exceed the cumulative amount previously reflected as a reduction of income available to common stockholders for that security.

For common stock that is redeemable at fair value, no adjustment to the EPS numerator is required because redemption at fair value is not considered an economic distribution different from other common stockholders.

ASC 480-10-S99-3A, paragraph 21 (FN 18), also states that common stock redeemable based on a specified formula is considered to be redeemable at fair value if the formula is designed to approximate fair value. However, a formula based on a fixed multiple of EBITDA does not approximate fair value, as the appropriate multiple for determining fair value may change over time.

Example FSP 7-1 illustrates how to calculate income available to common stockholders when mezzanine equity in the form of common stock is redeemable for cash at an amount other than fair value.

EXAMPLE FSP 7-1

Accretion of mezzanine common stock in the calculation of the numerator for basic EPS

FSP Corp has 200 outstanding shares of common stock. One hundred shares of the common stock are redeemable for cash at an amount other than fair value.

During the reporting period, there is a $100 increase in the redemption value of the stock ($20 of which is in excess of changes in the stock's fair value) and income of $500.

How should FSP Corp determine the numerator for basic EPS?

Analysis

The numerator depends on FSP Corp's accounting policy choice. If FSP Corp elects to treat the entire adjustment as being akin to an actual dividend, the numerator would be $400 ($500 less $100). If it elected to treat only the portion of the periodic adjustment to the instrument's carrying amount that reflects a redemption in excess of fair value as being akin to an actual dividend, the numerator would be $480 ($500 less $20).

Impact of mezzanine equity in the form of preferred stock

Any accretion or decretion of preferred stock classified as mezzanine equity should reduce or increase the numerator. Decretion can only be recorded to the extent of prior accretion on that instrument, until actual redemption occurs (see FSP 7.4.1.3 for guidance after adoption of ASU 2020-06 and FSP 7.4.1.3A for guidance before adoption of ASU 2020-06).

Impact of mezzanine equity in the form of a noncontrolling interest in a consolidated subsidiary

The same EPS concepts for parent-issued common and preferred mezzanine equity apply to noncontrolling interests in the form of common and preferred equity.

For mezzanine equity-classified noncontrolling interests in the form of preferred stock, presentation of the impact to the numerator may vary, depending on the terms of the redemption feature. If the redemption feature in the preferred securities is issued or guaranteed by the parent, the resulting increases or decreases in the carrying amount of the redeemable noncontrolling interest are treated in the same manner for EPS purposes as dividends on nonredeemable preferred stock of the parent. Therefore, the entire amount of increases or decreases in the carrying amount of a redeemable preferred stock will reduce or increase the numerator in the computation of the parent's EPS, although increases to the numerator cannot exceed prior decreases recorded for that security.

If the subsidiary must redeem the preferred security with no parent company guarantee, the adjustment is attributed to the parent and the noncontrolling interest in accordance with ASC 260-10-55-20 and Example 7 in ASC 260-10-55-64 through ASC 260-10-55-67. As explained in these references, the per-share earnings of the subsidiary are included in the consolidated EPS computations based on the consolidated group's holding of the subsidiary securities pursuant to the two-class method at the subsidiary level (see FSP 7.4.2).

For mezzanine equity-classified noncontrolling interests in the form of common stock, no adjustment is needed if the common stock is redeemable at fair value, as redemption at fair value is not considered an economic distribution different from other common stockholders. However, for mezzanine equity-classified noncontrolling interests in the form of common stock that is redeemable at a value other than fair value, the manner in which the adjustments affect the numerator may differ, depending on how a reporting entity accounts for the redemption feature in its calculation of net income attributable to the parent.

If the terms of the redemption feature are fully considered in the attribution of net income to the parent, the reporting entity would not adjust the numerator, as the redemption feature is already included in the attribution of net income. However, if the terms of the redemption feature are not considered in the attribution of net income, then the parent should adjust the numerator for the impact of the redemption feature using similar approaches as described above.

7.4.1.3 Redemption, induced conversion, or certain modifications of preferred stock–after adoption of ASU 2020-06

ASC 260-10-S99-2 notes that the EPS numerator should be adjusted for a redemption of preferred stock when the fair value of consideration paid upon redemption exceeds the carrying amount, net of its issuance costs, because the excess represents a return to preferred stockholders.

The calculation is as follows:

Fair value of consideration transferred	***less***	Carrying value, net of issuance costs	***equals***	Adjustment to numerator

When the consideration is less than the carrying amount, net of issuance costs, the reporting entity should add the difference to the EPS numerator. For example, this would apply when a redemption is effected at a discount to the carrying amount of the preferred security.

This guidance applies to redemptions of convertible preferred stock regardless of whether the embedded conversion feature is "in-the-money" or "out-of-the-money" at the time of redemption. Example FSP 7-2 illustrates the impact of a redemption of preferred stock on the computation of basic EPS.

EXAMPLE FSP 7-2

Impact of redemption of preferred stock on the calculation of basic EPS

On January 1, 20X6, FSP Corp issued perpetual preferred stock that is convertible in four years. The par value (and issuance price) of the convertible preferred stock is $1 million. The par value is equal to the fair value at the date of issuance.

On December 31, 20X7, FSP Corp paid shareholders $1.2 million in cash to redeem the preferred stock.

What is the impact of the redemption of the convertible preferred stock on the calculation of basic EPS?

Analysis

The difference between the fair value of the consideration transferred to preferred stockholders less the carrying value of the preferred stock would be treated as a "deemed dividend" to preferred shareholders and would result in a reduction to the numerator in the computation of basic EPS.

In this example, the reduction to the numerator in the computation of basic EPS is determined as follows:

Fair value of consideration transferred	$1,200,000
Less: Carrying value of preferred stock	(1,000,000)
Reduction in numerator related to "deemed dividend"	$200,000

If conditionally redeemable preferred shares, initially classified in mezzanine equity, are subsequently determined to be ASC 480 liabilities due to a change in facts (such as the exercise of a holder put feature), such shares would require reclassification from mezzanine equity to a liability. ASC 480-10-30-2 requires the issuer to measure the liability initially at fair value and reduce equity by the amount of the initial measurement, recognizing no gain or loss in the income statement. This reclassification of shares to a liability is akin to the redemption of such shares by the issuance of debt.

Similar to the accounting for the redemption of preferred shares in ASC 260-10-S99-2, if the fair value of the liability differs from the carrying amount of the preferred shares upon reclassification, the

reporting entity should deduct the difference from, or add to, the numerator (i.e., as a deemed dividend or as a return from preferred stockholders).

ASC 810-10-40-2 provides guidance on the accounting for a redemption of a subsidiary's preferred stock, either directly by the subsidiary or by its parent, that is not classified as a liability in the parent's consolidated balance sheet. This type of transaction is treated in the parent's consolidated financial statements as an equity transaction and not recorded in the income statement. The related retained earnings charge or credit is reflected in EPS in the same manner described above.

While ASC 260-10-S99-2 states that the excess consideration requires an adjustment to the numerator, it does not address the treatment of the redemption of preferred stock of a subsidiary when that subsidiary's operations will be classified as a discontinued operation. We believe that, because the adjustment is directly associated with the subsidiary being discontinued, it should be attributed to discontinued operations in computing EPS. The impact of attributing the adjustment to discontinued operations could be meaningful because doing so would result in excluding this amount from the control number for purposes of determining whether potential common shares are dilutive or anti-dilutive in the computation of diluted EPS (see FSP 7.5.1).

Additionally, ASC 260-10-S99-2 indicates that in an induced conversion of preferred shares, the excess of the fair value of securities issued over the fair value of securities issuable pursuant to the original contractual conversion terms also represents a return to preferred stockholders and should reduce the numerator of EPS.

Lastly, as noted in FG 7.8.2, certain modifications of preferred stock can also result in an adjustment to the EPS numerator as a deemed dividend, based on the incremental fair value arising from the modification.

7.4.1.3A Redemption, induced conversion, or certain modifications of preferred stock–before adoption of ASU 2020-06

ASC 260-10-S99-2 notes that the EPS numerator should be adjusted for a redemption of preferred stock when the fair value of consideration paid upon redemption exceeds the carrying amount, net of its issuance costs, because the excess represents a return to preferred stockholders. Reporting entities should first deduct the commitment date beneficial conversion feature (BCF) related to the preferred stock from the fair value of consideration paid. See FG 7.9.2A and FG 7.10.1A for a more detailed discussion of beneficial conversion features in conjunction with the redemption or induced conversion of preferred stock.

The calculation is as follows:

Fair value of consideration transferred	***minus***	original BCF	***less***	Carrying value, net of issuance costs	***equals***	Adjustment to numerator

When the consideration is less than the carrying amount, net of issuance costs, the reporting entity should add the difference between the carrying amount, net of issuance costs, and the consideration to the EPS numerator. For example, this would apply when a redemption is effected at a discount to the carrying amount of the preferred security.

This guidance applies to redemptions of convertible preferred stock regardless of whether the embedded conversion feature is "in-the-money" or "out-of-the-money" at the time of redemption. Example FSP 7-2A illustrates the impact of a redemption of preferred stock on the computation of basic EPS.

EXAMPLE FSP 7-2A

Impact of redemption of preferred stock on the calculation of basic EPS

On January 1, 20X6, FSP Corp issued perpetual preferred stock that is convertible in four years. The par value (and issuance price) of the convertible preferred stock is $1 million.

The convertible preferred stock also contains a beneficial conversion feature with an intrinsic value of $200,000 on the commitment date. The BCF is recorded as a discount on the preferred stock, with a related credit to APIC, and is being amortized to the first date at which the preferred stock is convertible.

On December 31, 20X7, FSP Corp paid shareholders $1.2 million in cash to redeem the preferred stock.

What is the impact of the redemption of the convertible preferred stock on the calculation of basic EPS?

Analysis

The difference between the fair value of the consideration transferred to preferred stockholders less the original BCF, and the carrying value of the preferred stock, including any unamortized discount related to the BCF, is treated as a "deemed dividend" to preferred shareholders and results in a reduction to the numerator in the computation of basic EPS.

In this example, the reduction to the numerator in the computation of basic EPS is determined as follows:

Fair value of consideration transferred	$1,200,000
Less: BCF (at original intrinsic value)	(200,000)
Less: Carrying value of preferred stock	(900,000)[1]
Reduction in numerator related to "deemed dividend"	$100,000

[1]$1,000,000 par value less $100,000 remaining discount associated with the BCF.

Note that the accounting model for reacquisition of debt securities that contain a BCF and its impact on the gain/loss on extinguishment in ASC 470-20-40-3 differs from that of preferred stock, which is addressed in ASC 260-10-S99-2 (see FG 7.10.1A).

If conditionally redeemable preferred shares, initially classified in mezzanine equity, are subsequently determined to be ASC 480 liabilities due to a change in facts (such as the exercise of a holder put feature), such shares would require reclassification from mezzanine equity to a liability. ASC 480-10-

30-2 requires the issuer to measure the liability initially at fair value, and reduce equity by the amount of the initial measurement, recognizing no gain or loss in the income statement. This reclassification of shares to a liability is akin to the redemption of such shares by the issuance of debt.

Similar to the accounting for the redemption of preferred shares in ASC 260-10-S99-2, if the fair value of the liability (less any initial BCF on the preferred stock) differs from the carrying amount of the preferred shares upon reclassification, the reporting entity should deduct the difference from, or add to, the numerator (i.e., as a deemed dividend or as a return from preferred stockholders).

ASC 810-10-40-2 provides guidance on the accounting for a redemption of a subsidiary's preferred stock, either directly by the subsidiary or by its parent, that is not classified as a liability in the parent's consolidated balance sheet. This type of transaction is treated in the parent's consolidated financial statements as an equity transaction and not recorded in the income statement. The related retained earnings charge or credit is reflected in EPS in the same manner described above.

While ASC 260-10-S99-2 states that the excess consideration requires an adjustment to the numerator, it does not address the treatment of the redemption of preferred stock of a subsidiary when that subsidiary's operations will be classified as a discontinued operation. We believe that, because the adjustment is directly associated with the subsidiary being discontinued, it should be attributed to discontinued operations in computing EPS. The impact of attributing the adjustment to discontinued operations could be meaningful because attributing it to discontinued operations would result in excluding this amount from the control number for purposes of determining whether potential common shares are dilutive or anti-dilutive in the computation of diluted EPS (see FSP 7.5.1).

Additionally, ASC 260-10-S99-2 indicates that in an induced conversion of preferred shares, the excess of the fair value of securities issued over the fair value of securities issuable pursuant to the original contractual conversion terms also represents a return to preferred stockholders and should reduce the numerator of EPS.

Lastly, as noted in FG 7.8.2, certain modifications of preferred stock can also result in an adjustment to the EPS numerator as a deemed dividend, based on the incremental fair value arising from the modification.

7.4.1.4A Adjustments related to beneficial conversion features–before adoption of ASU 2020-06

The guidance in this section is only applicable before the adoption of ASU 2020-06. A reporting entity should not apply this guidance after adoption of ASU 2020-06 as the beneficial conversion feature model is eliminated.

For convertible preferred securities, any amortization of the discount resulting from an allocation of proceeds to a beneficial conversion feature is analogous to a dividend. The reporting entity should recognize the amortization as a return to the preferred stockholders (a deemed dividend), following the guidance in ASC 470-20-30. The deemed dividend should be deducted from the numerator.

The reporting entity should also consider the deemed dividend when determining the dilutive impact of the convertible security in the computation of diluted EPS (see FSP 7.5.6A). That is, the adjustment to the numerator should be reversed if conversion is assumed.

For convertible debt securities, the discount created by recording the beneficial conversion feature represents an adjustment of the effective interest rate of the security, and the reporting entity should reflect it as a charge to interest cost.

For basic EPS, convertible debt instruments with BCFs would not result in an adjustment to the numerator, as the interest cost is already included in net income. However, the interest on the debt (inclusive of amortization of the discount), net of associated tax, is added back to the numerator if the security is assumed to be converted for purposes of calculating diluted EPS (see FSP 7.5.6A).

7.4.1.5 Adjustments related to instruments with down round features–after adoption of ASU 2020-06

ASU 2020-06 eliminates the beneficial conversion feature model for both convertible preferred stock and convertible debt. Under the new guidance, convertible preferred stock is subject to the measurement provisions that require a reporting entity to record the value of the effect of a down round feature when it is triggered. Convertible debt continues to be excluded from the measurement provisions of the down round guidance because ASC 825 requires an issuer of convertible debt to disclose the fair value of the convertible debt (at the convertible debt instrument level) in the notes to the financial statements.

The ASC Master Glossary provides the following definition of a down round feature.

Definition from ASC Master Glossary

Down round feature: A feature in a financial instrument that reduces the strike price of an issued financial instrument if the issuer sells shares of its stock for an amount less than the currently stated strike price of the issued financial instrument or issues an equity-linked financial instrument with a strike price below the currently stated strike price of the issued financial instrument.

A down round feature may reduce the strike price of a financial instrument to the current issuance price, or the reduction may be limited by a floor or on the basis of a formula that results in a price that is at a discount to the original exercise price but above the new issuance price of the shares, or may reduce the strike price to below the current issuance price. A standard antidilution provision is not considered a down round feature.

Down round features are most often found in warrants and conversion options embedded in debt or preferred equity instruments issued by private reporting entities, but may also be found in financial instruments issued by public reporting entities. These features reduce the strike price of the instrument when an issuer sells shares of its stock (or issues equity-linked instruments) for amounts less than the current strike price (or with a strike price less than the current strike price).

When a down round feature is triggered (i.e., when the strike or conversion price is reduced) on an equity-classified freestanding financial instrument (e.g., a warrant) or an equity-classified convertible preferred stock (if the conversion feature has not been bifurcated), reporting entities that present earnings per share must recognize the value of the effect of the down round feature as a deemed dividend. This value reduces the income available to common stockholders in the computation of basic earnings per share.

The value of the effect of the down round is calculated as the difference between (1) the fair value of the financial instrument (without the down round feature) with a strike price corresponding to the stated strike price of the issued instrument (that is, before the strike price reduction), and (2) the fair value of the financial instrument (without the down round feature) with a strike price corresponding to the reduced strike price. These fair values are determined as of the date the down round feature is triggered.

7.4.1.5A Adjustments related to instruments with down round features–before adoption of ASU 2020-06

The ASC Master Glossary provides the following definition of a down round feature.

Definition from ASC Master Glossary

Down round feature: A feature in a financial instrument that reduces the strike price of an issued financial instrument if the issuer sells shares of its stock for an amount less than the currently stated strike price of the issued financial instrument or issues an equity-linked financial instrument with a strike price below the currently stated strike price of the issued financial instrument.

A down round feature may reduce the strike price of a financial instrument to the current issuance price, or the reduction may be limited by a floor or on the basis of a formula that results in a price that is at a discount to the original exercise price but above the new issuance price of the shares, or may reduce the strike price to below the current issuance price. A standard antidilution provision is not considered a down round feature.

Down round features are most often found in warrants and conversion options embedded in debt or preferred equity instruments issued by private reporting entities, but may also be found in financial instruments issued by public reporting entities. These features reduce the strike price of the instrument when an issuer sells shares of its stock (or issues equity-linked instruments) for amounts less than the current strike price (or with a strike price less than the current strike price).

When a down round feature is triggered (i.e., when the strike price is reduced) on an equity-classified freestanding financial instrument (e.g., a warrant), reporting entities that present earnings per share must recognize the value of the effect of the down round feature as a deemed dividend. This value reduces the income available to common stockholders in the computation of basic earnings per share.

The value of the effect of the down round is calculated as the difference between (1) the fair value of the financial instrument (without the down round feature) with a strike price corresponding to the stated strike price of the issued instrument (that is, before the strike price reduction), and (2) the fair value of the financial instrument (without the down round feature) with a strike price corresponding to the reduced strike price. These fair values are determined as of the date the down round feature is triggered.

When a down round feature on an embedded conversion option (that is not separately accounted for) is triggered, the accounting guidance on contingent beneficial conversion features in ASC 470-20-25-20 must be considered.

7.4.1.6 *Adjustments for equity-classified written call options*

New guidance

In May 2021, the FASB issued ASU 2021-04, *Earnings Per Share (Topic 260), Debt—Modifications and Extinguishments (Subtopic 470-50), Compensation—Stock Compensation (Topic 718), and Derivatives and Hedging—Contracts in Entity's Own Equity (Subtopic 815-40)*. The ASU clarifies the guidance related to an issuer's accounting for modifications or exchanges of freestanding equity-classified written call options (for example, warrants) that remain equity-classified after modification or exchange. The amendments in the ASU are effective for all entities for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. Early adoption is permitted for all entities, including adoption in an interim period. If an entity elects early adoption in an interim period, the guidance should be applied as of the beginning of the fiscal year that includes that interim period.

If the modification or exchange of a freestanding equity-classified written call option is not within the scope of other guidance, a reporting entity shall apply the guidance in ASC 815-40-35-16 through ASC 815-40-35-18. Under this guidance, a reporting entity should recognize the effect of a modification or an exchange (as calculated below) in the same manner as if cash had been paid as consideration.

Modifications or exchanges that are not related to debt or equity financings, compensation for goods or services, or other exchange transactions within the scope of other guidance should be recognized as a dividend consistent with ASC 815-40-35-17(d). The dividend amount is measured as the excess, if any, of the fair value of the modified or exchanged instrument over the fair value of that instrument immediately before it is modified or exchanged in accordance with ASC 815-40-35-16. A reporting entity should deduct the effect of the modification or exchange (i.e., the dividend) in computing income available to common stockholders for basic earnings per share in accordance with ASC 260-10-45-15. See ASC 815-40-55-51 for an example of a warrant modification recognized as a dividend.

7.4.2 *Participating securities and the two-class method*

The capital structures of some reporting entities include participating securities. ASC 260-10-20 defines a participating security as follows:

Definition from ASC 260-10-20

Participating Security: A security that may participate in undistributed earnings with common stock, whether that participation is conditioned upon the occurrence of a specified event or not. The form of such participation does not have to be a dividend—that is, any form of participation in undistributed earnings would constitute participation by that security, regardless of whether the payment to the security holder was referred to as a dividend.

Examples of participating securities include:

- Securities that participate in dividends with common stock according to a predetermined formula (e.g., two for one) with, at times, an upper limit on the extent of participation (e.g., up to, but not beyond, a specified amount per share).

- A class of common stock with different dividend rates from those of another class of common stock but without priority or senior rights.

In accordance with ASC 260-10-45-60A, any securities meeting the definition of a participating security, irrespective of whether the securities are convertible, nonconvertible, or potential common stock are included in the computation of basic EPS using the two-class method.

7.4.2.1 Overview of the two-class method

ASC 260 describes the two-class method as an earnings allocation formula.

Excerpt from ASC 260-10-45-60

The two-class method is an earnings allocation formula that treats a participating security as having rights to earnings that otherwise would have been available to common shareholders…

The key to applying the two-class method in the computation of basic EPS is identifying any participating securities that are entitled to receive dividends if and when declared on common stock. These participating securities must be entitled to these rights in their current form (e.g., prior to exercise, settlement, conversion, or vesting).

The reporting entity is required to allocate any undistributed earnings between the common stockholders and the participating security holders based on their respective rights to receive dividends, as if all undistributed earnings for the period were distributed.

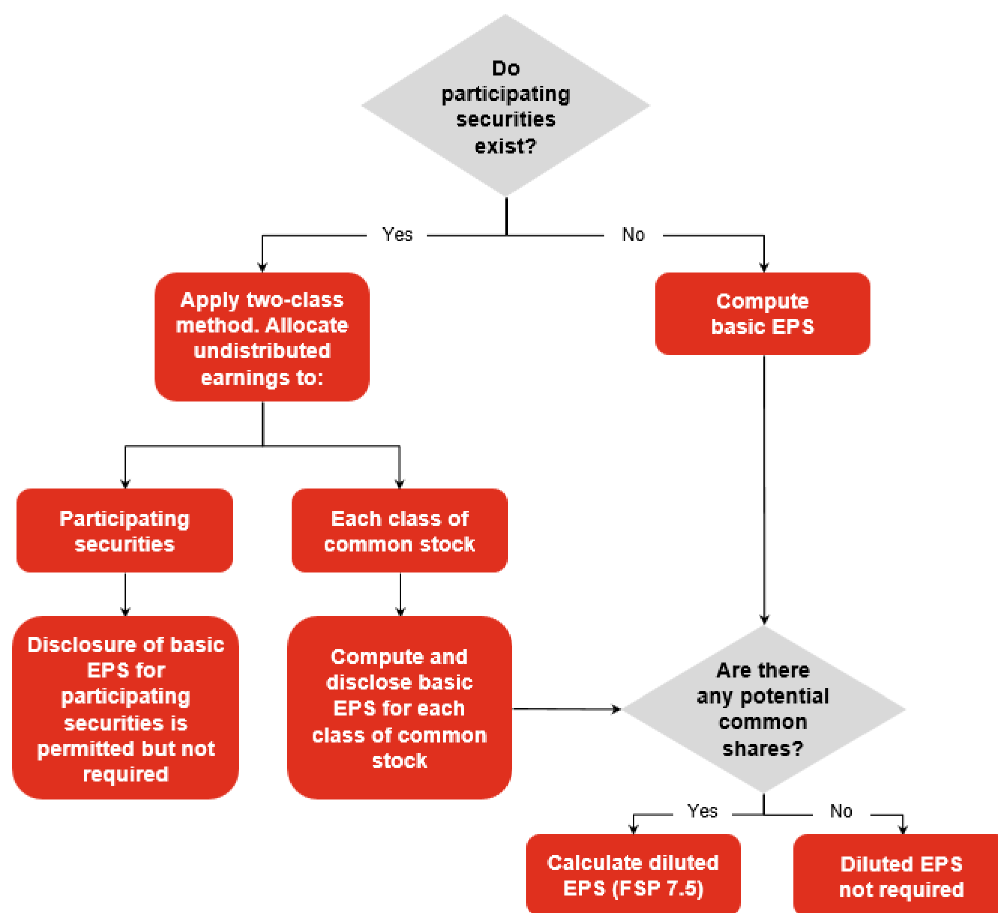
A participating security will reduce EPS regardless of whether dividends are actually paid, because the two-class method allocates earnings away from common stockholders to the participating security holders. This process is explained in FSP 7.4.2.2.

The reporting entity is not required to present basic and diluted EPS for participating securities, other than a second class of common stock, under the two-class method, but it is not precluded from doing so.

In some cases, a reporting entity may have two classes of common stock that have identical rights and privileges, except for voting rights. Generally, we believe the two classes can be combined and presented as one class for EPS purposes when the only difference is related to voting rights, but the classes otherwise share equally in dividends and residual net assets on a per share basis. In this situation, a reporting entity should clearly indicate that the earnings per share amounts reflect both classes of common stock, and should appropriately disclose the facts and circumstances in the footnotes.

Figure FSP 7-4 illustrates when and how to use the two-class method in computing basic EPS.

Figure FSP 7-4
EPS decision tree



7.4.2.2 Allocating undistributed earnings to participating securities

Reporting entities need to allocate undistributed earnings for the period to a participating security based on the contractual participation rights of the security to share in those earnings, as if all of the earnings for the period had been distributed. However, if the terms of the participating security do not specify objectively-determinable, nondiscretionary participation rights, undistributed earnings would not be allocated based on arbitrary assumptions.

In addition, if a reporting entity can avoid a distribution of earnings to a participating security, even when all of the earnings for the period are distributed, the reporting entity would not allocate undistributed earnings to that participating security.

The use of the two-class method requires an assumption of the hypothetical distribution of all earnings each period to all common stock and participating security holders according to the contractual terms of the securities. ASC 260-10-45-60B requires reporting entities to perform the hypothetical distribution of all earnings, regardless of whether those earnings would actually be distributed from an economic or practical perspective, and regardless of whether there are other legal or contractual limitations on its ability to pay dividends (e.g., debt covenants or state law considerations on the payment of dividends). The allocation of undistributed earnings is generally based on the weighted

average number of common shares and participating securities outstanding for the period, not based on the shares or participating securities outstanding at the end of the period.

Question FSP 7-1

Does a reporting entity have to allocate undistributed earnings based on the weighted average number of common shares and participating securities outstanding for the period when the entire class of securities is created, sold, converted, or redeemed during the period?

PwC response

No. When an entire class of participating securities is created, sold, converted, or redeemed during the period, we believe a reporting entity has the option of performing a separate allocation of undistributed earnings for the pre- and post-transaction period as an alternative to the weighted average allocation. Under this method, net income for the pre- and post-transaction portions of the period are allocated to the securities outstanding during each respective portion of the period. This earnings allocation methodology may be used only if the underlying accounting systems and controls provide that the net income amount for each portion of the period reflects all appropriate entries that a normal close process would include. The allocation methodology is an accounting policy choice and should be consistently applied.

Question FSP 7-2

In some entities (especially those with noncorporate structures), all distributions may follow a stated "waterfall" that requires that any distributions be first paid to Class A preferred unitholders until those holders receive a compounded cumulative annual return (e.g., 10%), as well as the return of all of their invested capital. Subsequent distributions are then paid to other unitholders, including common units.

In such a situation, in calculating earnings per share under the two-class method, does the hypothetical distribution of earnings in each period to all security holders following the terms of the organizing documents mean that all book net income up to the amount of invested capital of Class A preferred units should be allocated to the Class A preferred units, as that is how cash would be distributed?

PwC response

No. When considering the allocation of earnings between classes of securities, the focus is generally on the return on capital of each security, not the return of capital. As described above, the two-class method is an allocation of earnings of the reporting entity. This reflects the change in the net assets of the entity, and how each security holder shares in those increases and decreases. It is often the case that a reporting entity may be prohibited from paying any dividends on common stock while a class of preferred stock is outstanding. This effectively operates in a similar economic fashion as the situation described in the question but, as noted above, contractual limitations on the ability to pay dividends are ignored in the application of the two-class method.

Accordingly, we believe that in the above situation, earnings should generally be allocated first to the Class A preferred unitholders for their 10% cumulative dividends, and then shared between the common and preferred unitholders based on their right to receive dividends once dividends are being paid to the different classes. To do otherwise (i.e., to assume that all potential distributions would follow the waterfall and be used to repay the Class A preferred unitholders' invested capital) would

often allocate all earnings in all periods to the preferred unitholders (as each year is evaluated independently and if the principal is not actually paid, each year's allocation would assume that the invested capital still needs to be paid), which we do not believe is consistent with the sharing of earnings (i.e., increases in net asset value) of the reporting entity between the classes of unitholders. The allocation of earnings for these reporting entities can be particularly complex in periods of loss, or in periods subsequent to periods of loss.

7.4.2.3 Allocating losses to participating securities

As noted in ASC 260-10-45-67 and ASC 260-10-45-68, a reporting entity should only allocate losses to convertible and nonconvertible participating securities if, based on the contractual terms of the participating securities, the securities have a contractual obligation to share in the losses of the reporting entity and the basis on which losses are shared is objectively determinable.

ASC 260-10-45-67 provides criteria to determine whether the holder of a participating security has a contractual obligation to share in the losses.

If a participating security is not required to share losses, it will not be allocated losses in periods of net loss, although it would be allocated earnings in periods of net income. Each reporting period should be evaluated independently; there is no cumulative "tracking" of the amounts allocated. Although this treatment is not symmetrical, it is consistent with the notion that EPS should reflect the most dilutive results. The reporting entity should determine whether a participating security holder has an obligation to share in its losses each period.

In computing year-to-date EPS, reporting entities should use year-to-date income (or loss) in determining whether undistributed earnings should be allocated to participating security holders. For example, if there is a quarter-to-date loss but year-to-date income for a given period, the year-to-date EPS computation should include an allocation to participating security holders even if the quarter-to-date computation did not.

We believe the discussion of allocating losses in ASC 260-10-45-67 and ASC 260-10-45-68 was written in the context of preferential securities. If the participating security is a second class of common stock (such as a nonvoting class with different dividend rates) that shares equally in residual net assets, losses would generally be allocated equally to each class of common stock.

Example FSP 7-3 illustrates how to apply the two-class method to participating securities.

EXAMPLE FSP 7-3

Application of the two-class method of EPS

FSP Corp has 10 million shares of common stock and 2 million shares of convertible preferred stock (issued at $10 par value per share) outstanding.

FSP Corp's net income is $50 million.

Each share of preferred stock is convertible into 3 shares of common stock.

The preferred stock participates on a 1:1 basis in any common dividends that would have been payable had the preferred stock been converted immediately prior to the record date of any dividend declared on the common stock (i.e., as-converted basis).

At year-end, FSP Corp pays dividends of $2 per share to the common stockholders and $6 per share to the preferred stockholders, since each preferred share converts into 3 common shares.

How would FSP Corp compute basic EPS under the two-class method?

Analysis

Step 1: Calculate the undistributed earnings

Net income		$50,000,000
Less dividends declared:		
Common stock	($20,000,000)[1]	
Participating preferred stock	(12,000,000)[2]	(32,000,000)
Undistributed earnings		$18,000,000

[1] 10 million shares x $2 dividend/share

[2] 2 million preferred shares x $6 dividend per preferred share

Step 2: Allocate undistributed earnings to the two classes

To common:

[(Common shares outstanding) / (common shares outstanding + "as converted" shares of preferred)] x undistributed earnings

[(10,000,000) / (10,000,000 + 6,000,000)] x $18,000,000 = $11,250,000

To preferred:

[("As-converted" common shares) / (common shares outstanding + "as converted" shares of preferred)] x undistributed earnings

[(6,000,000) / (10,000,000 + 6,000,000)] x $18,000,000 = $6,750,000

Step 3: Compute basic EPS for common stockholders

Net income	$50,000,000
Less: Earnings attributable to preferred stockholders	(18,750,000)[1]
Income available to common stockholders	$31,250,000
Divided by common shares outstanding	10,000,000
Basic EPS	$3.13

[1] $12,000,000 dividend plus undistributed earnings of $6,750,000 allocated to preferred stockholders.

Allocating losses to restricted stock

Vested restricted stock may share in residual net assets because the fair value of the restricted stock would reflect any losses that have been incurred. However, unvested restricted shares do not share in residual net assets and, therefore, do not economically absorb the loss. As such, reporting entities should not allocate losses to unvested restricted shares.

Applying master limited partnership guidance to other types of corporate entities when allocating excess distributions

ASC 260 has certain provisions that specifically address the application of the two-class method to master limited partnerships when cash distributions exceed earnings for the period (see FSP 32 for further discussion). We believe this guidance may be applied by analogy to other types of corporate entities that have dividend distributions in excess of current period earnings. Therefore, in these situations, if the participating securities are contractually obligated to participate in the losses of the reporting entity, a portion of the excess distribution is allocated to these security holders based on their contractual participation in losses. If they do not participate in losses, all of the excess distribution is allocated to common stockholders.

Example FSP 7-4 illustrates how to apply the master limited partnership guidance when a reporting entity has participating securities and dividend distributions in excess of earnings.

EXAMPLE FSP 7-4

Allocating earnings to common shares when there are participating securities and dividends in excess of earnings

FSP Corp reports net income of $10 million in the quarter ended June 30, 20X7, and has 9.5 million shares of common stock outstanding.

FSP Corp has granted 1 million shares of unvested restricted stock to certain employees. The restricted stock is entitled to nonforfeitable dividends and, as such, is deemed to be a participating security. Requisite service is expected to be rendered for all shares of restricted stock.

During the quarter, FSP Corp pays dividends of $1/share, totaling $10.5 million ($9.5 million to the common stockholders and $1 million to the restricted stockholders).

How should FSP Corp allocate income to the common shares?

Analysis

By analogizing to the master limited partnership guidance, we believe FSP Corp generally should allocate the excess of distributions over earnings to the common shares, as the restricted shares have no obligation to participate in losses. As such, the excess of distributions over earnings would be allocated as follows:

	Common stock	Restricted stock	Total
Distributed earnings	$9,500,000	$1,000,000	$10,500,000
Excess distributions	(500,000)	—	(500,000)
Net income	$9,000,000	$1,000,000	$10,000,000

7.4.2.4 *Allocating earnings in unusual circumstances*

In a reporting period when there are different combinations of income and loss on different line items, and the participating securities are not contractually obligated to share in losses, there is no clear guidance in ASC 260 as to how earnings should be allocated to participating securities. We believe an acceptable approach is to allocate earnings to participating securities based on the "control number," as discussed in ASC 260-10-45-18 and FSP 7.5.1.

The "control number" concept requires the use of income from continuing operations (adjusted for preferred dividends, as described in paragraph ASC 260-10-45-11) to determine whether potential common shares are dilutive or anti-dilutive. Applying this concept by analogy, if a reporting entity has income from continuing operations but losses from discontinued operations resulting in an overall net loss, it could allocate the loss using the two-class method. However, if there is a loss from continuing operations but income from discontinued operations results in overall net income, nothing would be allocated to participating securities for any of the categories.

Another acceptable method is to treat each line item as an independent calculation and only allocate earnings to participating securities for those line items for which income is reported. There would be no allocation of losses to participating securities for those line items for which a loss is reported.

For example, in a reporting period in which there is a loss from continuing operations, gain from discontinued operations and overall net income, we believe an acceptable approach is to not allocate losses from continuing operations to the participating securities, as the participating securities do not have a contractual obligation to participate in losses. However, the gain from discontinued operations and net income would be allocated to participating securities. Under this method, the sum of the individual EPS income statement line items would not reconcile to the total net income per share.

Other allocation methods may also be appropriate. The reporting entity should make and disclose an accounting policy election related to the allocation methodology and consistently apply the policy elected.

7.4.2.5 *Other securities which may be considered participating*

Consistent with ASC 260-10-45-60A, potential common shares (securities or other contracts that may entitle their holders to obtain common stock such as options, warrants, forwards, or other contracts) may be participating securities if, in their current form, they are entitled to receive dividends when declared on common stock.

Stock options, warrants, and other contracts to issue common stock

A nonforfeitable right to dividends is a non-contingent transfer of value and one in which paid dividends are not forfeited if the award does not vest. ASC 260-10-45-61A notes that an unvested share-based payment award that includes nonforfeitable rights to dividends or dividend equivalents meets the definition of a participating security in its current form—that is, prior to the requisite service having been rendered for the award.

ASC 260-10-45-68B discusses the computation of EPS when share-based payment awards with nonforfeitable rights to dividends or dividend equivalents are present. ASC 718, *Compensation—Stock Compensation*, requires reporting entities to recognize compensation cost for nonrefundable dividends or dividend equivalents paid on awards for which the requisite service is not (or is not expected to be) rendered (see SC 2.9.3.1). Dividends or dividend equivalents paid on awards for which the requisite service is (or is expected to be) rendered are charged to retained earnings. The dividends or dividend equivalents declared or paid and charged to retained earnings for these awards should be included in the earnings allocation to participating securities, reducing income available to common shareholders. A reporting entity should not include dividends or dividend equivalents that have been accounted for as compensation cost in the earnings allocation to participating securities because that amount has already reduced net income. However, reporting entities should allocate undistributed earnings to all outstanding share-based payment awards that have nonforfeitable rights to dividends (i.e., participating awards), including those for which the requisite service is not expected to be rendered as these amounts are not reflected in compensation cost but will still reduce what is available for common shareholders.

If a reporting entity changes the estimate of the number of awards for which the requisite service is not expected to be rendered, it should apply this change to the calculation of EPS in the period the change in estimate occurs. This change in estimate will affect compensation cost and, therefore, net income in the current period; however, a current period change in an entity's expected forfeiture rate would not affect prior period EPS computations. The example in ASC 260-10-55-76A through ASC 260-10-55-76D (Case D: Participating Share-Based Payment Awards) illustrates this.

Share-based payment awards that include forfeitable rights to dividends are not considered participating securities and should not be allocated undistributed earnings. However, similar to the guidance above for awards with nonforfeitable rights to dividends, the dividends or dividend equivalents actually declared or paid and charged to retained earnings for awards with forfeitable rights to dividends should also reduce income available to common shareholders. These amounts reflect dividends that have been paid to other-than-common-stockholders, and reduce the amount available for distribution to the common stockholders.

Convertible securities and options

Participation may not always involve the right to receive dividends in cash. For example, certain securities, including some share-based payment awards, do not pay dividends to the holders when declared on common stock. Instead, the conversion or exercise price of the security may be adjusted for dividends to keep the holder whole. In some cases, those adjustments may constitute participation rights.

If a convertible security has a mandatory conversion date, and if dividends or dividend equivalents are transferred to the holder of the convertible security in the form of a reduction of the conversion price or an increase in the conversion ratio of the security, then such feature would represent a participation

right, because the transfer of value is not contingent on a decision to exercise (similar to a forward contract). In such cases, the reporting entity would reflect the participating feature in EPS as a participation right.

Dividends or dividend equivalents transferred to the holder of a convertible security in the form of an adjustment or reduction of the conversion price or an increase in the conversion ratio of the security do not represent participation rights if conversion is optional (i.e., at the election of either the holder or the reporting entity). This conclusion also applies to other securities that could be (but are not required to be) converted into a reporting entity’s common stock (e.g., options or warrants), if those securities provide for an adjustment to the exercise price that is tied to the declaration of dividends by the issuer.

Since obtaining the benefit of an adjustment to the conversion or exercise price is dependent on the actual conversion or exercise of the security, which may or may not occur, these types of adjustments may not result in an actual transfer of value to the holder of the security (they are referred to as contingent transfers of value) and are, therefore, not a participation right. Accordingly, reporting entities should not allocate any undistributed earnings to these securities.

Forward contracts

In accordance with ASC 260-10-45-63, a provision in a forward contract to issue a reporting entity’s own equity shares that reduces the contractual price per share when dividends are declared on the issuing entity’s common stock is a participation right.

ASC 260-10-45-63

In a forward contract to issue an entity's own equity shares, a provision that reduces the contract price per share when dividends are declared on the issuing entity's common stock represents a participation right. Such a provision constitutes a participation right because it results in a noncontingent transfer of value to the holder of the forward contract for dividends declared during the forward contract period. That is, the forward contract holder has a right to participate in the undistributed earnings of the issuing entity because a dividend declaration by the issuing entity results in a transfer of value to the holder of the forward contract through a reduction in the forward purchase price per share. Because that value transfer is not contingent - as opposed to a similar reduction in the exercise price of an option or warrant - the forward contract is a participating security, regardless of whether, during the period the contract is outstanding, a dividend is declared.

Variable share-settled instruments (such as FELINE PRIDES, ACES and DECS)

Certain equity-linked securities involve arrangements with variable settlement features, referred to as “variable share forwards,” or “variable share forward delivery agreements.” These instruments are marketed by financial institutions under different proprietary names (e.g., FELINE PRIDES, ACES, and DECS).

Variable share forward delivery arrangements differ from fixed-term forwards through which the holder will always receive the benefit of dividends if declared (i.e., the transfer of value is non-contingent). Under variable share forwards, the holder is required to pay a certain amount of money to the reporting entity at the settlement date, and either of the following will occur:

- If the reporting entity's stock price at settlement falls within the established range, commonly referred to as the "dead zone," there is no transfer of value, and the holder receives a variable number of shares of reporting entity stock with value equal to the contractual amount owed by the holder.

- If the reporting entity's stock price at settlement is above or below a certain range, the holder receives a fixed number of shares of reporting entity stock and realizes a benefit or loss.

The terms of these arrangements typically include a provision that, if the reporting entity declares a dividend on common stock while the arrangement is outstanding, the stock prices associated with the end points of the range, and the number of shares delivered when the stock price at settlement is outside of the range, are adjusted according to a formula. However, there is no adjustment to the number of shares delivered when the stock price at settlement is within the range.

Economically, these securities act as a combination of a written call option and a purchased put option, each with different strike prices. The issuer of a variable share forward delivery agreement should determine whether any adjustment provisions included in its contract convey a contingent or a non-contingent transfer of value for dividends declared. Generally, a variable share forward delivery agreement is not considered a participating security provided:

- The agreement does not entitle the holder to participate in dividends if the final settlement is within the range; and

- At issuance, it is at least reasonably possible that the final settlement of the contract will be at a price within the range.

To determine whether it is reasonably possible for a particular variable share forward delivery agreement to settle at a price within the dead zone, the reporting entity may need to perform a quantitative evaluation that incorporates:

- The contractual terms of the agreement, including the method of adjusting for dividends and the maturity date,

- Volatility of the issuer's stock,

- Historical and expected dividends, and

- The width of the dead zone, and whether the issuer's stock price is inside or outside the dead zone at issuance.

We believe the assessment as to whether these variable share forward agreements constitute participating securities need only be performed at issuance of the instrument, or upon a subsequent modification.

Mandatorily redeemable stock

Under ASC 480, *Distinguishing Liabilities from Equity*, mandatorily redeemable financial instruments are accounted for as liabilities. If these instruments have a right to dividends declared on the common shares, they are considered participating securities. Therefore, in computing the numerator, reporting entities should deduct any amounts, including contractual (cumulative)

dividends and participation rights (e.g., of senior securities) in undistributed earnings that are attributable to mandatorily redeemable financial instruments (regardless of form), unless those amounts have already been recognized as interest in the income statement.

7.4.2.6 Targeted stock

Some registrants issue classes of stock that they characterize as "targeted" or "tracking" stock. The dividend rates associated with these classes of stock differ and are based upon the earnings of a specific business unit, activity, or assets of the registrant. As such, they are subject to the two-class method of ASC 260.

A reporting entity with targeted stock should ensure it is compliant with the contractual terms of the arrangement as to how the reporting entity's overall earnings would be allocated to the different classes of stock, especially if there are inter-unit transactions that are eliminated in consolidation. The total amount of earnings attributable to all the classes of stock under the two-class method for EPS purposes should be equal to consolidated income. In addition, EPS with respect to any class of the reporting entity's securities should be presented only in the reporting entity's consolidated financial statements, or in its related consolidated information, as that is the entity that issued the stock, and not the targeted business.

7.4.3 Denominator

The denominator of the basic EPS computation starts with the weighted-average number of common shares outstanding, which is defined in ASC 260-10-20.

Definition from ASC 260-10-20

Weighted-average number of common shares outstanding: The number of shares determined by relating the portion of time within a reporting period that common shares have been outstanding to the total time in that period. In computing diluted EPS, equivalent common shares are considered for all dilutive potential common shares.

The number of weighted-average common shares outstanding is the average of shares outstanding and assumed to be outstanding (e.g., contingently issuable shares if the contingency has been met). While a daily calculation would be the most precise, other averaging methods may be used as long as they produce reasonable results. As noted in ASC 260-10-55-2, methods that introduce artificial weighting are not acceptable. The reporting entity should weight shares issued and shares reacquired during the period for the portion of the period they were outstanding.

Figure FSP 7-5 is a summary of selected securities that are excluded from the denominator of basic EPS, except as noted, and the section in this chapter where each security is discussed in detail.

Figure FSP 7-5

Selected securities excluded from the denominator of basic EPS

Type of security	Impact on denominator of basic EPS	Section
Contingent shares	Not included in the basic EPS denominator until the contingency has been resolved	FSP 7.4.3.1
Mandatorily convertible instruments	Not included in the basic EPS denominator	FSP 7.4.3.2
Prepaid variable share forward sale contracts	Variable shares in excess of the minimum number to be issued under the arrangement are not included in the basic EPS denominator.	FSP 7.4.3.3
Restricted stock-based compensation awards	Not included in the basic EPS denominator until vested, unless vesting occurs upon retirement and the employee is retirement eligible	FSP 7.4.3.4
Employee stock options	Not included in the basic EPS denominator	FSP 7.4.3.5
Mandatorily redeemable common stock	Not included in the basic EPS denominator if the stock is liability classified under ASC 480	FSP 7.4.3.6
Forward purchase contracts for a fixed number of shares	Shares subject to the forward purchase contract are not included in the basic EPS denominator if the forward purchase contract requires physical settlement of a fixed number of shares in exchange for cash.	FSP 7.4.3.6
Share lending arrangements	Not included in the basic EPS denominator unless default of the share lending arrangement occurs	FSP 7.4.3.7
Employee stock purchase plans	Typically not included in the basic EPS denominator until the shares are actually purchased	FSP 7.4.3.8

7.4.3.1 *Contingent shares*

In accordance with ASC 260-10-45-12C and ASC 260-10-45-13, contingently issuable shares, including shares issuable for little or no consideration, are included in the denominator for basic EPS only when the contingent condition has been met and there is no longer a circumstance in which those shares would not be issued. For example, if the issuance of shares were subject to a shareholder vote, they would not be included in EPS until the vote occurs. The shares are included in the computation of

basic EPS as of the date that issuance of the shares is no longer contingent, even if the shares are not legally issued until a later date.

However, awards for which restrictions have lapsed, and shares to be issued to settle a deferred compensation obligation that may only be settled in shares (for example, Plan A in ASC 710-10-25-15), are included as outstanding shares for basic EPS.

Outstanding common shares that are contingently returnable are treated in the same manner as contingently issuable shares.

7.4.3.2 Mandatorily convertible instruments

In August 2008, the FASB issued an exposure draft (ED) that proposed amendments to FASB Statement No. 128, *Earnings Per Share* (FAS 128). The Basis for Conclusions of the ED stated that the shares to be issued upon conversion of a mandatorily convertible instrument should be included in basic EPS only if the holder has the present right or is deemed to have the present right to share in current-period earnings with common shareholders. Accordingly, mandatorily convertible instruments would only be included in the computation of basic EPS if they were considered participating securities.

Although the 2008 ED was never issued, we believe that the proposed guidance reflects the views of the FASB. As such, we believe that shares issuable pursuant to a mandatorily convertible security should not be included in the computation of the denominator of basic EPS. These shares should be included in the computation of diluted EPS using the if-converted method (see FSP 7.5.6 for guidance after adoption of ASU 2020-06 and FSP 7.5.6A for guidance before adoption of ASU 2020-06). Such shares would be included in the numerator of basic EPS only if the instrument was determined to be a participating security (see FSP 7.4.2).

7.4.3.3 Prepaid variable share forwards

Prepaid variable share forwards require a company to issue a variable number of shares at a future stipulated date. The number of shares to be issued is generally dependent on the volume weighted average price of the company's stock as of the stipulated date. Generally, there is a minimum number of shares that will be issued. The August 2008 ED to amend FAS 128 stated the following:

Excerpt from August 2008 proposed amendment to FAS 128

The Board agreed that including an instrument in basic EPS that does not give the holder the present ability to become a common shareholder provides an inaccurate depiction that, in all cases, the holder has the same claim to current-period earnings as a common shareholder even if the holder has stated participation rights that differ from common shareholders. Accordingly, the Board decided that the holder of (a) an instrument that is currently exercisable for little or no cost to the holder or (b) a share that is currently issuable for little or no cost to the holder has the present ability to become a common shareholder and, therefore, has the present right to share in current-period earnings with common shareholders.

Although there is some diversity in practice, we believe that the minimum number of shares issuable pursuant to this type of contract generally should be included in the weighted average number of shares outstanding in the computation of basic EPS. This is because they represent shares that have

already been paid for and will be issued through only the passage of time at no additional cost to the holder.

In addition, we believe that any additional number of shares that would be issuable pursuant to the contract based on the period-end stock price, assuming the reporting date were the settlement date, should be included in diluted EPS as contingently issuable shares (see FSP 7.5.3). This is because the contract has been prepaid and the company has a contingent obligation to issue shares without additional consideration at a future date.

If the condition is based on an average of market prices over some period of time (e.g., a 10-day average), the corresponding average for the period (i.e., the 10 days leading up to the period-end date) should be used.

7.4.3.4 Restricted stock-based compensation awards

Unvested restricted stock or restricted stock units are excluded from the denominator of basic EPS, because the employee has not yet earned the shares (i.e., there is still a further "payment" in the form of future employee services). While the shares may be considered legally issued and outstanding under the terms of the restricted stock agreement, they are not considered issued for accounting purposes. However, if the reporting entity is required to issue shares to settle a restricted stock unit award, once the units are vested, the reporting entity includes the shares in basic EPS as of the vesting date, regardless of whether they have been legally issued. This is because the shares are considered issuable for little to no consideration under ASC 260-10-45-13 at this point. However, if either the reporting entity or the holder can elect cash or share settlement of the award, such awards should not be included in basic EPS, even if vested, as the reporting entity may not ultimately issue shares to settle the award.

Unvested restricted stock that must be settled in shares and is eligible for vesting upon an employee's retirement is included in the denominator in the computation of basic EPS at the earlier of (1) the stated vesting date, or (2) the date the employee becomes eligible for retirement. At the date the employee becomes eligible for retirement, any remaining stated vesting period is considered nonsubstantive because issuance of the shares is not dependent on any service after that date.

7.4.3.5 Employee stock options

Stock options are excluded from the basic EPS denominator because they are not considered outstanding shares. The shares should be included in the denominator at the time of exercise.

Reporting entities should consider the substance, rather than the legal form, of all awards to determine the appropriate EPS treatment. For example, unvested stock options that allow the employee to "early exercise" but for which the reporting entity has the right to repurchase the shares at the exercise price (or the lesser of the current fair value or original exercise price) if the employee terminates employment prior to vesting should not be included in the basic EPS denominator prior to the stated vesting date. The shares issued upon early exercise are treated as contingently returnable pursuant to the guidance in ASC 260-10-45-13 and are still subject to a substantive vesting period. Therefore, these shares should not be included in basic EPS.

7.4.3.6 Common stock subject to repurchase

ASC 480-10-45-4 requires the following to be excluded from the denominator: (1) mandatorily redeemable shares of common stock requiring liability classification under ASC 480, and (2) shares of common stock subject to forward purchase contracts that require physical settlement of a fixed number of shares in exchange for cash. However, as described in ASC 480-10-45-4, any amounts, including contractual (accumulated) dividends and participation rights in undistributed earnings, attributable to the shares to be repurchased that have not been recognized as interest costs should be deducted from income available to common shareholders pursuant to the two-class method of computing earnings per share. See FG 9.2.2.1 for further information on accounting for physically settled forward repurchase contracts.

Reporting entities may conclude that separately executed legal forward contracts with the same counterparty should be combined for accounting purposes. For example, when two or more forward contracts entered into in contemplation of each other with the same counterparty, including one that is for a fixed number of shares, together act as a forward contract on a variable number of shares, the shares underlying the forward contracts should be included in the denominator for basic EPS. This is because, in substance, the settlement is not in a fixed number of shares and so would not be excluded under the provision in ASC 480-10-45-4. Determining whether two or more forward contracts should be evaluated together is highly judgmental and should be carefully evaluated.

Forward purchase contracts that do not meet the criteria above impact the computation of the diluted EPS denominator under the guidance in ASC 260-10-45-35. See FSP 7.5.5.9 (after adoption of ASU 2020-06) or FSP 7.5.5.9A (before adoption of ASU 2020-06) for details.

7.4.3.7 Share lending agreements

A reporting entity that is a convertible bond issuer may enter into a share lending agreement with an investment bank. A share lending agreement is intended to facilitate the ability of investors, primarily hedge funds, to borrow shares to hedge the conversion option in the convertible debt. These agreements are often executed when the issuer's stock is difficult or expensive to borrow in the conventional stock loan market.

Typically, share lending arrangements require the issuer to issue shares to the investment bank in exchange for a small fee, generally equal to the common stock's par value. In exchange, the investment bank promises to return the loaned shares to the issuer upon conversion or maturity of the convertible debt. The shares issued are legally outstanding, and are entitled to vote and receive dividends. However, under the terms of the arrangement, the investment bank may agree to reimburse the issuer for dividends received and may agree to not vote on any matters submitted to a vote of the reporting entity's stockholders.

ASC 470-20-45-2A states that loaned shares are excluded from EPS unless default of the share lending arrangement occurs, at which time the loaned shares would be included in the computation of basic EPS. If dividends on the loaned shares are not reimbursed to the reporting entity, the reporting entity would deduct any amounts, including contractual (accumulated) dividends and participation rights in undistributed earnings, attributable to the loaned shares from the numerator, in a manner consistent with the two-class method (see FSP 7.4.2).

See FG 6.10.4A and FG 6.9.4 for a discussion of the recognition and measurement considerations of a share lending arrangement before and after adoption of ASU 2020-06, respectively.

7.4.3.8 *Employee stock purchase plans (ESPPs)*

Many companies offer ESPPs in which employees have a specified amount of their pay withheld for purposes of purchasing the reporting entity's shares at a discount to the then current fair value. These arrangements are typically considered a form of share-based compensation awards, as described in SC 5. The impact of these arrangements on EPS depends on whether the employees' participation can be revoked.

If employees can withdraw the amount of salary withheld during the offering period or must remain employed through the end of the offering period in order to purchase the shares, the arrangement is still an option or an unvested share-based compensation award through the end of the offering period. Until then, the shares calculated based on the employees' withholding and the ESPP's terms would not be included in the denominator of basic EPS. In such circumstances, the withholdings are a liability of the reporting entity that can be settled in cash or shares at the option of the employee. To be included in the basic EPS denominator, the shares have to be unequivocally issuable by the reporting entity.

If, however, the employee's participation is irrevocable (even if employment was to terminate), the employee has no ability to obtain a refund of the amounts withheld, and the number of shares is fixed, there is no contingency. The reporting entity has received cash and has an irrevocable obligation to issue the shares. Therefore, the reporting entity would include the shares in the computation of basic EPS based on the amounts withheld and the ESPP's purchase price formula.

In our experience, it is unusual for an ESPP to allow an employee to continue to participate in the plan after termination of employment; as a result, the employee is generally refunded any amounts withheld upon termination. Therefore, shares issuable under an ESPP are still dependent on continued employment and will typically not be included in basic EPS until the completion of the offering period, at which time the arrangement is fully vested and the number of shares to be issued are known. The potential shares should be considered for inclusion in diluted EPS, as described in FSP 7.5.5.5.

7.4.3.9 *Penny warrants*

As noted in ASC 260-10-45-13, shares issuable for little to no consideration should be included in the number of outstanding shares used for basic EPS (and therefore diluted EPS, as well, as shares included in basic EPS are never removed from the calculation of diluted EPS). There is no guidance on what is considered "little to no" consideration, and whether this literature should be applied to unexercised warrants or options. In their proposed amendments to pre-Codification FAS 128 (the source of ASC 260) in 2008, the FASB proposed that warrants or options exercisable for little to no cost (sometimes referred to as "penny warrants") be included in the denominator of basic EPS (and therefore diluted EPS) once there were no further vesting conditions or contingencies associated with them. The vesting conditions are relevant as future service is considered a form of "consideration." While the proposed amendments were not issued, we believe that this is the most current thinking of the FASB and that equity-classified penny warrants should generally be included in the computation of basic EPS. Contingent shares are not included in basic EPS until the contingency is resolved. Determination of what is considered little to no consideration still requires judgment, and would typically be assessed at the issuance (or grant) date of the instrument in relation to the stock price at that time.

However, liability-classified penny warrants (e.g., puttable penny warrants) generally should not be included in the weighted average number of outstanding shares for basic EPS. Liability-classified

penny warrants generally would only be considered in the calculation of diluted EPS, unless they are also considered participating securities.

7.5 Diluted EPS

Diluted EPS gives effect to all dilutive potential common shares outstanding during a period. The computation of diluted EPS is similar to the computation of basic EPS except that the denominator is increased to include the number of additional common shares that would have been outstanding if the dilutive potential common shares had been issued. The potential common shares (as defined in ASC 260-10-20) are weighted for the period the instruments were outstanding (i.e., as of the beginning of the period or the date of issuance, if later).

Definition from ASC 260-10-20

Potential common stock: A security or other contract that may entitle its holder to obtain common stock during the reporting period or after the end of the reporting period.

This definition encompasses options, warrants, convertible securities, and contingent stock agreements.

In computing diluted EPS, reporting entities may have to adjust the numerator used in the basic EPS computation, subject to sequencing rules addressed in FSP 7.5.1, to make adjustments for any dividends and income or loss items associated with potentially dilutive securities that are assumed to have resulted in the issuance of common shares. ASC 260-10-55-32 indicates that these income or loss items should also include the fair value adjustments on instruments accounted for as liabilities, but which may be settled in shares that would result from the assumed issuance of potential common shares.

Because the numerator and denominator used for basic EPS are the starting point in computing diluted EPS, the concepts discussed in FSP 7.4 which address the computation of basic EPS remain relevant when computing diluted EPS.

Reporting entities should include dilutive instruments that are (1) issued, (2) expire unexercised, or (3) are cancelled during the period in the denominator of diluted EPS for the portion of the period they were outstanding.

Additionally, reporting entities should include dilutive instruments exercised during the period in the denominator of diluted EPS for the period prior to exercise. Thereafter, reporting entities include the actual shares issued in the denominator for both basic and diluted EPS.

7.5.1 *Anti-dilution and sequencing – the control number concept*

Computations of diluted EPS should generally not give effect to any individual class of potential common stock instrument for any period in which its inclusion would have the effect of increasing EPS (or decreasing the loss per share) otherwise computed (i.e., it is anti-dilutive).

Reporting entities use the control number concept to determine whether a potential common stock instrument is dilutive. The control number to be used is income/loss from continuing operations (adjusted for preferred dividends, as described in ASC 260-10-45-20). The control number concept

requires that the same number of potentially dilutive securities applied in computing diluted EPS from continuing operations be applied to all other categories of income or loss, even if they would have an anti-dilutive effect on such categories.

For example, if a reporting entity were to report income from continuing operations, a loss from discontinued operations, and a net loss, the number of potential common shares used in the computation of diluted EPS from continuing operations would be used in determining diluted per share amounts of loss from discontinued operations and net loss, although this would result in reduced (or anti-dilutive) reported per share losses for those items.

In determining whether potential common shares are dilutive or anti-dilutive, the reporting entity should consider each issue or series of issues of potential common shares separately, rather than in the aggregate.

To reflect maximum potential dilution, the reporting entity should consider each issue or series of issues of potential common shares in sequence, from the most dilutive to the least dilutive (refer to Example 4 in ASC 260-10-55-57 through ASC 260-10-55-59). That is, dilutive potential common shares with the lowest earnings per incremental share are included in diluted EPS before those with higher earnings per incremental share. It would not be appropriate to simply calculate the impact of all potential common shares in the aggregate to determine if the end result is dilutive to basic EPS (see Example FSP 7-18).

7.5.2 Participating securities

Reporting entities should consider the effects of participating securities when computing diluted EPS. When there are participating securities, the computation under the two-class method for basic EPS may be more dilutive than the diluted EPS computation (using either the if-converted (see FSP 7.5.6 for guidance after adoption of ASU 2020-06 and FSP 7.5.6A for guidance before adoption of ASU 2020-06) or treasury stock method (see FSP 7.5.5), whichever is appropriate for that type of instrument). For example, the allocation of net income to a participating share of unvested stock that shares equally in all dividends with outstanding shares would be based on the full weighted-average number of unvested shares. However, the number of potential common shares that would be included for the unvested stock under the treasury stock method would be lower than the nominal number of shares because of the incorporation of unamortized compensation cost as “proceeds,” as described at FSP 7.5.5. Therefore, the dilution to actual outstanding shares under the treasury stock method would be smaller than the dilution under the two-class method.

In these cases, because of the anti-dilution provision in ASC 260-10-45-17 through ASC 260-10-45-20, exercise or conversion should not be assumed. Rather, the allocation of earnings to participating security holders performed under the two-class method should be followed. Therefore, the numerator should be reduced for both basic and diluted EPS, and since the participating securities are not considered converted/exercised, the denominator should not be adjusted.

The impact of participating securities on the calculation of diluted EPS for other types of potential common shares is discussed at FSP 7.5.7 and FSP 7.5.8.

7.5.3 *Contingently issuable shares*

Shares (including those issued in connection with a business combination) whose issuance is contingent upon the satisfaction of certain conditions are considered outstanding and included in the computation of diluted EPS as follows:

- If all necessary conditions have been satisfied by the end of the period (the events have occurred), the shares are included in diluted EPS as of the beginning of the period in which the conditions were satisfied (or as of the date of the contingent stock agreement, if later). However, they would only be included in basic EPS from the date upon which the contingency was resolved.

- If all necessary conditions have not been satisfied by the end of the period, the number of contingently issuable shares to be included in diluted EPS is based on the number of shares, if any, that would be issuable if the end of the reporting period was the end of the contingency period if the result is dilutive (i.e., the number of shares that would be issuable based on current period earnings or period-end market price). These contingently issuable shares are included in the denominator of diluted EPS as of the beginning of the period (or as of the date of the contingent stock agreement, if later).

General guidelines for the application of these principles for different types of contingencies are as follows:

- *Specified amount of earnings*

  If attainment or maintenance of a specified amount of earnings is the condition, and if that amount has been attained, the additional shares are considered to be outstanding for the purpose of computing diluted EPS if their effect is dilutive. The diluted EPS computation should include those shares that would be issued under the conditions of the contract based on the assumption that the current amount of earnings will remain unchanged until the end of the agreement, but only if the effect would be dilutive. No projection of future results is made.

- *Market price of stock at a future date*

  The number of shares contingently issuable may depend on the market price of the stock at a future date. In that case, computations of diluted EPS should reflect the number of shares that would be issued based on the current market price at the end of the period being reported on, if their effect is dilutive. If the condition is based on an average of market prices over some period of time (e.g., a 10-day average of prices), the corresponding average for the period (i.e., the 10 days leading up to the period-end date) is used.

- *Both future earnings and future prices*

  If the number of shares contingently issuable depends on both future earnings and future prices of the shares, the determination of the number of shares included in diluted EPS must be based upon both conditions—that is, earnings to date and current market price—as they exist at the end of the reporting period. Unless both conditions are being met at the end of the reporting period, no contingently issuable shares are included in diluted EPS.

- *Other types of conditions*

  If the contingency is based on a condition other than earnings or market price (for example, opening a certain number of retail stores), the contingent shares are included in the computation of diluted EPS based on the assumption that the current status of the condition will remain unchanged until the end of the contingency period.

In making the evaluation, each period should be evaluated independently.

Outstanding common shares that are contingently returnable are treated in the same manner as contingently issuable shares.

Example FSP 7-5 illustrates the treatment of a business combination earn-out provision in the computation of diluted EPS.

EXAMPLE FSP 7-5

Impact of an earn-out based on earnings on diluted EPS when cumulative earnings fluctuate

An earn-out provision for a 20X6 business combination is payable in shares if cumulative earnings from the date of the business combination, January 1, 20X6, through December 31, 20X7 exceed a specified target.

The cumulative earnings target is first achieved in the 20X6 year-to-date fourth quarter results.

Because of a loss in the first quarter of 20X7, cumulative results fall below the target at the end of that period.

What is the impact on the EPS computation?

Analysis

The shares should be included in the denominator of diluted EPS from the beginning of the fourth quarter for 20X6. They would not be included in diluted EPS before that time. However, because cumulative results do not meet the target at the end of the first quarter of 20X7, the shares would not be included in that quarter's EPS computations and would not be included again until the earnings target is achieved. Prior period EPS should not be revised.

When the earn-out is classified as a liability but could (or must) be settled in shares, an adjustment also needs to be made to the numerator in the EPS calculation related to the impact of any mark-to-market adjustments. See FSP 7.5.6 for guidance after adoption of ASU 2020-06 and FSP 7.5.6A for guidance before adoption of ASU 2020-06.

For contingently issuable financial instruments other than shares (e.g., a contingently exercisable warrant or a share-based payment award with performance or market conditions), if the potential common shares may be assumed to be issuable based on the conditions specified for its issuance as described above, the impact on the computation of diluted EPS is determined by use of the treasury stock guidelines for options and warrants (see FSP 7.5.5.1), the if-converted method for convertible securities (see FSP 7.5.6 for guidance after adoption of ASU 2020-06 and FSP 7.5.6A for guidance before adoption of ASU 2020-06), or the provisions for contracts that may be settled in stock or cash

(see FSP 7.5.7.1 for guidance after adoption of ASU 2020-06 and FSP 7.5.7.1A for guidance before adoption of ASU 2020-06), as appropriate.

Year-to-date computations for contingent shares

As noted in ASC 260-10-45-49, for year-to-date computations, contingent shares are included in diluted EPS on a weighted-average basis. That is, contingent shares are weighted for the interim periods in which they were included in the computation of diluted EPS. This methodology can result in a lack of comparability from quarter to quarter. Moreover, the sum of quarterly EPS data will not necessarily equal cumulative EPS data, and transactions considered dilutive or anti-dilutive in certain quarters may not be in other quarters. This is illustrated in ASC 260-10-55-50.

Example FSP 7-6 illustrates the treatment of contingent shares in the year-to-date diluted EPS computation when the contingency is met during the year.

EXAMPLE FSP 7-6

Impact of an earn-out on year-to-date diluted EPS

An earn-out provision for a 20X6 business combination is payable in shares if cumulative earnings from the date of the business combination, January 1, 20X6, through December 31, 20X7 exceed a specified target.

The cumulative earnings target is first achieved in the 20X6 third quarter and remains above the threshold at December 31, 20X6.

What is the impact on the EPS computations in 20X6?

Analysis

In the year-to-date diluted EPS computation for 20X6, the shares associated with the earn-out would be included as if issued on the first day of the third quarter of 20X6 (not the first day of the year). The shares would also be included in the quarterly EPS computation for the third and fourth quarters of 20X6.

The shares would not be included in the quarterly or year-to-date EPS computations for either the first or second quarter of 20X6 as the earnings target was not being achieved at that time.

7.5.4 *Diluted EPS computation methods*

Figure FSP 7-6 summarizes which methods of including potentially dilutive securities in diluted EPS should be used for various securities after adoption of ASU 2020-06.

Figure FSP 7-6

Methods of incorporating potentially dilutive securities in diluted EPS after adoption of ASU 2020-06

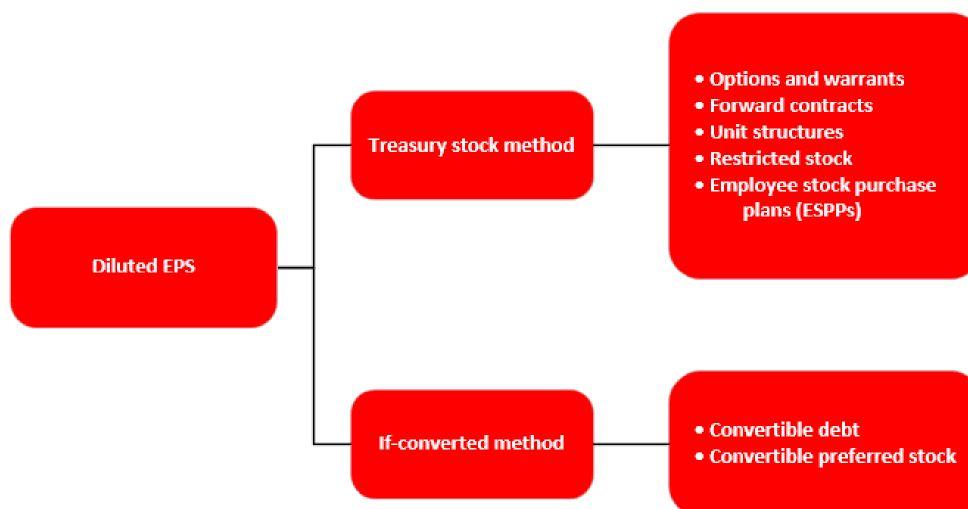
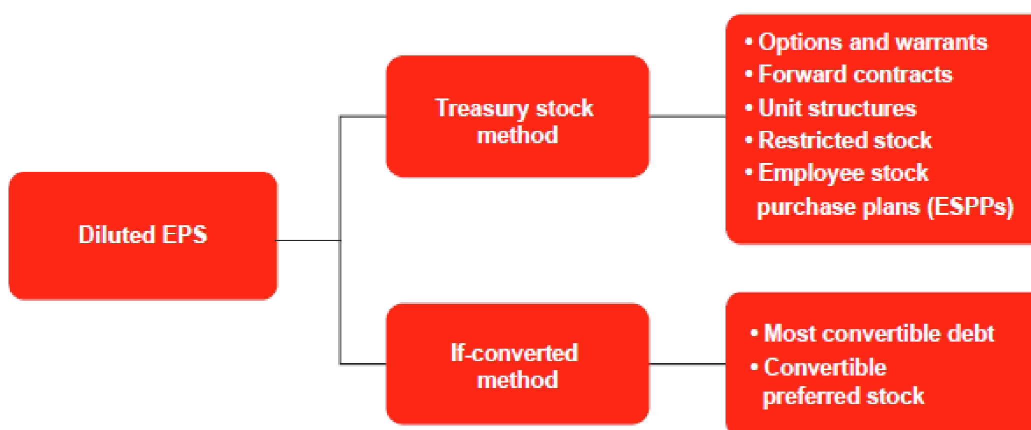


Figure FSP 7-6A summarizes which methods of including potentially dilutive securities in diluted EPS should be used for various securities before adoption of ASU 2020-06.

Figure FSP 7-6A

Methods of incorporating potentially dilutive securities in diluted EPS before adoption of ASU 2020-06



7.5.5 *Treasury stock method*

The treasury stock method considers the dilutive effect of issued, exercised, or expired options and warrants (and their equivalents) issued by a reporting entity in the computation of diluted EPS for the period they were outstanding. Equivalents include restricted stock, stock purchase contracts (e.g., forward sale contracts), and partially-paid stock subscriptions.

Definition from ASC 260-10-20

Treasury stock method: A method of recognizing the use of proceeds that could be obtained upon exercise of options and warrants in computing diluted EPS. It assumes that any proceeds would be used to purchase common stock at the average market price during the period.

Like other types of potential common stock, each issue or series of issues should be considered separately in determining whether potential common shares are dilutive or anti-dilutive.

A nonrecourse note issued by an option holder to the reporting entity to exercise the option should be treated as if the option remains outstanding. Accordingly, the nonrecourse loan amount should be considered as exercise proceeds in the application of the treasury stock method.

If the option holder issues a recourse note to the reporting entity to exercise the option, the reporting entity should perform additional analysis to determine the substance of the arrangement. The relevant factors are more fully described in SC 2.3.

7.5.5.1 Written options and warrants

Options and warrants that are equity-classified will be dilutive when the average market price of the common stock during the period exceeds the exercise price (i.e., they are "in-the-money"). Options and warrants that are liability-classified should be evaluated under the guidance in FSP 7.5.7.1 (after adoption of ASU 2020-06) or FSP 7.5.7.1A (before adoption of ASU 2020-06) pertaining to instruments settleable in cash or shares when their presumed exercise would result in incremental common shares.

ASC 260-10-45-23 provides guidelines for applying the treasury stock method:

- Assume exercise or settlement of the instrument at the later of the time of issuance or the beginning of the period
- Assume the proceeds from exercise or settlement have been used to repurchase the reporting entity's common shares at their average market price during the period
- Include the incremental shares (shares assumed to be issued less shares assumed to have been repurchased) in the denominator

Example FSP 7-7 illustrates how to calculate the number of incremental shares that would result from the assumed exercise of warrants for purposes of computing diluted EPS under the treasury stock method.

EXAMPLE FSP 7-7

Application of the treasury stock method for warrants on common stock

FSP Corp has outstanding warrants to issue 500,000 shares of its common stock with a strike price of $10 per share. These options are equity classified (i.e., derivative accounting under ASC 815 is not required) and can only be settled in shares.

The average market price of the common stock during the period is $20.

How should FSP Corp include the warrants in the diluted EPS computation for the period?

Analysis

FSP Corp should include the incremental shares in the denominator of diluted EPS using the treasury stock method. The incremental shares are calculated assuming the warrants are exercised at the beginning of the period (or date of issuance of the warrant, if later), as follows:

Step 1: Calculate the assumed proceeds

Assumed proceeds = Number of options x strike price

$5,000,000 = 500,000 x $10/share

Step 2: Calculate the number of shares assumed to be repurchased

Shares = Assumed proceeds / average market price

250,000 shares = $5,000,000 / $20/share

Step 3: Calculate the incremental shares assumed to be issued

Incremental shares = Common shares issuable upon exercise of warrants – shares assumed to be repurchased

250,000 shares = 500,000 shares – 250,000 shares

The assumed proceeds under the treasury stock method are calculated differently for stock-based compensation awards. See FSP 7.5.5.5.

7.5.5.2 *Purchased options*

ASC 260-10-45-37 notes that purchased puts and calls held by the reporting entity on its own stock should not be included in the denominator of diluted EPS because inclusion would be anti-dilutive. The put options would be exercised only when the exercise price is higher than the market price, and the call option would be exercised only when the exercise price is lower than the market price. In both instances, their effect would be anti-dilutive under the treasury stock method and the reverse treasury stock method, respectively. The reverse treasury stock method is addressed in FSP 7.5.5.9 (after adoption of ASU 2020-06) or FSP 7.5.5.9A (before adoption of ASU 2020-06).

Reporting entities may enter into arrangements that include two contracts: (1) a separate purchased option, and (2) a written option. The changes in the value of the purchased option and written option may offset or hedge each other. We believe it would generally be inappropriate to combine the purchased option and the written option in the computation of EPS (this is consistent with pre-Codification FAS 128, paragraph 112 (*Basis for Conclusions*)), unless these transactions are otherwise combined for US GAAP. Conversely, if the reporting entity entered into a single contract for a net purchased option (such as a “capped call option”), exclusion from the EPS computations would generally be appropriate.

7.5.5.3 Options or warrants to purchase convertible securities

Written options or warrants to purchase convertible debt or preferred stock (that is classified as mezzanine equity) are liabilities under ASC 480-10-25-13.

Reporting entities should assume options or warrants to purchase convertible securities are exercised when the average prices of both the convertible security and the common stock obtainable upon its conversion are above the exercise price of the option or warrant.

However, reporting entities should not assume exercise unless they assume conversion of similar outstanding convertible securities, if any. After considering the anti-dilution sequencing rules, the reporting entity should determine the number of incremental shares of the convertible security (which will then be converted to common stock) using the treasury stock method similar to other options or warrants. There is no need to impute interest or dividends on the incremental shares, as these items would be reversed by the if-converted adjustments for the assumed conversions. See further discussion of conversion adjustments in FSP 7.5.6 (after adoption of ASU 2020-06) or FSP 7.5.6A (before adoption of ASU 2020-06).

7.5.5.4 Unit structures

In a unit structure, a reporting entity issues debt to an investment bank, which will be remarketed to investors at a date in the future, and concurrently issues a forward sale contract on its own shares. A unit structure is economically similar to convertible debt; however, unlike convertible debt, the forward contract for the reporting entity's shares is legally detachable from the debt. Generally, the conversion option in convertible debt is not separable from the debt. Further, in the case of a unit structure, the debt often matures at a different (usually later) time than the forward contract does.

If the remarketing of the debt in the unit structure is successful, which is the expected outcome, the investor will use the cash received from the remarketing to settle the obligation under the forward. In the unlikely event of a failed remarketing of the debt, the debt is tendered by the holder as payment upon the exercise of the forward contract.

We believe the reporting entity should use the treasury stock method for the forward sale contract to compute diluted EPS if the chances of a failed remarketing are remote. In applying the treasury stock method, the reporting entity should determine the number of shares to be issued based on the average stock price and the terms of the forward contract.

The reporting entity should review the assumptions leading to this conclusion at the end of each reporting period. If the chance of a failed remarketing of the debt is no longer remote, the unit structure is, in effect, convertible debt under ASC 260-10-55-9. In that case, the reporting entity should use the if-converted method to compute diluted EPS, because the debt will be tendered by the investor in satisfaction of the investor's obligation under the forward contract.

7.5.5.5 Stock-based compensation under the treasury stock method

The calculation of assumed proceeds under the treasury stock method for stock-based compensation awards requires additional considerations because the reporting entity receives the benefit of future service, which is considered additional proceeds.

The assumed proceeds under the treasury stock method include:

- The exercise price of the stock options, if any
- Average unrecognized compensation cost for future service

Although compensation cost may only be recognized for awards that are expected to vest (determined by applying the pre-vesting forfeiture rate assumption), for those reporting entities that elect to estimate forfeitures, all options and shares outstanding that have not been forfeited are included in diluted EPS. In other words, the amount of stock-based compensation cost in the numerator may include a forfeiture rate assumption, while the number of shares in the denominator does not.

See Example FSP 7-8 for an illustration of the difference between the compensation cost recorded for share-based payment awards in the income statement and the amounts included in the assumed proceeds calculation.

Applying the treasury stock method to in-the-money options could be anti-dilutive if the sum of the proceeds, including the unrecognized compensation, exceeds the average stock price. In that case, those options would be excluded from the computation of diluted EPS. For example, if the average market price of the underlying stock was $12, an option with an exercise price of $10 (i.e., $2 in-the-money) and average unrecognized compensation for the period of $4 would be anti-dilutive because the assumed proceeds of $14 ($10 +$4) is greater than the average market price of the underlying share of $12. As a result, these awards are excluded from the diluted EPS denominator.

Stock options

Stock options with service conditions are included in the computation of the denominator of diluted EPS using the treasury stock method if the option is dilutive. In computing diluted EPS, reporting entities should include all outstanding options that are dilutive, without considering the impact of a forfeiture-rate assumption applied for purposes of recognizing compensation cost under ASC 718.

Reporting entities should include stock options with performance or market conditions in the computation of diluted EPS if the options are dilutive and if their conditions (1) have been satisfied at the reporting date (the events have occurred), or (2) would have been satisfied if the reporting date was the end of the contingency period (for example, the number of shares that would be issuable based on current period earnings or period-end market price). When making the determination, a reporting entity should not use projections that look beyond the current reporting period. In essence, it should follow the contingently issuable share guidance described in FSP 7.5.3.

For example, assume that a stock option has a performance condition under which the option vests when earnings before interest, taxes, depreciation, and amortization (EBITDA) reaches $15 million. At the end of the third quarter, EBITDA is $13 million and the company believes that EBITDA will be $17 million at the end of the year. The option would be excluded from the third quarter diluted EPS computation because the performance condition had not been achieved as of the end of that period, as required by ASC 260-10-45-51.

If the performance or market condition was satisfied, or would have been satisfied if the performance or market metric was measured as of the reporting date, the stock options would be included in diluted EPS from the beginning of the period (or date of grant, if later) using the treasury stock method, if the option is dilutive.

Stock options often contain both performance and market conditions. If the award vests if either the performance or market condition is met, then assuming the options are dilutive, the award would be included in the computation of diluted EPS if either condition has been satisfied at the reporting date or would have been satisfied if the reporting date was the end of the contingency period. If both conditions must be met in order to vest, the award would be included in the computation of diluted EPS if the options are dilutive and both conditions have been satisfied at the reporting date or would have been satisfied if the reporting date was the end of the contingency period.

The accounting treatment for options with performance conditions under ASC 718 requires a probability assessment as to whether the option will vest; the accounting treatment under ASC 260 does not call for an assessment of the probability of vesting. Therefore, the numerator in the EPS computations may include compensation cost related to the performance awards, but the performance awards themselves may be excluded from the denominator. There are no adjustments made to the EPS numerator for such situations.

Example FSP 7-8 illustrates the impact of stock options granted to employees on the computation of diluted EPS.

EXAMPLE FSP 7-8

Stock option with a service condition

On January 1, 20X7, FSP Corp grants employees 10,000 nonqualified stock options with an exercise price of $10. Each stock option has a $4 fair value at the grant date. 25% of the shares vest each year over a four-year period. The employee must be employed by the reporting entity on each vesting date to become vested in each tranche.

FSP Corp has elected a policy of straight-line attribution of compensation cost, and a policy of estimating forfeitures. The assumed forfeiture rate is 5% each year. No options were forfeited during 20X7.

The market price of the common stock is: $10 on January 1, 20X7; $26 on December 31, 20X7; $18 average for 20X7.

Treasury stock computation:

The treasury stock calculations use actual forfeitures rather than the forfeiture assumption used for compensation cost recognition purposes. The results of the calculations are hypothetical for EPS purposes and would not agree to the financial statement amounts. The calculations are only used to determine the number of options to include in the diluted EPS computation.

- Hypothetical total book compensation cost = $40,000

  $4 (fair value per option on grant date) multiplied by 10,000 (options outstanding)

- Hypothetical cost will be recognized ratably over four years ($10,000 per year)

- Hypothetical unrecognized compensation cost at December 31, 20X7 = $30,000

  $40,000 (hypothetical total book compensation cost) minus $10,000 (hypothetical book compensation cost recognized in 20X7)

How many potential common shares should be included in diluted EPS for the year ended December 31, 20X7 for these stock options, assuming the shares are dilutive at the end of 20X7?

Analysis

The options are included in the diluted EPS computation by applying the treasury stock method and assuming that the proceeds will be used to buy back shares. Proceeds equal the hypothetical average unrecognized compensation cost plus the exercise price.

- Hypothetical average unrecognized compensation cost for 20X7 = $35,000

  Average of $40,000 (hypothetical unrecognized compensation cost at January 1, 20X7) and $30,000 (hypothetical unrecognized compensation cost at December 31, 20X7)

- Assumed proceeds = $135,000

  $100,000 (10,000 options x $10 exercise price per option) plus $35,000 (hypothetical average unrecognized compensation cost)

- Shares assumed repurchased = 7,500 shares

  $135,000 (assumed proceeds) divided by $18 (20X7 average stock price)

- Incremental shares to be included in the December 31, 20X7 diluted EPS computation = 2,500 shares

  10,000 (shares issuable upon exercise) minus 7,500 (shares assumed repurchased)

Restricted stock

A reporting entity should include both of the following in its computation of diluted EPS using the treasury stock method:

- Unvested restricted stock with service conditions

- Unvested restricted stock with a performance or market condition that is considered contingently issuable shares pursuant to ASC 260-10-45-48

Assumed proceeds under the treasury stock method consist of unamortized compensation cost. If dilutive, the unvested restricted stock would be considered outstanding as of the later of the beginning of the period or the grant date for diluted EPS computation purposes. If anti-dilutive, it should be excluded from the diluted EPS computation.

Example FSP 7-9, Example FSP 7-10, and Example FSP 7-11 illustrate the impact of restricted stock granted to employees on the computation of diluted EPS.

EXAMPLE FSP 7-9

Restricted stock with a service condition

On January 1, 20X6, FSP Corp grants employees 10,000 shares of restricted stock with a fair value of $10 per share. The shares are legally issued and outstanding, and the employee is not required to pay for the restricted stock. All shares are expected to vest. The average stock price for the year ended December 31, 20X6 is $15 per share.

25% percent of the shares vest each year over a four-year period. The employee must be employed by the reporting entity on each vesting date to become vested in each tranche. The company has elected a policy of straight-line attribution and estimating forfeitures.

Expense computation:

- Total book compensation cost = $100,000

  $10 (fair value per share on January 1, 20X6) multiplied by 10,000 shares

- Compensation cost will be expensed ratably over four years ($25,000 per year)

- Unrecognized compensation cost at December 31, 20X6, is $75,000

  ($100,000 minus $25,000)

How many shares are included in diluted EPS for the year ended December 31, 20X6, assuming the shares are dilutive at the end of 20X6?

Analysis

The unvested shares are included in the diluted EPS computation by applying the treasury stock method and assuming that the proceeds will be used to buy back shares. Proceeds equal the average unrecognized compensation cost plus any purchase price.

- Average unrecognized compensation cost for 20X6 = $87,500

  Average of $100,000 (unrecognized compensation cost at January 1, 20X6) and $75,000 (unrecognized compensation cost at December 31, 20X6)

- There are no assumed proceeds from exercise (because the employee is not required to pay for the restricted stock)

- Assumed repurchase = 5,833 shares

  $87,500 (assumed proceeds) divided by $15 (20X6 average stock price)

- Incremental shares to be included in the December 31, 20X6 diluted EPS computation = 4,167 shares

  10,000 (unvested shares outstanding) minus 5,833 shares (assumed repurchased)

EXAMPLE FSP 7-10

Restricted stock with a performance condition

On January 1, 20X6, FSP Corp grants 10,000 shares of restricted stock with a fair value of $10 per share. The shares are legally issued and outstanding, and the employee is not required to pay for the restricted stock. All shares are expected to vest. The average stock price for the year ended December 31, 20X6 is $15 per share.

25% of the shares vest each year over a four-year period if certain performance conditions are met. The vesting provision includes a performance condition that requires the reporting entity's revenues to exceed $100 million in 20X6; $115 million in 20X7; $130 million in 20X8; and $145 million in 20X9 for the respective year's award to vest.

The requirements for a grant date are met on January 1, 20X6, for all tranches.

Each tranche is based on performance within that year; therefore, each tranche is treated as a separate award with a service inception date of January 1 of each year and a one-year requisite service period.

The reporting entity recognizes compensation cost for each tranche over the respective one-year requisite service period if it is probable that the target established for that year will be met.

Revenues for the year ended December 31, 20X6 were $120 million.

Compensation cost computation:

- Total book compensation cost = $100,000

  $10 (fair value per share on January 1, 20X6) multiplied by 10,000 shares

- Compensation cost will be expensed ratably over four years ($25,000 per year)

- Unrecognized compensation cost at December 31, 20X6, is $75,000

  ($100,000 minus $25,000)

How many shares are included in diluted EPS for the year ended December 31, 20X6, assuming the shares are dilutive at the end of 20X6?

Analysis

Using the treasury stock method, the diluted EPS computation would reflect the number of shares that would be issued based on the assumption that the current amount of revenue achieved will remain unchanged through the end of the performance period.

One way of viewing the contingent share guidance in ASC 260-10-45-48(b) in this case is to treat the amount of revenue generated in the current reporting period ($120 million) as if it were the amount earned in each respective contingent period, since each tranche is treated as a separate award. Under this approach, the 20X6 performance condition for revenue exceeding $100 million has been satisfied at the reporting date, and the 20X7 performance condition for revenue exceeding $115 million would have been satisfied if the reporting date was the end of that contingency period.

The performance conditions for 20X8 and 20X9 would not have been satisfied by revenue of $120 million. Therefore, under this approach, 5,000 shares (the 20X6 and 20X7 tranches) would be included in the diluted EPS computation process. The 20X8 and 20X9 tranches would not be included.

- Average unrecognized compensation cost for 20X6 = $37,500

  Average of $50,000 (unrecognized compensation cost at January 1, 20X6 related to shares for which the performance condition has been or would have been satisfied based upon the current period results) and $25,000 (unrecognized compensation cost at December 31, 20X6 related to those same shares)

  The unrecognized compensation cost only reflects shares related to the 20X6 and 20X7 performance goals ($25,000 in compensation cost per tranche multiplied by two tranches). The unrecognized compensation cost related to the 20X8 and 20X9 performance goals is excluded because those performance goals are not being satisfied based upon the current period results and therefore the shares in those two tranches are not included in the EPS computations.

- Assumed repurchase = 2,500 shares

  $37,500 (assumed proceeds) divided by $15 (20X6 average stock price)

- Incremental shares to be included in the December 31, 20X6, diluted EPS computation = 2,500 shares

  5,000 (unvested shares outstanding for which the performance condition has been or would have been satisfied based upon the current period results) minus 2,500 shares (assumed repurchased)

We believe an alternative approach would also be acceptable in this particular fact pattern in which the award includes multiple independent periods with discrete performance targets associated with service in that period. Under the alternative approach, the entity would not project any further earnings in future periods (as described in ASC 260-10-45-51 and footnote (f) of the example in ASC 260-10-55-56). Under this approach, only the 20X6 tranche of 2,500 shares would be included in the above calculations because as of the reporting date, no earnings would be assumed for the future independent periods. This approach may not be appropriate in fact patterns that vary from this illustration.

EXAMPLE FSP 7-11

Restricted stock with a market condition

On January 1, 20X6, FSP Corp grants employees 10,000 shares of restricted stock. The shares are legally issued and outstanding, and the employee is not required to pay for the restricted stock.

The vesting provisions are market conditions that state that 50% of the restricted stock will vest if the stock price is higher than $18 on December 31, 20X9, and the remaining 50% of the restricted stock will vest if the stock price is higher than $22 on December 31, 20X9. The recipient is also required to still be employed at the vesting date; FSP Corp expects all of the employees to remain employed through that date. Any shares that do not vest will be forfeited. The fair value of the restricted stock on the grant date is $80,000; the effect of the market conditions is reflected (i.e., discounted) in the award’s fair value.

The market price of the underlying stock is $20 on December 31, 20X6, and the average stock price for the year ended December 31, 20X6 is $15 per share.

Expense computations:

- Total book compensation cost = $80,000
- Compensation cost will be recognized ratably over four years ($20,000 per year)
- Unearned compensation cost at December 31, 20X6, is $60,000

  ($80,000 minus $20,000)

How many shares are included in diluted EPS for the year ended December 31, 20X6, assuming the shares are dilutive at the end of 20X6?

Analysis

Following the contingently issuable share guidance in ASC 260-10-45-48 and ASC 260-10-45-52, the diluted EPS computation should reflect the number of shares that would be issued based on comparing the stock price at the end of the period to the market condition metric. Because the stock price at the end of 20X6 is higher than the $18 threshold price but lower than the $22 threshold price, 50% of the restricted shares would be assumed to be issued.

Then, the treasury stock method would be applied as follows:

- There are no cash proceeds for the restricted shares
- Average unrecognized compensation cost for 20X6 = $70,000

  Average of $80,000 (unrecognized compensation cost at January 1, 20X6) and $60,000 (unrecognized compensation cost at December 31, 20X6)

Although the stock price at the end of the period is only higher than the $18 threshold price and 50% of the shares would vest based upon that price, the entire award's average unrecognized compensation cost is included in the treasury stock method proceeds calculation (not 50%). Under the stock compensation guidance, the effect of a market condition is reflected in the award's fair value on the grant date and all compensation cost for an award that has a market condition should be recognized if the requisite service period is fulfilled, regardless of the level at which the market condition is satisfied (including even if the award never vests). This is because the likelihood of achieving the market condition is incorporated into the fair value of the award. Therefore, there is no direct correlation between the number of shares that ultimately vest in a market condition award and the amount of compensation cost recognized. As a result, changes in the number of shares assumed to be issued under the award for EPS purposes would not change the amount of compensation cost associated with the award that should be used in the treasury stock method calculations.

This differs from Example FSP 7-10 because, as noted above, an award with a market condition is accounted for and measured differently from an award that has a performance or service condition. For awards with performance or service conditions, there is a direct correlation between the number of shares that ultimately vest and the amount of compensation cost recognized; therefore, changes in the number of shares assumed to be issued under the award for EPS purposes would change the amount

of compensation cost associated with the award that should be used in the treasury stock method calculations.

- Assumed repurchase = 4,666 shares

  $70,000 (assumed proceeds) divided by $15 (20X6 average stock price)

- Incremental shares to be included in December 31, 20X6, diluted EPS computation = 334 shares

  5,000 (unvested shares outstanding) minus 4,666 shares (assumed repurchased)

If the stock price were below $18 at the end of 20X6, which is less than the lowest threshold price, then none of the restricted shares would be included in the diluted EPS computation.

Stock award modifications

In computing diluted EPS, a reporting entity should treat the modification of a share-based award as if there was a cancellation and new issuance of an award. This includes modifications that are made in conjunction with an equity restructuring, such as a spin-off or large cash dividend.

Consistent with the approach described in ASC 260-10-45-26, the reporting entity should treat the "before" and "after" awards (i.e., the original and the modified awards) separately and include each for the weighted average period that each was outstanding.

Therefore, the reporting entity will perform two treasury stock method calculations.

- Based on the terms of the award and the average stock price for the period prior to the modification (weighted for the appropriate period)

- Based on the terms of the award and the average stock price for the period after the modification (weighted for the appropriate period)

The sum of the two calculations will equal the number of incremental shares to be included in the diluted EPS computation. The reporting entity does the "as if" cancellation and reissuance for any share-based payment award whose terms have changed.

Reporting entities that conclude that they should not account for the effects of a modification pursuant to ASC 718-20-35-2A through ASC 718-20-35-9 should still consider the changes it made to the award when applying ASC 260. For example, a reporting entity may modify an award by reducing both the strike price and the number of share options. If the value, the vesting conditions, and the classification of the award are the same immediately before and after the change to the award, then the reporting entity would not account for the effects of the modification. Although the reporting entity would not account for the effects of the modification, it should not ignore the changes it made to the award when it applies the guidance in ASC 260.

Employee stock purchase plans (ESPPs)—after adoption of ASU 2020-06

Under ASC 718, ESPPs are treated as options granted at the start of the offering period. Similarly, ESPPs are considered options to be included in diluted EPS using the treasury stock method because granting an employee the ability to purchase stock at a defined price through an ESPP is very similar

to a conventional employee stock option with a vesting period. Both awards give the employee the ability to purchase reporting entity stock in the future at a potentially discounted price. Accordingly, an ESPP represents potential common shares that reporting entities should include in the denominator for the computation of diluted EPS. The same is true for non-compensatory ESPPs, except there would be no unrecognized compensation cost included in assumed proceeds under the treasury stock method.

Because the vesting of an ESPP is typically based on service, not performance, reporting entities should consider the plan in the denominator for diluted EPS purposes from the start date of the offering period. The fact that employees have amounts withheld from their paychecks to pay for the shares over time is a funding mechanism for the ultimate payment of the exercise price; it does not change the nature of the potentially dilutive option arrangement.

At the beginning of the ESPP offering period, management can begin to estimate how many shares of stock will eventually be purchased based on the employees' withholding elections, the current stock price, and the terms of the ESPP (e.g., the purchase price discount), assuming that the employees continue their employment through the offering period. This is considered the grant date of the share-based compensation award under ASC 718-50-35-1. Changes to employee withholding elections are considered modifications for diluted EPS purposes and are reflected in diluted EPS on a prospective basis.

When including ESPPs in the computation of diluted EPS, a reporting entity must calculate the number of shares to be issued under the ESPP and the hypothetical number of shares that can be repurchased under the treasury stock method. The difference between these two amounts represents the incremental number of potential common shares to be included in the computation of diluted EPS, weighted for the appropriate period of time that the awards were outstanding during the reporting period.

After adoption of ASU 2020-06, we believe there are two acceptable methods to compute the number of shares issuable under the ESPP - either using the average market price during the period or following the contingently issuable shares guidance (which reflects historical practice prior to ASU 2020-06). The method elected should be consistently applied.

Average market price approach

This view uses the average market price for the period to compute the number of shares to be issued under the ESPP. This view is based on the guidance in ASC 260-10-45-21A, which requires use of the average market price to calculate the denominator for diluted EPS when changes in an entity's share price may affect the number of shares needed to settle the instrument. Since the calculation of the number of shares issuable upon completion of the offering period in most ESPPs is affected by the entity's share price at that date, this guidance would apply and the average share price for the period would be used.

Under this approach, at each reporting date during the offering period, reporting entities would divide the total expected withholdings during the entire offering period (based on current employee elections) by the average market price during the reporting period applied to the purchase price formula (e.g., if the ESPP provides for a 15% discount from the stock price, then the average market price during the period should be multiplied by 85%) to calculate the number of shares issuable under the ESPP.

Contingently issuable shares approach

This view recognizes that prior to implementing ASU 2020-06, the number of shares issuable under an ESPP was determined by application of the contingently issuable shares guidance in ASC 260-10-45-48 through ASC 260-10-45-52. Under this view, the number of common shares issuable is calculated based on the number of shares that would be issuable if the reporting date were the end of the contingency period (applying the purchase price formula in the ESPP) because it is based on a future market price. Therefore, a reporting entity would utilize the entity's share price as of the beginning of the offering period, the share price at the reporting date, and the purchase price formula defined in the ESPP to determine the number of shares issuable. This view reflects the language in the Basis for Conclusions of ASU 2020-06, which states "the Board decided to retain the current guidance for calculating diluted EPS for stock-based compensation because those arrangements are not within the scope of this project."

Under this approach, the total expected withholdings during the entire offering period (based on current employee elections), the stock price at the beginning of the offering period and at the reporting date, and the purchase price formula for the ESPP determine the number of shares considered issuable under the plan, consistent with ASC 260-10-45-52 for market price contingencies. Therefore, if the plan requires the purchase price to be 85% of the lesser of the beginning or ending stock price in the offering period, the reporting entity would compare the stock price at the beginning of the offering period to the stock price at the reporting date and use the lower of those two stock prices (multiplied by 85%) in the calculation of the number of shares issuable under the ESPP. If the formula uses an average stock price over a period of time (such as the last 10 business days before the purchase date), the average for that same period of time as of the end of the reporting period should be used, consistent with ASC 260-10-45-52.

Application of the treasury stock method

Under either approach, the hypothetical number of shares that could be repurchased (using the average market price for the period) is netted against the number of shares issuable under the ESPP in order to determine the incremental shares to be included in the calculation of diluted EPS under the treasury stock method. The reporting entity should determine the assumed proceeds to be used in this calculation as the sum of (1) the cash assumed to be received over the course of the offering period (based on current employee elections), and (2) the average unrecognized compensation cost related to the ESPP during the period.

The reporting entity would then divide the total assumed proceeds by the average stock price for the reporting period to determine the hypothetical number of shares that can be repurchased. In calculating the dilutive effect of an ESPP on EPS, reporting entities should incorporate the aggregate expected amount of withholdings during the entire offering period, rather than only the withholding amount received up to the reporting date. Reporting entities should consider the entire offering period because the ESPP is treated as an option for both accounting and EPS purposes. Accordingly, reporting entities should consider all amounts to be withheld from employees to purchase shares under the plan, both current withholdings and expected withholdings, as part of the assumed proceeds under the treasury stock method for EPS. Furthermore, because the amount withheld from employees is recorded by the reporting entity as a liability (as it belongs to the employees until the offering period has ended), it is not considered a prepayment of the purchase price of the shares for diluted EPS purposes and, therefore, continues to be included in the assumed proceeds for the treasury stock method calculation.

In summary, in order to determine the ESPP's impact on diluted EPS, the reporting entity should:

- assess employment status and employee participation as of the reporting date to ensure that employees' elections are appropriately considered in the computation,
- determine the exercise (i.e., purchase) price by utilizing either (a) the average stock price during the reporting period and the purchase price discount defined in the ESPP (if applying the approach in ASC 260-10-45-21A) or (b) the stock price as of the beginning of the offering period, the stock price at the reporting date, and the purchase price formula defined in the ESPP (if applying the contingently issuable shares guidance consistent with historical practice),
- project total withholdings over the course of the offering period, and
- calculate the number of shares issuable under the ESPP and hypothetical repurchases under the treasury stock method (considering total expected withholdings and average unrecognized compensation cost as assumed proceeds). The difference between these two amounts represents the net incremental number of potential common shares to be included in the diluted EPS calculation, weighted for the portion of the reporting period that the ESPP offering period was outstanding

Example FSP 7-12 illustrates the computation of diluted EPS for an ESPP after adoption of ASU 2020-06. This example depicts the calculation of the number of shares issuable under the ESPP using both the average market price during the period and the contingently issuable shares guidance.

EXAMPLE FSP 7-12

Impact on diluted EPS of an ESPP after adoption of ASU 2020-06

FSP Corp has an ESPP that begins a six-month offering period on October 1, 20X6 (ending on March31, 20X7).

The ESPP allows employees to elect to withhold a certain amount of their salary (up to 15%) to purchase the reporting entity's stock at a discounted price.

The ESPP provides for shares to be purchased at 85% of the lesser of the stock price at the beginning or end of the offering period (i.e., a look-back option) and is considered compensatory. Since the plan is compensatory, the reporting entity recognizes compensation cost for the ESPP.

Employees are allowed to withdraw from the ESPP at any time during the offering period, are required to withdraw if terminated, and upon withdrawal will be reimbursed any amount withheld.

The stock price on October 1, 20X6, the beginning of the six-month offering period, is $25. After applying the ESPP's discount, the formula price would be $21.25 ($25 × 85%).

The stock price on December 31, 20X6, the reporting date, is $20. After applying the ESPP's discount, the formula price (if determined at this date) would be $17 ($20 × 85%).

Employee withholdings at December 31, 20X6 total $3,380,000. Expected withholdings for the remaining offering period, based on current employee elections, is $3,420,000. Therefore, the expected total withholdings are $6,800,000.

Average stock price during the period from October 1 to December 31, 20X6 is $22.

Average unrecognized compensation cost during the period from October 1 to December 31, 20X6 is $1,000,000.

How many shares should FSP Corp include in diluted EPS for the year ended December 31, 20X6, assuming the shares are dilutive at the end of 20X6?

Analysis

Application of the average market price approach:

In applying the average market price guidance in ASC 260-10-45-21A, FSP Corp would calculate the number of shares projected to be issued under the ESPP as of December 31, 20X6 as 363,636, determined as follows:

$6,800,000 (expected total withholding amount) divided by $18.70 (average stock price for the period of $22 multiplied by ESPP formula of 85% of stock price)

Total assumed proceeds = $7,800,000, calculated as follows:

$6,800,000 (expected total withholding amount) plus $1,000,000 (average unrecognized compensation cost during the reporting period)

Shares assumed repurchased = 354,545 shares, calculated as follows:

$7,800,000 (assumed proceeds) divided by $22 (average stock price)

Incremental shares to be included in the December 31, 20X6 diluted EPS computation = 2,273 shares, calculated as follows:

[363,636 (gross number of shares to be issued under the ESPP) minus 354,545 (shares assumed repurchased)] x 3 / 12 (ESPP is outstanding for 3 of 12 months in 20X6)

Application of the contingently issuable share approach:

Alternatively, if FSP Corp applied the contingently issuable share guidance (consistent with historical practice prior to adoption of ASU 2020-06) in calculating diluted EPS for its ESPP, the number of shares projected to be issued would be 400,000, and the resulting incremental shares to be included in the December 31, 20X6 diluted EPS computation would be 11,364. The shares assumed to be repurchased under the treasury stock method is unchanged as assumed proceeds are divided by the average stock price under both methods. See below for detailed calculations.

Number of shares projected to be issued at December 31, 20X6 = 400,000, determined as follows:

$6,800,000 (expected total withholding amount) divided by $17 (purchase price per share determined by the ESPP purchase price formula based on the December 31, 20X6 stock price)

The formula price of $17 per share on the reporting date is used because the ESPP contains a look-back option and this price is lower than the formula price at the beginning of the offering period. If the

stock price on the reporting date was greater than the stock price at the beginning of the offering period, the reporting entity would use the formula price at the beginning of the offering period to calculate the shares projected to be issued due to the look-back option.

Incremental shares to be included in the December 31, 20X6 diluted EPS computation = 11,364, determined as follows:

[400,000 (gross number of shares to issue under the ESPP as calculated above) minus 354,545 (shares assumed repurchased)] x 3 / 12 (ESPP is outstanding for 3 of 12 months in 20X6)

Employee stock purchase plans (ESPPs)—before adoption of ASU 2020-06

Under ASC 718, ESPPs are treated as options which are granted at the start of the offering period. Similarly, ESPPs are considered options to be included in diluted EPS using the treasury stock method because granting an employee the ability to purchase stock at a defined price through an ESPP is very similar to a conventional employee stock option with a vesting period. Both awards give the employee the ability to purchase reporting entity stock in the future at a potentially discounted price. Accordingly, an ESPP represents potential common shares that reporting entities should include in the denominator for the computation of diluted EPS. The same is true for non-compensatory ESPPs, except there would be no unrecognized compensation cost included in assumed proceeds under the treasury stock method.

Because the vesting of an ESPP is typically based on service, not performance, reporting entities should consider the plan in the denominator for diluted EPS purposes from the start date of the offering period. The fact that employees have amounts withheld from their paychecks to pay for the shares over time is a funding mechanism for the ultimate payment of the exercise price; it does not change the nature of the potentially dilutive option arrangement.

At each reporting date during the offering period, reporting entities should apply the guidance in ASC 260-10-45-48 through ASC 260-10-45-52 for contingently issuable shares, and ASC 260-10-45-22 through ASC 260-10-45-26 for the treasury stock method. Under this guidance, the number of incremental potential common shares included in diluted EPS is based on the number of shares that would be issuable if the reporting date were the end of the contingency period, net of the hypothetical shares that could be repurchased under the treasury stock method.

The employees' withholding elections at period-end, the stock price at the beginning of the offering period and at the reporting date, and the purchase price formula for the ESPP will determine the number of shares issuable under the plan, consistent with ASC 260-10-45-52, for market price contingencies. Therefore, if the plan requires the purchase price to be the lesser of the beginning or ending stock price in the offering period, the reporting entity would compare the stock price at the beginning of the offering period to the stock price at the reporting date and use the lower of those two stock prices in the calculation of purchase price.

The reporting entity should calculate the assumed proceeds under the treasury stock method based on the sum of (1) the cash assumed to be received over the course of the offering period, and (2) the average unrecognized compensation cost related to the ESPP during the period.

The reporting entity would divide the total assumed proceeds by the average stock price for the reporting period to determine the hypothetical number of shares that can be repurchased under the treasury stock method.

In calculating the dilutive effect of an ESPP on EPS, reporting entities should base the number of shares issued on the aggregate expected amount of withholdings during the entire offering period, rather than only the withholding amount received up to the reporting date. Reporting entities should consider the entire offering period because the ESPP is treated as an option for both accounting and EPS purposes. Accordingly, reporting entities should consider all amounts to be withheld from employees to purchase shares under the plan, both current withholdings and expected withholdings, as part of the assumed proceeds under the treasury stock method for EPS.

Because the amount withheld from employees is recorded by the reporting entity as a liability (as it belongs to the employees until the offering period has ended), it is not considered a prepayment of the purchase price of the shares for diluted EPS purposes and therefore, continues to be included in the assumed proceeds for the treasury stock method calculation.

At the beginning of the ESPP offering period, management can determine, based on the employees' withholding elections and the current stock price, how many shares of stock will eventually be purchased, assuming that the employees continue their employment through the offering period. This is considered the grant date of the share-based compensation award under ASC 718-50-35-1. Changes to employee withholding elections are considered modifications for diluted EPS purposes, and are reflected in diluted EPS on a prospective basis.

Accordingly, in order to determine the ESPP's impact on diluted EPS, the reporting entity should:

- assess employment status and employee participation as of the reporting date to ensure that employees' elections are appropriately considered in the computation,
- determine the exercise price by utilizing the stock price as of the beginning of the offering period, the stock price at the reporting date, and the purchase price formula defined in the ESPP,
- project total withholdings over the course of the offering period, and
- calculate the number of shares to be issued under the ESPP and hypothetical repurchases under the treasury stock method (considering total expected withholdings and average unrecognized compensation cost as assumed proceeds). The difference between these two amounts represents the net incremental number of potential common shares to be included in the diluted EPS calculation.

Example FSP 7-13A illustrates the computation of diluted EPS for an ESPP before adoption of ASU 2020-06.

EXAMPLE FSP 7-13A

Impact on diluted EPS of an employee stock purchase plan before adoption of ASU 2020-06

FSP Corp has an ESPP that begins a six-month offering period on September 1, 20X6 (ending on February 28, 20X7).

The ESPP allows employees to elect to withhold a certain amount of their salary (up to 15%) to purchase the reporting entity's stock at a discounted price.

The ESPP provides for shares to be purchased at 85% of the lesser of the stock price at the beginning or end of the offering period (i.e., a look-back option) and is considered compensatory. Since the plan is compensatory, the reporting entity recognizes compensation cost for the ESPP.

Employees are allowed to withdraw from the ESPP at any time during the offering period, are required to withdraw if terminated, and upon withdrawal will be reimbursed any amount withheld.

The stock price on September 1, 20X6, the beginning of the six-month offering period, is $25. After applying the ESPP's discount, the formula price would be $21.25 ($25 × 85% = $21.25).

The stock price on December 31, 20X6, the reporting date, is $20. After applying the ESPP's discount, the formula price would be $17 ($20 × 85% = $17).

Employee withholdings at December 31, 20X6, total $4,500,000. Expected withholdings for the remaining offering period, based on current employee elections, is $2,300,000. Therefore, the expected total withholdings are $6,800,000.

Average stock price during the period from September 1 to December 31, 20X6, is $22.

Average unrecognized compensation cost during the period from September 1 to December 31, 20X6 = $1,650,000.

How many shares should FSP Corp include in diluted EPS for the year ended December 31, 20X6, assuming the shares are dilutive at the end of 20X6?

Analysis

FSP Corp would calculate the number of shares projected to be issued at December 31, 20X6 under the ESPP as 400,000, determined as follows:

$6,800,000 (expected total withholding amount) divided by $17 (purchase price per share determined by the ESPP purchase price formula)

The formula price of $17 per share on the reporting date is used because the ESPP contains a look-back option and this price is lower than the formula price at the beginning of the offering period. If the stock price on the reporting date was greater than the stock price at the beginning of the offering period, the reporting entity would have used the formula price at the beginning of the offering period to calculate the shares projected to be issued due to the look-back option.

Total assumed proceeds = $8,450,000, calculated as follows:

$6,800,000 (expected total withholding amount) plus $1,650,000 (average unrecognized compensation cost during the reporting period)

Shares assumed repurchased = 384,091 shares, calculated as follows:

$8,450,000 (assumed proceeds) divided by $22 (average stock price)

Incremental shares to be included in the December 31, 20X6 diluted EPS computation = 5,303 shares, calculated as follows:

[400,000 (gross number of shares to issue under the ESPP) minus 384,091 shares (assumed repurchased)] x 4 / 12 (ESPP is outstanding for 4 of 12 months in 20X6)

Because most ESPPs provide for the purchase of shares at a discount to the market price, there is typically a dilutive effect on EPS. However, the inclusion of unrecognized compensation cost in the calculation of assumed proceeds tends to mitigate the impact, particularly in the earlier portions of the offering period. Once there is an obligation to issue shares (on March 1 in the above example), the shares would be included in basic EPS on a prospective basis. During the quarter ending March 31, along with being included in basic EPS for the one month from March 1 to March 31, the ESPP would also affect diluted EPS on a weighted average basis for the period from January 1 to February 28.

Stock-appreciation rights

A stock-appreciation right (SAR) is a contract that gives the employee the right to receive an amount of stock that equals the appreciation in a company's stock from an award's grant date to the exercise date. SARs generally do not involve payment of an exercise price and may be settled in cash or in stock.

If a SAR is required to be settled in cash, the only effect the cash-settled SAR would have on the numerator is through the recognition of compensation cost in net income.

If a SAR is required to be settled in stock, it will be included in the computation of diluted EPS (if the award is dilutive) based on the net number of shares issuable using the average stock price for the period. Because an employee typically does not pay to exercise a stock-settled SAR, only unrecognized compensation cost is considered proceeds when calculating the dilutive effect under the treasury stock method.

If the reporting entity or the employee can decide whether a SAR will be settled in cash or in stock, see FSP 7.5.7.1 (after adoption of ASU 2020-06) or FSP 7.5.7.1A (before adoption of ASU 2020-06) for the appropriate EPS treatment.

Some cash and stock-settled SARs may be treated differently for determining the classification of an award and related compensation cost to be recorded, and for EPS purposes. For example, a SAR that provides the employee with the choice of settlement method is a liability-classified award; however, EPS will be computed on the assumption that the award will be settled in shares because it is more dilutive. In accordance with ASC 260-10-55-33, the reporting entity should not adjust the numerator for recorded compensation expense in that situation.

7.5.5.6 Market prices used in the treasury stock method

In applying the treasury stock method, a simple average of market prices usually will be adequate. As noted in ASC 260-10-55-5, closing daily market prices are generally adequate for use in computing the average market price. When prices fluctuate widely, however, an average of the daily high and low price usually would be more representative. A reporting entity should consistently apply the method used to compute the average market price, unless it is no longer representative because of changed conditions.

When market prices are unavailable (e.g., the pre-IPO period for a reporting entity going public, or a reporting entity that has been delisted) for periods presented in the financial statements, management should use its best estimate of the fair value of the entity's shares during the period. Management's determination of fair value of its shares should be consistent with the fair values and assumptions used in the calculation of the reporting entity's stock compensation cost and disclosures.

7.5.5.7 Year-to-date computations pursuant to the treasury stock method

Earnings per share for a quarter should be based on the weighted average number of shares of common stock and dilutive potential common shares outstanding during that quarter, rather than calculated as the difference between year-to-date earnings per share and cumulative earnings per share for previous quarters of the fiscal year. When performing year-to-date computations pursuant to the treasury stock method, the reporting entity does not perform the year-to-date computation independently using the whole year as the averaging period; rather, it is an average of the quarters' weighted average incremental shares under the treasury stock method. For the purpose of determining the weighted average number of shares in applying the treasury stock method to year-to-date computations, reporting entities should use the guidance in ASC 260-10-55-3.

Excerpt from ASC 260-10-55-3

...the number of incremental shares to be included in the denominator shall be determined by computing a year-to-date weighted average of the number of incremental shares included in each quarterly diluted EPS computation.

However, in computing year-to-date diluted EPS, reporting entities should use year-to-date income (or loss) from continuing operations as the basis for determining whether or not dilutive potential common shares not included (or included) in one or more quarterly computations of diluted EPS are included in the year-to-date computation.

For example, if a reporting entity had a year-to-date loss from continuing operations that included quarters with income, any incremental shares included in the quarters with income would not be included in the denominator for the year-to-date diluted EPS computation. Likewise, if a reporting entity had year-to-date income, and in-the-money options or warrants were excluded from one or more quarterly diluted EPS computations because the effect was anti-dilutive due to a loss in that quarter, then those options or warrants should be included in the EPS denominator (on a weighted average basis) in the year-to-date computation.

Disclosure in the annual report of the quarterly per share data required by S-K 302 should reflect the average shares outstanding during each particular quarter. If the sum of such quarterly EPS amounts differs significantly from annual EPS, the reason for the difference should be explained in a note to the quarterly financial data included in the annual report.

See ASC 260-10-55-3A, Example 1 in ASC 260-10-55-38 through ASC 260-10-55-50, and Example 12 in ASC 260-10-55-85 for an illustration of this concept.

7.5.5.8 Modifications to use of the treasury stock method

Options or warrants may permit or require the holder of the option to tender debt or other securities of the issuer (or its subsidiary or parent) in payment of all or a portion of the exercise price.

In computing diluted EPS, the reporting entity assumes (1) those options or warrants are exercised, and (2) the debt or other securities is tendered (this is, effectively, the if-converted method which is discussed in FSP 7.5.6 (after adoption of ASU 2020-06) and FSP 7.5.6A (before adoption of ASU 2020-06)). The reporting entity adds back interest (net of tax) on any debt assumed to be tendered to the numerator and also adjusts the numerator for any nondiscretionary adjustments based on income (net of tax), such as profit-sharing and royalty agreements. See ASC 260-10-55-9.

If tendering cash, however, would be more advantageous to the option or warrant holder, and the contract permits tendering cash, the reporting entity should apply the treasury stock method. See ASC 260-10-55-9.

The terms of certain options or warrants may require that proceeds received from their exercise be applied to retire debt or other securities of the issuer (or its parent or subsidiary). In computing diluted EPS, the reporting entity assumes those options or warrants are exercised and the proceeds applied to purchase the debt at its average market price rather than to purchase common stock under the treasury stock method. In doing so, it should add back interest (net of tax) on any debt assumed to be repurchased to income available to common stockholders. It also adjusts the numerator for any nondiscretionary adjustments based on income (net of tax). However, the reporting entity should apply the treasury stock method for excess proceeds received from the assumed exercise (i.e., the proceeds received on exercise exceed the amount of debt retired). See ASC 260-10-55-10.

Convertible securities that permit or require the payment of cash by their holder at conversion are deemed to be warrants. In computing diluted EPS, the reporting entity should apply the proceeds assumed to be received to purchase common stock using the treasury stock method, and should assume the convertible security is converted under the if-converted method. See ASC 260-10-55-11.

7.5.5.9 Reverse treasury stock method—after adoption of ASU 2020-06

Contracts that require the reporting entity to repurchase its own stock (such as written put options and forward purchase contracts, other than physically-settled forward purchase contracts for a fixed number of shares accounted for pursuant to ASC 480-10-45-4; see FSP 7.4.3.6) are reflected in the computation of diluted EPS if their effect is dilutive.

Net cash or net share settled forward repurchase contracts—after adoption of ASU 2020-06

A reporting entity should not deduct the shares underlying a forward repurchase contract that allows or requires net cash or net share settlement from weighted average common shares outstanding for purposes of calculating basic and diluted earnings per share. That treatment is only applicable to forward contracts that require the delivery of a fixed number of shares for a fixed amount of cash at settlement.

A forward repurchase contract that requires net cash settlement should not be included in the denominator of the computation of diluted earnings per share because the contract does not allow for share settlement, nor should there be an adjustment to the numerator for the gain or loss recorded through earnings for the period. A forward repurchase contract that allows for net share settlement or gross physical settlement, or physical settlement in exchange for specified quantities of assets other than cash, should be included in the computation of diluted earnings per share using the reverse treasury stock method described in ASC 260-10-45-35. A forward repurchase contract that allows for net cash or net share settlement (or net cash or physical settlement) should be included in the

computation of diluted earnings per share using the reverse treasury stock method and share settlement must be assumed in accordance with ASC 260-10-45-45. In performing the reverse treasury stock method for these contracts, the gain or loss on the contract that was recorded through earnings for the period should be added to or deducted from the numerator. These contracts may be anti-dilutive and, in such cases, there would be no adjustment to earnings per share.

ASC 260-10-45-35

Contracts that require that the reporting entity repurchase its own stock, such as written put options and forward purchase contracts other than forward purchase contracts accounted for under paragraphs 480-10-30-3 through 30-5 and 480-10-35-3, shall be reflected in the computation of diluted EPS if the effect is dilutive. If those contracts are in the money during the reporting period (the exercise price is above the average market price for that period), the potential dilutive effect on EPS shall be computed using the reverse treasury stock method. Under that method:

a. Issuance of sufficient common shares shall be assumed at the beginning of the period (at the average market price during the period) to raise enough proceeds to satisfy the contract.

b. The proceeds from issuance shall be assumed to be used to satisfy the contract (that is, to buy back shares).

c. The incremental shares (the difference between the number of shares assumed issued and the number of shares received from satisfying the contract) shall be included in the denominator of the diluted EPS computation.

ASC 260-10-45-45

The effect of potential share settlement shall be included in the diluted EPS calculation (if the effect is more dilutive) for an otherwise cash settleable instrument that contains a provision that requires or permits share settlement (regardless of whether the election is at the option of an entity or the holder, or the entity has a history or policy of cash settlement). An example of such a contract accounted for in accordance with this paragraph and paragraph 260-10-45-46 is a written call option that gives the holder a choice of settling in common stock or in cash. An election to share settle an instrument, for purposes of applying the guidance in this paragraph, does not include circumstances in which share settlement is contingent upon the occurrence of a specified event or circumstance (such as contingently issuable shares). In those circumstances (other than if the contingency is an entity's own share price), the guidance on contingently issuable shares should first be applied, and, if the contingency would be considered met, then the guidance in this paragraph should be applied. Share-based payment arrangements that are payable in common stock or in cash at the election of either the entity or the grantee shall be accounted for pursuant to this paragraph and paragraph 260-10-45-46, unless the share-based payment arrangement is classified as a liability because of the requirements in paragraph 718-10-25-15 (see paragraph 260-10-45-45A for guidance for those instruments). If the payment of cash is required only upon the final liquidation of an entity, then the entity shall include the effect of potential share settlement in the diluted EPS calculation until the liquidation occurs.

Written put options—after adoption of ASU 2020-06

A written put option that is required to be net cash settled should not be included in the denominator of the diluted earnings per share computation because it does not allow for share settlement, nor should there be an adjustment to the numerator for the gain or loss recorded through earnings for the

period. A written put option that is required to be settled in shares should be included in the computation of diluted earnings per share using the reverse treasury stock method as described in ASC 260-10-45-35. A written put option that allows for net share or net cash settlement should also be included in the computation of diluted earnings per share using the reverse treasury stock method and share settlement must be assumed as discussed in ASC 260-10-45-45. In performing the reverse treasury stock method for these contracts, the gain or loss on the contract that was recorded through earnings for the period should be added to or deducted from the numerator. These contracts may be anti-dilutive and, in such cases, there would be no adjustment to earnings per share.

Application example—after adoption of ASU 2020-06

Example FSP 7-14 illustrates the application of the reverse treasury stock method to written put options.

EXAMPLE FSP 7-14

Reverse treasury stock method

FSP Corp sells a put option that allows the investor to sell 100 shares to FSP Corp at an exercise price of $25; the average market price for the period is $20.

How should FSP Corp compute diluted EPS?

Analysis

The incremental number of shares to be included in diluted EPS is 25. This is computed as follows:

- Assume 125 shares are issued at the beginning of the period to raise enough proceeds to satisfy the put option exercise price of $2,500 (100 shares at $25). Number of shares assumed to have been issued is calculated by dividing the required proceeds of $2,500 by the average market price of $20 per share for the period.

- The $2,500 in proceeds from issuance of new shares is then used to satisfy the put on 100 shares.

- The EPS computation should include 25 incremental shares—125 shares assumed to be issued less the 100 shares assumed to have been repurchased.

7.5.5.9A Reverse treasury stock method—before adoption of ASU 2020-06

Contracts that require the reporting entity to repurchase its own stock (such as written put options and forward purchase contracts, other than physically-settled forward purchase contracts for a fixed number of shares accounted for pursuant to ASC 480-10-45-4; see FSP 7.4.3.6) are reflected in the computation of diluted EPS if their effect is dilutive.

Net cash or net share settled forward repurchase contracts—before adoption of ASU 2020-06

A reporting entity should not deduct the shares underlying a forward repurchase contract that allows or requires net cash or net share settlement from weighted average common shares outstanding for

purposes of computing basic and diluted earnings per share. That treatment is only applicable to forward contracts that require the delivery of a fixed number of shares for a fixed amount of cash at settlement.

A forward repurchase contract that requires net cash settlement should not be included in the denominator of the diluted earnings per share computation because the contract does not allow for share settlement, nor should there be an adjustment to the numerator for the gain or loss recorded through earnings for the period. A forward repurchase contract that allows for net share settlement or gross physical settlement should be included in the computation of diluted earnings per share using the reverse treasury stock method described in ASC 260-10-45-35. A forward repurchase contract that allows for either net cash or net share settlement should be included in the computation of diluted earnings per share using the reverse treasury stock method and the guidance applicable to contracts that may be settled in cash or shares (see FSP 7.5.7.1A). In performing the reverse treasury stock method for these contracts, the gain or loss on the contract that was recorded through earnings for the period should be added to or deducted from the numerator. These contracts may be anti-dilutive and, in such cases, there would be no adjustment to earnings per share.

ASC 260-10-45-35

Contracts that require that the reporting entity repurchase its own stock, such as written put options and forward purchase contracts other than forward purchase contracts accounted for under paragraphs 480-10-30-3 through 30-5 and 480-10-35-3, shall be reflected in the computation of diluted EPS if the effect is dilutive. If those contracts are in the money during the reporting period (the exercise price is above the average market price for that period), the potential dilutive effect on EPS shall be computed using the reverse treasury stock method. Under that method:

a. Issuance of sufficient common shares shall be assumed at the beginning of the period (at the average market price during the period) to raise enough proceeds to satisfy the contract.

b. The proceeds from issuance shall be assumed to be used to satisfy the contract (that is, to buy back shares).

c. The incremental shares (the difference between the number of shares assumed issued and the number of shares received from satisfying the contract) shall be included in the denominator of the diluted EPS computation.

Written put options—before adoption of ASU 2020-06

A written put option that is required to be net cash settled should not be included in the denominator of the diluted earnings per share computation because it does not allow for share settlement, nor should there be an adjustment to the numerator for the gain or loss recorded through earnings for the period. A written put option that is required to be settled in shares should be included in the computation of diluted earnings per share using the reverse treasury stock method described in ASC 260-10-45-35. A written put option that allows for net share or net cash settlement should also be included in the computation of diluted earnings per share using the reverse treasury stock method and the guidance applicable to contracts that may be settled in cash or shares (see FSP 7.5.7.1A). In performing the reverse treasury stock method for these contracts, the gain or loss on the contract that was recorded through earnings for the period should be added to or deducted from the numerator.

These contracts may be anti-dilutive and, in such cases, there would be no adjustment to earnings per share.

Application example—before adoption of ASU 2020-06

Example FSP 7-14A illustrates the application of the reverse treasury stock method to written put options.

EXAMPLE FSP 7-14A

Reverse treasury stock method

FSP Corp sells a put option that allows the investor to sell 100 shares to FSP Corp at an exercise price of $25; the average market price for the period is $20.

How should FSP Corp compute diluted EPS?

Analysis

The incremental number of shares to be included in diluted EPS is 25. This is computed as follows:

- Assume 125 shares are issued at the beginning of the period to raise enough proceeds to satisfy the put option exercise price of $2,500 (100 shares at $25). Number of shares assumed to have been issued is calculated by dividing the required proceeds of $2,500 by the average market price of $20 per share for the period.
- The $2,500 in proceeds from issuance of new shares is then used to satisfy the put on 100 shares.
- The EPS computation should include 25 incremental shares—125 shares assumed to be issued less the 100 shares assumed to have been repurchased.

7.5.6 If-converted method for convertible securities—after adoption of ASU 2020-06

ASC 260 considers all convertible securities, including convertible debt and convertible preferred stock, which by their terms may be converted into common stock of the reporting entity, as potential common shares.

Share-settled convertible debt and convertible preferred stock are generally included in diluted EPS using the if-converted method as described in ASC 260-10-45-40 through ASC 260-10-45-42.

Definition from ASC 260-10-20

If-converted method: A method of computing EPS data that assumes conversion of convertible securities at the beginning of the reporting period (or at time of issuance, if later).

The dilutive effect of convertible securities should be reflected in diluted EPS by application of the if-converted method as described in ASC 260-10-45-40.

ASC 260-10-45-40

The dilutive effect of convertible securities shall be reflected in diluted EPS by application of the if-converted method. Under that method:

a. If an entity has convertible preferred stock outstanding, the preferred dividends applicable to convertible preferred stock shall be added back to the numerator. The amount of preferred dividends added back will be the amount of preferred dividends for convertible preferred stock deducted from income from continuing operations (and from net income) in computing income available to common stockholders pursuant to paragraph 260-10-45-11.

b. If an entity has convertible debt outstanding:

    1. Interest charges applicable to the convertible debt shall be added back to the numerator. For convertible debt for which the principal is required to be paid in cash, the interest charges shall not be added back to the numerator.

    2. To the extent nondiscretionary adjustments based on income made during the period would have been computed differently had the interest on convertible debt never been recognized, the numerator shall be appropriately adjusted. Nondiscretionary adjustments include any expenses or charges that are determined based on the income (loss) for the period, such as profit-sharing and royalty agreements.

    3. The numerator shall be adjusted for the income tax effect of (b)(1) and (b)(2).

c. The convertible preferred stock or convertible debt shall be assumed to have been converted at the beginning of the period (or at time of issuance, if later), and the resulting common shares shall be included in the denominator. See paragraph 260-10-45-21A if the incremental shares are variable (such as when calculating a conversion premium).

When applying the if-converted method to convertible preferred stock, a reporting entity adds back the preferred dividends (declared or cumulative undeclared) applicable to the convertible preferred stock in the period to the diluted EPS numerator. Such add-back would also include any adjustments charged or credited to equity in the period to accrete preferred stock classified as mezzanine equity to its cash redemption price (or recorded upon a redemption or induced conversion), and any participating dividends allocated to the convertible preferred stock in the period for purposes of basic EPS.

A reporting entity with convertible debt outstanding will adjust the numerator for the income tax effect of interest charges and nondiscretionary adjustments, computed on a "with or without" basis. Nondiscretionary adjustments include any expenses or charges that are determined based on the income (loss) for the period, such as profit sharing and royalty agreements.

The if-converted calculations are not affected by the reporting entity's current stock price in relation to the conversion price. That is, a convertible security has the same effect on diluted EPS when the conversion option is far out of the money (i.e., the security has little chance of being converted), as it does when it is deep in the money (i.e., the security has a high likelihood of being converted).

In determining the common shares to be included in the denominator under the if-converted method, if the number of shares issuable upon conversion is variable, reporting entities should follow the guidance in ASC 260-10-45-21A, which requires the use of the average market price when determining the number of shares that may be issued.

Convertible debt in which the principal amount must be settled in cash and the "conversion spread value" in shares (known in practice as an "Instrument C" bond) is included in diluted EPS using the if-converted method as described in ASC 260-10-55-84 through ASC 260-10-55-84B. Specifically, there would be no interest expense adjustment to the numerator for the cash-settled portion of the instrument because that portion will always be settled in cash (see ASC 260-10-45-40). Similarly, for convertible preferred stock for which the stated value is required to be paid in cash, a reporting entity should not add the preferred dividends back to the diluted EPS numerator in applying the if-converted method (by analogy to the convertible debt guidance in ASC 260-10-45-40(b)(1)).

The denominator of diluted EPS for Instrument C is determined by dividing the "conversion spread value" of the share-settled portion of the instrument by the average share price over the reporting period. The "conversion spread value" is the value that would be delivered to investors in shares based on the terms of the bond upon an assumed conversion. In addition, for the purpose of determining the weighted average number of shares for the year-to-date diluted EPS computation for Instrument C, the number of incremental shares to be included in the denominator should be determined by averaging the number of incremental shares included in each quarterly diluted EPS computation.

The issuer of a debt instrument that may settle the bond upon conversion in any combination of cash or shares at the issuer's option (known in practice as an "Instrument X" bond) must assume for purposes of the diluted EPS computation that the instrument is settled in shares. See FSP 7.5.7.1 for details.

When the conversion feature embedded in a convertible debt instrument is bifurcated from the debt host and accounted for separately pursuant to the derivative accounting literature, the debt host and the separated conversion feature (i.e., the embedded derivative) are each treated as a separate unit of account. The discount created on the debt by separation of the conversion feature should be amortized through interest expense over the life of the debt, and the conversion feature should be measured at fair value each reporting period with changes in fair value included in earnings.

Despite the fact that the debt and conversion feature are considered separate units of account for accounting purposes, they are treated as one instrument for EPS purposes (as it is a single convertible debt instrument) and included in the diluted EPS calculation using the if-converted method.

In addition to the adjustment for interest expense (which includes amortization of the discount created upon bifurcation of the conversion option from the debt), the change in fair value each period related to the bifurcated conversion option should be deducted from/added back to the numerator (adjusted for any tax effect) in calculating diluted EPS.

As discussed further in FSP 7.5.7.1, ASC 260-10-55-32 requires reporting entities to exclude the income statement impact of instruments assumed to be settled in shares for EPS purposes and that are required to be reported as assets or liabilities, from the numerator in the diluted EPS calculation. The fair value adjustment is nondiscretionary in all periods, whether a gain or loss, and so should be deducted from/added to the numerator. As a result of the adjustments to the diluted EPS numerator for the interest expense and fair value gain or loss, and the denominator adjustment for the number of

shares assumed to be converted, the security may be dilutive or antidilutive. If antidilutive, the security should be excluded from the diluted EPS calculation altogether.

If a reporting entity enters into an interest rate swap as a hedge of the interest associated with convertible debt that automatically terminates upon settlement or conversion of the debt (i.e., termination is nondiscretionary), the interest expense adjustment to the numerator is inclusive of the impact on interest expense arising from interest rate swaps formally designated as hedging instruments. If the swap arrangement does not automatically terminate upon conversion, the reporting entity should exclude the impact of the swap from the add-back, and add back only the contractual interest on the debt in the numerator.

Conversion is not assumed for purposes of computing diluted EPS if the effect would be anti-dilutive, such as in the following situations:

- Convertible debt is anti-dilutive when its interest and nondiscretionary adjustments (net of tax) per common share obtainable on conversion exceeds basic EPS.

- Convertible preferred stock is anti-dilutive when the amount of the dividend declared in, or accumulated for, the current period, including any deemed dividends or related accretion and participation in dividends, per common share obtainable on conversion exceeds basic EPS.

Similarly, in periods of net loss, the application of the if-converted method to convertible securities is generally anti-dilutive (see FSP 7.5.7.1 for a situation when it may not be).

Reporting entities should include convertible securities that have a dilutive effect on EPS in the denominator of diluted EPS from the beginning of the period or from the date of issuance, if later. They should also include dilutive convertible securities that are extinguished or redeemed, and securities in which the conversion options lapsed, in the denominator for the period they were outstanding. Consistent with ASC 260-10-S99-2, in circumstances when dilutive convertible securities are extinguished or redeemed and there is a gain or loss on extinguishment or induced conversion reflected in the numerator of basic EPS, the gain or loss should be reversed in the numerator of diluted EPS because the shares are assumed to have been converted at the beginning of the period.

Dilutive convertible securities converted during the period are included in the denominator of diluted EPS for the period prior to their conversion. Thereafter, the shares issued are included in the denominator of both basic and diluted EPS.

Example FSP 7-15 and Example FSP 7-16 illustrate the application of the if-converted method for convertible debt.

EXAMPLE FSP 7-15

Application of the if-converted method to convertible debt

On January 1, 20X7, FSP Corp issued $10 million of convertible bonds (10,000 bonds in $1,000 increments), at par. On the issuance date, FSP Corp's common stock price was $100 per share. The terms of the bonds include:

- A coupon rate of 2% per year, which results in after-tax interest expense of $30,000 per quarter ($10 million x 2% x 1/4 = $50,000 less income tax of $20,000 (40% tax rate x $50,000)).

- A requirement that FSP Corp deliver 8 shares per bond to bondholders upon conversion (which equates to a conversion price of $125), or 80,000 shares (10,000 bonds x 8 shares per bond) in total.

FSP Corp has 10 million weighted average common shares outstanding, and net income for the quarter ended March 31, 20X7 is $50 million.

How should FSP Corp include the convertible bonds in the diluted EPS computation for the period ended March 31, 20X7?

Analysis

FSP Corp should include the convertible bonds in diluted EPS using the if-converted method as follows.

	Basic EPS	Adjustments	Diluted EPS
Earnings	$50,000,000	$30,000	$50,030,000
Weighted average common shares and potential common shares	10,000,000	80,000	10,080,000
EPS	$5.00		$4.96

EXAMPLE FSP 7-16

Computing year-to-date diluted EPS when convertible debt is anti-dilutive in certain periods and dilutive in others

FSP Corp is profitable for the year but has net losses in the first and second quarters of 20X7. FSP Corp issued convertible debt in the prior year, which has been outstanding for all of 20X7.

When adding back interest expense on the convertible debt and adjusting the weighted average shares to reflect conversion at the beginning of those periods, the results are anti-dilutive for both the discrete quarters and for the year-to-date EPS computation for the first and second quarters. The result of assuming conversion in the third and fourth quarters is dilutive.

How would FSP Corp compute year-to-date EPS for the third and fourth quarters of 20X7?

Analysis

For the nine- and twelve-month period computations, the assessment of whether the convertible debt is anti-dilutive should consider the entire period for which the convertible debt was outstanding (the nine- or twelve-month periods). The fact that there are discrete quarters in which the conversion was anti-dilutive does not matter, and those periods would not be excluded from the nine- and twelve-month year-to-date calculations. Example 1 (transaction e) in ASC 260-10-55 illustrates this point. Note: This would also be true if FSP Corp was profitable in all quarters, but the application of the if-converted method was still anti-dilutive in the first and second quarters due to the add-back per

common share exceeding basic EPS. This is different than the treatment of treasury stock method shares in year-to-date diluted EPS computations, as described in FSP 7.5.5.7.

Question FSP 7-3

In the second quarter, FSP Corp declared and paid a special dividend to holders of common stock. As a result, the conversion rate on FSP Corp's convertible notes was reduced in accordance with their contractual terms. How should the change in the conversion rate be treated for purposes of computing diluted EPS?

PwC response

We believe that either of the following approaches would be acceptable.

- By analogy to ASC 260-10-45-42 (which addresses convertible securities issued, converted, or extinguished during the period), FSP Corp could calculate the number of shares to include in the denominator for the period by adding:
  - the number of shares issuable based on the conversion rate in effect before the special dividend, weighted for that period, and
  - the number of shares issuable based on the new conversion rate, weighted for the appropriate period.
- By analogy to ASC 260-10-45-52 (which addresses contingently issuable shares), FSP Corp could calculate the number of shares to include in the denominator for the period by using the number of shares issuable upon conversion determined solely by the end-of-period conversion price. This would reflect a maximum amount of dilution based on the number of shares that would be issuable as of the end of the period and going forward.

Choosing which approach to follow is an accounting policy decision and should be consistently applied in all periods for similar instruments.

7.5.6.1 Treatment of capitalized interest on convertible debt—after adoption of ASU 2020-06

Capitalized interest from convertible debt could present a conceptual problem in applying the if-converted method. Application of the if-converted method requires the add-back of interest expense and certain other non-discretionary adjustments to net income when convertible securities are assumed to be converted. Accordingly, when any portion of convertible debt interest has been capitalized during a period, it is appropriate, in the EPS computations only, to assume that such interest was not incurred during the period and, therefore, neither capitalized nor expensed, and to make an "as-if" recomputation of interest that would have been capitalized based on interest on other debt.

In this situation, the reporting entity would adjust the numerator to eliminate any effect of the convertible debt interest that was expensed and any other interest expense that would have been capitalized on other debt instruments had the convertible debt not been in existence. As usual, the effect of the "if converted" method cannot be anti-dilutive.

To illustrate, assume a reporting entity has convertible debt that is included using the "if-converted" method for diluted EPS purposes. In general, the reporting entity should determine the amount of interest related to the convertible security included in interest expense and include only that amount (net of tax) in the "if-converted" method calculation. In other words, the reporting entity should not add back to the numerator of diluted EPS the interest attributable to convertible debt that has been capitalized based upon the requirements of ASC 835-20.

The rationale is that capitalized interest is, by definition, not an expense of the current period and, therefore, assumed conversion of the debt at the beginning of the current period generally would not have affected net income if the interest was capitalized. However, the reporting entity should consider whether assumed conversion at the beginning of the period would have affected the overall amount of interest capitalized on other debt, and thus income. The reporting entity should perform a "with conversion" and "without conversion" calculation of capitalized interest to determine if assumed conversion at the beginning of the period would have affected income. If the capitalized interest would have been different if conversion had occurred at the beginning of the period, the reporting entity should treat that difference as a nondiscretionary amount and include it as an adjustment in the diluted EPS computation in accordance with ASC 260-10-45-40.

7.5.6.2 Partial redemption or induced conversion on diluted EPS—after adoption of ASU 2020-06

As discussed in FSP 7.4.1.3 and FSP 7.5.6, a reporting entity may offer an incentive to preferred stockholders to either redeem or convert their outstanding shares.

If a reporting entity effects a redemption or induced conversion of only a portion of the outstanding securities of a class of preferred stock, any excess consideration is attributed to only those shares that are redeemed or converted. ASC 260-10-S99-2 indicates that, in determining the dilutive effect of the preferred stock, each group—those remaining outstanding and those redeemed or converted—are considered separately, as they have different effective dividend yields resulting from the excess consideration.

Example FSP 7-17 illustrates how to determine if assumed conversion is dilutive when a portion of outstanding preferred stock securities are redeemed during the period.

EXAMPLE FSP 7-17

Determining whether redemption of a portion of outstanding preferred shares is dilutive

FSP Corp has shares of common stock and 100 shares of convertible preferred stock outstanding at the beginning of a period.

The convertible preferred stock was issued at fair value, which was equal to its par value of $10 per share, has a stated dividend of 5%. Each share of preferred stock is convertible into one share of common stock.

During the reporting period, 20 preferred shares were redeemed at a per share price of $12.

How should FSP Corp determine whether conversion is dilutive?

Analysis

FSP Corp should apply the guidance in ASC 260-10-S99-2 and determine whether conversion is dilutive (1) for 80 of the preferred shares (the shares remaining outstanding) by applying the if-converted method from the beginning of the period to the end of the period using the stated dividend of 5%, and (2) for the 20 shares redeemed by applying the if-converted method from the beginning of the period to the date of redemption, using both the stated dividend of 5% and the $2 per share redemption premium.

7.5.6.3 Contingently convertible instruments—after adoption of ASU 2020-06

Some conversion options can only be exercised by the holder upon satisfaction of a contingency. There are two broad categories of conversion option contingencies:

- *Contingencies tied to the issuer's stock price*

  For example, the investor cannot exercise the conversion option until the issuer's stock price reaches a level of 120% of the conversion price.

- *Contingencies tied to an event or index other than the issuer's stock price*

  For example, the investor can only exercise the conversion option upon the issuer's successful completion of an IPO.

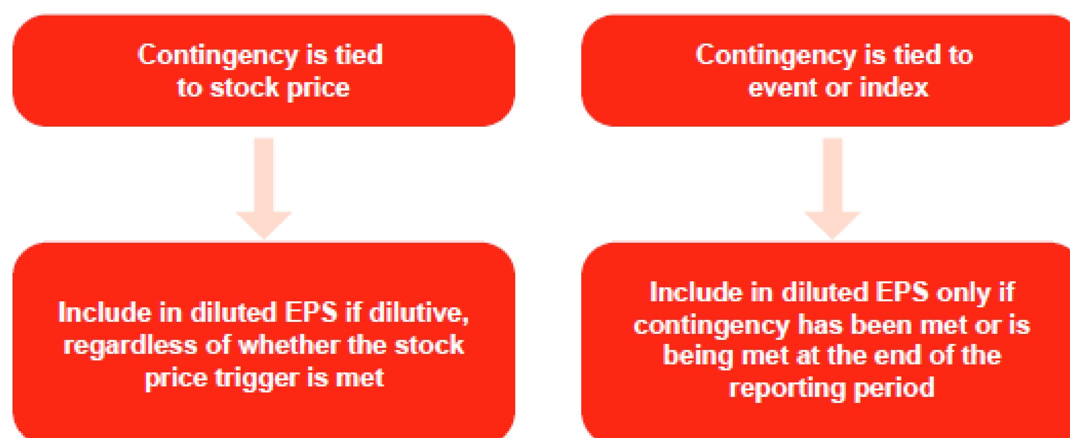
If the instrument's conversion is based on achieving a substantive contingency based on an event or index other than the issuer's stock price, the reporting entity would not include the instrument in diluted EPS until the non-market based contingency has been met or is being met based on circumstances at the end of the reporting period, consistent with the guidance in ASC 260-10-45-48. For example, if the contingency was based on an IPO, and an IPO had not been completed by period end, the contingently convertible instruments would not be included in diluted EPS for the period.

However, based on the guidance in ASC 260-10-45-44, contingently convertible instruments that are tied to the reporting entity's stock price should be treated in the same manner as other convertible securities and included in diluted EPS, if the effect is dilutive, regardless of whether the stock price trigger has been met.

Further, delayed convertibility based solely on the passage of time does not avoid including the security immediately pursuant to the if-converted method based on the requirements above, even if the security is not convertible for many years.

Figure FSP 7-8 illustrates the treatment of the two types of conversion contingencies.

Figure FSP 7-8
EPS treatment of contingently convertible securities in diluted EPS



ASC 260-10-45-44 applies to all issued securities that have embedded market-price-contingent conversion features, including contingently convertible debt, contingently convertible preferred stock, and convertible debt for which, upon conversion, the issuer must satisfy the principal amount of the debt in cash and may satisfy the conversion premium in either cash or stock. ASC 260-10-45-44 does not cover freestanding instruments and contingent conversion features that are based on a contingency other than a market price trigger, nor does it apply to stock warrants or options that are only exercisable upon achieving a market condition (see FSP 7.5.3).

The diluted EPS calculation should use the if-converted method regardless of the terms of the security as follows:

- If upon conversion, the reporting entity could deliver the full number of shares, it should use the approach described in ASC 260-10-45-40 through ASC 260-10-45-42.

- If upon conversion, the reporting entity is required to deliver cash for the par value of the security, and could deliver shares only for the differential between the stock price and the conversion price, it should use the approach described in ASC 260-10-55-84 through ASC 260-10-55-84B.

7.5.6A If-converted method for convertible securities—before adoption of ASU 2020-06

ASC 260 considers all convertible securities, including convertible debt and convertible preferred stock, which by their terms may be converted into common stock of the reporting entity, as potential common shares.

Share-settled convertible debt and convertible preferred stock are generally included in diluted EPS using the if-converted method described in ASC 260-10-45-40. However, convertible debt with a cash conversion feature, specifically Instrument C (as discussed in FG 6.6A and FSP 7.5.6.3A), is typically included in diluted EPS using the net share settlement method described at ASC 260-10-55-84 through ASC 260-10-55-84B.

Definition from ASC 260-10-20

If-converted method: A method of computing EPS data that assumes conversion of convertible securities at the beginning of the reporting period (or at time of issuance, if later).

Under the "if-converted" method:

- If a reporting entity has convertible preferred stock outstanding, it adds back the preferred dividends (declared or cumulative undeclared) applicable to the convertible preferred stock in the period to the diluted EPS numerator. Such add-back would also include deemed dividends in the period from amortization of a beneficial conversion feature, any adjustments charged or credited to equity in the period to accrete preferred stock classified as mezzanine equity to its cash redemption price (or recorded upon a redemption or induced conversion), and any participating dividends allocated to the convertible preferred stock in the period for purposes of basic EPS.

- If a reporting entity has convertible debt outstanding, the reporting entity should:

  (1) Add back interest charges applicable to such convertible debt in the period, including interest expense from the amortization of a BCF, to the numerator,

  (2) Adjust the numerator if nondiscretionary adjustments based on income made during the period would have been computed differently had the interest on convertible debt not been recognized, and

  (3) Adjust the numerator for the income tax effect of adjustments (1) and (2), computed on a "with or without" basis. See TX 9.4.6 for tax considerations related to BCF on convertible debt.

Nondiscretionary adjustments include any expenses or charges that are determined based on the income (loss) for the period, such as profit-sharing and royalty agreements.

When the conversion feature embedded in a convertible debt instrument is bifurcated from the debt host and accounted for separately pursuant to the derivative accounting literature, the debt host and the separated conversion feature are each treated as a separate unit of account. The discount created on the debt by separation of the conversion feature should be amortized through interest expense over the contractual life of the debt, and the conversion feature should be marked to fair value each reporting period with changes in fair value included in earnings.

Despite the fact that the debt and conversion feature are considered separate units of account for accounting purposes, they are treated as one instrument for EPS purposes (as it is a single convertible debt instrument) and included in the diluted EPS calculation using the if-converted method.

In addition to the adjustment for interest expense (which includes amortization of the discount created upon bifurcation of the conversion option from the debt), the mark-to-market gain or loss each period related to the bifurcated conversion option should be deducted from/added back to the numerator (adjusted for any tax effect) in calculating diluted EPS.

As discussed further in FSP 7.5.7.1A, ASC 260-10-55-32 requires reporting entities to exclude the income statement impact of instruments assumed to be settled in shares for EPS purposes, and that are required to be reported as assets or liabilities, from the numerator in the diluted EPS calculation.

The mark-to-market adjustment is nondiscretionary in all periods, whether a gain or loss, and so should be deducted from/added to the numerator. As a result of the adjustments to the diluted EPS numerator for the interest expense and mark-to-market gain or loss, and the denominator adjustment for the number of shares assumed to be converted, the security may be dilutive or antidilutive. If antidilutive, the security should be excluded from the diluted EPS calculation altogether.

If a reporting entity enters into an interest rate swap as a hedge of the interest associated with convertible debt that automatically terminates upon settlement or conversion of the debt (i.e., termination is nondiscretionary), the interest expense adjustment to the numerator is inclusive of the impact of the interest rate swap. If the swap arrangement does not automatically terminate upon conversion, the reporting entity should exclude the impact of the swap from the add-back, and add back only the contractual interest on the debt in the numerator.

Conversion is not assumed for purposes of computing diluted EPS if the effect would be anti-dilutive, such as in the following situations:

- Convertible debt is anti-dilutive when its interest and nondiscretionary adjustments (net of tax) per common share obtainable on conversion exceeds basic EPS.

- Convertible preferred stock is anti-dilutive when the amount of the dividend declared in, or accumulated for, the current period, including any deemed dividends or related accretion and participation in dividends, per common share obtainable on conversion exceeds basic EPS.

Similarly, in periods of net loss, the application of the if-converted method to convertible securities is generally anti-dilutive (see FSP 7.5.7.1A for a situation where it may not be).

The if-converted calculations are not affected by the reporting entity's current stock price in relation to the conversion price. That is, a convertible security has the same effect on diluted EPS when the conversion option is far out of the money (i.e., the security has little chance of being converted), as it does when it is deep in the money (i.e., the security has a high likelihood of being converted).

Reporting entities should include convertible securities that have a dilutive effect on EPS in the denominator of diluted EPS from the beginning of the period or from the date of issuance, if later. They should also include dilutive convertible securities that are extinguished or redeemed, and securities in which the conversion options lapsed, in the denominator for the period they were outstanding. Consistent with ASC 260-10-S99-2, in circumstances when dilutive convertible securities are extinguished or redeemed and there is a gain or loss on extinguishment or induced conversion reflected in the numerator of basic EPS, that gain or loss should be reversed in the numerator of diluted EPS because the shares are assumed to have been converted at the beginning of the period.

If the number of shares to be issued upon conversion varies based on (1) the stock price at the conversion date, (2) an average of stock prices around the conversion date, or (3) a formula based on stock prices, the reporting entity should determine the number of shares included in the diluted EPS denominator by applying the conversion formula to the corresponding stock prices at the end of the reporting period. For example, if the number of shares issued upon conversion is based on the average stock price for the 10 days prior to conversion, the stock price on the last 10 days of the reporting period should be used to calculate the number of shares included in the diluted EPS denominator for the period.

Dilutive convertible securities converted during the period are included in the denominator of diluted EPS for the period prior to their conversion. Thereafter, the shares issued are included in the denominator of both basic and diluted EPS.

Example FSP 7-15A and Example FSP 7-16A illustrate the application of the if-converted method for convertible debt.

EXAMPLE FSP 7-15A

Application of the if-converted method to convertible debt

On January 1, 20X7, FSP Corp issued $10 million of convertible bonds (10,000 bonds in $1,000 increments), at par. On the issuance date, FSP Corp's common stock price was $100 per share. The terms of the bonds include:

- A coupon rate of 2% per year, which results in after-tax interest expense of $30,000 per quarter ($10 million x 2% x 1/4 = $50,000 less income tax of $20,000 (40% tax rate x $50,000)).

- A requirement that FSP Corp deliver 8 shares per bond to bond holders upon conversion (which equates to a conversion price of $125), or 80,000 shares (10,000 bonds x 8 shares per bond) in total.

FSP Corp has 10 million weighted average common shares outstanding, and net income for the quarter ended March 31, 20X7 is $50 million.

How should FSP Corp include the convertible bonds in the diluted EPS computation for the period ended March 31, 20X7?

Analysis

FSP Corp should include the convertible bonds in diluted EPS using the if-converted method, if it is dilutive.

	Basic EPS	Adjustments	Diluted EPS
Earnings	$50,000,000	$30,000	$50,030,000
Weighted average common shares and potential common shares	10,000,000	80,000	10,080,000
EPS	$5.00		$4.96

EXAMPLE FSP 7-16A

Computing year-to-date diluted EPS when convertible debt is anti-dilutive in certain periods and dilutive in others

FSP Corp is profitable for the year but has net losses in the first and second quarters of 20X7. FSP Corp issued convertible debt in the prior year, which has been outstanding for all of 20X7.

When adding back interest expense on the convertible debt and adjusting the weighted average shares to reflect conversion at the beginning of those periods, the results are anti-dilutive for both the discrete quarters and for the year-to-date EPS computation for the first and second quarters. The result of assuming conversion in the third and fourth quarters is dilutive.

How would FSP Corp compute year-to-date EPS for the third and fourth quarters of 20X7?

Analysis

For the nine- and twelve-month period computations, the assessment of whether the convertible debt is anti-dilutive should consider the entire period for which the convertible debt was outstanding (the nine- or twelve-month periods). The fact that there are discrete quarters in which the conversion was anti-dilutive does not matter, and those periods would not be excluded from the nine- and twelve-month year-to-date calculations. Example 1 (transaction e) in ASC 260-10-55 illustrates this point. Note: This would also be true if FSP Corp was profitable in all quarters, but the application of the if-converted method was still anti-dilutive in the first and second quarters due to the add-back per common share exceeding basic EPS. This is different than the treatment of treasury stock method shares in year-to-date diluted EPS computations, as described in FSP 7.5.5.7.

Question FSP 7-3A

In the second quarter, FSP Corp declared and paid a special dividend to holders of common stock. As a result, the conversion rate on FSP Corp's convertible notes was reduced in accordance with their contractual terms. How should the change in the conversion rate be treated for purposes of computing diluted EPS?

PwC response

We believe that either of the following approaches would be acceptable.

- By analogy to ASC 260-10-45-42 (which addresses convertible securities issued, converted, or extinguished during the period), FSP Corp could calculate the number of shares to include in the denominator for the period by adding:
  - the number of shares issuable based on the conversion rate in effect before the special dividend, weighted for that period, and
  - the number of shares issuable based on the new conversion rate, weighted for the appropriate period.
- By analogy to ASC 260-10-45-52 (which addresses contingently issuable shares), FSP Corp could calculate the number of shares to include in the denominator for the period by using the number

of shares issuable upon conversion determined solely by the end-of-period conversion price. This would reflect a maximum amount of dilution based on the number of shares that would be issuable as of the end of the period and going forward.

Choosing which approach to follow is an accounting policy decision and should be consistently applied in all periods for similar instruments.

In addition, FSP Corp should consider whether the change in the conversion rate creates a contingent beneficial conversion feature under the guidance in ASC 470-20-25-20.

7.5.6.1A Treatment of capitalized interest on convertible debt—before adoption of ASU 2020-06

Capitalized interest from convertible debt could present a conceptual problem in applying the if-converted method. Application of the if-converted method requires the add-back of interest expense and certain other non-discretionary adjustments to net income when convertible securities are assumed to be converted. Accordingly, when any portion of convertible debt interest has been capitalized during a period, it is appropriate, in the EPS computations only, to assume that such interest was not incurred during the period and, therefore, neither capitalized nor expensed, and to make an "as-if" recomputation of interest that would have been capitalized based on interest on other debt.

In this situation, the reporting entity would adjust the numerator to eliminate any effect of the convertible debt interest that was expensed, and to eliminate any other interest expense that would have been capitalized on other debt instruments had the convertible debt not been in existence. As usual, the effect of the "if converted" method cannot be anti-dilutive.

To illustrate, assume a reporting entity has convertible debt that is included using the "if-converted" method for diluted EPS purposes. In general, the reporting entity should determine the amount of interest related to the convertible security included in interest expense and include only that amount (net of tax) in the "if-converted" method calculation. In other words, the reporting entity should not add back to the numerator of diluted EPS the interest attributable to convertible debt that has been capitalized based upon the requirements of ASC 835-20.

The rationale is that capitalized interest is, by definition, not an expense of the current period and, therefore, assumed conversion of the debt at the beginning of the current period generally would not have affected net income if the interest was capitalized. However, the reporting entity should consider whether assumed conversion at the beginning of the period would have affected the overall amount of interest capitalized on other debt, and thus income. The reporting entity should perform a "with conversion" and "without conversion" calculation of capitalized interest to determine if assumed conversion at the beginning of the period would have affected income. If the capitalized interest would have been different if conversion had occurred at the beginning of the period, the reporting entity should treat that difference as a nondiscretionary amount, and include that amount as an adjustment in the diluted EPS computation in accordance with ASC 260-10-45-40.

7.5.6.2A Partial redemption or induced conversion on diluted EPS—before adoption of ASU 2020-06

As discussed in FSP 7.4.1.3A and FSP 7.5.6A, a reporting entity may offer an incentive to preferred stockholders to either redeem or convert their outstanding shares.

If a reporting entity effects a redemption or induced conversion of only a portion of the outstanding securities of a class of preferred stock, any excess consideration is attributed to only those shares that are redeemed or converted. ASC 260-10-S99-2 indicates that, in determining the dilutive effect of the preferred stock, each group—those remaining outstanding and those redeemed or converted—are considered separately, as they have different effective dividend yields resulting from the excess consideration.

Example FSP 7-17A illustrates how to determine if assumed conversion is dilutive when a portion of outstanding preferred stock securities are redeemed during the period.

EXAMPLE FSP 7-17A

Determining whether redemption of a portion of outstanding shares is dilutive

FSP Corp has shares of common stock and 100 shares of convertible preferred stock outstanding at the beginning of a period.

The convertible preferred stock was issued at fair value, which was equal to its par value of $10 per share, has a stated dividend of 5%, and each share of preferred stock is convertible into one share of common stock.

During the reporting period, 20 preferred shares were redeemed at a per share price of $12.

How should FSP Corp determine whether conversion is dilutive?

Analysis

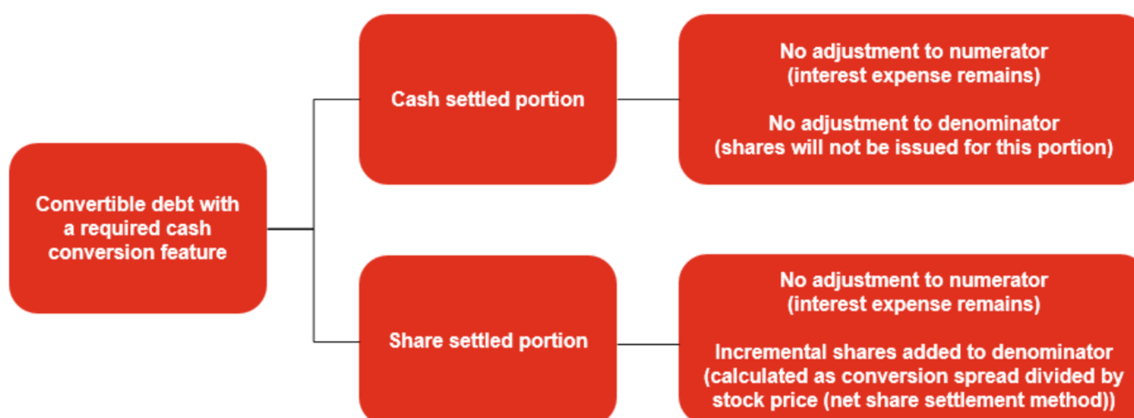
In this example, FSP Corp should apply the guidance in ASC 260-10-S99-2 and determine whether conversion is dilutive (1) for 80 of the preferred shares (the shares remaining outstanding) by applying the if-converted method from the beginning of the period to the end of the period using the stated dividend of 5%, and (2) for the 20 shares redeemed by applying the if-converted method from the beginning of the period to the date of redemption, using both the stated dividend of 5% and the $2 per share redemption premium.

7.5.6.3A Convertible debt with a cash conversion feature—before adoption of ASU 2020-06

Traditional share-settled convertible debt provides the holder with the full number of shares underlying the bond upon conversion (i.e., no cash is received). However, a convertible bond with a cash conversion feature allows the issuer to settle its obligation upon conversion, either in whole or in part, in a combination of cash or stock, either mandatorily or at the issuer's option. Convertible debt with a cash conversion feature (FG 6.6A) in which the principal amount must be settled in cash is not included in diluted EPS using the if-converted method.

Figure FSP 7-7A illustrates the treatment of these instruments, which is discussed further in ASC 260-10-55-84 through ASC 260-10-55-84B.

Figure FSP 7-7A
EPS treatment of convertible debt with a required cash conversion feature



The number of shares included in the denominator of diluted EPS is determined by dividing the "conversion spread value" of the share-settled portion of the instrument by the share price. The "conversion spread value" is the value that would be delivered to investors in shares based on the terms of the bond upon an assumed conversion. An issuer should elect a policy of determining the share price to be used to calculate the number of shares included in diluted EPS. We believe it is permissible to use either (1) an average share price over the reporting period, or (2) the share price formula stated in the agreement, which would be applied to the corresponding stock prices at the end of the period.

However, the issuer of a debt instrument that may settle in any combination of cash or stock at the issuer's option (known in practice as an "Instrument X" bond) should consider the guidance on instruments settleable in cash or shares. See FSP 7.5.7.1A for details.

7.5.6.4A Contingently convertible instruments—before adoption of ASU 2020-06

Some conversion options can only be exercised by the holder upon satisfaction of a contingency. There are two broad categories of conversion option contingencies:

- *Contingencies tied to the issuer's stock price*

  For example, the investor cannot exercise the conversion option until the issuer's stock price reaches a level of 120% of the conversion price.

- *Contingencies tied to an event or index other than the issuer's stock price*

  For example, the investor can only exercise the conversion option upon the issuer's successful completion of an IPO.

If the instrument's conversion is based on achieving a substantive contingency based on an event or index other than the issuer's stock price, the reporting entity would not include the instrument in diluted EPS until the non-market based contingency has been met or is being met based on circumstances at the end of the reporting period, consistent with the guidance in ASC 260-10-45-48.

For example, if the contingency was based on an IPO, and an IPO had not been completed by period end, the contingently convertible instruments would not be included in diluted EPS for the period.

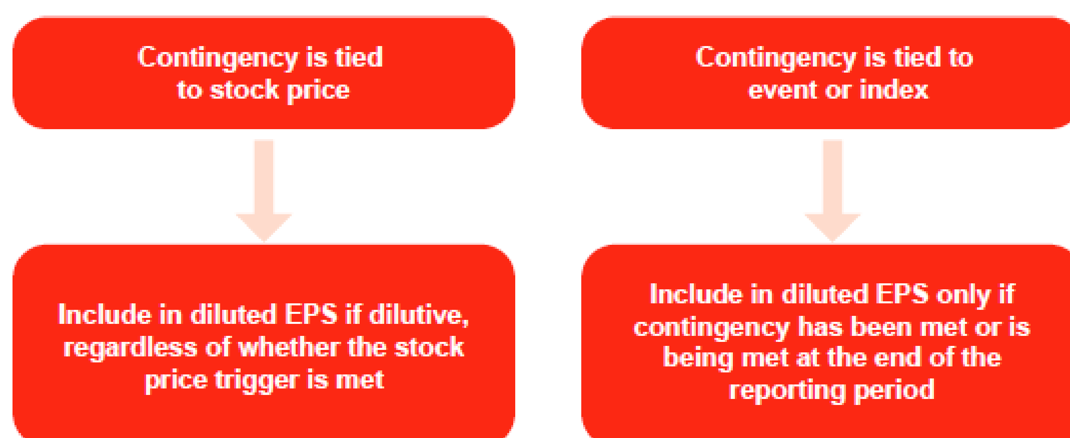
However, based on the guidance in ASC 260-10-45-44, contingently convertible instruments that are tied to the reporting entity's stock price should be treated in the same manner as other convertible securities and included in diluted EPS, if the effect is dilutive, regardless of whether the stock price trigger has been met.

Further, delayed convertibility based solely on the passage of time does not avoid including the security immediately in the if-converted method based on the requirements above, even if the security is not convertible for many years.

Figure FSP 7-8A illustrates the treatment of the two types of conversion contingencies.

Figure FSP 7-8A

EPS treatment of contingently convertible securities in diluted EPS



ASC 260-10-45-44 applies to all issued securities that have embedded market-price-contingent conversion features, including contingently convertible debt, contingently convertible preferred stock, and convertible debt for which, upon conversion, the issuer must satisfy the principal amount of the debt in cash, and may satisfy the conversion premium in either cash or stock. ASC 260-10-45-44 does not cover freestanding instruments and contingent conversion features that are based on a contingency other than a market price trigger, nor does it apply to stock warrants or options that are only exercisable upon achieving a market condition (see FSP 7.5.3).

The diluted EPS calculation depends on the terms of the security as follows:

- If upon conversion, the reporting entity could deliver the full number of shares, it should use the if-converted method.
- If upon conversion, the reporting entity is required to deliver cash for the par value of the security, and could deliver shares only for the differential between the stock price and the conversion price, it should use the net share settlement method described in ASC 260-10-55-84 through ASC 260-10-55-84B.

7.5.7 *Other arrangements potentially impacting diluted EPS*

There are various other arrangements that could result in the issuance of additional shares of stock by the reporting entity and, therefore, impact the computation of diluted EPS. These include: financial instruments settleable in cash or shares, subsidiary share agreements, and escrow share arrangements.

7.5.7.1 *Instruments settleable in cash or shares—after adoption of ASU 2020-06*

Certain debt instruments may allow the issuer, at its election, to settle in cash or shares upon conversion, redemption, or maturity. The guidance in this section would also apply to financial instruments classified as liabilities due to the application of other guidance, such as ASC 815 or ASC 480.

In accordance with ASC 260-10-45-45, the effect of potential share settlement should be included in the diluted EPS calculation (if the effect is more dilutive) for any instrument that contains a provision that requires or permits share settlement (regardless of whether the election is at the option of an entity or the holder, or if the entity has a history or policy of cash settlement). If the ability to settle an instrument in shares is based on achieving a substantive contingency based on an event or index other than the issuer's stock price, see FSP 7.4.6.3.

However, there is an exception to this requirement for certain share-based payment awards classified as a liability because of the requirements in ASC 718-10-25-15 that can be settled in cash or shares at an entity's option. Under this guidance, an entity that nominally has the choice of settling share-based payment awards in cash or shares but predominantly settles in cash, or usually settles in cash whenever a grantee asks for cash settlement, is viewed to have established a substantive liability and the share-based payment award is classified as such. In this case, the reporting entity is allowed to overcome the presumption that the contract will be settled in shares if past experience or a stated policy provides a reasonable basis to conclude that the contract will be paid partially or wholly in cash. The FASB included this exception in ASU 2020-06 (which retains historical guidance in effect prior to the issuance of ASU 2020-06) as it did not wish to reevaluate aspects of share-based payment awards.

Adjustment of numerator

For an instrument that is accounted for as a liability, or in some cases an asset, with changes in fair value recorded in earnings, the calculation of assumed share settlement for EPS purposes would include an adjustment of the diluted EPS numerator to eliminate the effects of the contract that have been recorded in net income (net of tax, if any), and an adjustment of the denominator to include the impact of the share-settled contract, if dilutive in the aggregate. However, in accordance with ASC 260-10-55-33, this adjustment to the numerator would not be made for liability-classified stock-based compensation awards with assumed share settlement. This is because even if the stock-based compensation award were equity-classified, the reporting entity would still be recording compensation cost.

If a reporting entity reports a net loss for the period, potential common shares are generally anti-dilutive. However, if the net loss includes a change in fair value gain on an instrument that is classified as an asset or liability, and share settlement is assumed, this could result in the instrument being dilutive because the reversal of a gain in the numerator creates a larger loss and potentially a larger loss per share. For the instrument to be dilutive, the fair value gain that is reversed in the numerator (i.e., the increase to the net loss) must exceed the impact of the potential common shares that are

added to the denominator as a result of presumed share settlement. When evaluating whether the instrument is dilutive, the collective impact of both the numerator and denominator adjustments on diluted EPS should be considered, versus evaluating the impact to the numerator and denominator separately. Additionally, the reporting entity would not adjust the numerator of diluted EPS in such a situation unless the application of the treasury stock method to the options and warrants in question would result in incremental potential common shares.

7.5.7.1A Instruments settleable in cash or shares—before adoption of ASU 2020-06

Certain debt instruments may allow the issuer, at its election, to settle in cash or shares. The guidance in this section would also apply to financial instruments classified as liabilities due to the application of other guidance, such as ASC 815 or ASC 480.

Under ASC 260-10-55-32 through ASC 260-10-55-36A, when the reporting entity has the choice, and controls the settlement method of a security, it should presume share settlement for EPS purposes. However, it may overcome this presumption, and assume cash settlement, when there is a past practice or substantive stated policy that provides a reasonable basis to believe that the contract will be paid partially or wholly in cash.

We understand the SEC staff looks to a number of factors in evaluating whether a reporting entity's stated policy to cash-settle a portion of its convertible debt instruments is substantive, including:

- *Settlement alternatives as a selling point*

  The extent to which the ability to share settle factored into senior management's decision to approve the issuance of the instrument rather than an instrument that only allowed for cash settlement

- *Intent and ability to cash settle*

  The extent to which the reporting entity has the positive intent and ability to cash settle the face value and interest components of the instrument upon conversion

  The reporting entity should consider both current and projected liquidity in determining whether positive intent and ability exists. Management's representation attesting to the positive intent and ability to cash settle is also a factor.

- *Disclosure commensurate with the reporting entity's intention*

  The extent to which the disclosures included in current period financial statements, and those included in the instrument's offering documents, acknowledge and support the reporting entity's positive intent and ability to adhere to its stated policy

- *Past practice*

  Whether the reporting entity has previously share-settled contracts that provided a choice of settlement alternatives

If the instrument provides the counterparty with the choice of settlement method, the reporting entity should use the more dilutive outcome each period (cash vs. shares); past experience or a stated policy is not determinative.

When computing the numerator in the diluted EPS computation, the reporting entity needs to make independent quarterly and year-to-date determinations of the most dilutive method of settlement, similar to the treatment of the convertible preferred stock in Example 1 of ASC 260-10-55-38 through ASC 260-10-55-50.

The computation of diluted EPS can be more complex if the presumption of how a contract will settle changes to cash settlement or vice versa. In these situations, the computation of diluted EPS should reflect the change in the settlement assumption on a prospective basis, and the change in presumption should be disclosed. If, subsequent to issuance, a reporting entity could overcome the share settlement presumption and assume cash settlement, the computation of diluted EPS would reflect the contract as share-settled up until the date the assumption was changed. Thereafter, EPS would reflect the contract as cash-settled. The ability to overcome the presumption of share settlement will become difficult if a reporting entity has a past practice of changing its assumption from cash settlement to share settlement.

Question FSP 7-4A

A reporting entity issues a convertible debt instrument with a cash conversion feature that allows the reporting entity to settle the entire obligation, both the par value and the conversion spread value, in any combination of cash or stock upon conversion (i.e., Instrument X).

Can the reporting entity assert that the instrument will be fully settled in cash for purposes of its diluted EPS calculation?

PwC response

No. Generally, it would not be appropriate to assume that the entire instrument will be cash-settled for purposes of diluted EPS because the value of the conversion spread is limitless (i.e., there is no limit to how high the reporting entity's stock price may rise), which would make it difficult for a company to assert that it would have the intent and ability to always settle the arrangement in cash.

Adjustment of numerator

For a security that is accounted for as a liability, or in some cases an asset, with changes in fair value recorded in earnings, the calculation of assumed share settlement for EPS purposes would include an adjustment of the diluted EPS numerator to eliminate the effects of the contract that have been recorded in net income (net of tax, if any), and an adjustment of the denominator to include the impact of the share-settled contract, if dilutive in the aggregate. However, in accordance with ASC 260-10-55-33, this adjustment to the numerator would not be made for liability-classified stock-based compensation awards with assumed share settlement. This is because even if the stock-based compensation award were equity-classified, the reporting entity would still be recording compensation cost.

If a reporting entity reports a net loss for the period, potential common shares are generally anti-dilutive. However, if the net loss includes a mark-to-market gain on an instrument that is classified as

an asset or liability, and share settlement is assumed, this could result in the instrument being dilutive because the reversal of a gain in the numerator creates a larger loss and potentially a larger loss per share. For the instrument to be dilutive, the mark-to-market gain that is reversed in the numerator (i.e., the increase to the net loss) must exceed the impact of the potential common shares that are added to the denominator as a result of presumed share settlement. When evaluating whether the instrument is dilutive, the collective impact of both the numerator and denominator adjustments on diluted EPS should be considered, versus evaluating the impact to the numerator and denominator separately. Additionally, the reporting entity would not adjust the numerator of diluted EPS in such a situation unless the application of the treasury stock method to the options and warrants in question would result in incremental potential common shares.

Reporting entities may treat such contracts differently for accounting recognition purposes and for EPS purposes. For example, certain contracts that provide the reporting entity with the choice of settlement method would be treated as equity instruments for accounting purposes. Regardless of the balance sheet classification, however, if the reporting entity has a past practice or stated policy of settling such contracts in cash, the EPS computations would assume cash settlement.

For contracts accounted for as equity that are treated as cash settled for EPS, the reporting entity should also adjust the numerator when computing diluted EPS to reflect the income or loss on the contract that would have resulted during the period if the contract had been reported as an asset or liability. These adjustments are only permitted to the extent that accounting for the instrument as equity versus an asset or liability has an effect on net income.

Example FSP 7-18A illustrates the impact of a liability-classified warrant on the computation of diluted EPS.

EXAMPLE FSP 7-18A

Determining whether cash or share settlement is more dilutive for a liability-classified warrant

FSP Corp has net income of $10 million for 20X7 and 1 million shares of common stock outstanding for the period.

FSP Corp has outstanding warrants to issue 50,000 shares of its common stock with a strike price of $10 per share. These warrants are liability-classified and are marked-to-market each reporting period. The after-tax mark-to-market adjustment related to the warrants is a $0.5 million charge for the period (the warrant's fair value increased in the period, resulting in an income statement charge for FSP Corp), which is already reflected in the $10 million net income figure. The warrants were outstanding for the entire period.

FSP Corp has no other potential common shares. The average market price of the common stock during the period is $15. The holder of the warrants has the choice of settlement in cash or shares. FSP Corp believes, based on past experiences, that the warrants will be share-settled.

How should FSP Corp include the warrants in the diluted EPS computation for the period?

Analysis

For warrants that may be cash- or share-settled at the holder's election, past experience or a stated policy for settlement is not relevant. Accordingly, EPS should be based on the more dilutive of the

settlement alternatives. If the warrants are assumed to be cash-settled, diluted EPS for the period is $10 per share ($10 million net income / 1 million shares), as no adjustment is required to either the numerator or denominator.

If the warrants are assumed to be share-settled, diluted EPS for the period is $10.33 per share (calculated below), as both the numerator and the denominator should be adjusted for the assumed exercise.

Calculation of diluted EPS with assumed share settlement:

Net income	$10,000,000	
Add back of MTM loss	500,000	
Income available to common stockholders		$10,500,000
Common shares outstanding		1,000,000
Shares issued upon exercise of warrants	50,000	
Less: shares repurchased with proceeds[1]	(33,333)	
Incremental shares issued		16,667
Weighted average shares outstanding		1,016,667
Diluted EPS		$10.33

[1] Calculated as: [(50,000 warrants multiplied by the $10 strike price) / $15 average share price]

The warrants should be presumed to be cash-settled, as that is more dilutive.

7.5.7.2 *Securities of subsidiaries and of other investees*

The effect on consolidated diluted EPS of options, warrants, and convertible securities issued by a subsidiary or investee depends on whether the securities issued by the subsidiary or investee enable their holders to obtain common stock of the subsidiary or investee, or the common stock of the parent. In computing consolidated diluted EPS, including for investments in common stock of corporate joint ventures and investee companies accounted for under the equity method, reporting entities should use the following general guidelines:

- Securities issued by the subsidiary that enable the holder to obtain the subsidiary's common stock should be included by the subsidiary in its computation of diluted EPS data. Those diluted per-share earnings should then be included in the parent's consolidated diluted EPS computation based on the parent's share of the subsidiary's securities (diluted EPS of subsidiary multiplied by the number of shares owned by parent equals earnings included in the numerator of consolidated

diluted EPS). Therefore, a reduction of subsidiary diluted EPS due to increased potential common shares issued by the subsidiary results in a reduction in the numerator of consolidated diluted EPS.

- The parent reporting entity should consider securities of a subsidiary that are convertible into parent common stock as potential common shares in computing consolidated diluted EPS.

A detailed example of the EPS computations for the parent and the subsidiary when the subsidiary's securities enable their holders to obtain subsidiary common stock is presented in Example 7 in ASC 260-10-55-64 through ASC 260-10-55-67. The same approach should be used by an investor in an equity method investment.

The reporting entity should use the if-converted method in determining the diluted EPS impact of securities issued by a parent that are convertible into common stock of a subsidiary or an investee reporting entity accounted for under the equity method. The securities are assumed to be converted, and the income available to parent company common stockholders is adjusted as necessary. That is, the numerator is adjusted appropriately for any change in the income reported by, or allocated to, the parent (such as dividend income or equity method income) due to the increase in the number of common shares of the subsidiary or equity method investee as a result of the assumed conversion. However, the denominator of the diluted EPS computation would not be affected, because the number of shares of parent company common stock outstanding would not change upon assumed conversion.

7.5.7.3 Escrow share arrangements

There are potential accounting implications when stockholders place a portion of their shares in escrow in connection with an initial public offering or other financing transactions. In ASC 718-10-S99-2, the SEC staff expressed a view that escrow arrangements that involve the release of shares based on performance-related criteria are presumed to be equivalent to reverse stock splits that are followed by a grant of restricted stock awards under a performance-based plan. See further discussion in SC 6.6.1.

Escrowed shares are generally legally outstanding and reported as such on the face of the balance sheet. However, reporting entities should consider these arrangements share-based payment awards for diluted EPS purposes and apply the guidance as to when contingently issuable shares are included in diluted EPS in ASC 260-10-45-48.

7.5.8 Computation of diluted EPS with participating securities

In determining whether potential common shares are dilutive or anti-dilutive, the reporting entity should consider each issue or series of issues of potential common shares separately, rather than in the aggregate.

ASC 260 does not provide an example of how to compute diluted EPS under the two-class method. In August 2008, the FASB included guidance on computing diluted EPS under the two-class method in an exposure draft for FAS 128R. FAS 128R was never finalized, but while the computation methodology it discussed is not required, we believe it represents useful guidance that should be considered. The exposure draft included three examples:

- Common stock with a participating preferred security

- Two classes of common stock with different dividend rights when one is convertible into the other
- Two classes of common stock with different dividend rights when one class is convertible into the other and there are convertible bonds outstanding

In computing diluted EPS under the two-class method described in the exposure draft to FAS 128R, undistributed earnings allocated away from common stockholders in the basic EPS computation are reversed, and then re-allocated to each class of common or potential common shares and participating securities that are assumed to be outstanding for the period at each stage of the sequencing process. FSP Example 7-19 illustrates the impact on diluted EPS when the allocation of undistributed earnings is re-computed at each step in the sequencing process.

7.5.9 Illustrative computation of diluted EPS

ASC 260-10-55-57 through ASC 260-10-55-59 (Example 4: Anti-dilution Sequencing) illustrates sequencing in the computation of diluted EPS (see FSP 7.5.1). Example FSP 7-19 also illustrates this concept, without using the re-allocation process described in FSP 7.5.8.

EXAMPLE FSP 7-19

Diluted EPS and the application of anti-dilution sequencing

FSP Corp has 10 million shares of common stock and 2 million shares of convertible preferred stock (issued at $10 par value per share) outstanding during 20X7 and has net income of $50 million.

Each share of preferred stock is convertible into two shares of common stock. The preferred stock is entitled to a cumulative annual dividend of $0.50 per preferred share (5% of the $10 par value), and then participates on a 1:1 basis in any common dividends that would have been payable had the preferred stock been converted immediately prior to the record date of any dividend declared on the common stock (i.e., on an "as-converted" basis).

For the year ended December 31, 20X7, dividends of $2 per share are paid to the common stockholders and, accordingly, participating dividends of $4 per preferred share are paid to the preferred stockholders, since each share of preferred converts into 2 common shares, in addition to the cumulative annual preferred dividend of $0.50.

FSP Corp also has 1.2 million stock options outstanding that were issued with an exercise price of $10 per share.

This example assumes that all compensation cost was recorded in prior years. The weighted average market price of FSP Corp's common stock for 20X7 is $15 per share.

How should diluted EPS be computed?

Analysis

Step 1: Allocate undistributed earnings under the two-class method

Net income		$50,000,000
Less: Dividends declared:		
Common stock	20,000,000	
Cumulative annual preferred stock dividend	1,000,000[1]	
Participating preferred stock dividend	8,000,000[2]	
Undistributed 20X7 earnings		$21,000,000

[1] 2 million shares multiplied by $0.50 per preferred share dividend

[2] 4 million "as-converted" shares of common stock [2 million preferred shares multiplied by 2 shares of common stock per share of preferred] multiplied by $2 per share dividend paid on common stock

	Common stock	Preferred stock	Total
Distributed earnings	$20,000,000	$9,000,000	$29,000,000
Undistributed earnings	15,000,000[1]	6,000,000[2]	21,000,000
	$35,000,000	$15,000,000	$50,000,000

[1] 10 million common shares / (10 million + 4 million as-converted) = 71% multiplied by $21 million

[2] 4 million as-converted shares / (10 million + 4 million as-converted) = 29% multiplied by $21 million

Step 2: Calculate Basic EPS

	Common stock	Preferred stock
Distributed earnings	$2.00	$4.50
Undistributed earnings	1.50	3.00
Basic EPS	$3.50	$7.50

Step 3: Calculate the potential common shares related to options under the treasury stock method

Number of shares issued upon exercise		1,200,000
Less: shares repurchased with proceeds		
Cash proceeds (1,200,000 multiplied by $10)	$12,000,000	
Unamortized compensation cost[1]	—	
Total proceeds	$12,000,000	
Divided by average stock price	$15	
Shares repurchased		(800,000)
Incremental shares issued		400,000

[1] None in this example as all compensation cost was previously recorded.

Step 4: Determine the earnings per incremental share for each class of security

	Add-back to income	Increase in number of common shares	Earnings add-back per incremental share
Options	0	400,000	—
Convertible preferred stock	$15,000,000	4,000,000	$3.75

The security with the lowest earnings per incremental share has the most dilutive impact on EPS. In this case, the options are most dilutive, followed by the convertible preferred, so this is the sequence that is followed for determining diluted EPS.

Further, because the EPS associated with the convertible preferred stock is greater than basic EPS, the convertible preferred stock is considered anti-dilutive, as illustrated below.

Step 5: Compute diluted EPS

	Income	Common shares	Diluted EPS
As reported for basic	$35,000,000	10,000,000	$3.50
Options	—	400,000	
	$35,000,000	10,400,000	$3.37 Dilutive
Convertible preferred stock	15,000,000	4,000,000	
	$50,000,000	14,400,000	$3.47 Anti-dilutive

Because diluted EPS increases from $3.37 to $3.47 when convertible preferred shares are included in the computation, the convertible preferred shares are anti-dilutive, and are excluded from the computation of diluted EPS. Therefore, diluted EPS is reported as $3.37.

This example illustrates the importance of following the proper sequencing when determining whether potential common shares are dilutive or anti-dilutive. If all potential common shares had been included in the diluted EPS computation without proper sequencing, it would have appeared that diluted EPS is $3.47, because $3.47 is dilutive versus the $3.50 computed for basic EPS. However, computing diluted EPS in the manner required by ASC 260 produces a more dilutive result, and the reporting entity reports $3.37.

Note: The emphasis in this example (FSP Example 7-18) is on anti-dilution sequencing. In addition, this example includes a participating security, but does not re-compute the allocation of undistributed earnings between the participating security and the common shares at each step in the sequencing process. FSP Example 7-19 illustrates the impact on diluted EPS when the allocation of undistributed earnings is re-computed at each step in the sequencing process. This is consistent with how the FASB proposed it in the exposure draft for FAS 128R.

Example FSP 7-20 illustrates the computation of diluted EPS under the two-class method (as proposed in the exposure draft to FAS 128R):

EXAMPLE FSP 7-20

Diluted EPS under the two-class method proposed in the exposure draft to FAS 128

FSP Corp has 10 million shares of common stock and 2 million shares of convertible preferred stock (issued at $10 par value per share) outstanding during 20X7 and has net income of $50 million.

Each share of preferred stock is convertible into two shares of common stock. The preferred stock is entitled to a cumulative annual dividend of $0.50 per preferred share (5% of the $10 par value), and then participates on a 1:1 basis in any common dividends that would have been payable had the preferred stock been converted immediately prior to the record date of any dividend declared on the common stock (i.e., on an "as-converted" basis).

For the year ended December 31, 20X7, dividends of $2 per share are paid to the common stockholders and, accordingly, participating dividends of $4 per preferred share are paid to the

preferred stockholders, since each share of preferred converts into 2 common shares, in addition to the cumulative annual preferred dividend of $0.50.

FSP Corp also has 1.2 million stock options outstanding that were issued with an exercise price of $10 per share.

This example assumes that all compensation cost was recorded in prior years. The weighted average market price of FSP Corp's common stock for 20X7 is $15 per share.

How should diluted EPS be computed using the re-allocation methodology described in FSP 7.5.8?

Analysis

Step 1: Allocate undistributed earnings under the two-class method

Net income		$50,000,000
Less: Dividends declared:		
Common stock	20,000,000	
Cumulative annual preferred stock dividend	1,000,000[1]	
Participating preferred stock dividend	8,000,000[2]	
Undistributed 20X7 earnings		$21,000,000

[1] 2 million shares multiplied by $0.50 per preferred share dividend

[2] 4 million "as-converted" shares of common stock [2 million preferred shares multiplied by 2 shares of common stock per share of preferred] multiplied by $2 per share dividend paid on common stock

	Common stock	Preferred stock	Total
Distributed earnings	$20,000,000	$9,000,000	$29,000,000
Undistributed earnings	15,000,000[1]	6,000,000[2]	21,000,000
	$35,000,000	$15,000,000	$50,000,000

[1] 10 million common shares / (10 million + 4 million as-converted) = 71% multiplied by $21 million

[2] 4 million as-converted shares / (10 million + 4 million as-converted) = 29% multiplied by $21 million

Step 2: Calculate Basic EPS

	Common stock	Preferred stock
Distributed earnings	$2.00	$4.50
Undistributed earnings	1.50	3.00
Basic EPS	$3.50	$7.50

Step 3: Calculate the potential common shares related to options under the treasury stock method

Number of shares issued upon exercise		1,200,000
Less: shares repurchased with proceeds		
Cash proceeds (1,200,000 multiplied by $10)	$12,000,000	
Unamortized compensation cost[1]	—	
Total proceeds	$12,000,000	
Divided by average stock price	$15	
Shares repurchased		(800,000)
Incremental shares issued		400,000

[1] None in this example as all compensation cost was previously recorded.

Step 4: Determine the earnings per incremental share for each class of security

	Add-back to income	Increase in number of common shares	Earnings add-back per incremental share
Options	0	400,000	—
Convertible preferred stock	$15,000,000	4,000,000	$3.75

The security with the lowest earnings per incremental share has the most dilutive impact on EPS. In this case, the options are most dilutive, followed by the convertible preferred, so this is the sequence that is followed for determining diluted EPS.

Step 5: Compute diluted EPS

1: Re-allocate undistributed earnings to preferred stockholders after assumed exercise of options

4,000,000 if-converted shares / (10,000,000 + 4,000,000 if-converted + 400,000 incremental shares from options) = 28% multiplied by $21,000,000 = $5,833,333.33

2: Re-compute diluted EPS after the reallocation of undistributed earnings to preferred stockholders

	Undistributed and distributed earnings to common stockholders	Common shares	Earnings per share
As reported-Basic	$35,000,000	10,000,000	$3.50
Add-back: Undistributed earnings allocated to preferred shares in basic computation	$6,000,000		
Options		400,000	
Less: Undistributed earnings reallocated to preferred shares	($5,833,333)	—	
Subtotal	$35,166,667	10,400,000	$3.38 Dilutive
Add-back: Undistributed earnings re-allocated to preferred shares	$5,833,333	—	
Add-back: Distributed earnings to preferred shares	$9,000,000	4,000,000	
Total	$50,000,000	14,400,000	$3.47 Anti-dilutive

Because diluted EPS increases when convertible preferred shares are included in the computation, the convertible preferred shares are anti-dilutive, and are ignored in the computation of diluted EPS. Therefore, diluted EPS is reported as $3.38.

Summary of total amount allocated for diluted EPS purposes:

	Common stock	Preferred stock	Total
Distributed earnings	$20,000,000	$9,000,000	$29,000,000
Undistributed earnings	$15,166,667	$5,833,333	$21,000,000
Total	$35,166,667	$14,833,333	$50,000,000

Summary of diluted earnings per share amounts:

	Common stock	Preferred stock
Distributed earnings	$1.92	$2.25
Undistributed earnings	$1.46	$1.46
Diluted EPS	$3.38	$3.71

As the example demonstrates, when using the reallocation method proposed in the exposure draft to amend FAS 128, diluted EPS is $3.38 per common share, as opposed to $3.37 per common share. This incremental $0.01 per common share results from the reallocation of undistributed earnings performed under this method. Assuming that the options have been outstanding as common shares from the beginning of the period, the reallocation method proposed in the exposure draft to amend FAS 128 results in less undistributed earnings being allocated away from the common stock to the preferred stock, and, as a result, EPS per common share is higher.

Reporting entities using the two-class method for the first time may use the method of computing diluted EPS under the two-class method proposed in the August 2008 ED to FAS 128. However, reporting entities that have not historically used this two-class method should continue to compute diluted EPS in the manner they have historically applied.

7.6 Change in capital structure—updated May 2022

This section addresses how EPS can be affected by various changes in capital structure. Changing from an LLC or partnership to a C-corp is addressed in FSP 32.

7.6.1 Stock splits/reverse stock splits/stock dividends

If the number of common shares outstanding increases as a result of a stock dividend or stock split, or decreases as a result of a reverse stock split, the reporting entity should adjust the computations of basic and diluted EPS retroactively for all periods presented to reflect that change in capital structure. If changes in common stock resulting from stock dividends, stock splits, or reverse stock splits occur after the close of the period but either (1) before issuance of the financial statements, or (2) before the effective date of the registration statement, whichever is later, as applicable, the per-share computations for those and any prior period financial statements presented should be based on the new number of shares. If per-share computations reflect such changes in the number of shares, ASC 260-10-55-12 requires disclosure of those changes, including the retroactive treatment, explanation of the change made, and the date the change became effective.

The effective date of a stock split (i.e., the distribution date, which is the date that the shares begin trading at their new split-adjusted price) may affect the form of disclosure in the financial statements.

Figure FSP 7-9 illustrates the appropriate financial statement presentation for stock splits in various situations for a registrant that is already a public entity.

Figure FSP 7-9
Presentation of EPS upon stock splits

The following assumptions are applicable in each case:

- The latest balance sheet date is December 31, 20X7.
- The accountant's report date and financial statement issuance date through filing of the Annual Report on Form 10-K is January 31, 20X8.
- The variable assumptions are the declaration dates and effective dates of the stock split.

	Split Date		
Case	**Declared**	**Effective**	**Financial statement presentation**
I	11/15/X7	12/16/X7 or 1/16/X8	Split would be reflected in 12/31/X7 balance sheet, 20X7 statement of changes in stockholders' equity, and in per share data for all periods presented.
II	1/16/X8	1/31/X8	Same as I.
III	12/16/X7 or 1/20/X8	2/20/X8	Split would be disclosed in a footnote along with the pro forma effect (labeled unaudited) on the 12/31/X7 balance sheet. Historical per share data would remain on a pre-split basis, and pro forma per share data (labeled "unaudited") on a post-split basis would be disclosed in the notes to the financial statements.

Case III illustrates the appropriate presentation when, at the time financial statements are issued, a split has been declared, but is not effective. In this situation, historical EPS must be disclosed on a pre-split basis since the subsequent event "triggering" the split (i.e., its effectiveness) has not occurred as of the time the financial statements are issued. However, once the split is effective, the reported historical EPS becomes irrelevant in relation to post-split shares outstanding, as well as to post-split market price.

Consequently, if a split has been declared, but is not effective at the date the financial statements are issued, pro forma EPS (labeled "unaudited") on a post-split basis should be presented in the footnotes in addition to historical EPS, which is presented on a pre-split basis. If the financial statements are reissued after the effective date, the aforementioned pro forma amounts would become historical EPS and the previously-disclosed historical amounts would be deleted.

7.6.2 Stock rights plans

A rights issue whose exercise price at issuance is less than the fair value of the stock contains a bonus element that is similar to a stock dividend. If a rights issue contains such a bonus element and it is offered to all existing stockholders, the reporting entity should adjust basic and diluted EPS retroactively for the bonus element for all periods presented. If this occurs after the close of the period but before issuance of the financial statements, the per-share computations for those and any prior period financial statements presented are based on the new number of shares, reflecting the bonus element.

If the ability to exercise the rights issue is contingent on an event other than the passage of time (e.g., a change in control), the reporting entity need not consider the bonus element in the denominator of either basic or diluted EPS until such time as the contingency is resolved.

See further discussion in ASC 260-10-55-13 and ASC 260-10-55-14.

7.6.3 Distributions with components of stock and cash

ASC 505-20-15-3 through 3A provides guidance for real estate investment trusts (REITs) that declare a distribution that stockholders can elect to receive in cash or shares of equivalent value, with a potential limitation on the total amount of cash that stockholders can elect to receive in the aggregate.

The stock portion of a distribution to stockholders that allows them to elect to receive cash or shares with a potential limitation on the total amount of cash that all stockholders can elect to receive in the aggregate is considered a share issuance, not a stock dividend. Therefore, for EPS computation purposes, the stock portion of the distribution is reflected in EPS prospectively, consistent with the treatment of other new share issuances. It is not reflected retroactively as would be the case for a stock dividend.

7.6.4 IPO or spin-off of a subsidiary and recapitalizations

When a reporting entity completes an IPO or a spin-off of either an existing subsidiary or a “carve-out” business, questions often arise as to how to compute EPS in the historical financial statements of the subsidiary or carve-out business.

In computing basic EPS for a carve-out business, the number of shares issued to the owner upon the legal formation of the entity that holds the business and contribution of that business to the entity is used as the denominator for all periods presented, akin to the treatment of a stock split. In this case, the number of shares issued simply reflects a recharacterization of the capital account previously held by the owner. No historical EPS is presented in SEC filings of the carve-out business before the legal formation of the entity, the contribution of the businesses, and the capitalization of the entity.

With respect to an existing subsidiary (i.e., an entity with a separate legal identity), the historical weighted average number of shares actually outstanding during each period is reflected in the denominator for all periods presented. However, issuance of shares to new investors in connection with the IPO/spin-off is treated prospectively from the issuance date. In connection with a stock split, EPS is restated for all periods presented. See FSP 7.6.1 for details.

In computing diluted EPS for a carve-out business or an existing subsidiary whereby parent options issued to employees are exchanged for options in the affiliate at the date of the IPO/spin-off, the dilutive effect of the affiliate options exchanged for the parent options is included in the affiliate’s denominator on a prospective basis. Previous periods are not affected, as the exchange of parent options for affiliate options is considered a modification of the terms of the original award. However, if the affiliate issues options and warrants to the parent company itself as part of the initial capitalization of the carved-out business, then the options are treated as if they were outstanding for all periods presented.

It is also common for reporting entities to recapitalize or reorganize their legal entity structure in preparation for an IPO. There is limited guidance on such transactions. However, ASC 260-10-55-17 provides guidance on computing EPS in reorganizations.

ASC 260-10-55-17

When common shares are issued to acquire a business in a business combination, the computations of EPS shall recognize the existence of the new shares only from the acquisition date. In reorganizations, EPS computations shall be based on analysis of the particular transaction and the provisions of this Subtopic.

The reporting entity should evaluate the facts and circumstances of each situation when concluding on the appropriate EPS treatment. For example, some transactions may result in an exchange of equity interests, but no change in relative shareholder rights, rank, or value before and after the transaction. Such reorganizations may be equivalent to a stock split (simply changing the form of legal ownership to a new structure) and require retrospective treatment for EPS purposes, even if effected after the latest balance sheet date. Any financial statements issued, or SEC filings made, after the effective date of such an event should reflect the transaction retrospectively for EPS purposes (i.e., it should be pushed back to prior periods).

In other transactions, often involving more complex capital structures, the reorganization transaction may reflect a value-for-value exchange of equity interests at the point of the recapitalization, which results in a change in relative shareholder rights or rank before and after the transaction. This transaction may be more akin to the repurchase of equity interests through the issuance of new equity interests, and be afforded prospective treatment in the EPS computation.

Oftentimes in an IPO, changes in capitalization will occur upon the effective date of the registration statement or completion (i.e., closing) of the IPO. Such changes could include conversion of preferred stock into common stock. In these cases, EPS should be presented for all periods based on the historical capital structure, and the conversion should be reflected in EPS prospectively from the date of conversion.

See FSP 7.7 for various pro forma EPS considerations related to a change in capital structure in conjunction with an IPO.

Question FSP 7-5

Under ASC 805, *Business Combinations*, a common control merger is recorded at carryover basis, and the receiving entity reflects the acquired business for all prior periods (or since the date common control was obtained, if later), as if the entities had always been combined. How should the entity reflect the impact of the merger on EPS?

PwC response

If the receiving entity issued shares to the stockholders of the contributing entity, this should be reflected in EPS in a similar fashion as a stock split (i.e., recharacterization of the historical common ownership) and reflected retrospectively for all periods presented under common control. The ratio of exchange of receiving entity shares issued for each share of the transferred entity should be multiplied by the weighted average number of shares and potential shares of the transferred entity for each reporting period, and added to the number of shares and potential shares of the receiving entity.

If the receiving entity paid cash to the stockholders of the contributing entity, there should generally be no impact to EPS. However, if the receiving entity issued shares to new investors to raise that cash,

the receiving entity generally would present those newly-issued shares in pro forma EPS computations, consistent with the discussions in FSP 7.7.2 and FSP 7.7.3.

7.6.4.1 Computation of earnings per share in a reverse acquisition

In a reverse acquisition, the financial statements of the combined entity reflect the capital structure (i.e., share capital, share premium and treasury capital) of the legal acquirer (i.e., accounting acquiree), including the equity interests issued in connection with the reverse acquisition. However, consistent with the nature of a reverse acquisition, the number of common shares reflected as outstanding for the reporting periods prior to the acquisition date is computed as the weighted-average number of common shares of the legal acquiree (i.e., accounting acquirer) outstanding during the period, multiplied by the exchange ratio established in the merger agreement. In other words, it is as if the legal acquiree underwent a stock-split/reverse stock split, and then issued additional shares on the acquisition date. See BC 2.10.5 for further details.

7.6.5 Partially paid shares and partially paid stock subscriptions

If a reporting entity has common shares issued in a partially paid form, and those shares are entitled to dividends in proportion to the amount paid, the common-share equivalent of those partially paid shares is included in the basic EPS computation if they were entitled to participate in dividends.

Partially paid stock subscriptions that do not share in dividends until fully paid are considered the equivalent of warrants, and are included in the diluted EPS computation using the treasury stock method. The unpaid balance is assumed to represent proceeds used to purchase stock, and the incremental number of shares to be included is the difference between the number of shares subscribed and the number of shares assumed to be purchased.

7.6.6 Bankruptcy

Under ASC 852-10-45-16, EPS is computed during the bankruptcy period following all of the provisions of ASC 260. This standard specifically notes that any potential changes in the capital structure as a result of the plan of bankruptcy are disclosed but not reflected in the computation of EPS.

7.6.7 Computing EPS when changing legal form

EPS should be presented for all periods based on historical net income unadjusted for income taxes or other pro forma adjustments. See FSP 32.4.2.1 for further discussion of presentation requirements upon a change in tax status.

7.7 Certain pro forma EPS considerations—added May 2022

In certain instances, pro forma EPS may be required as discussed in the following sections.

7.7.1 Change in capital structure in conjunction with an IPO

If, in conjunction with an IPO, a conversion of outstanding securities (e.g., a conversion of preferred stock into common stock upon completion of the IPO) will occur subsequent to the latest balance sheet

date and the conversion will result in a material reduction of earnings per share (excluding effects of offering proceeds), pro forma EPS for the latest year and interim period should be presented giving effect to the conversion (but not the offering proceeds). If the conversion of outstanding securities does not result in a material reduction of EPS, the presentation of pro forma EPS giving effect to the conversion of outstanding securities is optional. See SEC FRM 3430.3.

Additionally, if a recapitalization transaction is determined to be more akin to the repurchase of equity interests through the issuance of new equity interests, and afforded prospective treatment in the EPS computation (as discussed in FSP 7.6.4), pro forma EPS giving effect to the exchange should be presented for the latest year and interim period.

7.7.2 EPS when dividends are paid from the proceeds of an IPO

A private company or subsidiary may use the proceeds of an IPO to pay a dividend to its promoters/owners or parent company. In some situations, the dividend may exceed earnings in the most recent year. In such a case, the reporting entity should include unaudited pro forma per share data (for the latest year and interim period only) on the face of the income statement, giving effect to the number of shares whose proceeds would be necessary to pay the portion of the dividend that exceeds the current year's earnings.

The pro forma EPS requirement also applies to both of the following situations:

- A dividend that is declared after the date of the latest balance sheet included in the registration statement if the dividend exceeds earnings for the previous twelve months
- A planned (but not yet declared) dividend if the planned dividend exceeds earnings for the previous twelve months, even if the dividend will not be funded from the proceeds of the IPO (e.g., the dividends were/will be funded from the proceeds of a line of credit or cash on hand)

SEC FRM 3420.2 addresses the application of ASC 855-10-S99-1 (SAB Topic 1.B.3) when the dividend to be paid exceeds both the last twelve months' earnings and the proceeds from the equity offering. In that instance, the pro forma EPS computation should not reflect more shares than will be outstanding after the offering.

To present a transparent picture for the investor in this case, reporting entities should also adjust the numerator of the pro forma EPS computation to reflect the incremental interest expense (net of tax) relating to the portion of the dividend that exceeds both the gross proceeds from the equity offering and the previous 12 months' earnings, which would be assumed to be funded by debt.

7.7.3 Offerings involving debt or other capital retirements

SAB Topic 3.A reminds registrants of the pro forma requirements of S-X Article 11 in a registration statement of convertible preferred stock or debt when the proceeds will be used to extinguish existing preferred stock or debt and the extinguishments will have a material effect on EPS.

We believe that registrants should also consider the guidance in SAB Topic 3.A when there is an issuance of common stock with similar use of the related proceeds to retire preferred stock or debt. In this situation, the pro forma EPS calculations would be based on the shares outstanding prior to sale plus the shares required to be sold to raise the cash necessary to extinguish the preferred stock or debt (i.e., not necessarily the entire proposed issuance), calculated using the offering price per share to the public. Net income would be adjusted to eliminate the interest expense, net of related tax effect (or, in

the case of preferred stock, net income attributable to common stockholders would be adjusted to eliminate the dividends on the preferred stock). The additional shares should be included for the elapsed time from the beginning of the period or the date of issuance of the preferred stock or debt, if later. If the proceeds of the offering exceed the preferred stock or debt to be extinguished, only the number of shares necessary to raise the proceeds to extinguish the preferred stock or debt would be included in the denominator. The amount of dividends or interest expense eliminated should be the amount actually attributable to the preferred stock or debt extinguished.

Another situation generally requiring pro forma EPS involves a newly formed corporate entity (e.g., a recently incorporated carve-out or leveraged buyout). The capital structure of such an entity often includes temporary or bridge financing. For example, for tax purposes a company may use preferred stock rather than debt as the bridge financing vehicle, which will be extinguished with the proceeds of a public equity offering.

Example FSP 7-21 illustrates the calculation of pro forma EPS when a registrant uses the proceeds from an offering to extinguish existing debt.

EXAMPLE FSP 7-21

Calculation of pro forma EPS - proceeds of common share offering used to extinguish debt

FSP Corp will offer 10,000 common shares at $10 per share for total proceeds of $100,000. At December 31 20X1, FSP Corp has net income of $100,000, weighted average shares outstanding of 20,000, and a reported basic EPS of $5.00. The tax rate is 30%.

With a portion of the proceeds from the offering, FSP Corp will extinguish $50,000 of its existing debt, of which $25,000 was issued on January 1, 20X1 and $25,000 was issued on July 1, 20X1. The interest rate is 10%, and interest expense for the year is $3,750.

How should FSP Corp calculate pro forma basic EPS?

Analysis

FSP Corp should calculate pro forma basic EPS as follows:

Step 1: Determine the weighted average shares for pro forma purposes (denominator)

Weighted average shares, as reported	20,000
Additional shares for debt being extinguished – January 1 issuance $25,000 (amount of debt to be extinguished) / $10 (per share stock price) = 2,500 shares The entire 2,500 shares are included in the calculation because the debt was outstanding for the entire fiscal year.	2,500

Additional shares for debt being extinguished – July 1 issuance $25,000 (amount of debt to be extinguished) / $10 (per share stock price) = 2,500 shares The 2,500 shares are weighted based on the period for which the debt was outstanding as follows: 2,500 shares x 6/12 (debt was outstanding for half the year) = 1,250 shares	1,250
Weighted average shares, as adjusted	**23,750**

Step 2: Determine the net income for pro forma purposes (numerator)

Net income, as reported	$100,000
Add back: Interest expense for the year related to debt to be extinguished, net of tax effects $3,750 minus tax effects of $1,125 ($3,750 x 30% tax rate) = $2,625	$2,625
Net income, as adjusted	**$102,625**

Step 3: Calculate pro forma basic EPS

Net income, as adjusted	$102,625
Weighted average shares, as adjusted	23,750
Pro forma EPS – basic	**$4.32**

As illustrated above, the pro forma basic EPS calculation only includes the number of shares associated with the actual amount of debt being extinguished ($50,000) and not the entire share offering proceeds ($100,000).

7.7.4 *Considerations in filings subsequent to an IPO*

Pro forma earnings per share amounts generally should not be presented in the financial statements in subsequent Exchange Act filings (e.g. annual and interim filings on Forms 10-K and 10-Q), even if such amounts were included in the financial statements in the IPO registration statements.

See FSP 7.6.1 for guidance when presenting EPS in Exchange Act filings that gives effect to stock splits, reverse stock splits, stock dividends, and recapitalizations that were declared and effective in different reporting periods.

If the issuer was formerly a Sub-Chapter S corporation, partnership, or similar tax exempt enterprise, and voluntarily provided pro forma data (reflecting adjustments for taxes only) for all periods presented, the issuer should continue to present that pro forma data for periods prior to becoming a

taxable entity (including the period of change) in subsequent Exchange Act filings, consistent with FSP 32.4.2.1. Such pro forma presentations should continue to calculate the pro forma tax expense based on statutory rates in effect for the earlier period. See SEC FRM 3410.1 and SEC FRM 3410.2.

7.8 EPS in prior period adjustments

In the event of a restatement of prior period earnings, retrospective application of a new accounting principle, or a discontinued operation, the reporting entity should restate prior EPS data and disclose the per-share effect of the restatement in the period of restatement.

The reporting entity should compute restated EPS as if the restated income or loss had been reported originally in the prior periods. It is possible that common stock assumed to be issued upon exercise, conversion, or issuance of potential common shares may not be included in the computation of restated EPS amounts. That is, retroactive restatement of income from continuing operations could cause potential common shares originally determined to be dilutive to become anti-dilutive or vice versa. Retroactive restatement may also cause the numerator of the EPS computation to change by an amount that differs from the amount of the retroactive adjustment.

7.9 EPS considerations for private companies

EPS is only required for reporting entities with publicly-traded equity securities, including those that have filed a registration statement to sell equity securities. Other reporting entities that choose to present EPS are required to comply with the requirements of ASC 260.

Chapter 8: Other assets–updated April 2023

8.1 Other assets overview

This chapter provides the presentation and disclosure requirements for assets that are not covered in other chapters of this guide. This includes:

- Receivables (see FSP 8.3)
- Inventory (see FSP 8.4)
- Prepaid assets and other current and noncurrent assets (see FSP 8.5)
- Long-lived assets (see FSP 8.6)
- Capitalized software (see FSP 8.7)
- Intangible assets (see FSP 8.8)
- Goodwill (see FSP 8.9)

Presentation and disclosure requirements for common assets that are not included in this chapter are covered elsewhere in this guide, as follows: contract assets and contract liabilities are covered in FSP 33; cash and restricted cash are covered in FSP 6; investments are covered in FSP 9; equity method investments are covered in FSP 10; lease receivables are covered in FSP 14; recognition of intangible assets and goodwill in a business combination are covered in FSP 17; securitized receivables and repurchase agreements are discussed in FSP 22; and receivables from related parties are covered in FSP 26.

8.2 Other assets—scope and relevant guidance

The prevailing presentation and disclosure guidance related to assets comes from US GAAP and is applicable to all reporting entities. The primary authoritative guidance is listed below for each type of asset. If there is other guidance applicable to a specific asset type, it is noted in the applicable section.

ASC 310, *Receivables*

ASC 330, *Inventory*

ASC 340, *Other Assets and Deferred Costs*

ASC 350, *Intangibles – Goodwill and Other*

ASC 360, *Property, Plant, and Equipment*

Regulation S-X 5-02 applies only to SEC registrants and provides guidance on certain assets that are required to be presented as individual balance sheet line items, if material.

New guidance

ASU 2016-13

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. ASU 2016-13 introduces a new model for recognizing credit losses on financial instruments based on an estimate of current expected credit losses. The ASU also provides updated guidance for the impairment of available-for-sale debt securities and includes additional disclosure requirements. Subsequent to the issuance of this standard, the FASB issued additional ASUs amending and clarifying the guidance based on feedback from constituents and discussions of the Transition Resource Group.

The new guidance is effective for smaller reporting companies (SRCs) and entities other than public business entities for fiscal years beginning after December 15, 2022, including interim periods. Early adoption is permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The new presentation and disclosure guidance in ASU 2016-13 has not been reflected in this chapter but is included in LI 12.

In March 2022, the FASB issued ASU 2022-02, *Financial Instruments - Credit Losses (Topic 326), Troubled Debt Restructurings and Vintage Disclosures*. ASU 2022-02 eliminates the accounting guidance for TDRs in ASC 310-40, *Receivables - Troubled Debt Restructurings by Creditors,* and introduces new disclosure requirements. The elimination of TDRs can only be applied by entities that have adopted the CECL model in ASU 2016-13. For entities that have not adopted ASU 2016-13, the TDR guidance remains applicable until they adopt ASU 2016-13. The presentation and disclosure requirements of ASU 2022-02 are covered in LI 12 and are not discussed in this guide.

ASU 2017-04

In June 2016, the FASB issued ASU 2017-04, *Simplifying the Test for Goodwill Impairment*. This guidance eliminates Step 2 of the current goodwill impairment test, which requires a hypothetical purchase price allocation to measure goodwill impairment. Entities that have not elected the private company alternative for goodwill will be required to apply the guidance in fiscal years beginning after December 15, 2022. Early adoption is permitted. Early adoption in a fiscal year is precluded if an impairment test earlier in that fiscal year applied the former impairment guidance.

8.3 Receivables – before the adoption of ASU 2016-13

Virtually every reporting entity holds receivables, though their nature varies depending on the characteristics of the business. Accordingly, the guidance governing the receivables will also vary. This section addresses presentation and disclosure considerations for the following topics:

- Accounts and notes receivable and financing receivables, including allowances for credit losses and impaired loans
- Shareholder and other receivables
- Discounts or premiums on note receivables
- Loan origination and other fees, including net fees and costs
- Hypothecation or other pledging of receivables

New guidance

Upon adoption of ASU 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, the presentation and disclosure of receivables will change significantly. ASU 2016-13 introduces a new model for recognizing credit losses on financial instruments based on an estimate of current expected credit losses. The ASU also provides updated guidance regarding the impairment of available-for-sale debt securities and includes additional disclosure requirements.

Additionally, ASU 2022-02 eliminates the accounting guidance for TDRs in ASC 310-40, *Receivables - Troubled Debt Restructurings by Creditors,* but introduces new disclosure requirements for loan modifications with borrowers experiencing financial difficulty. The elimination of TDRs can only be applied by entities that have adopted the CECL model introduced by ASU 2016-13. For entities that have not adopted ASU 2016-13, the TDR guidance remains applicable until they adopt ASU 2016-13.

The new presentation and disclosure guidance in ASU 2016-13 and ASU 2022-02 have not been reflected in this chapter but are included in LI 12.

8.3.1 *Accounts and notes receivable and financing receivables*

The term "accounts and notes receivable" is used in S-X 5-02 and is generally consistent with the "financing receivable" terminology used in US GAAP. Financing receivables are contractual rights to receive cash either on demand or on fixed or determinable dates; they are recognized as assets on the balance sheet. Examples of financing receivables include trade accounts receivable, notes receivable, credit card receivables, loans, and certain receivables relating to a lessor's rights to payments from a lease.

8.3.1.1 Presentation requirements

ASC 310-10-45-2 permits loans or trade receivables to be presented as aggregate amounts. However, major categories of loans or trade receivables should be presented separately either on the balance sheet or in the footnotes. Receivables that are held for sale should be presented separately on the balance sheet from other receivables.

Unearned discounts (other than cash or quantity discounts), finance charges, or prepaid interest should be reflected as deductions from the related receivable. An allowance for doubtful accounts also should be shown as a reduction of the related receivable.

Notes and accounts receivable from officers, employees, or affiliated companies are required to be disclosed separately on the balance sheet. Additionally, ASC 310-10-45-14 requires notes received as equity contributions to be presented in equity. As noted in ASC 505-10-45-2, reporting such a note as an asset is generally not appropriate.

S-X 5-02 requires SEC registrants to separately disclose receivables from customers (trade), related parties, underwriters, promoters, and employees (other than related parties) that arose in a manner other than the ordinary course of business; other receivables; and receivables held for sale (reported at lower of cost or fair value).

In addition, if the aggregate amount of notes receivable exceeds 10% of the aggregate amount of receivables, SEC registrants must separately disclose accounts receivable and notes receivable either on the balance sheet or in a footnote.

8.3.1.2 Disclosure requirements

ASC 310-10-50-2 specifies the information required to be addressed in an accounting policy footnote for all loans and trade receivables.

ASC 310-10-50-2

The summary of significant accounting policies shall include the following:

a. The basis for accounting for loans and trade receivables

b. The method used in determining the lower of cost or fair value of nonmortgage loans held for sale (that is, aggregate or individual asset basis)

c. The classification and method of accounting for interest-only strips, loans, other receivables, or retained interests in securitizations that can be contractually prepaid or otherwise settled in a way that the holder would not recover substantially all of its recorded investment

d. The method for recognizing interest income on loan and trade receivables, including a statement about the entity's policy for treatment of related fees and costs, including the method of amortizing net deferred fees or costs.

Additionally, ASC 310-10-50-4 requires reporting entities to disclose the allowance for credit losses (i.e., allowance for doubtful accounts), unearned income, unamortized premiums and discounts, and net unamortized deferred fees and costs in their financial statements. In addition, reporting entities should disclose their policy for writing off uncollectible trade accounts receivable (excluding credit card receivables) that have a contractual maturity of one year or less, and arose from the sale of goods or services.

Receivables are generally considered to be financial assets, and as such, reporting entities are required to comply with the fair value disclosure requirements of ASC 825, *Financial Instruments* (see FSP 20). However, as noted in ASC 310-10-50-26, reporting entities do not need to provide the fair value disclosures for trade receivables due in one year or less.

ASC 310-10-50-6 through ASC 310-10-50-7A require accounting policy disclosures by class of financing receivables, except for the following types of financing receivables, as detailed in ASC 310-10-50-5A and ASC 310-10-50-5B:

- Receivables measured at fair value through earnings (see FSP 20)
- Receivables measured at lower of cost or fair value (see ASC 948-310-50)
- Trade accounts receivable (other than credit card receivables) that have a contractual maturity of one year or less, and arose from the sale of goods or services
- Participant loans in defined contribution pension plans

- Loans acquired with deteriorated credit quality (see discussion under "Loans acquired with deteriorated credit quality" below)

The accounting policy disclosures should include the following:

Excerpt from ASC 310-10-50-6

a. The policy for placing financing receivables, if applicable, on nonaccrual status (or discontinuing accrual of interest)

b. The policy for recording payments received on nonaccrual financing receivables, if applicable

c. The policy for resuming accrual of interest

d. Subparagraph superseded by Accounting Standards Update No. 2010-20

e. The policy for determining past due or delinquency status.

As required by ASC 310-10-50-7 and ASC 310-10-50-7A, reporting entities should disclose the amount of financing receivables on nonaccrual status and the amounts that are 90 days or more past due and still accruing, as of each balance sheet date. They should also disclose the aging for financing receivables that are past due at the end of the reporting period.

Reporting entities may have credit exposure related to off-balance-sheet loan commitments, standby letters of credit, certain financial guarantees, and other similar instruments (other than those within the scope of ASC 815, *Derivatives and Hedging*). In addition to the disclosures required by ASC 450, *Contingencies* (see FSP 23), reporting entities should also describe the accounting policies and methods used to estimate its liabilities related to off-balance-sheet credit exposures and related charges. The disclosure should discuss factors that influenced management's judgment and the risk elements relevant to their financial instruments.

Reporting entities are also required by ASC 310-10-50-29 to disclose quantitative and qualitative information by class that indicates the credit quality of their financing receivables. This information should include all of the following:

- A description of the credit quality indicator

- The recorded investment in financing receivables by credit quality indicator

- The date/range of dates for which each credit quality indicator was updated

In addition, if reporting entities disclose internal risk ratings, they should provide qualitative information on how those ratings relate to the risk of loss.

Allowance for credit losses related to financing receivables

The disclosure requirements discussed in this section apply to financing receivables, except for the receivables listed in ASC 310-10-50-7B (e.g., certain trade accounts receivable, receivables measured at fair value with changes in fair value reported in earnings, receivables measured at lower of cost or fair

value, and participant loans in defined contribution pension plans), and a lessor's net investment in leveraged leases.

ASC 310 requires reporting entities to disclose information about financing receivables' allowance for credit losses at a portfolio segment level.

ASC 310-10-50-11B

a. A description of the entity's accounting policies and methodology used to estimate the allowance for credit losses, including all of the following:

    1. A description of the factors that influenced management's judgment, including both of the following:

        i. Historical losses

        ii. Existing economic conditions.

    2. A discussion of risk characteristics relevant to each portfolio segment

    3. Identification of any changes to the entity's accounting policies or methodology from the prior period and the entity's rationale for the change.

b. A description of the policy for charging off uncollectible financing receivables

c. The activity in the allowance for credit losses for each period, including all of the following:

    1. The balance in the allowance at the beginning and end of each period

    2. Current period provision

    3. Direct write-downs charged against the allowance

    4. Recoveries of amounts previously charged off.

d. The quantitative effect of changes identified in item (a)(3) on item (c)(2)

e. The amount of any significant purchases of financing receivables during each reporting period

f. The amount of any significant sales of financing receivables or reclassifications of financing receivables to held for sale during each reporting period

g. The balance in the allowance for credit losses at the end of each period disaggregated on the basis of the entity's impairment method

h. The recorded investment in financing receivables at the end of each period related to each balance in the allowance for credit losses, disaggregated on the basis of the entity's impairment methodology in the same manner as the disclosure in item (g).

In order to disaggregate the information required by items (g) and (h) on the basis of the impairment methodology, ASC 310-10-50-11C requires reporting entities to separately disclose:

- Amounts collectively evaluated for impairment (determined under ASC 450-20)
- Amounts individually evaluated for impairment (determined under ASC 310-10-35)
- Amounts related to loans acquired with deteriorated credit quality (determined under ASC 310-30)

In addition, ASC 210-10-45-13 requires reporting entities to deduct asset valuation allowances for losses from the assets or group of assets to which the allowances relate. ASC 310-10-50-14 requires reporting entities to include appropriate disclosure of asset valuation allowances in the footnotes.

Finally, if loan products have contractual terms that expose the reporting entities to risks and uncertainties, the disclosure requirements of ASC 275, *Risks and Uncertainties*, may be required. See FSP 24 for discussion of disclosure requirements associated with risks and uncertainties.

Impaired loans

ASC 310-10-35-16 defines impaired loans.

Excerpt from ASC 310-10-35-16

A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement.

Sometimes a financing receivable may meet the definition of an impaired loan. In these situations, ASC 310-10-50-14A requires reporting entities to disclose both the accounting policy and the amounts of such loans. In addition, the following disclosures are required for partially charged off loans. These disclosures are not applicable to fully charged off loans since both the recovered investment and allowance for credit losses will equal zero.

ASC 310-10-50-15

An entity shall disclose all of the following information about loans that meet the definition of an impaired loan in paragraphs 310-10-35-16 through 35-17 by class of financing receivable:

a. As of the date of each statement of financial position presented:

   1. Subparagraph superseded by Accounting Standards Update No. 2010-20
   2. Subparagraph superseded by Accounting Standards Update No. 2010-20
   3. The recorded investment in the impaired loans and both of the following:

      i. The amount of that recorded investment for which there is a related allowance for credit losses determined in accordance with Section 310-10-35 and the amount of that allowance

ii. The amount of that recorded investment for which there is no related allowance for credit losses determined in accordance with Section 310-10-35.

4. The total unpaid principal balance of the impaired loans.

b. The entity's policy for recognizing interest income on impaired loans, including how cash receipts are recorded

c. For each period for which results of operations are presented:

1. The average recorded investment in the impaired loans

2. The related amount of interest income recognized during the time within that period that the loans were impaired

3. The amount of interest income recognized using a cash-basis method of accounting during the time within that period that the loans were impaired, if practicable.

d. The entity's policy for determining which loans the entity assesses for impairment under Section 310-10-35

e. The factors considered in determining that the loan is impaired.

As discussed in ASC 310-10-50-11B(c), reporting entities should disclose the activity in the total allowance for credit losses related to loans for each period presented, including the balance in the allowance at the beginning and end of each period, additions charged to operations, direct write-downs charged against the allowance, and recoveries of amounts previously charged off.

Finally, as discussed in ASC 310-10-50-19, when a change in present value attributable to the passage of time is recorded as interest income, disclosure of the amount of the change is required.

Creditor disclosures of troubled debt restructurings

ASC 310-40 requires a creditor to disclose the amount of commitments, if any, it has made to lend additional funds to debtors whose receivables to the creditor have been modified in a troubled debt restructuring (TDR).

However, for impaired loans that have been previously restructured in a modification determined to be a TDR when subsequently there is an additional modification of terms, the disclosures required by ASC 310-10-50-15(a) and ASC 310-10-50-15(c) may not be required in years after the subsequent restructuring if both of the following conditions exist:

- The interest rate in the subsequent restructuring agreement is greater than or equal to the rate the creditor was willing to accept for a new loan with comparable risk at the time of the subsequent restructuring and no concessions have been granted

- The loan would not meet the requirements for a TDR based on the terms of the subsequent restructuring agreement (i.e., the borrower is no longer experiencing financial difficulty and no concession was granted)

This disclosure exception should be applied consistently for all subsequently restructured loans in a TDR.

ASC 310-10-50-31 through ASC 310-10-50-34 also provide disclosure requirements for a creditor's troubled debt restructuring of financing receivables, including a creditor's modification of a lease receivable that meets the definition of a troubled debt restructuring. This guidance is not applicable to certain receivables listed in ASC 310-10-50-32 (i.e., certain trade accounts receivable, receivables measured at fair value with changes in fair value reported in earnings, receivables measured at lower of amortized cost basis or fair value, and participant loans in defined contribution pension plans).

For all income statement periods presented, reporting entities must disclose the following for any troubled debt restructurings of financing receivables occurring during the period:

- Qualitative and quantitative information, by class, including how the receivable was modified and the modification's financial effects
- Qualitative information, by portfolio segment, discussing how such modifications factor into the determination of the allowance for credit losses

If there was a payment default during the period on any financing receivables that were modified as a troubled debt restructuring within the previous twelve months, reporting entities should also disclose the following for each income statement presented:

- Qualitative and quantitative information, by class, indicating the types and amount of financing receivables that defaulted
- Qualitative information, by portfolio segment, discussing how such defaults factor into the determination of the allowance for credit losses

Loans acquired with deteriorated credit quality

A reporting entity may purchase loans with deteriorated credit quality. ASC 310-30 provides specific disclosure requirements for these types of loans.

For such loans, ASC 310-30-50-1 requires reporting entities to describe in their footnotes how prepayments are considered when determining contractual cash flows and cash flows expected to be collected. In addition, ASC 310-30-50-2 requires additional disclosures.

ASC 310-30-50-2

In addition to disclosures required by other generally accepted accounting principles (GAAP), for each balance sheet presented, an investor shall disclose the following information about loans within the scope of this Subtopic:

a. Separately for both those loans that are accounted for as debt securities and those loans that are not accounted for as debt securities, all of the following.

    1. The outstanding balance (see paragraph 310-30-50-3) and related carrying amount at the beginning and end of the period

2. The amount of accretable yield at the beginning and end of the period, reconciled for additions, accretion, disposals of loans, and reclassifications to or from nonaccretable difference during the period

3. For loans acquired during the period, the contractually required payments receivable, cash flows expected to be collected, and fair value at the acquisition date

4. For those loans within the scope of this Subtopic for which the income recognition model in this Subtopic is not applied in accordance with paragraph 310-30-35-3, the carrying amount at the acquisition date for loans acquired during the period and the carrying amount of all loans at the end of the period.

b. Further, for those loans that are not accounted for as debt securities, both of the following:

1. The amount of both of the following:

   i. Any expense recognized pursuant to paragraph 310-30-35-10(a)

   ii. Any reductions of the allowance recognized pursuant to paragraph 310-30-35-10(b)(1) for each period for which an income statement is presented.

2. The amount of the allowance for uncollectible accounts at the beginning and end of the period.

8.3.2 Shareholder and other receivables

SAB Topic 4.E, *Receivables from Sale of Stock* (codified in ASC 310-10-S99-2), states that reporting entities should generally separately present on the balance sheet all amounts receivable from officers and directors resulting from sales of stock or from other transactions (other than expense advances or sales on normal trade terms). This presentation is required regardless of whether such amounts are shown as assets or deductions from shareholders' equity. Refer to FSP 5 for further discussion on determining the appropriate presentation of this type of receivable.

In accordance with S-X 5-02(17), other receivables that are in excess of 5% of total assets should be presented separately on the face of the balance sheet or in a footnote.

8.3.3 Discounts or premiums on note receivables

Often, the face amount of a note receivable does not represent the present value of the consideration given or received in the exchange. In this situation, the reporting entity records a discount or premium equal to the difference between the consideration and the face value.

ASC 835-30 includes the presentation and disclosures required for discounts or premiums on note receivables.

ASC 835-30-45-1A

The discount or premium resulting from the determination of present value in cash or noncash transactions is not an asset or liability separable from the note that gives rise to it. Therefore, the discount or premium shall be reported in the balance sheet as a direct deduction from or addition to the face amount of the note. Similarly, debt issuance costs related to note shall be reported in the balance sheet as a direct deduction from the face amount of that note. The discount, premium, or debt issuance costs shall not be classified as a deferred charge or deferred credit.

ASC 835-30-45-2

Paragraph 835-30-25-1A provides requirements for the balance sheet presentation for the discount or premium and debt issuance costs of a note. The description of the note shall include the effective interest rate. The face amount of the note also shall be presented in the financial statements or disclosed in the notes to financial statements. (See paragraph 835-30-50-1.)

ASC 835-30-45-3

Amortization of discount or premium shall be reported as interest expense in the case of liabilities or as interest income in the case of assets. Amortization of debt issuance costs also shall be reported as interest expense.

See FSP 12 for further discussion of discount and premium presentation and disclosure considerations from the debtor's perspective.

8.3.4 Loan origination and other fees

The unamortized balance of purchase premiums and discounts, loan origination fees, commitment fees, and other fees or costs that are being recognized as an adjustment of yield should be reported on the balance sheet as part of the loan balance to which it relates. Any commitment fee that meets the criteria of ASC 310-20-35-3 should be classified as deferred income in the financial statements.

Excerpt from ASC 310-20-35-3(a)

If the entity's experience with similar arrangements indicates that the likelihood that the commitment will be exercised is remote, the commitment fee shall be recognized over the commitment period on a straight-line basis as service fee income. If the commitment is subsequently exercised during the commitment period, the remaining unamortized commitment fee at the time of exercise shall be recognized over the life of the loan as an adjustment of yield. The term remote is used here, consistent with its use in Topic 450, to mean that the likelihood is slight that a loan commitment will be exercised before its expiration.

Per ASC 310-20-45-3, loan origination, commitment, and other fees and costs recognized as an adjustment of yield should be reported as part of interest income. Amortization of other fees, such as commitment fees that are being amortized on a straight-line basis over the commitment period or included in income when the commitment expires, should be reported as service fee income.

8.3.4.1 *Net fees and costs*

Reporting entities may acquire a loan by initially lending money or by purchasing the loan from another party. Typically, nonrefundable fees and costs are associated with these lending activities and loan purchases. As part of the disclosure of the method for recognizing interest income on loans, ASC 310-20-50-1 requires reporting entities to include their accounting policy for related fees and costs and their method of amortizing net deferred fees or costs.

ASC 310-20-50 includes other required disclosures related to net fees and costs.

ASC 310-20-50-2

Entities that anticipate prepayments in applying the interest method shall disclose that policy and the significant assumptions underlying the prepayment estimates.

ASC 310-20-50-3

The unamortized net fees and costs shall be reported as a part of each loan category. Additional disclosures such as unamortized net fees and costs may be included in the notes to the financial statements if the lender believes that such information is useful to the users of financial statements.

ASC 310-20-50-4 requires reporting entities to disclose the net amount of credit card fees received and costs for both purchased and originated credit cards capitalized at the balance sheet date and the related accounting policy and amortization periods.

8.3.5 *Hypothecation or other pledging of receivables*

S-X 4-08(b) requires disclosure of the amount of receivables mortgaged, pledged, or otherwise subject to lien. Any obligations collateralized should also be identified.

8.4 *Inventory*

The presentation requirements for inventory are generally dictated by SEC guidance, while the disclosure requirements are found in both SEC and US GAAP guidance. The extent of disclosure requirements varies depending on the method of accounting for inventory.

Note about ongoing standard setting

The FASB has an active project related to the disaggregation of income statement expenses. This project would require disaggregation of costs incurred that are capitalized into inventory during the reporting period. Financial statement preparers and other users of this publication are therefore encouraged to monitor the status of the project, and if finalized, evaluate the effective date of the new guidance and the implications on disclosure.

8.4.1 *General presentation requirements*

S-X 5-02(6)(a) requires an SEC registrant to state separately on the balance sheet or in a footnote the amounts of major classes of inventory, such as finished goods, inventoried costs relating to long-term contracts or programs, work in process, raw materials, and supplies.

As discussed in ASC 420-10-S99-3, inventory markdowns, including those attributed to an exit plan or other restructuring activity (not accounted for as discontinued activity) should be classified on the income statement as a component of cost of goods sold.

8.4.2 *General disclosure requirements*

As discussed in ASC 330-10-30-1 and ASC 330-10-35-1B, the primary basis of accounting for inventories is cost, provided cost is not higher than the net amount realizable from the subsequent sale of the inventories. ASC 330-10-50-1 and S-X 5-02(6)(b) require reporting entities to disclose the basis of accounting for inventories (e.g., lower of cost or net realizable value).

S-X 5-02(6)(b)

The basis of determining the amounts shall be stated.

If "cost" is used to determine any portion of the inventory amounts, the description of this method shall include the nature of the cost elements included in inventory. Elements of "cost" include, among other items, retained costs representing the excess of manufacturing or production costs over the amounts charged to cost of sales or delivered or in-process units, initial tooling or other deferred startup costs, or general and administrative costs.

The method by which amounts are removed from inventory (e.g., "average cost," "first-in, first-out," "last-in, first-out," "estimated average cost per unit") shall be described. If the estimated average cost per unit is used as a basis to determine amounts removed from inventory under a total program or similar basis of accounting, the principal assumptions (including, where meaningful, the aggregate number of units expected to be delivered under the program, the number of units delivered to date and the number of units on order) shall be disclosed.

If any general and administrative costs are charged to inventory, state in a note to the financial statements the aggregate amount of the general and administrative costs incurred in each period and the actual or estimated amount remaining in inventory at the date of each balance sheet.

When a significant change in basis occurs, ASC 330-10-50-1 requires disclosures regarding the nature of the change and its effect on income. ASC 330-10-50-1 also requires disclosure of the measurement basis and the nature of any change therein as well as, if material, the effect on income. In the rare instances that inventory is stated above cost or at sales price, this fact should be disclosed. If inventory is presented at standard cost, it should be titled appropriately, as required by ASC 330-10-30-12.

ASC 330-10-30-12

Standard costs are acceptable if adjusted at reasonable intervals to reflect current conditions so that at the balance-sheet date standard costs reasonably approximate costs computed under one of the recognized bases. In such cases descriptive language shall be used which will express this relationship, as, for instance, "approximate costs determined on the first-in first-out basis," or, if it is desired to mention standard costs, "at standard costs, approximating average costs."

ASC 330-10-50-1 requires disclosure of the basis of stating inventories (e.g., average cost, first-in, first-out (FIFO), last-in, first-out (LIFO), estimated average cost per unit). If LIFO or estimated average

cost per unit is used, additional disclosures are required, as discussed in S-X 5-02(6)(b)-(c). LIFO disclosures are detailed in FSP 8.4.3. If the estimated cost per unit method is used, reporting entities should disclose the principal assumptions, including, where meaningful, the aggregate number of units expected to be delivered under the program, the number of units delivered to date, and the number of units on order.

As discussed in S-X 4-08(b), for any inventory mortgaged, pledged, or otherwise subject to lien, the approximate amounts thereof and the related obligations collateralized by those assets should be disclosed.

Substantial and unusual losses that result from the subsequent measurement of inventory should be disclosed in the financial statements as discussed in ASC 330-10-50-2. In addition, ASC 330-10-50-5 requires the amounts of net losses on firm purchase commitments accrued to be disclosed separately in the income statement.

Some reporting entities maintain a stock of spare parts that is used in connection with maintenance agreements with customers for customer-owned equipment. Often, when the reporting entities replace a particular part, the removed part is repaired and maintained for future use. The refurbished parts should be classified as inventories. To the extent the refurbished parts are no longer used, the loss in utility of such parts should be recorded in the period in which it occurs in accordance with ASC 330-10-35-2.

8.4.3 Last-in, first-out (LIFO) inventories

Reporting entities that use LIFO for tax reporting purposes are required to also use LIFO for accounting reporting purposes under the LIFO conformity requirement (Internal Revenue Code 472-2(e)). Supplemental disclosure of non-LIFO information is allowed, as long as it accompanies the primary financial statement, and is clearly labeled as being supplemental.

When the LIFO inventory method is used, S-X 5-02(6)(c) requires reporting entities to disclose the excess of replacement or current cost over stated LIFO value. This disclosure can be made parenthetically on the face of the balance sheet or in a footnote. In addition, if the method of calculating LIFO inventory does not allow for the practical determination of amounts assigned to major classes of inventory, S-X 5-02(6)(a) requires the amounts of those classes to be stated under cost flow assumptions other than LIFO. However, the excess of such total amounts over the aggregate LIFO amount should be shown as a deduction to arrive at the amount of LIFO inventory.

SAB Topic 11.F, *LIFO Liquidations* (codified in ASC 330-10-S99-3), requires sufficient disclosure in the footnotes of the impact of LIFO liquidations on net income. Furthermore, these effects should not receive any special treatment on the income statement (e.g., they should be included in the same line item where inventory costs are expensed).

8.4.3.1 LIFO used for a portion of inventories

If LIFO is not used for all inventories, disclosure is recommended regarding the extent to which LIFO is used, which generally means the nature and dollar amount of inventories priced at LIFO and under other methods.

8.4.4 Change in inventory costing method

A change in inventory costing method is a change in accounting principle. As such, a reporting entity that changes its method of inventory costing is required to justify and disclose the change and explain why the newly adopted principle is preferable. If the change in inventory costing is material, a preferability letter is required for public reporting entities, as further discussed in FSP 30.4.1.

Refer to FSP 30 for further considerations related to accounting changes and IV 1.4.3 and 3.5 for additional guidance on inventory accounting changes.

8.5 Prepaid assets and other current and noncurrent assets

Presentation and disclosure requirements for prepaid assets and other current and noncurrent assets vary depending on the nature of the asset and the underlying guidance. Prepaid assets are required to separately stated on the balance sheet or in a footnote in accordance with S-X 5-02(7). For all other current assets, S-X 5-02(8) requires any amounts in excess of 5% of total current assets to be separately disclosed on the balance sheet or in a footnote. For noncurrent assets, S-X 5-02(17) requires any noncurrent asset that is in excess of 5% of total assets to be disclosed separately on the balance sheet or in a footnote. In addition, any significant increase or decrease in that asset should be explained in the footnotes. With respect to any significant deferred charges, the policy for deferral and amortization should also be provided in the footnotes.

There are also specific disclosure requirements related to foreclosed or repossessed assets. ASC 310-10-45-3 requires foreclosed or repossessed assets to be identified either on the face of the balance sheet or in the footnotes unless such assets will be utilized by the reporting entities in operations (e.g., returned inventory that will be resold). In addition, in accordance with ASC 310-10-50-11, reporting entities should disclose the carrying amount of foreclosed residential real estate properties held at the reporting date as a result of obtaining physical possession.

8.5.1 Accounting and disclosure for advertising costs

ASC 720-35-05-4 defines advertising.

Excerpt from ASC 720-35-05-4

The promotion of an industry, an entity, a brand, a product name, or specific products or services so as to create or stimulate a positive entity image or to create or stimulate a desire to buy the entity's products or services.

Advertising generally uses a form of media, such as the internet, mail, television, radio, telephone, facsimile machine, newspaper, magazine, coupon, or billboards, to communicate with potential customers.

Advertising costs have two primary components: (1) the costs of producing, such as idea development, writing advertising copy, artwork, printing, audio and video crews, actors, and (2) the costs of communicating advertisements that have been produced, such as magazine space, television airtime, billboard space, and distribution (for example, postage stamps).

The costs of premiums, contest prizes, gifts, and similar promotions, as well as discounts or rebates, including those resulting from the redemption of coupons, are not considered advertising costs for purposes of applying the guidance in ASC 720-35. Refer to RR 4 for additional guidance on accounting for discounts, rebates, and coupons.

Additionally, ASC 705-20 addresses accounting by a customer (including a reseller) for certain cash consideration received from a vendor. Cooperative advertising arrangements generally fall within the scope of ASC 705-20-25-3. Refer to FSP 3.6.15 for guidance on cooperative advertising.

The costs of advertising within the scope of ASC 720-35 should be either: (1) expensed as incurred or (2) deferred and then expensed the first time the advertising takes place. This is an accounting policy decision and the method selected should be applied consistently to similar types of advertising activities. For example, individual components of the production costs of a television commercial expected to air throughout a six-month campaign (e.g., the costs of hiring an actor for filming) should be expensed as incurred or deferred until the first time the commercial is shown, depending on the accounting policy selected. If an entity has a policy of deferring incurred costs until the first time the advertising takes place, and facts and circumstances change such that it is no longer probable that the advertising for which costs were deferred will ever be shown, the costs being deferred should be expensed immediately.

Costs of advertising are not incurred until the item or service has been received. For example, if an entity paid $5 million to purchase daily television airtime for five months, the entity should expense this cost when the television airtime is utilized. Therefore, the $5 million should be expensed as the commercials air over the five month period (as incurred), as opposed to expensing the $5 million in its entirety the first time the commercial airs. No advertising costs should be expensed prior to being incurred.

ASC 720-35-25-1A discusses advertising payments that occur after recognizing revenues related to those costs (e.g., reimbursement to customers under a cooperative advertising arrangement). This guidance states that obligations should be accrued, and the advertising costs expensed when the related revenues are recognized. Reporting entities making payments to customers should first evaluate whether the payments are in exchange for a distinct good or service received from the customer. Refer to RR 4.6.1 for additional guidance on payments to a customer.

ASC 720-35-50 requires reporting entities to disclose information related to advertising costs.

ASC 720-35-50-1

The notes to financial statements shall disclose both of the following:

a. The accounting policy selected from the two alternatives in paragraph 720-35-25-1 for reporting advertising, indicating whether such costs are expensed as incurred or the first time the advertising takes place

b. The total amount charged to advertising expense for each income statement presented.

8.5.1.1 *Interim financial reporting for advertising costs*

ASC 720-35 only applies to annual financial statements. ASC 270, *Interim Reporting*, specifically ASC 270-10-45-9, provides guidance specific to advertising costs. Refer to FSP 29 for additional details related to interim financial reporting.

8.5.1.2 *Tangible assets used for advertising*

Tangible assets, such as blimps or billboards (but not the production costs of the image being displayed), may be used for several advertising campaigns. The costs of these assets should be capitalized and depreciated or amortized over their expected useful life. That depreciation or amortization is a cost of advertising. Management should have plans to support their assertion as to the expected useful life of these tangible assets.

Point of sale materials, such as brochures and catalogues, may be accounted for as prepaid supplies until they no longer are owned or expected to be used, in which case their cost would be a cost of advertising accounted for in conformity with the guidance in ASC 720-35.

8.6 *Long-lived assets*

ASC 360 provides guidance for presentation and disclosure of long-lived assets. In accordance with ASC 360-10-05-2, the general subsections address property, plant, and equipment, including accumulated depreciation, while the impairment or disposal subsections provide additional guidance for the impairment or disposal of long-lived assets, which may include property, plant, and equipment, finite-lived intangible assets, right-of-use assets, and other assets part of an asset or disposal group.

ASC 360-10-50-1 provides the general disclosure requirements for property, plant, and equipment.

ASC 360-10-50-1

Because of the significant effects on financial position and results of operations of the depreciation method or methods used, all of the following disclosures shall be made in the financial statements or in notes thereto:

a. Depreciation expense for the period

b. Balances of major classes of depreciable assets, by nature or function, at the balance sheet date

c. Accumulated depreciation, either by major classes of depreciable assets or in total, at the balance sheet date

d. A general description of the method or methods used in computing depreciation with respect to major classes of depreciable assets.

In accordance with ASC 360-10-50-1(a), depreciation expense for the period is required to be disclosed. Some reporting entities comply with this disclosure requirement by presenting the amount on the statement of cash flows. In disclosing the major classes of depreciable assets, ASC 360-10-50-1(b) requires reporting entities to disclose depreciable assets by nature (e.g., machinery and equipment, buildings) or by function (e.g., manufacturing, marketing, transportation). In addition,

consistent with ASC 360-10-50-1(d), reporting entities should disclose the useful lives of major classes of assets.

S-X 4-08(b) requires disclosure of any assets mortgaged, pledged, or otherwise subject to lien, and the obligations collateralized should be identified.

8.6.1 *Held and used long-lived assets (impairment)*

Specific impairment disclosures are required by ASC 360-10-50-2 when an impairment loss is recognized for long-lived assets classified as held and used. These disclosures are required in the period the impairment loss is recognized and for all periods in which the impairment loss is disclosed in the financial statements.

ASC 360-10-50-2

All of the following information shall be disclosed in the notes to the financial statements that include the period in which an impairment loss is recognized:

a. A description of the impaired long-lived asset (asset group) and the facts and circumstances leading to the impairment

b. If not separately presented on the face of the statement, the amount of the impairment loss and the caption in the income statement or the statement of activities that includes that loss

c. The method or methods for determining fair value (whether based on a quoted market price, prices for similar assets, or another valuation technique)

d. If applicable, the segment in which the impaired long-lived asset (asset group) is reported under Topic 280.

ASC 360-10-45-4 requires an impairment loss recognized for a long-lived asset (asset group) classified as held and used to be included in income from continuing operations before income taxes. If a subtotal such as “income from operations” is presented, that subtotal should include the impairment loss.

8.6.2 *Held for sale long-lived assets*

ASC 360 provides guidance for when to classify long-lived assets as held for sale.

Excerpt from ASC 360-10-45-9

A long-lived asset (disposal group) to be sold shall be classified as held for sale in the period in which all of the following criteria are met:

a. Management, having the authority to approve the action, commits to a plan to sell the asset (disposal group).

b. The asset (disposal group) is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (disposal groups).

c. An active program to locate a buyer and other actions required to complete the plan to sell the asset (disposal group) have been initiated.

d. The sale of the asset (disposal group) is probable, and transfer of the asset (disposal group) is expected to qualify for recognition as a completed sale, within one year, except as permitted by paragraph 360-10-45-11.

e. The asset (disposal group) is being actively marketed for sale at a price that is reasonable in relation to its current fair value. The price at which a long-lived asset (disposal group) is being marketed is indicative of whether the entity currently has the intent and ability to sell the asset (disposal group). A market price that is reasonable in relation to fair value indicates that the asset (disposal group) is available for immediate sale, whereas a market price in excess of fair value indicates that the asset (disposal group) is not available for immediate sale.

f. Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

Refer to PPE 5.3.1 for further details on how to apply the above requirements.

Once a long-lived asset (disposal) group, including an asset group considered a component of a reporting entity, meets these requirements, it is subject to the presentation and disclosure requirements in ASC 360-10-50-3.

ASC 360-10-50-3

For any period in which a long-lived asset (disposal group) either has been disposed of or is classified as held for sale (see paragraph 360-10-45-9), an entity shall disclose all of the following in the notes to financial statements:

a. A description of the facts and circumstances leading to the disposal or the expected disposal.

b. The expected manner and timing of that disposal.

c. The gain or loss recognized in accordance with paragraphs 360-10-35-37 through 35-45 and 360-10-40-5.

d. If not separately presented on the face of the statement where net income is reported (or in the statement of activities for a not-for-profit entity), the caption in the statement where net income is reported (or in the statement of activities for a not-for-profit entity) that includes that gain or loss.

e. If not separately presented on the face of the statement of financial position, the carrying amount(s) of the major classes of assets and liabilities included as part of a disposal group classified as held for sale. Any loss recognized on the disposal group classified as held for sale in accordance with paragraphs 360-10-35-37 through 35-45 and 360-10-40-5 shall not be allocated to the major classes of assets and liabilities of the disposal group.

f. If applicable, the segment in which the long-lived asset (disposal group) is reported under Topic 280 on segment reporting.

In accordance with ASC 360-10-45-14, a long-lived asset classified as held for sale (but that does not meet the criteria for presentation as a discontinued operation in accordance with ASC 205-20-45-10) should be presented separately on the balance sheet of the current period. The prior period comparative balance sheet, if any, is not required to be recast, however, we believe a reporting entity may elect to do so in order to achieve comparability. Refer to FSP 27 for the presentation and disclosure requirements associated with disposal groups classified as held for sale that qualify as discontinued operations.

The assets and liabilities of a disposal group classified as held for sale should not be offset or presented as a single amount; rather, those assets and liabilities should be presented separately in the asset and liability sections of the balance sheet. When assets and liabilities are reclassified as held for sale, they should generally be presented as current or noncurrent assets held for sale, and current and noncurrent liabilities held for sale, based on the classification of the particular asset or liability. To classify all assets and liabilities held for sale as current, reporting entities should consider whether the disposal is expected to be consummated within one year of the balance sheet date and whether the reporting entity expects to use the sale proceeds to reduce long-term borrowings (in accordance with guidance in ASC 210-10-45-4). If the sale is expected to be completed within one year and the proceeds are not expected to be used to pay down long-term borrowings, current classification is acceptable. Otherwise, a reporting entity should follow the current and noncurrent classification noted above. The major classes of assets and liabilities classified as held for sale either should be presented separately on the face of the balance sheet or disclosed in the notes to financial statements (ASC 360-10-50-3(e)).

Individually significant disposal not eligible for discontinued operations

In addition to the disclosures in ASC 360-10-50-3, there may be circumstances in which a long-lived asset (disposal group) includes an individually significant component of a reporting entity that either has been disposed of or is classified as held for sale, but does not meet the criteria for presentation as a discontinued operation in accordance with ASC 205-20. In such circumstances, additional disclosures are required in accordance with ASC 360-10-50-3A.

Excerpt from ASC 360-10-50-3A

a. For a public business entity and a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, both of the following:

    1. The pretax profit or loss (or change in net assets for a not-for-profit entity) of the individually significant component of an entity for the period in which it is disposed of or is classified as held for sale and for all prior periods that are presented in the statement where net income is reported (or statement of activities for a not-for-profit entity) calculated in accordance with paragraphs 205-20-45-6 through 45-9

    2. If the individually significant component of an entity includes a noncontrolling interest, the pretax profit or loss (or change in net assets for a not-for-profit entity) attributable to the parent for the period in which it is disposed of or is classified as held for sale and for all prior periods that are presented in the statement where net income is reported (or statement of activities for a not-for-profit entity).

b. For all other entities, both of the following:

> 1. The pretax profit or loss (or change in net assets for a not-for-profit entity) of the individually significant component of an entity for the period in which it is disposed of or is classified as held for sale calculated in accordance with paragraphs 205-20-45-6 through 45-9
>
> 2. If the individually significant component of an entity includes a noncontrolling interest, the pretax profit or loss (or change in net assets for a not-for-profit entity) attributable to the parent for the period in which it is disposed of or is classified as held for sale.

All reporting entities must provide the disclosures for the initial period in which an individually significant component is sold or classified as held for sale. An individually significant component that is held for sale should continue to provide the disclosures in each reporting period that it remains held for sale. Public business entities and certain not-for-profit entities must also include comparative disclosures for all periods presented in the income statement.

There is no guidance on how to evaluate whether an individual component is significant or whether to consider the gain or loss on disposal when determining significance. Reporting entities must exercise judgment in assessing significance and should consider both quantitative and qualitative factors about the effect of the disposal on their balance sheet, income statement, and statement of cash flows. Reporting entities should also consider whether disclosure should be provided when multiple disposals of individually insignificant components occur in the same reporting period.

8.6.2.1 Change to a plan of sale

Reporting entities may change a plan to sell a long-lived asset (disposal group). As discussed in ASC 205-20-50-3, in the period that decision is made, the reporting entities should describe the facts and circumstances leading to the decision to change the plan and its effect on the income statement for the period and any prior periods presented.

If the reporting entity decides not to sell a long-lived asset (disposal group) previously classified as held for sale, such asset (disposal group) should be reclassified as held and used in the period when the decision is made. Any required adjustment to the carrying amount due to the reclassification should be included in income from continuing operations in the period of the subsequent decision not to sell. This adjustment should be reported in the same income statement caption used to report a loss, if any, recognized in accordance with ASC 360-10-45-5. The results of operations of a component previously reported in discontinued operations in accordance with ASC 205-20-45-3 should be reclassified and included in income from continuing operations for all periods presented. Consistent with the income statement guidance regarding discontinued operations classification, generally the balance sheet presentation is to reclassify the assets and liabilities previously reported as held for sale to held and used.

8.6.2.2 Newly acquired asset classified as held for sale

ASC 360-10-45-12 provides specific criteria which, if met, require the acquirer to present newly-acquired assets as assets held for sale. The criteria requires a plan to dispose of the assets within a year, and that it be probable that the acquirer will meet the other held-for-sale criteria (discussed in FSP 8.6.2) within a short period of time after the acquisition date (usually within three months).

8.6.2.3 *Loss exceeds carrying amount of the long-lived assets*

The difference between the carrying amount and fair value less cost to sell of the disposal group may exceed the carrying amount of long-lived assets in the disposal group. In these situations, the SEC staff has indicated that one acceptable approach for accounting for the loss on sale is to redefine the unit of account as the entire disposal group. In that case, a loss should be recognized to record the disposal group at the lower of its carrying amount or its fair value less cost to sell by means of a valuation allowance. If this approach is selected, the reporting entity should clearly disclose where these amounts are reflected in the financial statements and whether additional losses are expected in the future. See PPE 5.3.3.6 for discussion of other acceptable approaches when the difference between the carrying amount and fair value less cost to sell of the disposal group exceeds the carrying amount of long-lived assets in the disposal group.

8.6.3 *Additional disclosure requirements–recognized impairments*

ASC 820-10-50 indicates that measurements based on fair value (e.g., non-recurring fair value measurements required by ASC 360) are also subject to the disclosure requirements in ASC 820. Required disclosures include the fair value measurement, relevant measurement date, reasons for the fair value measurement, valuation techniques, and information about the inputs to the fair value measurement, including significant unobservable inputs. Refer to FSP 20.3.1 for details regarding the general fair value disclosure requirements.

In addition to the fair value measurement disclosures, ASC 275-10-50 requires a reporting entity to disclose its use of estimates when the resolution of matters could differ significantly from what is currently expected, and if it is reasonably possible that the estimates will change in the near term and the effect of the change will be material. Disclosure may also be required under ASC 275 even if a reporting entity concludes that an impairment charge is not required. Refer to FSP 24.3.3 for further information about the requirements of ASC 275.

8.6.4 *Disposal gain or loss*

The guidance for presentation of a gain or loss recognized on the sale of a long-lived asset (disposal group) is set forth in ASC 360-10-45-5.

ASC 360-10-45-5

A gain or loss recognized (see Subtopic 610-20 on the sale or transfer of a nonfinancial asset) on the sale of a long-lived asset (disposal group) that is not a discontinued operation shall be included in income from continuing operations before income taxes in the income statement of a business entity. If a subtotal such as income from operations is presented, it shall include the amounts of those gains or losses.

As discussed in ASC 360-10-S99-1, such amounts should also not be included as an adjustment to depreciation expense.

For guidance on the presentation of a gain or loss recognized on the sale of a disposal group that meets the definition of a business, see FSP 3.6.6.

8.6.5 *Long-lived assets to be disposed of other than by sale*

A long-lived asset to be disposed of other than by sale (e.g., by abandonment, in an exchange measured based on the recorded amount of the nonmonetary asset relinquished, or in a distribution to owners in a spinoff) should continue to be classified as held and used until it is disposed. Prior to disposal, all long-lived assets that are held and used are subject to the presentation and disclosure requirements discussed in FSP 8.6 and FSP 8.6.1.

8.6.6 *Spare parts*

It is not unusual for reporting entities to maintain "stores" items, which are spare maintenance materials and parts kept on hand as backup components in the event of equipment failure. Spare parts are also held on hand if the lead time to acquire new parts is long or contractual maintenance agreements require that the reporting entity maintain such parts on hand. These items are considered essential to the operations of the facility.

Reporting entities should consider the relevant facts and circumstances associated with their spare parts to determine whether they should be classified as long-lived assets or inventory. The policy should be consistently applied. Refer to PPE 1.5.3 for additional information related to the accounting and classification of spare parts.

8.7 *Capitalized software*

The presentation and disclosures in the financial statements of software-related costs differ depending on the nature of the costs and how the software is used. As described in SW 7, the accounting guidance for software-related costs is generally modeled after the inventory guidance (for software that is sold to customers) or the property, plant, and equipment guidance (for software that is used internally); accordingly, the presentation of those respective costs is generally similar to those financial statements line items. The presentation and disclosure requirements discussed in this section are applicable to software to be sold, leased, or otherwise marketed, internal-use software, and cloud computing arrangements (CCAs).

Note about ongoing standard setting

The FASB has an active project related to the accounting and disclosure of software costs. Financial statement preparers and other users of this publication are therefore encouraged to monitor the status of the project, and if finalized, evaluate the effective date of the new guidance and the implications on disclosures.

8.7.1 *Software to be sold, leased, or marketed*

Capitalized software development costs related to software to be sold, leased, or otherwise marketed, whether acquired or developed internally, should generally be classified as an amortizable intangible asset. Classification as inventory may be appropriate if the software was purchased from others and will be re-sold. While the accounting requirements of ASC 350, *Intangibles - Goodwill and Other*, do not apply to capitalized development costs related to software to be sold, leased, or marketed, the presentation and disclosure requirements do. More specifically, the disclosure requirements of ASC 350-40-50-1, which refer to other topics in the Codification, are discussed in FSP 8.8.2. The disclosure requirements of ASC 350-30-50-1 through ASC 350-30-50-3 related to intangible assets subject to amortization, which are described in FSP 8.9 and FSP 17, also apply.

Amortization of capitalized costs for software to be sold, leased, or otherwise marketed is recorded within cost of sales. This is because the amortization is directly associated with revenue recognized on a software product that is marketed to others, and as such, the expense would be charged to cost of sales or a similar expense category, consistent with the costs of other non-software products that are sold or marketed to others. ASC 985-20, *Software—Costs of Software to Be Sold, Leased, or Marketed,* includes an illustration describing the application of the disclosure requirements under ASC 275 to risks and uncertainties related to externally marketed software costs. In particular, the illustration includes a reporting entity that discloses that the carrying amount of its capitalized software is subject to significant uncertainty, as related to estimates of future years' revenues and useful lives that are made at the date of the financial statements, which may significantly impact the carrying amount of capitalized software costs.

Costs incurred for a software product to be sold, leased, or otherwise marketed that are classified as research and development would be subject to the disclosure requirements in ASC 730-10 (see FSP 3.6.5). In addition, ASC 985-20-50-1 details additional required disclosures.

Excerpt from ASC 985-20-50-1

Both of the following shall be disclosed in the financial statements:

a. Unamortized computer software costs included in each balance sheet presented.

b. The total amount charged to expense in each income statement presented for both of the following:

    1. Amortization of capitalized computer software costs

    2. Amounts written down to net realizable value.

The amortization and write-down amounts may be combined with only the total of the two expenses being disclosed.

8.7.2 *Internal-use software*

ASC 350-40, *Intangibles—Goodwill and Other, Internal-Use Software*, provides guidance on accounting for the costs of software developed or obtained for internal use. See SW 3 for details on the recognition and measurement of these costs.

Excerpt from ASC 350-40-15-2A

Internal-use software has both of the following characteristics: (1) the software is acquired, internally developed, or modified solely to meet the entity's internal needs and (2) during the software's development or modification, no substantive plan exists or is being developed to market the software externally.

While ASC 350-40 does not provide guidance on the presentation and disclosure of internal-use software costs, the presentation generally aligns with "Licensed software" in Figure FSP 8-1. In accordance with ASC 350-40-50-1, disclosures for internal-use software should be in accordance with existing authoritative literature included within ASC 360-10, Property, plant, and equipment—Overall

(see FSP 8.6), ASC 730-10, Research and Development—Overall (see FSP 3.6.5), ASC 275, Risks and Uncertainties (see FSP 8.9.1.2), and ASC 235, Notes to Financial Statements (see FSP 1.1.4).

8.7.3 *Cloud computing arrangements*

A cloud computing arrangement (CCA) may be referred to as software-as-a-service (SaaS) and may include other SaaS-type services, such as platform-as-a-service, infrastructure-as-a-service, and other hosting arrangements. "Hosting" refers to situations in which the end user does not take possession of the software; instead, the software resides on the vendor's or a third party's hardware (servers), and the customer accesses the software remotely. Some CCAs include a traditional license to the software in addition to the remote service. See SW 4.

If the CCA includes a software license in addition to the hosting service, the costs associated with the software license could be in the scope of the guidance for internal-use software or the guidance for software to be sold, leased, or otherwise marketed, depending on the reporting entity's use of the software. If the CCA is accounted for solely as a service contract, only the implementation costs of the CCA are subject to internal-use software guidance under ASC 350-40. However, it is important to note that while the accounting for CCA implementation costs follows the internal-use software model, the presentation in the balance sheet, income statement, and statement of cash flows of these costs is similar to other services. The guidance requires reporting entities to present implementation costs related to a CCA in the same financial statement line items as the CCA service fees, resulting in key differences from the presentation of costs related to licensed software.

Figure FSP 8-1 illustrates the differences in presentation between internal-use software costs (licensed software) and implementation costs related to a CCA.

Figure FSP 8-1
Financial reporting presentation of cloud computing arrangements

Financial statement	Licensed software	Cloud computing arrangement
Balance sheet	Fixed or intangible asset	Prepaid or other asset
Income statement	Depreciation/amortization	Cash operating expense
Statement of cash flows	Investing activities	Operating activities

The presentation requirements could impact key metrics such as EBITDA because the recognition of capitalized implementation costs associated with a CCA over the contract period are considered cash operating expenses, not depreciation or amortization.

Additionally, while the guidance under ASC 350-40 requires a reporting entity to present the capitalized implementation costs of a CCA in the balance sheet in the same line item that a prepayment for the fees of the associated hosting arrangement would be presented, the guidance does not address whether all or a portion of those costs should be classified as current or noncurrent.

Reporting entities should apply the guidance in ASC 210-10, *Balance Sheet—Overall,* related to prepaid expenses to determine the appropriate classification.

Reporting entities are required to disclose the nature of their hosting arrangements that are service contracts. In addition, reporting entities are required to make the disclosures in ASC 360-10 (see FSP 8.6) as if the capitalized implementation costs of a CCA were a separate major class of depreciable asset. These include disclosure of the balance of major classes of depreciable assets, accumulated amortization, amortization expense for all income statement periods presented, and a general description of methods(s) used to compute amortization.

Transition guidance for ASU 2018-15 – CCA implementation costs

ASC 350-40 provides accounting guidance for implementation costs of a hosting arrangement that is a service contract, including guidance on presentation of those costs and the related amortization in the financial statements. Refer to SW 4.2 for the transition guidance.

8.8 Intangible assets

The presentation and disclosure requirements discussed in this section are applicable to the acquisition and postacquisition periods for intangible assets under ASC 350. See FSP 17 for additional presentation and disclosure requirements for business combinations.

ASC 350-30-50-1 requires certain disclosures for acquired intangible assets, regardless of whether the assets are acquired via a business combination or an asset acquisition. The disclosures are required in the notes to financial statements in the period of acquisition.

ASC 350-30-50-1

For intangible assets acquired either individually or as part of a group of assets (in either an asset acquisition, a business combination, or an acquisition by a not-for-profit entity), all of the following information shall be disclosed in the notes to financial statements in the period of acquisition:

a. For intangible assets subject to amortization, all of the following:

   1. The total amount assigned and the amount assigned to any major intangible asset class

   2. The amount of any significant residual value, in total and by major intangible asset class

   3. The weighted-average amortization period, in total and by major intangible asset class.

b. For intangible assets not subject to amortization, the total amount assigned and the amount assigned to any major intangible asset class.

c. The amount of research and development assets acquired in a transaction other than a business combination or an acquisition by a not-for-profit entity and written off in the period and the line item in the income statement in which the amounts written off are aggregated.

d. For intangible assets with renewal or extension terms, the weighted-average period before the next renewal or extension (both explicit and implicit), by major intangible asset class.

This information also shall be disclosed separately for each material business combination or acquisition by a not-for-profit entity or in the aggregate for individually immaterial business combinations or acquisitions by a not-for-profit entity that are material collectively if the aggregate fair values of intangible assets acquired, other than goodwill, are significant.

ASC 350-30-45-1 requires intangible assets to be presented separately on the balance sheet at an individual, class, or aggregate level.

S-X 5-02(15) requires separate presentation for each class of intangible assets that is in excess of 5% of total assets, along with the basis of determining the respective amounts. Any significant addition or deletion should be explained in a footnote. S-X 5-02(16) requires that the amount of accumulated depreciation and amortization related to intangible assets be stated separately on the balance sheet or in a footnote.

Information related to intangible assets should be disclosed in the financial statements or the footnotes for each period for which a balance sheet is presented.

ASC 350-30-50-2

The following information shall be disclosed in the financial statements or the notes to financial statements for each period for which a statement of financial position is presented:

a. For intangible assets subject to amortization, all of the following:

   1. The gross carrying amount and accumulated amortization, in total and by major intangible asset class

   2. The aggregate amortization expense for the period

   3. The estimated aggregate amortization expense for each of the five succeeding fiscal years.

b. For intangible assets not subject to amortization, the total carrying amount and the carrying amount for each major intangible asset class

c. The entity's accounting policy on the treatment of costs incurred to renew or extend the term of a recognized intangible asset

d. For intangible assets that have been renewed or extended in the period for which a statement of financial position is presented, both of the following:

   1. For entities that capitalize renewal or extension costs, the total amount of costs incurred in the period to renew or extend the term of a recognized intangible asset, by major intangible asset class

   2. The weighted-average period before the next renewal or extension (both explicit and implicit), by major intangible asset class.

Example 13 (see paragraph 350-30-55-39) illustrates these disclosure requirements.

ASC 350-30-45-2 also requires amortization expense and impairment losses for intangible assets to be presented in income statement line items within continuing operations. We believe the impairment loss should be included in the subtotal "income from operations," if presented. Refer to FSP 3.6.8 for income statement presentation and disclosure requirements.

8.8.1 Impairment losses

ASC 350-30-50 requires disclosure for each impairment loss recognized related to an intangible asset.

Excerpt from ASC 350-30-50-3

a. A description of the impaired intangible asset and the facts and circumstances leading to the impairment

b. The amount of the impairment loss and the method for determining fair value

c. The caption in the income statement or the statement of activities in which the impairment loss is aggregated

d. If applicable, the segment in which the impaired intangible asset is reported under Topic 280.

The above disclosures should continue to be included in the footnotes whenever the financial statements include the income statement for the year in which the impairment loss was recognized.

As discussed in ASC 350-30-50-3, disclosures for impairment losses for intangible assets not subject to amortization are the same as the disclosure requirements for intangible assets subject to amortization.

ASC 820-10-50 indicates that measurements based on fair value (e.g., non-recurring fair value measurements required by ASC 360 for finite-lived intangibles or impairments of indefinite-lived intangibles under ASC 350) are also subject to the disclosure requirements in ASC 820. Required disclosures include the fair value measurement, relevant measurement date, reasons for the fair value measurement, valuation techniques, and information about the inputs to the fair value measurement, including significant unobservable inputs. Refer to FSP 20.3.1 for details regarding the general fair value disclosure requirements.

In addition to the fair value measurement disclosures, ASC 275-10-50 requires a reporting entity to disclose its use of estimates when the resolution of matters could differ significantly from what is currently expected, and if it is reasonably possible that the estimates will change in the near term and the effect of the change will be material. Disclosure may also be required under ASC 275 even if a reporting entity concludes that an impairment charge is not required. Refer to FSP 24.3.3 for further information about the requirements of ASC 275.

8.8.2 Estimate of useful life

ASC 275, *Risks and Uncertainties,* requires reporting entities to disclose the estimated useful life of an intangible asset when it is reasonably possible the estimate will change and have a material impact on the financial statements.

The materiality criterion may be met if a change in useful lives or a change in expected likelihood of renewal is material individually or in aggregate by major intangible asset class.

8.8.3 Renewal/extension of intangible asset's legal or contractual life

ASC 350-30-50-4 requires reporting entities to disclose information that enables financial statement users to assess the extent to which the expected future cash flows associated with the intangible asset are affected by the reporting entities' intent or ability (or both intent and ability) to renew or extend the arrangement.

8.9 Goodwill

As discussed in ASC 350-20-45-1, reporting entities are required to present the aggregate amount of goodwill as a separate line item in the balance sheet.

8.9.1 Goodwill reconciliation

A reconciliation of the carrying amount of goodwill at the beginning and end of the reporting period is required and should include the following:

Excerpt from ASC 350-20-50-1

The changes in the carrying amount of goodwill during the period shall be disclosed, showing separately:

a. The gross amount and accumulated impairment losses at the beginning of the period

b. Additional goodwill recognized during the period, except goodwill included in a disposal group that, on acquisition, meets the criteria to be classified as held for sale in accordance with paragraph 360-10-45-9

c. Adjustments resulting from the subsequent recognition of deferred tax assets during the period in accordance with paragraphs 805-740-25-2 through 25-4 and 805-740-45-2

d. Goodwill included in a disposal group classified as held for sale in accordance paragraph 360-10-45-9 and goodwill derecognized during the period without having previously been reported in a disposal group classified as held for sale

e. Impairment losses recognized during the period in accordance with this Subtopic

f. Net exchange differences arising during the period in accordance with Topic 830

g. Any other changes in the carrying amounts during the period

h. The gross amount and accumulated impairment losses at the end of the period.

ASC 350-20-50-1 also requires reporting entities that report segments under ASC 280, *Segment Reporting*, to disclose this information in total, and for each reportable segment. Significant changes in the allocation of goodwill should also be disclosed by segment. If any portion of goodwill has not yet

been allocated to a reporting unit at the date the financial statements are issued, that unallocated amount and the reasons for not allocating that amount should be disclosed.

A reporting entity may change its internal organizational structure such that the composition of reportable segments changes under ASC 280. This would result in the reporting entity restating all periods shown to reflect the new segments (see FSP 25.7.8 for further discussion). If the change in reporting structure does not change the composition of the entity's reporting units (e.g., the reporting units are being combined into a new reporting unit), the disclosures required for goodwill under ASC 350-20-50-1 could be revised without a reallocation of goodwill to reporting units.

If the composition of one or more of the reporting entity's reporting units is changed, the guidance in ASC 350-20-35-39 through ASC 350-20-35-40 should be used to reassign assets and liabilities to the reporting units affected. Goodwill should be reassigned to the reporting units affected at the time the change to the structure is made and reported (in accordance with ASC 350-20-50-1(g)). This should be done using a relative fair value allocation approach similar to that used when a portion of a reporting unit is to be disposed of using the relative fair value approach discussed in ASC 350-20-40-3. Recasting goodwill disclosures for periods prior to the change to reflect the change on an "as if" basis is not necessary. Refer to BCG 9 for further details on this topic.

New guidance

Upon adoption of ASU 2017-04, *Intangibles – Goodwill and Other (Topic 350): Simplifying the Accounting for Goodwill Impairment,* additional disclosures are required for reporting entities that have reporting units with zero or negative carrying amounts of net assets.

ASC 350-20-50-1A

Entities that have one or more reporting units with zero or negative carrying amounts of net assets shall disclose those reporting units with allocated goodwill and the amount of goodwill allocated to each and in which reportable segment the reporting unit is included.

8.9.2 Goodwill impairment

As discussed in ASC 350-20-45-2, the aggregate amount of goodwill impairment losses should be presented as a separate line item on the income statement within continuing operations unless a goodwill impairment is associated with a discontinued operation. Disclosure is required for each goodwill impairment loss recognized.

ASC 350-20-50-2

For each goodwill impairment loss recognized, all of the following information shall be disclosed in the notes to the financial statements that include the period in which the impairment loss is recognized:

a. A description of the facts and circumstances leading to the impairment

b. The amount of the impairment loss and the method of determining the fair value of the associated reporting unit (whether based on quoted market prices, prices of comparable businesses or nonprofit activities, a present value or other valuation technique, or a combination thereof)

c. If a recognized impairment loss is an estimate that has not yet been finalized (see paragraphs 350-20-35-18 through 35-19), that fact and the reasons therefore and, in subsequent periods, the nature and amount of any significant adjustments made to the initial estimate of the impairment loss.

This information should continue to be disclosed in the footnotes until the impairment loss is no longer presented.

ASC 820-10-50 indicates that measurements based on fair value (e.g., impairments of goodwill under ASC 350) are also subject to the disclosure requirements in ASC 820. Required disclosures include the fair value measurement, relevant measurement date, reasons for the fair value measurement, valuation techniques, and information about the inputs to the fair value measurement, including significant unobservable inputs.

ASC 820-10-50-2(bbb) requires quantitative disclosures about significant unobservable inputs used in fair value measurements categorized within Level 3 of the fair value hierarchy. These disclosures are not required for fair value measurements related to the financial accounting and reporting for goodwill after its initial recognition in a business combination. Refer to FSP 20.3.1 for details regarding the general fair value disclosure requirements.

In addition to the fair value measurement disclosures, ASC 275-10-50 requires a reporting entity to disclose its use of estimates when the resolution of matters could differ significantly from what is currently expected, and if it is reasonably possible that the estimates will change in the near term and the effect of the change will be material. Disclosure may also be required under ASC 275 even if a reporting entity concludes that an impairment charge is not required. Refer to FSP 24.3.3 for further information about the requirements of ASC 275.

New guidance

Upon adoption of ASU 2017-04, Intangibles – Goodwill and Other (Topic 350): Simplifying the Accounting for Goodwill Impairment, ASC 350-20-50-2(c) is superseded.

8.10 Other assets considerations for private companies

Certain presentation and disclosure requirements discussed in this chapter are only required for SEC registrants. In some instances, the difference in requirements is due to differences in US GAAP. These differences are discussed in FSP 8.10.1,FSP 8.10.2 and FSP 8.10.3.

The remaining differences are due to incremental presentation and disclosure requirements mandated by the SEC. These are summarized in Figure FSP 8-1 in FSP 8.10.4.

8.10.1 Indefinite-lived intangible assets (private companies)

In accordance with ASC 350-30-50-3A, when disclosing an indefinite-lived intangible asset after its initial recognition, a private company is not required to disclose the quantitative information about significant unobservable inputs used in fair value measurements categorized within Level 3 of the fair value hierarchy required by paragraph ASC 820-10-50-2(bbb).

8.10.2 Goodwill impairment evaluation (private companies)

New guidance

In March 2021, the FASB issued ASU 2021-03, *Accounting Alternative for Evaluating Triggering Events*. ASU 2021-03, *Accounting Alternative for Evaluating Triggering Events* provides eligible private companies and not-for-profit entities an accounting policy election to apply an alternative method for evaluating goodwill impairment triggering events. If elected, this alternative allows the reporting entity to perform its goodwill triggering event assessment only as of the end of each reporting period.

In accordance with ASC 350-20-50-3B, a reporting entity that elects the accounting alternative for a goodwill impairment triggering event evaluation should disclose the alternative as a significant accounting policy in the footnotes to the financial statements in accordance with ASC 235-10-50-1. Other than the accounting policy disclosure, a reporting entity is not required to make incremental disclosures related to this accounting alternative.

8.10.3 Goodwill amortization (private companies)

ASC 350 allows eligible private companies to amortize goodwill and apply a one-step impairment model. If elected, ASC 350 requires certain disclosures, which differ from those discussed in FSP 8.9.

The private company alternative in ASC 350 requires the aggregate amount of goodwill, net of accumulated amortization and impairment, to be presented as a separate line item on the balance sheet. The amortization and aggregate amount of impairment of goodwill is required to be presented on the income statement line items within continuing operations (or similar caption) unless the amortization or a goodwill impairment loss is associated with a discontinued operation. In that case, the amortization and impairment should be included (on a net-of-tax basis) within the results of discontinued operations.

For each period for which a balance sheet is presented, private companies are required to disclose in the footnotes (1) the amount assigned to goodwill in total and by major business combination or by reorganization event resulting in fresh-start reporting, and (2) the weighted-average amortization period in total and the amortization period by major business combination or by reorganization event resulting in fresh-start reporting. ASC 350-20-50-5 provides additional information that is required in each period for which a balance sheet is presented.

ASC 350-20-50-5

The following information shall be disclosed in the financial statements or the notes to the financial statements for each period for which a statement of financial position is presented:

a. The gross carrying amounts of goodwill, accumulated amortization, and accumulated impairment loss

b. The aggregate amortization expense for the period

c. Goodwill included in a disposal group classified as held for sale in accordance with paragraph 360-10-45-9 and goodwill derecognized during the period without having previously been reported in a disposal group classified as held for sale.

ASC 820-10-50-2(bbb) requires quantitative disclosures about significant unobservable inputs used in fair value measurements categorized within Level 3 of the fair value hierarchy. These disclosures are not required for fair value measurements related to the financial accounting and reporting for goodwill after its initial recognition in a business combination.

8.10.3.1 Impairment loss (private companies)

For each goodwill impairment loss recognized, the following information should be disclosed in the footnotes that include the period in which the impairment loss is recognized:

Excerpt from ASC 350-20-50-6

a. A description of the facts and circumstances leading to the impairment

b. The amount of the impairment loss and the method of determining the fair value of the entity or the reporting unit (whether based on prices of comparable businesses, a present value or other valuation technique, or a combination of those methods)

c. The caption in the income statement in which the impairment loss is included

d. The method of allocating the impairment loss to the individual amortizable units of goodwill.

This information should continue to be disclosed in the footnotes whenever the financial statements include the income statement for the period in which the impairment loss was recognized.

8.10.3.2 Intangible assets subsumed into goodwill (private companies)

ASC 805-20 provides private companies the option not to recognize separate from goodwill: (a) customer-related intangible assets (unless they are capable of being sold or licensed independent from other assets) and (b) noncompetition agreements. Instead, the value of these intangibles would be included as a part of goodwill. A private company that elects the guidance on intangibles must also adopt the goodwill accounting alternative (see FSP 8.10.3).

ASC 805-20 does not require any incremental disclosure requirements. However, it is important to note that any intangibles subsumed into goodwill by applying this guidance require qualitative disclosure in accordance with the following guidance:

Excerpt from ASC 805-30-50-1

Paragraph 805-10-50-1 identifies one of the objectives of disclosures about a business combination. To meet that objective, the acquirer shall disclose all of the following information for each business combination that occurs during the reporting period:

a. A qualitative description of the factors that make up the goodwill recognized, such as expected synergies from combining operations of the acquiree and the acquirer, intangible assets that do not qualify for separate recognition, or other factors.

Therefore, private companies must describe the nature of the intangible assets that are included in goodwill.

8.10.4 SEC requirements not applicable to private companies

Figure FSP 8-1 illustrates the presentation and disclosure requirements only required for SEC registrants.

Figure FSP 8-1

Presentation and disclosure requirements applicable only to SEC registrants

Description	Reference	Section
Separate disclosure of receivables that exceed 10% of aggregate receivables	S-X 5-02 3(b)	FSP 8.3.1
Disclosure of receivables mortgaged, pledged, or otherwise subject to lien	S-X 4-08 (b)	FSP 8.3.5
Separate disclosure of major classes of inventory	S-X 5-02 6(a)	FSP 8.4.1
Disclosure of the excess of replacement or current cost overstated LIFO value	S-X 5-02 6(c)	FSP 8.4.3
Separate disclosure of prepaid assets	S-X 5-02(7)	FSP 8.5
Separate disclosure of other current assets that exceed 5% of total current assets	S-X 5-02(8)	FSP 8.5
Separate disclosure of other noncurrent assets that exceed 5% of total assets	S-X 5-02(17)	FSP 8.5
Separate presentation for each class of intangible assets that exceed 5% of total assets	S-X 5-02 (15)	FSP 8.8

Chapter 9: Investments—debt and equity securities—updated November 2019

9.1 Chapter overview—updated September 2022

This chapter outlines the presentation and disclosure of investments in debt and equity securities and includes examples of the required disclosures.

This chapter does not address investments in consolidated entities (FSP 18), equity method investments (FSP 10), hedging of investments (DH 6), or subsidiary investments in parent company common stock in the subsidiary's standalone financial statements (FSP 5.9.4).

New guidance

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. ASU 2016-13 introduces a new model for recognizing credit losses on financial instruments based on an estimate of current expected credit losses. The ASU also provides updated guidance for the impairment of available-for-sale debt securities and includes additional disclosure requirements. Subsequent to the issuance of this standard, the FASB issued additional Accounting Standards Updates amending and clarifying the guidance based on feedback from constituents and discussions of the Transition Resource Group.

The new presentation and disclosure guidance in ASU 2016-13 has not been reflected in this chapter, but is included in LI 12.

In June 2022, the FASB issued ASU 2022-03*, Fair Value Measurements of Equity Securities Subject to Contractual Sale Restrictions*. ASU 2022-03 clarified that a contractual restriction on the sale of an equity security (for example, an underwriter lock-up agreement) is not considered part of the unit of account of an equity security. As a result, such restriction is not considered in measuring fair value of the equity security. ASU 2022-03 is effective for public business entities for fiscal years beginning after December 15, 2023, and interim periods within those fiscal years. For all other entities, the guidance is effective for fiscal years beginning after December 15, 2024, and interim periods within those fiscal years. Early adoption is permitted for both interim and annual financial statements that have not yet been issued or made available for issuance.

The guidance in ASU 2022-03 has not been reflected in this chapter, but is included in LI 12.

9.2 Scope and relevant guidance

ASC 320, *Investments—Debt Securities* and ASC 321, *Investments—Equity Securities*, establish requirements for the presentation and disclosure of investments in debt and equity securities and investments in certain limited partnerships and limited liability companies that do not qualify for the equity method. For simplicity, throughout this chapter, the terms "investments" or "investment securities" are used to pertain to all investments within the scope of ASC 320 or ASC 321. As discussed in ASC 320-10-15-2 through ASC 320-10-15-3 and ASC 321-10-15-2 through ASC 320-10-15-3, the guidance applies to all reporting entities, other than reporting entities in specialized industries that account for substantially all investments in debt and equity securities at fair value with changes in fair value recognized through net income. These include broker-dealers, investment companies, defined benefit pension plans, and other postretirement plans.

Once a reporting entity determines that an investment meets the definition of a security, it should then determine whether that security meets the definition of a debt or equity security (see LI 2.2.2 for

details on this assessment). This determination impacts classification and measurement, as well as the presentation and disclosure requirements.

ASC 325, *Investments—Other*, provides guidance for the presentation and disclosure of investments not within the scope of other authoritative guidance, including investments in insurance contracts and beneficial interests in securitized financial assets.

Other relevant guidance for SEC registrants in this chapter includes S-X 5-02. Regulation S-X also includes industry-specific guidance, which is not addressed in this chapter.

9.3 Overview of classification guidance

As discussed in ASC 320-10-25, the classification of debt investment securities as trading, available-for-sale (AFS), or held-to-maturity (HTM) determines the subsequent recognition and measurement of such investments. Figure FSP 9-1 summarizes the presentation of debt investments within the scope of ASC 320. See PwC's *Loans and investments* guide for further discussion.

Figure FSP 9-1
Balance sheet and income statement presentation of debt securities

Classification of debt security	Valuation	Treatment of unrealized gain/loss	Other income statement effects
Trading	Fair value	Recognized in net income	Interest and dividends as earned
Held-to-maturity	Amortized cost basis	Not recognized	Interest as earned Credit component of other-than-temporary impairment losses through income and remainder in OCI Gains and losses from sale
Available-for-sale	Fair value	Recognized in AOCI as a separate component of stockholders' equity	Interest as earned Credit component of other-than-temporary impairment losses through income and remainder in OCI Gains and losses from sale

Equity securities are generally measured at fair value or using the elective methodology prescribed in ASC 321-10-35-2 for equity securities without readily determinable fair values. This methodology is also referred to as the measurement alternative. The measurement alternative may not be elected by entities that follow specialized accounting models (as described in FSP 9.2), or for investments that qualify for measurement under the net asset value (NAV) practical expedient in ASC 820, *Fair value measurement*.

Figure FSP 9-2 summarizes the presentation of equity securities within the scope of ASC 321. See LI 2 for further discussion.

Figure FSP 9-2
Balance sheet and income statement presentation of equity securities

Measurement of equity security	Valuation	Treatment of unrealized gain/loss	Other income statement effects
Equity securities with readily determinable fair value	Fair value	Recognized in net income	Dividends as earned
Equity securities without readily determinable fair value	Fair value / NAV[1] / measurement alternative[2]	Recognized in net income	Dividends as earned Gains and losses from sale Impairment loss (if applicable)[2]

[1] Investments in certain funds qualify for the use of the NAV practical expedient instead of fair value. See FV 6.2.6.

[2] When a reporting entity elects the measurement alternative in ASC 321, the equity interest is recorded at cost less impairment. The carrying amount is subsequently increased or decreased for observable price changes (i.e., prices in orderly transactions for the identical investment or similar investment of the same issuer). Any adjustments to the carrying amount are recorded in net income. In addition, the investment is written down to fair value through earnings if the required qualitative assessment indicates impairment.

9.4 Balance sheet presentation

ASC 825-10-45-1A requires reporting entities to present financial assets and financial liabilities separately by measurement category and form of financial asset (i.e., securities or loans and receivables) on the balance sheet or in the footnotes.

In addition to the requirements for specific line items, reporting entities subject to Article 5 of SEC Regulation S-X (i.e., commercial and industrial companies) are required to present all amounts in excess of 5% of total assets separately on the face of the balance sheet or in a note in accordance with Regulation S-X Rule 5-02(17).

A reporting entity should present assets that are measured at fair value separate from similar assets that are measured at amortized cost basis on the face of the balance sheet in accordance with ASC 320-10-45-1, ASC 825-10-45-1A, and Regulation S-X Rule 5-02. To accomplish this, a reporting entity should present either:

- The aggregate of fair value and non-fair value amounts in the same line item on the balance sheet with parenthetical disclosure of the fair value amount included in the aggregate amount; or
- The fair value and non-fair value carrying amounts in two separate line items

While Regulation S-X Rule 5-02 requires a separate line item for "marketable securities," it refers to the disclosure requirements for current marketable equity securities prescribed by GAAP. Those requirements are detailed in ASC 321. For marketable securities other than equity securities, S-X 5-02 requires reporting entities to state parenthetically on the balance sheet or in the notes the basis for

determining the aggregate amount presented on the balance sheet. Amortized cost basis is required to be disclosed if the securities are presented at fair value and, likewise, fair value is required to be disclosed if the securities are presented at amortized cost basis.

We believe complying with ASC 320 and ASC 321 satisfies the requirements of S-X 5-02 in that investments in debt and equity securities will be presented separate from other assets. We do not believe the term "marketable securities" is required on the face of the balance sheet.

See FSP 5.9.4 for information on the presentation of a subsidiary's investment in its parent's stock.

Example FSP 9-1 illustrates how a reporting entity may present debt securities on the balance sheet.

EXAMPLE FSP 9-1

Presentation of marketable debt securities

FSP Corp has marketable debt securities at December 31, 20X7 consisting of securities classified as held-to-maturity with an amortized cost basis of $150 and a fair value of $160 and securities classified as available-for-sale with an amortized cost basis of $90 and a fair value of $100.

How should FSP Corp present these marketable debt securities on the balance sheet as of December 31, 20X7?

Analysis

FSP Corp may present these marketable securities on the balance sheet as follows:

Securities at fair value (amortized cost basis is $90)	$100
Securities at amortized cost basis (fair value is $160)	$150

Reporting entities subject to industry-specific guidance under Regulation S-X, such as bank holding companies and insurers, have different reporting requirements with regard to balance sheet captions. For example, insurers are required to present fixed-maturity securities separate from equity securities on the face of the balance sheet. This chapter does not address industry-specific presentations. See LI 12.11 and LI 12.12 for additional considerations for insurance and banking entities subject to Article 7 or Article 9 of Regulation S-X, respectively.

9.4.1 *Current and noncurrent classification*

A reporting entity that presents a classified balance sheet (see FSP 2.3.4) should report individual debt securities classified as trading, available-for-sale (AFS), or held-to-maturity (HTM) as either current or noncurrent on an individual basis under the provisions of ASC 210, *Balance Sheet*. This is achieved by applying one of the following two approaches consistently.

The first approach is to classify securities based on their maturities (for debt securities) and the reporting entity's reasonable expectation with regard to those securities (i.e., expectations of sales and redemptions). If the reporting entity expects to convert securities to cash within one year (or normal operating cycle), the securities should be classified as current assets. If this criterion is not met, the securities should be classified as noncurrent.

The second approach is to classify securities based on whether they represent the investment of funds available for current operations, as defined in ASC 210-10-45-1 and ASC 210-10-45-2. Under this approach, the reporting entity does not need to have a stated expectation to sell such securities within one year or normal operating cycle for such securities to be classified as current; however, the securities need to be available for use, if needed, for current operations.

As discussed in ASC 320-10-25-1(c), HTM debt securities are, by definition, those for which management has the intent and ability to hold to maturity. Therefore, classification of the individual securities as current or noncurrent is based on the maturity date or call date if exercise of the call within the next operating period or fiscal year is probable. For example, HTM securities that mature within one year are classified as current.

Investments in securities or advances made for the purposes of control, affiliation, or other continuing business advantage are excluded from the definition of current assets in ASC 210-10-45-4. Therefore, securities held for such purposes should be classified as noncurrent.

9.5 Income statement presentation

ASC 320 broadly describes when amounts should be recognized in net income; however, it provides limited guidance with regard to presentation in specific line items in the income statement. As a result, there is diversity in practice. For example, unrealized holding gains and losses on equity securities, trading securities, and securities for which the fair value option has been elected are typically classified as either "trading gains and losses" or "other income," but other presentation may be appropriate.

For certain other items, there is specific guidance on the line in the income statement in which an item should be recorded, including the following:

- Amortization of discount or premium, as well as loan origination, commitment, and other fees and costs recognized as an adjustment of the effective interest rate, should be reported as interest income or expense

- Commitment fees amortized on a straight-line basis over the commitment period or included in income when the commitment expires should be reported as service fee income

See FSP 9.5.1 and FSP 9.5.2 for discussion of the income statement and comprehensive income presentation of other-than temporary impairments, respectively.

9.5.1 Other-than-temporary impairments—income statement

If the fair value of a debt security is less than its amortized cost basis, the investment is impaired. If the impairment is deemed other-than-temporary (OTTI), the portion representing the credit loss is recognized in net income and the portion of the loss relating to all other factors is recognized in other comprehensive income (OCI).

ASC 320-10-45-8A requires reporting entities to present the total OTTI in the income statement "with an offset" for the amount of the total OTTI that is recognized in OCI. Example 2A in ASC 320-10-55-21A illustrates the application of this guidance using three line items in the income statement. That example shows total OTTI, the "offset" included in OCI, and net impairment recognized in earnings as three separate line items. We believe it is also acceptable to present the net impairment loss on the face of the income statement rather than as three separate line items, provided it is accompanied by either:

- total OTTI, with OTTI recognized in OCI presented parenthetically in the OTTI caption on the income statement or
- total OTTI, with OTTI recognized in OCI presented separately at the bottom of the income statement.

We do not consider it acceptable to only present the total OTTI and OTTI recognized in OCI in the footnotes.

9.5.2 Other-than-temporary impairments—within OCI

Reporting entities should present amounts recognized in accumulated other comprehensive income (AOCI) related to held-to-maturity (HTM) and available-for-sale (AFS) debt securities for which a portion of an other-than-temporary impairment (OTTI) was recognized in net income separate from other components of AOCI.

When an OTTI is recognized, the security's amortized cost basis is adjusted for the component of the OTTI recognized in earnings (i.e., the credit-related component). The security's carrying value is adjusted to its fair value at the measurement date, which includes the effect of the impairment charge recorded in OCI (i.e., the whole OTTI – the credit- and non-credit-related components).

The difference between the new amortized cost basis and carrying value that arises from the recognition of an OTTI results in the need for additional analysis to determine the total OTTI to be presented in the income statement in subsequent periods. Essentially, an additional OTTI does not exist unless the fair value of the security has further declined since the most recent OTTI (i.e., below the new amortized cost basis). However, even if the fair value of the security has not decreased subsequent to the recognition of an OTTI, if a credit loss is realized, the reporting entity may recognize an additional OTTI in the income statement.

Example FSP 9-2, Example FSP 9-3, and Example FSP 9-4 illustrate the presentation and disclosure considerations associated with recording amounts in AOCI and net income for debt securities with OTTI impairments.

EXAMPLE FSP 9-2

Financial statement presentation of debt security with OTTI

On January 1, 20X4, FSP Corp acquires a debt security for $1,000 (at par) with a fixed interest rate of 4.5% per year and a maturity at December 31, 20X8. The security is classified as AFS.

On December 31, 20X7, the fair value of the debt security is $700. FSP Corp assesses whether the impairment is other-than-temporary. It determines that it does not intend to sell the security and it is not more likely than not that it will be required to sell the security. However, based on an evaluation of all available information, including a discounted cash flow analysis, FSP Corp does not expect to recover the entire amortized cost basis of the security.

FSP Corp determines a credit loss exists and, therefore, an OTTI has occurred. FSP Corp separates the total impairment of $300 (the cost basis of $1,000 less the fair value of $700 as of December 31, 20X7) into (1) the amount representing the decrease in cash flows expected to be collected (i.e., the credit loss) of $120 and (2) the amount related to all other factors of $180 (i.e., the non-credit component).

How should FSP Corp present this OTTI in its financial statements?

Analysis

In accordance with ASC 320-10-35-34, FSP Corp should recognize an OTTI in net income of $120 for the credit loss and recognize the remaining impairment loss of $180 separately in OCI.

After the recognition of the OTTI, the debt security's adjusted amortized cost basis is $880 (i.e., the previous cost basis less the credit loss recognized in net income) and its carrying value is $700 (i.e., fair value). FSP Corp presents the gross $300 impairment on the face of the income statement, with the $180 non-credit impairment deducted from that amount in a separate line.

Total other-than-temporary impairment	$ 300
Portion of impairment loss recognized in OCI	(180)
Net other-than-temporary impairment loss recognized in net income	**$ 120**

Other presentation alternatives, as discussed in FSP 9.5.1, may be appropriate.

EXAMPLE FSP 9-3

Presentation and disclosure of OCI for AFS securities with OTTI

At December 31, 20X7, FSP Corp has an AFS debt security with a $100 amortized cost basis and a fair value of $60. FSP Corp assesses whether the impairment is other-than-temporary. It determines that it does not intend to sell the security and it is not more likely than not that it will be required to sell the security. However, based on an evaluation of all available information, including a discounted cash flow analysis, FSP Corp does not expect to recover the entire amortized cost basis of the security (i.e., the present value of the amounts expected to be collected is less than amortized cost basis). This impairment is considered other-than-temporary and comprises a $10 credit-related impairment and a $30 non-credit-related component.

At March 31, 20X8, the fair value of this AFS debt security increases to $64, with no additional credit-related impairments.

How should this AFS security be presented in OCI and disclosed in the footnotes at the end of each reporting period?

Analysis

At December 31, 20X7, FSP Corp should record a $30 debit (charge) in the OTTI-related component of OCI. FSP Corp should also disclose this as a component of AOCI, as required by ASC 220-10-45-14 through ASC 220-10-45-14A (see FSP 4.5). The credit-related OTTI charge of $10 should be classified as a realized loss in net income, and the new amortized cost basis of the security is $90.

At March 31, 20X8, there are no additional impairments to the security, as the fair value increased period-over-period. A $4 credit should be included in the OTTI-related component of OCI. The disclosure of AOCI components should show a $26 debit balance in the OTTI-related component of AOCI.

Further, FSP Corp should disclose the total OTTI recognized in AOCI cumulatively of $30 at December 31, 20X7 and March 31, 20X8, in accordance with ASC 320-10-50-2(aaa), which requires total OTTI recognized in AOCI to be separately disclosed. The purpose of this disclosure is to accumulate the gross OTTI recognized since acquisition of the security, regardless of subsequent movements in the security's fair value. Therefore, subsequent increases in the fair value of the previously impaired securities *should not* be reflected in this disclosure.

Question FSP 9-1 addresses the current period presentation of an increase in the fair value and an increase in expected credit losses of a previously other-than-temporarily impaired AFS debt security.

Question FSP 9-1

How should a subsequent increase in the fair value of a previously other-than-temporarily impaired AFS debt security, accompanied by an increase in expected credit losses for that debt security, be presented in equity and OCI in the current period?

PwC response

A reporting entity should recognize a realized loss for a subsequent increase in expected credit losses for a previously other-than-temporarily impaired AFS debt security. The realized loss is offset by a corresponding reduction in the previous non-credit OTTI recognized in OCI. That is, even though on a comprehensive income basis there is no additional impairment, the nature of the impairment has changed between the credit loss portion and the non-credit loss portion of the total OTTI amount.

EXAMPLE FSP 9-4

Subsequent increase in the fair value of a previously other-than-temporarily impaired AFS debt security with an increase in expected credit losses

At December 31, 20X7, FSP Corp has an AFS debt security with a $100 amortized cost basis and a fair value of $60. FSP Corp assesses whether the impairment is other-than-temporary. It determines that it does not intend to sell the security and it is not more likely than not that it will be required to sell the security. However, based on an evaluation of all available information, including a discounted cash flow analysis, FSP Corp does not expect to recover the entire amortized cost basis of the security (i.e., the present value of the amounts expected to be collected is less than amortized cost basis). This impairment is considered other-than-temporary and comprises a $10 credit-related impairment and a $30 non-credit-related component.

At March 31, 20X8, the AFS debt security has a fair value of $64 and an additional $5 of credit-related impairment.

What is the impact on OCI and the income statement presentation of this AFS security for the quarter ended March 31, 20X8?

Analysis

In accordance with ASC 320-10-45-8A, the income statement presentation for the quarter ended March 31, 20X8 should be as follows.

Total other-than-temporary impairment	$ 0
Portion of impairment loss recognized in OCI	(5)
Net other-than-temporary impairment loss recognized in net income	$(5)

Because FSP Corp recognized the additional $5 of OTTI through net income (for the credit-related impairment), the new amortized cost basis of the security is $85.

The activity in comprehensive income for the quarter ended March 31, 20X8 consists of a $5 reclassification to net income and a $4 increase in fair value of the debt security.

Change in OTTI-related component of unrealized gain/loss	$9 credit

AOCI balances would consist of the following component at March 31, 20X8.

OTTI-related component of unrealized gain/loss	$21 debit

This amount is calculated as the 20X5 $30 non-credit component of OTTI less the $5 reclassification from OCI to net income in 20X6 and the $4 unrealized gain recognized in 20X8. It equals the new amortized cost basis of $85 less fair value of $64.

Further, FSP Corp should also disclose the total OTTI recognized in AOCI of $30 at December 31, 20X7 and $25 at March 31, 20X8 in accordance with ASC 320-10-50-2(aaa).

9.6 Debt security disclosure requirements

ASC 320-10-50 provides disclosure guidance related to investments in debt securities. Generally, the disclosures are required to be segregated by security accounting classification (i.e., trading, available-for-sale [AFS], or held-to-maturity [HTM]), and highlight key information to investors about the types and terms of securities held.

Additional disclosures could be required for securities measured at fair value (see FSP 20.3).

9.6.1 Major security types

Many investments disclosures, including those required for securities classified as AFS or HTM, are required to be provided by major security type. ASC 320-10-50-1B provides guidance to help reporting entities evaluate the level at which the disclosures should be provided. It requires reporting entities to consider whether the discussion of certain security types should be further disaggregated based on common characteristics underlying the securities (e.g., geographic concentration, credit quality, economic characteristics). For example, a reporting entity that separates AFS debt securities into government bonds and mortgage-backed securities may want to consider whether further detail would be beneficial to investors. If so, the reporting entity may consider separating government bonds between US and foreign, or separating mortgage-backed securities into commercial and residential.

Figure FSP 9-3, Figure FSP 9-4, Figure FSP 9-5, Figure FSP 9-6, Figure FSP 9-7, and Figure FSP 9-8 include sample disclosures that present debt securities disaggregated into three major security types.

These are only examples; the level of disaggregation will vary by reporting entity and the nature of its portfolio.

9.6.2 *Disclosures for securities classified as AFS*

When disclosing debt securities classified as AFS in accordance with ASC 320-10-50-2, a reporting entity should disclose the following information by major security type for the securities held as of the date of each balance sheet presented.

- Amortized cost basis
- Aggregate fair value
- Total other-than-temporary impairment recognized in accumulated other comprehensive income (AOCI)
- Total gains for securities with net gains in AOCI
- Total losses for securities with net losses in AOCI

Figure FSP 9-3 illustrates an example disclosure for AFS securities in accordance with ASC 320-10-50-2. It includes example classes of instruments.

Figure FSP 9-3

Sample AFS disclosure of amortized cost basis, fair value, and total OTTI information

Note X: Investments

The following table summarizes the unrealized positions for available-for-sale fixed-maturity debt securities, disaggregated by class of instrument.

Single year depicted for simplicity.

ASC 320-10-50-2 reference	A	B	c	aa	aaa
	Amortized cost basis	**Gross unrealized gains**	**Gross unrealized losses**	**Fair value**	**Total OTTI in AOCI[1]**
US Treasury securities	$500	$50	$3	$547	$0
Foreign government bonds	780	10	30	760	5
Asset-backed securities	20	17	7	30	6
Total fixed maturities	**$1,300**	**$77**	**$40**	**$1,337**	**$11**

[1] Represents the amount of OTTI in AOCI that was not included in net income. Amount excludes unrealized gains on impaired AFS securities relating to changes in their value subsequent to the impairment measurement date.

9.6.2.1 *Reclassifications out of AOCI for AFS securities*

For each income statement presented, ASC 320-10-50-9 requires a reporting entity to disclose the change in net unrealized holding gain or loss on AFS securities reported in AOCI during the period and

the amount of gains and losses reclassified out of OCI into net income upon sale of the securities through a “Realized gain/loss” line in the income statement. ASC 220-10-45-17 requires reporting entities to disclose the location in the income statement to which amounts were reclassified from AOCI. FSP 4.5.5.1 includes a sample disclosure.

These required disclosures can either be shown as part of the statement of changes in equity or in a footnote.

9.6.3 Disclosures for securities classified as HTM

When disclosing securities classified as HTM in accordance with ASC 320-10-50-5, a reporting entity should disclose the following information by major security type, as of each balance sheet date presented.

- Amortized cost basis
- Aggregate fair value (PBEs only)
- Gross unrecognized holding gains (PBEs only)
- Gross unrecognized holding losses (PBEs only)
- Net carrying amount
- Total other-than-temporary impairment recognized in accumulated other comprehensive income
- Gross gains and losses in AOCI for any derivatives that hedged the forecasted acquisition of the HTM securities

Figure FSP 9-4 provides an example of a disclosure for HTM securities in accordance with ASC 320-10-50-5.

Figure FSP 9-4
Sample disclosure—HTM amortized cost and fair value information

Assume the reporting entity does not have amounts previously recognized in AOCI associated with these HTM securities (ASC 320-10-50-5(dd)) and the net carrying amount (ASC 320-10-50-5(d)) is presented on the face of the balance sheet.

Single year depicted for simplicity.

Note X—Investments (continued)

The following table summarizes the unrealized positions for held-to-maturity securities, disaggregated by class of instrument.

ASC 320-10-50-5 reference	a	b	c	aa
	Amortized cost basis	**Gross unrealized gains**	**Gross unrealized losses**	**Fair value**
US Treasury securities	$410	$67	$13	$464
Foreign government bonds	280	28	30	278
Asset-backed securities	90	11	14	87
Total	**$780**	**$106**	**$57**	**$829**

9.6.4 Disclosures for AFS and HTM securities classified by maturity date

In addition to the disclosures in FSP 9.6.2 and FSP 9.6.3, ASC 320-10-50-3 and ASC 320-10-50-5 require presentation of investments in AFS and HTM securities, respectively, by maturity date. This disclosure should include the fair value and net carrying amount (if different than the fair value). The disaggregation by contractual maturity illustrated in Figure FSP 9-5 (i.e., due within one year, due after one year through five years, etc.) is the minimum level of disaggregation required by ASC 942-320 for depository and lending institutions. All other reporting entities may use judgment to determine the level of disaggregation.

The fair value and net carrying value for debt securities that do not have a single maturity date, such as mortgage-backed securities, may be disclosed separate from those included in the aging groupings. Alternatively, if a reporting entity chooses to allocate such securities across the aging categories, it should disclose the basis for allocation.

Figure FSP 9-5 illustrates an example of a single disclosure for AFS and HTM securities.

Figure FSP 9-5
Sample disclosure—AFS and HTM securities grouping by contractual maturity

Note X—Investments (continued)

The following table summarizes the fair value and amortized cost bases of the available-for-sale and held-to-maturity securities by contractual maturity.

Single year depicted for simplicity.

	Available-for-sale		**Held-to-maturity**	
	Amortized cost basis	**Fair value**	**Amortized cost basis**	**Fair value**
Due within one year	$434	$429	$117	$121
Due after one year through five years	235	241	78	92

	Available-for-sale		Held-to-maturity	
	Amortized cost basis	Fair value	Amortized cost basis	Fair value
Due after five years through ten years	213	211	289	306
Due after ten years	398	426	206	223
Asset-backed securities	20	30	90	87
Total	**$1,300**	**$1,337**	**$780**	**$829**

Actual maturities may differ from contractual maturities because certain borrowers have the right to call or prepay certain obligations.

9.6.5 Disclosure of impairments of securities

ASC 320-10-50-6 through ASC 320-10-50-8B outline the quantitative and qualitative disclosure requirements for reporting entities with impaired securities, including those with OTTI.

9.6.5.1 Investments in an unrealized loss position – quantitative disclosures

For all investments in an unrealized loss position for which an OTTI has not been recognized in net income, including investments for which a portion of an OTTI has been recognized in OCI, a reporting entity should disclose both of the following, aggregated by major security type as of each balance sheet date (in a tabular format).

- Aggregate related fair value of investments with unrealized losses
- Aggregate amount of unrealized losses (the amount by which amortized cost basis exceeds fair value)

Reporting entities should segregate these amounts by those investments in a continuous unrealized loss position for (1) less than 12 months and (2) 12 months or longer.

Figure FSP 9-6 illustrates an example of a disclosure of the length of time individual securities have been in a continuous unrealized loss position.

Figure FSP 9-6

Sample disclosure—length of time individual securities have been in a continuous unrealized loss position, aggregated by major security type

Note X—Investments (continued)

The following table summarizes the fair value and gross unrealized losses aggregated by category and the length of time that individual securities have been in a continuous unrealized loss position.

Single year depicted for simplicity.

	Less than twelve months		Greater than twelve months		Total	
	Fair value	Gross unrealized loss	Fair value	Gross unrealized loss	Fair value	Gross unrealized loss
US Treasury securities	$687	$16	$324	$—	$1,011	$16
Foreign government bonds	608	29	430	31	1,038	60
Asset-backed securities	30	14	87	7	117	21
Total debt securities	**$1,325**	**$59**	**$841**	**$38**	**$2,166**[1]	**$97**[2]

[1] Represents the sum of the total fair value of the HTM and AFS portfolios.

[2] Represents the sum of the (1) gross unrealized losses on HTM securities of $57 (per Figure FSP 9-4) and (2) the gross unrealized losses on AFS securities of $40 (per Figure FSP 9-3).

When a portion of an OTTI is not recognized in net income (i.e., it is recognized in OCI), the duration of that unrealized loss is measured using the balance sheet date of the reporting period in which the OTTI was first recognized in OCI as the starting reference point. Continuous unrealized loss positions stop when either of the following happens.

- The reporting entity recognizes an OTTI in net income for the total amount by which amortized cost basis exceeds fair value.
- The fair value of the security equals or exceeds the amortized cost basis of the investment.

9.6.5.2 *Investments in an unrealized loss position—qualitative disclosures*

As discussed in ASC 320-10-50-6(b), as of the latest balance sheet date, a reporting entity should include a narrative disclosure that allows a user to understand the information (both positive and negative) the reporting entity considered in reaching its conclusion as to why an impairment was not deemed other-than-temporary. The reporting entity may aggregate the disclosure by investment category, unless there are individually significant unrealized losses. ASC 320 outlines examples of the information reporting entities should consider including in this qualitative disclosure.

Excerpt from ASC 320-10-50-6(b)

This disclosure could include all of the following:

1. The nature of the investment(s)
2. The cause(s) of the impairment(s)
3. The number of investment positions that are in an unrealized loss position
4. The severity and duration of the impairment(s)
5. Other evidence considered by the investor in reaching its conclusion that the investment is not other-than-temporarily impaired, including, for example, any of the following:
   i. Performance indicators of the underlying assets in the security, including any of the following:
      01. Default rates
      02. Delinquency rates
      03. Percentage of nonperforming assets.
   ii. Loan-to-collateral-value ratios
   iii. Third-party guarantees
   iv. Current levels of subordination
   v. Vintage
   vi. Geographic concentration
   vii. Industry analyst reports
   viii. Sector credit ratings
   ix. Volatility of the security's fair value
   x. Any other information that the investor considers relevant.

ASC 320-10-55-23 provides a detailed narrative disclosure that illustrates some of these points. In certain examples in that illustration, the entity has securities in unrealized loss positions that it concludes are not other-than-temporarily impaired. As a result, the entity discloses it does not intend to sell the securities nor does it believe it is more likely than not it will be required to sell them before recovery of their amortized cost basis. Reporting entities should then consider what additional information is necessary to achieve the objective of the disclosure. For example, a reporting entity with asset-backed securities with more significant unrealized losses might elaborate and describe its assessment process, considering the performance indicators noted in paragraph 5.i of ASC 310-10-50-6.

9.6.5.3 Credit losses recognized in net income

For both interim and annual reporting periods in which an OTTI of a debt security is recognized and only the credit loss is recognized in net income, a reporting entity should disclose by major security type the methodology and significant inputs used to measure the amount related to the credit loss. Examples of significant inputs are included in ASC 320-10-50-8A and are similar to those described in ASC 320-10-50-6.

As discussed in ASC 320-10-50-8B, a reporting entity should disclose a tabular rollforward of the amount related to credit losses recognized in net income. This rollforward is meant to provide investors with additional information regarding management's expectations of credit losses, how those expectations develop over time, and how actual experience compares to prior expectations.

The cumulative balance being rolled forward is not an actual financial statement account balance. Rather, it represents a memo account relating to the cumulative credit loss activity recorded in income on impaired debt securities for which a portion of the impairment was recorded in OCI. One of the focus areas for stakeholders is the disclosure of additional credit losses recognized on securities for which a credit loss had previously been recognized (item e in ASC 320-10-50-8B) because this provides some indication of management's ability to accurately estimate credit losses on a timely basis.

Subsequent increases in expected cash flows on a previously other-than-temporarily impaired debt security (ASC 320-10-50-8B(f)) are recognized as a yield adjustment on a prospective basis. We believe the intent of the FASB was to require disclosure in the rollforward of the amount recognized in net income in the current period that relates to the expected increase in cash flows. However, the components of the rollforward are identified as "minimum" disclosures, suggesting supplemental disclosure of the entire increase in expected cash flows is not precluded. Similarly, supplemental disclosure of the accretion of discounted expected cash flows recognized in the period is not precluded.

Figure FSP 9-7 illustrates the rollforward of credit losses recognized in net income for which a portion was recognized in OCI.

Figure FSP 9-7

Sample disclosure—the rollforward of credit losses recognized in net income on fixed-maturity securities

Note X—Investments (continued)

The following table summarizes the credit loss recognized in earnings on fixed-maturity securities for which a portion of the OTTI was recognized in OCI.

Single year depicted for simplicity.

		ASC 320-10-50-8B reference
Balance, beginning of year	$129	a
Credit losses for which OTTI was not previously recognized	31	b
Credit-impaired securities disposed of for which there was no prior intent or requirement to sell	(48)	c
Credit-impaired securities *not* disposed of for which there was no prior intent or requirement to sell	12	d
Credit impairments on previously impaired securities	19	e
Accretion recognized due to changes in cash flows expected to be collected over the remaining expected term	(12)	f
Increases due to the passage of time	3	f
Balance, end of year	**$134**	g

9.6.6 Sales, transfers, and related matters

Additional disclosures are required when investments in available-for-sale debt securities are sold during a period or transferred between classifications (e.g., from AFS to HTM), as outlined in ASC 320-10-50-9 through ASC 320-10-50-13.

For each period for which an income statement is presented, ASC 320-10-50-9 requires the following disclosures for AFS securities.

- Proceeds from sales and maturities
- Gross realized gains and losses
- The basis on which the cost of a security sold or the amount reclassified out of AOCI into income was determined (e.g., specific identification, average cost, or other method)
- The amount of the net unrealized holding gain or loss for the period included in AOCI
- The amount of gains and losses reclassified out of AOCI into income for the period

ASC 320-10-50-9 also requires disclosure of trading gains and losses on trading securities still held at the balance sheet date.

Figure FSP 9-8 illustrates the disclosure of the proceeds from sales or maturities and the gross realized gains and losses. FSP 4.5 details the disclosure requirements associated with the amounts in, and reclassified out of, AOCI.

Figure FSP 9-8

Example disclosure of the proceeds and gross realized gains and losses from sales or maturities of AFS securities

Note X: Investments (continued)

The following table summarizes the proceeds and gross realized gains and losses from sales or maturities of AFS securities.

[For example purposes, only a single year is shown.]

	Gross realized gains	Gross realized losses	Gross proceeds from sales	Gross proceeds from maturities
Fixed-maturity AFS securities	$314	$149	$2,100	$300

The gross proceeds from sales and maturities may alternatively be presented on the face of the statement of cash flows.

For any sales of, or transfers from, securities classified as HTM, a reporting entity should disclose the items required by ASC 320-10-50-10 in the notes for each period for which an income statement is presented.

Excerpt from ASC 320-10-50-10

a. The net carrying amount of the sold or transferred security

b. The net gain or loss in accumulated other comprehensive income for any derivative that hedged the forecasted acquisition of the held-to-maturity security

c. The related realized or unrealized gain or loss

d. The circumstances leading to the decision to sell or transfer the security. (Such sales or transfers should be rare, except for sales and transfers due to the changes in circumstances identified in paragraph ASC 320-10-25-6(a) through (f).)

According to ASC 320-10-35-16, the fair value at the date of the transfer, adjusted for subsequent amortization, becomes the amortized cost basis of the security transferred to HTM for the disclosures required by ASC 320.

Although ASC 320-10-35-12 states transfers of securities from AFS to trading should be rare, ASC 320-10-50-9(c) requires the reporting entity to disclose the gross gains and gross losses included in income from the transfer.

9.6.7 *Options that do not qualify for derivative accounting*

As discussed in ASC 320-10-55-5, when a reporting entity enters into forward contracts or options that (1) are not derivatives subject to ASC 815 and (2) involve the acquisition of securities that will be accounted for under ASC 320, it should report those contracts consistent with the accounting, presentation, and disclosure requirements of ASC 320.

ASC 815-10-50-9 requires the reporting entity to disclose its accounting policy for the premium paid to acquire such options that are classified as held-to-maturity or available-for-sale.

9.6.8 *Beneficial interests in securitized financial assets*

A reporting entity may own debt securities representing beneficial interests in securitized financial assets that have been accounted for as sales. In these situations, in addition to meeting the disclosure requirements of ASC 320, the reporting entity should consider the disclosure requirements in ASC 860-20-50-4. See FSP 22 for additional information on transfers.

As discussed in ASC 325-40-45-1, the amount of accretable yield on beneficial interests in securitized financial assets may not be displayed on the balance sheet.

9.7 *Equity security disclosure requirements*

ASC 321-10-50 provides disclosure guidance on investments in equity securities.

9.7.1 *Measurement alternative disclosures*

As explained in LI 2, ASC 321-10-35-2 provides an elective measurement alternative for equity securities without readily determinable fair values. ASC 321-10-50-3 lists specific disclosure requirements for investments measured under this method.

In each interim and annual reporting period, ASC 321-10-50-3 requires the following disclosures for equity investments that are accounted for under the measurement alternative:

- The carrying amount of these equity investments
- The amount of impairments and downward adjustments, if any, on both an annual and cumulative basis
- The amount of upward adjustments, if any, on both an annual and cumulative basis
- Additional information (in narrative form) that is sufficient to permit financial statement users to understand the quantitative disclosures and the information that the entity considered in reaching the carrying amounts and upward or downward adjustments resulting from observable price changes.

We believe that the disclosures required by ASC 321-10-50-3 should only include equity investments that are held by the reporting entity at the end of the period.

Additionally, as the measurement alternative is a nonrecurring fair value measurement, an entity should follow the applicable disclosure requirement in ASC 820-10-50 for nonrecurring fair value measurements.

Impairments and adjustments due to observable prices

ASC 321-10-50-3(b) specifically requires disclosure of the upward and downward adjustments to equity investments without readily determinable fair values for which the measurement alternative is used on a gross basis; they should not be combined into one net number. However, we believe that downward adjustments due to impairments and downward adjustments due to observable price changes can be combined for the purposes of this disclosure. Reporting entities should consider whether separate presentation of impairments and downward adjustments due to observable price changes would provide decision-useful information to users of the financial statements.

9.7.2 Disclosures for all equity investments

Separate from the disclosures for equity investments accounted for under the measurement alternative, ASC 321-10-50-4 requires reporting entities to disclose the amount of unrealized gains and losses for all equity investments for each period in which a statement of operations is presented. This disclosure includes equity investments accounted for under the measurement alternative and equity investments that are reported on a fair value basis.

ASC 321 provides an example of the formula for calculating the unrealized gains and losses to be disclosed.

Excerpt from ASC 321-10-50-4

Net gains and losses recognized during the period on equity securities	$105
Less: Net gains and losses recognized during the period on equity securities sold during the period	(80)
Unrealized gains and losses recognized during the reporting period on equity securities still held at the reporting date	$25

Only the amount of unrealized gains and losses on equity investments still held at the reporting date (i.e., the $25) is required to be disclosed, although a reporting entity is not precluded from presenting how this number is calculated.

See FSP 20 for the required disclosures related to fair value.

9.7.3 Options that do not qualify for derivative accounting

As discussed in ASC 321-10-55-3, when a reporting entity enters into forward contracts or options that (1) are not derivatives subject to ASC 815 and (2) involve the acquisition of securities that will be accounted for under ASC 321, it should report those contracts consistent with the accounting, presentation, and disclosure requirements of ASC 321.

9.8 *Considerations for private companies*

The presentation and disclosure requirements for investments are generally applicable to both public and private reporting entities.

Although S-X 5-02 requires use of the term "marketable securities" to describe investments in debt and equity securities, we believe complying with the ASC 320 guidance satisfies this S-X requirement as well. As such, we see no difference in the reporting requirements for debt and equity securities between public and private companies. However, reporting entities that are not public business entities are not required to disclose the fair value of financial instruments measured at amortized cost basis.

Chapter 10: Equity method investments and joint ventures–updated September 2023

10.1 Equity method investments and joint ventures—overview

This chapter discusses the presentation and disclosure requirements for equity method investments and joint ventures. ASC 323, *Investments—Equity Method and Joint Ventures*, is the primary guidance for accounting for equity method investments, but the SEC also has certain presentation and disclosure requirements for SEC registrants. Generally, ASC 323 requires an equity method investment to be shown on the balance sheet of the investor as a single amount. Likewise, the investor's share of earnings or losses from an equity method investment should generally be shown on the income statement as a single amount. Alternatives to the single line presentation on the balance sheet and income statement may be used in limited situations, as discussed later in the chapter.

ASC 323 also outlines various disclosures for equity method investments. The extent of the disclosure requirements is predicated on the significance of an investment to the investor's balance sheet and income statement.

In August 2023, the FASB issued ASU 2023-05, *Business Combinations – Joint Venture Formations (Subtopic 805-60): Recognition and Initial Measurement*, which creates guidance to address accounting for contributions received by the joint venture entity upon formation and includes disclosures required at formation.

See EM 3 and EM 4 for guidance on the initial and subsequent measurement of equity method investments. See EM 6 for guidance on accounting for joint ventures.

10.2 Equity method investments—scope and relevant guidance

The guidance in ASC 323 applies to all reporting entities. Investments held in common stock and/or in-substance common stock (collectively, referred to as "common stock") of entities other than consolidated subsidiaries are usually accounted for by one of two methods—the equity method or the fair value method. The equity method should be applied when an investor has the ability to exercise significant influence over the operating and financial policies of the investee, unless the investor elects the fair value option available under ASC 825, *Financial Instruments*. See EM 2 for a discussion of whether an investor has significant influence.

If the investor elects the fair value option, the investor is still required to provide certain of the equity method disclosures described in ASC 323. See FSP 10.6 for further information on the required disclosures when an investor elects the fair value option.

Investments in partnerships and other joint ventures are generally accounted for using the equity method of accounting, as described in EM 1.3. See EM 1 for further guidance on which investments are within the scope of the equity method of accounting.

10.3 Equity method investments—balance sheet presentation

ASC 323-10-45-1 requires an investment in common stock accounted for under the equity method to be shown as a single amount on the investor's balance sheet. Multiple equity method investments can be aggregated for purposes of presentation on the balance sheet. In addition, a reporting entity may combine an investment in common stock with advances or investments in senior or other securities of an investee in a single amount for purposes of balance sheet presentation; however, disclosure of the types of investments will generally be required.

When labeling the balance sheet caption for an equity investment, the term "investments at equity" should be used only in circumstances where the carrying amount of the investment equals the investor's underlying equity in investee net assets. Generally, the basis of accounting should be described in a footnote rather than in the balance sheet caption.

An investor's share of losses of an investee may exceed the carrying amount of the investment accounted for under the equity method. In certain circumstances, an investor may continue to recognize its share of investee losses in excess of the investor's carrying amount of the investment, resulting in a balance sheet credit. In such circumstances, the carrying amount should be classified as a liability. The balance sheet caption should be appropriately descriptive to reflect the nature of this liability (e.g., "accumulated losses of unconsolidated companies in excess of investment," "estimated losses on investment," or "estimated liability–guarantee of obligation of unconsolidated affiliate"). See EM 4.5 for further information.

Question FSP 10-1

Is a reporting entity permitted to separately present its share of each asset and liability of its investee individually?

PwC response

Typically, an investor is not permitted to separately present its share of each asset and liability of an investee (the so-called "expanded equity" or "proportionate consolidation" approach). However, as discussed in ASC 810-10-45-14, a reporting entity is permitted to use the proportionate consolidation approach to account for a noncontrolling interest in an unincorporated legal entity when the investee's activities are in the extractive or construction industries. An investor also may use proportionate consolidation to present undivided ownership interests in assets provided certain conditions are met. For more information on proportionate consolidation, see CG 8.4.

10.4 Equity method investments—income statement presentation

ASC 323-10-45-1 requires an investor's share of earnings or losses from its investment in common stock accounted for under the equity method to be shown as a single amount on the income statement, except for its share of accounting changes reported in the financial statements of the investee, which should be classified separately in the investor's income statement. In addition, an investor may need to make other adjustments to its proportionate share of the earnings or losses of an investee (e.g., eliminating intercompany gains and losses, recognizing impairments at the investor level, converting

the investee's financial statements to US GAAP), as further discussed in this section. Equity method investments can be aggregated for purposes of presenting the investor's share of earnings or losses in the income statement.

When practicable, the investee's financial information should be as of the same dates and for the same periods as presented in the reporting entity's financial statements. However, if the investee's financial information is reported on a lag, the reporting entity would ordinarily record its share of the earnings or losses of an investee using the most recently available financial statements, provided this approach is applied consistently. If an investor changes the period of the lag, that would generally be considered a change in accounting principle and require retrospective application and disclosures in accordance with ASC 250. See EM 4.4 for further information on lag reporting.

10.4.1 Equity method investments—presentation alternatives – Updated November 2021

The investor's share of the investee's earnings or losses is generally presented as a single amount in the income statement. Limited exceptions to this presentation are permissible, as discussed in this section.

Example FSP 10-1 illustrates the presentation of equity in net earnings of an investee as a single amount in the income statement.

EXAMPLE FSP 10-1

Presentation of equity in net earnings of investee as a single amount

FSP Corp owns 40% of the common stock of Company A and has the ability to exercise significant influence over the operating and financial policies of this investee. FSP Corp accounts for Company A as an equity method investee. There are no intercompany transactions, consolidation-type adjustments required for investee capital changes (e.g., exercise of stock options issued by investee), or differences between investor cost and underlying equity in investee net assets. FSP Corp is taxed at 40%.

Additionally, note that any tax provision required by ASC 740, *Income Taxes,* relating to the temporary difference arising from the use of the equity method for book purposes and the cost method for tax purposes has been omitted to simplify the illustration.

During the year, FSP Corp has income before taxes of $160,000 and income taxes of $64,000. FSP Corp's portion of Company A's earnings is $39,000, net of tax.

How should FSP Corp present the equity in net earnings of Company A as a single amount in the financial statements?

Analysis

FSP Corp should present the equity in net earnings of Company A as a single amount as follows:

Income before income taxes and equity in net earnings of affiliate	$160,000
Income taxes	64,000
Income before equity in net earnings of affiliate	96,000
Equity in net earnings of affiliate	39,000
Net income	$135,000

The presentation in Example FSP 10-1 is consistent with the presentation requirements of S-X-5-03. S-X 5-03 generally requires equity method earnings to be presented below the income tax line unless a different presentation is justified by the circumstances. The SEC staff has indicated that, in certain limited circumstances, it may be appropriate to include income from equity investments in operations because some reporting entities operate their business largely through equity investees, or the equity investee may be integral to the investor's operations. However, classification within revenue from contracts with customers is not allowed.

The income statement caption for the equity method earnings should be appropriately titled depending on its nature (e.g., "Equity in net earnings of Company A," or "Share of net earnings of equity method investee"). Additionally, the subtotal for income prior to equity in net earnings of affiliate (required for SEC registrants) should be appropriately titled, as illustrated in Example FSP 10-1.

If the equity method earnings are of such a nature that it is acceptable for them to be presented within operations, the amount must be net of taxes as recorded by the investee in determining its net income. To do otherwise would be tantamount to proportionate consolidation.

When the investee is a partnership, the investor/partner's share of the income of the partnership is taxable at the investor level, not at the partnership level. In such cases, a question may arise as to whether the equity earnings should be reported before or after the investor's income tax provision on its income statement. We would encourage the investor to report equity earnings after the income tax provision line on its income statement because any taxes due on its equity method investment in the partnership would be reported in its income tax provision.

Figure FSP 10-1 illustrates common methods an investor may use for income statement presentation of equity method earnings, which depend on the nature of the equity method investee and whether the investee is a taxable or non-taxable entity.

In practice, the presentation of equity in earnings in the income statement varies. Careful consideration should be given to how investor and investee activity related to an equity method investment is presented. Depending on the facts and circumstances, an alternative presentation may be acceptable when accompanied by appropriate disclosures in order to allow users of the financial statements to understand the activity presented.

Figure FSP 10-1

Methods of presenting earnings of equity method investees in the income statement

	Presentation	Additional considerations
Earnings of non-taxable investees	In operating profit	The SEC staff has indicated that presenting equity method earnings from an investee within the operating income section of the investor's income statement is acceptable in very limited circumstances.
	Before tax provision line item	For a non-taxable investee, there is no difference between gross or net of tax presentation as the investee is not taxed.
	Below tax provision line item	The investor's income tax provision line would include any income tax levied against the investor for its share of the investee's results.
Earnings of taxable investees ("net of tax" presentation)	In operating profit	The SEC staff has indicated that presenting equity method earnings from an investee within the operating income section of the investor's income statement is acceptable in very limited circumstances.
	Below tax provision line item	The investor's income tax provision line would include any income tax levied against the investor for its share of the investee's results.

10.4.1.1 Other relationships between the investor and investee

In certain situations, investments are made principally to secure channels of distribution or to finance licensees. In such cases, the return on the investment in common stock may be nominal and incidental to earning royalties, technical fees, and similar types of income. In other cases, in addition to an investment in common stock, the investor may have a substantial investment in the investee in the form of advances or senior securities.

In such circumstances, because of the interplay between royalties, technical fees, interest, or other items, and the return on investment in the investee entity, it may be more meaningful to combine these amounts in presenting equity in income of the investee. When such presentation is used, the following should be considered:

- The investment account on the balance sheet should include the investment in common stock, advances, and senior securities consistent with how it is presented in the income statement.
- The separate amounts and the fact that they were combined in the financial statements are required to be disclosed. Appropriately descriptive captions should be used (e.g., "equity in income of and technical fees and interest earned from investees").

10.4.1.2 Full or partial sale of equity method investment

The gain or loss from the sale of an equity method investment may be presented in either of the following ways in the income statement:

- In non-operating income, gross of tax, before the income tax provision

- In the same line item in which the investor reports the equity in earnings of the investee

These methods are also appropriate to record a gain or loss when the investor's ownership interest is diluted as a result of the investee issuing additional shares, and the investor does not maintain its proportionate ownership interest (i.e., an indirect sale). See EM 5.4 for further information on indirect sales. Appropriate disclosures about the sale should be made in the investor's financial statements as necessary, in accordance with the guidance in ASC 860.

In accordance with ASC 205-20-45, the sale of an equity method investment may qualify as discontinued operations. For more information on the criteria for reporting discontinued operations, refer to FSP 27.

10.4.1.3 Other-than-temporary impairment

When an investor records an other-than-temporary impairment charge for an equity method investment, the impairment charge should generally be included as a component of the investor's share of the earnings or losses of the investee.

In the absence of prescriptive disclosure requirements for an other-than-temporary impairment under ASC 323, a reporting entity may consider disclosing the following in the notes to the financial statements in the period in which it recognizes an other-than-temporary impairment:

- A description of the impaired equity method investment and the facts and circumstances leading to the impairment, and
- The amount of the impairment loss included in the investor's share of earnings or losses of the investee

See FSP 20.3 for the required disclosures for assets measured at fair value on a non-recurring basis.

10.4.1.4 Investor cost vs. underlying equity in net assets of investee

When an investor purchases an investment that will be accounted for by the equity method, the amount paid for the investment may not equal the investor's proportionate share of the investee's net book value. Any difference between the two amounts is commonly referred to as a basis difference. The investor's share of the investee's earnings should be adjusted for the amortization or accretion of basis differences between the carrying amount and its interest in the underlying net assets of the investee, if applicable (see EM 3.3.1 and EM 4.3.1 for further information).

The guidance in ASC 323-10-35-13 requires that a difference between the cost of an investment and the amount of underlying equity in net assets of an investee be accounted for as if the investee were a consolidated subsidiary. The investor must identify which individual assets or liabilities have fair values different from the corresponding amounts recorded in the investee's financial statements. If the basis difference is assigned to depreciable or amortizable assets, such as property, plant, and equipment or intangibles assets, the difference should be depreciated, amortized, or accreted over the useful lives of the related assets and included as a component of the investor's share of the earnings or losses of the investee.

10.4.1.5 Intercompany profits on transactions between investor and investee

The presentation of the effects of intercompany profits on transactions between an investor and an investee in an investor's income statement and balance sheet will depend on what is most meaningful in the circumstances. A number of alternative methods of presentation may be acceptable, as discussed in EM 4.2. Refer to FSP 26.4 for further information on related party disclosure requirements.

10.4.1.6 Private company accounting alternatives adopted by investee

A public company investor may have an interest in a private company investee that has elected an accounting alternative approved by the Private Company Council (PCC) and endorsed by the FASB (PCC alternative). A public company investor should eliminate the effects of its private company investee's application of such PCC alternatives by adjusting its proportionate share of the earnings or losses of the investee to arrive at an equity in earnings amount as if the investee had never elected the PCC alternative. These adjustments are required because PCC alternatives are not available to public companies.

10.4.1.7 New accounting principle adopted by investee at a different time

An investor and its investees may adopt new accounting principles at different times because of early adoption of the standard by one of the entities or a later mandatory adoption date for companies that are not public business entities.

An investor is not required to adjust its financial statements for a difference in the investee's adoption date.

10.4.1.8 Discontinued operations reported by an investee

If the investee reports a discontinued operation, the investor should consider whether this represents a strategic shift that has (or will have) a major effect on its own operations and financial results and, therefore, also requires discontinued operation presentation by the investor. It is rare for the criteria for discontinued operations to be met at the investor level and, therefore, an investor would generally not report discontinued operations in its income statement for its share of the discontinued operations of an equity method investee. See FSP 27 for further information on the presentation of discontinued operations. If the investor does not report discontinued operations, it would report its share of the investee's discontinued operations as part of the single amount in the income statement representing the investor's share of the investee's earnings or losses.

10.4.1.9 Investments in tax credit entities (after adoption of ASU 2023-02)

New guidance

In March 2023, the FASB issued ASU 2023-02, *Investments – Equity Method and Joint Ventures (Topic 323): Accounting for investments in tax credit structures using the proportional amortization method*. The new guidance expands the use of the proportional amortization method of accounting for investments in tax credit vehicles, which historically was only allowed for qualifying investments in affordable housing tax credit structures. ASU 2023-02 is effective for public entities for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. For all other

entities, the guidance is effective for fiscal years beginning after December 15, 2024. Early adoption is permitted.

Many companies, particularly financial institutions, invest in limited partnerships or limited liability companies that generate various tax credits, such as those for qualified affordable housing projects, new markets, or renewable energy such as solar or wind. These investors earn federal tax credits as the principal return for providing capital to facilitate the development, construction, and/or rehabilitation of qualified projects. See FSP 16.5.4 for additional disclosure considerations and TX 3.3.6 for additional discussion on investments in tax credit structures, including criteria for determining which programs may be eligible for the proportional amortization method.

For guidance related to accounting for investments in tax credit entities prior to the adoption of ASU 2023-02, refer to FSP 10.4.1.9A.

10.4.1.9A *Low income housing tax credit partnerships (before adoption of ASU 2023-02)*

Many companies, particularly financial institutions, invest in limited partnerships or similar limited liability companies that operate qualified affordable housing projects or invest in one or more other entities that operate qualified affordable housing projects. These investors earn federal tax credits as the principal return for providing capital to facilitate the development, construction, and rehabilitation of low income rental property. The income statement presentation of these types of equity investments is discussed in EM 1.3.6. ASC 323-740-50 discusses the disclosure requirements for these types of investments.

For guidance related to accounting for investments in tax credit entities after adoption of ASU 2023-02, refer to FSP 10.4.1.9.

10.4.1.10 *Proportionate consolidation*

The proportionate consolidation method reflects an investor's proportionate share of each item of income and expense of the investee, as adjusted for any consolidation entries. As discussed in FSP 10.3, this presentation method is only permitted in limited circumstances.

Intercompany sales between the investor and investee should be eliminated; however, the amount eliminated under the proportionate consolidation method should not exceed the investor's share of investee sales. If intercompany sales are equal to or less than the investor's share of the investee sales, the intercompany sales should be fully eliminated.

10.4.2 *Investee accounting changes*

An investor's equity share of an investee's accounting change should be reported in the investor's financial statements as if the investor had made the change. This treatment is a logical extension of the consolidation guidance.

ASC 250-10-45-3 clarifies that the adoption of accounting changes should follow the transition requirements specified in the Accounting Standards Update. In the unusual instance when there are no transition requirements, the update should be adopted by adjusting assets, liabilities, and opening retained earnings in the first comparative period presented.

When an investee records the cumulative effect of adoption of an accounting change retrospectively through opening retained earnings, the investor would reflect the investee's adoption through a corresponding adjustment to its opening retained earnings. Example FSP 10-2 illustrates this concept. Conversely, adoption of an accounting change by an investee through net income, which is less common, would be recorded by the investor through its net income.

EXAMPLE FSP 10-2

Presentation of investor's share of an investee's accounting change

FSP Corp owns 40% of the common stock of Company C and has the ability to exercise significant influence over the operating and financial policies of this investee. FSP Corp accounts for Company C as an equity method investee. As a result of adoption of a new accounting standard on January 1, 20X1, Company C recorded a cumulative effect charge through retained earnings.

FSP Corp's portion of Company C's net income is $104,000 and its portion of the cumulative effect charge is $20,000. FSP Corp's net income for the year, prior to its equity earnings in Company C, is $134,000.

How should FSP Corp present the effect of Company C's accounting change in its financial statements?

Analysis

FSP Corp should record its share of the cumulative effect charge as an adjustment to retained earnings since that is how Company C recorded adoption of the new accounting standard.

FSP Corp's statement of changes in stockholders' equity should be presented as follows:

FSP Corp
Statement of Changes in Stockholders' Equity
Year ended December 31, 20X1

	Common stock $0.01 par value				
	Shares	Amount	Additional paid-in capital	Retained earnings	Total stockholders' equity
Balance at December 31, 20X0	1,000,000	$10,000	$20,546,987	$5,000,000	$25,556,987
Issuance of common stock	200,000	2,000	1,999,800	—	2,001,800
Net income				238,000	238,000
Cumulative effect charge resulting from an accounting change at equity method investee				(20,000)	(20,000)
Balance at December 31, 20X1	1,200,000	$12,000	$22,546,787	$5,218,000	$27,776,787

10.4.3 Investment becomes qualified for the equity method

As discussed in ASC 323-10-35-33, a reporting entity with an investment that was previously accounted for on a basis other than the equity method (e.g., at fair value) may increase its level of ownership such that the investor has the ability to exercise significant influence. The equity method of accounting should be applied prospectively, including all required equity method disclosures, from the date significant influence is obtained. See EM 5.3 for further information on investments that qualify for the equity method of accounting.

For example, assume a reporting entity owns 15% of an investee that is measured at fair value through earnings. It subsequently increases its ownership interest to 40%, which results in the investor applying the equity method. The investor would prospectively reflect its 40% interest using the equity method.

10.4.4 Investment no longer qualifies for the equity method

As discussed in ASC 323-10-35-36, when an investment in common stock of an investee entity no longer qualifies for accounting under the equity method (e.g., the ability to exercise significant influence over operating and financial policies of an investee no longer exists), the investor should discontinue accruing its share of earnings or losses of the investee. This is a change of circumstances, not a change in accounting principle, and therefore is not reflected retrospectively. Additionally, as discussed in ASC 323-10-35-39, the investor's share of the investee's other comprehensive income should be reclassified to the carrying value of the investment at the time of discontinuance of the equity method of accounting. In executing the reclassification, the reporting entity should first reduce the carrying value of the investment to zero and then record any remaining balance in income. See EM 5.4.3 for further information on investments that no longer qualify for the equity method.

10.4.5 Controlling interest to noncontrolling investment—equity method

In accordance with ASC 250-10-20, a change in reporting entity includes "changing specific subsidiaries that make up the group of entities for which consolidated financial statements are presented." Circumstances may arise in which a parent's controlling financial interest (e.g., generally an ownership interest in excess of 50% of the outstanding voting stock) is reduced to a noncontrolling investment that still enables it to exercise significant influence over the operating and financial policies of the investee. A change that results from changed facts and circumstances (such as a partial sale of a subsidiary), where there was only one acceptable method of accounting prior to the change in circumstances (consolidation) and only one acceptable method of accounting after the change (equity method accounting), is not a change in reporting entity and should not be accounted for retrospectively. Accordingly, a change from a consolidated controlling interest to a noncontrolling investment accounted for under the equity method should be accounted for prospectively from the date of change in control.

If a reporting entity loses control of a subsidiary that is a business, it should follow the derecognition guidance in ASC 810-10-40 and the disclosure requirements in ASC 810-10-50 (see FSP 18.7.2). If a reporting entity loses control of a subsidiary that is not a business and all or substantially all of the assets of the subsidiary are non-financial assets, the reporting entity should follow the derecognition guidance in ASC 610-20. See PPE 6.2.4 for further guidance on the derecognition standard for non-financial assets.

10.5 Equity method investments—statement of other comprehensive income

As discussed in ASC 323-10-35-18, a reporting entity is required to record its proportionate share of its equity method investees' comprehensive income. This requirement is consistent with the guidance in ASC 323-10-35-15, which indicates that an investee's transactions that are of a capital nature and affect the investor's share of the investee's stockholders' equity should be accounted for as if the investee were a consolidated subsidiary.

The format used by an investee to report comprehensive income, including other comprehensive income (OCI), should not impact how the investor displays its proportionate share of OCI of its investee. Accordingly, an investor is permitted to combine its proportionate share of OCI from an equity method investment with its own OCI items and report those aggregated amounts (by each category).

Alternatively, as depicted in Figure FSP 10-3, an investor would be permitted to separately report OCI items related to an equity method investee.

Figure FSP 10-3

Separate presentation in the statement of comprehensive income of equity method investee OCI items

FSP Corp
Statement of Comprehensive Income
For the year ended December 31, 20X1

Net income	$4,150
Other comprehensive income, net of deferred income taxes:	
Changes in foreign currency translation adjustments	10
Changes in defined benefit plans:	
Actuarial losses and prior service cost/credit before reclassification to net earnings	(50)
Amounts reclassified to net earnings	14
	(36)
Ownership share of equity method investment:	
Other comprehensive income, before reclassifications to net earnings	21
Amounts reclassified to net earnings	(2)
	19
Other comprehensive income, net of deferred income taxes	(7)
Comprehensive income	4,143
Comprehensive income attributable to noncontrolling interests	(3)

Comprehensive income attributable to FSP Corp	$4,140

Note X—Changes in accumulated other comprehensive income by component

The following table presents a rollforward of accumulated other comprehensive income, net of tax:

	Currency translation adjustments	Benefit plans	Equity method investment	Accumulated other comprehensive loss
Beginning balance, January 1, 20X1	$20	$(206)	$33	$(153)
Period change	10	(36)	19	(7)
Ending balance, December 31, 20X1	$30	$(242)	$52	$(160)

10.5.1 Equity method—foreign entity

Reporting entities should also apply the guidance applicable to OCI and cumulative translation adjustments accounted for in accordance with ASC 830 for equity method investments that are (or are part of) a foreign entity, and for domestic equity method investments that have an investment in a foreign entity. When the equity method is used, the reporting entity's financial statements should include a proportionate share of any investee's translation adjustments (e.g., when the investee has a subsidiary that is a foreign entity) in OCI, as well as its proportionate share of the direct effects of translating an equity method investee that reports in a foreign currency (e.g., the investee is a foreign entity). See FX 5 for further guidance on foreign currency translation adjustments.

10.6 Equity method investments—disclosures

ASC 323-10-50-1 through ASC 323-10-50-2 sets forth guidelines regarding disclosures that should be made in the financial statements of an investor when it accounts for investments under the equity method. The guidance states:

Excerpt from ASC 323-10-50-1

...references in this Subtopic to common stock refer to both common stock and in-substance common stock that give the investor the ability to exercise significant influence over the operating and financial polices of an investee even though the investor holds 50% or less of the common stock or in-substance common stock (or both common and in-substance common stock).

ASC 323-10-50-2

The significance of an investment to the investor's financial position and results of operations shall be considered in evaluating the extent of disclosures of the financial position and results of operations of an investee. If the investor has more than one investment in common stock, disclosures wholly or partly on a combined basis may be appropriate.

The guidance also indicates that investments may be appropriately combined or grouped, either wholly or in part, for disclosure purposes. In addition, the nature and extent of disclosures may vary based on the significance of an investment to the investor.

If the investee is a variable interest entity (VIE), the investor is required to make the equity method investment disclosures in accordance with ASC 323-10-50, in addition to the required disclosures for VIEs in ASC 810-10-50. Refer to FSP 18.4 for additional information on the required disclosures for VIEs.

ASC 323-10-50-3 requires the following disclosures with regard to equity method investments:

- *Name of each investee and percentage of ownership of common stock by the investor*

  Normally, the names of investees and the percentage owned would be included only for individually significant investees, for large holdings in publicly held investees, or where otherwise clearly informative to the users of financial statements. The percentage of ownership generally should be disclosed as a range where numerous individually immaterial investments in corporate joint ventures or other investees are accounted for under the equity method.

- *Accounting policies of the reporting entity with respect to investments in common stock*

  The name of any significant investee in which the investor holds 20% or more of the outstanding voting stock (or an ownership interest of 3% to 5% for investments in limited partnerships, limited liability companies, trusts and similar entities), for which the investment is not accounted for under the equity method, should be disclosed. The reasons why the equity method is not considered appropriate should also be disclosed. Additionally, the name of any significant investee in which the investor holds less than 20% of the outstanding voting stock (or an ownership interest of 3% to 5% for investments in limited partnerships, limited liability companies, trusts and similar entities)in circumstances where such investment is accounted for under the equity method should be disclosed, along with the reasons why such treatment is considered appropriate.

- *Difference, if any, between the amount at which an investment is carried and the amount of underlying equity in net assets, and the accounting treatment for the basis difference*

  Intra-entity (intercompany) income eliminations, as well as other basis differences such as goodwill, should be disclosed. Basis differences are discussed further in FSP 10.4.1.4 and EM 3.3.1.

- *Market value of investments in common stock for which a quoted market value is available*

  If specific circumstances lead the reporting entity to decide not to disclose this information (e.g., when the market for a stock is thin and quoted market value may not be representative of the investor's holding), the reporting entity should disclose the reasons for reaching that determination.

- *Summarized information as to assets, liabilities, and results of operations of investees, either individually or grouped*

  The disclosure of summarized financial information is also required under SEC rules. While the disclosure requirement for summarized financial information in ASC 323-10-50-3(c) is more

general in nature, the SEC disclosure requirement provides specific guidance as to the financial captions that should be disclosed.

S-X 4-08(g) sets forth disclosure requirements for annual periods, and S-X 10-01(b)(1) stipulates interim disclosure requirements. Refer to FSP 10.6.1 and FSP 10.6.2 for further discussion of SEC disclosure requirements on an annual and interim basis, respectively. If an investment accounted for by the equity method exceeds 20% based on the investment test or income test as defined in S-X 1-02(w), separate financial statements—not just summarized financial information—are required in the investor's Form 10-K in accordance with S-X 3-09.

- *Material effects of possible conversions, exercises, or contingent issuances of investee securities that would significantly affect the investor's share of reported earnings or losses of the investee*

  Investee common stock equivalents and dilutive securities are taken into account in computing the investor's earnings per share (see ASC 323-10-50-3(d)). Disclosure of the potential effects should normally be made only if the conversion, exercise, or issuance would significantly change the investor's share of investee net assets or reported income. Otherwise, disclosures should be limited to the nature of the contingency and the effect on income for the most recent period and financial position at the end of the period. Refer to FSP 7 for further discussion of EPS considerations.

Equity method investments may also generate temporary differences for tax purposes that must be disclosed under ASC 740. Refer to FSP 16 for required disclosures related to deferred taxes. In addition to those disclosures, ASC 323-740-S99-1, *Taxes of Investee Company*, indicates that if an equity method investee's effective tax rate differs by more than 5% from the statutory Federal income tax rate, the investor is required to disclose the tax components of the reconciliation if such information is available and material to the investor's balance sheet or income statement.

10.6.1 Guarantee issued by investor on behalf of equity method investee

As further described in EM 3.2.3, an investor may issue a guarantee to a third party on behalf of an equity method investee. In such situations, the investor should consider the guidance in ASC 460, *Guarantees,* and if applicable record a liability to reflect its obligation. ASC 460 does not prescribe a specific account for the guarantor's offsetting entry when it recognizes a liability at the inception of a guarantee. That offsetting entry depends on the circumstances in which the guarantee was issued. See ASC 460-10-55-23 for implementation guidance.

Subsequent accounting for the guarantee would be in accordance with ASC 460, and therefore would not impact the carrying amount of the equity method investment (i.e., the subsequent accounting for the equity method investment is governed by ASC 323). Subsequent changes in the fair value of the guarantee would be recorded separately from the equity method investment.

FSP 23.6 illustrates the required disclosures when accounting for a guarantee.

10.6.2 Disclosures required if fair value option is elected

If a reporting entity would have accounted for an investment using the equity method, but instead elected to use the fair value option, the reporting entity must include certain disclosures for equity method investments as required by ASC 825-10-50-28(f). See FSP 20.6.3.2 for discussion of these disclosure requirements.

10.6.3 *Annual summarized financial information—equity method investees*

SEC rules provide significance thresholds for determining whether an SEC registrant is required to provide summarized financial information under S-X 4-08 and/or full separate financial statements under S-X 3-09 relating to an unconsolidated subsidiary or equity method investee. The rules are regarded by the SEC as an interpretation of ASC 323-10-50-3, which states that summarized financial information or separate statements may be required for equity investees if the investments are material in relation to the investor's financial position or results of operations.

S-X 4-08(g) requires reporting entities to disclose summarized financial information of unconsolidated subsidiaries and equity method investees for all periods presented if any one of the three significant subsidiary tests outlined in S-X 1-02(w) exceeds 10% on an individual basis or on an aggregated basis for any combination of unconsolidated subsidiaries or equity method investees for any of the periods presented.

In accordance with FRM 2420.5, if separate financial statements of significant investees are included in an annual report to shareholders or a Form 10-K (as required by S-X 3-09), the summarized data required by S-X 4-08(g) is not required for those entities. In some cases, the financial statements required by S-X 3-09 are not filed concurrent with the Form 10-K, but rather are filed by amendment at a later date. In such cases, the SEC registrant may not omit the summarized financial information for the significant investees from the financial statements in its initial Form 10-K filing.

If required, the summarized financial information disclosures must include, at a minimum, the following financial statement captions:

- Current assets
- Noncurrent assets
- Current liabilities
- Noncurrent liabilities
- Redeemable preferred stock
- Noncontrolling interest
- Net sales or gross revenue
- Gross profit (or alternatively, costs and expenses applicable to net sales or gross revenues)
- Income or loss from continuing operations
- Net income or loss
- Net income or loss attributable to the entity

If the balance sheet is not classified, information should be provided that indicates the nature and amount of major components of assets and liabilities. In addition, for specialized industries, other information may be substituted for sales and related costs if they are more meaningful.

Once the significance test is triggered, summarized financial information for all equity investees must be disclosed in the aggregate or individually (not just those that are significant individually). In other words, there is not a materiality threshold for individual entities that would exempt an investee from being included in the disclosures. In limited circumstances, the exclusion of such data may be appropriate for certain entities where it is impractical to gather the information and such information is de minimis. Although aggregation is generally permitted, the SEC staff has, in certain circumstances, issued comments that it believes aggregation is misleading or suppresses important information. In those cases, the SEC staff has requested that certain investees be presented separately. Separate information may be requested for individual investees that are significant quantitatively or qualitatively. The SEC staff has indicated that the disclosure requirements of S-X 4-08(g) and S-X 3-09 also apply to investments accounted for using the fair value option if the investment would otherwise have been accounted for using the equity method.

10.6.4 Interim summarized financial information—equity method investees

S-X 10-01(b)(1) requires reporting entities to include in their interim financial statements separate summarized income statement information for each equity method investee for which (1) separate financial statements of the investee would be required for annual periods, and (2) the investee would be required to file quarterly financial information in Form 10-Q if the investee were a registrant (e.g., the investee would not be a foreign private issuer if it were a registrant).

As discussed in SEC FRM 2420, reporting entities should use the investment and income tests in S-X 1-02(w) (see FSP 10.6.1), substituting 20% for 10%, to determine whether “separate financial statements would otherwise be required for annual periods.” The investment tests would be based on the two balance sheets included in the Form 10-Q and the income tests would be based on the year-to-date income statements included in the Form 10-Q.

The minimum disclosures below must be included for each significant investee and may be aggregated with similar minimum disclosures for other significant investees. The information must be presented for both the current and prior comparative year-to-date periods included in the interim financial statements:

- Net sales or gross revenues
- Gross profit (or, alternatively, costs and expenses applicable to net sales or gross revenues)
- Income or loss from continuing operations
- Net income or loss, and
- Net income or loss attributable to the entity

S-X 10-01(b)(1) requires disclosure of income statement information in the interim financial statements, whereas the annual requirements under S-X 4-08(g) require summarized financial information for both the balance sheet and income statement. Additionally, interim disclosures are only required for the investees that meet the significance tests, whereas on an annual basis a reporting entity must disclose summarized financial information for all equity method investees once the significance test is triggered. As discussed in FRM 2420, registrants should omit income averaging when implementing the income test for interim financial statements.

There are distinct requirements for a reporting entity when assessing the significance of equity method investments and unconsolidated investments for interim periods under S-X 10-01(b)(1) and annual periods under S-X 4-08(g) and S-X 3-09. For example, a reporting entity may be required to include S-X 10-01(b)(1) disclosures for an interim period and not be required to provide financial statements of the investee under S-X 3-09 for the annual periods if significance changes by year end given that significance tests include different information (e.g., year-to-date income statement for the interim period as compared to the income statement for the full annual period).

10.7 Equity method investments—considerations for private companies

The guidance on presentation and disclosure of equity method investments is similar for private and public companies. However, the SEC has particular views regarding income statement presentation and additional rules surrounding the disclosure requirements for equity method investees.

As discussed in FSP 10.6, SEC registrants are required to disclose the tax components of the investee's effective tax rate if the investee's effective tax rate differs by more than 5% from the statutory Federal income tax rate. This disclosure is not required for private companies.

In addition, the SEC rules are more prescriptive with respect to disclosures required for summarized financial information of equity method investees. Summarized financial information of equity method investees is required to be disclosed under ASC 323 if the investments are material to the investor. However, judgment must be used to determine whether an investment is material to the balance sheet and income statement of the investor. In contrast, SEC rules establish significance tests which determine whether an investor is required to disclose the equity method investee summarized financial information.

S-X 4-08(g) also establishes the specific financial statement captions that must be included in the disclosure. In contrast, ASC 323 does not specify the captions that must be included in the summarized financial information.

Lastly, S-X 10-01(b)(1) specifies interim disclosure requirements for summarized financial information of equity method investees, while such information is not explicitly required under the ASC 270 minimum disclosure requirements.

10.7.1 Private company accounting alternatives

See FSP 10.4.1.6 for information on the implications of a private company investee's election of private company accounting alternatives on a public company investor's equity method accounting.

10.8 Joint venture entity disclosures – added September 2023

New guidance

In August 2023, the FASB issued ASU 2023-05, Business Combinations – Joint Venture Formations (Subtopic 805-60): Recognition and Initial Measurement. The new guidance is addressed in EM 6.4.

In the period in which the formation date occurs, a joint venture entity is required to disclose information that enables the users of its financial statements to understand the nature and financial effects of the joint venture formation. The disclosure requirements in ASC 805-60-50-2 indicate that the following should be disclosed in the period of formation:

- Formation date
- Description of the joint venture's purpose and why it was formed
- Formation date fair value of the joint venture as a whole
- Description of the assets and liabilities recognized at formation
- Amounts recognized for each major class of assets and liabilities at formation
- Qualitative description of factors that make up any goodwill recognized

In lieu of disclosure in the footnotes, a joint venture may elect to present a balance sheet as of the formation date that reflects the amounts recognized for each major class of assets and liabilities.

Additionally, if a measurement period is needed because the initial accounting for the joint venture formation is incomplete and therefore the amounts recognized in the financial statements are provisional, a joint venture entity is required to disclose the following:

- The reasons why the initial accounting is incomplete
- The assets, liabilities, noncontrolling interest or formation-date fair value of the joint venture entity as a whole for which the initial accounting is incomplete
- The nature and amount of any measurement period adjustments that are recognized in the period, including separately the amount of adjustments to current-period income statement line items relating to the income effects that would have been recognized in previous periods if the adjustment to provisional amounts was recognized as of the formation date

Chapter 11: Other liabilities—updated April 2022

11.1 Other liabilities overview

This chapter provides considerations for reporting entities related to liabilities that are not covered by other chapters within the FSP guide. It focuses on US GAAP and SEC requirements that a reporting entity should consider with regard to liabilities when preparing the financial statements and related disclosures.

This chapter identifies common liabilities and discusses related presentation and disclosure considerations. Topics discussed include:

- Accounts and notes payable
- Accruals (including warranty, environmental, employee compensation, restructuring, etc.)
- Asset retirement obligations
- Deferred revenue
- Liabilities held for sale

11.2 Other liabilities—classification

As discussed in FSP 2, a reporting entity should consider the ASC Master Glossary definition of current liabilities in preparing a classified balance sheet.

Definition from ASC Master Glossary

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

The discussion in this chapter does not address current versus noncurrent classification. Each reporting entity should consider their facts and circumstances in light of the ASC definition when determining how to classify liabilities in their financial statements.

11.3 Accounts and notes payable

Figure FSP 11-1 includes the items that are required by S-X 5-02(19)(a) to be stated separately on the balance sheet or disclosed in the footnotes. It also references the section in this guide where each item is discussed in more detail.

Figure FSP 11-1

S-X 5-02(19)(a) required balance sheet disclosures

Amounts payable to	Section
Trade creditors	FSP 11.3.1
Banks for borrowings	FSP 12
Holders of commercial paper	FSP 12
Factors or other financial institutions for borrowings	FSP 12
Related parties	FSP 26
Underwriters, promoters, and employees	FSP 11.3.2
Others	FSP 11.3.3

11.3.1 Trade creditors

This caption typically represents amounts owed to suppliers of goods and services that a reporting entity consumes through operations. There are numerous considerations that a reporting entity should evaluate related to these payables, the most common of which are discussed in the following subtopics.

11.3.1.1 Bank and book overdrafts

Book overdrafts—representing outstanding checks in excess of funds on deposit—should be classified as liabilities at the balance sheet date. Bank overdrafts—representing the total of checks honored by the bank that exceed the amount of cash available in the reporting entity's account—result in the creation of a short-term loan.

See FSP 6.5.1.2 and FSP 6.5.1.1 for presentation and disclosure considerations related to book and bank overdrafts.

11.3.1.2 Classification of outstanding checks

Non-authoritative guidance included in AICPA Q&A Section 1100.08 indicates that outstanding checks should be presented as a reduction of cash. As a result, in practice, most preparers present a liability on the balance sheet equal to only the amount of outstanding checks in excess of available cash and disclose that such liability is a reinstatement of liabilities cleared in the bookkeeping process.

Example FSP 11-1 illustrates the classification of outstanding checks covered by funds on deposit.

EXAMPLE FSP 11-1

Offset outstanding checks against cash deposits

FSP Corp has three separate bank accounts with the same bank: a deposit account, a main account, and a disbursement account. The deposit account is used by the reporting entity to accumulate deposits from customers. At the end of each business day, any amounts in the deposit account are

automatically swept into the main account. FSP Corp uses the disbursement account to write checks. Each day, the bank accumulates the total amount of the checks presented for payment and, pursuant to its account agreement with FSP Corp, sweeps an equal amount out of the main account into the disbursement account to cover the balance. According to the account agreement, the bank has a right to draw any amount from an account with a positive balance to cover an account with a negative balance. As of year-end, FSP Corp has a negative balance in its general ledger account for the disbursement account of $9 million (representing outstanding checks), a positive balance in its general ledger account for the main account of $8 million, and a zero balance in the deposit account.

How should FSP Corp present its cash accounts on its balance sheet?

Analysis

Because the bank has the ability to draw any amount from an account with a positive balance to cover an account with a negative balance, FSP Corp should offset the $8 million positive balance in the main account against the $9 million in outstanding checks (negative balance in the disbursement account). The net amount of $1 million should be reported as a current liability on FSP Corp's balance sheet.

11.3.1.3 Checks written but not released

Checks that have not been released by the end of the accounting period (i.e., not mailed or otherwise transmitted to the payee) should not be deducted from the cash balance (i.e., the related balances should still be reflected as cash and the related account payable or other liability).

11.3.1.4 Drafts payable

A draft is an order to pay a certain sum of money. It is signed by the drawer (e.g., an insurance company for a claim payment) and payable to order or bearer (e.g., an insurance policyholder). When the draft is presented to the drawee (i.e., the bank), it is paid only upon the approval of the drawer.

Drafts and checks have different legal characteristics. A check is payable on demand, whereas a draft must be approved for payment by the drawer before it is honored by the bank.

Drafts payable should be netted against the cash balance, similar to the treatment for outstanding checks. It is acceptable, however, for a reporting entity to present drafts payable gross as a liability if the total amount is disclosed either on the balance sheet or in a footnote. This approach recognizes that there is a legal distinction between a check and a draft. The policy election must be consistently applied.

11.3.1.5 Supplier finance programs—updated September 2022

Supplier finance programs may also be referred to as reverse factoring, payables finance, or structured payables arrangements. A reporting entity (i.e., the buyer) uses these programs to provide its suppliers of goods or services/vendors access to payment from a third-party finance provider or intermediary in advance of an invoice due date originally agreed with the buyer. It is common in such arrangements for the buyer to confirm the amount and validity of invoices to the finance provider in advance of the early payment offer. Although not determinative, one indicator that a reporting entity may have a supplier finance program is the commitment to pay a third party (other than the supplier) for a confirmed invoice without offset, deduction, or any other ability to avoid payment.

In determining whether an entity has established a supplier finance program, all available evidence should be considered, including arrangements between (1) the reporting entity and the finance provider or intermediary and (2) the reporting entity and its suppliers whose invoices the entity has confirmed as valid.

Balance sheet presentation

Depending on the reporting entity's level of involvement and whether or not the supplier finance program represents a financing of the original obligation, the terms of the supplier finance program could cause the substance of the liability to change from trade payable to debt. This change in classification could affect a reporting entity's leverage ratios, and possibly, its covenants.

The presentation of supplier finance programs is not addressed directly in authoritative literature. When entering into supplier finance programs, a reporting entity should weigh the evidence to determine whether the obligations in the program are more akin to a trade payable or debt. Program terms differ, and even similar programs in different markets or jurisdictions may be accounted for differently because of variations in industry norms and laws by jurisdiction.

When evaluating whether an obligation is more akin to a trade payable or debt, a reporting entity should consider:

- Are the terms of the payable typical for the specific reporting entity and industry? Said differently, would a supplier offer those terms to the reporting entity absent any other considerations?
- As a result of the supplier finance program, was the payable modified so significantly such that it should be considered a new arrangement?

Figure FSP 11-2 details factors a reporting entity should consider to determine whether an obligation in a supplier finance program should be presented as a trade payable or debt financing.

Figure FSP 11-2

Supplier finance programs—classification considerations

Program terms	**Indicates that the economic substance of the obligation could remain consistent with that of a trade payable**	**Indicates that the economic substance of the obligation could be more consistent with debt**
What are each party's roles and responsibilities in the negotiations of the supplier finance program?	The reporting entity simply introduces the vendor and the financial institution/ intermediary.	The reporting entity is significantly involved in the negotiation of terms between its vendors and a financial institution/intermediary, or the reporting entity is a party to the arrangement.
Are credits still negotiated between the reporting entity and the vendor?	The reporting entity retains its right to negotiate with the vendor and its ability to realize negotiated credit memos.	The reporting entity does not retain its right to negotiate with the vendor and loses the ability to realize negotiated credit memos.

Program terms	Indicates that the economic substance of the obligation could remain consistent with that of a trade payable	Indicates that the economic substance of the obligation could be more consistent with debt
Is the program offered to a wide range of companies or by a wide range of vendors? Is vendor participation in the program voluntary?	The program is available to a broad range of vendors. While we do not believe that the arrangement needs to be offered to all of the reporting entity's vendors (or to all buyers of those suppliers), availability of a program to a broad range of vendors is a helpful indicator.	There are a limited group of vendors or buyers, or the program mandates that the vendor accept an early payment for an amount less than the invoice.
Has the financial institution obtained any new rights, such as the ability to decide which vendor invoices get paid?	The financial institution/ intermediary has not obtained any rights that the vendor did not have before the start of the program.	The arrangement results in the financial institution/ intermediary receiving new rights that the vendor did not have before the supplier finance program.
How are fees calculated when the reporting entity uses a paying agent's accounts payable platform?	The servicing fee paid to the buyer (if any) is in line with a typical paying arrangement. A servicing fee does not in and of itself change the nature of the transactions being serviced as long as it is in line with a typical paying arrangement.	Servicing or other fees earned by the reporting entity are variable based on vendor participation.
Are the terms of the payables consistent with those that other buyers would obtain without a supplier finance program?	Invoice terms between the buyer and vendor are similar to those typically offered by vendors to other buyers without supplier finance programs.	Payment terms are extended beyond industry norms.
Is the purpose of the transaction in substance an effort by the reporting entity to finance trade payables by extending terms beyond industry norms?	The terms of the invoice are not changed or extended from the terms originally negotiated between the buyer and vendor.	Terms are extended or otherwise designed to allow the reporting entity to finance the payment contractually due to the vendor.
Is the reporting entity's parent jointly and severally liable for the obligation?	There is no parent guarantee, as parent guarantees are not typical of trade payables. However, if the obligation was already implicitly guaranteed, making it explicit via the supplier finance program, this may not, in and of itself, make the obligation debt if the	The obligation was not already implicitly guaranteed, but a guarantee was made explicit via the supplier finance program.

Program terms	Indicates that the economic substance of the obligation could remain consistent with that of a trade payable	Indicates that the economic substance of the obligation could be more consistent with debt
	guarantee is the only "debt-like" characteristic. Determination of whether an obligation was already implicitly guaranteed requires judgment.	
Has the legal character of the obligations changed?	There are no changes in legal character.	There are changes to the obligation such that it is no longer consistent with a UCC-compliant trade payable.

Notwithstanding these considerations, the presence of certain terms may suggest that the obligation is, in substance, debt. These include:

- An incremental increase in the price of the goods to compensate vendors who provide extended payment terms
- The original liability being extinguished
- Interest accruing on the balance prior to the due date (although penalties for non-payment may be imposed after that)
- The financial institution having the right to draw on the reporting entity's other accounts without its permission if the designated payment account has insufficient funds, if not part of the reporting entity's normal banking arrangement
- Altering the trade payable's seniority in the reporting entity's capital structure
- Requiring the reporting entity to post collateral on the trade payable
- Default on invoice payment under the arrangement triggering a cross-default (other than a general debt obligation cross-default)

Balance sheet classification of the liability also impacts the statement of cash flows. See FSP 6.8.9 for discussion of the statement of cash flows classification.

Example FSP 11-2 illustrates the application of the accounts payable versus debt classification considerations.

EXAMPLE FSP 11-2

Supplier finance programs — accounts payable versus debt classification

FSP Corp and its financial institution ask certain of FSP Corp's vendors to enter into a new payment program. Under the payment program, the financial institution pays the vendors directly and participates in an early pay discount that the vendors offer for invoices paid within 15 days. FSP Corp

is then obligated to pay the financial institution the agreed-upon amount at the invoice due date. The amount FSP Corp pays the financial institution at the due date is less than the full amount of the invoice because the financial institution has offered FSP Corp a portion of the early pay discount it receives from the vendor.

Should FSP Corp classify the payable to the financial institution as accounts payable?

Analysis

No. The arrangement between the financial institution and FSP Corp results in FSP Corp securing financing at a lower cost of funds than in the vendor's original invoice. FSP Corp received an early-pay discount for which it was not otherwise eligible. As such, FSP Corp should derecognize its trade account payable and record a new liability classified on its balance sheet as a borrowing from the lender.

Further, FSP Corp's statement of cash flows should reflect an operating cash outflow and financing cash inflow related to the affected trade payable balances, and a financing cash outflow upon payment to the financial institution and settlement of the obligation. See FSP 6.8.9 for discussion of the statement of cash flows classification of supplier finance programs.

New guidance

In September 2022, the FASB issued ASU 2022-04, *Disclosure of Supplier Finance Program Obligations*, which requires disclosures about supplier finance programs. While this standard does not address the accounting for or financial statement presentation of these arrangements, it requires specific disclosures intended to enhance transparency, such as key terms of the program, amounts outstanding, balance sheet presentation, and associated rollforward information. These disclosures are required for supplier finance programs, regardless of the financial statement presentation (i.e., as trade payables or as debt) of the related liabilities. Traditional paying agent arrangements discussed in FSP 11.3.1.6 are not in the scope of ASU 2022-04.

For all entities, the amendments are effective for fiscal years beginning after December 15, 2022, including interim periods with those fiscal years, except for the requirement to disclose rollforward information, which is effective for fiscal years beginning after December 15, 2023. Early adoption is permitted.

The amendments should be applied retrospectively to each period in which a balance sheet is presented, except for the amendment on rollforward information, which should be applied prospectively. During the fiscal year of adoption, the information on the key terms and balance sheet presentation, which are annual disclosure requirements, should also be disclosed in each interim period. For example, for a calendar year-end entity, disclosure of the amounts outstanding, key terms, and balance sheet presentation is required beginning in the first quarter 2023 financial statements. Disclosure of the rollforward information would first be required in the 2024 annual financial statements.

Required disclosures after adoption of ASU 2022-04

Reporting entities that use supplier finance programs must disclose sufficient information to enable users of financial statements to understand the nature and potential magnitude of the programs,

activity during the period, and changes from period to period. There are both annual and interim disclosure requirements included in ASC 405-50-50-3 through ASC 405-50-50-4. If a reporting entity uses more than one supplier finance program, it may aggregate disclosures, but not to the extent that useful information is obscured by the aggregation of programs that have substantially different characteristics.

The following disclosures are required in annual periods.

- Key terms of the program including, but not limited to:
  - A general description of the payment terms, including payment timing and the basis for its determination
  - Assets pledged as security or other forms of guarantees provided for the committed payment to the finance provider or intermediary

  See ASC 405-50-55-1 through 405-50-55-3 for an illustrative example of the disclosure of key terms.

- Obligations confirmed as valid under the program:
  - Amount outstanding that remains unpaid by the entity at the end of the reporting period and where those obligations are presented in the balance sheet (if there is more than one balance sheet line item, disclose the amount in each line item)
  - Rollforward of the obligations that includes, at a minimum, all of the following:
    - Amount outstanding at the beginning of the reporting period
    - Amounts added to the program during the reporting period
    - Amounts settled during the reporting period
    - Amount outstanding at the end of the reporting period.

  See ASC 405-50-55-4 through 405-50-55-5 for an illustrative example of the rollforward disclosure.

In interim periods, a reporting entity should disclose the amount of obligations confirmed as valid that remain outstanding at the end of the reporting period. Also, during the fiscal year of adoption, the information on the key terms and balance sheet presentation, which are annual disclosure requirements, should also be disclosed in each interim period.

11.3.1.6 Liabilities settled through paying agents

In some circumstances, a reporting entity may engage a financial institution to operate solely as a paying agent by entering into arrangements that allow for the financial institution to make payments on its behalf. In some instances, these arrangements may allow the reporting entity to participate in rebates or "rewards" programs based on transaction volume. Generally, a reporting entity settles the

outstanding obligations to the paying agent within the same time period that the reporting entity would have settled the vendor payable, absent a paying agent.

Transaction types vary, and include:

- *P-cards*

  Employees of the reporting entity make small-dollar purchases, and the reporting entity owes the financial institution issuing the credit card directly. Generally, payment terms are 30–60 days from closure of the billing period, though in some cases, a higher volume of purchases may drive a shorter payment period.

- *e-payables*

  A reporting entity charges its trade payables to virtual credit cards, thus settling the obligations to the vendors and creating new obligations to financial institutions. Generally, e-payables allow for larger dollar purchases than p-cards, and are also generally payable 30 days after billing period closure, similar to standard credit card arrangements.

- *Clearing accounts*

  Vendors (often of health care companies) have access to a bank account in the reporting entity's name and can post charges directly to that account.

  In some circumstances, the use of these payment mechanisms may result in a change in the legal form of a reporting entity's liability because it pays a paying agent who had paid off and extinguished the reporting entity's obligation to a third-party vendor.

  Although the reporting entity may now be legally obligated to make payment to the financial institution, this arrangement may still be classified as a trade payable since the payable arose from normal operating purchases and no financing costs are involved. Trade payable designation may still be acceptable if (1) payment is made quickly (within the month) and (2) the arrangement is more for convenience than financing. This may be true even if rebates are received from the card issuer based on the volume of use.

  See FSP 6.8.1.1 for discussion of classification in the statement of cash flows when a paying agent is used.

11.3.2 Underwriters, promoters, and employees

S-X 5-02 requires reporting entities to separately present in the financial statements amounts payable to the following classes of individuals:

- Underwriters — Section 2(a)(11) of the 1933 Securities Act broadly defines the term "underwriter" as:

Excerpt from Section 2(a)(11) of 1933 Securities Act

The term "underwriter" means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission.

- Promoters — Rule 405 of the 1933 Securities Act defines a "promoter" as:

Excerpt from Securities Act of 1933, Rule 405

(i) Any person who, acting alone or in conjunction with one or more other persons, directly or indirectly takes initiative in founding and organizing the business or enterprise of an issuer; or

(ii) Any person who, in connection with the founding and organizing of the business or enterprise of an issuer, directly or indirectly receives in consideration of services or property, or both services and property, 10 percent or more of any class of securities of the issuer or 10 percent or more of the proceeds from the sale of any class of such securities. However, a person who receives such securities or proceeds either solely as underwriting commissions or solely in consideration of property shall not be deemed a promoter within the meaning of this paragraph if such person does not otherwise take part in founding and organizing the enterprise.

- Employees — The ASC Master Glossary defines an employee as an individual over whom a reporting entity can either exercise, or has the right to exercise, sufficient control to establish an employer-employee relationship

11.3.3 Accounts or notes payable to other parties

A reporting entity should report accounts or notes payable to other parties in addition to those discussed in FSP 11.3.1 through FSP 11.3.2. Others can include, but are not limited to, repurchase agreements. See FSP 22 for presentation and disclosure considerations related to repurchase agreements.

11.4 Accruals and other liabilities

S-X 5-02.20 and S-X 5-02.24 require reporting entities to separately state on the balance sheet or in the footnotes any item in excess of 5% of total current liabilities, or 5% of total liabilities not otherwise addressed by the specific categories of S-X 5-02. Given the broad definition of accruals and other liabilities, this section captures the more common disclosure considerations related to accruals and other liabilities, and provides an interpretation of certain specific disclosure requirements.

11.4.1 Dividends payable

See FSP 5 for presentation and disclosure considerations related to dividends payable and stock dividends.

11.4.2 Income taxes

See FSP 16 for presentation and disclosure considerations related to income taxes.

11.4.3 Employee benefits

Employee benefits is a broad topic and includes a number of subtopics. Subtopics covered within this guide include:

- Compensated absences (FSP 11.4.3.1)
- Rabbi trusts (FSP 11.4.3.2)
- Pension and other postemployment benefits (FSP 13)
- Stock-based compensation (FSP 15)

11.4.3.1 Compensated absences

ASC 710, *Compensation,* requires an employer to accrue a liability, considering anticipated forfeitures, related to employees' compensation for future absences if all of the following criteria are met:

- The employer's obligation relating to employees' rights to receive compensation for future absences is attributable to services already rendered by the employee
- The obligation relates to rights that accumulate or vest
- Payment is probable
- The amount of payment is reasonably estimable

In certain instances, a reporting entity may have to disclose a liability even if it has not yet been recorded. ASC 710-10-50 requires a reporting entity to disclose compensated absences if the employer meets the first three criteria listed above, but the amount is not reasonably estimable.

11.4.3.2 Rabbi trusts

ASC 710 addresses the accounting for deferred compensation when a portion of an employee's compensation (e.g., bonuses) is invested in the stock of the employer (or other securities) and placed in a "rabbi trust." These invested assets are in the name of the employer and not the employee. Accordingly, the accounts of the rabbi trust should be consolidated with the accounts of the employer in the employer's financial statements. Depending on the provisions of the plan, an employee might be allowed to immediately diversify their stock held in the rabbi trust into nonemployer securities or to diversify after a holding period; other plans do not allow for diversification. The deferred compensation obligation of such plans may be settled in (1) cash, by having the trust sell the employer stock (or the diversified assets) in the open market, (2) shares of the employer's stock, or (3) diversified assets. Some plans restrict the manner of settlement to only delivery of the shares of the employer stock.

Assets held by the rabbi trust

Although placement of assets in a rabbi trust prevents the plan participants from being deemed to have constructively received the assets (thus deferring the taxation of that compensation), rabbi trusts are not protected from the general creditors of the reporting entity. Therefore, assets held in the rabbi trust are accounted for based on their nature like other investments held by the reporting entity.

Employer stock held by a rabbi trust should be classified and accounted for in equity in the consolidated financial statements of the employer in a manner similar to treasury stock (i.e., changes in fair value are not recognized). This presentation is required regardless of whether the deferred compensation obligation may be settled in cash, shares of the employer's stock, or diversified assets.

Diversified assets held by a rabbi trust should be accounted for in accordance with the applicable US GAAP for the particular asset. For example, if the diversified asset is a debt security, that security would be accounted for in accordance with ASC 320, *Investments—Debt Securities* and classified as trading, available-for-sale, or held-to-maturity, depending on the nature and risks of the security.

Deferred compensation obligation

For plans that permit diversification or cash settlement at the option of the employee, the deferred compensation obligation should be classified as a liability and adjusted to reflect changes in the fair value of the amount owed to the employee. Changes in the fair value of the deferred compensation obligation should be recorded in the income statement, even if changes in the fair value of the assets held by the rabbi trust are recorded in other comprehensive income pursuant to ASC 320.

When diversification is not permitted and the deferred compensation obligation is required to be settled by delivery of a fixed number of shares of employer stock, the deferred compensation obligation should be classified in equity. Changes in the fair value of the amount owed to the employee should not be recognized in the rabbi trust liability.

For the EPS implications for rabbi trusts, see FSP 7.

11.4.4 Restructuring

ASC 420, *Exit or Disposal Cost Obligations*, addresses significant issues related to the recognition, measurement, and reporting of costs associated with exit and disposal activities, including restructuring activities.

11.4.4.1 Presentation and disclosure - exit or disposal obligations

The FASB has specified certain classification requirements related to costs and reversal of liabilities that are often relevant for exit and disposal costs.

ASC 420-10 requires extensive disclosures in the footnotes in the period in which an exit or disposal activity is initiated and until that activity is completed. Disclosures related to one-time termination benefits are principally focused on the amount to be paid.

ASC 420-10-50-1 requires all of the following information to be disclosed in the footnotes. The disclosures required must be made in all periods, including interim periods, until the exit plan is completed.

Excerpt from ASC 420-10-50-1

a. A description of the exit or disposal activity, including the facts and circumstances leading to the expected activity and the expected completion date

b. For each major type of cost associated with the activity (for example, one-time employee termination benefits, contract termination costs, and other associated costs), both of the following shall be disclosed:

   1. The total amount expected to be incurred in connection with the activity, the amount incurred in the period, and the cumulative amount incurred to date

   2. A reconciliation of the beginning and ending liability balances showing separately the changes during the period attributable to costs incurred and charged to expense, costs paid or otherwise settled, and any adjustments to the liability with an explanation of the reason(s) why.

c. The line item(s) in the income statement or the statement of activities in which the costs in (b) are aggregated

d. For each reportable segment, as defined in Subtopic 280-10, the total amount of costs expected to be incurred in connection with the activity, the amount incurred in the period, and the cumulative amount incurred to date, net of any adjustments to the liability with an explanation of the reason(s) why

e. If a liability for a cost associated with the activity is not recognized because fair value cannot be reasonably estimated, that fact and the reasons why.

The reconciliation footnote prescribed in ASC 420-10-50-1(b)(2) is intended to address potential concerns regarding the comparability of information, as well as to provide information that will aid users of the financial statements in assessing the effects of these activities over time. In addition, ASC 420-10-50-1(d) requires disclosure of the amount of costs incurred and expected to be incurred in connection with exit and disposal activities by reportable segment, for both the current period and cumulative amounts to date. In the event a reporting entity recognizes liabilities for exit costs and involuntary employee termination benefits relating to multiple exit plans, it should generally present separate information for each material individual exit plan.

If a liability for costs associated with an exit or disposal activity is not recognized when management commits to a restructuring plan, ASC 420 requires that a reporting entity disclose information regarding the costs the entity expects to incur in connection with those activities. This provides users of the financial statements with the necessary information to assess the effects of the activity, both initially and over time.

Each provision for asset write-downs and similar allowances should be disclosed separately and distinguished from provisions for restructuring charges. For example, amounts should be disclosed separately for write-downs of PP&E, intangible assets, inventory, litigation costs, and environmental clean-up costs. A reporting entity should be careful when grouping together exit and involuntary termination costs, as the SEC staff has often requested greater disaggregation and more precise labeling in the income statement line items and footnotes when reporting entities group these costs together.

Provisions and write-downs unrelated to a formal restructuring plan should be disclosed separately from those charges arising as a result of a discretionary exit decision.

Question FSP 11-1 addresses the classification of inventory markdowns due to restructuring activities.

Question FSP 11-1

How should the markdown of inventory be classified when it is due to activities taken in connection with a restructuring decision?

PwC response

As discussed in SAB Topic 5.P.4 (codified in ASC 420-10-S99-2), the SEC staff recognized that there may be circumstances in which a reporting entity might assert that inventory markdowns are costs directly attributable to a decision to exit or restructure an activity. However, given the difficulty in distinguishing inventory markdowns attributable to a decision to exit or restructure from those markdowns that are attributable to external market factors, the SEC staff has indicated that inventory markdowns should be classified in the income statement as a component of costs of goods sold.

The SEC staff has also indicated that reporting entities should evaluate restructuring liabilities at each balance sheet date (annual and interim) to ensure that unnecessary amounts are reversed in a timely manner. Disclosure should be provided when material reversals are made. A reversal of a liability should be recorded in the same income statement line item that was used when a liability was initially recorded. Amounts determined to be in excess of those required for the stated restructuring activity may not be used for other payments. The SEC staff has emphasized that costs incurred in connection with an exit plan should be charged to the exit accrual only to the extent that those costs were specifically included in the original estimation of the accrual. Costs incurred in connection with an exit plan not specifically contemplated in the original estimate of the liability should be charged to expense in the period in which they are incurred.

ASC 420-10 does not require that reporting entities disclose specific information about the number of employees or the employee groups that are to be terminated. However, reporting entities are not precluded from voluntarily providing such information.

11.4.4.2 Income statement presentation - exit or disposal obligations

Reporting entities are not prohibited from separate income statement presentation of costs associated with exit or disposal activities covered by ASC 420, excluding those activities that involve a discontinued operation. However, ASC 420 requires classification of those costs as part of income from continuing operations before income taxes.

The SEC provides additional guidance in SAB Topic 5.P.3 (codified in ASC 420-10-S99-1) about the appropriate presentation of exit or disposal costs for SEC registrants.

Excerpts from ASC 420-10-S99-1

...[t]he staff believes that restructuring charges should be presented as a component of income from continuing operations, separately disclosed if material. Furthermore, the staff believes that a separately presented restructuring charge should not be preceded by a sub-total representing "income from continuing operations before restructuring charge" (whether or not it is so captioned). Such a presentation would be inconsistent with the intent of FASB ASC Subtopic 225-20.

...The staff believes that the proper classification of a restructuring charge depends on the nature of the charge and the assets and operations to which it relates. Therefore, charges which relate to activities for which the revenues and expenses have historically been included in operating income should generally be classified as an operating expense, separately disclosed if material.

To be consistent with the guidance in ASC 420, we believe the earnings per share effect of exit and disposal costs should not be disclosed on the face of the income statement. Additionally, revenue, related costs, and expenses that will not be continued should not be netted and reported as a separate component of income unless they qualify as discontinued operations. See FSP 27 for discussion of presentation and disclosure requirements associated with discontinued operations.

11.4.5 *Warranty*

Although product warranties are excluded from the recognition and measurement requirements of ASC 460, *Guarantees,* they are still subject to certain of its disclosure requirements. Specifically, ASC 460-10-50-8(b) and ASC 460-10-50-8(c) require the reporting entity providing the warranty to disclose its accounting policy and methodology used in determining its liability for product warranties. The reporting entity should provide a tabular reconciliation of the changes in its aggregate warranty liability for each year an income statement is presented in the financial statements.

Extended warranty contracts are subject to the guidance in ASC 606, including related disclosures. Refer to FSP 33.3.

Figure FSP 11-3 includes an example of the reconciliation of product warranty that should be presented for all income statement periods presented.

Figure FSP 11-3

Sample disclosure — reconciliation of product warranty liability

	For the year ended December 31, 20X1
Balance at the beginning of the period	$5,000
Accruals for warranties issued	1,225
Accruals related to pre-existing warranties (including changes in estimates)	375*
Settlements made (in cash or in kind)	(2,750)
Impact of foreign exchange rate changes	80*
Balance at the end of the period	$3,930

* Could be an increase or (decrease).

In addition to this tabular reconciliation, reporting entities should consider including narrative disclosure to explain any significant changes or unusual items presented in the table.

11.4.6 Unconditional promises to give

ASC 720, *Other Expenses*, provides guidance on the recognition and measurement of accounting for contributions, including an unconditional promise to give. Unconditional promises (e.g., pledges to a not-for-profit organization) are any promises that depend only on the passage of time or demand by the promissee for performance. Disclosures for the makers of these promises and indications of the intention to give are included within ASC 450, *Contingencies* (see FSP 23), and ASC 470, *Debt* (see FSP 12).

11.4.7 Legal or contractual liability versus contingent liability

A liability represents a present obligation by a reporting entity to transfer or provide an economic benefit to others (e.g., pay cash, convey assets, perform services). Many obligations that qualify as liabilities stem from contracts or other arrangements that are legally enforceable by the government or the courts.

For contractual or legal obligations, there is generally no uncertainty about whether a liability exists once the obligating event has occurred (e.g., receiving a product that the reporting entity ordered even though an invoice has not been received or completing a sale that subjects the reporting entity to a tax on that sale). After the obligating event has occurred, probability of the reporting entity potentially settling the liability for an amount other than the calculated legal or contractual obligation is not relevant in measuring the liability.

On the other hand, a contingent liability involves uncertainty about whether a loss has been incurred. A liability for a contingent loss should be accrued only if the loss is both (1) probable and (2) reasonably estimable. See FSP 23.4.

Question FSP 11-2

Can a reporting entity consider administrative practices and precedents when measuring a liability for an unpaid tax that is not in the scope of ASC 740, *Income Taxes*?

PwC response

Maybe. The concept of administrative practices and precedents is codified in GAAP only in the context of income taxes within the scope of ASC 740. While there is no explicit authoritative guidance in GAAP that addresses this concept in the context of measuring a liability for an unpaid tax, ASC 105, *Generally Accepted Accounting Principles*, allows reporting entities to analogize to accounting guidance for similar transactions. A legal obligation under the tax law may be considered similar to an income tax obligation under the tax law. Therefore, in limited situations, and subject to sufficient evidence of the relevant taxing authority's behavior, it may be acceptable for a reporting entity to consider administrative practices and precedents in measuring a liability for unpaid taxes that are not in the scope of ASC 740. As described in TX 15.3.1.4, administrative practices and precedents represent situations in which a tax position could be considered a technical violation of tax law, but the relevant taxing authority has a widely known, well understood, and consistent practice of nevertheless accepting the taxpayer's position (with full knowledge of the position being taken and the taxpayers

underlying circumstances). By definition, administrative practices and precedents are specific to each jurisdiction and each type of tax position and they depend on observed behavior by the taxing authority, not merely an expectation of (1) the taxing authority's willingness to negotiate, or (2) past, ad hoc, amnesty programs. However, if a taxing authority has published administrative procedures or otherwise widely known and well understood consistent practices, we believe it would be acceptable for a taxpayer to consider them when assessing measurement of a liability for unpaid non-income-based taxes. Application of this concept outside of ASC 740 should be approached with caution and significant judgment will be required to determine whether it is appropriate to consider administrative practices and precedents to reduce the measurement of what is otherwise a legal liability. Alternatively, it would generally be appropriate to assume application of the relevant statute as written until the liability is settled with the relevant taxing authority.

Once recognized, a legal or contractual liability should be derecognized when the liability derecognition guidance in ASC 405-20-40-1 is met, unless addressed by other guidance.

ASC 405-20-40-1

Unless addressed by other guidance (for example, paragraphs 405-20-40-3 through 40-4 or paragraphs 606-10-55-46 through 55-49), a debtor shall derecognize a liability if and only if it has been extinguished. A liability has been extinguished if either of the following conditions is met:

a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes the following:

    1. Delivery of cash

    2. Delivery of other financial assets

    3. Delivery of goods or services

    4. Reacquisition by the debtor of its outstanding debt securities whether the securities are cancelled or held as so-called treasury bonds.

The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor. For purposes of applying this Subtopic, a sale and related assumption effectively accomplish a legal release if nonrecourse debt (such as certain mortgage loans) is assumed by a third party in conjunction with the sale of an asset that serves as sole collateral for that debt.

Example FSP 11-3 and Example FSP 11-4 illustrate the accounting for interest and penalties resulting from a failure to remit sales tax.

EXAMPLE FSP 11-3

Interest and penalties — legal liability versus loss contingency

FSP Corp appropriately collected sales tax from its customers in State X. However, FSP Corp failed to timely remit the sales tax collected to State X. The relevant statute in State X includes explicit provisions requiring a company to pay interest and penalties in the event sales tax is not appropriately remitted.

Should FSP Corp record a liability for the interest and penalties in the period in which such amounts were incurred or assess as a loss contingency under ASC 450, *Contingencies*?

Analysis

In this example, the characteristics of a liability have been met: (a) FSP Corp has a present obligation to pay interest and penalties once it failed to timely remit the sales tax collected from its customers to the appropriate state taxing authority; and (b) FSP Corp has a legal obligation, in accordance with the statute, to pay cash to the taxing authority as a result of the unremitted sales tax.

Therefore, in addition to the base sales tax amounts, FSP Corp should accrue a liability for statutory interest and penalties as a result of its failure to remit sales tax. The liability for the penalties was incurred at the point in time FSP Corp failed to timely remit the sales tax collected; the liability for interest was incurred at the statutorily specified rate over time as the amounts remained unpaid.

EXAMPLE FSP 11-4

Interest and penalties — accounting for future abatements

Assume the same facts as Example FSP 11-3, but in this case for State Y. State Y's statutes also include provisions for voluntary disclosure filings to abate penalties (and possibly interest). Based solely on discussions with FSP Corp's legal and tax departments, FSP Corp expects that the accrued interest and penalties liability balance owed will be reduced by 50% within six months.

Should FSP Corp adjust the interest and penalties liability balance today for anticipated settlements or abatements?

Analysis

In cases where a specific violation of tax law has occurred (e.g., failure to timely remit sales tax collections), the amount of interest and penalties due to the state taxing authorities is generally fixed, determinable, and not subject to uncertainty. The abatement provisions in State Y's statute do not defease the original liability until a waiver is granted by the applicable state taxing authority. Thus, the abatement of such amounts is not solely within the control of FSP Corp.

As such, liabilities initially recorded for interest and penalties should not be adjusted for anticipated settlements or abatements until FSP Corp is legally released of its obligation to remit interest and penalties, which generally occurs at the time the state notifies FSP Corp of the abated amount due.

11.5 Environmental accruals

ASC 410-30, *Environmental Obligations*, provides accounting considerations related to the recognition, measurement, presentation, and disclosure of environmental remediation liabilities. ASC 410-30-55 provides illustrations and examples of the disclosure requirements related to environmental remediation liabilities, environmental remediation costs, loss contingencies, and liabilities with numerous potential outcomes. The following section provides a discussion of the presentation and disclosure considerations for environmental obligations. Additionally, see FSP 24 for presentation and disclosure considerations related to risks and uncertainties and FSP 23.4.3 for discussion of insurance recoveries related to environmental obligations.

ASC 410-30-10-1 discusses when a reporting entity should recognize a liability relating to environmental remediation.

ASC 410-30-10-1

This Subtopic requires that an entity recognize a liability for obligations associated with environmental remediation liabilities that relate to pollution arising from some past act, generally as a result of the provisions of Superfund, the corrective-action provisions of the Resource Conservation and Recovery Act, or analogous state and non-U.S. laws and regulations.

As discussed in ASC 410-30-25-16, environmental contamination costs are generally expensed. ASC 410-30-25-18 allows for the capitalization of environmental remediation costs if certain criteria are achieved. For example, if a reporting entity is involved in an oil spill and decides to reinforce the hulls of oil tankers to improve the safety of the ships and prevent future oil spills, those costs may be capitalized. In addition, if a reporting entity acquires fixed assets to clean up an oil spill, it may capitalize the costs unless the assets do not have a future use. These assets should be classified on the balance sheet as current or noncurrent based on the ASC Master Glossary definitions. Presentation of the remediation liabilities and these related assets is discussed in the following section.

11.5.1 Presentation considerations-environmental remediation obligations

ASC 410-30-45-1 through ASC 410-30-45-6 details other presentation matters related to accrued liabilities and assets related to environmental remediation obligations. The guidance details the following points:

- *Balance sheet classification*

  Where a classified balance sheet is presented, a reporting entity should present separately the current and noncurrent portions of the environmental remediation liability recorded, based on the expected timing of settlement.

- *Right of setoff*

  If all conditions in ASC 210, Balance Sheet, are met, assets and liabilities related to environmental remediation activities may be reported net. However, as discussed in ASC 410-30-45-2, the FASB observed that it would be rare, if ever, that all of the conditions would be met for environmental remediation liabilities, the related insurance, and potential third-party recoveries.

- *Operating expense classification*

  As discussed in ASC 410-30-45-4, environmental remediation costs are required to be charged against operations since the events underlying the incurrence of the obligation relate to the reporting entity's operations. Any recoveries should be reflected in the same income statement line as the original expense. To the extent a reporting entity has earmarked assets for funding its environmental liabilities, the earnings on those assets should be reported as investment income.

- *Discontinued operations*

  A reporting entity should classify environmental remediation expenses and recoveries as discontinued operations if they meet the requirements in ASC 205-20, Discontinued Operations.

11.5.2 Required disclosures

ASC 410-30-50-4 through ASC 410-30-50-7 outlines the specific disclosure requirements with respect to environmental remediation obligations. They include:

- The undiscounted amount and the discount rate used in the present-value determinations (if a reporting entity utilizes a present value measurement technique).
- The disclosures required by ASC 275-10, *Risks and Uncertainties*, related to environmental remediation liabilities. See FSP 24 for disclosures related to risks and uncertainties.
- The disclosures required by ASC 450-20, *Contingencies,* related to environmental remediation loss contingencies. See FSP 23 for information about disclosure requirements for contingencies.

ASC 410-30-50-13 through ASC 410-30-50-17 provides additional guidance related to the disclosure of contingencies. It specifically reminds reporting entities that if there are existing laws and regulations to report the release of hazardous substances and begin a remediation study, those requirements would represent a loss contingency subject to the disclosure considerations within ASC 450-20.

11.5.3 Additional disclosure recommendations

ASC 410-30-50-8 through ASC 410-30-50-12 outlines the following disclosures that a reporting entity should consider, but that are not required.

- The event, situation, or circumstances that might trigger recognition of a loss contingency related to a reporting entity's remediation-related obligations (e.g., upon completion of a feasibility study)
- Policy concerning the timing of recognition of recoveries
- Additional specific disclosures related to the environmental remediation loss contingencies that would be useful to further a user's understanding of the reporting entity's financial statements
- Period over which disbursements for recorded amounts will occur
- Expected period for realization of recognized probable recoveries
- Estimated time frame for resolution of the uncertainty
- Reason why an estimate of a probable or reasonably possible loss or range of loss cannot be made, if applicable
- Specific considerations related to a specific site, including the total amount accrued for the site, the nature of any reasonably possible loss contingency, whether any other parties are involved and share in the obligation, status of regulatory proceedings, or estimated time frame for resolution of the remediation loss contingency

- Details related to the amount of environmental remediation costs recognized in the income statements (e.g., amount recognized in each period, recoveries credited to environmental remediation costs in each period, where costs are captured in financial statements, etc.)

11.5.4 SEC reporting considerations

For SEC registrants, important interpretative guidance with respect to product and environmental remediation liabilities is included in SAB Topic 5.Y, *Accounting and Disclosures Relating to Loss Contingencies* (codified in ASC 450-20-S99-1), and SAB Topic 10.F, *Presentation of Liabilities for Environmental Costs* (codified in ASC 980-410-S99-1). ASC 450-20-S99-1 indicates that product and environmental remediation liabilities are typically of such significance that specific disclosures regarding the judgments and assumptions underlying the recognition and measurement of the liabilities are necessary to prevent the financial statements from being misleading. The SEC staff has indicated that, in addition to the disclosures required by ASC 450 and ASC 410-30, it may be necessary to disclose the following information to prevent the financial statements from being misleading:

Excerpt from ASC 450-20-S99-1

- Circumstances affecting the reliability and precision of loss estimates.
- The extent to which unasserted claims are reflected in any accrual or may affect the magnitude of the contingency.
- Uncertainties with respect to joint and several liability that may affect the magnitude of the contingency, including disclosure of the aggregate expected cost to remediate particular sites that are individually material if the likelihood of contribution by the other significant parties has not been established.
- Disclosure of the nature and terms of cost-sharing arrangements with other potentially responsible parties.
- The extent to which disclosed but unrecognized losses are expected to be recoverable through insurance or other sources, with disclosure of any material limitation of that recovery.
- Uncertainties regarding the legal sufficiency of insurance claims or solvency of insurance carriers.
- The time frame over which the accrued or presently unrecognized amounts may be paid out.
- Material components of the accruals and significant assumptions underlying estimates.

ASC 450-20-S99-1 further states that reporting entities should disclose in the footnotes material liabilities that may occur upon the sale, disposal, or abandonment of a property related to site restoration, monitoring commitments, or other exit costs as a result of unanticipated contamination of assets. These disclosures would generally include the nature of the costs, total anticipated costs, total costs accrued to date, balance sheet classification of the accrued amounts (i.e., current versus noncurrent), and the amount of reasonably possible additional losses.

The SAB topic also states that if an asset held for sale will require remediation prior to the sale, or as a condition of sale, a footnote should describe how these future expenditures are considered in the

assessment of the asset's value. Additionally, a reporting entity should disclose if it may be liable (unless the likelihood of a material unfavorable outcome is remote) for remediation of environmental damage relating to assets or businesses previously disposed. The SEC registrant's accounting policy with respect to such costs should be disclosed.

The SAB topic is not intended to impose an affirmative obligation to determine potential closure costs for an operating manufacturing plant that the reporting entity has no plans to sell or abandon and for which no ASC 450 obligation exists.

In addition to the specific topics discussed by the SEC staff within the SAB topic, reporting entities should be aware of the following with respect to environmental reporting.

- *Compliance costs*

  The SEC has historically viewed the cost of compliance with all specific federal, state, local, and foreign laws relating to the environment as part of the total environmental expenditures. The SEC staff has suggested that the future estimated cost of compliance be disclosed in accordance with the guidance in ASC 450-20-S99-1.

- *Accrued costs*

  There is no requirement to disclose amounts accrued for specific contingencies unless failure to disclose such amounts would omit information material to an investor. In past comment letters, and as implied in ASC 450-20-S99-1, the SEC staff has requested information on the total amounts accrued for environmental remediation liabilities, such as breakdowns by type of accrual or by type of site. In some instances, the SEC staff may request this supplemental information.

- *Uncertainties*

  Reporting entities should ensure that disclosures related to environmental accruals include discussion of any uncertainties. Disclosures related to environmental liabilities should include details about the uncertainties related to the estimate and the range of reasonably possible losses in excess of the amount recorded as a liability, or state that such an estimate cannot be made.

The SEC staff has indicated that it generally expects SEC registrants to record an estimated liability for environmental exposures. See FSP 23.4 for additional discussion of SEC reporting considerations regarding contingencies.

11.5.5 Separate environmental costs footnote

Many reporting entities with significant environmental expenditures include an environmental costs footnote, outlining both their policies regarding the classification of expenditures between capital and operating expense, and their processes for determining the amount of environmental remediation obligations to accrue. ASC 235-10-50-3 requires disclosure when environmental matters are material.

Figure FSP 11-3 includes an example disclosure of an environmental remediation costs footnote.

Figure FSP 11-3
Sample disclosure — environmental remediation costs

Environmental remediation costs

FSP Corp accrues for losses associated with environmental remediation obligations when such losses are probable and reasonably estimable. Accruals for estimated losses from environmental remediation obligations generally are recognized no later than completion of the remedial feasibility study. Such accruals are adjusted as further information develops or circumstances change. Costs of future expenditures for environmental remediation obligations are not discounted to their present value. Recoveries of environmental remediation costs from other parties are recorded as assets when their receipt is deemed probable. Consolidated provisions made in 20X3 for environmental liabilities were $10 million ($11 million and $13 million in 20X2 and 20X1, respectively), and the balance sheet reflects accumulated liabilities of $70 million and $75 million as of December 31, 20X3, and 20X2, respectively.

11.6 Asset retirement obligations

ASC 410-20 describes standards for the recognition and measurement of an asset retirement obligation (ARO), which is a legal obligation associated with the retirement of a tangible long-lived asset that results from the acquisition, construction, development, and/or normal operation of that asset. ASC 410-20-25-4 through ASC 410-20-25-5 requires asset retirement obligations to be recognized at fair value in the period in which it is incurred with a corresponding increase in the carrying amount of the related long-lived asset, referred to as an asset retirement cost (ARC). ASC 410-20-45-1 specifically requires that accretion expense be classified as an operating expense in the income statement using a caption that appropriately characterizes the nature of the expense. See PPE 3 for further discussion of AROs, including balance sheet and income statement presentation.

11.6.1 Disclosure requirements

ASC 410-20-50-1 requires multiple disclosures for entities that have AROs associated with their assets. A general description of any ARO and the associated long-lived assets is required. If a reporting entity has legally segregated any assets to settle the ARO, ASC 410-20-50-1(b) requires disclosure of the fair value of those assets. This requirement only applies to assets that have been legally restricted for settlement of the ARO, such as in a sinking fund, trust, or other arrangement, and not to any general internal funding policy that a reporting entity may adopt.

As discussed in ASC 410-20-50-1(c), a reporting entity is also required to reconcile the aggregate carrying value of the AROs at the beginning of the period to the aggregate carrying value of the AROs at the end of the period. This reconciliation is required for each income statement period presented, but is only required in reporting periods when there have been significant changes in liabilities incurred or settled, accretion expense, or revisions in estimated cash flows. Best practice would be to include the reconciliation (or information sufficient to allow the user to construct the reconciliation) if any of the amounts in the reconciliation are significant, without regard to whether they have changed. A reporting entity should not look only to significant changes in the components of the reconciliation, but also look to significant changes in the liability year over year. For instance, if AROs incurred during the period are significant each year but constant, we believe that the reconciliation should be provided.

If a reporting entity cannot reasonably estimate the fair value of an ARO, ASC 410-20-50-2 requires disclosure of that fact and the reasons why it cannot be estimated. For example, if a reporting entity has an ARO associated with an asset with an indeterminate life, no reasonable estimation of the fair value of the ARO is possible and no liability is recorded. However, management should consider disclosure of the potential cash flows (based on current estimated costs) related to this unrecognized ARO.

11.7 Liabilities held for sale

ASC 205-20-45 requires segregation of any liabilities related to disposal groups classified as held for sale on the balance sheet. Assets and liabilities of a disposal group should not be offset and presented as a single amount; rather those assets and liabilities should be presented separately in the assets and liabilities sections of the balance sheet. For example, captions such as current assets held for sale, noncurrent assets held for sale, current liabilities held for sale and noncurrent liabilities held for sale could be shown. The major classes of liabilities classified as held for sale should be presented separately on the balance sheet or disclosed in the notes to the financial statements.

ASC 205-20-45 does not provide guidance on whether liabilities held for sale should be classified as current or noncurrent on the balance sheet. In general, when assessing whether a liability is current, a reporting entity may consider the guidance in ASC 210-10-45-1 through ASC 210-10-45-4. To classify all liabilities held for sale as current, a reporting entity should consider whether the disposal is expected to be consummated within one year of the balance sheet date and whether the reporting entity does not expect use the sale proceeds to reduce long-term borrowings. If such conditions are met at the balance sheet date, current classification may be acceptable. Classification should be assessed each reporting period date through the sale date.

We have seen instances in practice where liabilities of a disposal group that does not qualify as a discontinued operation have been reclassified on the balance sheets of periods ended prior to the period in which the component becomes held for sale or is disposed of, presumably under the theory that this is an extension of the reclassification requirement for operations of discontinued operations. While not required under ASC 205-20, the Codification of Statements on Auditing Standards Section 708, *Consistency of Financial Statements,* implies that such reclassifications are permissible and requires that material reclassifications be indicated and explained in the footnotes. Accordingly, reporting entities may retroactively segregate liabilities of a disposal group provided appropriate disclosure is made. For additional information related to discontinued operations, see FSP 27.

We also believe that, in a spin-off transaction that does not qualify as a discontinued operation, it is acceptable to reclassify the prior period balance sheet into segregated assets and liabilities (similar to if the entity had been held for sale). However, because assets and liabilities disposed of through a spin-off transaction are required to remain classified as held and used until the spin-off has occurred, reclassification of the prior year balance sheet would not be appropriate until completion of the spin-off.

11.8 Other liabilities considerations for private companies

The disclosure requirements of the FASB codification discussed above apply equally to public and private companies. However, certain disclosure items are only required by SEC registrants. Figure FSP 11-4 summarizes the requirements specific to SEC reporting entities discussed in this chapter.

Figure FSP 11-4

Presentation and disclosure requirements applicable only to SEC registrants

Description	Reference	Section
Disclose separately, on the balance sheet or in a footnote, any item in excess of 5% of total current liabilities or total liabilities	S-X 5-02	FSP 11.4
Disclose separately amounts payable to certain parties	S-X 5-02	FSP 11.3
Disclosures related to environmental obligations	ASC 450-20-S99-1 ASC 980-410-S99-1	FSP 11.5.4

ASC 420-10-S99-1 details the SEC staff's requirements for the presentation of restructuring charges. Although not technically applicable to private companies, based on limited authoritative guidance, we believe private companies should consider applying this guidance as well. For additional information related to ASC 420-10-S99-1, see FSP 11.4.4.2.

Chapter 12: Debt—updated May 2022

12.1 Debt — overview

This chapter discusses a reporting entity's balance sheet presentation of debt and the related disclosures. It provides insight into how to assess certain facts and circumstances to determine whether debt should be classified as current or noncurrent at the balance sheet date. Additionally, it discusses the classification of costs incurred in issuing, modifying, and extinguishing debt in the balance sheet and the income statement, as well as the presentation of debt extinguishment gains or losses in the income statement. Finally, it discusses the balance sheet presentation of debt discounts and premiums.

For recognition and measurement considerations relevant to debt, see PwC's *Financing transactions* guide.

New guidance

In August 2020, the FASB issued ASU 2020-06, *Debt—Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging—Contracts in Entity's Own Equity (Subtopic 815-40)*. The ASU simplifies the accounting for certain financial instruments with characteristics of liabilities and equity. The FASB reduced the number of accounting models for convertible debt and convertible preferred stock instruments and made certain disclosure amendments to improve the information provided to users. In addition, the FASB amended the derivative guidance for the "own stock" scope exception (see FG 5) and certain aspects of the EPS guidance (see FSP 7).

For public business entities that meet the definition of an SEC filer, excluding entities eligible to be smaller reporting companies as defined by the SEC, the guidance is effective for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. The one-time determination of whether an entity is eligible to be a smaller reporting company is based on an entity's most recent determination as of August 5, 2020, in accordance with SEC regulations. For all other entities, the guidance is effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted, but no earlier than fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. The FASB also specified that an entity must adopt the guidance as of the beginning of its annual fiscal year and is not permitted to adopt the guidance in an interim period, other than the first interim period of their fiscal year.

Guidance in this chapter has been updated to reflect the new ASU and impacted sections are denoted with "after adoption of ASU 2020-06" and "before adoption of ASU 2020-06."

12.2 Debt — scope and relevant guidance

ASC 470, *Debt,* provides the primary accounting and reporting guidance for debt for all reporting entities. However, its guidance for separate classification of current assets and current liabilities is only applicable when a reporting entity prepares a classified balance sheet.

For SEC registrants, Regulation S-X Rule 5-02 and Regulation S-X Rule 4-08 provide disclosure requirements for debt. ASC 470-10-S99-3, *Classification of Short-term Obligations—Debt Related to Long-Term Projects,* also provides classification guidance for SEC registrants.

Finally, SEC registrants that issue registered securities that are guaranteed, or that guarantee a registered security, are subject to Regulation S-X Rule 13-01.

12.3 Balance sheet classification — term debt

Accurate debt classification is important for reasons beyond simply complying with US GAAP. First, it can impact a reporting entity's ability to raise funds. Debt classification is typically a key component in calculating ratios that prospective investors and lenders (creditors) use to gauge a reporting entity's liquidity and credit risk. In addition, balance sheet classification can impact contractual covenant compliance. Covenants may require a reporting entity to calculate certain financial ratios that are directly affected by debt classification. One such example is working capital, which is calculated as the difference between current assets and current liabilities.

There are many nuances to consider when classifying debt, and often, a debt agreement can include terms that may yield unanticipated classification answers. These terms include:

- Call and put options
- Subjective acceleration clauses
- Debt covenants

ASC 470-10-20 defines a long-term obligation.

Definition from ASC 470-10-20

Long-term obligations: Long term obligations are those scheduled to mature beyond one year (or the operating cycle, if applicable) from the date of an entity's balance sheet.

As a general rule, if the debt is a long-term obligation, it is ordinarily presented as noncurrent. Conversely, if the debt is a short-term obligation (either by its original terms or because of a non-waived covenant violation), the debt is generally presented as current. Specific classification considerations are discussed in the following sections.

12.3.1 Callable debt

Debt agreements may contain call options that give the borrower (debtor) the option to prepay the debt prior to its maturity date. The terms of these options may vary. For example, some agreements allow for prepayment of debt at any time while others allow prepayment only upon specific contingent events.

Typically, the existence of a call option in a debt agreement should not impact classification because call options are at the borrower's discretion. The call options do not create a requirement to pay off the debt at a certain date, but rather they give the borrower a choice to pay off the debt prior to maturity.

In addition, exercising a call right or announcing the intent to exercise a call right after the balance sheet date but prior to issuance of the financial statements generally does not affect classification.

12.3.1.1 Exercising a call right prior to the balance sheet date

If the reporting entity announces a plan to exercise a call right prior to the balance sheet date, the debt should be classified as current if that announcement creates a legally-binding obligation or an

irrevocable commitment to redeem the debt within one year from the balance sheet date (or the operating cycle, if longer).

12.3.1.2 *Exercising a call right after the balance sheet date*

The announcement and execution of a call option after the balance sheet date but before the financial statements are issued has no effect on balance sheet classification. However, the reporting entity should disclose the exercise of the call option subsequent to the balance sheet date as a nonrecognized subsequent event. See FSP 28.6.3.2 for further discussion.

12.3.2 *Puttable debt*

Debt agreements may contain put options that allow the lender to demand repayment prior to maturity. Puttable debt is also sometimes referred to as callable debt because debt that is puttable to the borrower/issuer is equivalent to debt that is callable by the lender. Regardless of terminology, this feature provides the lender with the right to deliver its loan back to the borrower/issuer at a fixed price that meets the more general description of a put option.

Some put options can be exercised at any time, while others are contingently exercisable upon the occurrence of specific events. Debt classification for these types of instruments requires consideration of the terms in the debt agreement.

12.3.2.1 *Due-on-demand loan agreements*

Debt that is puttable by the lender based on conditions that existed at the balance sheet date is considered a due-on-demand loan. Due-on-demand loan agreements provide the lender with a right to demand repayment at any time at its discretion. The due-on-demand language can vary by agreement. Some typical examples include the following:

- The term note matures in monthly installments or on demand, whichever is earlier
- Principal and interest are due on demand or annually

As discussed in ASC 470-10-45-10, obligations that, by their terms, are due on demand or will be due on demand within one year (or the operating cycle, if longer) from the balance sheet date—even if liquidation is not expected within that period—are required to be classified as current liabilities.

12.3.2.2 *Subjective acceleration clauses*

Long-term financing agreements may contain subjective acceleration clauses (SAC), in which the lender may refuse to continue to lend if the borrower experiences an adverse change. These clauses are typically referred to as material adverse change (MAC) or material adverse effect (MAE) clauses.

Unlike a demand provision, a SAC typically requires a covenant violation or default event to occur before it can be invoked. The ASC Master Glossary defines a subjective acceleration clause.

Definition from ASC Master Glossary

Subjective Acceleration Clause: A subjective acceleration clause is a provision in a debt agreement that states that the creditor may accelerate the scheduled maturities of the obligation under conditions that are not objectively determinable (for example, if the debtor fails to maintain satisfactory operations or if a material adverse change occurs).

As discussed in ASC 470-10-45-2, the likelihood of the due date being accelerated determines the classification of debt with a SAC.

- If acceleration of the due date is probable (e.g., the reporting entity has recurring losses or liquidity problems), the long-term debt subject to a SAC should be classified as a current liability. For purposes of this determination, reporting entities should use the definition of "probable" in ASC 450, *Contingencies*.

- If acceleration of the due date is judged reasonably possible, disclosure of the existence of a SAC clause is generally sufficient. The debt may be classified as noncurrent.

- If the acceleration of the due date is deemed remote, neither reclassification nor disclosure is required.

Example FSP 12-1 illustrates the accounting treatment for debt due on demand and debt with a subjective acceleration clause.

EXAMPLE FSP 12-1

Demand provision versus subjective acceleration clause

As of December 31, 20X1, FSP Corp, a reporting entity whose financial condition is strong, has two outstanding loans, Loan D and Loan S. Both loans have a stated maturity date beyond December 31, 20X2 (one year from the balance sheet date).

Loan D contains a demand provision that allows the lender to put the debt to FSP Corp at any time.

Loan S contains a SAC that would allow the lender to put the debt to FSP Corp if a material adverse change in FSP Corp's financial condition occurs.

The lender historically has not accelerated due dates of loans containing similar clauses.

How should FSP Corp classify Loan D and Loan S on its balance sheet as of December 31, 20X1?

Analysis

Loan D should be classified as current. A demand provision requires current liability classification even if liquidation is not expected within the period.

Loan S should be classified as noncurrent (as long as there are no covenant violations). A SAC does not require classification of the debt as current if the likelihood of acceleration of the due date (the lender's

exercise of the SAC) is not probable. Because the likelihood of acceleration of the due date is remote, no disclosure is required either.

12.3.2.3 *Contingently puttable debt*

Debt agreements may contain clauses that make the debt puttable upon certain contingent events. At each reporting period, the reporting entity should assess whether a contingent event has occurred as of the balance sheet date that makes the debt obligation puttable. If so, current classification is required. See FSP 12.12 and FSP 23.4 for disclosure considerations.

12.3.3 *Classification of debt with a covenant violation*

Many debt agreements include covenants on the borrower for the life of the agreement. Breach of a covenant triggers an event of default, which may lead to an increase in the interest rate or a potential demand for repayment (i.e., the debt becomes due).

Figure FSP 12-1 summarizes various covenant violation scenarios and their related impact on classification. It also references the section in this chapter where each scenario is discussed in detail.

Figure FSP 12-1
Debt classification resulting from covenant violations at the balance sheet date

Covenant violation scenario	Classification	Section
(1) Violation; no waiver; no grace period	Current	FSP 12.3.3.1
(2) Violation; no waiver; grace period		FSP 12.3.3.2
— It is probable the violation will be cured	Noncurrent	
— It is not probable the violation will be cured	Current	
(3) Violation; waiver or modification obtained after the balance sheet date		FSP 12.3.3.3
— Covenant not required to be met within one year from the balance sheet date	Noncurrent	
— It is reasonably possible the covenant will be met at subsequent testing dates within one year from the balance sheet date	Noncurrent	
— It is probable the covenant will not be met at subsequent testing dates within one year from the balance sheet date	Current	

Covenant violation scenario	Classification	Section
(4) Violation avoided through modification made before the balance sheet date		FSP 12.3.3.4
— It is reasonably possible the covenant will be met at subsequent testing dates within one year from the balance sheet date	Noncurrent	
— It is probable the covenant will not be met at subsequent testing dates within one year from the balance sheet date	Current	
(5) Violation occurring or anticipated after the balance sheet date	Noncurrent	FSP 12.3.3.5

See FSP 12.9 for a discussion of the balance sheet classification of unamortized debt issuance costs and FSP 12.8 for discussion of the balance sheet classification of debt discount/premium associated with debt that is reclassified to current due to a covenant violation.

12.3.3.1 Covenant violation - no waiver obtained

If a borrower violates a debt covenant that does not include a specified grace period, the obligation becomes puttable by the lender (i.e., due-on-demand debt). As discussed in FSP 12.3.2.1, long-term obligations that are, or will be, puttable by the lender are required to be classified as current liabilities.

12.3.3.2 Covenant violation - no waiver obtained and a grace period

If a covenant violation has occurred at the balance sheet date and there is a grace period in effect, these puttable obligations should be classified as current. However, if it is probable the violation will be cured within that period, ASC 470-10-45-11(b) indicates that the obligation can be classified as noncurrent.

12.3.3.3 Covenant violation - waiver or modification

Classification of debt that has a covenant violation waived or modified after the balance sheet date depends on the manner in which the waiver or modification was provided.

Same or more restrictive covenant is required to be met going forward

Frequently, a covenant violation occurs at the balance sheet date and the lender requires the borrower to meet the same covenant, or a more restrictive covenant, in the next 12 months. ASC 470-10-55-2 through ASC 470-10-55-6 indicates that the obligation should be classified as a noncurrent liability at the balance sheet date if a waiver is obtained, unless the borrower concludes that the chance of meeting the same or more restrictive covenants at subsequent compliance measurement dates within the next year is remote (i.e., it is probable the borrower will violate the future covenant). As long as the borrower can conclude that it is at least reasonably possible that it will be able to meet the covenant when required, the debt should remain classified as noncurrent.

Example FSP 12-2 illustrates the classification of debt with a waiver of a covenant violation but the lender requires the borrower to meet the same covenant going forward.

EXAMPLE FSP 12-2

Classification of debt with waiver of a covenant violation at the balance sheet date, but the same covenant needs to be met going forward

FSP Corp, the borrower, is not in compliance with its working capital covenant at December 31, 20X1.

The lender waives its right to put the debt based on the December 20X1 violation. However, FSP Corp is required to meet the same working capital covenant on March 31, 20X2, and it is probable that it will not do so.

How should FSP Corp classify the debt in the December 31, 20X1 balance sheet?

Analysis

FSP Corp should classify the debt as a current liability in its December 31, 20X1 balance sheet. Although it obtained a waiver for the violation occurring at the balance sheet date, it is probable it will not meet that covenant in the next period, triggering current classification.

Same or more restrictive covenant is not required to be met going forward

If a covenant violation has occurred at the balance sheet date, the lender may not require the borrower to meet the same covenant, or a more restrictive covenant, in the next 12 months (although this circumstance is unusual). ASC 470-10-45-11(a) indicates that the associated obligations should be classified as current unless one of the following conditions exists:

- *The lender has waived the right to demand repayment for more than a year (or an operating cycle, if longer) from the balance sheet date*

  If the obligation is puttable because of violations of certain provisions of the debt agreement, the lender needs to waive its right with regard to only those specific violations.

- *The lender has subsequently lost the right to demand repayment for more than a year (or an operating cycle, if longer) from the balance sheet date*

  For example, if the borrower has cured the violation after the balance sheet date and the obligation is not puttable at the time the financial statements are issued, the lender has lost the right to demand repayment.

12.3.3.4 Covenant violation avoided through a loan modification

A borrower may determine in advance of the balance sheet date that it will not be able to meet certain covenants. The borrower may seek to modify the debt agreement in advance so it will be compliant at the balance sheet date. In this fact pattern, the modification is in substance a waiver, except that it is obtained prior to the actual violation (instead of after, as a waiver would be).

ASC 470-10-55-4(d) provides guidance for when a covenant would have been violated at the balance sheet date absent a modification of the debt agreement before the balance sheet date, and for which violation is probable at the subsequent compliance date after the balance sheet date. It requires current classification of the debt, unless the provisions of ASC 470-10-45-13 through ASC 470-10-45-

20 for refinancing short-term debt (discussed in FSP 12.3.4) are met, in which case the debt may be classified as noncurrent.

Example FSP 12-3 illustrates the classification of debt when a covenant violation is avoided through a loan modification.

EXAMPLE FSP 12-3

Classification of debt with a covenant violation avoided at the balance sheet date through a loan modification

FSP Corp, the borrower, does not expect to be in compliance with its working capital covenant at December 31, 20X1.

On December 15, 20X1, FSP Corp negotiates a modification to the debt agreement to eliminate this covenant until June 29, 20X2.

FSP Corp is required to meet the same working capital covenant on June 30, 20X2, and it is probable that it will not do so.

How should FSP Corp classify the debt in the December 31, 20X1 balance sheet?

Analysis

FSP Corp should classify the debt as a current liability at the balance sheet date because it would have violated the covenant at December 31, 20X1 had it not entered into the loan modification, and because it is probable it will not meet that covenant within the next year.

12.3.3.5 Covenant violation after the balance sheet date

ASC 470-10-55-4(a) through ASC 470-10-55-4(c) address classification when a covenant violation is probable after the balance sheet date, but no violation existed at the balance sheet date. In those instances, noncurrent classification would be appropriate (assuming all other conditions for noncurrent classification have been met). This is true regardless of whether the violation occurs after the balance sheet date but before the financial statements are issued, or if the violation is anticipated to occur in the next year. In these situations, ASC 470-10-55-5 requires the borrower to disclose the adverse consequences of its probable failure to satisfy future covenants.

The key factor in understanding this conclusion is that compliance with debt covenants is determined at the balance sheet date. The guidance in ASC 470-10-55-2 through ASC 470-10-55-6 is similar to subsequent events guidance—indicating that "unless the facts and circumstances would indicate otherwise," the borrower should classify the obligation as noncurrent in these circumstances.

We believe the wording "unless the facts and circumstances would indicate otherwise" was added to the guidance to permit current classification in the limited circumstances when the reporting entity concluded this was a more appropriate presentation.

Example FSP 12-4 illustrates the classification of debt with a covenant violation after the balance sheet date.

EXAMPLE FSP 12-4

Classification of debt with a covenant violation after the balance sheet date

FSP Corp, the borrower, receives an audit opinion in February 20X2 on its December 31, 20X1 financial statements with an emphasis of a matter paragraph related to its ability to continue as a going concern. FSP Corp's debt agreement states that receiving an audit opinion with a going concern issue is an event of default. Therefore, this covenant was violated in the following year when the going concern opinion was issued.

How should FSP Corp classify the debt in the December 31, 20X1 balance sheet?

Analysis

It depends.

We believe if the debt agreement contains a SAC, it should be classified as current at December 31, 20X1. Consistent with the guidance discussed in FSP 12.3.2.2, acceleration of the due date is probable due to the going concern opinion.

If there is no SAC, FSP Corp should apply judgment. Technically, the covenant violation occurred after the balance sheet date, so a literal read of the guidance would indicate noncurrent classification. However, based on the facts and circumstances of this example (i.e., the going concern issue), FSP Corp might deem it more appropriate to classify the debt as current.

12.3.4 Refinancing short-term debt

ASC 470-10-45-14 indicates that short-term obligations should be reclassified as noncurrent at the balance sheet date if the borrower has both the intent and ability to refinance the short-term obligation on a long-term basis. ASC 470-10-45-14(a) indicates that a borrower can demonstrate this intent and ability by actually refinancing the short-term obligation before the financial statements are issued in one of the following ways:

- Issuing a long-term obligation
- Issuing an equity security

Additionally, in lieu of actually issuing a new long-term obligation, ASC 470-10-45-14(b) indicates that a borrower can evidence its ability to refinance on a long-term basis by entering into a financing agreement before the financial statements are issued. The financing agreement would need to satisfy all of the following conditions:

- It does not expire within one year from the balance sheet date.
- It is only cancelable by the lender based on objective measures.
- No violation of any provision in the agreement exists at the balance sheet date or balance sheet issuance date, or if a violation does exist, the reporting entity has obtained a waiver
- The lender is expected to be financially capable of honoring the financing agreement.

12.3.4.1 *Refinancing short-term debt - subjective acceleration clause*

As discussed in ASC 470-10-55-1, there is a high threshold to achieve noncurrent classification for debt that is otherwise current through the issuance of a financing agreement. Long-term financing agreements that contain subjective acceleration, material adverse change, or material adverse effect clauses are specifically prohibited from being used to support reclassification of short-term obligations from current to noncurrent. This is because the parties to the financing agreement may interpret SAC, MAC, MAE, and other nonobjectively verifiable clauses differently.

Due to their subjective nature, such clauses may result in the lender refusing to allow the reporting entity to refinance its short-term obligations. Therefore, this would undermine the reporting entity's assertion that it has the "ability" to refinance the current obligation into long-term, noncurrent debt. However, an agreement that objectively defines an "adverse change" would be acceptable for purposes of demonstrating ability to refinance (or continuing to finance). The "adverse change" definition should include specific, quantifiable criteria, such as minimum working capital requirements, maximum dollar or percentage decrease in sales or earnings, or other objective measurements. If such criteria are present, noncurrent classification would be acceptable, provided the other required conditions are met.

It may be difficult to meet the objectivity standard in some cases. For example, language may appear to be objective but require the use of subjective assumptions—for example, forward-looking criteria that require the use of projections, which are subjective by their nature. Such a provision would not be considered an objectively-defined "adverse change." Reporting entities should ensure that language included in agreements to provide a more precise definition of "adverse change" is truly objective, and not simply less subjective than the original language.

The following subsections discuss certain situations that may impact a reporting entity's ability to meet the requirements of ASC 470-10-45-14(b) with regard to subjective clauses.

Upfront representations and warranties

Certain clauses in financing agreements involve the reporting entity representing to the lender that, between the date of the most recent audited financial statements and the date of signing the financing agreement, there have been no MACs or MAEs. If a financing agreement requires a borrower to make such a representation each time it requests funding under the agreement, this financing agreement would not evidence an ability to borrow on a long-term basis.

On the other hand, if a date-limited representation is required only at the time of, and as a condition of, entering into the financing agreement, the borrower and the lender have the ability to evaluate whether or not a material event or a material change actually occurred prior to execution of the financing agreement. If the lender determines that such an event has not occurred, the financing agreement is executed and, thereafter, the agreement is substantively not cancelable. Therefore, the borrower is able to demonstrate its intent to refinance on a long-term basis.

The borrower needs to determine whether the MAE or MAC was a date-limited representation required *only* at the time of, and as a condition of, entering into the financing agreement to achieve noncurrent classification. Specifically, such representation clauses need to (1) include date range limitations for the period from the most recent audited financial statements to the date of signing the financing agreement, (2) be represented and warranted only at the time the financing agreement was

entered into as a condition to execution of the agreement, and (3) not be subject to re-representation requirements in the future, such as at the time of a future draw-down request.

Dual-trigger clause qualifying language

Dual-trigger clauses—which trigger a MAE or MAC only after a sufficiently-objective clause is not met (i.e., if the objectively verifiable portion is met, the second portion would never be operable)—are also acceptable for purposes of asserting ability to refinance long-term.

A dual-trigger clause may take the form of a management representation required at the time of draw down, such as:

> "Since the date of our last representation to you, there have been no lawsuits filed that have had or are expected to have a material adverse effect on our financial position or results of operations."

Whether a lawsuit has been filed is an objective matter. If no lawsuits have been filed during the representation period, there is no basis for the lender to refuse to fund the draw-down request. This subjective qualifier becomes operative only after the objective event occurs. In the absence of the occurrence of the objective event, there would be no event of default that allows the lender to refuse to honor a draw-down request.

Cross-default clauses

Notwithstanding the above, there have been instances when a SAC, MAC, or MAE included in unrelated debt obligations could cause a cross-default of the long-term financing agreement that the reporting entity would use to support its "ability" assertion under ASC 470-10-45-14. If there is such a clause, the conditions of ASC 470-10-45-14 would not be met and the debt should remain classified as current.

Example FSP 12-5 demonstrates the classification of debt when the reporting entity seeks to refinance but the new agreement contains a SAC clause.

EXAMPLE FSP 12-5

Classification of short-term debt based on a financing agreement containing a SAC clause

At the balance sheet date, FSP Corp has a $10 million borrowing with a contractual maturity of less than 12 months. FSP Corp also has a $100 million revolving credit agreement that is unused and that has a remaining term of 5 years. Borrowings under the revolver may be long-term, as the borrower is permitted to choose any debt term from one to five years. However, future borrowings under the revolving credit agreement are subject to a SAC.

How should FSP Corp classify the $10 million borrowing at the balance sheet date?

Analysis

Even if the borrower has the intent to use the revolver to refinance its short-term obligation, it must classify the $10 million outstanding debt as part of current liabilities. This is because the SAC undermines the borrower's ability to refinance the short-term debt on a long-term basis.

12.3.4.2 Use of working capital to refinance debt

ASC 470-10-45-15 indicates that a short-term obligation should be included in current liabilities if it is repaid after the balance sheet date, and is subsequently replaced or replenished by long-term debt before the balance sheet is issued. The FASB noted that repayment of a short-term obligation before funds are obtained through a long-term financing requires the use of current assets and, as such, the short-term obligation cannot be excluded from current liabilities at the balance sheet date. Specifically, as illustrated in the example in ASC 470-10-55-33 through ASC 470-10-55-36, the repayment of commercial paper using working capital after the balance sheet date, followed by a borrowing under a long-term debt arrangement to replenish the working capital prior to the financial statement issuance date, does not meet the intent requirement for refinancing a short-term borrowing on a long-term basis.

12.3.4.3 Inability to refinance debt with parent commitment

Occasionally a borrower may obtain a long-term commitment from its parent (i.e., a parent support letter) as evidence of its intent and ability to refinance a short-term obligation on a long-term basis. Such agreements need to be reviewed carefully. This is because the parent controls the subsidiary and is a related party. If the agreement can be cancelled at any time or there is no deterrent to prevent the parent from cancelling the agreement, the agreement would not meet the provisions of ASC 470-10-45-14(b)(1) and the debt therefore could not be presented as noncurrent.

12.3.4.4 Refinancing with successive short-term borrowings

A short-term obligation that will be refinanced with successive short-term obligations may be classified as noncurrent as long as the cumulative period covered by the financing agreement is uninterrupted and extends beyond one year. This would include short-term borrowings under revolving credit agreements that permit either continuous replacement with successive short-term borrowings for more than a year or conversion to term loans extending beyond a year at the reporting entity's option. However, as discussed in ASC 470-10-45-21, these borrowings can only be classified as noncurrent if the borrower intends to utilize those provisions and meets the criteria for refinancing the short-term debt on a long-term basis included in ASC 470-10-45-14 (b).

The rollover provisions should be included in the terms of the debt obligation; classification as noncurrent cannot be based solely on management's intent. For example, short-term debt in the form of commercial paper should be supported by a contractually long-term financing arrangement, such as a revolving credit agreement with sufficient unused borrowing capacity to support the ability to refinance the commercial paper. However, any SACs, MACs, or MAEs in the refinancing agreements would cause the reporting entity to fail to meet the requirements to assert its ability to refinance its short-term debt on a long-term basis.

12.4 Balance sheet classification — revolving debt agreements

A line of credit or revolving debt arrangement is an agreement that provides the borrower with the ability to do all of the following:

- Borrow money at different points in time, up to a specified maximum amount

- Repay portions of previous borrowings
- Re-borrow under the same contract

Line of credit and revolving debt arrangements may include both amounts drawn by the borrower (a debt instrument) and a commitment by the lender to make additional amounts available to the borrower under predefined terms (a loan commitment).

12.4.1 Revolving debt requiring execution of a note

Revolving debt arrangements with a contractual term beyond one year may require the execution of a note for each borrowing under the arrangement (see FG 1.3). While the credit arrangement may permit long-term borrowings, the underlying notes may be for a shorter term, possibly less than one year. When the revolver includes individual notes, the reporting entity should classify the debt based on the term of each individual note, not based on the expiration date of the revolver, unless the conditions for noncurrent classification based on a refinancing are met (see FSP 12.3.4 for a discussion of the classification of short-term debt refinanced on a long-term basis).

Certain revolving debt arrangements may have a feature that gives the borrower the option to select between two different types of borrowings, each with potentially different terms. For example, a borrower may be able to choose between the following:

- A long-term loan with a certain interest rate having a maturity date consistent with the expiration date of the revolving debt arrangement
- A short-term loan with a maximum maturity of 90 days that carries a different interest rate from the first option

In this example, the second option would require current classification unless (1) the conditions for refinancing the short-term debt on a long-term basis are met, or (2) the short-term loan automatically converts at its maturity date, without any further actions, into a long-term loan, as described in the first option. If the debt instrument automatically converts, it is in-substance long-term debt and, therefore, we believe noncurrent classification is appropriate.

12.4.2 Revolving debt that specifies a borrowing base

Borrowings under a contractually short-term revolver may be renewed or extended through a long-term financing agreement. Sometimes these borrowings specify objective criteria, such as the attainment of specified operating results, levels of financial position, or other measures (e.g., inventory levels) that the reporting entity must maintain or achieve in the future to continue borrowing. This is commonly referred to as a borrowing base.

In such cases, consistent with the guidance in ASC 470-10-45-19, the reporting entity should classify the outstanding short-term borrowings as noncurrent if it is reasonable to expect that the specified criteria will be met, such that long-term borrowings (or successive short-term borrowings for an uninterrupted period) will be available to refinance the short-term debt on a long-term basis. The reporting entity must also demonstrate the intent and ability to refinance, as discussed in FSP 12.3.4. Achieving noncurrent classification in this scenario requires a high degree of assurance.

Borrowings under contractually long-term revolving debt agreements may also reference a borrowing base. We believe there are two methods for determining how the borrowing base impacts the classification of debt as current or noncurrent.

- Treat the borrowing base as a debt covenant and assess it with all other debt covenants under the model discussed in FSP 12.3.3.
- Classify the outstanding borrowings as noncurrent only if it is reasonable to expect that the specified criteria will be met over the 12 months following the balance sheet date. This method is based on the ASC Master Glossary definition of a current liability.

Selection of an approach represents an accounting policy decision that should be applied consistently.

Example FSP 12-6 demonstrates the classification of a revolving credit facility that is subject to a working capital requirement.

EXAMPLE FSP 12-6

Classification of a revolver subject to a working capital requirement

FSP Corp has $10 million outstanding on its short-term revolving credit facility at December 31, 20X1. As long as FSP Corp complies with the provisions of the credit facility, which has a specified borrowing base, the amounts borrowed are permitted to be continuously renewed at its option for successive 120-day periods through December 31, 20X4. The revolver's borrowing base is calculated using a multiple of working capital. The borrowing base is calculated quarterly. Any outstanding amount that exceeds the calculated borrowing base is not permitted to be renewed, but rather is due and payable at the end of its 120-day term.

FSP Corp's outstanding borrowings did not exceed the borrowing base calculated on December 31, 20X1. It expects that the lowest borrowing base amount for the upcoming 12 months following the balance sheet date will be $6 million.

There are no events of default or covenants breached as of December 31, 20X1 and all other terms within the agreement are usual and customary.

How should FSP Corp classify the outstanding short-term borrowings in the December 31, 20X1 financial statements? What if the borrowings under the revolver were contractually long-term?

Analysis

Since FSP Corp's outstanding borrowings did not exceed the borrowing base at December 31, 20X1 and it expects that the lowest borrowing base will be $6 million through January 1, 20X3, $6 million should be classified as noncurrent, assuming all of the other requirements for refinancing short-term debt on a long-term basis are met. As management expects the borrowing base to be as low as $6 million in the coming year, the excess of borrowings of $4 million ($10 million outstanding less the $6 million recorded as noncurrent) should be classified as current.

In contrast, if the borrowings under the credit facility were contractually long-term, we believe FSP Corp could apply either of the two models for determining the current and noncurrent amounts. Under the first method, all of the debt would be noncurrent because FSP Corp is not in violation of the

"covenant" (i.e., it has a sufficient borrowing base at the balance sheet date). Under the second method, $6 million of the debt would be classified as noncurrent and $4 million would be classified as current based on FSP Corp's estimate of the borrowing base for the following year.

12.4.3 Revolving debt - lockbox arrangements and SACs

As discussed in ASC 470-10-45-5, borrowings that are legally long-term under a revolving credit agreement should be classified as current if they include a requirement to maintain a lockbox arrangement (or a sweep feature or other lender arrangement), whereby remittances from the borrower's customers are used to reduce the revolving debt outstanding. A revolving credit arrangement with a required lockbox is inherently short-term based on the definition of a current liability because a lockbox requires that the debt be serviced with working capital.

The only way this type of arrangement could be considered noncurrent is if the revolving credit agreement permits either (1) continuous replacement with successive short-term borrowings for more than a year or (2) conversion to term loans extending beyond a year at the reporting entity's option and the borrower intends to utilize those provisions and meets the criteria for refinancing the short-term debt on a long-term basis (as discussed in FSP 12.3.4). However, if there is a SAC in the agreement, the agreement will not meet the requirements to refinance the short-term obligation on a long-term basis and the arrangement should be classified as current.

In contrast, as discussed in ASC 470-10-45-6, borrowings outstanding under a long-term revolving credit agreement that includes a requirement to maintain a "springing" lockbox (an agreement whereby remittances from the borrower's customers are not forwarded to the lender to reduce the debt outstanding until and unless an event of default occurs) are classified as noncurrent as long as no event of default occurred prior to the balance sheet date. A SAC in such agreement would be evaluated using the guidance in FSP 12.3.2.2.

12.4.4 Revolving debt related to long-term projects

ASC 470-10-S99-3, *Classification of Short-term Obligations—Debt Related to Long-Term Projects,* provides guidance for public companies that have a revolving cover loan associated with a long-term construction project.

Excerpt from ASC 470-10-S99-3

Facts: Companies engaging in significant long-term construction programs frequently arrange for revolving cover loans which extend until the completion of long-term construction projects. Such revolving cover loans are typically arranged with substantial financial institutions and typically have the following characteristics:

1. A firm long-term mortgage commitment is obtained for each project.

2. Interest rates and terms are in line with the company's normal borrowing arrangements.

3. Amounts are equal to the expected full mortgage amount of all projects.

4. The company may draw down funds at its option up to the maximum amount of the agreement.

5. The company uses short-term interim construction financing (commercial paper, bank loans, etc.) against the revolving cover loan. Such indebtedness is rolled over or drawn down on the revolving cover loan at the company's option. The company typically has regular bank lines of credit, but these generally are not legally enforceable.

When these conditions exist—representing a firm commitment throughout the construction program for permanent mortgage financing, and there are no contingencies other than completing construction—the borrowing may be classified as noncurrent with appropriate disclosure.

12.4.5 Increasing rate debt

Revolving debt agreements may have a maturity date that can be extended at the option of the borrower at each maturity date until final maturity. In such cases, the interest rate on the note may increase a specified amount each time the note is renewed. These types of instruments are called increasing rate debt instruments. ASC 470-10-45-7 indicates that classification of the debt as current or noncurrent should reflect the borrower's anticipated source of repayment (e.g., current assets, new short-term debt, or long-term refinancing agreement). Guidance in ASC 470-10-35 requires the borrower to estimate the life of the debt to calculate one blended effective interest rate, but the classification need not be consistent with the time frame used to determine the blended effective interest rate.

12.5 Balance sheet classification — paid-in-kind notes

The terms of debt instruments may permit or require the borrower to satisfy accrued interest on the debt with additional paid-in-kind (PIK) notes having identical terms (maturity date, interest rate, etc.) as the original debt. In such cases, the original debt is referred to as a PIK note. Typically, the interest may be paid either in cash or additional PIK notes, at the borrower's discretion. If the borrower intends to pay the interest with additional notes, the balance sheet classification of the accrued interest payable should be assessed under the guidance in ASC 470-10-45-14 for refinancing short-term debt (FSP 12.3.4), as illustrated in Example FSP 12-7.

EXAMPLE FSP 12-7

Classification of accrued interest settleable in PIK notes

In October 20X1, FSP Corp issues floating-rate senior PIK notes that are due on September 30, 20X3.

The notes have semiannual interest payments payable in the form of cash or additional PIK notes at FSP Corp's option.

FSP Corp intends to pay the interest in the form of additional PIK notes. The maturity date of the PIK notes delivered to settle the interest payments is the same as the original note.

How should FSP Corp classify the accrued interest on the notes as of December 31, 20X1?

Analysis

FSP Corp should classify the accrued interest as a noncurrent liability since it has both the intent and ability to refinance the short-term liability (accrued interest) on a long-term basis.

The issuance of the original PIK notes demonstrates FSP Corp's ability to consummate a refinancing of the interest on a long-term basis, with terms that are readily determinable and meet *all* of the following conditions that are based on the requirements for ASC 470-10-45-14, as follows:

- The obligation does not expire within one year from FSP Corp's balance sheet.
- The agreement (i.e., the right to satisfy interest with long-term PIK notes) is not cancellable by the lender.
- The PIK notes issued under the agreement are not puttable, except for violations for which compliance is objectively measurable.
- There is no violation of any financing agreement provisions at the balance sheet date.
- There is no available information that indicates a violation has occurred after the balance sheet date and prior to the issuance of the financial statements, which would prevent the issuer from having the right to satisfy the interest with long-term PIK notes; for example, there is no covenant violation of the original PIK notes that would do either of the following:
  - Accelerate their due date and the due date of any additional PIK notes that might be used to satisfy the interest
  - Prevent the issuer from electing to pay the interest in PIK notes while there is a covenant violation of the original PIK notes
- The lender entered into the financing agreement permitting interest to be refinanced with PIK notes.
- FSP Corp is expected to be financially capable of honoring the agreement.

Given these facts, we believe FSP Corp should classify the accrued interest as noncurrent.

12.6 Balance sheet classification — variable rate demand obligations

A Variable Rate Demand Obligation (VRDO) is a debt instrument, typically a bond, that the lender can put to (i.e., demand repayment from) the borrower. This feature gives the lender the ability to redeem the investment on short notice (usually seven days) by putting the debt to the borrower's remarketing agent. Upon a lender's exercise of a put, the remarketing agent will resell the debt to another lender to obtain the funds to honor the put (i.e., to repay the original lender). If the remarketing agent fails to sell the debt (referred to as a "failed remarketing"), the funds to pay the lender who exercised the put will often be obtained through a liquidity facility issued by a financial institution. Liquidity facilities typically take the form of a standby or direct-pay letter of credit, line of credit, or standby bond purchase agreement.

ASC 470-10-55-7 through ASC 470-10-55-9 addresses these instruments. The guidance indicates that the presence of a "best-efforts" remarketing agreement (typical for VRDO issuances) should not be considered when evaluating whether the VRDO should be classified as current or noncurrent.

A reporting entity should assume that a put will occur, and unless the VRDO borrower has the ability and intent to refinance the debt on a long-term basis, VRDOs should be classified as a current liability.

If a liquidity facility provides the borrower with the ability to refinance, borrowers should evaluate the terms of their liquidity agreements in light of the requirements for refinancing a short-term borrowing on a long-term basis (as addressed in FSP 12.3.4) for attributes that could impact balance sheet classification of the debt, including the following:

- *Expiration date of the commitment*

  To achieve noncurrent classification, a liquidity facility for the VRDOs cannot expire within one year of the balance sheet date. VRDOs supported by liquidity agreements that expire within one year of the balance sheet should be classified as current.

- *Covenant violations*

  Violations of covenants in liquidity agreements could cause termination of the agreement or demand for immediate repayment of any draws. Therefore, a violation of any provision in the financing agreement at the balance sheet date, or available information that indicates a violation occurred after the balance sheet date but prior to the issuance of the financial statements, would trigger current classification. A covenant violation occurring prior to or after the balance sheet date requires a waiver to be obtained to achieve noncurrent classification. The form and content of the waiver needs to be in force for at least 12 months and it should not be subject to termination beyond those conditions in the original agreement.

- *SAC, MAC, or similar clauses*

  The existence of subjective clauses that provide the lender with the ability to demand repayment based on subjective (rather than objective) criteria will typically preclude classification of the VRDOs as noncurrent.

- *Repayment terms*

  The repayment terms of the liquidity facility will impact the determination of amounts due within one year of the balance sheet date (and thus the amount of the VRDOs that must be classified as a current liability). Some liquidity facilities have repayment terms that are installment-based and others require a balloon payment at the facility's expiration date.

- *Ability to cancel*

  The lender should not have the ability to cancel the credit facility within one year from the balance sheet date except for violations of the terms of the agreement that can be objectively measured. This may include failure to meet a condition, or a breach or violation of a provision, such as a restrictive covenant, representation, or warranty.

12.7 Balance sheet classification—debt with cash conversion option—after adoption of ASU 2020-06

Upon conversion of traditional convertible debt, the lender receives common stock of the borrower, not cash. If the lender exercises its conversion option, it receives the full number of shares underlying the debt. In contrast, a convertible bond with a cash conversion feature is settled upon conversion, in whole or in part, in a combination of cash or stock either mandatorily or at the borrower's option.

Reporting entities should consider all terms of the convertible debt instrument when determining the proper balance sheet classification. Therefore, a borrower's determination of the classification of the debt instrument should be based on the terms of the debt as a whole.

Certain debt with a cash conversion feature permits the lender to exercise the conversion feature at any time. The debt may also contain non-contingent terms that, upon conversion, require the debt principal to be settled in cash and the remaining amount to be settled in shares or cash at the borrower's option. Typically, the debt principal settlement equals the accreted value, and the remainder represents the conversion spread (i.e., the value of the stock underlying the conversion option in excess of the accreted value). When these features exist, the debt is essentially demand debt, because the lender can unilaterally choose to convert the debt at any time, and the reporting entity would be compelled to pay cash.

Therefore, the convertible debt equal to the debt principal (or accreted value) should be classified as current because of the holder's legal ability to demand payment in cash, consistent with the guidance in ASC 470-10-45-10. The fact that the conversion feature may be out-of-the-money at the balance sheet date does not change the fact that the holder may convert at any time, and the reporting entity cannot predict future stock prices that could affect the amount of cash to be paid upon conversion at some point in the next 12 months (or current operating cycle). Therefore, we believe that the entire recorded amount of the debt should be classified as current, unless the reporting entity satisfies the requirements in ASC 470-10-45-14 regarding the ability and intent to refinance the debt on a long-term basis.

With respect to contingently convertible debt securities with a cash settlement feature, if the contingency has been met as of the balance sheet date, current classification is required if the holder has the right to demand payment of the principal amount in cash once the contingent event occurs. If the contingency has not been met at the balance sheet date (even if it is met prior to financial statement issuance), the debt principal should be classified as noncurrent debt at the balance sheet date.

Example FSP 12-8 illustrates the classification of debt when the lender has a contingent cash conversion option.

EXAMPLE FSP 12-8

Classification of debt with a contingent cash conversion option

FSP Corp, a calendar year entity, issues convertible debt with a cash settlement feature. The instrument has a stated life of 10 years, but allows the lender to put it back to the borrower at the end of 5 years. In addition, the instrument also allows the lender to convert the instrument for 90 days after a specific market price trigger is exceeded. If not converted within the 90-day period, it will cease

to be convertible, unless the market price contingency is met at the end of the 90 days, after which a new three month conversion period will apply. If the lender chooses to convert, the principal amount will be settled in cash and the conversion spread will be settled in cash or shares (at FSP Corp's discretion).

FSP Corp will amortize the debt issuance costs allocated to the debt component over 5 years (i.e., the first put date) using the interest method.

At March 31 of the second year, the market price trigger is met, which allows (but does not require) the lender to convert the debt until June 30. The lender decides not to convert the debt by June 30, and on June 30 the market price trigger is not met. Therefore, the debt ceases to be convertible by the lender on June 30.

What are the classification considerations for FSP Corp on March 31 and June 30 of the second year?

Analysis

Even though the debt is no longer convertible at the lender's option, the debt is effectively demand debt as of March 31 and would require current classification at March 31. At June 30, FSP Corp should reclassify the debt to noncurrent, as the lender no longer has the right to convert the debt.

12.7A Balance sheet classification—debt with cash conversion option—before adoption of ASU 2020-06

Upon conversion of traditional convertible debt, the lender receives common stock of the borrower, not cash. If the lender exercises its conversion option, it receives the full number of shares underlying the debt. In contrast, a convertible bond with a cash conversion feature allows the borrower to settle its obligation upon conversion, in whole or in part, in a combination of cash or stock either mandatorily or at the borrower's option. Convertible debt with cash conversion features are accounted for under the cash conversion subsections of ASC 470-20.

Excerpt from ASC 470-20-15-4 through 15-5

The guidance in the Cash Conversion Subsections applies only to convertible debt instruments that, by their stated terms, may be settled in cash (or other assets) upon conversion, including partial cash settlement, unless the embedded conversion option is required to be separately accounted for as a derivative instrument under Subtopic 815-15.

…

The Cash Conversion Subsections do not apply to any of the following instruments:

a. A convertible preferred share that is classified in equity or temporary equity.

b. A convertible debt instrument that requires or permits settlement in cash (or other assets) upon conversion only in specific circumstances in which the holders of the underlying shares also would receive the same form of consideration in exchange for their shares.

c. A convertible debt instrument that requires an issuer's obligation to provide consideration for a fractional share upon conversion to be settled in cash but that does not otherwise require or permit settlement in cash (or other assets) upon conversion.

ASC 470-20-45-3 indicates that the guidance in the cash conversion subsections of ASC 470-20 does not affect classification of the debt as current or noncurrent. Instead, reporting entities should consider all terms of the convertible debt instrument (including the equity component) when determining the proper classification. Therefore, regardless of the life used for amortization purposes, a borrower's determination of the classification of the liability component of the debt instrument should be based on the terms of the debt as a whole.

Some of the features in debt with a cash conversion feature may permit the lender to exercise the conversion feature at any time. They may also contain non-contingent terms that, upon conversion, require the debt principal to be settled in cash and the remaining amount to be settled in shares or cash at the borrower's option. Typically, the debt principal settlement equals the accreted value, and the remainder represents the conversion spread (i.e., the value of the stock underlying the conversion option in excess of the accreted value). When these features exist, the debt is essentially demand debt, because the lender can unilaterally choose to convert the debt at any time, and the reporting entity would be compelled to pay cash.

Therefore, the convertible debt equal to the debt principal (or accreted value) should be classified as current because of the holder's legal ability to demand payment in cash, consistent with the guidance in ASC 470-10-45-10. The fact that the conversion feature may be out-of-the-money at the balance sheet date does not change the fact that the holder may convert at any time, and the reporting entity cannot predict future stock prices that could affect the amount of cash to be paid upon conversion at some point in the next 12 months (or current operating cycle). Therefore, we believe that the entire recorded amount of the debt should be classified as current, unless the reporting entity satisfies the requirements in ASC 470-10-45-14 regarding the ability and intent to refinance the debt on a long-term basis.

With respect to contingently convertible debt securities with a cash settlement feature, if the contingency has been met as of the balance sheet date, the instruments would require current classification if the holder has the right to demand payment of the principal amount in cash once the contingent event occurs. If the contingency has not been met at the balance sheet date but is met prior to financial statement issuance, the debt principal should continue to be classified as noncurrent debt at the balance sheet date.

Example FSP 12-8A illustrates the classification of debt when the lender has a contingent cash conversion option.

EXAMPLE FSP 12-8A

Classification of debt with a contingent cash conversion option

FSP Corp, a calendar year entity, issues convertible debt that is within the scope of the cash conversion subsections of ASC 470-20. The instrument has a stated life of 10 years, but allows the lender to put it back to the borrower at the end of 5 years. In addition, the instrument also allows the lender to convert the instrument for 90 days after a specific market price trigger is exceeded. If not converted within the 90-day period, it will cease to be convertible, unless the market price contingency is met at the end of

the 90 days, after which a new three-month conversion period will apply. If the lender chooses to convert, the principal amount will be settled in cash and the conversion spread will be settled in cash or shares (at FSP Corp's discretion).

FSP Corp determines the expected life of the debt component is 5 years. Accordingly, FSP Corp will amortize the debt issuance costs allocated to the debt component over 5 years using the interest method.

At March 31 of the second year, the market price trigger is met, which allows (but does not require) the lender to convert the debt until June 30. The lender decides not to convert the debt by June 30, and on June 30 the market price trigger is not met. Therefore, the debt ceases to be convertible by the lender on June 30.

What are the classification considerations for FSP Corp on March 31 and June 30 of the second year?

Analysis

Even though the debt is no longer convertible at the lender's option, the debt is effectively demand debt during the reporting period ended March 31 and would require current classification at March 31. At June 30, FSP Corp should reclassify the debt to noncurrent, as the lender no longer has the right to convert the debt.

12.8 Balance sheet classification — amortizing loan

An amortizing loan has scheduled periodic payments that are applied to both principal and interest. The loan is initially measured on a present value basis. An amortization schedule is used to determine how much of each payment is applied to interest and principal each period. The payment is first applied to interest, and the remainder reduces the principal balance. Common examples of these types of financings are mortgages and lease liabilities.

Since the overall liability is measured on a present-value basis, the amount of the liability that should be reported as a current liability should be measured on the same basis. This amount is determined by applying the loan's effective interest rate to the total contractual payments that are due in the next 12 months (or operating cycle, whichever is longer).

As an alternative, a reporting entity may classify the total undiscounted contractual payments that are due in the next 12 months (or operating cycle, whichever is longer) as current, until the last year of the borrowing. In the last year of the borrowing, the carrying amount of the liability must be used as current because the total undiscounted payments will exceed the carrying value of the liability. Another acceptable alternative is to classify the portion of the total payments that are due in the next 12 months (or operating cycle if longer) that are attributed to principal payments in the loan amortization schedule.

A reporting entity should elect one of these methods and apply it consistently.

12.9 Balance sheet classification — debt issuance costs

Debt issuance costs include various incremental fees and commissions paid to third parties (not to the lender) in connection with the issuance of debt, including investment banks, law firms, auditors, and regulators.

As discussed in ASC 835-30-45-1A, debt issuance costs are required to be presented on the balance sheet as a direct deduction from the carrying value of the associated debt liability, consistent with the presentation of a debt discount. See FG 1.2 for further information.

The presentation of debt issuance costs as current or noncurrent follows the same principles as the guidance on presentation of debt discounts and premiums, which is addressed in FSP 12.8 and FG 1.2.

12.9.1 Commitment fees associated with revolving lines of credit

A revolving line of credit can be accessed or "drawn down" at any time at the borrower's discretion. In a typical arrangement, a borrower pays the lender a fee in exchange for the lender's commitment to stand ready to lend a specified maximum amount over a specified period of time. This means that a reporting entity may have paid the fee to provide access to the revolving line of credit, but may not have a liability on its books—either because it has not drawn down on the revolving line of credit, or it has repaid amounts previously drawn down.

Deferred initial up-front commitment fees paid by a reporting entity to a lender represent the benefit of being able to access capital over the contractual term, and therefore, meet the definition of an asset. Reporting entities should subsequently amortize the asset ratably over the term of the line-of-credit arrangement, regardless of whether there are any outstanding borrowings on the line-of-credit arrangement.

Reporting entities should classify the entire asset as noncurrent (unless the original commitment was for less than one year).

In the limited circumstances when a reporting entity draws down on a line of credit and does not intend to repay the borrowing until the contractual maturity of the arrangement (i.e., the borrowing is treated like a term loan), we believe the portion of the costs related to each respective draw down could be presented as a direct deduction from the carrying value of the debt when drawn. Under this approach, the reporting entity should amortize commitment fees for the portion associated with the draw down using the effective interest method (as is done for a term loan).

12.10 Other debt — balance sheet classification

Certain other situations may affect the balance sheet classification of debt. These are discussed in the following subsections.

12.10.1 Subsidiary's debt when fiscal year differs from parent

SEC registrants may need specific disclosures when a subsidiary with debt outstanding has a fiscal year that differs from its parent. For example, a subsidiary may have a material loan outstanding that is due beyond one year from its fiscal year-end. However, the maturity date of the loan payable may fall within the 12 months following the parent's fiscal year-end. In ASC 470-10-S99-4, the SEC staff

noted that it would expect to see the debt classified as current in the parent's consolidated financial statements in this fact pattern.

12.10.2 Debt restructuring

Debt modifications (including troubled debt restructurings) may change the terms of the debt—for example, the amount due within one year after the date of the borrower's balance sheet may change. These modifications may result in reclassification of all or a portion of the carrying amount of the debt at the time of restructuring.

12.10.3 Structured payables

Reporting entities that enter into structured payable programs need to consider whether the transaction terms could cause the substance of the liability to change from trade payables to debt. For considerations related to structured payables, see FSP 11.3.1.5.

Note about ongoing standard setting

In December 2021, the FASB issued an exposure draft that proposes required disclosures for supplier finance programs. As of the publication date of this guide, the proposed amendments have not yet been issued. Reporting entities should continue to monitor the status of these proposed amendments and, if finalized, the implications on disclosure.

12.11 Debt — income statement classification

This section discusses considerations for certain items that may affect income statement classification. They include:

- Debt extinguishment gains and losses (see FSP 12.11.1)
- Modification or exchanges (see FSP 12.11.2)
- Participating mortgage loans (see FSP 12.11.3)
- Debt with a conversion feature (see FSP 12.11.4 (after adoption of ASU 2020-06) or FSP 12.11.4A (before adoption of ASU 2020-06))
- Related party debt restructurings (see FSP 12.11.5)

12.11.1 Debt extinguishment gains and losses

Gains and losses from extinguishment of debt include the write-off of unamortized debt issuance costs, debt discount, and/or premium.

ASC 470-50-40-2 requires an extinguishment gain or loss to be identified as a separate item. However, given that neither the ASC guidance nor Regulation S-X specifies where in the income statement the gains and losses should be presented, we believe there is more than one acceptable approach. The

selected approach should be consistently applied to classifying an extinguishment gain or loss. Some approaches include:

- Classifying the amount as a separate line item on the income statement
- Classifying the extinguishment gain or loss in interest expense with disclosure of the components of the gain or loss in the footnotes

12.11.2 Income statement classification – revolving debt modifications

As discussed in ASC 470-50-40-21, a charge to income may result from a modification or exchange of a revolving debt agreement due to unamortized deferred costs being written off when the borrowing capacity of the new arrangement is less than the borrowing capacity of the old arrangement. This charge to earnings should be treated in a manner similar to gains and losses on extinguishments (discussed in FSP 12.11.1).

12.11.3 Participating mortgage loans

Under a participating mortgage loan arrangement, the lender (mortgagee) is entitled to share in the rental or resale proceeds from a property owned by the borrower (mortgagor). Any periodic amortization of debt discount relating to a participating liability is reported in interest expense. As discussed in ASC 470-30-40-1, any gain or loss resulting from the difference between the recorded amount of the debt (including the unamortized debt discount and the participation liability) and the amount exchanged to extinguish the debt before its due date is recognized in income in the period of extinguishment and treated as a debt extinguishment gain or loss (discussed in FSP 12.11.1).

12.11.4 Expense classification – debt with conversion feature—after adoption of ASU 2020-06

When a convertible debt instrument is converted to equity securities of the borrower pursuant to an inducement offer (expense recognized under ASC 470-20-40-16), the inducement charge should be treated in a manner similar to gains and losses on extinguishments (discussed in FSP 12.11.1).

12.11.4A Expense classification - debt with conversion feature—before adoption of ASU 2020-06

For debt with a conversion feature, the following expenses should be treated in a manner similar to gains and losses on extinguishments (discussed in FSP 12.11.1):

- The unamortized discount remaining at the date of conversion for instruments with beneficial conversion features (expense recognized under ASC 470-20-40-1)
- The inducement charge when a convertible debt instrument is converted to equity securities of the borrower pursuant to an inducement offer (expense recognized under ASC 470-20-40-16)

12.11.5 Restructuring debt with related parties

If a borrower restructures its debt with a debt holder that is also an equity holder, the counterparty may be considered a related party. In that case, it may not be appropriate to recognize any associated gain or loss in the income statement under ASC 470-50-40-2. Instead, such a restructuring may be essentially a capital transaction, and the gain or loss may be required to be classified in equity. See FG 3.3.5 for details on the accounting for this type of transaction.

12.12 Debt — disclosure

The disclosure requirements of ASC 470 vary depending on the nature of the debt. Regulation S-X also prescribes certain disclosure requirements for the debt of SEC registrants.

12.12.1 Long-term debt

The guidance in ASC 470-10-50-1 through ASC 470-10-50-5 provides the following general disclosure requirements for all long-term borrowings:

- The combined aggregate amount of maturities and sinking fund requirements for each of the five years following the date of the latest balance sheet
- The circumstances surrounding any debt obligations that have a covenant violation at the balance sheet date and are classified as noncurrent
- Subjective acceleration clauses required to be disclosed under ASC 470-10-45-2 (discussed in FSP 12.3.2.2)
- If a short-term obligation is excluded from current liabilities (as discussed in FSP 12.3.4), a general description of the financing agreement and the terms of any new obligation incurred, or expected to be incurred, or equity securities issued, or expected to be issued as part of the refinancing
- Explanation of the pertinent rights and privileges of various securities outstanding, including, but not limited to:
    - Information regarding participation rights
    - Call price and dates
    - Conversion exercise prices or rates and pertinent dates
    - Number of shares issued upon conversion, exercise, or satisfaction of required conditions during at least the most recent annual period and any subsequent interim period presented

Example 3 in ASC 470-10-55-10 through ASC 470-10-55-12 provides an example disclosure for a long-term borrowing.

Regulation S-X Rule 5-02 and Regulation S-X Rule 4-08 provide the following incremental disclosure requirements for long-term debt for public reporting entities. An SEC registrant is required to disclose the following separately on the balance sheet or in a footnote for each issue or type of debt (including capital leases).

- The general character of each type of debt including the rate of interest
- The date of maturity or maturities (if maturing serially)
- If the payment of principal or interest is contingent, an appropriate indication of such contingency

- A brief indication of priority
- If convertible, the basis
- The amount and terms (including commitment fees and the conditions under which commitments may be withdrawn) of unused commitments for long-term financing
- Any significant changes in the authorized or issued amounts of debt since the date of the latest balance sheet filed for the reporting entity
- The facts and amounts concerning any default in principal, interest, sinking fund, or redemption provisions with respect to any issue of securities or credit agreements or any covenant violation of a debt agreement, which default or violation existed at the date of the most recent balance sheet being filed, and which has not been subsequently cured. If a default or violation exists but acceleration of the obligation has been waived for a stated period of time beyond the date of the most recent balance sheet being filed, state the amount of the obligation and the period of the waiver.

In addition, since the nature of these incremental disclosure requirements appears to be consistent with the disclosure of "pertinent rights and privileges" discussed in ASC 470, private companies may also want to consider disclosing this information.

12.12.2 Short-term debt

Regulation S-X Rule 5-02 also includes disclosure requirements pertaining to short-term obligations for SEC registrants. They include:

- The amount and terms (including commitment fees and the conditions under which lines may be withdrawn) of unused lines of credit for short-term financing
- The weighted average interest rate on short term borrowings outstanding as of the date of each balance sheet presented
- The amount of the lines of credit that support a commercial paper borrowing arrangement or similar arrangements

12.12.3 Collateral

Reporting entities are required by ASC 860-30-50-1A to disclose in the balance sheet or footnotes the fact that assets are pledged as collateral against a liability.

Excerpt from ASC 860-30-50-1A(b)

… As of the date of the latest statement of financial position presented, both of the following:

1. The carrying amount and classifications of both of the following:

    i. Any assets pledged as collateral that are not reclassified and separately reported in the statement of financial position in accordance with paragraph 860-30-25-5(a)

ii. Associated liabilities.

2. Qualitative information about the relationship(s) between those assets and associated liabilities; for example, if assets are restricted solely to satisfy a specific obligation, a description of the nature of restrictions placed on those assets.

In our view, whenever the value of the collateral is less than the amount of the debt, it may be misleading to state on the balance sheet that the receivable or payable is "secured" because "secured" may imply "fully secured." Frequently, the value of the collateral is uncertain. Even if the valuation is determinable, and the collateral appears to be adequate, there can be no assurance that such value will persist. Consequently, we do not believe that reporting entities should describe assets pledged as collateral as "secured," even if qualified (such as "partly secured"). The following are illustrative balance sheet line items:

- Notes receivable pledged as collateral against $X of loans
- Notes payable (property, plant, and equipment with a net book amount of $X has been pledged as collateral)
- Notes payable (with collateral consisting of capital stock of certain subsidiaries representing X% of consolidated net assets)

When a reporting entity pledges stock of a consolidated subsidiary as collateral for bond or note issuances of an unconsolidated subsidiary, it should disclose this in the footnotes. It should also indicate the underlying net assets effectively pledged.

Also refer to Regulation S-X Rule 13-02 for guidance on financial statements of affiliates whose securities collateralize any class of securities that are registered or being registered.

12.12.4 Participating mortgage loans

ASC 470-30-50-1 requires issuers of participating mortgages to disclose all of the following:

- The aggregate amount of participating mortgage obligations
- The aggregate amount of gross participation liabilities and the related debt discount
- The lender's participation terms related to:
  - The operations of the mortgaged real estate
  - The increase in the fair value of the mortgaged real estate

12.12.5 Own-share lending arrangements — convertible debt issuance

A reporting entity that enters into a share-lending arrangement on its own shares in contemplation of a convertible debt offering or other financing should disclose a description of any outstanding share-

lending arrangements on its own stock. As discussed in ASC 470-20-50-2A, information to be disclosed includes:

- Number of shares, term, circumstances under which cash settlement would be required, and other significant terms
- Requirements for the counterparty to provide collateral
- Reason for entering into the arrangement
- Fair value of the outstanding loaned shares as of the balance sheet date
- Treatment for the purposes of calculating earnings per share
- Unamortized amount and classification of the issuance costs at the balance sheet date
- Amount of interest cost recognized relating to the amortization of the issuance cost associated with the share-lending arrangement for the reporting period
- Any amounts of dividends paid related to the loaned shares that will not be reimbursed

As discussed in ASC 470-20-50-2B, a reporting entity that enters into a share-lending arrangement on its own shares in contemplation of a convertible debt offering or other financing is also required to comply with the disclosure requirements of ASC 505, *Equity*. See FSP 5 for discussion of these requirements.

As discussed in ASC 470-20-50-2C, in the period in which a counterparty defaults, or a reporting entity concludes it is probable that the counterparty to its share-lending arrangement will default, the reporting entity should disclose:

- The amount of expense reported in the income statement in that period related to the default or any subsequent period
- Any material changes in the amount of expense recorded due to changes in fair value of the reporting entity's shares or probable recoveries
- If the default is probable but has not yet occurred, the number of shares related to the share-lending arrangement that will be reflected in basic and diluted earnings per share when the counterparty defaults

12.12.6 Convertible debt—after adoption of ASU 2020-06

ASC 470-20-50-1A discusses the objective of convertible debt disclosures.

ASC 470-20-50-1A

The objective of the disclosure about convertible debt instruments is to provide users of financial statements with:

a. Information about the terms and features of convertible debt instruments

b. An understanding of how those instruments have been reported in an entity's statement of financial position and statement of financial performance

c. Information about events, conditions, and circumstances that can affect how to assess the amount or timing of an entity's future cash flows related to those instruments.

12.12.6.1 Disclosure of pertinent rights and privileges—after adoption of ASU 2020-06

Pursuant to ASC 470-20-50-1B, reporting entities should describe the pertinent rights and privileges of each convertible debt instrument outstanding.

ASC 470-20-50-1B

An entity shall explain the pertinent rights and privileges of each convertible debt instrument outstanding, including, but not limited to, the following information:

a. Principal amount

b. Coupon rate

c. Conversion or exercise prices or rates and number of shares into which the instrument is potentially convertible

d. Pertinent dates, such as conversion date(s) and maturity date

e. Parties that control the conversion rights

f. Manner of settlement upon conversion and any alternative settlement methods, such as cash, shares, or a combination of cash and shares

g. Terms that may change conversion or exercise prices, number of shares to be issued, or other conversion rights and the timing of those rights (excluding standard antidilution provisions)

h. Liquidation preference and unusual voting rights, if applicable

i. Other material terms and features of the instrument that are not listed above.

12.12.6.2 Disclosure of contingently convertible instruments—after adoption of ASU 2020-06

In accordance with ASC 470-20-50-1C, reporting entities with contingently convertible instruments should disclose:

- Information about events or changes in circumstances that would adjust or change the contingency or would cause the contingency to be met

- Information about whether the calculation of diluted EPS includes the shares that would be issued if converted and the reasons why or why not

- Other information that is helpful to understand the nature of contingencies and potential impact of conversion

12.12.6.3 *Disclosures for each convertible debt instrument—after adoption of ASU 2020-06*

In accordance with ASC 470-20-50-1D, reporting entities should disclose:

Excerpt from ASC 470-20-50-1D

a. The unamortized premium, discount, or issuance costs and, if applicable, the premium amount recorded as paid-in capital in accordance with paragraph 470-20-25-13

b. The net carrying amount

c. For public business entities, the fair value of the entire instrument and the level of the fair value hierarchy in accordance with paragraphs 825-10-50-10 through 50-15.

These disclosures are required to be made at the individual instrument level.

12.12.6.4 *Additional disclosures for convertible debt instruments—after adoption of ASU 2020-06*

ASC 470-20-50-1E provides additional information reporting entities should disclose as of the balance sheet date.

ASC 470-20-50-1E

An entity shall disclose the following information as of the date of the latest statement of financial position presented:

a. Changes to conversion or exercise prices that occur during the reporting period other than changes due to standard antidilution provisions

b. Events or changes in circumstances that occur during the reporting period that cause conversion contingencies to be met or conversion terms to be significantly changed

c. Number of shares issued upon conversion, exercise, or satisfaction of required conditions during the reporting period

d. Maturities and sinking fund requirements for convertible debt instruments for each of the five years following the date of most recent statement of financial position presented in accordance with paragraph 470-10-50-1.

12.12.6.5 *Disclosure of interest expense—after adoption of ASU 2020-06*

For each period for which a statement of financial performance is presented, reporting entities should disclose, in the aggregate:

- The effective interest rate for the period

- The amount of interest recognized, disaggregated by contractual interest expense and the amortization of the premium, discount, or issuance costs

12.12.6.6 Disclosures related to fair value option—after adoption of ASU 2020-06

Reporting entities with convertible debt instruments measured at fair value as a result of applying the fair value option should provide disclosures in accordance with ASC 820-10, ASC 825-10, and ASC 470-20.

12.12.6.7 Derivative disclosures—after adoption of ASU 2020-06

The disclosures in ASC 815 and ASC 470 are required for a conversion option that is accounted for as a derivative.

Further, reporting entities should disclose the following information about derivative transactions entered into in connection with the issuance of convertible instruments, regardless of whether the derivative transactions are accounted for as assets, liabilities, or equity instruments:

- The terms of the derivative transactions (including terms of settlement)
- How the derivative transactions relate to the convertible debt instruments
- The number of shares underlying the derivative transactions
- The reasons for entering into the derivative transactions

12.12.6A Debt with cash conversion features—before adoption of ASU 2020-06

As discussed in FSP 12.7A, certain convertible debt instruments fall within the scope of the cash conversion guidance in ASC 470-20-15-4 through ASC 470-20-15-5.

ASC 470-20-50-3 through ASC 470-20-50-6 requires the following disclosures to be made as of each balance sheet presented for those instruments:

- The carrying amount of the equity component
- The principal amount, the unamortized discount, and the net carrying amount for the liability component

As of the most recent balance sheet date, the reporting entity should disclose the following terms:

- The remaining period over which any discount on the liability component will be amortized
- The conversion price and the number of shares issued upon conversion
- The amount by which the instrument’s if-converted value exceeds its principal amount, regardless of whether the instrument is currently convertible (for public entities only)

If any derivatives are executed in connection with these convertible debt instruments, the reporting entity should disclose the following related to the derivatives, regardless of whether the derivatives are accounted for as assets, liabilities, or equity instruments:

- The derivative transactions’ terms

- How those derivative transactions relate to the instruments
- The number of shares underlying the derivative transactions
- The reasons for entering into those derivative transactions

For each period for which an income statement is presented, a reporting entity should disclose both of the following related to the liability component: (1) the effective interest rate and (2) the amount of interest cost recognized relating to both the contractual interest coupon and amortization of the discount.

12.12.7 Troubled debt restructurings

ASC 470-60-50 provides specific disclosures for a troubled debt restructuring. It requires that a troubled borrower disclose the following, either in the financial statements or the footnotes:

- A description of the principal changes in terms, major features of settlement, or both
- Aggregate gain on restructuring of payables
- Aggregate net gain or loss on transfers of assets recognized during the period (see FSP 22 for guidance on transfers)
- Per-share amount of the aggregate gain on restructuring of payables

Reporting entities may group separate restructurings within a fiscal period for the same category of payables (for example, accounts payable or subordinated debentures) for disclosure purposes.

For financial statement periods after the troubled debt restructuring, the borrower should disclose amounts contingently payable that are included in the carrying amount of restructured payables and the conditions under which those amounts would become payable or be forgiven.

12.12.8 Revolving debt related to long-term projects

When an SEC registrant classifies a borrowing under a long-term project as noncurrent based on the conditions in FSP 12.4.4, it should make appropriate disclosures regarding the existence of such conditions.

12.13 Guarantees of a reporting entity's debt by others

Guarantees of debt are subject to the same disclosures as other guarantees in ASC 460, *Guarantees*. Guarantees are addressed in FSP 23.

Guarantees of a reporting entity's debt by its principal stockholders or other related parties require incremental disclosure as related party transactions under ASC 850-10-50. Presentation and disclosure requirements associated with related party transactions are addressed in FSP 26. Although not in the scope of ASC 460, we believe a reporting entity should consider disclosing guarantees obtained by the reporting entity (as opposed to those made by it), as such arrangements may indicate that the reporting entity is not able to obtain financing without the guarantees of others.

12.13.1 *Issuers of guaranteed securities*

SEC registrants may issue registered debt that is guaranteed by one or more subsidiaries, or SEC registrant-parent companies may serve as a guarantor for securities issued by one or more subsidiaries. Under the US securities laws, guarantees of securities are also considered securities, and therefore may be subject to the SEC's registration and reporting requirements.

Regulation S-X Rule 13-01 generally requires a registrant to make specified disclosures for each guaranteed security that is (i) subject to Section 13(a) or 15(d) of the Securities Exchange Act or (ii) being registered under the Securities Act, for which the registrant is the parent company (as defined in Regulation S-X Rule 3-10(b)(1)) of one or more subsidiaries that issue or guarantee the guaranteed security.

Regulation S-X Rule 13-01 generally requires every issuer of a registered security that is guaranteed and every guarantor of a registered security to file the financial statements required for a registrant. However, Regulation S-X Rule 13-01 provides relief that may result in significantly reduced reporting obligations (i.e., condensed consolidating financial information or narrative disclosure) if certain criteria are met.

The disclosure requirements of Regulation S-X Rule 13-01 are set forth in Regulation S-X Rule 13-01(a) and include both non-financial disclosures (Regulation S-X Rule 13-01(a)(1)-(3)) and financial disclosures (Regulation S-X Rule 13-01(a)(4) and Regulation S-X Rule 13-01(a)(5)). The parent company may elect to provide the disclosures in a footnote to its consolidated financial statements or in MD&A.

FSP 12.13.2 through FSP 12.13.2.3 summarize the Regulation S-X Rule 13-01 requirements.

12.13.2 *Non-financial disclosures required by S-X 13-01(a)(1)-(3)*

The non-financial disclosures include a description of (i) the issuers and guarantors, (ii) the terms and conditions of the guarantees, and (iii) how the structure of the guarantees and other factors may affect payment. Additionally, each subsidiary issuer/guarantor is required to be identified in an exhibit to the applicable filing (see Regulation S-K Item 601(b)(22)).

12.13.2.1 *Financial disclosures required by S-X 13-01(a)(4)*

Financial disclosures include summarized financial information described in Regulation S-X Rule 1-02(bb)(1) of each issuer and guarantor of the guaranteed security with an accompanying note that briefly describes the basis of presentation. The summarized financial information required by Regulation S-X Rule 13-01(a)(4) must exclude subsidiaries that are not issuers or guarantors, even if an issuer or guarantor would otherwise consolidate such non-issuer/non-guarantor subsidiaries.

In addition to the line items specified by Regulation S-X Rule 1-02(bb)(1), Regulation S-X Rule 13-01(a)(4)(iii) requires separate line items for an issuer's or guarantor's amounts due from, amounts due to, and transactions with (i) subsidiaries that are not issuers or guarantors and (ii) related parties.

The summarized financial information of each issuer and guarantor that is consolidated in the parent company's financial statements may generally be presented on a combined basis with summarized financial information of the parent company with appropriate eliminations.

12.13.2.2 *Financial disclosures required by S-X 13-01(a)(5)*

Disclosure of pre-acquisition summarized financial information is required in a Securities Act registration statement filed in connection with the offer and sale of a guaranteed security if:

- the parent company acquired a significant business after the date of the parent company's most recent balance sheet include in its consolidated financial statements, and
- the acquired business, one or more of the acquired business's subsidiaries, or the acquired business and one or more of its subsidiaries are issuers or guarantors of the guaranteed securities.

If the pre-acquisition summarized financial information is required, it would follow the form, content, and periods specified in Regulation S-X Rule 13-01(a)(4).

12.13.2.3 *Periods for which summarized financial information is required*

Summarized financial information is required as of and for the most recently ended fiscal year and year-to-date interim period included in the parent company's consolidated financial statements. Figure FSP 12-2 illustrates information that is required in a filing for a domestic calendar year-end SEC registrant parent company that is required to include the Regulation S-X Rule 13-01 disclosure in its filings.

Figure FSP 12-2
Required S-X 13-01 disclosure for a domestic calendar year-end SEC registrant

Filing	Required summarized financial information
Form 10-K for the year-ended December 31, 20X1	As of and for the year ended December 31, 20X1
Form 10-Q for the nine-month period ended September 30, 20X2	As of December 31, 20X1 and as of and for the nine-month period ended September 30, 20X2
Form S-3 filed to register the offer and sale of the securities subject to Regulation S-X Rule 13-01 by a calendar year-end parent company on September 15, 20X2	As of and for the year ended December 31, 20X1 and as of and for the six-month period ended June 30, 20X2

12.14 Registration rights arrangements

Registration rights allow the holder to require that a reporting entity file a registration statement for the resale of specified instruments. They may be provided to lenders in the form of a separate agreement, such as a registration rights agreement, or included as part of an investment agreement, such as an investment purchase agreement, warrant agreement, debt indenture, or preferred stock indenture. These arrangements may require the issuer to pay additional interest if a registration statement is not filed or is no longer effective.

Additional disclosures are required of the issuer of a registration payment arrangement for each registration payment arrangement or each group of similar arrangements. These requirements are based on those for guarantees in ASC 460-10-50-4 and include the following:

- The nature and term of the arrangement and financial instruments subject to the arrangement, and the circumstances that would require transfer of consideration
- Any settlement alternatives in the terms of the registration payment arrangement
- The undiscounted maximum potential amount of consideration that could be required to be transferred, or, if there is no limit, disclosure of that fact
- The current carrying amount of the liability representing the issuer's obligations under the registration payment arrangement
- The income statement classification of any gains and losses resulting from changes in the liability's carrying amount

12.15 Debt — considerations for private companies

The requirements of ASC 470 apply to both public and private companies. The following disclosure and classification requirements discussed in this chapter are required for SEC registrants only:

- Disclosure requirements under Regulation S-X Rule 5-02
- Related party disclosures under Regulation S-X Rule 4-08(k)
- Regulation S-X Rule 13-01 disclosures for issuer of a registered security that is guaranteed
- Regulation S-X Rule 13-02 for debt offerings that contain collateral features
- Classification considerations for revolving debt under long-term construction programs in ASC 470-10-S99

Chapter 13: Pensions and other postemployment benefits—updated March 2024

13.1 Pensions and other postemployment benefits—overview

This chapter addresses annual presentation and disclosure matters related to retirement benefits under ASC 715, *Compensation—Retirement Benefits*, and nonretirement postemployment benefits under ASC 712, *Compensation—Nonretirement Postemployment Benefits*. Interim presentation and disclosure requirements differ (see FSP 29).

For presentation considerations related to the presentation of retirement and other postemployment benefits in the statement of other comprehensive income, see FSP 4.

13.2 Pensions and other postemployment benefits—scope and relevant guidance

Retirement benefits are benefits that employers provide employees at retirement, including pensions, other postretirement benefits (OPEB) like health and welfare benefits, and similar benefits through defined contribution plans.

Nonretirement postemployment benefits are benefits that reporting entities provide employees after employment but before retirement, such as termination benefits.

The topics discussed in this chapter relate to the presentation and disclosure requirements for the employer's financial statements (not the benefit plan itself).

13.3 Defined benefit plans

This section covers the presentation of defined benefit plans in a reporting entity's financial statements and the disclosures in the accompanying notes.

A defined benefit plan is any retirement plan that is not a defined contribution plan, as described in FSP 13.4. Generally, a defined benefit plan is one that defines an amount of benefit to be provided, usually as a function of one or more factors, such as age, years of service, or compensation.

13.3.1 Balance sheet presentation

Balance sheet presentation of defined benefit plans involves two factors: recognition of the plan's funded status, and classification of the funded status as current and noncurrent. The funded status is the difference between the fair value of plan assets and the benefit obligation. The benefit obligation refers to the projected benefit obligation (PBO) for pension plans and the accumulated postretirement benefit obligation (APBO) for OPEB plans. As discussed in ASC 715-20-50-1(c), the funded status and its classification as current and noncurrent are required to be determined on a plan-by-plan basis.

13.3.1.1 Funded status presentation

As discussed in ASC 715-20-45-2, a reporting entity is required to recognize the funded status of its defined benefit plans on the balance sheet. As discussed in ASC 715-20-45-3, an overfunded benefit plan has plan assets that are greater than the benefit obligation (which would be presented as a net

benefit asset). An underfunded benefit plan has plan assets that are less than the benefit obligation, and an unfunded benefit plan has no plan assets (both are presented as a net benefit liability).

A reporting entity is not permitted to offset one plan's net benefit asset with another plan's net benefit liability. Further, all overfunded plans should be aggregated and recorded as a net benefit asset, and all unfunded or underfunded plans should be aggregated and recorded as a net benefit liability. Therefore, a reporting entity that has more than one plan may report both a net benefit asset and a net benefit liability on its balance sheet.

As defined in ASC 715-30-20 and ASC 715-60-20, for assets to be considered plan assets, the assets must be segregated in a trust or otherwise restricted for the sole use of paying benefits. The reporting entity is generally not permitted to access the funds for other uses. Only assets that meet the definition of plan assets can offset the liability on the balance sheet. Assets that do not meet the definition of plan assets are presented gross on the balance sheet and accounted for and classified depending on the nature of the asset.

Plan assets should be measured on the balance sheet date. However, ASC 715-30-35-63A provides a practical expedient as a policy election that allows employers with fiscal year-end dates that do not fall on a calendar month-end (e.g., companies with a 52/53 week fiscal year) to measure plan assets and obligations as of the calendar month-end closest to the fiscal year-end.

13.3.1.2 Balance sheet classification

As discussed in ASC 715-20-45-3, a reporting entity that presents a classified balance sheet is required to consider whether a portion of its net benefit liability should be presented as a current liability, on a plan-by-plan basis. The current liability is the amount of the benefit obligation that is payable over the next 12 months (or the operating cycle, if longer) that exceeds the fair value of plan assets. Payments include expected benefit payments, expected settlements (e.g., lump sum payments), and payments of other items reflected in the benefit obligation (e.g., administrative or claims costs). All expected payments for an unfunded plan to be made over the next 12 months (or operating cycle, if longer) from the balance sheet date are classified as a current liability.

In determining the current liability, a reporting entity should consider expected payments for the 12-month period from the balance sheet date. For example, in its 20X1 financial statements, a calendar year-end reporting entity should consider the expected payments for the period January 1, 20X2 to December 31, 20X2 in determining whether a portion of the liability should be classified as current. For its March 31, 20X2 balance sheet, the reporting entity should consider the expected payments for the period April 1, 20X2 to March 31, 20X3 (not just expected payments for the remainder of the year). A reporting entity is not required to remeasure plan assets and obligations in order to estimate expected payments for interim reporting purposes.

For plans that are overfunded (in a net asset position), the net benefit asset should be classified as a noncurrent asset. If a reporting entity expects a refund from the plan within the next 12 months—a rare occurrence in practice—the amount and timing of the refund should be disclosed, but not recorded as a current asset.

13.3.2 Income statement presentation

In the income statement, pension and OPEB costs are included in net periodic pension cost. Under ASC 715, net periodic benefit cost comprises:

- Service cost
- Interest cost
- Expected return on plan assets
- Amortization of prior service cost/credit
- Gains and losses
- Amortization of transition amount (this would have arisen upon the initial adoption of the guidance that is now in ASC 715)

Under ASC 715-20-45-3A, a reporting entity that sponsors one or more defined benefit plans will present net benefit cost as follows:

- Service cost will be included with other employee compensation costs within operations, if such a subtotal is presented.
- The other components of net benefit cost will be presented separately (in one or more line items) and outside of income from operations, if such a subtotal is presented.

If a separate line item is used to present the other components of net benefit cost, it should have an appropriate description. If a separate line item is not used, the reporting entity must disclose the line items in the income statement where the other components of net benefit cost are included.

Gains and losses from curtailments and settlements, and the cost of certain termination benefits accounted for under ASC 715, should be reported in the same fashion as the other components of net benefit cost.

Net periodic benefit cost is estimated at the beginning of the year, based on beginning-of-the-year (or end-of-prior-year) plan balances and assumptions.

When the plan is remeasured, typically at the end of the year, if the net benefit asset or liability changes by more than the net periodic benefit cost recorded, the difference is referred to as an actuarial gain or loss. How an actuarial gain or loss is recognized will depend on the reporting entity's accounting policy for gain and loss recognition. Some reporting entities first recognize such gains and losses in OCI and subsequently recognize these amounts in net periodic benefit cost in future periods. A reporting entity that has adopted an immediate recognition policy for gains and losses would recognize the gain or loss in net periodic benefit cost in the period in which it occurs.

Capitalizing costs

Similar to other employee costs, net periodic benefit costs should be capitalized in connection with the construction or production of an asset (e.g., inventories, self-constructed assets, internal use software). The amount capitalized will be limited to only the service cost component of the total net periodic pension and other postretirement benefit cost attributable to specific employees.

Excerpt from ASC 330-10-55-6A

The service cost component of net periodic pension cost and net periodic postretirement benefit cost is the only component directly arising from employees' services provided in the current period. Therefore, when it is appropriate to capitalize employee compensation in connection with the construction or production of an asset, the service cost component applicable to the pertinent employees for the period is the relevant amount to be considered for capitalization

The guidance does not prescribe how to determine the amount of net periodic benefit cost to allocate to the employees associated with the production or construction of an asset, or how to allocate the costs across the period the assets are being produced or constructed. This determination requires considerable judgment based on the relevant facts and circumstances.

13.3.3 Statement of stockholders' equity presentation

Reporting entities are permitted to recognize gains and losses in OCI and subsequently amortize those amounts as a component of net periodic benefit cost. Prior service cost (credit) generated from plan amendments is generally required to be treated in a similar manner (i.e., such amounts are first recognized in OCI and subsequently recognized in net periodic benefit cost through amortization). As amounts are amortized, a reclassification adjustment is recognized in AOCI.

See FSP 4 for further discussion of OCI reclassification adjustments.

13.3.3.1 Gains and losses

A gain or loss can result from a change in any of the following:

- The value of plan assets due to experience, both realized and unrealized, being different from that assumed (i.e., the expected return on plan assets)
- The benefit obligation resulting from experience different from that assumed
- Actuarial assumptions, including changes in discount rates

The amount of the net gain or loss recognized in AOCI, as well as the amount to amortize in the subsequent period, is recalculated at each measurement date. At a minimum, an amount should be amortized as a component of net periodic benefit cost for the year if the beginning-of-the-year net gain or loss in AOCI exceeds the "corridor" amount, i.e., 10% of the greater of the benefit obligation or the market-related value of plan assets.

A reporting entity may adopt an accounting policy for recognizing the net gain or loss that differs from the corridor approach, as long as it is a systematic method and the amount recognized each period is no less than the amount that would have been recognized under the corridor method. As discussed in ASC 715-20-50-1(o), a reporting entity should also disclose any alternative recognition policy.

13.3.3.2 Prior service cost (credit)

Prior service cost (credit) arises from plan amendments that increase (decrease) benefits for services rendered in prior periods. It is measured by the change in the benefit obligation at the date the

amendment is adopted. The amount to be amortized as a component of net periodic benefit cost each period is established at the date of the amendment. This amount should not be subsequently changed or recalculated, unless there is a significant event such as a curtailment. Prior service cost arising from each plan amendment should generally be amortized separately.

13.3.3.3 *Foreign pension and OPEB plans*

A reporting entity with foreign plans in which the functional currency for the entity with the foreign plan is different from the overall parent reporting currency needs to determine at what foreign currency rate to translate amounts in AOCI that are subsequently reclassified to net income. We believe that there are two acceptable approaches to account for the translation under ASC 830, *Foreign Currency Matters*, as described in Figure FSP 13-1 below. Selection of an approach represents an accounting policy decision that should be applied consistently.

Figure FSP 13-1

Acceptable approaches to account for the reclassification of foreign pension and OPEB items from AOCI to net income

Approach	Requirements of presentation
Historical rate	The amount of AOCI reclassified to net income each period is translated at the historical exchange rate in effect at the time the prior service costs (credits), net gain (loss), or transition asset (obligation) were initially recognized in OCI.
Current rate	The amount of AOCI reclassified to net income each period is translated at the current exchange rate in effect for the period in which the reclassification adjustment is reflected in net income. The rate used typically represents the average exchange rate for the period, since pension and OPEB expense is recognized ratably over the period.

13.3.4 *Subsidiaries participating in parent company plans*

When a reporting entity participates in a pension or OPEB plan sponsored by an affiliated entity (e.g., parent company, sister entity), the accounting in the standalone financial statements of the reporting entity should generally follow the “multiemployer” guidance in ASC 715-80 (discussed in FSP 13.5). The multiemployer guidance differs significantly from the traditional “single employer” accounting guidance. Under multiemployer accounting, a reporting entity typically recognizes expense based on the required contribution to the plan for the period. The reporting entity only recognizes a liability if the required contribution had not been paid at the end of the period.

A subsidiary that participates in its parent’s benefit plan is not required to provide the multiemployer disclosures described in FSP 13.5.1 and FSP 13.5.2. Rather, it should disclose the name of the plan and the amount of contributions to the plan.

13.3.5 *Reporting entities with two or more plans*

Reporting entities may aggregate the disclosures provided for all pension plans, and for all OPEB plans, unless disaggregating in groups provides more useful information or if a disclosure is specifically required, as discussed in this section.

13.3.5.1 Aggregate benefit obligation in excess of plan assets

Reporting entities may aggregate disclosures for plans whose plan assets exceed the benefit obligation, with separate disclosures for those plans whose benefit obligations exceed plan assets. However, ASC 715-20-50-3 requires that if a reporting entity choses to aggregate the disclosures required by ASC 715-20-50-1 for these plans, it also needs to include the disaggregated disclosure.

Post-adoption of ASU 2018-14

- For pension plans:
  - The projected benefit obligation and fair value of plan assets in the aggregate for plans with PBOs in excess of plan assets, and
  - The accumulated benefit obligation and fair value of plan assets in the aggregate for plans with ABOs in excess of plan assets.
- For postretirement plans, the accumulated postretirement benefit obligation and fair value of plan assets in the aggregate for plans with APBOs in excess of plan assets.

13.3.5.1A Aggregate benefit obligation in excess of plan assets

Reporting entities may aggregate disclosures for plans whose plan assets exceed the benefit obligation, with separate disclosures for those plans whose benefit obligations exceed plan assets. However, ASC 715-20-50-3 requires that if a reporting entity choses to aggregate the disclosures required by ASC 715-20-50-1 for these plans, it also needs to include the disaggregated disclosure.

In August 2018, the FASB issued ASU 2018-14, *Compensation—Retirement Benefits (Topic 715), Disclosure Framework—Changes to the Disclosure Requirements for Defined Benefit Plans*. The guidance is effective for fiscal years ending after December 15, 2020 for public business entities and for fiscal years ending after December 15, 2021 for all other entities. Early adoption is permitted for all entities. ASU 2018-14 only amends annual reporting requirements (i.e., it does not amend interim reporting requirements). A reporting entity should apply the amendments on a retrospective basis to all periods presented.

Pre-adoption of ASU 2018-14

Reporting entities may aggregate disclosures for plans whose plan assets exceed the benefit obligation, with separate disclosures for those plans whose benefit obligations exceed plan assets. However, ASC 715-20-50-3 requires that if a reporting entity choses to aggregate the disclosures required by ASC 715-20-50-1 for these plans, it also needs to include the disaggregated disclosure.

- For plans with benefit obligations in excess of plan assets as of the measurement date of each balance sheet presented, disclose the aggregate benefit obligation and aggregate fair value of plan assets
- For pension plans with an ABO in excess of plan assets, disclose the aggregate ABO and the aggregate fair value of plan assets

13.3.5.2 US and international plans

A reporting entity may aggregate its disclosure for US and non-US plans, unless the benefit obligations for the non-US plans are significant relative to the total benefit obligation and their assumptions are significantly different.

13.3.6 Disclosure

Information related to a reporting entity's net periodic benefit cost should be disclosed for each period that an income statement is presented. Similarly, information related to amounts presented in a reporting entity's balance sheet should be disclosed as of the date of each balance sheet presented. Information for pension plans should be provided separate from information about OPEB plans (see FSP 13.3.5 for discussion of disclosure requirements when a reporting entity has more than one pension or OPEB plan). Disclosure requirements differ depending on if the reporting entity is a public entity or a nonpublic entity.

ASC 715-20-20 defines both a nonpublic entity and a public entity.

Definition from ASC 715-20-20

Nonpublic entity: Any entity other than one with any of the following characteristics:

a. Whose debt or equity securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally

b. That is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets)

c. That makes a filing with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market

d. It is required to file or furnish financial statements with the Securities and Exchange Commission.

e. That is controlled by an entity covered by (a) through (d).

Publicly traded entity (or public entity): Any entity that does not meet the definition of a nonpublic entity.

Public reporting entities should provide the required disclosures from ASC 715-20-50-1 as further discussed in the remainder of this section. ASC 715-20-55-16 through ASC 715-20-55-17 include an illustrative example of the disclosure requirements.

A nonpublic company should refer to the disclosures required in ASC 715-20-50-5, and to the considerations for nonpublic companies (see FSP 13.7).

13.3.6.1 Description of the plans

Although not specifically required, a reporting entity should consider providing a general description of the defined benefit plans it sponsors to help financial statement users understand the current and future impact the benefits have on the financial statements. The following is information that a reporting entity may consider providing:

- Nature of the plans
- Benefits provided
- Employee groups entitled to benefits
- Description of the regulatory environment (e.g., ERISA) in which the plans operate
- Description of the risks to which the plans may expose the reporting entity
- Other information that would be useful to understand the plans

13.3.6.2 Amounts recognized on the balance sheet and funded status

ASC 715-20-50-1 requires a reporting entity to disclose the pension-related amounts recognized on the balance sheet, showing separately the net assets and net liabilities. A reporting entity should separately disclose the current and noncurrent liabilities recognized if it presents a classified balance sheet. A reporting entity should also disclose the funded status of the plans. These amounts should be consistent with the ending balances in the reconciliation of the benefit obligation and the fair value of plan assets, as discussed in FSP 13.3.6.3.

As discussed in ASC 715-20-50-1(e), for defined benefit pension plans, a reporting entity should disclose the accumulated benefit obligation (ABO). The ABO is a benefit obligation measure that incorporates past and current compensation levels, but unlike the projected benefit obligation, does not reflect expected benefit increases from future salary levels. The PBO is the benefit obligation that is used to calculate the net asset or liability included on the balance sheet, while the ABO is disclosed.

Reporting entities with two or more plans have additional disclosure requirements (see FSP 13.3.5 for discussion of disclosure requirements when a reporting entity has more than one pension or OPEB plan).

13.3.6.3 Reconciliation of the benefit obligation and plan assets

As discussed in ASC 715-20-50-1(a) through ASC 715-20-50-1(b), a reporting entity should disclose a reconciliation of the beginning and ending balances of the benefit obligation and the fair value of plan assets, showing separately the items that impact the balance. Figure FSP 13-2 identifies items that typically affect the benefit obligation, fair value of plan assets, or both.

Figure FSP 13-2

Items that typically affect the benefit obligation, fair value of plan assets, or both

Benefit obligation	Fair value of plan assets	Both
□ Service cost	□ Actual return on plan assets	□ Contributions by plan participants
□ Interest cost	□ Contributions by reporting entity	□ Benefits paid
□ Actuarial gains and loses		□ Foreign currency exchange rate changes

Benefit obligation	Fair value of plan assets	Both
□ Plan amendments		□ Business combinations
□ Curtailments		□ Divestitures
□ Termination benefits		□ Settlements

13.3.6.4 *Plan assets*

ASC 715-20-50-1(d) provides disclosure objectives for plan assets, indicating that the disclosures are intended to provide users of the financial statements with an understanding of:

- The plan's investment policies, strategies, and allocation decisions
- The classes of plan assets
- The inputs and valuation techniques used to measure the fair value of plan assets
- The effect of fair value measurements using significant unobservable inputs on changes in plan assets for the period
- Significant concentrations of risk within plan assets

The plan asset disclosures are intended to address users' desires for transparency about the types of assets and associated risks in a reporting entity's defined benefit pension and OPEB plans, and how economic events could have a significant effect on the value of plan assets.

Disclosure about investment policies and strategies

ASC 715-20-50-1(d)(5) requires a reporting entity to disclose information regarding how investment allocation decisions are made, including factors pertinent to understanding investment policies and strategies. Disclosures should include:

- A narrative description of investment policies and strategies
- Target allocation percentages or a range of percentages considering the classes of plan assets as of the latest balance sheet presented (on a weighted-average basis for reporting entities with more than one plan)
- Other factors pertinent to an understanding of the plan's policies and strategies, such as:
    - Investment goals
    - Risk management practices
    - Permitted and prohibited investments, including whether the use of derivatives is permitted
    - Diversification

- The relationship between plan assets and benefit obligations

- A description of the significant investment strategies of investment funds (e.g., hedge funds, mutual funds, private equity funds), if those investment funds represent a major class of plan assets.

Disclosure about classes of plan assets

As discussed in ASC 715-20-50-1(d)(5)(ii), a reporting entity should disclose the fair value of each class of plan assets as of each annual reporting date for which a balance sheet is presented. Asset classes should be disclosed based on the nature and risks of the assets.

Examples of classes of plan assets include:

- Cash and cash equivalents
- Equity securities (segregated by industry type, reporting entity size, or investment objective)
- Debt securities issued by national, state, and local governments
- Corporate debt securities
- Asset-backed securities
- Structured debt
- Derivatives on a gross basis (segregated by type of underlying risk in the contract, e.g., interest rate risk, foreign exchange risk, credit risk)
- Investment funds (segregated by type of fund)
- Real estate

Plan assets may be invested indirectly in many different asset categories (e.g., a mutual fund may invest in several different types of assets). A reporting entity is not required to allocate such indirect investments into respective asset categories. However, a reporting entity should consider the objectives of the disclosure in determining under which asset class such an investment should be disclosed. Specifically, disclosure of additional asset classes and/or further disaggregation of major categories would be appropriate if that information is expected to be useful in understanding the risks associated with each asset class or the overall expected long-term rate of return on assets.

As discussed in ASC 715-20-50-1(d)(5)(iii), a reporting entity is also required to provide a narrative description of the basis used to determine the overall expected long-term rate of return on assets. Such narrative should consider the classes of assets described above and include:

- The general approach used
- The extent to which the overall rate of return on assets assumption was based on historical returns
- The extent to which adjustments were made to those historical returns in order to reflect expectations of future returns and how those adjustments were determined.

Question FSP 13-1

Is a reporting entity required to separately disclose its investment strategy for each class of assets in the fair value hierarchy disclosure?

PwC response

The guidance does not explicitly require a reporting entity to disclose its investment strategy for each class of assets included in the fair value disclosure. Accordingly, investment strategies may be disclosed at the level provided to the portfolio managers provided it is clear how the strategy relates to the classes of plan assets. For example, if a plan's strategy is to invest 50% to 60% in equities, the reporting entity would not be required to break this target allocation into further subclasses (even where the fair value hierarchy disclosure presents several such subclasses of equities).

A reporting entity that applies the practical expedient related to the measurement date of defined benefit plan assets and obligations at the calendar month-end closest to the fiscal year-end date is subject to an additional disclosure requirement (if applicable), as described in ASC 715-20-50-1(d)(5)(ii).

Excerpt from ASC 715-20-50-1(d)(5)(ii)

If an employer determines the measurement date of plan assets in accordance with paragraph 715-30-35-63A or 715-60-35-123A and the employer contributes assets to the plan between the measurement date and its fiscal year-end, the employer shall not adjust the fair value of each class of plan assets for the effects of the contribution. Instead, the employer shall disclose the amount of the contribution to permit reconciliation of the total fair value of all the classes of plan assets to the ending balance of the fair value of plan assets.

Disclosure of fair value measurements of plan assets

Disclosures are required to enable users of the reporting entity's financial statements to assess the inputs and valuation techniques used to develop fair value measurements of plan assets. As discussed in ASC 715-20-50-1(d)(5)(iv), a reporting entity should disclose the following for each class of plan assets as of each annual reporting date for which a balance sheet is presented:

- The level within the fair value hierarchy in which the fair value measurements in their entirety fall, segregating fair value measurements using Level 1, Level 2, and Level 3 inputs. However, if the fair value is measured at net asset value (NAV) using the practical expedient, it should not be reflected in this table, but rather should be included as a reconciling item to the total fair value of plan assets. Investments for which NAV is fair value, and not a practical expedient, must still be included in the fair value table in the appropriate level.

- For Level 3 fair value measurements of plan assets, a reconciliation of the beginning and ending balances, separately presenting changes during the period attributable to:

    - Actual return on plan assets, separately identifying the amounts related to assets still held at the reporting date and assets sold during the period

- Purchases, sales, and settlements, net
- Transfers in or out of Level 3

- Information about the valuation technique(s) and inputs used to measure fair value, including a discussion of any changes in valuation techniques and inputs used during the period.

See FV 4.5 for further discussion of inputs to fair value measurement and the fair value hierarchy, including presentation when the inputs used to measure fair value fall within different levels of the fair value hierarchy.

ASC 715-20-50-1(d)(5)(iv)(02) requires the Level 3 asset reconciliation to include the actual return on plan assets, separately identifying the amount related to assets still held at the reporting date and the amount related to assets sold during the period. Questions have arisen in practice about how to define and measure realized and unrealized gains and losses on plan assets, as well as the appropriate format for presenting this information. The guidance does not specify a particular way to calculate realized and unrealized gains and losses, or the format of the Level 3 reconciliation disclosure. A reporting entity can exercise judgment in determining the manner and format of the disclosure, so long as it satisfies the disclosure objectives of the standard and is applied consistently each period.

In considering the guidance, we believe, for example, that it would be acceptable to separately present the actual return (realized and unrealized) on plan assets still held at the reporting date, and on assets sold during the period within the reconciliation. Alternatively, the actual return (realized and unrealized) may be presented as a single line item in the reconciliation, and the amounts associated with assets still held at the reporting date disclosed in a footnote to the reconciliation.

The disclosure requirements by level are similar to those required by ASC 820, *Fair Value Measurement* (see FSP 20). However, ASC 715 requires a reporting entity to segregate its Level 3 returns between those related to assets held and sold in lieu of the ASC 820 requirement to segregate gains and losses recognized in earnings from those recognized in other comprehensive income. That requirement does not apply to a reporting entity's disclosures about its pension and OPEB plan assets because the delayed recognition provisions for gains and losses makes it too difficult to determine whether gains or losses on plan assets were included in net income or OCI for the period.

Many reporting entities and plans use information provided by third parties in developing their fair value estimates. While reporting entities may receive information from the plan custodian or trustee regarding asset valuations and the classification of investments in the fair value hierarchy (i.e., whether inputs used to measure fair value are Level 1, 2 or 3), management remains responsible for the accuracy of such determinations. As such, reporting entities should understand the valuation methodologies used by their third party information providers. The AICPA Employee Benefit Plans Audit Quality Center Advisory, *Valuing and Reporting Plan Investments,* may help management understand its responsibility regarding the valuation and reporting of investments.

Question FSP 13-2

How should a reporting entity determine the level of disaggregation (e.g., the appropriate unit of account) for the fair value hierarchy disclosure?

PwC response

The guidance indicates that for purposes of the fair value disclosures, the asset classes should be based on the nature, characteristics, and risks of the assets in a reporting entity's plan.

Plan investments often involve complex structures with multiple layers. A reporting entity should determine the unit of account based on the legal structure, which will determine the level of disaggregation for the fair value hierarchy disclosure. In some cases, a plan may utilize a portfolio manager to manage a pool of investments (e.g., stocks and bonds) on its behalf, but the plan legally owns the underlying investments. In these situations, each individual stock and bond (i.e., CUSIP or trade lot) would be its own unit of account.

A plan may invest in an insurance contract that will generate returns based on the performance of underlying or referenced assets (e.g., pooled accounts). In these situations, the reporting entity may determine that the appropriate unit of account is the insurance contract rather than the underlying investment. Alternatively, some insurance contracts require that the underlying assets be maintained in a "separate account" of the insurance reporting entity, and sometimes the plan sponsor has some involvement in investment decisions relating to the separate account. These assets are generally not comingled with assets of the insurer or other plan sponsors, and while the insurer legally owns the assets, they may not be available to its general creditors in bankruptcy. Accordingly, it may be appropriate to look through the separate account to determine the appropriate level of the underlying investment.

Question FSP 13-3

How should investments measured at NAV using the practical expedient, cash, insurance contracts, dividends receivable, and accrued interest be included in the reporting entity's fair value hierarchy disclosure?

PwC response

The guidance requires disclosure of the fair value of each class of plan assets and the level within the fair value hierarchy based on the inputs used to develop the fair values. The following provides guidance on specific types of plan assets:

Investments measured at NAV using the practical expedient — Investments whose fair values are measured at NAV using the practical expedient should not be included in the fair value hierarchy table. Such investments should be included as a reconciling item between the fair value hierarchy disclosure and total plan assets. Investments measured at NAV not using the practical expedient should be included in the fair value hierarchy table.

Demand deposits and other cash — Cash on deposit held by a plan is recorded at the amount on deposit. Since no judgment is required to assess the fair value of cash, and the disclosure example in ASC 715-20-55-17 explicitly includes cash, it could be included in the fair value hierarchy disclosure. It

is appropriate to classify the fair value measurement for cash as Level 1 when the amounts are available on demand. It would also be acceptable to exclude cash from the fair value hierarchy disclosure and include it as a reconciling item between the fair value hierarchy disclosure and total plan assets.

Contracts with insurance companies — ASC 715-30-35-60 states that contracts with insurance companies (other than those that are in substance equivalent to the purchase of annuities) should be accounted for as investments and measured at fair value. The guidance further states that for some contracts, contract value may be the best evidence of fair value. If a contract has a determinable cash surrender value or conversion value, that amount is presumed to be its fair value.

We believe that these alternative measures are practical expedients to the required fair value measurement. This practical expedient does not relieve a reporting entity from the requirement to present such contracts as a component of the applicable major category of plan assets in the fair value disclosure. Accordingly, contracts issued by insurance companies, including those for which cash surrender value or contract value is used to estimate fair value, should be included in the fair value hierarchy disclosure.

Generally, contracts that are recorded at cash surrender value or contract value will be classified as Level 2 or Level 3, depending on the nature of the contract. For example, in some instances, the contract value or cash surrender value is based principally on a referenced pool of investment funds that actively redeems shares and for which prices may be observable, resulting in Level 2 classification. In other instances, the underlying investments may comprise less liquid funds or assets, resulting in Level 3 classification.

Dividends and interest receivable — Dividends and interest receivable included in plan assets are also required to be recorded at fair value. Given the short-term nature of these assets, reporting entities generally assert that the carrying amounts of these items approximate their fair values. A reporting entity that includes these assets in the fair value hierarchy should not classify these assets as Level 1 as there are no quoted prices in active markets. A reporting entity would need to assess the observability of inputs to determine whether the assets should be reported as Level 2 or Level 3. Alternatively, some reporting entities present these items as adjustments to reconcile the fair value hierarchy to the fair value of plan assets.

Question FSP 13-4

What should the Level 3 asset reconciliation start with -- the fair value estimates reported in the prior year financial statements or the revised amounts based on any final valuations received after those financial statements were issued?

PwC response

Many reporting entities apply a roll forward technique to estimate the year-end fair values of alternative investments (e.g., hedge funds and private equity funds) because valuations are difficult to obtain in a timely manner for year-end reporting. In these instances, reporting entities typically develop a best estimate using asset values at a period earlier than the year-end measurement date and make adjustments to roll forward the asset values to year-end. The year-end estimates are subsequently "trued-up" when the plan receives the final valuations (e.g., in the second quarter),

which are used to measure current year benefit cost and disclosed in the plan financial statements filed with Form 5500.

Assuming the reporting entity has concluded that any subsequent changes to the prior year fair value estimates were "changes in estimates" rather than "corrections of errors" (as defined by ASC 250, *Accounting Changes and Error Corrections*), the change in estimate should be reflected as current period activity (e.g., unrealized gain or loss) in the Level 3 asset reconciliation. In that case, the reconciliation should start with the fair value estimates reported in the prior year financial statements.

Question FSP 13-5

How should the Level 3 asset reconciliation present foreign exchange translation and transaction gains and losses?

PwC response

The effect of foreign currency translation and transaction gains and losses, to the extent they affect the change in the fair value of the Level 3 assets, may be presented as a component of actual return on plan assets for the period, or as a separate line item. If a reporting entity elects to present the foreign exchange amounts as a separate line item in the reconciliation, it is not necessary to disclose the amounts associated with assets sold and assets held at year-end.

Question FSP 13-6

If a pension plan is party to securities lending transactions (i.e., borrower of cash and lender of securities), should the obligation to buy back the securities on loan be included in the fair value disclosures, including the fair value hierarchy disclosure?

PwC response

Yes. The liability recognized in connection with a securities lending transaction (i.e., to repurchase the securities on loan) is included in the net assets of the plan at fair value. Accordingly, it is appropriate to include the securities lending liability in the fair value disclosures, including the fair value hierarchy disclosure.

Disclosure about significant concentrations of risk

Reporting entities are required to disclose significant concentrations of risk in plan assets. The guidance does not prescribe how a significant concentration should be determined. Each reporting entity should perform a risk assessment of its plan assets to determine whether it has any significant concentrations of risk that require disclosure. Reporting entities should consider concentrations of risk related to asset type, industry, or market.

Other asset disclosures

The guidance requires the following additional asset disclosures:

- If plan assets include securities of the reporting entity or a related party, the amounts and types of securities included in plan assets

- The approximate amount of future annual benefits covered by insurance contracts, including annuity contracts issued by the reporting entity or a related party (upon adoption of ASU 2018-14, this disclosure will no longer be required)

- Any significant transactions between the reporting entity or a related party and the plan during the year (upon adoption of ASU 2018-14, this disclosure will no longer be required)

- If plan assets are expected to be returned to the reporting entity during the next year (or operating cycle, if longer), the amount and timing of any such plan assets (upon adoption of ASU 2018-14, this disclosure will no longer be required)

13.3.6.5 Net periodic benefit cost and other comprehensive income

A reporting entity is required to disclose the net periodic benefit cost, amounts recognized in OCI, AOCI balances, and amounts expected to be amortized in the coming year.

Net periodic benefit cost

As discussed in ASC 715-20-50-1(h), a reporting entity should disclose its net periodic benefit cost and disclose the components of cost for each period for which an income statement is presented, including the following:

- Service cost

- Interest cost

- Expected return on assets

- Gain or loss

- Amortization of prior service cost/credit

- Gain or loss due to settlements or curtailments

- Amortization of transition asset or obligation

- If not presented in a separate line, the line item(s) in the income statement in which the components other than the service cost component are presented

Other comprehensive income and accumulated other comprehensive income

A reporting entity that defers amounts in AOCI (either gains and losses or prior service cost (credit) generated from a plan amendment) is required to disclose the following information about OCI and AOCI:

- For each year that an income statement is presented, amounts recognized in OCI during the year, including separately disclosing the net gain or loss, net prior service cost (credit), and amounts that are being reclassified or amortized from AOCI into net periodic benefit cost

- For each year that a balance sheet is presented, amounts in AOCI that have not yet been recognized as components of net periodic benefit cost

- Amounts expected to be amortized from AOCI into net periodic benefit cost in the coming year (upon adoption of ASU 2018-14, this disclosure will no longer be required)

13.3.6.6 Expected cash flows of the reporting entity and the plan

As discussed in ASC 715-20-50-1(f), a reporting entity should disclose expected benefit payments to be paid in each of the next five fiscal years, and the total to be paid in years five through ten. These amounts should be estimated based on the same assumptions that were used to measure the reporting entity's year-end benefit obligation. Expected benefit payments after year ten do not require disclosure.

A reporting entity should also disclose its best estimate of contributions expected to be paid to the plans in the coming year, including contributions required by funding regulations or laws, discretionary contributions, and noncash contributions. These amounts may be presented in the aggregate.

13.3.6.7 Assumptions

ASC 715-20-50-1(k) requires reporting entities to disclose the discount rate, the rate of salary increases (if any), and the expected long-term rate of return on plan assets on a weighted average basis used to determine (1) the year-end benefit obligation, and (2) the net periodic benefit cost for the year.

As discussed in ASC 715-20-50-1(k), reporting entities are required to disclose the assumptions used to determine the benefit obligation for each year that a balance sheet is presented, and the assumptions used to determine the net periodic benefit cost for each year that an income statement is presented.

As discussed in ASC 715-20-50-8, since net periodic benefit cost is estimated at the beginning of the year, based on beginning-of-the-year plan balances and assumptions, the assumptions used to determine the net periodic benefit cost are generally the same assumptions as those used for measuring the benefit obligation as of the prior year end. If a reporting entity performed an interim measurement, it should disclose either the beginning and interim rates, or a weighted average of the rates.

An SEC registrant with material defined benefit plans should disclose how it determines its assumed discount rate, either in the critical accounting policies section of MD&A or in the footnotes. That disclosure should include the specific source data used to support the discount rate and adjustments made to the source data.

If the reporting entity benchmarks its assumption off of published long-term bond indices, it should explain how it determined that the timing and amount of cash outflows related to the bonds included in the indices matches its estimated defined benefit payments. If there are differences between the terms of the bonds and the terms of the defined benefit obligations, or if the bonds are callable, the reporting entity should explain how it adjusted for the differences.

Question FSP 13-7

In addition to the traditional disclosure of the weighted-average discount rate used to measure the benefit obligation, is additional disclosure required if a reporting entity uses a disaggregated approach (such as the use of spot rates) to measure interest cost and/or service cost instead of using a single weighted-average discount rate?

PwC response

When a company changes from using a single weighted-average discount rate to a disaggregated approach that uses spot rates along the yield curve to calculate interest cost or service cost, the change is accounted for as a change in estimate. This change should be accompanied by robust disclosures as required by ASC 250-10-50-4.

In the period of change and in future periods, in addition to the traditional disclosure of the weighted-average discount rate used to measure the benefit obligation, reporting entities should also disclose the weighted-average discount rates (or effective rates) that were used to measure interest cost and service cost, as well as a narrative description of the disaggregated approach utilized.

Disclosures of assumptions after adoption of ASU 2018-14

Upon adoption of ASU 2018-14, a reporting entity will also be required to disclose the interest crediting rates for cash balance plans and other plans with a promised interest crediting rate. Typically, in such plans, the benefit is based on a hypothetical account balance that grows based on the plan formula. It may be a fixed rate or a variable rate based on the market or index level, and may have a floor or a ceiling. The required disclosure should be the assumed interest crediting rate over the life of the plan used to determine the projected benefit obligation.

13.3.6.8 *Certain disclosures for postretirement healthcare plans*

ASC 715-20-50 and ASC 715-60-50 provide guidance on the disclosure requirements for postretirement healthcare plans.

Assumptions and sensitivity

A reporting entity that sponsors postretirement healthcare plans should provide specific disclosures regarding the assumptions used to measure the expected cost of benefits covered by the plan. These assumptions include the following:

- Healthcare cost trend rate (used to project current per capita healthcare costs)
- Direction and pattern of the trend rates
- The ultimate trend rate (the rate at which healthcare cost trends will level off in some future year)
- The year when the reporting entity expects to reach the ultimate trend rate

A reporting entity should also provide a sensitivity analysis of the healthcare cost trend rate. This includes disclosing the effect of a one percentage point increase and decrease in the assumed health

care cost trend rates on the sum of service cost and interest cost components of the net periodic benefit costs, and on the benefit obligation. This disclosure will no longer be required after adoption of ASU 2018-14.

Medicare Prescription Drug, Improvement and Modernization Act of 2003

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 authorized Medicare to provide prescription drug benefits to retirees. The federal government makes subsidy payments to reporting entities that sponsor postretirement benefit plans under which Medicare-eligible retirees receive prescription drug benefits that are "actuarially equivalent" to the prescription drug benefits provided under Medicare. This prescription drug benefit program is commonly referred to as Medicare Part D.

ASC 715-60-50 provides guidance on disclosing the effects of the subsidy by a reporting entity that offers postretirement prescription drug coverage. In the first period that a reporting entity includes the effects of the subsidy when measuring its APBO and net periodic benefit cost, it should disclose the following in both interim and annual financial statements:

- The decrease in the APBO for the subsidy that relates to benefits attributed to past service

- The effect of the subsidy on the measurement of the current period's net periodic benefit cost, including the reduction in service cost and interest cost from the effects of the subsidy and the amortization of the gain for the reduction in the APBO

When providing the expected benefit payment disclosures, the reporting entity should provide the gross benefit payments (paid and expected), including prescription drug benefits, and, separately, the gross amount of the subsidy receipts (received and expected).

ASC 715-60-50-6 provides guidance for reporting entities that are unable to determine whether the benefits under its plan are actuarially equivalent to the Medicare Part D benefit. Those reporting entities should disclose (1) the existence of the Medicare Prescription Drug, Improvement, and Modernization Act, and (2) that its measures of the benefit obligation and net periodic benefit cost do not reflect any amounts associated with the subsidy, since it cannot conclude on whether the benefit is actuarially equivalent to Medicare Part D.

13.3.6.9 Significant events

Reporting entities may take actions that significantly affect their defined benefit plans. Appropriate disclosure about the nature and impact of these events is required.

Curtailments and settlements

As discussed in ASC 715-30-35-63B, two common significant events are curtailments and settlements. A curtailment is defined in ASC 715-30-20 as an event that significantly reduces the expected years of service of current employees or eliminates the accrual of benefits for future service for a significant number of employees. A settlement is defined in ASC 715-30-20 as an event that relieves the employer of the primary responsibility for the obligation to some or all participants, eliminates significant risks related to the obligation and the assets used to settle it, and is irrevocable. In these situations, as discussed in ASC 715-20-50-1(a), the reporting entity should disclose a description of the nature of the event and the quantitative effect on the periods presented.

Termination benefits

If a reporting entity is providing special or contractual termination benefits, ASC 715-20-50-1(q) requires the reporting entity to disclose a description of the nature of the event giving rise to the benefit and the cost recognized during the year.

Negative plan amendment that may be reversed as a result of litigation

The significant increase in the cost of providing healthcare benefits to retirees has prompted a number of reporting entities to amend the terms of their benefit plans to reduce or eliminate benefits, which may be considered a "negative plan amendment." There are presently no US federal laws prohibiting a reduction in OPEB benefits. However, reductions in benefits, whether made pursuant to a written plan or as a matter of historical procedure, have sometimes resulted in litigation against the reporting entity on behalf of the retirees. Such litigation may seek to retroactively reinstate the prior level of benefits.

If it is probable that the negative plan amendment will be rescinded due to litigation, the OPEB obligation should not be reduced by the effects of the negative plan amendment. If rescission is not probable, the facts and circumstances may indicate the existence of a contingent liability requiring disclosure pursuant to ASC 450, *Contingencies*.

13.3.6.10 Other disclosures

ASC 715-20-50 requires reporting entities to provide additional disclosures about defined benefit plans under certain circumstances, including the following:

- Any alternative methods for amortizing prior service cost or gains and losses
- A substantive commitment, such as a "past practice or a history of regular benefit increases, used as the basis for accounting for the benefit obligation"
- Japanese governmental settlement transactions, and the related required disclosures discussed in ASC 715-20-50-10 (upon adoption of ASU 2018-14, this disclosure will no longer be required)
- Measurement method used for plans with provisions that affect the measurement of vested benefits (discussed in ASC 715-30-35-40 and ASC 715-30-35-41) when the present value of benefits if the employee terminates immediately is greater than the present value of benefits calculated assuming a normal separation date (typically seen in foreign plans) (ASC 715-20-S99-2)
- Any significant change in the benefit obligation or fair value of plan assets not otherwise disclosed (upon adoption of ASU 2018-14, this disclosure will be required to include an explanation of the reasons for significant gains and losses affecting the benefit obligation)
- If applicable, the accounting policy election (see FSP 13.3.1.1) to measure plan assets and benefit obligations using the month-end that is closest to the employer's fiscal year-end in accordance with ASC 715-20-50-1(u), and the month-end measurement date

As a general matter, reporting entities should provide a description of all significant accounting policies and its policy for calculating the market-related value (MRV). As defined in ASC 715-30-20, the MRV is a balance used to calculate the expected return on plan assets. The MRV of plan assets is

either fair value or a calculated value. If the MRV used for recognizing gains or losses or for calculating the expected return on plan assets is a calculated value, the reporting entity should disclose the methodology for determining the MRV of plan assets. If the year-end MRV significantly differs from fair value, reporting entities should disclose the year-end MRV and the expected impact on benefit expense for the upcoming year.

13.4 Defined contribution plans

A defined contribution plan is a plan that provides an individual account for each participant, and specifies how contributions to the individual's account are to be determined instead of specifying the amount of benefit the individual is to receive.

13.4.1 General disclosure

As discussed in ASC 715-70-50-1, a reporting entity that sponsors one or more defined contribution plans should disclose the amount of cost recognized for these plan separate from its defined benefit plans. The disclosures should include a description of the nature and effect of any significant changes during the period affecting comparability, such as a change in the rate of reporting entity contributions, a business combination, or a divestiture.

13.4.2 Hybrid plans

Some plans contain features of both defined contribution and defined benefit plans. Some examples include cash balance plans and floor-offset plans. If, in substance, the plan provides a defined benefit, the accounting and disclosures should follow the requirements for a defined benefit plan.

13.5 Multiemployer plans

A multiemployer plan is a pension or OPEB plan to which two or more unrelated reporting entities contribute. The assets of the plan are commingled and can be used to provide benefits to employees of any of the participating reporting entities. These plans are usually, but not always, pursuant to a collective bargaining agreement. A reporting entity accounts for its participation in a defined benefit multiemployer plan by recognizing expense in the amount of contributions to the plan when they are required to be made, without any accrual of future contributions or consideration of the funded status of the plan.

13.5.1 Multiemployer pension plans

The disclosure requirements of ASC 715-80-50 are intended to provide information about a reporting entity's financial obligations to a multiemployer pension plan and to help financial statement users better understand the financial health of all of the significant plans in which the reporting entity participates. A reporting entity should provide a narrative description of the nature of, and its participation in, any multiemployer plans, indicating how the risks of participating in these plans differ from those of a single-employer plan.

As discussed in ASC 715-80-50-6, a reporting entity should also provide a description of any significant changes that affect the comparability of total reporting entity contributions from period to period, including from a business combination or divestiture, a change in the reporting entity contribution rate, or a change in the number of employees covered by the plan during the year.

As discussed in ASC 715-80-50-9, a reporting entity should disclose the total contributions, in the aggregate, made to all other multiemployer plans that are not individually significant, and the total contributions, in the aggregate, to all multiemployer plans.

ASC 715-80-55-6 through ASC 715-80-55-8 illustrate the disclosure requirements for multiemployer pension plans.

13.5.1.1 Plan information is available in the public domain

When information about the plan is available in the public domain (e.g., a Form 5500 for US plans), as discussed in ASC 715-80-50-5, a reporting entity should disclose the following for each individually significant plan:

- Plan's legal name and Employer Identification Number
- For each balance sheet presented, the plan's "zone status" (a color-coded designation based on the funded status of the plan), as defined by the Pension Protection Act of 2006 (the Act) or a subsequent amendment of the Act, or, if the zone status is not available, whether the plan was less than 65% funded, between 65% and 80% funded, or 80% or more funded
- For each period that an income statement is presented, the amount of the employer's contributions, whether those contributions represent more than 5% of total contributions to the plan per the plan's most recently available annual report (Form 5500 for US plans), and the year-end date of the plan to which the annual report relates
- Expiration dates of collective bargaining agreements, if applicable
- For the most recent annual period presented, whether the plan is subject to a funding improvement plan, whether the reporting entity paid a surcharge to the plan, and a description of any minimum contributions required in future periods

The guidance does not define the term "significant." When determining whether a plan is individually significant, a reporting entity should consider not only its contributions to the plan but other factors, such as the severity of the underfunded status of the plan and the relative proportion of the employer's participation in the plan.

These disclosure requirements are applicable for US and non-US plans, although obtaining some of this information for non-US plans may be more challenging. Reporting entities may also face other challenges for US or non-US plans, including obtaining the information necessary to prepare the disclosures on a timely basis. Some information may be unavailable at the financial statement date. In these cases, reporting entities should use the most recent information available (which may, for example, relate to a prior fiscal year) and disclose the year-end to which the information relates.

13.5.1.2 Plan information is not available in the public domain

As discussed in ASC 715-80-50-7, when plan information is not available in the public domain, a reporting entity should disclose, in addition to the information described in FSP 13.5.1.1, the nature of the benefits, a qualitative description of the extent to which the reporting entity could be responsible for the obligations of the plan, and other quantitative information about the plan, such as the total plan assets, the actuarial present value of accumulated plan benefits, and the total contributions

received by the plan. In addition, if this information is not available without undue cost or effort, a reporting entity should describe what information was omitted and the reason it was omitted, and provide alternative information to meet the overall disclosure objectives.

13.5.2 Multiemployer other postretirement plans

As discussed in ASC 715-80-50-11, a reporting entity that participates in a multiemployer plan that provides OPEB benefits (such as retiree medical benefits) should disclose the amount of contributions made to the plan, the nature of the benefits provided, and the types of employees covered by these benefits.

A reporting entity should also provide a description of any significant changes that affect the comparability of its total contributions from period to period, including from a business combination or divestiture, a change in its contribution rate, or a change in the number of employees covered by the plan during the year.

13.5.3 Potential withdrawal or increase in contribution level

As discussed in ASC 715-80-50-2, if withdrawal from a multiemployer plan would give rise to a liability and withdrawal is probable, the liability should be accrued. If withdrawal is reasonably possible, disclosure of the possible withdrawal liability should be made. Similar consideration should be given if it is either probable or reasonably possible that a reporting entity's contribution to the plan will increase in the future. A liability is generally required only if the increased future contributions are probable and relate to periods covered by the financial statements or earlier periods. If the employer is not required to recognize a liability, increases in future employer contributions that are reasonably possible should be disclosed.

13.6 Nonretirement postemployment benefits

A reporting entity that accounts for its nonretirement postemployment benefit plans by analogy to ASC 715 should generally provide the disclosures required by ASC 715, as discussed in FSP 13.3.6, if applicable. All other reporting entities should account for its nonretirement postemployment benefit plans in accordance with the guidance in ASC 712, *Compensation—Nonretirement Postemployment Benefits*.

13.6.1 Termination benefits

As discussed in ASC 712-10-50-1 and ASC 715-20-50-1(q), a reporting entity that provides contractual or special termination benefits should disclose a description of the nature of the event giving rise to the benefit, and the cost recognized during the year.

SAB Topic 5.P.4, *Restructuring Charges* (codified in ASC 420-10-S99-2), indicates that the SEC staff expect similar disclosures for employee termination benefits, whether those costs have been recognized pursuant to ASC 420, *Exit or Disposal Cost Obligations*, ASC 712, or ASC 715. See FSP 11 for discussion of disclosure requirements associated with exit or disposal costs.

13.6.2 Other postemployment benefits

If a reporting entity has a significant obligation for a postemployment benefit cost that was not accrued only because it cannot reasonably be estimated, then it should disclose that fact.

13.7 *Pensions and other postemployment benefits—considerations for private companies*

This section covers special considerations for nonpublic companies and highlights the differences in disclosure requirements from those applicable to public reporting entities.

A "nonpublic entity" is defined in ASC 715 as follows:

Definition from ASC 715-20-20

Any entity other than one with any of the following characteristics:

a. Whose debt or equity securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally

b. That is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets)

c. That makes a filing with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market

d. It is required to file or furnish financial statements with the Securities and Exchange Commission.

e. That is controlled by an entity covered by (a) through (d).

The disclosures for nonpublic company defined benefit plans are similar to those of a public reporting entity, with several exceptions, as illustrated in Figure FSP 13-3.

Figure FSP 13-3

Differences in disclosure requirements for nonpublic entities

Required disclosures for public but not nonpublic entities	Required disclosures for nonpublic entities	Nonpublic entity reporting reference	Section where public company requirements are discussed
Reconciliation of the beginning and ending balances of the benefit obligation and the fair value of plan assets	End of year balances for benefit obligation and fair value of plan assets, employer and participant contributions, and benefits paid	ASC 715-20-50-5a and ASC 715-20-50-5b	FSP 13.3.6.3

Required disclosures for public but not nonpublic entities	Required disclosures for nonpublic entities	Nonpublic entity reporting reference	Section where public company requirements are discussed
Reconciliation of the opening balances to the closing balances of plan assets measured on a recurring basis in Level 3 of the fair value hierarchy.	Amounts of transfers into and out of Level 3 of the fair value hierarchy and purchases of Level 3 plan assets	ASC 715-20-50-5c	FSP 13.3.6.3
Components of net periodic benefit cost	Amount of net periodic benefit cost	ASC 715-20-50-5q	FSP 13.3.6.5
Significant change in benefit obligation or fair value of plan assets, including an explanation of the reasons for significant gains and losses affecting the benefit obligation	Nature and effect of significant nonroutine events, including an explanation of the reasons for significant gains and losses affecting the benefit obligation	ASC 715-20-50-5m and ASC 715-20-50-5r	FSP 13.3.6.10
Alternative method used to amortize prior service cost or gains and losses	Not applicable	Not applicable	FSP 13.3.6.10
Substantive commitment used as a basis for accounting for benefit obligation	Not applicable	Not applicable	FSP 13.3.6.10

Chapter 14: Leases—Updated January 2023

14.1 Chapter overview

ASC 842, *Leases*, (the leases standard) provides guidelines for presenting and disclosing lease arrangements. This chapter provides an overview of those requirements for both lessees and lessors.

The objective of the disclosure requirements in the leases standard is to enable financial statement users to understand the amount, timing, and uncertainty of cash flows arising from leases. To achieve this objective, lessees and lessors are required to disclose qualitative and quantitative information about their leases, the significant judgments made in applying the lease guidance, and the amounts recognized in the financial statements related to those leases. Reporting entities should provide the appropriate level of detail so that the information provided is meaningful to financial statement users.

14.2 Lessees

Although a lessee is required to present assets and liabilities for all leases in a similar manner, presentation of expenses and cash flows will differ based on how a lease is classified.

14.2.1 Lessees: Balance sheet presentation

As discussed in ASC 842-20-45-1, a lessee should separately present a right-of-use asset and lease liability.

ASC 842-20-45-1

A lessee shall either present in the statement of financial position or disclose in the notes all of the following:

a. Finance lease right-of-use assets and operating lease right-of-use assets separately from each other and from other assets

b. Finance lease liabilities and operating lease liabilities separately from each other and from other liabilities.

Right-of-use assets and lease liabilities shall be subject to the same considerations as other nonfinancial assets and financial liabilities in classifying them as current and noncurrent in classified statements of financial position.

14.2.1.1 Right-of-use asset balance sheet presentation

Financial statement users may view right-of-use assets differently than other assets; therefore, finance lease and operating lease right-of-use assets should either be presented separately from each other and other assets on the balance sheet or disclosed in the notes to the financial statements along with the balance sheet line items in which those assets are included.

Although ASC 842-20-45-1 permits disclosure in the notes in lieu of separate presentation on the balance sheet, ASC 842-20-45-3 prohibits combining finance lease and operating lease right-of-use assets on the balance sheet.

As noted in LG 4.2.2.2, initial direct costs should be included in the initial measurement of the right-of-use asset.

There are certain situations that could cause an individual right-of-use asset to have a negative balance. If this occurs, the negative balance should be presented as a liability separate and apart from the lease liability.

Right-of-use assets are subject to the same considerations as other nonfinancial assets, such as property, plant, and equipment, in classifying them as current or noncurrent in a classified balance sheet. Consistent with the classification of property, plant, and equipment, the right-of-use asset should generally be classified as non-current for the entire lease term. A right-of-use asset recorded for a lease with an initial term of 12 months or less (i.e., the short-term lease measurement and recognition exemption was not taken) may be classified as current similar to other executory contracts.

14.2.1.2 Lessees: Presentation of finance and operating lease liabilities

Finance lease and operating lease liabilities should be presented separately from each other and from other liabilities on the balance sheet or disclosed in the notes to the financial statements along with the balance sheet line items in which those liabilities are included. Although ASC 842-20-45-1 permits disclosure in the notes in lieu of separate presentation on the balance sheet, ASC 842-20-45-3 prohibits combining finance lease and operating lease liabilities on the balance sheet.

14.2.1.3 Current versus noncurrent classification of the lease liability

Lease liabilities are subject to all of the same considerations as debt instruments in classifying them as current or noncurrent in a classified balance sheet. See FSP 12 for general debt classification guidance. The lease liability essentially functions as an amortizing loan FSP 12.8 provides guidance for these types of liabilities.

Classification of the lease liability as current or noncurrent is complicated if the lease incentive to be received within one year from the balance sheet date exceeds the lease payments due within that same period. As discussed in LG 3.3.4.2, an in substance fixed lease incentive that is expected to be received after lease commencement should be included when measuring the lease liability. This generally occurs when a lessor agrees to reimburse the lessee for leasehold improvements. For example, if within one year of the balance sheet date, there is a lease incentive of $1,000,000 that will be received and the total lease payments to be paid during that period are $800,000, there would be a net $200,000 inflow. This raises a question about what amount of the lease liability, if any, should be presented in current liabilities since the net amount for the period is an inflow. The cash inflows contemplated under the lease are included in the measurement of the overall lease liability and should not be netted against other current liabilities unless permitted by other applicable literature. In this case, no payments are required in the next 12 months (because there is a net cash inflow) so the entire lease liability is reflected as noncurrent.

14.2.2 Lessees: Income statement presentation

ASC 842-20-45-4 discusses lessee presentation in the income statement.

ASC 842-20-45-4

In the statement of comprehensive income, a lessee shall present both of the following:

a. For finance leases, the interest expense on the lease liability and amortization of the right-of-use asset are not required to be presented as separate line items and shall be presented in a manner consistent with how the entity presents other interest expense and depreciation or amortization of similar assets, respectively.

b. For operating leases, lease expense shall be included in the lessee's income from continuing operations.

14.2.2.1 Lessees: Finance lease income statement presentation

Reporting entities must present interest expense on the lease liability and amortization of the right-of-use asset in a manner consistent with how these costs are presented for other acquisitions of financed assets since they are economically similar. Therefore, interest expense on the lease liability should be presented with other interest expense in the income statement and amortization of the right-of- use asset should generally be presented with depreciation and/or amortization expense in the income statement.

14.2.2.2 Lessees: Presentation of variable lease payments

ASC 842 does not explicitly address whether variable lease payments made for a finance lease should be presented as lease expense (i.e., an operating expense) or interest expense in the income statement. We believe that either presentation is appropriate but careful consideration should be given to the economics of the lease when making this determination. For example, if a lease with all variable payments is classified as a finance lease, no lease liability would be recorded; in this case, it would be difficult to support presentation of the variable payments as interest expense given there is no liability associated with the lease.

14.2.2.3 Lessees: Operating lease income statement presentation

A lessee should present the lease expense of an operating lease as a single operating expense in income from continuing operations. As noted in LG 4.4.2, lease expense should generally be calculated on a straight-line basis. Although a lessee is not required to provide the components of lease expense, financial statement users will be able to derive certain information from the quantitative disclosures, including the weighted average discount rate. See LG 14.2.4 for further discussion.

14.2.3 Lessees: Qualitative disclosures

ASC 842-20-50-3 requires a lessee to disclose the following qualitative items.

ASC 842-20-50-3

A lessee shall disclose all of the following:

a. Information about the nature of its leases, including:

1. A general description of those leases.

2. The basis and terms and conditions on which variable lease payments are determined.

3. The existence and terms and conditions of options to extend or terminate the lease. A lessee should provide narrative disclosure about the options that are recognized as part of its right-of-use assets and lease liabilities and those that are not.

4. The existence and terms and conditions of residual value guarantees provided by the lessee.

5. The restrictions or covenants imposed by leases, for example, those relating to dividends or incurring additional financial obligations.

A lessee should identify the information relating to subleases included in the disclosures provided in (1) through (5), as applicable.

b. Information about leases that have not yet commenced but that create significant rights and obligations for the lessee, including the nature of any involvement with the construction or design of the underlying asset.

c. Information about significant assumptions and judgments made in applying the requirements of this Topic, which may include the following:

1. The determination of whether a contract contains a lease (as described in paragraphs 842-10-15-2 through 15-27)

2. The allocation of the consideration in a contract between lease and nonlease components (as described in paragraphs 842-10-15-28 through 15-32)

3. The determination of the discount rate for the lease (as described in paragraphs 842-20-30-2 through 30-4).

For more information about the significant assumptions and judgments noted in paragraphs ASC 842-20-50-3(c)(1) through ASC 842-20-50-3(c)(3), see LG 2.3, LG 2.4, and LG 3.3.4.6.

Lessees should disclose the election of the short-term lease measurement and recognition exemption (see LG 2.2.1). Additionally, if the short-term lease expense for the period does not reasonably reflect the lessee's ongoing short-term lease commitments, a lessee should disclose that fact and the amount of its short-term lease commitments.

Example LG 14-1 illustrates a disclosure requirement around short-term lease expense and on-going short-term lease commitments

EXAMPLE LG 14-1

Short-term lease expense for the period does not reasonably reflect on-going short-term lease commitments

Lessee Corp elects to apply the short-term lease measurement and recognition exemption to its office equipment. For the majority of the reporting period ending 12/31/X8, there were only two short-term

leases in that class. However, on 12/27/X8, Lessee Corp enters into 20 new lease agreements for office equipment and they all qualify for the short-term lease measurement and recognition exemption. The short-term lease expense for the reporting period ending 12/31/X8 was $300,000, but the total short-term lease payments for the following year will be $3,000,000.

Is Lessee Corp required to disclose the fact that the short-term lease payments will change in the following year?

Analysis

Yes, Lessee Corp must disclose the $3,000,000 commitment because the $300,000 of short-term lease expense recorded in the current period does not reasonably reflect its on-going short-term lease commitments.

14.2.3.1 Discount rate for lessees that are not public business entities

ASC 842-20-30-3 permits lessees that are other than public business entities to apply a risk-free discount rate by class of underlying asset. . An eligible lessee that makes this policy election should disclose the election and the class or classes of underlying assets to which it has been applied. See LG 3.3.4.6 for more information about this election

14.2.4 Lessees: Quantitative disclosures

The leases standard also requires a lessee to disclose certain quantitative items as discussed in ASC 842-20-50-4.

ASC 842-20-50-4

For each period presented in the financial statements, a lessee shall disclose the following amounts relating to a lessee's total lease cost, which includes both amounts recognized in profit or loss during the period and any amounts capitalized as part of the cost of another asset in accordance with other Topics, and the cash flows arising from lease transactions:

a. Finance lease cost, segregated between the amortization of the right-of-use assets and interest on the lease liabilities.

b. Operating lease cost determined in accordance with paragraphs 842-20-25-6(a) and 842-20-25-7.

c. Short-term lease cost, excluding expenses relating to leases with a lease term of one month or less, determined in accordance with paragraph 842-20-25-2.

d. Variable lease cost determined in accordance with paragraphs 842-20-25-5(b) and 842-20-25-6(b).

e. Sublease income, disclosed on a gross basis, separate from the finance or operating lease expense.

f. Net gain or loss recognized from sale and leaseback transactions in accordance with paragraph 842-40-25-4.

g. Amounts segregated between those for finance and operating leases for the following items:

1. Cash paid for amounts included in the measurement of lease liabilities, segregated between operating and financing cash flows

2. Supplemental noncash information on lease liabilities arising from obtaining right-of-use assets

3. Weighted-average remaining lease term

4. Weighted-average discount rate.

The amount of lease cost will not always be the same as the lease expense recognized. Lease cost may include items not recognized as lease expense (e.g., amounts capitalized as part of the cost of inventory).

A lessee should also disclose a maturity analysis of its finance lease and operating lease liabilities, separately showing:

- The undiscounted cash flows on an annual basis for a minimum of each of the next five years
- The sum of the undiscounted cash flows for all years thereafter
- A reconciliation of the undiscounted cash flows to the discounted finance lease liabilities and operating lease liabilities recognized in the statement of financial position

ASC 842-20-55-53 provides an example of this disclosure requirement.

14.2.5 Lessees: Interim disclosures

There are no specific interim disclosure requirements in ASC 842 for lessees. However, ASC 270, *Interim Reporting*, requires reporting entities to report significant changes in financial position, accounting principles, and estimates along with other information that helps users understand how the interim financial reporting results compare with those for its most recent annual period. Therefore, reporting entities should consider disclosing leasing events that have a significant impact on the interim financial statements compared to the previous year end. However, reporting entities may elect to provide interim lease disclosures in a manner consistent with its annual financial statements if its leasing activities are significant. Refer to FSP 29 for additional details related to interim financial reporting.

14.3 Lessors

Lessors are required to classify leases as sales-type, direct financing, or operating leases.

14.3.1 Lessors: Balance sheet presentation

A lessor's presentation of its leased asset is dependent on how the lease is classified.

14.3.1.1 *Lessors: Sales-type and direct financing leases*

In a sales-type or direct financing lease, the lessor derecognizes the leased asset and recognizes a lease investment on its balance sheet as discussed in LG 4.3.1. A lessor's aggregate net investment should be presented separate from other assets on the lessor's balance sheet.

Lease assets should be classified as current or noncurrent. See FSP 2 for information on balance sheet classification.

14.3.1.2 *Lessors: Operating lease balance sheet presentation*

A lessor should classify assets subject to operating leases as property, plant, and equipment (e.g., within buildings) or as a separate line item on the balance sheet (e.g., assets subject to operating leases). As with other fixed assets, property subject to operating leases may be presented net of accumulated depreciation on the balance sheet, but the accumulated depreciation should be shown on the face of the balance sheet or disclosed in the notes to the financial statements.

For operating leases with rents that change over time, the requirement to recognize rental income on a straight-line basis may generate a rent receivable or deferred rent revenue on the lessor's balance sheet. A lessor may also need to recognize a prepaid asset on the balance sheet arising from initial direct costs that the lessor will recognize as an expense over the lease term. Lessors should present a rent receivable, deferred rent, or prepaid initial direct costs with items of similar maturities on a classified balance sheet; for example, with other prepaid items associated with long-term contracts. See FSP 2 for information on balance sheet classification.

14.3.2 *Lessors: Income statement presentation*

LG 2 addresses certain concepts that impact the presentation in the income statement, including:

- Taxes (LG 2.4.1): ASC 842 permits lessors to gross up the income statement by presenting (1) sales or other similar taxes in revenue when such taxes are reimbursed by a lessee to the lessor and (2) the associated tax payment to the taxing authorities as expense. However, lessors can also make an accounting policy election to exclude from revenue and associated expense such taxes assessed by a governmental authority provided they are (a) imposed on and concurrent with a specific lease revenue-producing transaction, and (b) collected by the lessor from the lessee. This election is available irrespective of whether the taxes are a lessee or lessor cost. Examples of taxes eligible for this policy election include sales, use, value added, and some excise taxes. Taxes assessed on a lessor's gross receipts or on the lessor as owner of the underlying asset are excluded. Lessors are required to disclose their accounting policy election.

- Other lessor costs paid directly by the lessee to a third party (LG 2.4.1): ASC 842 requires a lessor to present a variable payment not included in contract consideration that is even partially related to a lease component on a gross basis in its income statement, i.e., it needs to be separately reported as revenue and expense. ASU 2018-20 provides relief from such gross presentation and requires a lessor to present the expense and payment by a lessee on a net basis (i.e., zero effect on the lessor's income statement) if the lessee directly remits the payment to a third party. However, this relief is not available if a lessor remits payment to a third party and is subsequently reimbursed by the lessee.

- Combining lease and certain nonlease components (LG 2.4.4.1): A lessor can elect a practical expedient, by class of underlying asset, to present lease and nonlease components together as one combined component if certain conditions are met. The combined component should be accounted for as a single performance obligation in accordance with ASC 606, *Revenue from Contracts with Customers*, if the nonlease component is the predominant component. Otherwise, the lessor should account for the combined component as a lease.

- Embedded leases (LG 2.3): Some leases embedded in service contracts may not have explicit consideration stated for the embedded lease. We believe arrangements that do not have stated consideration for embedded leases should generally be accounted for on a gross basis. Thus, a vendor should gross up its income statement for the "free" embedded lease. That is, the vendor should recognize additional revenue for the sale of its products/services to a customer and expense for the "free" embedded lease of the customer's asset.

The following subsections address how a lessor should present income in various situations.

14.3.2.1 Sales-type and direct financing leases

ASC 842-30-45-3 through ASC 842-30-45-4 provide guidance on a lessor's presentation of sales-type and direct financing leases in the income statement.

ASC 842-30-45-3

A lessor shall either present in the statement of comprehensive income or disclose in the notes income arising from leases. If a lessor does not separately present lease income in the statement of comprehensive income, the lessor shall disclose which line items include lease income in the statement of comprehensive income.

ASC 842-30-45-4

A lessor shall present any profit or loss on the lease recognized at the commencement date in a manner that best reflects the lessor's business model(s). Examples of presentation include the following:

a. If a lessor uses leases as an alternative means of realizing value from the goods that it would otherwise sell, the lessor shall present revenue and cost of goods sold relating to its leasing activities in separate line items so that income and expenses from sold and leased items are presented consistently. Revenue recognized is the lesser of:

   1. The fair value of the underlying asset at the commencement date

   2. The sum of the lease receivable and any lease payments prepaid by the lessee.

Cost of goods sold is the carrying amount of the underlying asset at the commencement date minus the unguaranteed residual asset.

b. If a lessor uses leases for the purposes of providing finance, the lessor shall present the profit or loss in a single line item.

A lessor in a sales-type lease will recognize a selling profit or loss (as well as the initial direct costs) at lease commencement. A lessor in a direct financing lease should defer the selling profit and initial direct costs, both of which are included in the net investment of the lease.

A sales type or direct financing lease results in a day-one selling loss when the fair value of the leased asset is lower than its carrying value plus initial direct costs incurred in connection with signing the lease. A lessor in a sales-type or direct financing lease that has not yet adopted ASU 2021-05 will recognize a selling loss upfront at lease commencement. Following its adoption of ASU 2021-05, the accounting by a lessor for a selling loss depends on whether the lease has variable payments that do not depend on an index or a rate. If so, the lease is classified as an operating lease. If not, the lessor will recognize a selling loss at lease commencement.

Any profit or loss recognized for a sales-type lease should be presented in a manner that best reflects the business model associated with the leased asset. For example, a manufacturer that leases assets as a means of realizing value from goods it would otherwise sell may present the revenue and cost of goods sold on a gross basis. Alternatively, if a lessor leases assets to generate revenue by providing financing, it may be appropriate to present the net profit or loss in a single line item.

For a direct financing lease, amortization of the initial direct costs should be recorded as a reduction of interest income, rather than as an expense, in accordance with ASC 835-30-45-3. Likewise, a loss in a direct financing lease should be presented in the same manner (i.e., a single line item). See LG 4.3.1.1 for additional details.

Variable lease payments

ASC 842 does not explicitly address whether variable lease payments received for a direct financing lease or sales type lease should be presented as lease income or interest income. We believe that either presentation is appropriate but careful consideration should be given to the economics of the lease when making this determination. For example, if a lease with all variable payments is classified as a sales type lease, no lease receivable would be recorded; in this case, it would be difficult to support presentation of the variable payments as interest income given there is no receivable associated with the lease.

14.3.2.2 Lessors: Operating lease income statement presentation

A lessor should recognize all of the following:

- Lease payment as income in profit or loss over the lease term on a straight-line basis unless another systematic and rational basis is more representative of the pattern in which a benefit is expected to be derived from the use of the underlying asset
- Variable lease payments as income in profit or loss in the period in which changes in facts and circumstances on which the variable lease payments are based occur
- Initial direct cost as an expense over the lease term on the same basis as lease income

A lessor should continue to measure the underlying asset subject to an operating lease in accordance with other GAAP. Depreciation of the underlying asset should be presented gross and should not offset rental income.

14.3.2.3 *Subleases*

ASC 842 requires that an intermediate lessor (i.e., a sublessor) disclose sublease income on a gross basis, separate from the finance or operating lease expense. However, there is no explicit guidance that addresses income statement presentation of sublease income.

Question 14-1

Can a sublessor net sublease income against head lease expense in the income statement?

PwC response

It depends.

We believe gross presentation on the income statement is acceptable in all cases. Under gross presentation, the sublessor presents sublease income separate from the head lease expense. This treatment is consistent with the balance sheet accounting for subleases when the original lessee is not relieved of its primary obligation under the head lease.

If the sublessor is not relieved of its primary obligation under the head lease, however, we believe the sublessor may net sublease income and expense in the income statement. One example of when netting may be acceptable is when the sublessor is subleasing simply to manage occupancy costs and provide flexibility to expand and contract occupancy to meet changing business needs. Assuming the sublessor elects to net, it would present head lease expense net of sublease income.

14.3.3 *Lessors: Disclosures*

ASC 842-30-50-3 and ASC 842-30-50-7 requires a lessor to disclose the following qualitative items.

ASC 842-30-50-3

A lessor shall disclose both of the following:

a. Information about the nature of its leases, including:

    1. A general description of those leases

    2. The basis and terms and conditions on which variable lease payments are determined

    3. The existence and terms and conditions of options to extend or terminate the lease

    4. The existence and terms and conditions of options for a lessee to purchase the underlying asset.

b. Information about significant assumptions and judgments made in applying the requirements of this Topic, which may include the following:

    1. The determination of whether a contract contains a lease (as described in paragraphs 842-10-15-2 through 15-27)

2. The allocation of the consideration in a contract between lease and nonlease components (as described in paragraphs 842-10-15-28 through 15-32)

3. The determination of the amount the lessor expects to derive from the underlying asset following the end of the lease term.

ASC 842-30-50-7

A lessor shall disclose information about how it manages its risk associated with the residual value of its leased assets. In particular, a lessor should disclose all of the following:

a. Its risk management strategy for residual assets

b. The carrying amount of residual assets covered by residual value guarantees (excluding guarantees considered to be lease payments for the lessor, as described in paragraph 842-30-30-1(a)(2))

c. Any other means by which the lessor reduces its residual asset risk (for example, buyback agreements or variable lease payments for use in excess of specified limits).

14.3.3.1 Lessors: Sales-type and direct financing leases disclosure

In addition to the general disclosures discussed previously, ASC 842-30-50-9 and ASC 842-30-50-10 require additional disclosures for sales-type and direct financing leases. We do not believe it is necessary to present these disclosures separately for sales-type and direct financing leases.

ASC 842-30-50-9 requires a lessor to disclose significant changes in the balance of its unguaranteed residual assets related to both sales-type and direct financing leases. It also requires a lessor in a direct financing lease to disclose the amount of deferred selling profit.

ASC 842-30-50-10

A lessor shall disclose a maturity analysis of its lease receivables, showing the undiscounted cash flows to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessor shall disclose a reconciliation of the undiscounted cash flows to the lease receivables recognized in the statement of financial position (or disclosed separately in the notes).

A lessor is also required to disclose its lease income in a tabular format in each annual and interim reporting period. For sales-type and direct financing leases, this tabular disclosure should include the following:

- Profit or loss recognized at the commencement date, disclosed on either a gross or net basis based on its business model
- Interest income, either in aggregate or separated by components of the net investment in the lease
- Lease income relating to variable lease payments not included in the measurement of the lease receivable

A lessor should also disclose the components of its aggregate net investment in sales-type leases and direct financing leases including:

- The carrying amount of its lease receivables
- Its unguaranteed residual assets
- Any deferred selling profit in direct financing leases (which is a reduction to the net investment)

14.3.3.2 Lessors: Operating lease disclosure

In addition to the general disclosures discussed previously, a lessor should disclose the following with respect to operating leases:

- A maturity analysis of lease payments, showing the undiscounted cash flows to be received on an annual basis for a minimum of the next five years and the total lease payments to be received in the remaining years. The maturity analysis for operating leases should not be combined with the maturity analysis for sales-type and direct financing leases
- The property, plant, and equipment disclosures required by ASC 360 separate from owned assets held and used by the lessor

A lessor is also required to disclose its lease income in a tabular format for each annual and interim reporting period. For operating leases, this tabular disclosure should include lease income relating to lease payments, including lease income relating to variable lease payments.

If a lessor elects the practical expedient to not separate nonlease components from lease components (discussed in LG 2.4.4.1), it is required to disclose the following:

- Its accounting policy election,
- The class or classes of underlying assets for which it has elected to apply the practical expedient,
- The nature of:
  - The lease and nonlease components included within the combined component and
  - The nonlease components, if any, that are accounted for separate from the combined component because they do not qualify for the practical expedient, and
- Whether the combined component is accounted for under the Leases or the Revenue guidance

14.4 Sale and leaseback transactions disclosures

Both the buyer-lessor and seller-lessee in a sale and leaseback transaction should disclose the main terms and conditions of the transactions. The seller-lessee should also disclose any gains or losses arising from the transaction separate from gains or losses on disposal of other assets.

14.5 Leveraged leases disclosures

If leveraged leasing is a significant part of a lessor's business activities (based on revenue, net income, or assets), the components of the net investment balance in leveraged leases should be disclosed. Those components include the following:

- Rentals receivable
- Investment-tax-credit receivable
- Estimated residual value of the leased asset
- Unearned and deferred income

Lessors are required to provide additional disclosures about their financing receivables pursuant to ASC 310. See FSP 8.3 for further discussion.

If accounting for leveraged leases creates a variation from the customary relationship between income tax expense and pretax accounting income, and the reason for that variation is not otherwise apparent, the lessor should disclose the reason for the variation.

14.6 Related party leases disclosures

Related party lessees and lessors should apply the disclosure requirements for related party transactions in ASC 850. See FSP 26 for information.

Chapter 15: Stock-based compensation—updated March 2024

15.1 Stock-based compensation—chapter overview

This chapter addresses presentation and disclosure considerations related to stock-based compensation awards. It also addresses nonemployee awards, implications for the separate financial statements of a subsidiary, employee stock ownership plans (ESOPs), and considerations for private companies.

For recognition and measurement topics related to stock-based compensation, see PwC's *Stock-based compensation* guide.

15.2 Stock-based compensation—scope and relevant guidance

Stock-based compensation refers to all forms of employee compensation that fall within the scope of ASC 718, *Compensation—Stock Compensation*, including shares, options, and other equity instruments. Liability-classified awards are also within the scope of ASC 718 if they are based, in part, on the price of the reporting entity's stock, or settled through the issuance of equity.

SEC guidance related to stock-based compensation is included in SAB Topic 14, *Share-Based Payment* (codified in ASC 718-10-S99-1).

SAB 120 expresses the SEC staff's views on accounting and related disclosures for share-based awards under ASC 718 that are granted shortly before a release of material non-public information that is expected to result in a material increase in share price (described in SAB 120 as "spring-loaded" awards). See SC 2.2 for further discussion.

15.3 Stock-based compensation—presentation

This section discusses presentation requirements and considerations for stock-based compensation on the balance sheet and in the income statement and statement of stockholders' equity. See FSP 6 for presentation considerations for the statement of cash flows.

15.3.1 Balance sheet

Stock-based compensation awards are classified as either equity or liabilities (see SC 3.3). When an award is classified as a liability, a reporting entity should determine whether it is a current or noncurrent liability. A liability-classified award is generally classified as current if a vested award is payable upon demand or if vesting is expected to occur within one year. All other liability awards are classified as noncurrent.

Example FSP 15-1 illustrates the balance sheet classification of a cash-settled award.

EXAMPLE FSP 15-1

Short-term versus long-term classification of a cash settled award

On December 1, 20X1, FSP Corp granted 100,000 cash-settled stock appreciation rights ("SARs") to certain employees. The SARs have a two-year vesting period. At December 31, 20X3, the fully vested awards are out-of-the-money and management expects the awards to remain out of the money for at least another twelve months. Accordingly, FSP Corp does not expect to settle the liability for these awards within the following year.

Under the guidance in ASC 718, the awards are classified as liabilities and are marked to market each period. Although the SARs are out of the money at December 31, 20X3, they are financial instruments that continue to have some value due to the option's time value component.

Should FSP Corp classify the SARs liability as non-current?

Analysis

No. The SARs liability should be classified as current because the SARs are fully vested and exercisable as of the balance sheet date. ASC 470-10-45-10 states that current liability classification includes obligations that, by their terms, are due on demand or will be due on demand within one year from the balance sheet date, even though settlement may not be expected within that period.

15.3.2 Income statement

Stock-based compensation expense should be included in the same income statement line or lines as the cash compensation paid to the employees receiving the stock-based awards (for example, cost of sales, research and development costs, or general and administrative costs).

As indicated in the SEC's Division of Corporation Finance Current Accounting and Disclosure Issues (Section I(B)(2)), reporting entities should avoid presenting stock-based compensation in any of the following ways:

- Separate line item presentation in the income statement (for example, a line item titled "noncash compensation")

- One or more separate line items

- A table totaling the amount of share-based compensation included in various line items

However, the SEC staff noted in SAB Topic 14F (codified in ASC 718-10-S99-1) that a parenthetical note to the respective income statement line items indicating the amount of stock-based compensation expense included in the line item would be acceptable. See sample presentation in Figure FSP 15-1.

Figure FSP 15-1
Sample stock-based compensation parenthetical presentation

Revenues	$xx
Cost of sales (including noncash compensation of $XX)	xx
Gross margin	xx
Selling expense (including noncash compensation expense of $XX)	xx
General and administrative expense (including noncash compensation expense of $XX)	xx
Research and development expense (including noncash compensation expense of $XX)	xx
Total operating expenses	xx
Income from operations	$xx

In addition, the SEC staff has not objected to a footnote presentation on the face of the income statement (as opposed to parenthetical disclosure) indicating the amount of stock-based compensation expense included in each of the respective expense line items. However, it is not acceptable to include a total of the stock-based compensation expense.

Other commonly accepted methods of disclosing total stock-based compensation expense include footnote disclosure or presenting the total as a line item in the statement of cash flows.

15.3.2.1 Capitalized compensation cost

The guidance uses the term compensation *cost* rather than compensation *expense* to emphasize that an entity could be required to capitalize stock-based compensation under the applicable US GAAP, similar to the treatment of cash compensation. For example, employee costs could require capitalization as:

- Inventory
- Deferred loan origination costs
- Contract accounting assets
- Self-constructed fixed assets
- Capitalized software (internal-use and to be sold, leased, or marketed)

As discussed in ASC 718-10-50-2(h)(1)(ii), a reporting entity should disclose the total compensation cost that is capitalized as part of the cost of an asset.

15.3.3 *Temporary (mezzanine) equity*

Financial statements filed with the SEC must follow the guidance in ASR 268, which requires certain awards to be classified as temporary equity. This guidance applies if redemption of the award (or underlying shares) is outside of the control of the issuer. This could include awards such as:

- Shares that are redeemable at the employee's discretion after a six-month holding period, or based on contingent events
- Options with underlying shares that are redeemable at the employee's discretion after a six-month holding period, or based on contingent events
- Options with cash settlement features based on contingent events

For information on accounting for awards classified as temporary equity, see SC 3.3.10. FSP 5.6.3 discusses presentation and disclosure requirements associated with temporary equity.

15.4 Stock-based compensation—disclosure

ASC 718-10-50-1 establishes four disclosure objectives for stock-based compensation. A reporting entity that has granted stock-based compensation awards to its employees should provide information that enables users of the financial statements to understand the following:

- The nature and general terms of stock-based compensation arrangements outstanding during the period
- The income statement effects of stock-based compensation
- The method of estimating the fair value of stock-based compensation awards
- The cash flow effects of stock-based compensation

ASC 718-10-50-2 specifies the minimum information that a reporting entity should provide in its annual financial statements in order to achieve these objectives. The specific requirements are discussed in the subsections below. In addition, ASC 718-10-55-134 through ASC 718-10-55-137 includes an illustrative example of the disclosure requirements.

Question FSP 15-1 addresses required share-based compensation disclosures for interim financial statements.

Question FSP 15-1

Is a reporting entity required to provide the disclosures outlined in ASC 718 in its interim financial statements?

PwC response

No. The disclosure requirements outlined in ASC 718 are only required in a reporting entity's annual financial statements. However, reporting entities should consider the guidance in ASC 270, *Interim Reporting*, which requires disclosure of significant changes since the last reporting period in interim

financial statements (see FSP 29). Many reporting entities provide disclosures about stock-based compensation on an interim basis to provide transparency into the activity occurring during the interim period.

15.4.1 Description of awards and methods

A reporting entity should include a description of its stock-based compensation arrangements, including the general terms of the awards, as well as any accounting policy elections. Such disclosure should include the following:

- The requisite service periods and any other substantial conditions, such as vesting conditions
- The maximum contractual term
- The number of shares authorized for awards of options or other equity instruments
- The method (for example, fair value, calculated value, or intrinsic value) used to measure compensation cost
- The policy for estimating expected forfeitures or recognizing forfeitures as they occur, if not separately disclosed elsewhere.

We believe reporting entities should also disclose its policy election for the attribution of awards with a graded vesting schedule and only service conditions.

15.4.2 Option and similar awards

A reporting entity that awards stock options or similar awards (such as stock appreciation rights) to its employees should provide a rollforward of activity for the most recent year an income statement is presented. As discussed in ASC 718-10-50-2(c)(1), the rollforward should include the number and weighted-average exercise price (or conversion ratios) of the following groups of awards:

- Outstanding at the beginning of the year
- Granted during the year
- Exercised or converted during the year
- Forfeited during the year
- Expired during the year
- Outstanding at the end of the year
- Exercisable or convertible at the end of the year

For fully vested awards and awards expected to vest, ASC 718-10-50-2(e) requires separate disclosure of the following for awards outstanding and awards currently exercisable (or convertible), at the date of the latest balance sheet:

- The number
- The weighted-average exercise price (or conversion ratio)
- Aggregate intrinsic value
- Weighted-average remaining contractual term

If a reporting entity elects to account for forfeitures when they occur in accordance with ASC 718-10-35-3, these disclosures also apply to unvested shares for which the requisite service period has not been rendered but for which the vesting is expected based on achievement of a performance condition.

A reporting entity should provide a description of its policy, if any, for issuing shares upon award exercise (or stock unit conversion), including the source of those shares (that is, new shares or treasury stock). If a reporting entity expects to repurchase shares in the following annual period, the reporting entity should disclose an estimate of the number (or range) of shares it will repurchase during that period.

Question FSP 15-2 addresses the issue of whether disclosure is required for awards when no compensation cost was recognized in the period.

Question FSP 15-2

Is a reporting entity required to include awards that are granted for which no compensation expense has been recognized (e.g., because the awards vest upon a performance condition that is not currently probable of occurring) in the rollforward?

PwC response

Yes. ASC 718 requires disclosure of awards granted during the year regardless of whether compensation expense has been recognized. However, if the grant date criteria in ASC 718 was not met (e.g., the key terms and conditions have not been communicated), then those awards should not be included as granted in the rollforward. This guidance is also applicable for other types of awards. See FSP 15.4.3.

15.4.3 Other awards

As discussed in ASC 718-10-50-2(c)(2), a reporting entity that grants its employees awards other than options (e.g., restricted stock) should provide a rollforward of activity for the most recent year an income statement is presented. The rollforward should include the number and weighted-average grant-date fair value (or calculated value or intrinsic value, if used) for the following groups of awards:

- Nonvested at the beginning of the year
- Granted during the year
- Vested during the year
- Forfeited during the year

- Nonvested at the end of the year

15.4.4 *Fair value disclosure*

As discussed in ASC 718-10-50-2(d), for each year an income statement is presented, a reporting entity should disclose:

- The weighted-average grant-date fair value (or calculated value or intrinsic value, if used) of equity awards granted during the year

- The total intrinsic value of options exercised (or stock units converted), stock-based liabilities paid, and the total fair value of shares vested during the year

For each year an income statement is presented, ASC 718-10-50-2(f) requires a reporting entity to provide a description of the method and significant assumptions used during the year to estimate the fair value (or calculated value, if used) of stock-based compensation awards, including (if applicable):

- Expected term

- Expected volatility

- Expected dividend rate

- Risk-free rate

- Discount for post-vesting restrictions and the method used to estimate it

A reporting entity that uses a valuation method that employs a range of assumptions over the contractual term of an award (e.g., a lattice model) should disclose the range of expected volatilities, dividend rates, and risk-free rates used, and the weighted-average expected volatility and dividend rate.

The guidance does not specify how to disclose the significant assumptions used when a reporting entity grants similar awards at different times throughout the year. Some reporting entities disclose a range of the significant assumptions used, while others disclose a weighted-average amount for each significant assumption.

15.4.4.1 *Expected term assumption*

As discussed in ASC 718-10-50-2(f)(2)(i), a reporting entity's disclosure of expected term should include a discussion of the method used to incorporate the contractual term of the awards and employees' expected exercise and expected post-vesting termination behavior.

A reporting entity that elects to use the simplified method discussed in SAB Topic 14 (Section D.2, question 6) to estimate expected term for its "plain-vanilla" options should disclose its use of the method and why it was selected. Disclosure should also be made of which options were valued using this method if not all options were valued using the same methodology, and the periods in which it was used.

For more discussion of the simplified method, see SC 9.3.

15.4.4.2 Expected volatility assumption

As discussed in ASC 718-10-50-2(f)(2)(ii), a reporting entity should disclose how it determined the expected volatility assumption. This could include whether the reporting entity used only implied volatility, historical volatility, or a combination of both, for which time periods, and the respective weighting.

As discussed in SC 6.2.1.1, a private company may use the calculated-value method to estimate fair value when sufficient information is not available to estimate expected volatility. This would entail substituting expected volatility with an industry sector index. In this case, a reporting entity should disclose the following:

- The reasons why it is not practicable to estimate expected volatility
- The industry sector index selected and the reasons for selecting it
- How it calculated historical volatility using that index

15.4.4.3 Change in valuation technique

A reporting entity may decide to change option-pricing models (for example, from Black-Scholes to a lattice model). A change in option-pricing model is not a change in accounting principle and therefore does not require preferability. However, a reporting entity should disclose any changes to the option-pricing model used and the reasons for the change.

15.4.5 Multiple awards

A reporting entity that grants awards under multiple employee stock-based compensation arrangements should provide separate disclosures for different types of awards to the extent they have different characteristics. For example, it may be important for a reporting entity to:

- Provide separate disclosure of weighted-average exercise prices (or conversion ratios) at the end of the year for stock options (or stock units) with a fixed exercise price (or conversion ratio) and those with an indexed exercise price (or conversion ratio)
- Segregate the number of stock options (or stock units) not yet exercisable into those that will become exercisable (or convertible) based either (a) solely on fulfilling a service condition, or (b) fulfilling a performance condition
- Provide separate disclosures for awards that are classified as equity and those classified as liabilities

15.4.6 Impact on financial statements

A reporting entity should disclose the impact of stock-based compensation on the financial statements. The disclosures should be made for each year an income statement is presented and should include:

- Total compensation cost for stock-based compensation awards recognized in income, as well as the total related income tax benefit

- Total compensation cost capitalized as part of the cost of an asset

- A description of significant modifications (including those that do not require modification accounting), including the terms, the number of employees affected, and the total (or lack of) incremental compensation cost resulting from the modifications. As of the latest balance sheet date presented, the reporting entity should also disclose the total compensation cost related to nonvested awards not yet recognized, and the weighted-average period over which it is expected to be recognized.

If not separately disclosed elsewhere (e.g., in the statement of cash flows), the reporting entity should also disclose the following for the most recent income statement year presented:

- Cash received from the exercise of stock options and similar awards

- All tax benefits from exercised stock options and similar awards.

- Cash used to settle equity instruments granted under stock-based compensation awards

Question FSP 15-3 discusses if expected forfeitures should be included in the disclosure of total compensation cost for nonvested awards.

Question FSP 15-3

Should a reporting entity reflect expected forfeitures in the disclosure of the total compensation cost related to nonvested awards not yet recognized?

PwC response

Yes, but expected forfeitures would only be included in this disclosure if the reporting entity's policy is to estimate forfeitures.

15.5 Separate financial statements of a subsidiary

In some situations, employees of a reporting entity receive stock-based awards from the reporting entity's parent, or an entity under common control. The reporting entity typically recognizes compensation cost in its financial statements if the awards were issued for services to the reporting entity. For example, if employees of Subsidiary A receive shares of the parent entity for services provided to Subsidiary A, Subsidiary A should recognize compensation cost with an offsetting entry to equity, representing a capital contribution from the parent. For more information on accounting for share awards issued by a parent, see SC 1.6.

A reporting entity that recognizes stock-based compensation in its separate financial statements for stock-based awards granted by the parent, or an entity under common control granted to its employees, should disclose the information required by ASC 718 (see FSP 15.4). These disclosures should include only information about awards granted to the reporting entity's employees.

15.6 Non-employee awards

A reporting entity that grants awards to non-employees, should provide disclosures similar to those required by ASC 718 if that information is important to understanding the effects of the transaction on the financial statements. The accounting for share-based payment awards issued to nonemployees is largely aligned with the guidance applicable to grants to employees and explicitly includes nonemployee awards in the scope of ASC 718 disclosures.

See SC 1.5 for guidance on determining whether an individual is an employee or non-employee.

15.7 Employee stock ownership plans (ESOPs)

An ESOP is a stock bonus plan that is designed to facilitate employee investment in the reporting entity's stock. ESOP plans can be non-leveraged or leveraged:

- *Non-leveraged ESOP*

  A reporting entity (sponsor) with a non-leveraged ESOP contributes cash to the ESOP to purchase the sponsor's stock, or contributes its stock directly to the ESOP.

- *Leveraged ESOP*

  A leveraged ESOP borrows funds from a lender to purchase the sponsor's shares. The sponsor generally guarantees the loan or otherwise commits, directly or indirectly, to make contributions and/or pay dividends to the ESOP. As an alternative to borrowing funds from a lender, the sponsor may directly loan funds to the ESOP. Sponsor contributions and, in most instances, dividends on the stock held by the ESOP, are used by the ESOP to service the debt.

15.7.1 Presentation

For non-leveraged ESOPs, when contributions are made and shares are purchased in the ESOP, common stock or additional paid-in capital are credited to the sponsor's equity accounts.

For leveraged ESOPs, sponsors should report the issuance of new shares or the sale of treasury shares to the ESOP, or external purchase of shares by the ESOP, when the issuance, sale, or purchase occurs, and should report a corresponding charge to "unearned ESOP shares," a contra-equity account. Sponsors should credit "unearned ESOP shares" as the shares are committed to be released, based on the cost of the shares to the ESOP.

A sponsor should report loans from outside lenders to its leveraged ESOPs as liabilities on its balance sheet and should report the related interest cost on the debt in its income statement. A sponsor with internally leveraged ESOPs (employer loans) should not report the loan receivable from the ESOP as an asset and should not report the ESOP's debt as a liability, or recognize interest income or cost on the sponsor loan.

Question FSP 15-4 addresses the classification of stock with a put option or a mandatory cash redemption feature held by an ESOP.

Question FSP 15-4

Under what circumstances should all or a portion of stock with a put option or a mandatory cash redemption feature held by an ESOP be classified outside of permanent equity in the sponsor's balance sheet?

PwC response

If there are conditions (regardless of their probability of occurrence) when holders of equity securities (i.e., ESOP participants) may demand cash in exchange for their securities, SEC registrants and private company financial statements filed with the SEC must reflect the maximum possible cash obligation related to those securities outside of permanent equity, in accordance with ASR 268. This is true regardless of whether the underlying shares have been allocated to participants.

Where the cash obligation relates only to a market value guarantee feature (i.e., a cash feature equivalent to the amount by which the "floor" exceeds the common stock market price as of the reporting date), reporting entities are permitted to classify only that portion of the obligation outside of permanent equity.

Alternatively, a reporting entity could classify the entire guaranteed value amount outside of permanent equity (e.g., in situations where there is uncertainty as to the ultimate cash obligation due to a possible market value decline in the underlying security).

15.7.2 Disclosure

Reporting entities that sponsor ESOPs should provide the disclosures described in ASC 718-40, *Employer Stock Ownership Plans*, as applicable. These include:

Excerpt from ASC 718-40-50-1

a. A description of the plan, the basis for determining contributions, including the employee groups covered, and the nature and effect of significant matters affecting comparability of information for all periods presented. For leveraged employee stock ownership plans and pension reversion employee stock ownership plans, the description shall include the basis for releasing shares and how dividends on allocated and unallocated shares are used.

b. A description of the accounting policies followed for employee stock ownership plan transactions, including the method of measuring compensation, the classification of dividends on employee stock ownership plan shares, and the treatment of employee stock ownership plan shares for earnings per share (EPS) computations. If the employer has both old employee stock ownership plan shares for which it does not adopt the guidance in this Subtopic and new employee stock ownership plan shares for which the guidance in this Subtopic is required, the accounting policies for both blocks of shares shall be described.

c. The amount of compensation cost recognized during the period.

d. The number of allocated shares, committed-to-be-released shares, and suspense shares held by the employee stock ownership plan at the balance-sheet date. This disclosure shall be made

separately for shares accounted for under this Subtopic and for grandfathered employee stock ownership plan shares.

e. The fair value of unearned employee stock ownership plan shares at the balance-sheet date for shares accounted for under this Subtopic. (Future tax deductions will be allowed only for the employee stock ownership plan's cost of unearned employee stock ownership plan shares.) This disclosure need not be made for old employee stock ownership plan shares for which the employer does not apply the guidance in this Subtopic.

f. The existence and nature of any repurchase obligation, including disclosure of the fair value (see paragraph 718-40-30-4) of the shares allocated as of the balance sheet date, which are subject to a repurchase obligation.

g. The amount and treatment in the EPS computation of the tax benefit related to dividends paid to any employee stock ownership plan, if material.

ASC 718-40-55-9 and ASC 718-40-55-20 provide illustrative examples of ASC 718-40-50-1's disclosure requirements.

15.8 Stock-based compensation—considerations for private companies

This section addresses presentation and disclosure considerations for private companies. ASC 718 defines a "public entity" as an entity that (1) has equity securities that trade on a public market (domestic or foreign), (2) files an initial prospectus in preparation to sell equity securities, or (3) is controlled by an entity that meets either of the first two criteria. Therefore, an entity with only publicly traded debt securities is a "non-public entity" under ASC 718; however, a subsidiary of an entity with publicly traded equity is also considered a public entity.

The presentation and disclosure guidance in this chapter is generally applicable to both public and non-public companies. A non-public entity under the ASC 718 definition that measures awards based on calculated value or intrinsic value should provide the disclosures in FSP 15.4 based on that measure. Additionally, non-public entities under the ASC 718 definition are not required to disclose the aggregate intrinsic value for fully vested awards and awards expected to vest, or for fully vested awards currently exercisable (see FSP 15.4.2).

Although only entities that file their financial statements with the SEC are required to classify certain ASC 718 awards as temporary equity (see FSP 15.3.3 and FSP 15.7.1), other non-public reporting entities should consider presenting these awards in temporary equity.

15.8.1 Private company simplification provisions

There are two simplification provisions included in ASC 718-10-30-20A through ASC 718-10-30-20B and ASC 718-30-30-2A that are only available to non-public entities.

A non-public entity is permitted to make a one-time election to change its measurement basis for all liability classified awards to intrinsic value, without requiring the entity to evaluate whether the change is preferable. Non-public entities that elect this practical expedient must disclose, in their first interim and annual period of adoption, the nature of and reason for the change in accounting

principle, as well as the cumulative effect of the change on retained earnings (or other appropriate components of equity or net assets). The guidance also provides non-public entities with a practical expedient for estimating the expected term of the award. If elected, non-public entities must disclose, in their first interim and annual period of adoption, the nature of and reason for the change in accounting principle.

15.8.2 Disclosures in periods prior to an initial public offering

The AICPA accounting and valuation guide *Valuation of Privately-Held-Company Equity Securities Issued as Compensation* (AICPA guide) provides both valuation and disclosure best practices related to privately-held-company equity securities issued as compensation, including awards that are within the scope of ASC 718. The AICPA guide recommends that private companies include information about stock-based compensation awards granted within 12 months of an initial public offering (in addition to the disclosures required by ASC 718).

Excerpt from AICPA guide, Chapter 14, *Accounting and Disclosures*

The task force recommends that financial statements included in a registration statement for an initial public offering (IPO) disclose, at a minimum, the following information for equity instruments granted during the 12 months prior to the date of the most recent balance sheet (year-end or interim) included in the registration statement:

a. For each grant date, the number of equity instruments granted, the exercise price and other key terms of the award, the fair value of the common stock at the date of grant, and the intrinsic value, if any, for the equity instruments granted (the equity instruments granted may be aggregated by month or quarter and the information presented as weighted average per share amounts)

b. Whether the valuation used to determine the fair value of the equity instruments was contemporaneous or retrospective

Chapter 16: Income taxes—updated September 2023

16.1 Income taxes—chapter overview

This chapter discusses the presentation and disclosure requirements of ASC 740, *Income Taxes*, and the applicable SEC requirements (primarily S-X 4-08(h)) and is organized as follows:

- Balance sheet presentation and disclosures for deferred tax accounts
- Income statement presentation and related disclosures
- Disclosures for uncertain tax positions
- Disclosures related to other topics affecting income taxes

Note about ongoing standard setting

The FASB has an active project related to income tax disclosure requirements. Financial statement preparers and other users of this publication are therefore encouraged to monitor the status of the project. Once finalized, financial statement preparers and users should evaluate the effective date of the new guidance and the implications on presentation and disclosure.

16.2 Balance sheet presentation of deferred tax accounts

ASC 740 provides specific guidance for the balance sheet presentation of deferred tax accounts and any related valuation allowance.

16.2.1 Principles of balance sheet classification

As discussed in ASC 740-10-45-4, a reporting entity should present deferred tax assets and liabilities separate from income taxes payable or receivable on the balance sheet. Deferred tax assets and liabilities, along with any related valuation allowance, must be classified as noncurrent if a reporting entity presents a classified balance sheet.

As discussed in ASC 740-10-45-6, a reporting entity can only offset deferred tax assets and liabilities within a jurisdiction–that is, reporting entities are prohibited from offsetting deferred tax liabilities from one jurisdiction against deferred tax assets of another jurisdiction. An asset versus liability classification exercise must be completed for each applicable tax-paying entity in each tax jurisdiction. Accordingly, in a single balance sheet, deferred taxes may appear under two different classifications: noncurrent asset and noncurrent liability.

Question FSP 16-1 addresses the netting of deferred tax balances when a jurisdiction does not allow tax consolidation but has an annual elective group relief provision.

Question FSP 16-1

A consolidated reporting entity operates in a jurisdiction that does not allow tax consolidation. However, the jurisdiction has annual elective group relief provisions for affiliated members, which allows a member with a loss for tax purposes to shift its loss to an affiliate that can use the loss to offset taxable income. For balance sheet presentation purposes, is netting the deferred tax balances permitted in the consolidated financial statements?

PwC response

A reporting entity must first determine whether the affiliated members are considered a single tax-paying component. We believe that the determining factors for this classification are (1) whether the taxing authorities can pursue one subsidiary for the other's income tax liabilities, and (2) whether the election allows for offset in all cases (e.g., whether it allows carryback or carryforward of losses among affiliated members). If the taxing authority can pursue one subsidiary for the other's income tax liabilities and if offset is unconditionally available, the affiliated members would be considered, in substance, a single tax-paying component and offsetting would be appropriate. However, if both of these conditions are not met, the affiliated members should be considered separate tax-paying components. As such, the deferred tax balances should not be offset, irrespective of whether the reporting entity plans to avail itself of the group relief provisions.

16.2.2 Balance sheet classification of investments in tax credit structures

Tax equity investors typically account for their investments in pass-through entities using the equity method of accounting under ASC 323 or may elect to account for their investment using another method, such as the proportional amortization method (PAM). PAM results in (1) the tax credit investment being amortized in proportion to the allocation of tax credits and other tax benefits in each period and (2) net presentation within the income tax line item. ASC 323-740 is silent about the balance sheet classification of investments accounted for under PAM. An investment in a tax credit structure should not be classified as a deferred tax asset as it is neither the result of a difference between the tax basis and reported amount in the financial statements of an asset or liability, nor is it analogous to a tax credit carryforward.

16.3 Disclosures related to balance sheet tax accounts

ASC 740-10-50-2 through ASC 740-10-50-8 and ASC 740-30-50-2 require disclosures related to balance sheet deferred tax accounts.

16.3.1 Tax effect of temporary differences giving rise to DTAs/DTLs

All reporting entities are required to disclose total deferred tax assets and total deferred tax liabilities for each period a balance sheet is presented. However, disclosure requirements regarding temporary differences and carryforward information differ between public entities and nonpublic entities. ASC 740 defines a public entity.

Definition from ASC 740-10-20

Public entity: An entity that meets any of the following criteria:

a. Its debt or equity securities are traded in a public market, including those traded on a stock exchange or in the over-the-counter market (including securities quoted only locally or regionally).

b. It is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).

c. Its financial statements are filed with a regulatory agency in preparation for the sale of any class of securities.

As discussed in ASC 740-10-50-6, public entities must disclose the approximate tax effect of each type of significant temporary difference and tax carryforward that comprises deferred tax assets and liabilities (before allocation of valuation allowances). ASC 740 does not impose a “bright line” for determining which types of temporary differences are significant and, therefore, this assessment requires judgment.

A nonpublic entity is not required to provide quantitative information regarding the types of temporary differences and carryforwards that give rise to significant deferred tax assets and liabilities. However, a nonpublic entity must disclose qualitative information on the nature of significant items, as discussed in ASC 740-10-50-8. See FSP 16.8 for additional disclosure considerations for nonpublic entities.

Question FSP 16-2

When disclosing deferred tax assets and deferred tax liabilities that relate to the same lease transaction, can a public entity net the two in its deferred tax asset and liability disclosures?

PwC response

Although the deferred tax asset and deferred tax liability relate to the same transaction, they are two separate temporary differences that will typically reverse in different patterns over the life of the lease. In accordance with the guidance in ASC 740-10-50-6, the deferred tax asset and deferred tax liability related to the lease should not be netted together and presented as a single number in the reporting entity’s disclosures. For more on deferred taxes related to lease transactions, refer to TX 5.8.2.2.

16.3.2 Total valuation allowance and the net change during the year

As discussed in ASC 740-10-50-2, reporting entities must disclose the total valuation allowance and the net change in the valuation allowance for each period a balance sheet is presented.

Since judgment about future taxable income is necessary in determining the need for and amount of a valuation allowance, management should consider disclosing the basis for its valuation allowance assessment, including the reliance on projections of future taxable income (if applicable). In some cases, SEC comment letters have indicated that certain incremental disclosures with respect to the realizability of deferred tax assets are required. For example, the SEC staff has emphasized the need to

provide disclosures regarding the relevant positive and negative factors considered when assessing the realization of deferred tax assets, such as sustained pretax profitability. The SEC staff also expects ample forewarning regarding any future valuation allowance increase or release. See FSP 24 for discussion of disclosure requirements associated with significant estimates.

Refer to TX 4.3.3.5 for discussion of certain rare situations in which it may be appropriate to write off an asset against the valuation allowance when the likelihood of realization is remote.

Additionally, the SEC requires a rollforward of the valuation allowance account to be included in the filing as part of the Regulation S-X, Rule 12-09 "valuation and qualifying accounts" schedule (Schedule II); however, reporting entities may include it in the financial statement footnotes instead of Schedule II.

16.3.3 Amounts and expiration of loss and tax credit carryforwards

Reporting entities should disclose the amounts and expiration dates of operating loss and tax credit carryforwards for tax purposes. Further, reporting entities may want to consider including other carryforwards, like interest limitation carryforwards. We believe footnote disclosure of the amounts of loss and other tax carryforwards should be on the same basis as presented on the balance sheet (i.e., tax effected and net of unrecognized tax benefits). If a reporting entity also presents the carryforwards in a footnote on a gross or "as filed" tax return basis, additional disclosures may be necessary to help the reader understand the difference between that amount and the balance sheet position.

Additionally, reporting entities should disclose the nature and potential effects of any other tax law provision that might limit the availability or utilization of loss or tax credit carryforward amounts. For example, carryforwards may face limitations caused by changes in ownership.

If there are circumstances that make a change in ownership reasonably possible in the foreseeable future, a general description of those circumstances may be warranted. More specific disclosures concerning the limitation should be made if the triggering event is probable. Some examples of circumstances that might warrant such disclosure include a planned public offering or outstanding convertible debt with an exercise price that is below market.

It may also be appropriate for reporting entities to disclose the fact that an annual limitation exists (e.g., NOLs that can only be used to offset a percentage of taxable income in a given year) so that financial statement users understand the timeframe over which carryforwards can be used and the effect the limitation has on cash taxes each year.

Regulated investment companies may need to consider additional disclosures related to expiration dates as prescribed by ASC 946-740-55-2.

16.3.4 Unrecognized deferred tax liability for subsidiaries and JVs

In certain situations, reporting entities might not record a deferred tax liability for specific temporary differences. In these situations, as discussed in ASC 740-30-50-2, the following disclosures are required:

- A description of the types of temporary differences and the types of events that would cause those differences to become taxable

- The cumulative amount of each type of temporary difference

- The amount of any unrecognized deferred tax liability for temporary differences related to investments in foreign subsidiaries and foreign corporate joint ventures that are essentially permanent in duration if determination of the amount of unrecognized deferred tax liability is practicable, or a statement that a determination is not practicable

  - We believe this disclosure should include unrecognized deferred liabilities related to the entire outside basis difference, including unremitted earnings and cumulative translation adjustments.

- The amount of any unrecognized deferred tax liability for each type of temporary difference other than those in the previous bullet

  - In accordance with ASC 740-30-25-18, this would apply to unremitted earnings of a domestic subsidiary or corporate joint venture that are permanent in duration that were earned prior to the 1993 effective date of ASC 740.

  - No disclosure is required for unremitted earnings of domestic subsidiaries if such earnings are expected to be recovered in a tax-free manner. For more information on unremitted earnings and outside basis differences, see TX 11.

If it is at least reasonably possible that within one year there will be a change in either a reporting entity's indefinite reversal assertion or in the expected method of recovery of the investment in a domestic subsidiary, disclosure under the risks and uncertainties guidance of ASC 275-10-50-9 may be required. See FSP 24.

The SEC staff also considers the consistency between a reporting entity's MD&A disclosures of liquidity and capital resources and its indefinite reinvestment assertions related to foreign earnings. For example, a reporting entity's MD&A might describe a business situation that necessitates significant cash, but the entity does not appear to have sufficient domestic cash available. The reporting entity's foreign subsidiaries may have sufficient cash to fund the parent, but the parent has asserted indefinite reinvestment of those funds. The staff's comments emphasize the need to provide accurate, transparent, and plain-language disclosures of significant tax-related assertions and estimates, including those associated with undistributed foreign earnings.

16.3.5 Other balance sheet disclosures required for income taxes

There are additional required balance sheet disclosures for deferred tax accounts:

- As discussed in ASC 740-10-50-3(b), any portion of the valuation allowance for deferred tax assets for which subsequently recognized tax benefits will be credited directly to contributed capital

- The amount of income tax expense or benefit allocated to each component of other comprehensive income, including reclassification adjustments, either on the face of the statements in which those components are displayed or in footnotes, as required by ASC 220-10-45-12

  - See FSP 4.4 for further discussion of these presentation options.

- As discussed in ASC 220-10-50-1, a description of the accounting policy for releasing disproportionate income tax effects from AOCI (e.g., for available for sale debt securities, the "aggregate portfolio" or "investment-by-investment" approach)
  - Refer to TX 12.3.3.3 for further discussion.
- As discussed in FASB Staff Q&A: Topic 740, No. 5, the accounting policy related to GILTI (i.e., accounting for GILTI as a period cost or recording GILTI deferred taxes) in accordance with ASC 235-10-50-1 through ASC 235-10-50-3

16.4 Income statement presentation of income taxes

Total income tax expense or benefit for the year generally equals the sum of total income tax currently payable or refundable (i.e., the amount calculated in the income tax return) and the total deferred tax expense or benefit, adjusted for any unrecognized tax benefits. This section discusses the appropriate presentation of income tax expense or benefit items in the financial statements.

16.4.1 Deferred tax expense or benefit

The total deferred tax expense or benefit for the year generally equals the change between the beginning-of-year and end-of-year balances of deferred tax accounts on the balance sheet (i.e., assets, liabilities, and valuation allowance). In certain circumstances, however, the change in deferred tax balances is reflected in other accounts. For example, some adjustments to deferred tax balances are recorded through other comprehensive income, such as balances related to pensions or available-for-sale debt investments. Other circumstances are described below.

When a business combination has occurred during the year, deferred tax liabilities and assets, net of the valuation allowance, are recorded at the date of acquisition as part of the purchase price allocation. When an asset or a group of assets is acquired other than as part of a business combination, and the amount paid is different from the tax basis of the asset(s), the tax effect is generally recorded as an adjustment to the book carrying amount of the related asset(s) as described in ASC 740-10-25-51 and may require the use of the simultaneous equation method. Refer to TX 10.12.1 for further discussion.

Changes in deferred tax balances resulting from foreign currency exchange rate changes may or may not be classified as a tax expense or benefit.

- When the US dollar is the functional currency, revaluations of foreign deferred tax balances are reported as either transaction gains and losses or, if considered more useful, as deferred tax expense or benefit, as described in ASC 830-740-45-1. If reported as deferred tax expense or benefit, the transaction gain or loss must still be included in the aggregate transaction gain or loss for the period required to be disclosed under ASC 830-20-45-1.
- When the foreign currency is the functional currency, revaluations of foreign deferred tax balances are included in cumulative translation adjustments. The revaluations of the deferred tax balances are not identified separately from revaluations of other assets and liabilities.
- Foreign withholding taxes related to the reversal of outside basis differences are technically a liability of the parent, and therefore, they are the parent's foreign currency transactions. As a result, if foreign withholding taxes are being recorded related to the outside basis difference in a

foreign subsidiary, the related transaction gains and losses caused by changes in the exchange rate should be accounted for as transaction gains and losses. Refer to TX 13 for further discussion.

16.4.2 Income statement presentation of interest and penalties

In accordance with ASC 740-10-45-25, the decision as to whether to classify interest expense related to income taxes as a component of income tax expense or interest expense is an accounting policy election. Penalties are also allowed to be classified as a component of income tax expense or another expense classification (e.g., selling, general and administrative expense) depending on the reporting entity's accounting policy.

Reporting entities are required to disclose their policy and the amount of interest and penalties charged to expense in each period, as well as the amounts accrued on the balance sheet for interest and penalties. Any change in the classification of interest or penalties is a change in accounting principle subject to the requirements of ASC 250, *Accounting Changes and Error Corrections*, and therefore must be a change to a preferable accounting method (see FSP 30).

Although ASC 740 does not provide guidance on the balance sheet classification of accrued interest and penalties, we believe that it should be consistent with the income statement classification. If the reporting entity's accounting policy election is to classify interest and penalties as "above the line" income statement items (i.e., included in pretax income or loss), the accrued balance sheet amounts should not be included with the tax balance sheet accounts. Instead, they should be included with accrued interest and/or other accrued expense.

ASC 740 is also silent on the classification of interest income received as it relates to income taxes. We believe that the classification of interest income should be consistent with the reporting entity's treatment of interest expense (i.e., either as a component of tax expense or as a pretax income line item).

Questions may arise as to whether the disclosure of total tax-related interest should be net of any interest income and of any potential tax benefit associated with an interest deduction. We believe that interest expense should be disclosed on a gross basis. However, if a reporting entity also wishes to disclose the amount of interest income it recorded in connection with tax overpayments, and any tax benefits generated from interest deductions, it would not be precluded from doing so.

16.4.3 Presentation of changes in tax laws, rates, or status

Reporting entities should include adjustments to deferred tax balances related to enacted changes in tax laws, tax rates, or tax status in income from continuing operations, regardless of whether the deferred tax balances originated from charges or credits to another category of income (e.g., discontinued operations or other comprehensive income).

When rate changes are enacted with retroactive effects, ASC 740-10-30-26 specifies that the current and deferred tax effects of items not included in income from continuing operations that arise during the current year, but before the date of enactment, should be measured based on the enacted rate at the time the transaction was recognized for financial reporting purposes. The adjustment that results from remeasuring these items because of the tax rate change should be reflected in income from continuing operations in the period of enactment.

Example FSP 16-1 illustrates the effect of a change in tax law and the appropriate intraperiod allocation.

EXAMPLE FSP 16-1

Presentation of the effects of a tax law change when prior year results are restated for discontinued operations

In the prior year, a provincial tax law was enacted in Country A which resulted in a charge to FSP Corp's consolidated financial statements. This effect was appropriately recorded in tax expense from continuing operations in the financial statements for that fiscal year. In the current year, FSP Corp agrees to sell all of its operations in Country A and recasts Country A's operations as a discontinued operation. The results from continuing operations no longer include any operations from Country A.

Should the effects of the tax law change that were originally recorded in continuing operations also be reclassified to discontinued operations?

Analysis

No. The effect of the change in tax law should be included in income from continuing operations for the period that includes the enactment date. Therefore, the amount of taxes associated with the discontinued operation should be the difference between the taxes previously reported in continuing operations and the amount of taxes allocated to continuing operations after the decision to dispose of Country A's operations occurred, which would still include the impact of the tax law change.

See TX 12 for more information on intraperiod tax allocations.

16.4.4 Income taxes attributable to noncontrolling interests

The financial statement amounts reported for income tax expense and net income attributable to noncontrolling interests differ based on whether the subsidiary is a C-corporation or a partnership. The tax status of each type of entity causes differences in the amounts a parent would report in its consolidated income tax provision and net income attributable to noncontrolling interests.

A C-corporation is generally a taxable entity and is responsible for the tax consequences of its transactions. Therefore, a parent that consolidates a C-corporation includes the income taxes of the C-corporation, including the income taxes attributable to the noncontrolling interest, in its consolidated income tax provision. Net income attributable to the noncontrolling interest should equal the noncontrolling interest's share of the C-corporation's net income, which would include a provision for income taxes.

The legal liability for income taxes of a partnership generally does not accrue to the partnership itself. Instead, the investors are responsible for income taxes on their share of the partnership's income. Therefore, a parent that consolidates a partnership only reports income taxes on its share of the partnership's income in its consolidated income tax provision. This results in a reconciling item in the parent's income tax rate reconciliation that should be disclosed. Net income attributable to the noncontrolling interest should equal the noncontrolling interest's share of the partnership's income, which would not include a provision for income taxes.

The guidance relating to partnerships is applicable to other pass-through entities, such as limited liability companies (if they elect to be taxed as a partnership) and subchapter S-corporations. Note that limited liability companies should follow the guidance for C-corporations if they elect to be taxed as such.

Example FSP 16-2 illustrates the presentation of income tax and net income attributable to noncontrolling interests when the subsidiary is a C-Corporation or partnership.

EXAMPLE FSP 16-2

Presentation of income tax and net income attributable to noncontrolling interest

FSP Corp has a 70% ownership interest in Subsidiary B. The other 30% is owned by an unrelated party. FSP Corp consolidates the financial statements of Subsidiary B. FSP Corp has pretax income from continuing operations of $500 for the year ended December 31, 20X1. This amount includes $200 of pretax income from continuing operations from Subsidiary B. FSP Corp's tax rate for the period is 25%. For purposes of this example, the tax effects of any outside basis differences have been ignored, and Subsidiary B is assumed to have no subsidiaries of its own.

How should income tax expense and net income be determined and presented in the consolidated financial statements?

Analysis

Assuming Subsidiary B is a C-corporation with a 25% tax rate, income tax expense and net income would be calculated and presented as follows:

Income from continuing operations, before tax	$500
Income tax expense	125[1]
Net income	375
Less: Net income attributable to noncontrolling interest	45[2]
Net income attributable to FSP Corp	$330

[1] Calculated as $500 x 25%
[2] Calculated as ($200 – (200 x 25%)) x 30%

Assuming Subsidiary B is a partnership, income tax expense and net income would be calculated and presented as follows:

Income from continuing operations, before tax	$500
Income tax expense	110[3]
Net income	390
Less: Net income attributable to noncontrolling interest	60[4]
Net income attributable to FSP Corp	$330

[3] Calculated as ($500 – (200 x 30%)) x 25%
[4] Calculated as $200 x 30%

If the subsidiary is a partnership, income attributable to noncontrolling interest should be disclosed as a reconciling item in FSP Corp's tax rate reconciliation.

16.4.5 *Presentation of cash and other benefits not considered "income tax" benefits when using PAM*

ASC 323-740 provides guidance when applying PAM, including the presentation of cash flows and other benefits that are not income tax benefits. PAM requires the initial cost of the tax equity investment less the expected residual value to be amortized in proportion to the tax benefits received over the period that the investor expects to receive the income tax credits and other income tax benefits. The initial cost is inclusive of unconditional future capital commitments (see "Delayed equity contributions" in TX 3.3.6.7) and the residual value is the expected proceeds upon exercise of a put or call option. This amortization (described in more detail in TX 3.3.6.4) is presented net of the related tax credits and other tax benefits within the income statement as a component of income tax expense (benefit). However, ASC 323-740-35-5 states that any non-income-tax-related benefits received from the investee (which could either be cash flow from operations or credits that are not considered income tax credits under ASC 740) should be included in pretax earnings when realized or realizable. Similarly, any gains or losses on the sale of the investment should also be included in pretax earnings at the time of sale.

16.5 *Disclosures related to income statement income tax amounts*

ASC 740-10-50-9 through ASC 740-10-50-14 require certain disclosures about income statement amounts related to income taxes. In addition, as discussed in ASC 740-10-50-14, the nature and effect of any significant matters affecting comparability of information for all periods presented (unless otherwise evident from other disclosures) should be disclosed. For SEC registrants, S-X 4-08(h) requires certain incremental disclosures.

16.5.1 *Amount of income tax expense or benefit*

As discussed in ASC 740-10-50-10, reporting entities are required to disclose the amount of income tax expense or benefit allocated to continuing operations. In practice, this is frequently presented on the face of the income statement. In addition, reporting entities must also disclose amounts separately allocated to other categories of income in accordance with the intraperiod tax allocation provisions, such as discontinued operations and a cumulative effect of a change in accounting principle.

16.5.2 *Effective tax rate reconciliation*

As discussed in ASC 740-10-50-12, public entities (see FSP 16.3.1 for definition) are required to provide a tax rate reconciliation that reconciles income tax expense attributable to continuing operations to the statutory federal income tax rate applied to pretax income from continuing operations (see FSP 16.8 for private entity disclosure requirements). Foreign public entities should use the income tax rate in the entity's country of domicile. When a rate other than the US federal corporate income tax rate is used, the rate and basis for using that rate should be disclosed.

Public entities can present the reconciliation using either dollar amounts or percentages. The reconciliation should include the estimated amount and the nature of each significant reconciling item.

Although ASC 740 does not define what "significant" means with regard to the rate reconciliation, S-X 4-08(h) does provide guidance. It requires disclosure of individual reconciling items that are more

than 5% of the amount computed by multiplying pretax income by the statutory tax rate (e.g., for a US-based entity subject to the 21% statutory tax rate, any item that increases or decreases the tax rate by 1.05% or more). SEC registrants should ensure that items are not aggregated or disaggregated to avoid this requirement, that reconciling items below this threshold are displayed in appropriate categories, and that groupings are consistent from year to year.

16.5.3 Significant components of income tax expense

Both public and nonpublic entities are required to disclose significant components of income tax expense attributable to continuing operations.

ASC 740-10-50-9

The significant components of income tax expense attributable to continuing operations for each year presented shall be disclosed in the financial statements or notes thereto. Those components would include, for example:

a. Current tax expense (or benefit)

b. Deferred tax expense (or benefit) (exclusive of the effects of other components listed below)

c. Investment tax credits

d. Government grants (to the extent recognized as a reduction of income tax expense)

e. The benefits of operating loss carryforwards

f. Tax expense that results from allocating certain tax benefits directly to contributed capital

g. Adjustments of a deferred tax liability or asset for enacted changes in tax laws or rates or a change in the tax status of the entity

h. Adjustments of the beginning-of-the-year balance of a valuation allowance because of a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years. For example, any acquisition-date income tax benefits or expenses recognized from changes in the acquirer's valuation allowance for its previously existing deferred tax assets as a result of a business combination (see paragraph 805-740-30-3).

The sum of the amounts disclosed for the components of tax expense should equal the amount of tax expense that is reported in income from continuing operations. Insignificant components can be grouped in an "other" category. These items are typically discussed in a narrative disclosure.

ASC 740-10-55-212 through ASC 740-10-55-216 provides three examples that illustrate this disclosure requirement.

16.5.3.1 Investment tax credit disclosures

ASC 740-10-50-20 requires disclosures detailing the method of accounting (either the deferral method or the flow-through method) used to account for investment tax credits and the amounts involved. See TX 3 for investment tax credit accounting considerations.

16.5.3.2 *Current and deferred taxes for changes in tax laws, rates, or status*

As discussed in FSP 16.4.3, the effects of changes in tax laws or rates are recognized in income from continuing operations in the period that includes the enactment date. The tax effect of the enacted tax rates on current and deferred tax assets and liabilities should be determined at the date of enactment using temporary differences and currently taxable income existing as of the date of enactment.

Changes in tax rates may be retroactive to the beginning of the current year. In these instances, we believe it would generally be sufficient to disclose (1) the effect of the rate change on beginning-of-year deferred tax balances, and (2) the effect of the rate change on current and deferred taxes provided prior to the enactment date. Both of these items should be considered in the rate reconciliation. In any case, the amount(s) disclosed should be clearly described.

As discussed in ASC 740-10-45-19, if a reporting entity experiences a change in tax status (e.g., change from a nontaxable partnership to a taxable corporation), the deferred tax effects of that change should be disclosed as a component of income tax expense attributable to continuing operations. See TX 8.1 for discussion of changes in tax status.

16.5.4 *Disclosures for investments in tax credit structures (after adoption of ASU 2023-02)*

ASC 323-740 addresses investments in tax credit structures that provide income tax credits and other income tax benefits associated with the development of certain types of projects, such as low-income housing, rehabilitation of historic structures, investments in the infrastructure of economically-challenged geographic areas, and renewable energy projects such as solar and wind. Provided certain criteria are met, investors can make an election to apply the proportional amortization method to such investments.

New guidance

ASU 2023-02, *Investments – Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method (a consensus of the Emerging Issues Task Force)*, expanded the availability of the proportional amortization method (PAM), previously allowed only for investments in low-income housing tax credit structures, to equity investments in other tax credit structures that meet certain criteria. See TX 3.3.6 for guidance regarding the application of PAM and the effective date of ASU 2023-02.

The disclosure requirements in ASC 323-740-50-1 through ASC 323-740-50-2 are meant to provide financial statement users with information about a reporting entity's investments in tax credit structures and their impact on reported financial results, including amounts reflected in the balance sheet, income statement, and statement of cash flows from these investments.

These disclosures are required not only for investments accounted for under PAM, but all investments within the tax credit programs for which the reporting entity has elected to apply PAM, including investments within that elected program that do not meet the conditions to apply PAM. A reporting entity could also choose to provide information about investments in tax credit programs for which the entity has elected not to apply PAM to better highlight amounts reflected in pre-tax income and income tax expense associated with all investments in tax credit structures.

The following disclosure requirements are applicable for both annual and interim periods:

ASC 323-740-50-1A

To meet the objectives in paragraph 323-740-50-1, a reporting entity shall disclose the following information about its investments that generate income tax credits and other income tax benefits from a tax credit program for which it has elected on a tax-credit-program-by-tax-credit-program basis to apply the proportional amortization method, including investments within that elected tax credit program that do not meet the conditions in paragraph 323-740-25-1:

a. The amount of income tax credits and other income tax benefits recognized during the period, including the line item in the statement of operations and statement of cash flows in which it has been recognized

b. The amount of investments and the line item in which the investments are recognized in the statement of financial position

c. For investments accounted for using the proportional amortization method, the amount of investment amortization recognized as a component of income tax expense (benefit)

d. For investments accounted for using the proportional amortization method, the amount of non-income-tax-related activity and other returns received that is recognized outside of income tax expense (benefit) and the line item in the statement of operations and statement of cash flows in which it has been recognized

e. For investments accounted for using the proportional amortization method, significant modifications or events that resulted in a change in the nature of the investment or a change in the relationship with the underlying project.

In accordance with ASC 323-740-50-2, a reporting entity should also consider the following disclosures:

- The amount of investment income or loss included in pretax income (for investments accounted for using the equity method)

- Any commitments or contingent commitments (e.g., guarantees or commitments to provide additional capital contributions), including the amount of delayed equity contributions and the year(s) in which contingent commitments are expected to be paid

- The amount and nature of impairment losses during the year resulting from the forfeiture or ineligibility of income tax credits or other circumstances (e.g., in a qualified affordable housing project investment, those impairment losses may be based on actual property-level foreclosures, loss of qualification due to occupancy levels, compliance issues with tax code provisions, or other issues)

In addition to the ongoing disclosure requirements discussed in this section, reporting entities must make disclosures regarding the transition to the new guidance in ASU 2023-02, consistent with ASC 250 on accounting changes and error changes, in the financial statements of both the interim period of the change and the fiscal year of the change.

See ASC 323-740-50 for disclosure considerations prior to the adoption of ASU 2023-02.

16.5.5 Additional income tax disclosures for SEC registrants

S-X 4-08(h) requires certain additional disclosures that are not specifically required by ASC 740. They include:

- Identifying the components of income (loss) before tax expense (benefit) as either foreign or domestic
- Separately stating for each major component of income tax expense (i.e., current and deferred) the amounts applicable to US federal income taxes, foreign income taxes, and other income taxes

These disclosure requirements apply not only to continuing operations, but also to total pretax income and total tax expense. However, question 7 of SAB Topic 6.I., *Accounting Series Release 149—Improved Disclosure Of Income Tax Expense*, indicates that "overall" disclosures of the components of total income tax expense (i.e., current versus deferred, and US federal versus foreign versus other) are acceptable. In other words, it is not necessary to make such disclosures separately with respect to each of the different categories (continuing operations, discontinued operations, other comprehensive income, etc.) in which income tax expense is reported.

In addition, SAB Topic 11.C, *Tax Holidays* (codified in ASC 740-10-S99-2), requires disclosure of tax holidays from income taxes that the reporting entity has been granted for a specified period. The disclosure should include the aggregate dollar and per-share effects of the tax holiday, and briefly describe the facts and circumstances, including the date on which the special tax status will terminate.

16.6 Presentation and disclosure of uncertain tax positions

Uncertain tax positions represent tax positions taken that are subject to varied interpretations of applicable tax law. ASC 740 prescribes a comprehensive two-step model for recognizing, measuring, and disclosing uncertain tax positions. This section includes discussion of the presentation and disclosure requirements related to uncertain tax positions. See TX 15 for discussion of the recognition and measurement requirements related to uncertain tax positions.

16.6.1 Presentation of unrecognized tax benefits

ASC 740-10-45-11 indicates that the balance sheet classification of a liability for an unrecognized tax benefit as current versus noncurrent is determined based on the expected timing of cash payments, if any. That is, to the extent that cash payments are anticipated within one year or the operating cycle, if longer, a liability for an unrecognized tax benefit is classified as a current liability. Otherwise, such amounts should be reflected as noncurrent liabilities.

Balance sheet classification should be based on management's expectation of future cash payments. For example, if $40 of a $100 liability for an unrecognized tax benefit is expected to be paid within 12 months, only $40 should be classified as a current liability; the remaining $60 should be classified as a noncurrent liability. Similarly, if management expects that its liability for an unrecognized tax benefit will reverse without cash consequences within 12 months (e.g., because the statute of limitation will expire), the associated liability should be classified as noncurrent because no cash payments are anticipated to settle the liability.

16.6.2 *Uncertain tax positions in foreign registrants*

Foreign registrants that present a US GAAP reconciliation must present the reconciliation in accordance with Item 18 of Form 20-F, and therefore are required to provide the complete disclosures. A non-issuer foreign business that provides a quantitative reconciliation under Item 17 of Form 20-F is not required to apply the disclosure provisions established in ASC 740-10-50-15, 50-15A and ASC 740-10-50-19.

16.6.2.1 *Netting unrecognized tax benefits with carryforwards*

ASC 740-10-45-10A and ASC 740-10-45-10B clarify the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. Unrecognized tax benefits should be presented in the financial statements as a reduction to the deferred tax asset related to an NOL carryforward, a similar tax loss, or a tax credit carryforward. This presentation is not appropriate if:

- the NOL, similar tax loss, or tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income generated by disallowance of a tax position, or
- the tax law does not require the entity to use, or the entity does not intend to use, the NOL, similar tax loss, or tax credit carryforward to offset additional income generated by disallowance of a tax position.

If either of these exceptions exist, the unrecognized tax benefit should be presented as a liability and not netted against the deferred tax asset for an NOL, similar tax loss, or tax credit carryforward.

Example FSP 16-3 illustrates how the unrecognized tax benefit should be considered when measuring the valuation allowance necessary to reduce deferred tax assets to their realizable value.

EXAMPLE FSP 16-3

Netting unrecognized tax benefits with NOL carryforwards

As of December 31, 20X1, Company A has $800 in NOL carryforwards. The related deferred tax assets (DTAs) are offset by a full valuation allowance as a result of significant negative evidence.

In 20X2, Company A expects to report taxable income of $100 on its tax return. This taxable income includes a $20 deduction that does not meet the ASC 740-10-25 recognition threshold and therefore constitutes an unrecognized tax benefit. Assume that the tax rate is 25% and that the assessment of the need for a full valuation allowance has not changed as of December 31, 20X2.

Should Company A reduce the DTA for the NOLs carried forward from 20X1 on its balance sheet for the unrecognized tax benefit recorded in 20X2?

Analysis

Yes. Company A should present the NOL carryforwards net of the liability for unrecognized tax benefit of $5 ($20 deduction x 25%). The $5 liability would be a source of income for the purposes of assessing whether a valuation allowance is necessary and would therefore reduce the valuation allowance required.

Balance sheet reporting as of December 31, 20X2, is as follows:

DTA-NOL carryforward	$ 170[1]
Valuation allowance	(170)
Net DTA	0

[1] NOL at 12/31/X1 of $800 – 20X2 taxable income of $100 = $700; $700 × 25% = $175 – $5 (liability for unrecognized tax benefit) = $170

16.6.3 Disclosure requirements for uncertain tax positions

ASC 740 requires a qualitative discussion of only those positions where a change is reasonably possible within the next 12 months. Further, for public entities as defined in ASC 740 (see FSP 16.3.1), the quantitative rollforward of unrecognized tax benefits is prepared on a worldwide aggregated basis. The specific disclosure requirements are discussed in the following sections.

ASC 740-10-55-217 provides an illustrative disclosure about uncertainty in income taxes.

Question FSP 16-3 addresses the periods for which unrecognized tax benefit disclosures should be included in annual financial statements.

Question FSP 16-3

For what periods should unrecognized tax benefit disclosures be provided for purposes of annual financial statements?

PwC response

ASC 740-10-50-15 requires reporting entities to provide disclosures as of the end of each annual reporting period presented in the financial statements.

To meet this requirement, we believe disclosures related to historical information reflected in the financial statements (e.g., the tabular reconciliation of unrecognized tax benefits discussed in FSP 16.6.5) should cover the years for which income statements are presented.

For disclosures that are primarily forward-looking in nature (e.g., the total amount of unrecognized tax benefit that, if recognized, would affect the effective tax rate discussed in FSP 16.6.6), we believe a reporting entity could present this information as of the most recent balance sheet date only. However, in practice, some reporting entities have taken an alternative point of view that the requirements related to unrecognized tax benefits should be presented for all periods presented. We believe either approach is acceptable for disclosures that are primarily forward-looking in nature.

16.6.4 Reasonably possible changes within the next 12 months

Reporting entities must disclose the nature of uncertain tax positions and related events if it is reasonably possible that the positions and events could change the associated recognized tax benefits

within the next 12 months. This includes previously unrecognized tax benefits that are expected to be recognized upon the expiration of a statute of limitations within the next year.

ASC 740-10-50-15(d) requires the following disclosures:

- Nature of the uncertainty
- Nature of the event that could occur within the next 12 months to cause the change
- Estimate of the range of the reasonably possible change, or statement that an estimate of the range cannot be made

In preparing this disclosure, all facts and circumstances should be considered. In certain instances, an uncertain tax position may not meet the recognition threshold, but management expects the statute of limitations to expire within the next 12 months and does not expect the taxing authority to identify the exposure. When this occurs, the total amount of the unrecognized tax benefit should be disclosed as being expected to change within the next 12 months.

Management will need to exercise judgment in determining the level of aggregation that is appropriate for this disclosure. While some level of aggregation is expected, we believe that the information should be appropriately detailed to provide a reader of the financial statements with some context as to which circumstances may cause the unrecognized tax benefits to significantly change.

The disclosure requirements related to unrecognized tax benefits apply annually as noted in ASC 740-10-50-15(d). However, the early warning disclosure requirements of ASC 275, *Risks and Uncertainties*, are also still applicable. Accordingly, reporting entities should disclose reasonably possible significant changes in unrecognized tax benefits on a rolling 12-month basis.

16.6.5 Tabular reconciliation of unrecognized tax benefits

ASC 740-10-50-15A requires public entities to disclose a reconciliation of the beginning and ending balances of the unrecognized tax benefits from uncertain positions. This rollforward must include all unrecognized benefits—whether they are reflected in a liability or as a decrease in a deferred tax asset (irrespective of whether a valuation allowance would be required). The rollforward should cover all income statement periods presented and include the following items.

Excerpt from ASC 740-10-50-15A(a)

1. The gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period
2. The gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during the current period
3. The amounts of decreases in the unrecognized tax benefits relating to settlements with taxing authorities
4. Reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations.

Public entities may consider including additional line items such as reclassifications of a liability to or from a deferred tax liability to reflect exposures that only affect timing. Public entities may also consider disaggregating the above line items to provide further details. For instance, they may disaggregate details about changes that affected the effective tax rate, or changes that were recorded outside the income statement (e.g., recorded as a component of other comprehensive income, against goodwill for uncertainties arising from business combinations, or decreases due to the disposal of a business unit).

An investor in a pass-through entity (e.g., partnerships, S-corporations, limited liability companies) should include in its tabular reconciliation its respective interest in the pass-through entity's underlying unrecognized tax benefits, regardless of whether the pass-through entity is consolidated or accounted for under the equity method. Conversely, an investor in a non-pass-through entity (e.g., an investment in a C-corporation) that is accounted for under the equity method would not be expected to include the uncertain tax positions of the non-pass-through investee in its tabular reconciliation. However, disclosures of significant tax uncertainties of a non-pass-through investee that could affect the investor may be appropriate.

16.6.5.1 Unrecognized tax benefits for positions taken in prior years

Amounts reported on the "unrecognized tax benefits for positions taken in prior years" line item typically represent an uncertain tax position taken in a prior year for which measurement has changed for one of two reasons: (1) the reporting entity met one of the subsequent recognition thresholds in ASC 740-10-25-8, or (2) new information supported a change in measurement.

Question FSP 16-4 addresses how a public entity should reflect an unrecognized tax benefit that reduces a deferred tax asset for an NOL carryforward, similar tax loss, or a tax credit carryforward when there is a change in corporate tax rate.

Question FSP 16-4

The tabular rollforward of unrecognized tax benefits should include the unrecognized tax benefits reported in the financial statements as a direct reduction to the deferred tax asset for the NOL carryforward, a similar tax loss, or the tax credit carryforward to which it relates. In instances when an unrecognized tax benefit reduces an NOL and there is a corporate tax rate change in the period, should the unrecognized tax benefit (as disclosed in the tabular rollforward) be adjusted to reflect the reduced corporate tax rate (e.g., from 35% to 21%)?

PwC response

Yes. The tabular rollforward reflects tax benefits that have not yet been recognized in the financial statements. In this scenario, the tax benefit that would be recognized upon a favorable resolution of the tax position would result in an NOL carryforward that would provide a 21% tax benefit. As a result, the tabular rollforward should reflect the unrecognized tax benefit at the reduced rate. This conclusion applies both when the unrecognized tax benefit is directly associated with a tax position taken in a tax year that resulted in the recognition of the NOL, and when the unrecognized tax benefit itself did not generate the NOL, but rather the NOL is available to offset any additional income if the tax position is disallowed.

16.6.5.2 *Unrecognized tax benefits for current year positions*

On occasion, a public entity may take an uncertain tax position during the year, and then change its assessment of the amount of benefit to be recognized within the same annual reporting period. When this occurs, the tabular reconciliation should only reflect the net addition in existence at the end of the year when disclosing the gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during the entire year.

16.6.5.3 *Settlement of unrecognized tax benefits with tax authorities*

Certain settlements with taxing authorities may result in no cash payments (e.g., a taxing authority may concede a position taken on a tax return resulting in no cash payments to the taxing authority for that position). Only amounts paid, or tax attributes (e.g., net operating losses) used in lieu of payment, should be included in this line item of the tabular reconciliation. Public entities should reflect a decrease in unrecognized tax benefits resulting from concessions or adjustments by the taxing authority as a change to prior-period unrecognized tax benefits.

If unrecognized tax benefits on a prior-year uncertain tax position were both established and paid out in the same year, public entities should report the movement gross. That is, an increase should be reflected in "The gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period" line, while the payment of cash to settle the position should be reflected in "The amounts of decreases in the unrecognized tax benefits relating to settlements with taxing authorities" line.

As illustrated in Example FSP 16-4, an increase in unrecognized tax benefits on one position and the settlement of an unrelated position during the same period, even if for a similar amount, should be reported gross.

EXAMPLE FSP 16-4

Tabular reconciliation — settlement of uncertain tax positions

In a prior year, FSP Corp had two unrecognized tax benefits (UTBs) of $100 and $150 (UTBs A and B, respectively) related to two different uncertain tax positions. For UTB A, FSP Corp reached an agreement with the taxing authority to settle the position for $80. For UTB B, it is in the appeals process and FSP Corp does not expect to settle the position until the following year. The $80 settlement for UTB A is paid after year end.

How should FSP Corp reflect the year's activity associated with these unrelated positions in its disclosure?

Analysis

A settlement reached with a taxing authority as of year-end should generally be shown in the line item "Decrease in unrecognized tax benefits relating to settlements with taxing authority," notwithstanding that the actual cash payment is made subsequent to year end. This is because the uncertainty related to these particular tax positions has been resolved as of the balance sheet date and it is clear that a payment will be made subsequent to year-end.

In this example, FSP Corp's line item "Decrease in unrecognized tax benefits relating to settlements with taxing authority" would show a decrease of $80 to reflect the $80 settlement for UTB A. The line item "Gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period" would reflect a decrease of $20 due to the unrecognized tax benefit of $100 for UTB A being resolved for $80.

No change would be reflected for UTB B because it is still in the appeals process.

16.6.5.4 UTB sustained due to lapse of the applicable statute of limitations

Amounts reported in this line represent tax benefits that were sustained by the reporting entity because the taxing authority's period of assessment has passed.

16.6.5.5 Examples of the UTB tabular reconciliation

Example FSP 16-5, Example FSP 16-6, and Example FSP 16-7 illustrate the impact of various scenarios on the tabular reconciliation of unrecognized tax benefits.

EXAMPLE FSP 16-5

Tabular reconciliation — valuation allowances

FSP Corp has taken various tax positions on a tax return that resulted in a net operating loss carryforward with a potential benefit of $10,000. The related deferred tax asset, if recorded, would require a full valuation allowance. Assume that only $3,000 of the potential $10,000 tax benefit has met the threshold for financial statement recognition.

What amount should be included in the tabular reconciliation of unrecognized tax benefits?

Analysis

FSP Corp should include $7,000 in the tabular reconciliation of unrecognized tax benefits. This represents the difference between the amount taken on the tax return ($10,000) and the amount recognized for financial reporting purposes ($3,000). In this case, the gross deferred tax asset and related valuation allowance reported in the income tax footnote should be $3,000. For balance sheet presentation purposes, no amount is recognized because the deferred tax asset of $3,000 is offset by the $3,000 valuation allowance.

The $7,000 reduction in the deferred tax asset is considered an unrecognized tax benefit and should be included in the annual tabular reconciliation, regardless of the fact that a valuation allowance would be required if the $7,000 were recognized.

In summary, all gross unrecognized tax benefits, whether they result in a liability or a reduction of deferred tax assets and/or refundable amounts, should be included in the tabular reconciliation.

EXAMPLE FSP 16-6

Tabular reconciliation — refund claim filed after the balance sheet reporting date

FSP Corp expects to file a refund claim (related to a current period tax position) after the balance sheet reporting date. An unrecognized tax benefit of $10,000 will be included within the refund claim.

Should this unrecognized tax benefit be included in the year-end tabular reconciliation, even though the refund claim that will give rise to the unrecognized tax benefit has not been filed as of the balance sheet date?

Analysis

Yes. Though not recognized in the financial statements, the unrecognized tax benefit associated with this claim should be disclosed in the tabular reconciliation as required by ASC 740-10-50-15A(a).

A public entity is required to evaluate tax positions in a refund claim regardless of whether the claim for refund is filed as of the current-period balance sheet date or is expected to be filed, provided it is related to a current-period or prior-period tax position.

EXAMPLE FSP 16-7

Tabular reconciliation — determining when to include items in the reconciliation

In the fourth quarter of 20X1, FSP Corp generates a loss of $1,000 related to the sale of an investment. Because FSP Corp does not have ordinary income or capital gains in the current year or the applicable carryback periods, the loss is a carryforward. Management expects to take a tax return filing position characterizing the loss as ordinary rather than capital in nature. There is some support in the law for the position; however, in applying ASC 740-10-25-6, management concludes that the position does not meet the more-likely-than-not threshold for financial statement recognition.

The applicable tax rate in the jurisdiction is 25% for both ordinary income and capital gains; however, capital losses can only be used to offset capital gains. FSP Corp recognizes a $250 deferred tax asset because the carryforward constitutes a tax attribute regardless of the nature of the loss.

In 20X2, FSP Corp generates a profit that is all ordinary in nature and utilizes all of its loss carryforwards to reduce taxable income and taxes payable.

How should the unrecognized tax benefit be recorded and presented in 20X1 and 20X2?

Analysis

We believe that $250 of unrecognized tax benefit should be included in the 20X1 tabular reconciliation. ASC 740 defines the term "tax position" as a position in a previously filed tax return or a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets and liabilities for interim or annual periods. As part of that definition, ASC 740 specifies that a tax position also encompasses the characterization of income.

In 20X2, a $250 unrecognized tax benefit liability should be recorded on the balance sheet because, at the time, FSP Corp began utilizing the "as filed" 20X1 loss carryforward to reduce taxable income and thus paid less income tax than it would have had the original $1,000 loss been determined to be

capital in nature. In addition, a deferred tax asset for the future deductible amount associated with the capital loss should continue to be recorded during 20X2 (and possibly beyond) even though, on an "as filed" basis, FSP Corp utilized the loss carryforward on the 20X2 tax return.

With regard to the 20X2 tabular reconciliation, since the $250 unrecognized tax benefit was included in 20X1, no additional entry is necessary in 20X2.

It should be noted that in both 20X1 and 20X2, FSP Corp must assess the realizability of the deferred tax asset based on whether there is sufficient future taxable income of the appropriate character (i.e., future capital gains). Otherwise, a valuation allowance would be required against the deferred tax asset. The unrecognized tax benefit amount would need to be included in the tabular reconciliation. In addition, FSP Corp must disclose the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate (see FSP 16.6.6 for discussion of this disclosure requirement).

16.6.5.6 Items to exclude from the UTB tabular reconciliation

Indirect effects between jurisdictions

An unrecognized tax benefit in one jurisdiction could have an impact on a tax liability in another jurisdiction (such as a state unrecognized tax benefit affecting the amount of state taxes that would be deductible for US federal purposes). When this occurs, the tabular reconciliation of unrecognized tax benefits should not include consideration of the effect in other jurisdictions (e.g., the corresponding deferred tax asset related to the federal deduction for state taxes). Instead, these indirect effects between jurisdictions are recorded in the financial statements if recognition and measurement have been met under ASC 740 and are therefore recognized and not a part of the disclosure of unrecognized tax benefits). See TX 15.3.1.6 for further discussion.

Interest and penalties

Interest and penalties should not be included in the annual tabular reconciliation as unrecognized tax benefits, even if a reporting entity has elected an accounting policy to classify interest and penalties as a component of income taxes. Refer to ASC 740-10-50-15A for the tabular reconciliation requirements.

Treatment of deposits

If a reporting entity makes an advance deposit (regardless of whether it is refundable on demand or considered by the taxing authority as a payment of taxes), it should have no impact on the amount of unrecognized tax benefit that is reflected in the tabular reconciliation. This is because advance deposits are essentially equivalent to advance tax payments. As such, they should not be included as an offset to unrecognized tax benefits in the annual tabular reconciliation disclosure. Advance tax payments or tax deposits do not serve as indicators of the uncertain tax positions sustainability; their effect is neutral with regard to the liability for unrecognized tax benefits.

16.6.6 Unrecognized tax benefits that would affect the ETR

ASC 740-10-50-15A(b) requires public entities to disclose the total amount of unrecognized tax benefits that, if recognized, would impact the effective tax rate. Therefore, this disclosure should include only unrecognized tax benefits that affect (if recognized) the tax provision within continuing operations.

Although this guidance specifically requires disclosure related to items that would affect the tax provision within continuing operations, public entities should also provide supplemental disclosures for resolutions of uncertain tax positions that, if sustained, would affect items other than the tax provision from continuing operations. Examples of unrecognized tax benefits that may not affect the tax provision within continuing operations include acquisition-related measurement period adjustments pursuant to ASC 805, *Business Combinations*, and measurement period adjustments occurring in connection with reorganizations in fresh-start balance sheets pursuant to ASC 852, *Reorganizations*.

In addition, as discussed in FSP 16.6.5.6, the indirect effects of uncertain tax positions in other jurisdictions should not be included within the tabular rollforward of unrecognized tax benefits. We understand, however, that for purposes of applying the disclosure requirements specified in ASC 740-10-50-15A(b), a public entity might consider the indirect effects in other jurisdictions.

Further, uncertain tax positions embedded in a net operating loss carryforward that carries a full valuation allowance would not affect the effective tax rate, as long as the uncertainty is expected to be resolved while a full valuation allowance is maintained. The guidance does not specify whether any of these positions are required to be included in this disclosure. However, we believe public entities should consider providing additional transparency in this disclosure. For example, consider an uncertain tax benefit that could create an additional net operating loss carryforward, along with an additional valuation allowance. In this situation, a public entity may disclose that if the unrecognized tax benefit is recognized, it would be in the form of a net operating loss carryforward, which is expected to require a full valuation allowance based on present circumstances.

16.6.7 Tax years subject to examination by major jurisdictions

ASC 740-10-50-15(e) requires reporting entities to disclose all tax years that remain open to assessment by a major tax jurisdiction. We believe, in certain situations, this disclosure would include a jurisdiction where the reporting entity has not filed a tax return. For example, the reporting entity may have taken a tax position regarding a tax status of one of its legal entities whereby the potential tax exposure related to the reporting entity could be significant. In this fact pattern, the reporting entity may need to identify the tax jurisdiction as still being subject to examination.

16.7 Other required disclosures related to income taxes

ASC 740 and other accounting standards require disclosures for other transactions that have income tax effects. These are discussed in the following sections.

16.7.1 Income tax-related disclosures for stock-based compensation

ASC 718-740 requires disclosures related to the income tax effects of stock-based compensation. See FSP 15 for these required disclosures.

16.7.2 Income tax-related disclosures for pass-through entities

Some business entities are treated as a conduit for tax purposes, where the business entity’s income is not taxed directly as a legal entity but is instead passed to its owners or investors. These entities can include partnerships, certain limited liability companies, and other entities disregarded for tax purposes. As provided under ASC 740-10-50-16, a public entity that is not subject to income taxes

because its income is taxed directly to its owners should disclose that fact, as well as the net difference between the tax bases and the reported amounts of the reporting entity's assets and liabilities.

Question FSP 16-5

Regulated investment companies (RICs) and real estate investment trusts (REITs) are taxable entities, but are not subject to income tax on income they distribute currently to shareholders if they meet certain requirements. In practice, most RICs and REITS distribute substantially all of their income such that they are effectively nontaxable. Do the disclosure requirements of ASC 740-10-50-16 apply to RICs and REITs?

PwC response

Yes. RICs and REITs are not subject to tax (by means of a dividends paid deduction) if distribution requirements and other conditions are met. Therefore, ASC 740-10-50-16 requires RICs and REITs that are publicly traded to disclose the fact that they are not taxed. In addition, it also requires such entities to disclose the net difference between the tax bases and the reported amounts of their assets and liabilities. Presumably this disclosure is meant to indicate to an owner (or prospective owner) what future taxable income or deductions, disproportionate to reported amounts, will be generated for his/her ownership interest by the entity's future operations. However, for some entities the depreciation or depletion deductions available to individual owners will not be pro rata to ownership interest but will instead reflect the different outside tax bases of the individual owners. Further, each owner's tax accounting (e.g., depletion calculations for mineral properties) might depend on his or her individual tax position. Thus, the entity itself frequently will not have information about individual owners' tax bases.

It does not appear that disclosure of the aggregate tax bases would be meaningful, since individual owners will not share the tax basis pro rata. We believe that if these circumstances make it impracticable for an entity to determine the aggregate tax basis of the individual owners, the entity should indicate this in the financial statements and explain that the amount would not be meaningful.

As RICs and REITs do not "pass through" tax losses to owners (as partnerships do), they must disclose the amount of any operating or capital loss carryforward.

When a pass-through entity is a member of a group that files a consolidated tax return, ASC 740-10-30-27A provides an accounting policy election for allocating consolidated income tax expense to the reporting entity if it is both (1) not subject to tax and (2) disregarded by the taxing authority. For example, this election would be available to a single-member LLC that did not "check the box" and elect to be taxed as an association, but would not be available to a partnership because it is not disregarded by the tax authority. This accounting policy election can be applied on an entity-by-entity basis even if the separate entities are included in the same consolidated income tax return. A reporting entity that meets this criteria and elects to include the allocated amount of current and deferred tax expense in its separately issued financial statements must disclose that fact, along with the disclosures discussed in FSP 16.7.3.

16.7.3 Tax disclosures in separate financial statements of a subsidiary

In accordance with ASC 740-10-50-17, when a reporting entity is a member of a group that files a consolidated tax return, it must disclose the following items in its separately issued financial statements:

- The aggregate amount of current and deferred tax expense for each income statement presented, and the amount of any tax-related balances due to or from affiliates as of the date of each balance sheet presented

- The principal provisions of the method by which the consolidated amount of current and deferred tax expense is allocated to members of the group, and the nature and effect of any changes in that method (and in determining related balances to or from affiliates) during the years for which the disclosures are presented

These disclosure requirements are in lieu of, rather than in addition to, the general disclosure requirements required under ASC 740. However, we believe that it may be helpful in separately issued financial statements to also include a description of the types, and potentially the amounts, of significant temporary differences and uncertain tax positions.

ASC 740-10-30-27A provides an accounting policy election for allocating consolidated income tax expense to the reporting entity if the reporting entity is both not subject to tax and disregarded by the taxing authority (e.g., single-member LLCs that did not "check the box" and elect to be taxed as an association). A reporting entity that meets this criteria and elects to include the allocated amount of current and deferred tax expense in its separately issued financial statements must disclose that fact.

In SAB Topic 1.B, *Allocation Of Expenses And Related Disclosure In Financial Statements Of Subsidiaries, Divisions Or Lesser Business Components Of Another Entity* (codified in ASC 220-10-S99-3), the SEC staff indicates that the separate return basis is the preferred method for computing the income tax expense of a subsidiary, division, or lesser business component of another entity included in consolidated tax returns. When the historical income statements in the filing do not reflect the tax provision on the separate return basis, the SEC staff typically requires a pro forma income statement for the most recent year and interim period reflecting a tax provision calculated on the separate return basis.

When a reporting entity has been included in a consolidated US tax return, it is jointly and severally liable with other members of the consolidated group for any additional taxes that may be assessed. There may be circumstances in which it is appropriate to disclose this contingent liability based on the disclosure requirements for loss contingencies.

For more information on separate financial statements of a subsidiary that is a member of a consolidated tax group, see TX 14.

16.7.4 *Significant income tax risks and uncertainties disclosures*

ASC 275 requires disclosures in annual and interim financial statements of risks and uncertainties (e.g., use of estimates) related to certain key information that helps users in assessing future performance.

The disclosure requirements in ASC 275 are relevant for other income tax matters, such as uncertain tax positions, valuation allowances, and indefinite reversal assertions for unremitted earnings of foreign subsidiaries. Additional disclosures may be required with respect to assumptions that management uses to estimate its balance sheet and income statement tax accounts.

When it is at least reasonably possible that a material adjustment will occur in the near term (generally considered one year), the financial statements should disclose this potential uncertainty along with a

range of potential changes to the recorded amounts. This requirement is discussed in ASC 275-10-50-6 and ASC 740-10-50-15(d), and an example relating to valuation allowances is provided in ASC 740-10-55-218 through ASC 740-10-55-222.

The threshold for disclosure is "reasonably possible," indicating that probability is more than remote. The premise behind this threshold is that significant one-time charges or benefits, such as a change in the assessment of the need for a valuation allowance, should not surprise the reader of the financial statements. The more significant the change in estimate, the more difficult it may be for a reporting entity to justify that a significant one-time event was not reasonably foreseeable at the time of its most recent previous filing. This is particularly important for SEC registrants because of their quarterly reporting requirements.

16.8 Tax disclosures for private companies

The tax-related disclosures required for nonpublic entities, as defined in the ASC 740 glossary, differ in some respect from those required for public entities.

Definition from ASC 740-10-20

Nonpublic entity: An entity that does not meet any of the following criteria:

a. Its debt or equity securities are traded in a public market, including those traded on a stock exchange or in the over-the-counter market (including securities quoted only locally or regionally).

b. It is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).

c. Its financial statements are filed with a regulatory agency in preparation for the sale of any class of securities.

A nonpublic entity is not required to numerically reconcile the statutory and effective rates (see FSP 16.5.2) or provide the approximate tax effect of each type of temporary difference and carryforward that gives rise to significant deferred tax assets and liabilities (see FSP 16.3.1). However, a nonpublic entity must disclose the nature of significant reconciling items as well as a description of the significant temporary differences and carryforwards in accordance with ASC 740-10-50-13.

Nonpublic entities are not required to include the following disclosures:

- Tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the reporting date

- The net difference between the tax bases and the reported amounts of assets and liabilities when they are structured as nontaxable entities

In addition, the requirements included in Figure FSP 16-1 apply only to SEC registrants.

Figure FSP 16-1

Presentation and disclosure requirements applicable only to SEC registrants

Description	Reference	Section
Disclose individual reconciling items that are more than five percent of the amount computed by multiplying pretax income by the statutory tax rate	S-X 4-08(h) (codified in ASC 235-10-S99-1)	FSP 16.5.2
Disclose the components of income (loss) before tax expense (benefit) as either foreign or domestic	S-X 4-08(h)	FSP 16.5.5
Separately state for each major component of income tax expense the amounts applicable to US federal income taxes, to foreign income taxes, and to other income taxes	S-X 4-08(h)	FSP 16.5.5
Disclose required information about tax holidays granted for a specified period in a foreign jurisdiction	SAB Topic 11.C (codified in ASC 740-10-S99-2)	FSP 16.5.5

Chapter 17: Business combinations—updated April 2022

17.1 Business combinations—chapter overview

This chapter discusses the presentation and disclosure requirements of ASC 805, *Business Combinations*. The disclosure provisions in ASC 805 are intended to enable users of financial statements to evaluate the nature and financial effects of all forms of business combinations.

Presentation and disclosure considerations for pushdown accounting (ASC 805-50) are also discussed in this chapter.

17.2 Business combinations—scope and relevant guidance

The disclosure guidance in ASC 805 applies to all transactions that meet the definition of a business combination, including acquisitions by not-for-profit reporting entities. It does not apply to the formation of a joint venture, nor to the acquisition of a group of assets that do not constitute a business (see FSP 8 for disclosure requirements of such acquisitions). It also does not apply to business combinations between entities under common control.

If an acquiree prepares separate financial statements after an acquirer obtains control of the entity, a question arises as to whether the historical basis of the acquired company should be reflected in those separate financial statements or if the acquiree should "pushdown" the "stepped-up basis" of the acquirer. Pushdown accounting is an accounting election that establishes a new basis for the assets and liabilities of the acquired company. See FSP 17.6 for further discussion regarding the application of and disclosure requirements for pushdown accounting.

In some situations, a reporting entity may consolidate an acquired business in which it has less than 100% ownership. In these instances, the reporting entity must report a noncontrolling interest representing the portion of the acquired business it does not own. The presentation and disclosure requirements associated with noncontrolling interests are addressed in FSP 5.

ASC 810-10-50-3 requires the primary beneficiary of an acquired variable interest entity that is a business to provide the disclosures required by ASC 805 in the period of acquisition. The primary beneficiary of a variable interest entity that is not a business must disclose the amount of gain or loss recognized upon initial consolidation. Refer to FSP 18 for the disclosure requirements for primary beneficiaries.

17.3 Business combinations—presentation

There are a number of items that should be recognized in income under ASC 805, including transaction costs, restructuring charges, revaluations of contingent consideration, adjustments to acquired contingencies, gain or loss on previously held equity interests, credit loss expense for purchased financial assets that are not credit impaired (applicable after the adoption of ASU 2016-13) and bargain purchase gains.

Reporting entities will need to exercise judgment in determining the appropriate income statement classification for these items based on their nature. Generally, the income statement recognition of items in a business combination should mirror their recognition outside of a business combination, and most items recognized in income should be classified as part of operations. For example, transaction costs should typically be recorded in operations, particularly if the acquiring reporting entity has a history of making acquisitions or expects to make more acquisitions in the future.

Additionally, items that may occur as part of the business combination, but that are recognized separate from the business combination, such as employee compensation arrangements for postcombination services and the settlement of certain preexisting relationships, should generally be recorded in the income statement based on their nature.

Adjustments to an indemnification asset for an income tax liability should be recorded in pretax income, not as a part of income tax expense. This is because ASC 740 narrowly defines the term "income taxes" as domestic and foreign taxes based on income. Recoveries under an indemnification agreement do not fall within the scope of this definition. Therefore, although dollar-for-dollar changes in the income tax liability and the related indemnification asset (subject to the limitations of the indemnity and collectability) will be neutral on an after-tax basis, pretax income and tax expense will change when the amount of the income tax liability and related indemnification asset change.

Changes in fair value measurements of items such as contingent consideration may contain elements of changes in assumptions used in the determination of fair value and changes due to the passage of time (the time value of money). Generally, we would not expect reporting entities to separate a change in fair value into its components; we would expect the reporting entities to record the entire change as a component of operating income.

On the balance sheet, an acquirer's obligation to pay contingent consideration or contingent right to receive a return of some consideration paid (i.e., contingently returnable consideration) is recognized as an asset, a liability, or in shareholders' equity. See BCG 2.6.4 for further details on the classification.

17.4 Disclosures for business combinations

The disclosure provisions of ASC 805-10-50 are intended to enable users of financial statements to evaluate the nature and financial effects of:

- A business combination that occurs either during the current reporting period or after the reporting date, but before the financial statements are issued or are available to be issued

- Adjustments recognized in the current reporting period that relate to business combinations that occurred in current or previous reporting periods

The guidance indicates that the disclosure provisions should be considered minimum requirements. Reporting entities should provide additional disclosures, if necessary, to meet these objectives. See FSP 28.6.3.1 for disclosure requirements for business combinations that occur as subsequent events.

As discussed in ASC 805-10-50-1, all disclosures should be made in the period in which the business combination occurs. Reporting entities should typically include the disclosures in subsequent financial statements if an acquisition occurred in a previous reporting period and that period is presented in the financial statements. For example, assume a reporting entity includes balance sheets for two years and income statements for three years in its 20X3 financial statements. If it completed a material acquisition in 20X1, the reporting entity should disclose the 20X1 income statement disclosures in their 20X3 financial statements. However, certain of the original disclosures may no longer be relevant since the 20X3 financial statements do not include a 20X1 balance sheet, and may be omitted.

17.4.1 *General acquisition disclosures*

As discussed in ASC 805-10-50-2, reporting entities should disclose the name and a description of the acquiree (e.g., type of business). The disclosure should also describe the primary reason the reporting entity completed the acquisition (e.g., to expand global reach, increase capacity, enter a new line of business). The disclosure should include the acquisition date (i.e., the date control is obtained), a description of how the acquirer obtained control of the acquiree (e.g., execution of a share purchase agreement), and the percentage of ownership acquired (i.e., voting equity interests). This disclosure should be included for each material business combination that occurs during the reporting period.

17.4.1.1 *Aggregation of immaterial business combinations*

A reporting entity may complete several immaterial business combinations in the same accounting period. The disclosures required by ASC 805-10-50-2(e) through ASC 805-10-50-2(h), ASC 805-20-50-1(a) through ASC 805-20-50-1(e) and ASC 805-30-50-1(a) through ASC 805-30-50-1(f) are required in the aggregate for immaterial business combinations that are collectively material.

17.4.2 *Disclosure of consideration transferred in a business combination*

A reporting entity must disclose the acquisition date fair value of the total consideration transferred (i.e., the purchase price) in a business combination. The consideration transferred may include items in addition to, or in lieu of, cash. In addition to disclosing the total consideration, a reporting entity must disclose the acquisition date fair value of each major class of consideration. Consideration may include cash, other assets (tangible or intangible), or a business or subsidiary of the reporting entity. A business transferred as consideration may trigger separate presentation and disclosure requirements, such as the disclosures for a discontinued operation. Refer to FSP 27.5 for disclosure requirements related to discontinued operations.

If the acquirer transfers cash in a business combination and the acquiree has cash on its balance sheet at the acquisition date, we believe the consideration transferred should be disclosed as the gross amount transferred (rather than the amount net of cash acquired, which is disclosed in the statement of cash flows as described in FSP 6.8.20. For example, if Company A pays $100 million of cash to the sellers of Company T, and Company T has $5 million of cash on its balance sheet at the acquisition date, the total consideration transferred by Company A to disclose in the footnotes is $100 million (not $95 million).

Consideration transferred may also be comprised of liabilities incurred for contingent consideration or other liabilities incurred by the buyer to the former owners of the acquiree (e.g., a note payable to the seller). An acquirer may also settle (i.e., pay off) some or all of the outstanding debt of the acquiree on, or in close proximity to, the acquisition date. See BCG 2.5.11 for discussion of the impact of debt assumed or paid off at the time of closing and whether it should be recognized as a component of consideration transferred, and FSP 6.8.20 for discussion of the impact on the statement of cash flows.

Consideration may also include common or preferred stock, options, or warrants of the acquirer or member interests of mutual entities, as well as the portion of stock-based compensation awards issued as replacement awards to grantees of the acquiree that is recorded as part of consideration transferred in the acquisition (see further discussion in BCG 3.4). If equity instruments are provided as consideration, disclosure should include the number of securities issued or issuable, and the method of measuring fair value. If common stock of an SEC registrant is provided as consideration, the

disclosure typically includes the number of shares issued and the price of the stock on the acquisition date.

17.4.3 *Disclosure of contingent consideration and indemnification assets*

The same information is required to be disclosed for both contingent consideration arrangements (as discussed in ASC 805-30-50-1(c)) and arrangements in which the seller indemnifies the buyer (e.g., indemnification assets) (as discussed in ASC 805-20-50-1(a)):

Excerpt from ASC 805-30-50-1(c) and ASC 805-20-50-1(a)

1. The amount recognized as of the acquisition date
2. A description of the arrangement and the basis for determining the amount of payment
3. An estimate of the range of outcomes (undiscounted) or, if a range cannot be estimated, that fact and the reasons why a range cannot be estimated. If the maximum amount of the payment is unlimited, the acquirer shall disclose that fact.

Indemnification assets and the related liabilities are generally presented gross (i.e., not netted against one another) because the right of offset typically does not exist. Refer to FSP 17.3 for income statement presentation considerations related to indemnifications for an income tax liability.

17.4.4 *Disclosure of major classes of assets acquired and liabilities assumed*

ASC 805-20-50-1(c) requires reporting entities to disclose the amounts recognized for assets acquired and liabilities assumed as of the date of acquisition. This disclosure includes recognized contingent assets and liabilities. The disclosure is required to be prepared by each major class of assets and liabilities, and is typically presented in a tabular format that reconciles the consideration transferred to the assets/liabilities acquired.

17.4.5 *Disclosure of acquired receivables after ASC 326/ASC 842*

Subsequent to the adoption of ASU 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, and ASU 2016-02, *Leases (Topic 842)*, the following information must be disclosed for acquired receivables that are not subject to the requirements of ASC 326-20 related to purchased financial assets with credit deterioration:

Excerpt from ASC 805-20-50-1(b)

1. The fair value of the receivables (unless those receivables arise from sales-type leases or direct financing leases by the lessor for which the acquirer shall disclose the amounts recognized as of the acquisition date)
2. The gross contractual amounts receivable
3. The best estimate at the acquisition date of the contractual cash flows not expected to be collected.

The disclosures shall be provided by major class of receivable, such as loans, net investment in sales-type or direct financing leases in accordance with Subtopic 842-30 on leases—lessor, and any other class of receivables.

The revised guidance under ASC 326 is effective for public business entities that are SEC filers, excluding entities eligible to be smaller reporting companies (SRCs) as defined by the SEC. For SRCs and all other entities, the revised guidance will be effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. Early adoption is permitted. For additional information on the definition of SRCs and the effective dates of ASU 2016-13, refer to LI 13.1.

The accounting and disclosure requirements of ASC 326 are covered in PwC's *Loans and Investments* guide (see LI 12).

The revised guidance under ASC 842 is effective for public business entities, employee benefit plans that file with or furnish financial statements to the SEC, and not-for-profit entities that have issued, or are a conduit bond obligor for, securities that are traded on an exchange or over-the-counter market. For all other entities, the new guidance is effective for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. Early adoption is permitted.

The accounting and disclosure requirements of ASC 842 are covered in PwC's *Leases* guide. See FSP 14.1.

17.4.5A Disclosures of acquired receivables (before new guidance)

If a reporting entity has adopted ASU 2016-02, *Leases (Topic 842)* but has not yet adopted ASU 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, the terminology in ASC 805-20-50-1(b)(1) is updated to conform with the new accounting guidance in ASC 842. The following information must be disclosed for acquired receivables that are not subject to the requirements of ASC 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality:*

Excerpt from ASC 805-20-50-1(b)

1. The fair value of the receivables (unless those receivables arise from sales-type leases or direct financing leases by the lessor for which the acquirer shall disclose the amounts recognized as of the acquisition date)

2. The gross contractual amounts receivable

3. The best estimate at the acquisition date of the contractual cash flows not expected to be collected.

The disclosures shall be provided by major class of receivable, such as loans, net investment in sales-type or direct financing leases in accordance with Subtopic 842-30 on leases—lessor, and any other class of receivables.

The revised guidance under ASC 842 is effective for public business entities, employee benefit plans that file with or furnish financial statements to the SEC, and not-for-profit entities that have issued, or are a conduit bond obligor for, securities that are traded on an exchange or over-the-counter market. For all other entities, the new guidance is effective for fiscal years beginning after December 15, 2021,

and interim periods within fiscal years beginning after December 15, 2022. Early adoption is permitted.

The accounting and disclosure requirements of ASC 842 are addressed in PwC's *Leases* guide. See FSP 14.1.

For discussion of disclosure requirements for acquired receivables that are subject to ASC 310-30, see FSP 8.3.1.2.

Disclosures of acquired receivables for reporting entities prior to adoption of ASC 326/ASC 842

If a reporting entity has not adopted ASU 2016-02 nor ASU 2016-13, the following information must be disclosed for acquired receivables that are not subject to the requirements of ASC 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality:*

Excerpt from ASC 805-20-50-1(b)

1. The fair value of the receivables
2. The gross contractual amounts receivable
3. The best estimate at the acquisition date of the contractual cash flows not expected to be collected.

The disclosures shall be provided by major class of receivable, such as loans, direct financing leases in accordance with Subtopic 840-30, and any other class of receivables.

For discussion of disclosure requirements for acquired receivables that are subject to ASC 310-30, see FSP 8.3.1.2.

17.4.5.1 Disclosures for financial assets acquired (after ASC 326)

Upon adoption of ASU 2016-13, financial assets held at amortized cost within the scope of the ASU should be assessed in order to determine whether the receivables have experienced more than insignificant credit deterioration since origination at the date of purchase. If the assets are classified as purchased credit deteriorated (PCD assets), the initial recognition of an allowance for credit losses is required to be recognized through an increase to the amortized cost basis of the finance receivable at acquisition (i.e., a balance sheet gross up). In contrast, the initial recognition of an estimated allowance for credit losses on an asset that is not accounted for under the PCD model is reported in current earnings. Subsequently, the accounting for PCD assets under ASC 326-20 follows the CECL model, as appropriate, with all adjustments to the allowance recognized through current earnings. Refer to LI 9 for further information on the PCD accounting model, and refer to LI 12 on the presentation and disclosure requirements for PCD and non-PCD assets.

17.4.5.1A Disclosures for financial assets acquired (before ASC 326)

Reporting entities that acquire finance receivables as part of a business combination will need to assess the impact of acquired finance receivables on their existing allowance for credit loss policies. They will need to classify the acquired finance receivables into the appropriate portfolio segments and

classes to be reflected in accordance with the interim and annual disclosure provisions of ASC 310, *Receivables*. Refer to FSP 8.3 for disclosure requirements related to finance receivables.

17.4.6 Disclosures about assets and liabilities arising from contingencies

The following information related to contingencies should be included within the financial statement footnote that describes the business combination:

Excerpt from ASC 805-20-50-1(d)

1. For assets and liabilities arising from contingencies recognized at the acquisition date:

   i The amounts recognized at the acquisition date and the measurement basis applied (that is, at fair value or at an amount recognized in accordance with Topic 450 and Section 450-20-25).

   ii. The nature of the contingencies.

   An acquirer may aggregate disclosures for assets or liabilities arising from contingencies that are similar in nature.

2. For contingencies that are not recognized at the acquisition date, the disclosures required by Topic 450 if the criteria for disclosures in that Topic are met.

An acquirer may aggregate disclosures for assets and liabilities arising from contingencies that are similar in nature.

As described in ASC 805-20-50-1(d)(2), there may be circumstances in which a contingency is not recognized by the acquirer on the acquisition date but certain disclosures are still required. If there is at least a reasonable possibility that a loss may have been incurred and certain other conditions are met (see ASC 450-20-50-3), certain disclosures related to the contingency should be provided pursuant to ASC 450.

As discussed in SEC FRM 3250.1(h), if the initial accounting for a contingency is incomplete, SEC registrants are required to disclose that the purchase price allocation is preliminary/provisional. In addition, SEC registrants should disclose the following:

- A clear description of the nature of the contingency
- The reasons why the allocation is preliminary/provisional, including identification of the information that the SEC registrant has arranged to obtain
- When the allocation is expected to be finalized
- Other available information that could enable a reader to understand the magnitude of any potential adjustment

Refer to FSP 23 for further presentation and disclosure requirements related to liabilities arising from contingencies.

17.4.7 *Disclosures for contract assets and liabilities (after adoption of ASU 2021-08)*

If a reporting entity elects any of the practical expedients provided in ASU 2021-08, *Business Combinations (Topic 805): Accounting for Contract Assets and Contract Liabilities from Contracts with Customers* (as described in BCG 2.5.16), in accordance with ASC 805-20-50-5 the entity should disclose the expedients that have been used. Additionally, a qualitative assessment of the estimated effect of applying each of the expedients should be disclosed to the extent reasonably possible.

ASU 2021-08 is effective for public business entities for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. For all other entities, the new guidance is effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Entities should apply the guidance in ASU 2021-08 on a prospective basis to all business combinations with an acquisition date on or after the effective date. Early adoption is permitted, including in an interim period, for any period for which financial statements have not yet been issued.

17.4.8 *Goodwill acquisition disclosures*

The following information is required to be disclosed when an acquirer recognizes goodwill in a business combination:

Excerpts from ASC 805-30-50-1

a. A qualitative description of the factors that make up the goodwill recognized, such as expected synergies from combining operations of the acquiree and the acquirer, intangible assets that do not qualify for separate recognition, or other factors.

…

d. The total amount of goodwill that is expected to be deductible for tax purposes.

Consistent with ASC 805-30-50-1(e), when reporting entities are required to disclose segment information, they should disclose the amount of goodwill by reportable segment. In addition, if the assignment of goodwill to reporting units is not complete as of the financial statements issuance date, the reporting entities should disclose this fact.

Refer to FSP 8.9 for day-two presentation and disclosure requirements related to goodwill.

17.4.9 *In-process research and development (IPR&D) disclosures*

ASC 805 does not require specific disclosures for IPR&D intangible assets acquired in a business combination. However, the SEC staff has encouraged registrants to provide additional disclosures about material IPR&D to enhance an investor’s understanding of the registrant’s use and expected use of resources in research and development activities. Examples of such disclosures include:

- Nature and status of each major research and development project or group of related projects currently in process

- Appraisal method (e.g., based on discounted probable future cash flows on a project-by-project basis)

- Significant assumptions, such as:

  - The period in which material net cash inflows from significant projects are expected to commence

  - Any anticipated material changes from historical pricing, margins, and expense levels

  - The risk-adjusted discount rate applied to the project's cash flows

17.4.10 Disclosure of changes in acquirer's valuation allowance

ASC 740-10-50-9(h) requires disclosure of adjustments to the beginning-of-the-year balance of a deferred tax asset valuation allowance because of a change in circumstances that causes a significant change in judgment about the realizability of the related deferred tax asset in future years. ASC 805-740-50-1 indicates that a business combination is an example of a transaction that may require such an adjustment and should be disclosed as such. See TX 10.5.4 for further information on changes to acquirer's deferred tax balances as a result of an acquisition transaction.

17.4.11 Disclosure of separately recognized transactions

The acquirer and the acquiree may have had a preexisting relationship or other arrangement before negotiations for the business combination began, or they may enter into an arrangement during the negotiations that is separate from the business combination. A transaction entered into by or on behalf of the acquirer or primarily for the benefit of the acquirer or the combined entity is likely to be a separate transaction.

Acquisition-related costs (e.g., finder's fees, advisory, legal, or accounting fees) are considered separate transactions. The following are additional examples of separate transactions:

- Transactions that effectively settle preexisting relationships between the acquirer and acquiree

- Transactions that compensate employees or former owners of the acquiree for future services

- Transactions that reimburse the acquiree or its former owners for the acquirer's acquisition-related costs

As discussed in ASC 805-10-50-2(e), for transactions that are recognized separate from the acquisition of assets and assumption of liabilities in the business combination, a reporting entity should disclose the following:

- A description of the transaction

- The accounting for the transaction

- The amounts recognized for each transaction and the line item in the financial statements in which each amount is recognized

- If the transaction was the settlement of a preexisting relationship, the method used to determine the settlement amount

Additionally, as discussed in ASC 805-10-50-2(f), a reporting entity is required to disclose the amount of any issuance costs (i.e., costs to issue debt or equity instruments used to effect the business combination) that were not expensed and how they were recognized.

17.4.12 Disclosure of bargain purchases

As discussed in ASC 805-30-25-2 through ASC 805-30-25-4, a bargain purchase arises when the fair value of the net assets acquired in a business combination exceeds the consideration transferred, resulting in a gain being recorded by the acquirer. In business combinations where the acquirer makes a bargain purchase, the following items must be disclosed:

Excerpt from ASC 805-30-50-1(f)

1. The amount of any gain recognized in accordance with paragraph ASC 805-30-25-2 and the line item in the income statement in which the gain is recognized

2. A description of the reasons why the transaction resulted in a gain.

ASC 805-30-55-14 through ASC 805-30-55-16, Example 1: Bargain Purchases, provides an illustration of these disclosure requirements.

We believe that because a bargain purchase gain is not expected to be recognized frequently, it may be appropriate to present a bargain purchase gain as an unusual or infrequently occurring item in accordance with ASC 220-20-45-1.

17.4.13 Disclosures for partial and step acquisitions

As discussed in ASC 805-20-50-1(e), a reporting entity should disclose the following for each business combination in which the acquirer holds less than 100% of the equity interests in the acquiree at the acquisition date:

- The fair value of the noncontrolling interest in the acquiree at the acquisition date

- The valuation technique(s) and significant inputs used to measure the fair value of the noncontrolling interest

In addition to the above disclosures for noncontrolling interests, ASC 805-10 also requires the following disclosures for previously held equity interests in the acquiree at the acquisition date:

ASC 805-10-50-2(g)

In a business combination achieved in stages, all of the following:

1. The acquisition-date fair value of the equity interest in the acquiree held by the acquirer immediately before the acquisition date

2. The amount of any gain or loss recognized as a result of remeasuring to fair value the equity interest in the acquiree held by the acquirer immediately before the business combination (see paragraph 805-10-25-10) and the line item in the income statement in which that gain or loss is recognized
3. The valuation technique(s) used to measure the acquisition-date fair value of the equity interest in the acquiree held by the acquirer immediately before the business combination
4. Information that enables users of the acquirer's financial statements to assess the inputs used to develop the fair value measurement of the equity interest in the acquiree held by the acquirer immediately before the business combination.

17.4.14 *Presentation of reverse acquisitions*

A reverse acquisition occurs if the entity that issues securities (the legal acquirer) is identified as the acquiree for accounting purposes and the entity whose equity interests are acquired (legal acquiree) is the acquirer for accounting purposes. ASC 805-40-45-2 indicates that the presentation of the financial statements in a reverse acquisition represents the continuation of the legal acquiree, except for the legal capital structure in a reverse acquisition. See BCG 2.10.3 for further information on the presentation requirements for a business combination accounted for as a reverse acquisition. Also, see FSP 7.6.4.1 for information on the calculation of earnings per share in a reverse acquisition.

17.4.15 *Presentation of common control transactions*

Common control transactions are not within the scope of the business combinations guidance in ASC 805-10-15; rather, these transactions are covered in ASC 805-50. ASC 805-50-05-5 states that some transfers of net assets or exchanges of shares between entities under common control result in a change in reporting entity. If a transaction combines two or more commonly controlled entities that historically have not been presented together, the resulting financial statements are effectively considered to be those of a different reporting entity. See BCG 7.1.3.2 for information on financial statement presentation requirements when presenting a change in reporting entity in a common control transaction. Also, see BCG 7.1.4 for financial statement presentation considerations for the transferring entity in a common control transaction.

17.4.16 *Acquiree's financial information and pro forma financial information*

In business combinations where the acquirer is a public entity, as defined in ASC 805-10-20, the acquirer must disclose certain financial information related to the acquiree and provide pro forma financial data, as described in the excerpt below:

Excerpt from ASC 805-10-50-2(h)

1. The amounts of revenue and earnings of the acquiree since the acquisition date included in the consolidated income statement for the reporting period.

2. If comparative financial statements are not presented, the revenue and earnings of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period (supplemental pro forma information).

3. If comparative financial statements are presented, the revenue and earnings of the combined entity as though the business combination(s) that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period (supplemental pro forma information). For example, for a calendar year-end entity, disclosures would be provided for a business combination that occurs in 20X2, as if it occurred on January 1, 20X1. Such disclosures would not be revised if 20X2 is presented for comparative purposes with the 20X3 financial statements (even if 20X2 is the earliest period presented).

4. The nature and amount of any material, nonrecurring pro forma adjustments directly attributable to the business combination(s) included in the reported pro forma revenue and earnings (supplemental pro forma information).

If any of the above disclosures are impracticable, the acquirer should disclose that fact and explain why the disclosure is impracticable. In this context, impracticable has the same meaning as described in ASC 250-10-45-9 (see FSP 30.4.3.1).

Question FSP 17-1 addresses, and Example FSP 17-1 illustrates, the number of years a reporting entity is required to present supplemental pro forma revenue and earnings of the combined entity.

Question FSP 17-1

If a reporting entity presents three years of income statements, is it required to present three years of supplemental pro forma revenue and earnings of the combined entity?

PwC response

No. A reporting entity is only required to present two years (the year of the transaction and the prior annual reporting period) of supplemental pro forma revenue and earnings of the combined entity even if its financial statements include three years of income statements. For interim reporting, the supplemental pro forma information should be presented for both the quarter and year-to-date periods.

EXAMPLE FSP 17-1

ASC 805 supplemental pro forma financial information requirements

FSP Corp, a calendar year-end reporting entity, acquired Sub Corp on May 15, 20X2. The acquisition is material to the financial statements of FSP Corp.

In the financial statements included in its SEC filings in subsequent years, how would FSP Corp present its pro forma revenue and earnings?

Analysis

SEC filing	Supplemental pro forma required	Supplemental pro forma not required	Explanation
Q2 20X2	X		Present pro forma revenue and earnings as if the acquisition occurred on January 1, 20X1 for

SEC filing	Supplemental pro forma required	Supplemental pro forma not required	Explanation
			the three and six months ended June 30, 20X1 and 20X2.
Q3 20X2	X		Present pro forma revenue and earnings as if the acquisition occurred on January 1, 20X1 for the three months ended September 30, 20X1 and the nine months ended September 30, 20X1 and 20X2.
Annual 20X2	X		Present pro forma revenue and earnings as if the acquisition occurred on January 1, 20X1 for the annual periods ended December 31, 20X1 and December 31, 20X2.
Q1 20X3		X	No requirement to present pro forma information because the period of acquisition would not be presented in the comparative first quarter 20X2 financial statements.
Q2 20X3 Q3 20X3	X X		Retain the 20X2 pro forma disclosures because the 20X2 period of acquisition is presented as comparative information.
Annual 20X3	X		Retain the 20X1 and 20X2 pro forma disclosures because the 20X and 20X2 periods are presented as comparative information.
Annual 20X4	X		Retain the 20X2 pro forma disclosures because the 20X2 period is presented as comparative information.

FSP Corp would not be required to present pro forma information in the financial statements included in the first quarter 20X3 because the period of acquisition would not be presented in the comparative first quarter 20X2 financial statements. However, FSP Corp would be permitted to include first quarter 20X2 pro forma information and should evaluate whether inclusion of the information would be beneficial to the readers' understanding of the effects of the acquisition on the consolidated financial statements.

If FSP Corp were to file a new or amended registration statement before the Form 10-K for 20X3 is filed, FSP Corp may be required to include updated Regulation S-X Article 11 pro forma financial information. See FSP 17.4.16.2.

17.4.16.1 Preparation of ASC 805 pro forma information

ASC 805 does not provide specific guidance regarding how reporting entities should calculate pro forma revenue and earnings. Generally, a reporting entity adds the results from the financial statements of the acquiree to its historical financial results after making adjustments for some or all of the following:

- *Alignment of accounting policies*

  For example, a reporting entity would adjust the pro forma financial information for the effect of applying a different inventory accounting policy at the acquiree level.

- *The effect of fair value adjustments*

  For example, a reporting entity would include amortization of intangible assets and depreciation of the tangible assets recognized as part of the business combination as if the assets were recognized at acquisition date fair value as of the beginning of the comparative period.

- *Transaction costs*

  A reporting entity would include costs resulting from the business combination in earnings as though the acquisition occurred as of the beginning of the comparative period.

- *Taxation*

  A reporting entity would need to consider the tax effects of the acquisition and related adjustments as if the acquiree had been part of the reporting entity since the beginning of the comparative period.

- *Financial structure*

  A reporting entity would need to consider adjustments reflecting the new capital structure, including additional financing or repayments of debt as part of the acquisition.

Adjustments that are not factually supportable are not appropriate. For example, it generally would not be appropriate to incorporate cost savings and other synergistic benefits resulting from the business combination in pro forma amounts.

Reporting entities are also required to provide disclosure of any material, nonrecurring pro forma adjustments directly attributable to the business combination that is included in the supplemental pro forma information. ASC 805-10-55-50 provides examples of nonrecurring pro forma adjustments, including acquisition-related costs and a nonrecurring expense related to the fair value adjustment to inventory on the acquisition date.

Pro forma financial information giving effect to business combinations is often presented in SEC registration statements, proxy statements, and Form 8-Ks as required by Regulation S–X Article 11.

Reporting entities should note that pro forma information presented in accordance with ASC 805 will likely differ from that required by Regulation S-X Article 11 (see Figure FSP 17-1).

17.4.16.2 *Regulation S-X Article 11 pro formas*

Regulation S-X Article 11 provides the SEC's requirements for the presentation of pro forma condensed financial information regarding significant business combinations that have occurred during the most recent fiscal year or subsequent interim periods. For more information on the preparation of Regulation S-X Article 11 pro forma condensed financial information, refer to SEC FRM Topic 3.

The filing of Regulation S-X Article 11 pro forma financial information does not satisfy the requirement to include ASC 805-10-50-2(h) pro forma disclosures in the footnotes, and vice versa. Pro forma disclosures required by ASC 805-10-50-2(h) might be required even when Regulation S-X Article 11 pro forma financial information is not required due to differences in the relevant materiality thresholds. Regulation S-X Article 11 pro forma information is based on the quantitative significance of the acquisition to the acquirer under Regulation S-X Rule 1-02(w), whereas ASC 805 disclosure requirements are based on materiality to the financial statements taken as a whole.

There are also a number of differences between the form and content of pro forma financial information between ASC 805-10-50-2(h) and Regulation S-X Article 11. Figure FSP 17-1 highlights ASC 805 and Regulation S-X Article 11 requirements related to the preparation of pro forma financial information.

Figure FSP 17-1

ASC 805 and Regulation S-X Article 11 pro forma requirements for acquired businesses

Topic	ASC 805	Regulation S-X Article 11
Periods to present	ASC 805 requires that US public business entities disclose supplemental[1] pro forma information for the results of operations for the current period and the comparable prior period. Pro forma financial information related to results of operations of periods prior to the combination is limited to the results of operations for the immediately preceding period.	Regulation S-X Article 11 requires a pro forma condensed balance sheet based on the latest balance sheet included in the filing (unless the acquisition is already reflected in the historical balance sheet). The pro forma condensed income statement is based on the latest fiscal year (unless required to be accounted for retrospectively (e.g., common control transactions, discontinued operations)) and subsequent interim period included in the filing. Comparative prior year interim period information is permissible, but not required.
Length of time disclosures must be "retained"	Pro forma disclosures should be repeated whenever the year or interim period of the acquisition is presented. See Question FSP 17-1 and Example FSP 17-1.	In a subsequent registration statement, if historical financial statements of the acquired entity are required to be included or incorporated, a pro forma condensed balance sheet is not required if an acquisition is already reflected on the historical balance sheet; however,

Topic	ASC 805	Regulation S-X Article 11
		disclosures related to the acquisition are required. Generally, a pro forma condensed income statement must be presented until the transaction to which the pro forma disclosure relates has been reflected in the audited financial statements for a 9 - 12-month period (depending on significance). In other words, a pro forma condensed income statement should be filed for the most recent fiscal year and for the period from the most recent fiscal year end to the most recent interim date for which a balance sheet is required (a pro forma condensed income statement for the corresponding interim period of the preceding fiscal year may also be filed). However, a pro forma condensed income statement may not be filed when the historical income statement reflects the transaction for the entire period.
Format	ASC 805-10-50-2h requires disclosure of revenue and earnings amounts on a pro forma basis. Additional line items (e.g., operating income, income from continuing operations) are permissible.	Regulation S-X Article 11 requires a pro forma condensed balance sheet, pro forma condensed income statements, which must include income (loss) from continuing operations and income (loss) from continuing operations attributable to the controlling interest, and explanatory footnotes. The pro forma financial information must also include an introductory paragraph that provides a description of each transaction for which pro forma effect is being given, entities involved, periods for which the pro forma information is presented, and an explanation of what the pro forma presentation shows.
Materiality	ASC 805 disclosure requirements are based on materiality to the financial statements taken as a whole.	Regulation S-X Article 11 pro forma information is based on the quantitative significance of the acquisition to the acquirer under Regulation S-X Rule 1-02(w), substituting 20% for 10% each place it appears therein.

Topic	ASC 805	Regulation S-X Article 11
Date of combination	If comparative financial statements are not presented, ASC 805 requires that the pro forma information be prepared for the current reporting period as though the acquisition had occurred as of the beginning of the current annual reporting period. If comparative financial statements are presented, the pro forma information should be prepared as though the acquisition occurred at the beginning of the comparable prior annual reporting period. The "as if" date of the acquisitions would not be revised in the pro forma information in future periods when additional financial statement periods are presented.	Regulation S-X Rule 11-02(a)(6)(i)(B) states that the pro forma adjustments related to the condensed income statement should be computed assuming the transaction was consummated at the beginning of the fiscal year presented. The SEC staff has interpreted this to mean that the pro forma adjustments are to be computed for both the annual and interim income statements, assuming that the acquisition occurred at the beginning of the annual period.
Nonrecurring items	ASC 805 requires adjustments that are nonrecurring in nature to be included in the pro forma amounts.	Regulation S-X Rule 11-02(a)(6) and Regulation S-X Rule 11-02(a)(7) include the following three categories of adjustments: (1) Transaction accounting adjustments to reflect only the application of required accounting to the transaction, such as acquisition accounting; (2) Autonomous entity adjustments to reflect the operations and financial position of the registrant as an autonomous entity if the registrant was previously part of another entity, such as a spin-off transaction in which the costs allocated to the entity do not reflect all of the expected costs of operating as a standalone public company; and (3) Management's adjustments depicting synergies and dis-synergies of an acquisition or disposition for which pro forma effect is being given. Transaction accounting and autonomous entity adjustments are required when the conditions for their presentation are met. Autonomous entity adjustments must be presented in a separate column from transaction accounting adjustments. Management's adjustments may (but are not required to) be presented only in the notes to the pro forma financial

Topic	ASC 805	Regulation S-X Article 11
		statements at the discretion of management if, in management's opinion, they enhance an understanding of the pro forma effects of the transaction and certain conditions are met. All pro forma adjustments should refer to notes that clearly explain the assumptions involved.
Per share data	ASC 805 does not require pro forma per share data.	Regulation S-X Rule 11-02(a)(9i) and Regulation S-X Rule 11-02(a)(9ii) require the following to be presented on the face of the pro forma income statement: □ The acquirer's historical and pro forma basic and diluted per share data based on continuing operations attributable to the controlling interests and the number of shares used to calculate such per share amounts, and may only give effect to Transaction accounting adjustments and Autonomous entity adjustments. The number of shares used in the computation of the pro forma per share amounts based on the weighted average
		number of shares outstanding during the period adjusted to give effect to the number of shares issued or to be issued to consummate the transaction, or if applicable, whose proceeds will be used to consummate the transaction, as if the shares were outstanding as of the beginning of the period presented. The pro forma effect of potential common stock being issued in the transaction (e.g., a convertible security), or the proceeds that would be used to consummate the transaction, on pro forma earnings per share is calculated in accordance with US GAAP as if the potential common stock was outstanding as of the beginning of the period presented.
Footnotes	ASC 805 requires disclosure of the nature and amount of any material, nonrecurring pro forma adjustments directly attributable to the acquisition included in the	Regulation S-X Article 11 requires explanatory footnotes to be sufficiently detailed to enable a clear understanding of the assumptions and calculations involved in developing each of the pro forma adjustments. Regulation S-X Rule 11-02(a)(11)(i) requires that the

Topic	ASC 805	Regulation S-X Article 11
	reported pro forma revenue and earnings.	explanatory notes disclose the revenues, expenses, gains and losses, and related tax effects that will not recur in the income of the registrant beyond twelve months after the transaction. Incremental disclosures are specifically required in the explanatory footnotes for Transaction accounting adjustments (Regulation S-X Rule 11-02(a)(11)(ii)) and Autonomous entity adjustments (Regulation S-X Rule 11-02(a)(11) (iii)).
Other completed or probable transactions	ASC 805 allows adjustments for completed business acquisitions but does not permit adjustments for probable business acquisitions or other significant transactions (e.g., a completed or probable significant business disposition).	Regulation S-X Article 11 allows adjustments for probable business acquisitions and other significant transactions (e.g., a completed or probable significant business disposition).

[1] Information disclosed in the financial statements and notes is generally not marked "unaudited." However, one of the exceptions is business combination supplemental pro forma information required to be disclosed by ASC 805-10-50-2. Refer to paragraph 11 of PCAOB AS 3105, *Departures from unqualified opinions and other reporting circumstances*, for further details.

17.4.17 *Initial accounting for a business combination is incomplete*

If the initial accounting for a business combination is incomplete by the end of the reporting period in which the acquisition occurs, the acquirer is required to report provisional amounts for the items for which the accounting is incomplete. As described in BCG 2.9, the acquirer has a period of time, referred to as the measurement period, to finalize the accounting for a business combination. In accordance with ASC 805-20-50-4A, in such circumstances, the acquirer should disclose the reasons the initial accounting is incomplete and the specific assets, liabilities, equity interests, or items of consideration for which the initial accounting is incomplete. The acquirer is also required to disclose the nature and amount of any measurement period adjustments recognized during the reporting period, including the amount of adjustment to current-period income statement line items that would have been recognized in prior periods if the adjustment to provisional amounts had been recognized as of the acquisition date. Alternatively, the acquirer can present those amounts separately on the face of the income statement.

If the acquisition date of a business combination is after the reporting date, but before the financial statements are issued or are available to be issued, the acquirer is required to disclose the same information as is required for acquisitions completed during the reporting period. However, as discussed in ASC 805-10-50-4, ASC 805-20-50-3, and ASC 805-30-50-3, if the initial accounting for the business combination is incomplete, reporting entities should describe which disclosures could not be made, which are preliminary, and the reasons the acquisition accounting could not be completed.

17.4.18 *Financial statement effect of adjustments related to prior acquisitions*

There may be adjustments recorded in one period that relate to prior acquisitions, which are not necessarily reflective of the ongoing operations of the acquired business. As outlined in ASC 805-10-

50-5, an objective of the related disclosures is to provide information that enables users of financial statements to evaluate the financial effects of adjustments recognized in the current reporting period relating to business combinations that occurred in the current or previous reporting periods.

Accordingly, reporting entities are required to disclose the following for each material business combination, or in the aggregate for individually immaterial business combinations that are collectively material:

- Measurement period adjustments (see FSP 17.4.18.1)
- Contingent consideration adjustments (see FSP 17.4.18.2)

17.4.18.1 Measurement period adjustment disclosures

An acquirer has up to one year from the acquisition date (referred to as the measurement period) to finalize the accounting for a business combination. The acquirer should book provisional amounts if the initial accounting for a business combination is incomplete. During the measurement period, the acquirer should record the cumulative impact of measurement period adjustments made to provisional amounts in the period that the adjustment is determined. As discussed in ASC 805-20-50-4A(c), the acquirer should present separately on the face of the income statement or disclose in the notes the portion of the adjustment to each income statement line item that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date.

When the accounting for a business combination includes provisional amounts, the following information must be disclosed.

ASC 805-20-50-4A

If the initial accounting for a business combination is incomplete (see paragraphs 805-10-25-13 through 25-14) for particular assets, liabilities, noncontrolling interests, or items of consideration and the amounts recognized in the financial statements for the business combination thus have been determined only provisionally, the acquirer shall disclose the following information for each material business combination or in the aggregate for individually immaterial business combinations that are material collectively to meet the objective in paragraph 805-10-50-5:

a. The reasons why the initial accounting is incomplete

b. The assets, liabilities, equity interests, or items of consideration for which the initial accounting is incomplete

c. The nature and amount of any measurement period adjustments recognized during the reporting period in accordance with paragraph 805-10-25-17, including separately the amount of adjustment to current period income statement line items relating to the income effects that would have been recognized in previous periods if the adjustment to provisional amounts were recognized as of the acquisition date. Alternatively, an acquirer may present those amounts separately on the face of the income statement.

Reporting entities should recognize a measurement period adjustment to provisional amounts in the reporting period in which the adjustments are determined in accordance with ASC 805-10-25-17. For the supplemental pro forma information required by ASC 805-10-50-2(h) (see FSP 17.4.16), we believe the effects of a measurement period adjustment should be presented on a retrospective basis as of the beginning of the period presented (or as of the beginning of the comparable prior period when comparative financial statements are presented).

Considerations related to interim reporting

The prospective nature of measurement period adjustments and the need to disclose the retrospective impact to historical financial information has additional implications if the reporting entity prepares interim financial statements.

Example FSP 17-2 demonstrates the additional interim reporting implications of measurement period adjustments.

EXAMPLE FSP 17-2

Measurement period adjustments in interim reporting

FSP Corp is an SEC registrant that reports under US GAAP and has a calendar year-end. FSP Corp acquires SUB Corp on October 1, 20X1. On May 31, 20X2, new information related to facts that existed at the acquisition date arises that leads to a measurement period adjustment. FSP Corp has already filed its Form 10-K for the year ended December 31, 20X1 and a Form 10-Q for the quarterly period ended March 31, 20X2.

How should FSP Corp report the measurement period adjustment?

Analysis

FSP Corp should take the following actions in its June 30, 20X2 Form 10-Q:

- Recognize the cumulative impact of the measurement period adjustment (i.e., the current and prior period impact) on the statements of income, comprehensive income, cash flows, and changes in stockholders' equity (if applicable) for the three-month and six-month periods ended June 30, 20X2

- Disclose the nature and amount of the measurement period adjustment, including separate disclosure of the amount of adjustment to the statement of income line items in the three-month and six-month periods ended June 30, 20X2 that would have been recognized in previous periods if the adjustment to provisional amounts were recognized as of October 1, 20X1

- No adjustment to the December 31, 20X1 balance sheet or the statements of income, comprehensive income, cash flows, and changes in stockholder's equity (if applicable) for the year ended December 31, 20X1 or for three-month period ended March 31, 20X2 should be recorded

In its December 31, 20X2 Form 10-K, FSP Corp should reflect the cumulative impact of the measurement period adjustment, including the prior period impact, on the 20X2 statements of income, comprehensive income, cash flows, and changes in stockholders' equity (if applicable). FSP Corp should disclose the nature and amount of the measurement period adjustment, including

separate disclosure of the amount of adjustment to income statement line items in 20X2 that would have been recognized in previous periods if the adjustment to provisional amounts were recognized as of October 1, 20X1. No adjustment should be reflected in the financial statements as of and for the year ended December 31, 20X1 or the selected quarterly data in the footnotes to the financial statements (if presented) for the quarterly periods ended December 31, 20X1 and March 31, 20X2.

17.4.18.2 *Disclosure of contingent consideration adjustments*

The following disclosures must be provided when adjustments related to contingent consideration arrangements are recorded in reporting periods subsequent to the acquisition date:

Excerpt from ASC 805-30-50-4

a. For each reporting period after the acquisition date, until the entity collects, sells, or otherwise loses the right to a contingent consideration asset, or until the entity settles a contingent consideration liability, or the liability is cancelled or expires, all of the following:

   1. Any changes in the recognized amounts, including any differences arising upon settlement
   2. Any changes in the range of outcomes (undiscounted) and the reasons for those changes
   3. The disclosures required by Section 820-10-50.

The fair value disclosures required by ASC 820 are broadly applicable to most assets and liabilities measured at fair value, including those acquired in a business combination. ASC 820 requires different disclosures if the related assets or liabilities are remeasured at fair value on a recurring basis. Refer to FSP 20 for further information on fair value disclosure requirements.

17.5 Sample business combination disclosures

Figure FSP 17-2 illustrates disclosures of a business combination in the annual statements of a calendar year-end reporting entity. It also includes a sample goodwill rollforward (see FSP 8). Figure FSP 17-2 is one practical example, but reporting entities can use various formats to meet the disclosure requirements. ASC 805-10-55-37 through ASC 805-10-55-50 provide an additional example of the disclosure requirements.

Figure FSP 17-2

Sample business combination disclosures [with added references to ASC 805]

Note X - Acquisitions

On August 1, 20X2, FSP Corp completed the acquisition of 50% of the common shares of Sub Corp, increasing its interest from 20% to 70%, and providing FSP Corp control over Sub Corp. Sub Corp became a consolidated subsidiary of FSP Corp on this date. Sub Corp is a shoe retailer operating in the United States and most Western European countries. FSP Corp previously accounted for its 20% interest in Sub Corp as an equity method investment. As a result of the acquisition, FSP Corp is expected to expand the sale of its shoes in the United States and Western European markets [ASC 805-10-50-2(a)–(d)].

The acquired business contributed revenues of $44,700 and earnings of $2,700 to FSP Corp for the period from August 1, 20X2 to December 31, 20X2 [ASC 805-10-50-2(h)(1)]. The following unaudited pro forma summary presents consolidated information of FSP Corp as if the business combination had occurred on January 1, 20X1 [ASC 805-10-50-2(h)(3)].

	Pro forma year ended December 31, 20X2 (unaudited)	**Pro forma year ended December 31, 20X1 (unaudited)**
Revenue	$220,300	$205,300
Earnings	$33,100	$13,200

FSP Corp did not have any material, nonrecurring pro forma adjustments directly attributable to the business combination included in the reported pro forma revenue and earnings [ASC 805-10-50-2(h)(4)].

These pro forma amounts have been calculated after applying FSP Corp's accounting policies and adjusting the results of Sub Corp to reflect the additional depreciation and amortization that would have been charged assuming the fair value adjustments to property, plant, and equipment, and intangible assets had been applied from January 1, 20X1, with the consequential tax effects.

In 20X2, FSP Corp incurred $200 of acquisition-related costs. These expenses are included in general and administrative expense on FSP Corp's consolidated income statement for the year ended December 31, 20X2 [ASC 805-10-50-2(e) and ASC 805-10-50-2(f)] and are reflected in pro forma earnings for the year ended December 31, 20X1 in the table above.

The following table summarizes the consideration transferred to acquire Sub Corp and the amounts of identified assets acquired and liabilities assumed at the acquisition date, as well as the fair value of the noncontrolling interest in Sub Corp at the acquisition date [ASC 805-30-50-1(b) and ASC 805-20-50-1(c)]:

Fair value of consideration transferred:	
Cash	$6,500
Common shares	5,500
Contingent consideration	2,000
Total	$14,000
Fair value of FSP Corp's investment in Sub Corp held before the business combination [ASC 805-10-50-2(g)(1)]	$5,600
Fair value of the noncontrolling interest in Sub Corp [ASC 805-20-50-1(e)(1)]	$8,000

Recognized amounts of identifiable assets acquired and liabilities assumed:	
Cash and cash equivalents	$500
Trade receivables	6,500
Inventories	4,000
Financial assets	1,000
License (included in intangibles)	3,000
Trademarks (included in intangibles)	1,850
Property, plant, and equipment	63,500
Trade and other payables	(12,500)
Warranty liability	(1,000)
Borrowings	(37,500)
Deferred tax liabilities	(2,000)
Retirement benefit obligations	(2,500)
Total identifiable net assets	$24,850
Goodwill	$2,750

FSP Corp issued 220 common shares that had a total fair value of $5,500 based on the closing market price of $25 per share on August 1, 20X2, the acquisition date [ASC 805-30-50-1(b)(4)].

As a result of FSP Corp obtaining control over Sub Corp, FSP Corp's previously held 20% interest in Sub Corp was remeasured to fair value, resulting in a gain of $900. This gain has been recognized in the line item "other (losses)/gains—net" on the consolidated income statement [ASC 805-10-50-2(g)(2)].

The fair value of the noncontrolling interest of $8,000 and the fair value of the previously held equity interest of $5,600 in Sub Corp were estimated by applying a market approach and an income approach, respectively. These fair value measurements of the noncontrolling interest and the previously held equity interest are based on significant inputs not observable in the market, and thus represent Level 3 measurements. The fair value estimates for the noncontrolling interest and the previously held equity interest are based on (1) an assumed discount rate range of 20–25%, (2) an assumed terminal value based on a range of terminal EBITDA multiples between 3 and 5 times (or, if appropriate, based on long-term sustainable growth rates ranging from 3% to 6%), (3) assumed financial multiples of reporting entities deemed to be similar to Sub Corp, and (4) assumed adjustments because of the lack of control or lack of marketability, as relevant, that market participants would consider when estimating the fair value of the noncontrolling interest and the previously held equity interest in Sub Corp [ASC 805-20-50-1(e), ASC 805-10-50-2(g)].

The acquisition of Sub Corp includes a contingent consideration arrangement that requires additional consideration to be paid by FSP Corp to the sellers of Sub Corp based on the future net income of Sub Corp over a three-year period. Amounts are payable three years after the acquisition date. The range of the undiscounted amounts FSP Corp could pay under the contingent consideration agreement is between zero and $3,000. The fair value of the contingent consideration recognized on the acquisition date of $2,000 was estimated by applying the income approach [ASC 805-30-50-1(c)]. That measure

is based on significant Level 3 inputs not observable in the market. Key assumptions include (1) a discount rate range of 10% to 15%, and (2) probability adjusted level of net income between $8,000 and $8,500.

As of December 31, 20X2, there were no changes in the recognized amounts or range of outcomes for the contingent consideration recognized as a result of the acquisition of Sub Corp [ASC 805-30-50-4(a)].

The goodwill is attributable to the workforce of the acquired business and the significant synergies expected to arise after FSP Corp's acquisition of Sub Corp [ASC 805-30-50-1(a)].

The goodwill is not deductible for tax purposes [ASC 805-30-50-1(d)]. All of the $2,750 of goodwill was assigned to FSP Corp's Retail Shoes segment [ASC 805-30-50-1(e)].

The fair value of the assets acquired includes trade receivables of $6,500 that are not purchased financial assets with credit deterioration. The gross amount due under contracts is $6,800, of which $300 is expected to be uncollectible [ASC 805-20-50-1(b)]. FSP Corp recognized an allowance with a corresponding credit loss expense of $65 during 20X2. FSP Corp did not acquire any other class of receivable as a result of the acquisition of Sub Corp. [See LI 12 for CECL disclosure requirements.]

The fair values of the acquired license and trademark intangible assets of $3,000 and $1,850, respectively, are provisional pending receipt of the final valuations for those assets [ASC 805-20-50-4A].

Prior to the acquisition, FSP Corp had a preexisting relationship with Sub Corp. FSP Corp had a receivable of $200 for certain trademark fees. These fees were disputed by Sub Corp. FSP Corp believed the amount receivable was $150, reflecting a partial reserve of $50. As part of the acquisition terms, the receivable was settled for $140. FSP Corp recorded a loss upon settlement of $10 as a result of the acquisition, which was recorded separate from the business combination. The settlement loss was recorded in general and administrative expense on FSP Corp's consolidated income statement [ASC 805-10-50-2(e) and ASC 805-10-50-2(f)].

A liability arising from a contingency of $1,000 has been recognized at fair value for expected warranty claims on products sold by Sub Corp during the last two years. FSP Corp expects that the majority of this expenditure will be incurred in 20X3 and that all costs will be incurred by 20X4.

See Note Z, Subsequent Events, for disclosures regarding the acquisition of LTR Company, which took place after the balance sheet date, but before the issuance of these financial statements [ASC 805-10-50-4].

Note Y—Goodwill

The changes in the carrying amounts of goodwill for the retail shoes and retail coats segments are as follows [ASC 350-20-50-1 and ASC 805-30-50-4(b)]:

	Retail shoes segment	Retail coats segment	Total
Balance as of January 1, 20X1			
Goodwill	$6,600	$2,400	$9,000
Accumulated impairment loss	(300)	(300)	(600)
Balance as of January 1, 20X1, net	6,300	2,100	8,400
Reduction of goodwill related to dispositions	(900)	(500)	(1,400)
Effect of foreign currency	100	100	200
Balance as of December 31, 20X1			
Goodwill	5,800	2,000	7,800
Accumulated impairment loss	(300)	(300)	(600)
Balance as of December 31, 20X1, net	5,500	1,700	7,200
Increase in goodwill related to acquisition	2,750	—	2,750
Reduction of goodwill related to disposition	(300)	—	(300)
Effect of foreign currency	100	(200)	(100)
Balance as of December 31, 20X2			
Goodwill	8,350	1,800	10,150
Accumulated impairment loss	(300)	(300)	(600)
Balance as of December 31, 20X2, net	$8,050	$1,500	$9,550

17.6 Pushdown accounting

Under US GAAP, an acquirer of a business initially recognizes most of the acquired assets and liabilities at fair value. If the acquired business prepares separate financial statements, a question arises as to whether the historical basis of the acquired company or the "stepped-up basis" of the acquirer should be reflected in those separate financial statements. Pushdown accounting refers to the latter, which means establishing a new basis for the assets and liabilities of the acquired company based on a "push down" of the acquirer's stepped-up basis.

17.6.1 Change-in-control events (pushdown accounting)

As discussed in ASC 805-50-25-4, reporting entities have the option to apply pushdown accounting when they are acquired by another party (i.e., upon a change-in-control event).

For purposes of pushdown accounting, as discussed in ASC 805-50-25-6, a change-in-control event is one in which an acquirer obtains control of a company. As discussed in ASC 805-50-25-4, an acquirer might obtain control of a company in a variety of ways, including by transferring cash or other assets, by incurring liabilities, by issuing equity interests, or a combination thereof. In some cases, an acquirer might obtain control of a company without transferring consideration, such as when certain rights in a contract lapse. As discussed in ASC 805-50-25-5, the guidance on consolidations in ASC 810 and business combinations in ASC 805 should be used to determine whether an acquirer has obtained control of a company.

There may also be instances when there is a change-in-control event, but business combination accounting under ASC 805 is not applied by the acquirer. This may be the case, for example, if the acquirer is an individual that does not prepare financial statements, or an investment company that accounts for its investments at fair value (e.g., a private equity company). In these situations, as discussed in ASC 805-50-30-10, an acquired company could still elect to apply pushdown accounting as if the acquirer had applied business combination accounting under ASC 805.

The election is available to the acquired company, as well as to any direct or indirect subsidiaries of the acquired company. As discussed in ASC 805-50-25-8, each acquired company or any of its subsidiaries can make its own election independently.

17.6.2 Making the election to apply pushdown accounting

Before making an election, it is important to consider the needs of the users of an acquired company's financial statements. Some users may prefer the "stepped-up basis" that results from pushdown accounting. Other users may prefer the historical basis to avoid distorting income statement trends as a result of increased amortization and depreciation expense. Users that are focused on cash flow and EBITDA measures may be indifferent as these measures are often not significantly affected by pushdown accounting. Assessing user needs may be more challenging when there are multiple users of the financial statements with different needs (e.g., creditors versus equity investors).

Some acquirers may prefer to apply pushdown accounting to avoid separate tracking of assets, such as goodwill and fixed assets, at two different values (historical and "stepped-up basis"). Conversely, an acquired company may prefer to carry over its historical basis. Companies may also want to consider tax reporting implications and may prefer to carry over their historical basis for financial reporting purposes when carry over basis is being used for tax reporting purposes (i.e., when there is no tax "step-up").

The decision to apply pushdown accounting is usually made in the reporting period in which the change-in-control event occurs. This means that a company would have until its financial statements are issued (or are available to be issued) to make the election.

The decision to apply pushdown accounting is irrevocable. However, if a reporting entity has not applied pushdown accounting for a change-in-control event, it may elect to do so in a subsequent period as a change in accounting principle, if preferable (see FSP 30.4). The reporting entity would

retrospectively adjust its reporting basis as of the date of the most recent change-in-control event, even when that event preceded the issuance of the pushdown accounting guidance.

Retrospective application of pushdown accounting may be appropriate to align the reporting basis of a subsidiary with that of its parent. This would require the use of the parent's business combination accounting as of the most recent change-in-control event. It would also require a roll-forward of that accounting (e.g., depreciation and amortization of stepped-up values, and potential impairments). Sometimes, the parent may not have applied business combination accounting (e.g., a private equity parent) or may not have applied it at a precise enough level for the subsidiary's separate financial statements. In those cases, the subsidiary would have to retrospectively determine the fair value of its assets and liabilities as of the most recent change-in-control event, which can be difficult and costly.

As discussed in ASC 805-50-25-6, the decision of whether to apply pushdown accounting upon a change-in-control event does not establish an accounting policy. That is, a company may elect to apply pushdown accounting for one change-in-control event and, independent from that election, decide not to apply pushdown accounting upon the next change-in-control event, or vice versa.

17.6.3 Pushdown accounting presentation considerations

The application of pushdown accounting represents the termination of the old accounting entity and the creation of a new one. That is, the assets and liabilities of the acquiree are recognized based on the parent's new basis with an offset to additional paid-in capital. In addition, when pushdown accounting is applied, retained earnings and accumulated other comprehensive income of the predecessor company are not carried forward because a new basis of accounting has been established.

Accordingly, it would not be appropriate for financial statements for a given period to combine pre- and post-pushdown periods. For example, it would be inappropriate for a reporting entity with a December 31, 20X2 year-end, for which pushdown was applied as of July 1, 20X2, to present a combined income statement for the pre- and post-acquisition periods in the 12 months ended December 31, 20X2. This would also apply to the statements of cash flows, changes in stockholders' equity, and comprehensive income. Footnote disclosures related to pre- and post-pushdown periods should likewise not be combined.

For the financial statements and footnote disclosure presented in a tabular format, reporting entities would generally include a vertical black line between the predecessor and successor columns to highlight for the reader the change in basis between the pre- and post-pushdown periods. For example, the balance sheet as of December 31, 20X2 would reflect the post-pushdown period, while the comparative prior year balance sheet would reflect the pre-pushdown period as of December 31, 20X1, separated by a vertical black line. The columns related to the pre-pushdown period columns are generally labelled "Predecessor Company," while the post-pushdown period columns are generally labelled "Successor Company." Other, similar designations can also be used.

A discussion of the basis of presentation should be included in the footnotes to the financial statements. This discussion should notify the reader that the reporting entity's results of operations and cash flows after the transaction are not comparable with those prior to the acquisition as a result of pushdown accounting, and therefore have been segregated in the respective financial statements.

Refer to BCG 10 for additional considerations related to the presentation of pushdown accounting.

17.6.3.1 Contingent acquisition-related costs "on the line"

In situations when predecessor and successor financial statements are presented with a "blackline" resulting from the effects of pushdown accounting, a question often arises as to which period acquiree expenses should be recorded in if the amounts are contingent on the closing of a business combination (e.g., acquiree's investment banker "success" fees, acquiree's share-based awards with performance conditions vesting upon a change in control). See BCG 2.7.1.5 for considerations on the presentation of acquiree acquisition-related expenses that are contingent on the closing of a business combination, including related disclosure considerations.

An acquirer's costs that are contingent upon the closing of a business combination should be recognized in the acquirer's financial statements in the period that includes the acquisition.

17.6.3.2 Impact of successor accounting changes on predecessor

The application of pushdown accounting represents the termination of the old accounting entity and the creation of a new one. As the "predecessor company" and "successor company" are separate reporting entities (and as such are not comparable), any changes in accounting policies or principles, including the adoption of new accounting standards, elected by the successor should not be "pushed back" to the predecessor. Instead, any differences in accounting policies or principles should be disclosed between the predecessor and successor companies within the footnotes to the financial statements.

The only exception to this rule exists in Section 13210.2 of the SEC's Financial Reporting Manual, which requires that the predecessor financial statements be retrospectively reclassified to reflect the impact of a successor's discontinued operations. However, the guidance should generally not be applied by analogy to other accounting policies or principles of the successor.

17.6.4 Pushdown accounting disclosure considerations

If a reporting entity elects pushdown accounting in its separate financial statements, ASC 805-50 requires that disclosures are provided that enable users to evaluate the effect of pushdown accounting.

ASC 805-50-50-6

Information to evaluate the effect of pushdown accounting may include the following:

a. The name and a description of the acquirer and a description of how the acquirer obtained control of the acquiree.

b. The acquisition date.

c. The acquisition-date fair value of the total consideration transferred by the acquirer.

d. The amounts recognized by the acquiree as of the acquisition date for each major class of assets and liabilities as a result of applying pushdown accounting. If the initial accounting for pushdown accounting is incomplete for any amounts recognized by the acquiree, the reasons why the initial accounting is incomplete.

e. A qualitative description of the factors that make up the goodwill recognized, such as expected synergies from combining operations of the acquiree and the acquirer, or intangible assets that do not qualify for separate recognition, or other factors. In a bargain purchase (see paragraphs 805-30-25-2 through 25-4), the amount of the bargain purchase recognized in additional paid-in capital (or net assets of a not-for-profit acquiree) and a description of the reasons why the transaction resulted in a gain.

f. Information to evaluate the financial effects of adjustments recognized in the current reporting period that relate to pushdown accounting that occurred in the current or previous reporting periods (including those adjustments made as a result of the initial accounting for pushdown accounting being incomplete [see paragraphs 805-10-25-13 through 25-14]).

The information in this paragraph is not an exhaustive list of disclosure requirements. The acquiree shall disclose whatever additional information is necessary to meet the disclosure objective set out in paragraph 805-50-50-5.

When an acquired company elects pushdown accounting, it should provide the same disclosures that would be provided by the acquirer pursuant to ASC 805, as applicable. It should also provide all relevant disclosures required by US GAAP in periods subsequent to the business combination, including but not limited to those relating to goodwill, intangible assets, and fair value measurements.

When pushdown accounting is applied, the reporting entity should consider disclosing pro forma information similar to that relating to business combinations described in ASC 805 in order to demonstrate the effects of the acquisition and related pushdown accounting on the acquired entity. If that pro forma information is presented, it should be presented for the entire fiscal period (i.e., reflecting the impact of the business combination and related pushdown accounting for the entire fiscal period). The pro forma information should not be presented separately for the successor and predecessor periods. Pro forma information for the prior year comparative periods should also be included.

Question FSP 17-2 addresses the disclosure requirements when there is a change-in-control event and the reporting entity does not elect pushdown accounting.

Question FSP 17-2

Is a reporting entity that does not elect pushdown accounting required to disclose that there was a change-in-control event or that it elected not to apply pushdown accounting?

PwC response

No. A reporting entity that does not elect pushdown accounting upon a change-in-control event is not required to disclose that there was a change-in-control event or that it decided not to elect pushdown accounting.

17.6.5 Example of "blackline" financial statements

Example FSP 17-3 illustrates the presentation of "blackline" financial statements when a change-in-control event has occurred and pushdown accounting is elected in the standalone financial statements of the acquiree.

EXAMPLE FSP 17-3

Presentation of "blackline" financial statements

Parent Corp is a non-public company that reports under US GAAP and has a calendar year-end. Parent Corp acquires 100% of the outstanding equity interests in Sub Corp, also a non-public company, on August 15, 20X2. Due to Sub Corp's debt agreement with a lender, there is an ongoing reporting requirement for standalone financial statements of the Sub Corp reporting entity. Sub Corp has elected to apply pushdown accounting in its standalone financial statements as of the change-in-control date. Accordingly, Sub Corp will present "blackline" financial statements reflecting the change-in-control transaction.

How should Sub Corp reflect pushdown accounting in its standalone financial statements?

Analysis

Sub Corp should consider the following in its standalone financial statements:

- The application of pushdown accounting represents the termination of the "old" (i.e., predecessor) reporting entity and the creation of a "new" (i.e., successor) reporting entity as of close-of-business on August 15, 20X2 when the change-in-control transaction was consummated. As such, the successor reporting entity's assets and liabilities will be recognized based on Parent Corp's new basis, with an offset to additional paid-in capital. In addition, retained earnings and accumulated other comprehensive income of the predecessor should not be carried forward, as a new basis of accounting has been established.

- For the financial statements and footnote disclosures presented in a tabular format, Sub Corp should include a vertical black line between the predecessor and successor columns to highlight for the reader the change in basis between the pre- and post- change-in-control periods. The columns related to the pre-change-in-control period columns should be labelled "Predecessor Company," while the post-change-in-control period columns should be labelled "Successor Company" (these or similar naming conventions may be used).

- Disclosure of the basis of presentation should be included in the footnotes to the financial statements. This disclosure should notify the reader that the predecessor and successor results of operations and cash flows are not comparable as a result of the application of pushdown accounting.

- Sub Corp should disclose information to evaluate the effect of pushdown accounting, including but not limited to those disclosures discussed in FSP 17.6.4. Additionally, Sub Corp should consider including other disclosures as required by ASC 805 to enable a user of the financial statements to evaluate the effects of pushdown accounting.

The following is an illustration of Sub Corp's consolidated statement of operations:

Sub Corp
Statements of Operations
Periods from August 16, 20X2 through December 31, 20X2 (Successor), January 1, 20X2 through August 15, 20X2 (Predecessor), and Year ended December 31, 20X1 (Predecessor)

	Successor	Predecessor	
(in millions)	**Period from August 16, 20X2 through December 31, 20X2**	**Period from January 1, 20X2 through August 15, 20X2**	**Year ended December 31, 20X1**
Net revenue	$ XX	$ XX	$ XX
Cost of goods sold	XX	XX	XX
Selling, general and administrative	XX	XX	XX
Depreciation and amortization	XX	XX	XX
Income from operations	XX	XX	XX
Interest expense, net	XX	XX	XX
Income before income taxes	XX	XX	XX
Income tax expense	XX	XX	XX
Net income	$ XX	$ XX	$ XX

"Blackline" presentation would also be applied to Sub Corp's consolidated balance sheet, statement of cash flows, statement of stockholders' equity, and statement of comprehensive income (not illustrated here).

Additionally, in the basis of presentation footnote disclosure within Sub Corp's financial statements, an excerpt of language to describe the basis of presentation may include the following:

Predecessor

The year ended December 31, 20X1 and the period from January 1, 20X2 through August 15, 20X2 reflect the historical cost basis of accounting of Sub Corp that existed prior to the Acquisition (see Note X). These periods are referred to as "Year ended December 31, 20X1 (Predecessor)" and "Period from January 1, 20X2 through August 15, 20X2 (Predecessor)."

Successor

The period from August 16, 20X2 through December 31, 20X2 is referred to as the "Successor period" and "Period from August 16, 20X2 through December 31, 20X2 (Successor)." The Successor period reflects the costs and activities as well as the recognition of assets and liabilities of Sub Corp at their

fair values pursuant to the election of pushdown accounting as of the consummation of the Acquisition (see Note X).

Due to the application of acquisition accounting by our Parent, the election of pushdown accounting, and the conforming of significant accounting policies, the results of operations, cash flows, and other financial information for the Successor period are not comparable to the Predecessor periods.

An illustrative example of Sub Corp's footnote disclosure for property, plant, and equipment is presented below:

Property, plant, and equipment, net of accumulated depreciation is as follows:

(in millions)	**Successor 20X2**		**Predecessor 20X1**	
Machinery and equipment	$	XX	$	XX
Land and buildings		XX		XX
Furniture and fixtures		XX		XX
		XX		XX
Less: Accumulated depreciation		XX		XX
		XX		XX
Construction in progress		XX		XX
Total property, plant and equipment, net	$	XX	$	XX

Depreciation expense related to property, plant, and equipment was $X million, $X million, and $X million for the year ended December 31, 20X1 (Predecessor), the period from January 1, 20X2 through August 15, 20X2 (Predecessor), and the period from August 16, 20X2 through December 31, 20X2 (Successor), respectively.

"Blackline" presentation would also be applied to all other Sub Corp footnote disclosures presented in tabular form (not illustrated here).

Note that these examples are select financial statement disclosures to emphasize certain aspects of ASC 805-50-50-6. Sub Corp should also disclose other information to describe the effects of pushdown accounting, including, but not limited to, those disclosures discussed in ASC 805-50-50-6 and other disclosures as required by ASC 805 to enable a user of the financial statements to evaluate the effects of pushdown accounting. Additionally, all other required GAAP disclosures would be included in Sub Corp's financial statements.

17.7 Business combinations—considerations for private companies

The requirements of ASC 805 apply equally to SEC registrants and private companies. Disclosures and reporting requirements related to pro forma financial information and S-X regulations only apply to SEC registrants.

Refer to FSP 8.10.2 for discussion of the goodwill presentation and disclosure requirements for private companies if a reporting entity adopts the private company accounting alternative for goodwill.

Refer to FSP 8.10.3.2 for discussion of the disclosure requirements of certain intangible assets subsumed into goodwill for private companies if a reporting entity adopts the private company accounting alternative for intangible assets acquired in a business combination. A private company that elects the accounting alternative for intangible assets must also adopt the goodwill accounting alternative.

Chapter 18: Consolidation—updated September 2023

18.1 Consolidation—chapter overview

This chapter addresses presentation and disclosure matters applicable to consolidated entities and to variable interests in variable interest entities (VIEs) that are not consolidated by their holders.

- This chapter includes discussion of: Presentation and disclosure considerations broadly applicable to consolidated financial statements
- Disclosure objectives and specific disclosure requirements for reporting entities that hold interests in VIEs
- Presentation and disclosure for voting interest entities or VOEs (the term VOE is not defined in authoritative accounting guidance, but it is commonly used to refer to an entity that is not a VIE)
- Other related presentation and disclosure matters, including presentation of nonhomogeneous subsidiaries, combined financial statements, and deconsolidation of a subsidiary

The matters addressed in this chapter assume the reporting entity will consolidate an entity on the date it obtains a controlling financial interest in the entity in accordance with ASC 810, *Consolidation*, or ASC 805, *Business Combinations*. Accounting for transactions resulting in the initial consolidation or deconsolidation of a subsidiary is discussed in PwC's CG and BCG, and proportionate consolidation is discussed CG 8.4.

18.2 Consolidation—scope and relevant guidance

The primary source of authoritative guidance on consolidation and deconsolidation is ASC 810. ASC 810 prescribes consolidation requirements specific to VIEs and VOEs (with specific guidance for VOE limited partnerships), and also provides general accounting and disclosure guidance for all other entities.

S-X 3A-02 through S-X 3A-03 include additional consolidation-related guidance applicable to SEC registrants. Reporting entities should be aware that VIE disclosures are incremental to disclosures required by other applicable areas of US GAAP (e.g., ASC 860, *Transfers and Servicing*; and ASC 820, *Fair Value Measurements*).

18.3 General consolidation presentation and disclosure principles

Consolidated financial statements include the accounts of a reporting entity and all other legal entities in which it holds a controlling financial interest (i.e., subsidiaries of the reporting entity). ASC 810-10-10-1 and S-X 3A-02 affirm the fundamental principle in US GAAP that consolidated financial statements are presumed to be more meaningful than separate financial statements. Determining whether a reporting entity's interest in a legal entity provides it with a controlling financial interest depends on a number of different factors.

Consolidation presentation and disclosure requirements vary depending on whether the subsidiary is a VIE (see CG 2) or a VOE (see CG 3). In any event, when a reporting entity consolidates a wholly- or partially-owned subsidiary, it should disclose its consolidation policy. In addition, as discussed in ASC

810-10-50-2AC, if a reporting entity includes its consolidation disclosures in multiple footnotes, it should cross-reference between them.

18.3.1 Disclosure of - partially-owned consolidated subsidiaries

A reporting entity should disclose the effects of any changes in a subsidiary's equity that is attributable to the reporting entity (e.g., a capital contribution or the reporting entity's purchase or sale of its subsidiary's equity).

When a reporting entity consolidates a less-than-wholly-owned subsidiary, ASC 810-10-45-18 to ASC 810-10-45-21 requires the parent to attribute the following amounts to the controlling and noncontrolling investors on the face of the income statement:

- Consolidated net income or loss
- Consolidated comprehensive income or loss

Additionally, as discussed in ASC 810-10-50-1A(b), the following amounts that are attributable to the parent should be presented on the face of the financial statements or separately disclosed in the footnotes:

- Income from continuing operations
- Income from discontinued operations

Further, as discussed in ASC 810-10-50-1A(c), a parent should perform a reconciliation of the change in stockholders' equity as of the beginning and end of each reporting period presented, including the following components:

- Total equity (net assets)
- Equity (net assets) attributable to the reporting entity
- Equity (net assets) attributable to the noncontrolling interest(s)

This reconciliation should also include separate disclosure of net income, each component of comprehensive income, and transactions with owners acting in their capacity as owners. For transactions with owners, contributions from and distributions to the owners should be shown separately.

ASC 810-10-50-1A(d) requires reporting entities to disclose in the footnotes a separate table (or schedule) that shows the effects of any changes in a parent's ownership interest in a subsidiary. The disclosure is only required in periods when a parent's ownership interest in a subsidiary changes.

In addition, a reporting entity may have multiple consolidated subsidiaries for which disclosure of information described in ASC 810-10-45-18 through ASC 810-10-45-21 is warranted. It may choose to present such information on an aggregated basis.

For additional presentation and disclosure considerations related to noncontrolling interest, including instances when noncontrolling interest is required to be classified as mezzanine equity, refer to FSP 5.3.1 and FSP 5.6.3.

18.3.2 General consolidation disclosure considerations

Reporting entities should consider separate disclosure of instances when (1) a majority-owned subsidiary is not consolidated, and (2) a less than majority-owned subsidiary is consolidated.

Consolidation is an area that has drawn comments from the SEC staff. The SEC staff may request additional disclosure when a reporting entity's disclosures do not provide adequate transparency regarding its conclusions related to consolidation, including in the following areas:

- The terms of the reporting entity's interests in an entity
- The factors considered by the reporting entity when determining why it does or does not consolidate an entity
- A discussion of why the reporting entity does not consolidate an entity in which it owns greater than 50 percent of the outstanding equity interests or receives a majority of the entity's economics (such as the nature and substance of rights held by the minority investor), especially when these types of conditions exist and an entity is being deconsolidated.

18.4 Variable interest entities (VIEs)

Reporting entities that hold variable interests in VIEs follow the presentation and disclosure requirements of ASC 810-10. These requirements address the presentation of a consolidated VIE and also stipulate specific disclosures for variable interests in both consolidated and unconsolidated VIEs.

18.4.1 Balance sheet presentation of consolidated VIEs

In accordance with ASC 810-10-45-25, a reporting entity that is the primary beneficiary of a VIE is required to separately present each of the following in its consolidated balance sheet:

- The VIE's assets that can be used to settle only the VIE's obligations
- The VIE's liabilities if the VIE's creditors (or beneficial interest holders) have no recourse against the general credit of the primary beneficiary

The VIE's liabilities and assets may not be offset and reported as a single line item in the primary beneficiary's financial statements; they are required to be presented on a gross basis.

This reporting requirement does not require that each individual consolidated VIE's assets and liabilities be presented separately on the face of the balance sheet. The same (or similar) assets of all consolidated VIEs may be aggregated and presented as a single line item in the reporting entity's consolidated balance sheet. The same (or similar) liabilities may also be similarly aggregated as a single line item in the liability section of the reporting entity's balance sheet. See FSP 18.4.3 for additional information.

Because criteria for separate reporting of the assets and liabilities of a consolidated VIE differ, it is possible that only the assets or only the liabilities, but not necessarily both, of a particular VIE need to be separately presented. For example, the primary beneficiary of a securitization structure or a real estate entity may need to separately present the assets of the VIE because they can only be used to settle the VIE's beneficial interests or obligations. However, if the primary beneficiary guaranteed the liabilities of the VIE, separate presentation of the VIE's obligations is not required since the beneficial interest holders or lenders have recourse to the primary beneficiary's general credit.

Only the assets and liabilities of a consolidated VIE meeting the conditions in ASC 810-10-45-25 must be presented separately on the face of the reporting entity's balance sheet. While the guidance does not specify how the VIE's assets and liabilities should be presented, we believe the following methods are acceptable:

- Parenthetically disclose the amount of assets and liabilities related to consolidated VIEs included in each balance sheet line item

- Separately present the assets and liabilities of a consolidated VIE for each balance sheet line item

Example FSP 18-1 illustrates presentation alternatives for a consolidated VIE.

EXAMPLE FSP 18-1

Balance sheet presentation alternatives for a consolidated VIE

FSP Corp determines that it is the primary beneficiary of Company V, a VIE. Company V's assets consist primarily of cash and accounts receivable, which can only be used to settle specific Company V short-term and long-term debt obligations. Holders of those obligations do not have recourse to FSP Corp's general credit.

Is separate presentation of Company V's assets and liabilities required?

Analysis

Yes, separate presentation is required. To comply with the presentation requirements in ASC 810-10-45-25, FSP Corp may choose to report the assets and obligations of Company V parenthetically, as shown below.

Assets	
Cash (amounts related to VIE of $4)	$20
Inventory	14
Accounts receivable (amounts related to VIE of $1)	8
Property, plant and equipment (net)	25
Other assets	3
Total assets	$70

Liabilities and Stockholders' Equity	
Accounts payable	$23
Short-term debt (including debt of VIE of $2)	10
Long-term debt (including debt of VIE of $3)	19
Other liabilities	13
Equity	5
Total liabilities and stockholders' equity	$70

If (1) Company V's assets could be used to settle any of FSP Corp's obligations, or (2) Company V's creditors had recourse to FSP Corp's general credit, FSP Corp would not be required to separately present Company V's assets and liabilities.

If a consolidated VIE's creditors have partial recourse against the VIE's primary beneficiary, separate reporting of the VIE's liabilities generally would not be required but would be recommended. Similarly, if the assets of a consolidated VIE can be used to settle only certain obligations of the primary beneficiary, separate reporting of the consolidated VIE's assets generally would not be required but would be recommended. Also, if only certain assets of the consolidated VIE can be used to settle obligations of the VIE's primary beneficiary, separate reporting of those consolidated VIE's assets would not be required. If the consolidated VIE's assets and liabilities are not separately reported by the primary beneficiary, then the primary beneficiary should consider disclosing the reason why there is no separate reporting.

In some cases, a consolidated VIE's outstanding equity interests may be owned by one or more third-party investors. Provided the VIE's equity interests are reported within the equity section in the VIE's stand-alone financial statements, these interests should be reported in the primary beneficiary's consolidated balance sheet as noncontrolling interests (NCI), as shown on the example balance sheet in FSP Figure 2-1. The primary beneficiary can make a policy election to present NCI related to a consolidated VIE(s) separately or on an aggregate basis with all other NCIs.

18.4.2 VIE disclosures

If a reporting entity concludes that it has a variable interest in a VIE, it should comply with the VIE principal disclosure objectives and the specific VIE disclosures required in ASC 810-10-50. Additional disclosures are often added to the specific required disclosures to comply with the principal objectives.

As discussed in ASC 810-10-50-2AA, the principal objective of the VIE disclosures is to provide users of the reporting entity's financial statements with information that includes the following:

- Significant judgments and assumptions made in determining whether it needs to consolidate a VIE and/or disclose information about its involvement with a VIE

- The nature of the restrictions, if any, on a consolidated VIE's assets and on the settlement of the VIE's liabilities

- The nature of and changes in the risks associated with a reporting entity's involvement with a VIE

- How a reporting entity's involvement with a VIE affects its financial position, financial performance, and cash flows

The FASB's inclusion of disclosure objectives emphasizes the need for reporting entities not to assume that the specific disclosure requirements in ASC 810 are sufficient. Instead, reporting entities should apply judgment in determining what is necessary to provide financial statement users with decision-useful information.

The content of a reporting entity's VIE disclosures depends on the extent to which it is involved with the VIE, the significance and form of the involvement, and whether the VIE is consolidated. Although ASC 810-10-50-8 articulates the broad objectives of these disclosures in a principles-based manner, many of the disclosure requirements in ASC 810-10-50 are granular and prescriptive. However, reporting entities should ensure that their VIE disclosures, when viewed in their totality, clearly communicate the purpose and design of its interests in VIEs and describe the significant judgments made in connection with the primary beneficiary evaluation.

Figure FSP 18-1 summarizes ASC 810's specific VIE disclosure requirements.

Figure FSP 18-1

VIE disclosure requirements

Relationship	Disclosures
Holder of variable interests in a VIE, regardless of whether the holder is the primary beneficiary (ASC 810-10-50-5A through ASC 810-10-50-5B)	□ Methodology for concluding whether the reporting entity is (or is not) the primary beneficiary of the VIE, including disclosure of key factors, assumptions, and significant judgments used in making this determination □ Which factors resulted in a change in reporting, if applicable, including the impact of that change on the consolidated financial statements (e.g., the reporting entity previously consolidated the VIE and is no longer consolidating it) □ Whether the reporting entity provided or will provide financial or other support that it was not previously contractually required to provide, including: o The type and amount of support o The primary reasons for providing that support o If the reporting entity is not the primary beneficiary, qualitative and quantitative information regarding its involvement with the VIE □ Information (quantitative and qualitative) about the reporting entity's involvement with the VIE, including its nature, size, purpose, activities, and how it is financed □ A VIE may issue voting equity interests, and the reporting entity that holds a majority voting interest also may be the primary beneficiary of the VIE. If so, and if the VIE meets the definition of a business and

Relationship	Disclosures
	the VIE's assets can be used for purposes other than settlement of the VIE's obligations, the ASC 810-10-50-5A disclosures are not required (ASC 810-10-50-5B).
Primary beneficiary of the VIE (ASC 810-10-50-3 and ASC 805-10-50-1 through ASC 805-10-50-4)	□ The carrying amount and classification of the VIE's assets and liabilities included in the consolidated financial statements, including qualitative information about the relationship(s) between those assets and liabilities □ If creditors of a VIE have no recourse to the reporting entity's general credit, information about lack of recourse □ Terms of arrangements that could require the reporting entity to provide support to the VIE, including events that could expose the reporting entity to loss □ On initial consolidation of a business, disclosures required by ASC 805, as described in FSP 17.4 □ On initial consolidation of a VIE that is not a business (see BC 2), the amount of gain or loss recognized (if any) □ A VIE may issue voting equity interests, and the reporting entity that holds a majority voting interest also may be the primary beneficiary of the VIE. If so, and if the VIE meets the definition of a business and the VIE's assets can be used for purposes other than settlement of the VIE's obligations, the ASC 810-10-50-3 disclosures are not required.
Not the primary beneficiary of the VIE (ASC 810-10-50-4)	□ The carrying amount and classification of the assets and liabilities in the reporting entity's balance sheet that relate to the reporting entity's variable interest in the VIE □ Maximum exposure to loss as a result of the reporting entity's involvement with the VIE, including how the reporting entity determined that amount and the significant sources of that exposure to loss ○ Disclose if the reporting entity's maximum exposure to loss cannot be quantified □ A tabular comparison of the carrying amounts of the assets and liabilities, with the corresponding maximum exposure to loss, accompanied by a description of all qualitative and quantitative reasons for the differences between the carrying amount of the assets and liabilities and maximum exposure to loss (considering all variable interests and arrangements, both explicit and implicit) □ Information about liquidity arrangements, guarantees, and/or other commitments by third parties that may affect the fair value or risk of

Relationship	Disclosures
	the reporting entity's variable interests in a VIE (encouraged but not required) □ If the reporting entity is not the primary beneficiary of the VIE because there is "shared power," significant factors considered and judgments made in determining that power is shared (see CG 5.2.4 and CG 5.2.6)

ASC 810-10-50-3 requires the primary beneficiary of an acquired variable interest entity that is a business to provide the disclosures required by ASC 805 in the period of acquisition (see FSP 17.4). The primary beneficiary of a VIE that is not a business must disclose the amount of gain or loss recognized upon initial consolidation. Reporting entities should ensure that their disclosures are sufficient when such circumstances exist.

A reporting entity may find it is useful for users of its financial statements to see consolidating financial statements. A reporting entity may present consolidating financial statements in its VIE footnote, including summarized balance sheet and income statement information.

The SEC staff has focused on accounting and disclosure when a reporting entity does not consolidate a VIE but is expected to absorb the economics that are disproportionate to its power over the VIE. In these instances, the reporting entity should disclose the existence and nature of such arrangements as well as the judgments made when determining that the reporting entity is not the VIE's primary beneficiary.

The SEC staff has also requested additional disclosure to comply with general disclosure objectives of ASC 810-10, such as:

- A description of why the entity being evaluated for consolidation is not a VIE
- When a VIE is deconsolidated by a reporting entity, but the reporting entity retains a significant economic interest, more discussion of the judgments made in that determination
- When decision making (i.e., "power") and economics are disproportionate, provide more clear and transparent disclosure when determining that the reporting entity is not the VIE's primary beneficiary
- For entities that issue financial guarantees, additional information about reasons for changes in consolidation conclusions
- For financial institutions:
  - Why certain investment vehicles have been consolidated and others have not
  - The consolidation model applied to specific investments
  - The qualitative and quantitative analysis used to determine the primary beneficiary
  - The sufficiency of the related disclosures

18.4.3 Aggregation considerations

ASC 810 allows information about the same or similar VIEs to be disclosed on an aggregated basis. Aggregation is permitted if separate reporting would not provide more useful information to investors. ASC 810-10-50-9 requires that the assessment of "similar" consider the significance of each VIE to the reporting entity, and the reporting entity's exposure to the risks and rewards of each VIE on a qualitative and quantitative basis. We believe qualitative characteristics could include the following:

- The purpose and design of the VIE
- The risks it was designed to pass along to its variable interest holders
- The nature of the VIE's assets
- The magnitude and nature of the reporting entity's involvement with the VIE

When the reporting entity aggregates its VIE disclosures, it should distinguish between VIEs that are consolidated and VIEs that are not consolidated. Reporting entities should also consider describing the basis for aggregating "similar" VIEs.

In addition, ASC 810-10-50-10 requires a reporting entity to apply judgment, based upon facts and circumstances, in determining the appropriate level of detail to provide in order to satisfy the requirements of the variable interest model. A reporting entity should consider whether the disclosures are more useful to the financial statement users on an aggregated or disaggregated basis.

18.4.4 Maximum loss

As noted in Figure 18-1, a reporting entity is required to provide certain information about its exposure to "maximum loss" arising from its involvement with a VIE that it does not consolidate. The maximum loss represents the loss that the reporting entity would incur if all of the VIE's assets were deemed worthless as of the reporting date. As discussed in ASC 810-10-50-4, the amount disclosed should include any additional costs the reporting entity would incur in connection with its involvement with the VIE. Common examples include the following:

- A holder of an equity method investment would be exposed to loss equal to the current carrying value of the investment, assuming no future capital funding requirements
- A guarantor of an entity's debt would be exposed to the amount of principal (and interest) guaranteed
- A reporting entity that has committed to purchase goods or services from a VIE would be exposed to costs equal to the notional amount it is contractually obligated to purchase

A reporting entity should disclose its maximum potential loss, regardless of probability. Further, reporting entities should assess whether their disclosures provide sufficient qualitative and quantitative data regarding the methodology used to calculate the maximum exposure to loss, including key inputs and assumptions.

If a reporting entity is involved with multiple VIEs, it may disclose its maximum exposure to potential losses on an aggregate basis for all similar VIEs.

18.4.5 VIE information "scope out"

ASC 810-10-15-17(c) provides a scope exception (commonly referred to as the "information scope out") for reporting entities that entered into arrangements prior to December 31, 2003 for which they are unable to obtain the information necessary to apply the VIE model. These instances were expected to be infrequent, especially if the reporting entity was involved in the design of the entity or if the reporting entity was exposed to substantial risks of the entity. This scope exception exempts such a reporting entity from determining whether a legal entity in which it has a variable interest is a VIE only after making an "exhaustive effort" to obtain the necessary information. The scope exception in this provision applies only as long as the reporting entity continues to be unable to obtain the necessary information. The scope out requires continuous reassessment. See CG 2.3.3 for additional information on the "information scope out" exception.

ASC 810-10-50-6 states that a reporting entity choosing to avail itself of this scope exception disclose the following:

- The number of legal entities for which the information required to perform the analysis has not been made available to the reporting entity, and the reasons

- The nature, purpose, size (if available), and activities of such entities, along with the nature of the reporting entity's involvement with those entities

- The reporting entity's maximum exposure to loss due to its involvement with the legal entities

- The amount of income, expense, purchases, sales, or other measure of activity between the reporting entity and the legal entities for all periods presented

Finally, a reporting entity that invokes this scope exception should supplement required disclosures with a discussion of the reasons it is unable to obtain this information.

18.4.6 Disclosure considerations for VIEs in certain jurisdictions

Arrangements involving VIEs are commonly used in jurisdictions where foreign ownership of domestic companies is restricted. To overcome foreign ownership restrictions, a reporting entity may use contractual arrangements, such as options and other arrangements, to convey decision-making and economic rights to the reporting entity. These rights may cause the reporting entity to consolidate the VIE.

These structures may involve holding companies designed to comply with these foreign ownership restrictions. In some cases, the registrant consolidates the holding company and the holding company consolidates the VIE. These structures have frequently attracted SEC staff comments, particularly with regard to registrants' consolidation conclusions (see FSP 18.4.2).

To help financial statement users better understand the judgments in connection with the consolidation assessment of VIEs in jurisdictions where holding companies are designed to comply with foreign ownership restrictions, we believe (and the SEC staff stated at the 2013 AICPA Conference) that the reporting entity should consider describing the following matters in sufficient detail relative to these VIE arrangements:

- Terms of the contractual arrangements with the VIE that were considered in the consolidation analysis (e.g., duration, decisions requiring consent of minority investors, renewal provisions, and revocability clauses)
- Service or other fees paid by the VIEs to the holding company under contractual arrangements
- Cash paid from the VIE to the reporting entity
- How such arrangements convey a controlling financial interest (i.e., the power to direct the entity's economically most significant activities and a potentially significant economic interest in the VIE)
- The critical judgments made in relation to the reporting entity's involvement in the VIE (e.g., the validity and enforceability of contracts with the parties involved)
- Whether there are any restrictions on the reporting entity's contractual rights
- Disaggregated balance sheet and income statement information
- Disclosure about retained earnings of the VIE when deferred taxes are not recognized

18.4.7 Disclosure related to interests in money market funds

ASC 810-10-15-12 provides a scope exception for interests in certain money market funds. The consolidation guidance no longer applies to money market funds registered with the SEC pursuant to Rule 2a-7 of the *Investment Company Act of 1940* (registered money market funds) and "similar" unregistered money market funds.

The scope exception also applies to all reporting entities that hold interests in registered and similar unregistered money market funds, including investors, sponsors, asset managers, and any other interest holders. Interest holders do not need to assess these funds for consolidation under any consolidation model (VIE or VOE). However, reporting entities will be required to provide enhanced disclosures, as discussed in ASC 810-10-15-12(f)(2), regarding sources of support to these funds, which would include:

- Capital contributions to the money market fund
- Standby letters of credit
- Guarantees of principal and interest
- Agreements to purchased troubled securities at amortized cost
- Waiver of fees, including management fees

18.4.8 Disclosure requirements for reporting entities that consolidate collateralized financing entities

ASC 810-10-50 requires additional disclosure requirements for a reporting entity that consolidates collateralized financing entities.

ASC 810-10-50-20 through 50-22

A reporting entity that consolidates a collateralized financing entity and measures the financial assets and the financial liabilities using the measurement alternative in paragraphs 810-10-30-10 through 30-15 and 810-10-35-6 through 35-8 shall disclose the information required by Topic 820 on fair value measurement and Topic 825 on financial instruments for the financial assets and the financial liabilities of the consolidated collateralized financing entity.

For the less observable of the fair value of the financial assets and the fair value of the financial liabilities of the collateralized financing entity that is measured in accordance with the measurement alternative in paragraphs 810-10-30-10 through 30-15 and 810-10-35-6 through 35-8, a reporting entity shall disclose that the amount was measured on the basis of the more observable of the fair value of the financial liabilities and the fair value of the financial assets.

The disclosures in paragraphs 810-10-50-20 through 50-21 do not apply to the financial assets and the financial liabilities that are incidental to the operations of the collateralized financing entity and have carrying values that approximate fair value.

18.5 Voting interest entities (VOEs)

A reporting entity with a financial interest in another entity should first determine whether the entity is a VIE. Reporting entities applying the VIE model would follow the presentation and disclosure requirements as discussed in FSP 18.4, in addition to those in FSP 18.3.

If the entity is not a VIE (or qualifies for one of the scope exceptions in ASC 810-10-15-17), the reporting entity would apply the VOE model. Reporting entities applying the VOE model would follow the general consolidation presentation and disclosure principles in FSP 18.3 and consider the disclosure requirements included in the following sections, depending upon the legal form of the entity. See CG 7 for additional information on the VOE model.

18.5.1 Corporations

If a reporting entity owns an interest in a legal entity that (1) is not a VIE (or qualifies for one of the scope exceptions in ASC 810-10-15-17), and (2) has a governance structure that operates like a corporation (i.e., it is governed by a board of directors (or equivalent) appointed or approved by its stockholders or owners), consolidation of the investee is generally required if the reporting entity owns greater than 50 percent of the investee's outstanding voting shares (or interests).

Despite owning a majority of a corporation's outstanding voting shares, in certain circumstances a reporting entity may conclude that consolidation is not appropriate. This might occur when the minority equity investors have substantive participating rights. See CG 3.4.2 for additional information on participating rights and their impact on the VOE model.

In such instances, the reporting entity should consider disclosing the following:

- The noncontrolling rights that allow the minority investors to effectively participate in decisions made in the ordinary course of business, the frequency with which such rights can be exercised, and why they are substantive

- The dispute resolution process if the majority investor and minority investors are unable to reach an agreement

- Example FSP 18-2 illustrates potential disclosure considerations when substantive participating rights prevent a majority investor from consolidating a voting interest entity.

EXAMPLE FSP 18-2

Disclosure considerations when substantive participating rights prevent a majority investor from consolidating a voting interest entity

FSP Corp owns 60% of VOE Corp's outstanding equity, with the remaining 40% owned by ABC Corp. Through its 60% equity interest, FSP Corp can appoint a majority of VOE Corp's board members.

FSP Corp determines that VOE Corp is not a VIE. Accordingly, FSP Corp applies the voting interest entity model to determine whether it should consolidate VOE Corp.

Although FSP Corp owns a majority of VOE Corp's equity, it determined that it does not have a controlling financial interest in VOE Corp since ABC Corp can veto the hiring, firing, and compensation of VOE Corp's Chief Executive Officer, Chief Operating Officer, and Chief Financial Officer.

What disclosures, if any, should FSP Corp consider in its consolidation footnote?

Analysis

FSP Corp should consider disclosing the existence of the participating right held by ABC Corp and the judgments made in concluding that this right (1) is substantive, and (2) provides ABC Corp with the ability to block key decisions made in the ordinary course of business.

FSP Corp's specific disclosures should provide transparency into the judgments made when concluding that it should not consolidate VOE Corp, despite its majority ownership interest.

18.5.2 Partnerships

A reporting entity with an interest in a partnership first determines whether the partnership is a VIE or qualifies for one of the scope exceptions in ASC 810-10-15-17. Assuming the partnership is not a VIE, the reporting entity would apply the VOE model and follow the general presentation and disclosures covered in FSP 18.3. In addition, a reporting entity should consider presenting additional information to investors about consolidated partnerships or similar entities that are not VIEs. This additional information could be conveyed by: (1) providing consolidating financial statements, or (2) separately by classifying the partnership's assets and liabilities on the reporting entity's consolidated balance sheet. Other presentation alternatives may be acceptable.

If a reporting entity is the general partner of a partnership that is a VOE (or an entity with a governance structure that is the functional equivalent of a limited partnership) and is not consolidating the partnership, it should consider disclosing the reason why. The disclosure may include the nature of substantive kick-out, liquidation, or participating rights held by the limited partners, as well as the specific factors considered when determining that such rights are substantive

(e.g., such rights are exercisable by a simple majority of the limited partners unrelated to the general partner). See CG 7.3.2 and CG 7.3.1 for additional information on participating and kick-out rights.

In practice, kick-out and liquidation rights are most commonly granted to limited partners in a limited partnership. When limited partners have been granted liquidation rights, the reporting entity (general partner) should consider disclosing the following:

- The limited partners' mechanism to call a vote to liquidate the limited partnership
- The frequency with which such rights can be exercised
- That the liquidation right can be exercised without cause
- The vote required to liquidate the limited partnership, including whether the vote is cast on an absolute basis or instead is based on the relative magnitude of the limited partners' capital accounts
- Whether the general partner and its related parties are excluded from the vote
- Whether the limited partners are subject to operational or financial barriers that would prevent them from exercising such rights (e.g., a significant termination penalty payable to the general partner upon dissolution of the limited partnership, absent cause)

If the limited partners have been granted participating rights, the reporting entity (general partner) may consider disclosure of the following:

- The noncontrolling rights that allow the limited partners to effectively participate in decisions made in the ordinary course of business
- The frequency with which such rights can be exercised
- Whether the exercise of such rights is subject to any operational barriers
- The dispute resolution process if the general partner and limited partners are unable to reach an agreement

Example FSP 18-3 illustrates potential disclosure considerations when substantive kick out rights prevent a general partner from consolidating a limited partnership.

EXAMPLE FSP 18-3

Disclosure considerations when substantive kick out rights prevent a general partner from consolidating a limited partnership

FSP Corp is the general partner of VOE LP. FSP Corp determines that VOE LP is not a VIE because a simple majority of the limited partners, unrelated to FSP Corp, were granted the right to liquidate VOE LP without cause at any time (and no other VIE criteria were met). Since FSP Corp can be removed as the GP at any time, it does not have a controlling financial interest in VOE LP and would not consolidate VOE LP.

What information should FSP Corp disclose with respect to its involvement with VOE LP?

Analysis

Although not required by ASC 810-20, FSP Corp should consider disclosing the key judgments made when determining that the liquidation right prevents FSP Corp, as general partner, from unilaterally controlling VOE LP.

Such disclosures may include the following:

- A description of the mechanism that allows the limited partners to exercise the liquidation right
- Whether any barriers exist that would prevent the limited partners from exercising their vote (e.g., termination penalties)

See FSP 18.5.2 for additional factors that a reporting entity should consider disclosing.

18.6 Consolidation procedures

The preparation of consolidated financial statements is based on the assumption that a reporting entity and its consolidated subsidiaries operate as a single economic entity. The presentation of a consolidated group may require certain adjustments for transactions occurring between the reporting entity and its subsidiaries. As a general rule, the amounts reported in consolidated financial statements should reflect the economic effects of only those transactions between the consolidated reporting entity and third parties.

18.6.1 Eliminating intra-entity transactions in consolidation

Consistent with the single economic entity premise, when preparing consolidated financial statements, a consolidated reporting entity should eliminate all intra-entity balances and transactions with its consolidated subsidiaries, including:

- Accounts payable/receivable
- Sales and purchases
- Interest
- Dividends
- Intra-entity lease arrangements
- Intra-entity profit or loss on assets remaining within the consolidated group

As a result of the foreign exchange transaction guidance in ASC 830, foreign exchange gains (losses) on intra-entity transactions, if present, may not eliminate in consolidation. Reporting entities are encouraged to consider disclosure in such situations.

See CG 8.2 for additional information on intra-entity transactions in consolidation.

18.6.1.1 *Capital transactions - reporting entity and its subsidiaries*

A reporting entity may enter into transactions with a consolidated subsidiary that impact the subsidiary's capital structure. Such transactions include the subsidiary's payment of stock dividends to the reporting entity or a recapitalization of the subsidiary. Although these transactions may affect the subsidiary's stand-alone financial reporting, they should not affect the reporting entity's consolidated retained earnings balance or accumulated other comprehensive income, as such amounts would eliminate in consolidation.

For purposes of presenting consolidated financial statements, the reporting entity should reflect its retained earnings balance, which includes its proportionate share of the retained earnings of the subsidiary accumulated after the date the reporting entity obtains a controlling financial interest in the subsidiary (e.g., the acquisition date), less any distributions made to the reporting entity's stockholders. Similarly, in the consolidated financial statements, the reporting entity should reflect its accumulated other comprehensive income balance, which includes its proportionate share of the accumulated other comprehensive income of the subsidiary accumulated after the date the reporting entity obtains a controlling financial interest in the subsidiary.

Similarly, a reporting entity and a consolidated subsidiary may enter into intra-company lending arrangements for commercial and/or tax purposes. Upon initial consolidation of the subsidiary, the reporting entity should eliminate the intercompany receivable/payable balances in consolidation and related interest income or expense.

18.6.2 *Fiscal periods of a reporting entity and its subsidiary*

The financial information in a set of consolidated financial statements is generally presumed to have been prepared as of the same date. As discussed in ASC 810-10-45-12, if a subsidiary's financial statements are not available in a timely manner, a reporting entity may consolidate a subsidiary's financial statements as of a date that differs from the reporting entity.

ASC 810-10-45-12

It ordinarily is feasible for the subsidiary to prepare, for consolidation purposes, financial statements for a period that corresponds with or closely approaches the fiscal period of the parent. However, if the difference is not more than about three months, it usually is acceptable to use, for consolidation purposes, the subsidiary's financial statements for its fiscal period; if this is done, recognition should be given by disclosure or otherwise to the effect of intervening events that materially affect the financial position or results of operations.

If the consolidated financial statements include the financial information of a subsidiary as of a date that differs from the reporting entity, the consolidated reporting entity should recognize, by disclosure or adjustment, the effects of events at the subsidiary level that have occurred during the intervening lag period and are material to the consolidated balance sheets or income statements. Each case requires an evaluation of the facts and circumstances to determine whether such events should be addressed through disclosure, or whether an adjustment to the consolidated financial statements is appropriate. In practice, recognition of most intervening events, other than intercompany transactions requiring elimination in consolidation, is typically by disclosure only.

When a consolidated subsidiary reports the results of its operations on a lag relative to its parent, the presentation of the subsidiary's operations may appear unusual. These presentation issues may be more pronounced in the year a reporting entity acquires a subsidiary whose results of operations will be reported on a lag. We encourage disclosure when the financial statements of a recently-acquired subsidiary are presented on a lag, so users of the financial statements understand the impact of a newly-acquired subsidiary on the consolidated financial statements.

See EM 4.4 for additional information on investee reporting on a lag.

Example FSP 18-4 illustrates the initial consolidation of a subsidiary that reports its operations on a lag relative to its parent.

EXAMPLE FSP 18-4

Initial consolidation of a subsidiary that reports its operations on a lag relative to its parent

FSP Corp acquires Sub Co on February 1, 20X8. Although FSP Corp and Sub Co both have fiscal years that end on December 31, FSP Corp will not be able to obtain quarterly financial results for Sub Co in time to report its results as part of its publicly-filed consolidated financial statements for the interim period ended March 31, 20X8. FSP Corp expects a similar delay in obtaining Sub Co's results in all future periods.

Therefore, FSP Corp adopts an accounting policy whereby the operations of Sub Co are consolidated on a one quarter (i.e., three month) lag and Sub Co's operating results for the period from February 1, 20X8 (date of acquisition) through March 31, 20X8 are omitted from FSP Corp's consolidated statement of operations for the quarter ended March 31, 20X8. These results will be included in FSP Corp's consolidated statement of operations for the quarter ended June 30, 20X8.

Should FSP Corp disclose the impact of its consolidation policy for Sub Co in its first quarter consolidated financial statements? If so, what specific information should be disclosed?

Analysis

Yes. FSP Corp should disclose its policy of reporting Sub Co's results on a one quarter lag. It should also disclose the fact that Sub Co's February and March 20X8 results of operations are excluded from FSP Corp's consolidated results of operations. Additionally, FSP Corp should disclose the fact that the Sub Co balance sheet information included in FSP Corp's consolidated balance sheet as of March 31, 20X8 is as of the acquisition date and, if applicable, whether such amounts are preliminary and subject to potential measurement period adjustments.

FSP Corp should also disclose or adjust its consolidated operating results for any intervening events at Sub Co (between the acquisition date and March 31, 20X8) that materially impact FSP Corp's consolidated financial position or results of operations. These same policy and related disclosures would also be included in FSP Corp's annual financial statements.

A change in the reporting date of a subsidiary is an accounting change which can be made only if the change results in preferable accounting in accordance with ASC 250. It would be difficult to justify the preferability of a change in the reporting period of a subsidiary that has the result of creating (or increasing) a lag period.

A reporting entity should follow the disclosure requirements in ASC 250-10-50 for changes in an accounting principle when a reporting entity changes or eliminates a difference in subsidiary reporting periods. That is, the reporting entity would retrospectively adjust the financial statements for all prior periods presented and disclosure should be made in the footnotes.

ASC 250-10-45-9 provides an exception in cases where retrospective adjustment is not practicable. If a reporting entity meets the conditions to qualify for the impracticability exception, it would not be required to retrospectively apply the effects of the change in the lag period.

When a reporting entity creates, changes, or eliminates a difference in an existing subsidiary's reporting period, it would be inappropriate to include a subsidiary's results for a period that is greater than the reporting entity's reporting period (e.g., subsidiary's reported results cannot be more than 3 months in a reporting entity's quarterly reporting). Reporting and disclosing changes in an accounting principle are addressed in FSP 30.

18.6.3 Specialized industry accounting principles in consolidation

Reporting entities may encounter recognition and measurement complexities when consolidating subsidiaries that follow specialized industry accounting principles. For example, a private equity fund that is consolidated by its general partner may report its investments at fair value in its stand-alone fund financial statements in accordance with the specialized industry accounting principles in ASC 946, *Financial Services - Investment Company*.

Under ASC 810-10-25-15, reporting entities should retain specialized industry accounting in consolidation and related accounting policy disclosures, if material, assuming the specialized accounting practice is appropriate at the subsidiary level.

18.6.4 Presentation of nonhomogeneous subsidiaries

As noted in FSP 18.3, a reporting entity generally consolidates another entity in which it holds a controlling financial interest. In some situations, the reporting entity and a consolidated subsidiary may have very different or "nonhomogeneous" operations (e.g., the reporting entity is a manufacturer and the subsidiary is in the insurance industry).

The consolidation guidance does not address how the assets, liabilities, and results of operations attributable to a nonhomogeneous subsidiary should be presented and disclosed in the consolidated financial statements of its parent. It is our understanding that the FASB did not prescribe presentation guidance with respect to nonhomogeneous subsidiaries to provide reporting entities flexibility based on their unique situation.

In our view, a reporting entity should consider the following factors when determining the best presentation alternative for users of its financial statements.

- *Regulation S-X rules and financial statement user needs*

  Both are biased toward expanded line item disclosure and disaggregation of information.

- *The materiality of the nonhomogeneous subsidiary*

  For example, the more material a subsidiary with an unclassified balance sheet is to the consolidated financial statements, the more likely that it is appropriate to present a consolidated unclassified balance sheet.

- *Diversity of the reporting entity and nonhomogeneous subsidiary's operations*

  The more diverse a nonhomogeneous subsidiary's operations are from the remainder of the reporting entity, the more appropriate expanded line item disclosure may be.

- *Future plans with regard to the subsidiary*

  A reporting entity's strategic plan for the subsidiary may affect whether the subsidiary's financial information should be presented on an aggregated or disaggregated basis. For example, it may be appropriate to disaggregate a nonhomogeneous subsidiary that is expected to expand. Disaggregated information may provide transparency that allows financial statement users to understand the nonhomogeneous subsidiary's contribution to the reporting entity's overall operations and performance.

In some cases, reporting entities may choose to provide consolidating financial data. This presentation alternative separates all income statement and balance sheet elements of the nonhomogeneous subsidiary from the remainder of the reporting entity in columnar format. Such amounts are then totaled to derive consolidated amounts.

There are several possible approaches for presentation of nonhomogeneous operations. The reporting entity should choose a reasonable approach that it believes will be most meaningful to its financial statement users, being mindful of the prohibition in S-K Item 10(e) against including non-GAAP financial measures in the financial statements, and apply the approach consistently across all periods presented.

18.7 Change in entities in the consolidated group

S-X 3A-03 requires public reporting entities to disclose material changes in the subsidiaries it includes or excludes in its consolidated or combined financial statements when compared to the prior fiscal year.

Reporting entities should follow the disclosure requirements in ASC 805 (see FSP 17) and ASC 810 for newly-consolidated entities, as applicable.

If a subsidiary of an SEC registrant is not consolidated, the reporting entity should disclose the reason for excluding the subsidiary from its consolidated financial statements and the basis of accounting for its investment in the subsidiary.

A change in a reporting entity's interest in an investee may impact the manner in which it accounts for that interest. For example, a reporting entity may account for its interest in an investee following the equity method of accounting and subsequently acquire additional shares, thereby resulting in consolidation. The following sections addresses the presentation and disclosure requirements to consider in such instances.

18.7.1 Change from fair value or equity method to consolidation

Initial consolidation of an investee previously reported using fair value or the equity method should be accounted for prospectively as of the date the entity obtained a controlling financial interest. Although prior years' financial statements of the subsidiary would not be consolidated with those of its parent because there was no controlling financial interest at those dates, public business entities should provide pro forma information required by ASC 805-10-50-2. See FSP 17.4.12.1 for more details.

If a change in ownership interest occurs after the balance sheet date, it is a nonrecognized subsequent event which may require disclosure. See FSP 28.6.3.9 for further discussion.

18.7.2 Deconsolidation

A reporting entity will deconsolidate a subsidiary (or derecognize a group of assets that meet the definition of a business as defined in ASC 805) upon the loss of control, consistent with the guidance in ASC 810-10-40-3A. Upon deconsolidation, the reporting entity would no longer present the subsidiary's assets, liabilities, and results of operations in its consolidated financial statements. The reporting entity should also consider the applicability of the presentation and disclosure requirements for discontinued operations as further discussed in FSP 27.

In the period a subsidiary is deconsolidated (or a group of assets that meet the definition of a business is derecognized), the reporting entity should include the following disclosures in its footnotes or, where appropriate, on the face of its income statement, as required by ASC 810-10-50-1B:

- The amount of any gain (loss) recognized
- The portion of any gain (loss) recognized that relates to the remeasurement of any retained interest in the deconsolidated subsidiary (or derecognized business) to fair value
- The income statement line item in which the gain (loss) is included (unless separately presented on the face of the income statement)
- A description of the valuation techniques utilized to measure the fair value of any direct or indirect retained interest in the deconsolidated subsidiary (derecognized business). Other disclosures may also apply (e.g., those required by ASC 820 regarding the fair value measurement's level within the fair value hierarchy)
- Information regarding the inputs used to measure the fair value of the retained interest
- The nature of any continuing involvement with the former subsidiary (business) upon deconsolidation (derecognition)
- Whether the transaction resulting in deconsolidation (derecognition) involved a related party (see FSP 26.5.8)
- Whether the former subsidiary (business) will be a related party after deconsolidation (derecognition) (see FSP 26.5.8)

It may be more effective to include such disclosures in the notes to the consolidated financial statements rather than on the face of the reporting entity's income statement. A reporting entity should present the information in a single note or by cross-referencing other footnotes.

If a reporting entity loses control of a subsidiary that is not a business and substantially all of the assets of the subsidiary are non-financial assets, the reporting entity should follow the derecognition guidance in ASC 610-20 (see PPE 6.2). For presentation and disclosure requirements of gains and losses recognized upon the derecognition of a long-lived asset, refer to FSP 8.

18.8 Combined financial statements

If a reporting entity concludes that consolidated financial statements are not required, it may still be appropriate to bring together the balance sheet, income statement, equity, and cash flow accounts of two or more affiliated companies into a single set of comprehensive financial statements (i.e., as a single reporting entity). This may also be appropriate when components of a business that are not legal entities are carved-out from a reporting entity. The financial statements of the affiliated group are referred to as "combined" financial statements and should be labeled as such (as opposed to "consolidated").

While consolidated financial statements are prepared on the basis of a controlling financial interest, as defined in ASC 810, combined financial statements are not. Combined statements may be prepared, for example, for entities under common control, because the resulting financial statements may be more meaningful than consolidated financial statements of the common parent. Combined financial statements may also be appropriate for entities that are under common management.

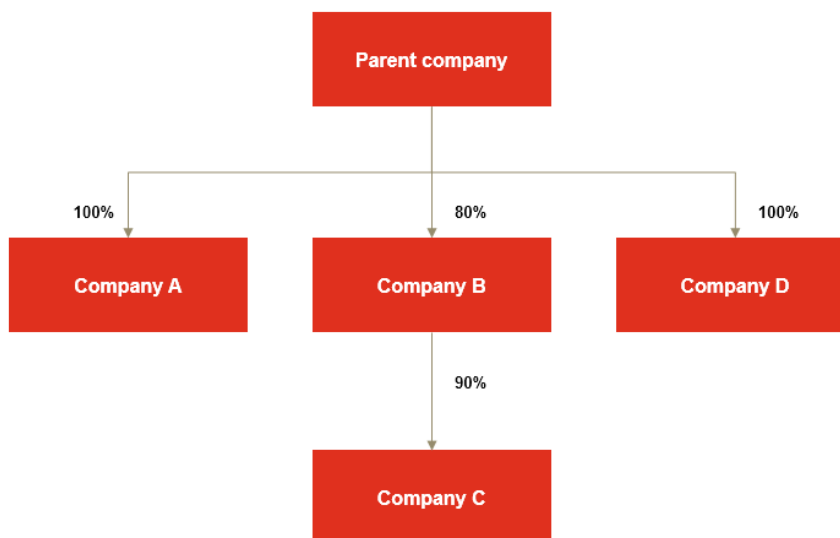
ASC 810-10-45-10 requires that combined financial statements be presented as if they are consolidated financial statements. Similar to consolidated financial statements, reporting entities eliminate intra-entity transactions in combined financial statements. Also, a reporting entity would treat noncontrolling interests, foreign operations, different fiscal periods, and income taxes in the same manner as in consolidated financial statements.

A noncontrolling interest is presented in combined financial statements when a subsidiary of any of the combined entities has a noncontrolling interest. The existence of a noncontrolling interest at the parent level is not reflected in the combined financial statements of the subsidiaries, as illustrated in the following example.

Example FSP 18-5 illustrates the presentation of noncontrolling interest in combined financial statements.

EXAMPLE FSP 18-5

Presentation of noncontrolling interest in combined financial statements



1. How would the interest not held by Parent Company in Company B be presented in the combined financial statements of Company A and Company B?

2. How would Company B's interest in Company C be presented in the combined financial statements of Company A and B?

Analysis

1. The combined financial statements of Company A and Company B would reflect 100% of Company B. There would be no accounting for the 20% not owned by Parent Company.

2. In the combined financial statements of Company A and Company B, the 10% of Company C not owned by Company B would be reflected as a noncontrolling interest.

18.9 Considerations for private companies

S-X 3A-02 and S-X 3A-03 provide guidance applicable only to SEC registrants.

Guidance in ASC 810-10-15-17AC through ASC 810-10-15-17AF allows reporting entities that are not public business entities to elect to not apply the VIE consolidation guidance to a legal entity under common control (including common control leasing arrangements) if both the parent and the legal entity being evaluated for consolidation are not public business entities.

If elected, the private company should apply other consolidation guidance, particularly the voting interest entity guidance, unless another scope exception applies. Under the accounting alternative, a private company that neither consolidates nor applies the VIE guidance to a legal entity under common control should disclose the following:

Excerpt from ASC 810-50-2AG

a. The nature and risks associated with a reporting entity's involvement with the legal entity under common control.

b. How a reporting entity's involvement with the legal entity under common control affects the reporting entity's financial position, financial performance, and cash flows.

c. The carrying amounts and classification of the assets and liabilities in the reporting entity's statement of financial position resulting from its involvement with the legal entity under common control.

d. The reporting entity's maximum exposure to loss resulting from its involvement with the legal entity under common control. If the reporting entity's maximum exposure to loss resulting from its involvement with the legal entity under common control cannot be quantified, that fact shall be disclosed.

e. If the reporting entity's maximum exposure to loss (from d.) exceeds the carrying amount of the assets and liabilities (from c.), the reporting entity should provide qualitative and quantitative information to allow users of financial statements to understand the excess exposure. That information should include, but is not limited to, the terms of the arrangements, considering both explicit and implicit arrangements, that could require the reporting entity to provide financial support (for example, implicit guarantee to fund losses) to the legal entity under common control, including events or circumstances that could expose the reporting entity to a loss.

Excerpt from ASC 810-50-2AH

In applying the disclosure guidance in paragraph 810-10-50-2AG(d) through (e), a reporting entity under common control shall consider exposures through implicit guarantees. Determining whether an implicit guarantee exists is based on facts and circumstances. Those facts and circumstances include, but are not limited to, whether:

a. A reporting entity has an economic incentive to act as a guarantor or to make funds available.

b. A reporting entity has acted as a guarantor for or made funds available to the legal entity in the past.

The private company should present these disclosures in addition to the disclosures required by other accounting standards (e.g., ASC 460, ASC 850, and ASC 842) and may combine them in a single footnote or by cross-referencing other footnotes.

Chapter 19: Derivatives and hedging—updated July 2022

19.1 Derivatives and hedging chapter overview

This chapter discusses the requirements for presenting and disclosing freestanding and embedded derivatives, including those to which hedge accounting is applied. It also addresses the presentation and disclosure requirements and assumes adoption of ASU 2022-01. It should be read in conjunction with DH 1, which includes information about how derivatives are traded in the market (i.e., whether they are over-the-counter, centrally-cleared, or exchange-traded) as this may impact their balance sheet and income statement presentation. Refer to FSP 19.2 for the effective dates of the new standards.

The following topics are addressed in this chapter:

- Balance sheet classification and presentation of derivatives, including offsetting considerations
- Income statement presentation of derivatives
- Disclosure requirements for all derivatives and those nonderivative instruments in hedging relationships

Disclosures required by ASC 815-40 for contracts in a reporting entity's own equity are addressed in FSP 5. The statement of cash flows classification of derivatives is addressed in FSP 6.

19.2 Derivatives and hedging scope and guidance

ASC 815, *Derivatives and Hedging*, establishes presentation and disclosure requirements for all nongovernmental reporting entities that use derivative instruments.

S-X 4-08(n) requires disclosure of the accounting policies for derivatives that materially affect the financial statements of public companies.

ASC 820, Fair Value Measurement, provides guidance on determining the fair value of all instruments, including derivatives. The presentation and disclosure requirements specific to fair value measurements are included in FSP 20.

New guidance

On March 28, 2022, the FASB issued ASU 2022-01. ASU 2022-01 expanded the ability to use portfolio layer method hedges (formerly referred to as last-of-layer hedges) and clarified how portfolio layer method hedges should be accounted for. This ASU is effective for public business entities for fiscal years beginning after December 15, 2022 and for all other entities for fiscal years beginning after December 15, 2023. Early adoption is permitted on any date. FSP 19.3 through FSP 19.5 assume adoption of ASU 2022-01.

19.3 Balance sheet presentation

All derivatives should be recognized on the balance sheet at fair value unless the private company simplified approach (discussed in DH 11) is used.

19.3.1 Balance sheet presentation—classified

ASC 815 does not provide specific guidance on the balance sheet classification of derivatives. General guidance on classification is included in ASC 210-10-45 and detailed in FSP 2.3.4. A reporting entity with significant derivative activity should disclose its accounting policy for determining the balance sheet classification of derivatives.

Applying the general classification guidance to a derivative can be difficult since it may be an asset in one period and switch to a liability in the next period (or vice versa), and its fair value is often a "net" number that may consist of a current asset and a noncurrent liability or a noncurrent asset and a current liability.

Consistent with the guidance in ASC 210, a derivative should generally be separated into its current and noncurrent components depending on the timing of the cash flows. That is, the fair value related to the cash flows occurring within one year should be classified as current, and the fair value related to the cash flows occurring beyond one year should be classified as noncurrent. A reporting entity should review those individual derivatives whose fair values are net assets to ascertain whether the current portion is a liability. It will often know (or be able to estimate) whether the current portion of a derivative is a liability either through its knowledge of forward prices/rates for the underlying or from details contained in the derivative's valuation report.

In addition, given the unique nature of derivatives and the lack of specific classification guidance for them, we believe the following additional concepts should be applied to the determination of the balance sheet classification of a derivative in a classified balance sheet:

- A derivative that matures within one year should be classified as current.

- A derivative that allows the counterparty to terminate the arrangement at fair value at any time should be classified as current when its fair value is a net liability, as required by ASC 210-10-45-7 for liabilities due on demand (addressed in FSP 12.3.2.1). Such termination provisions may be found in either the trade confirmation or the master agreement with the counterparty.

Notwithstanding the above, a reporting entity may choose not to separate a derivative into its current and long-term portions, provided the following rules are consistently applied to all derivatives in all periods:

- A derivative whose fair value is a net liability is classified in total as current.

- A derivative whose fair value is a net asset and whose current portion is an asset is classified in total as noncurrent. (If the current portion is a liability, it should be presented as a current liability.)

Example FSP 19-1 and Example FSP 19-2 illustrate presentation of a derivative in a classified balance sheet.

EXAMPLE FSP 19-1

Balance sheet classification of a derivative that is a net liability

On January 1, 20X1, DH Corp enters into a forward contract with Counterparty B that requires DH Corp to acquire specified volumes of a commodity, which will be delivered on December 31, 20X2 and December 31, 20X3. The contract does not allow either party to terminate the contract prior to maturity. There is no master netting agreement in place with Counterparty B. At inception, the forward contract has a fair value of zero, and DH Corp accounts for it as a derivative.

On December 31, 20X1, the derivative contract is in a $100 unrealized loss position from DH Corp's perspective (i.e., it is a liability). Based on DH Corp's analysis of the expected cash flows, approximately $40 of the unrealized loss position relates to commodities to be delivered on December 31, 20X2, and the final delivery will be on December 31, 20X3.

How should DH Corp present this derivative in a classified balance sheet?

Analysis

As of December 31, 20X1, DH Corp may present the derivative in either of the following ways, provided the approach taken is applied consistently.

Separately present current and noncurrent portions

	Current liability	**Noncurrent liability**
Derivative liability	$ 40	$ 60

Present entirely as a current liability

	Current liability	**Noncurrent liability**
Derivative liability	$ 100	$ 0

EXAMPLE FSP 19-2

Balance sheet classification of a derivative that is a net asset

On June 30, 20X1, DH Corp enters into an interest rate swap agreement with Counterparty C. The contract requires annual payments commencing on June 30, 20X2 for three years. The terms of the arrangement call for DH Corp to receive from Counterparty C payments based on LIBOR and pay to Counterparty C a fixed rate of interest.

On December 31, 20X1, the contract is in a $2 million unrealized gain position from DH Corp's perspective (i.e., it is an asset). The unrealized gain is made up of the net present value of each of the three payments:

Payment date	Fair value
June 30, 20X2	($500,000)
June 30, 20X3	850,000
June 30, 20X4	1,650,000
Total	$2,000,000

How should DH Corp present this derivative in its December 31, 20X1 classified balance sheet?

Analysis

At December 31, 20X1, DH Corp should present this derivative as follows:

Noncurrent asset	$2,500,000
Current liability	$(500,000)

However, if the current portion of the derivative were an asset, DH Corp could have elected to (1) present the entire derivative as noncurrent or (2) separately present the components as current and noncurrent, as applicable.

19.3.2 Balance sheet offsetting of derivatives

As discussed more fully in FSP 2.4, certain assets and liabilities may be netted on the balance sheet. Generally, they should only be netted if they meet the conditions in ASC 210-20-45-1. Those conditions are:

- The parties owe each other determinable amounts
- The reporting party has the legal right to set off the amount owed with the amount owed by the other party
- The reporting party intends to set off
- The right of setoff is legally enforceable

However, ASC 815-10-45-5 provides an exception for derivatives to the criterion related to the intent to set off. Even if the reporting party does not intend to set off the gross amounts, ASC 815 allows netting if the derivatives are with the same counterparty and the reporting entity has the right to set off the amounts owed under the derivatives pursuant to a master netting arrangement that is legally enforceable.

Although the term “master netting arrangement” is not specifically defined, ASC 815-10-45-5 provides some insight into master netting arrangements.

Excerpt from ASC 815-10-45-5

A master netting arrangement exists if the reporting entity has multiple contracts, whether for the same type of derivative instrument or for different types of derivative instruments, with a single counterparty that are subject to a contractual agreement that provides for the net settlement of all contracts through a single payment in a single currency in the event of default on or termination of any one contract.

Legal analysis and judgment are required in determining whether a transaction is governed by a master netting arrangement or similar agreement and in determining the legal rights of the reporting entity/counterparty, as they may vary by contract and by jurisdiction. Determining the legal rights should include an analysis of the operation of the contract itself and the enforceability of right to set off. Reporting entities should consider all relevant laws, including state laws about the right to set off and restrictions in the US Bankruptcy Code, in determining whether rights to set off are enforceable. See ASC 210-20-45-8 through ASC 210-20-45-9 for further details.

If the conditions for offsetting are met, a reporting entity may elect to report the fair value of its derivatives on a net basis by counterparty in the balance sheet. The choice to offset or not is an accounting policy election. Reporting entities should disclose the policy and apply it consistently. If a reporting entity elects to offset fair value amounts recognized for derivatives, the entity must also offset the fair value amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral. See FSP 19.3.2.3 for further information on the offsetting of collateral.

19.3.2.1 Master netting arrangements: over-the-counter

The International Swaps and Derivatives Association, Inc. (ISDA) created a framework/contract for bilateral, over-the-counter derivative trading. This framework is commonly referred to as the “ISDA Master Agreement.” For each counterparty derivatives are traded with, a separate ISDA Master Agreement must be executed.

Typically, part of the ISDA Master Agreement specifies the terms that provide for the right of set off. This allows an entity to net the derivatives traded with the respective counterparty under certain circumstances (such as in the event of default), provided the ISDA Master Agreement is legally enforceable.

19.3.2.2 Master netting arrangements: centrally-cleared

Determining the appropriate presentation for centrally-cleared derivatives requires a legal analysis of the facts and the contractual rights. Reporting entities need to review transactions individually to see if netting provisions exist when evaluating their ability to net under ASC 210 and ASC 815.

The ability to net centrally-cleared derivatives requires the trade to flow through both the same clearing member and clearing house. We are not aware of instances when legal counsel has supported the netting of transactions that are traded through different clearing members, even if the trades ultimately clear through the same clearing house.

Question FSP 19-1

Should the carrying amount of the derivative that is used in a fair value hedge of an on-balance sheet item be added to the carrying amount of the hedged item, such as in a fair value hedge of a fixed-rate debt obligation with a pay-floating, receive-fixed interest rate swap? Said differently, should the change in the fair value of the interest rate swap be added to the carrying amount of a debt obligation?

PwC response

No. The derivative liability is not associated with the future cash obligations to the debt holders and, therefore, should not be presented on a combined basis. The balance for the derivative asset or liability should be separate from the presentation of the hedged item.

19.3.2.3 Offsetting collateral

A reporting entity is required to recognize amounts for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable). A reporting entity may offset fair value amounts recognized for derivatives and "fair value amounts" related to collateral arising from derivatives that are subject to a master netting agreement. For the collateral receivable or payable, ASC 815-10-45-5 indicates that "fair value amounts" include amounts that approximate fair value. This applies only to collateral and should not be analogized to other receivables and payables.

A reporting entity that reports its derivatives net should also offset its cash collateral asset or liability against the fair value amounts recognized for derivatives executed with the same counterparty under the same master netting agreement provided the amounts for collateral meet the criteria for offsetting. If the collateral does not meet the criteria for offsetting, the reporting entity should report its derivatives net but is not permitted to net the related fair value amounts with the cash collateral.

As a corollary, if the reporting entity does not report its derivatives on a net basis, it is precluded from netting the related fair value amounts with the cash collateral.

The reporting entity's choice to offset or not must be applied consistently.

Collateral versus settlement

As discussed in DH 1.3.3.1, the legal nature of payments on derivatives determines if they are payments for collateral or settlement payments. For example, for centrally-cleared derivatives, it is important to understand the legal form of the variation margin, whether it is deemed to be collateral or a settlement payment. If the variation margin is considered a settlement payment, the balance sheet offsetting rules are not applicable because variation margin payments (receipts) do not qualify to be reported as separate deposit assets and liability balances. In this instance, the derivative contract and variation margin are considered a single unit of account for balance sheet presentation because the payment is legally a settlement of a portion of an outstanding contract.

Question FSP 19-2

Futures exchanges require an initial margin deposit and maintenance of the margin as long as the contract is open. If the initial margin is in cash, should it be classified as part of the carrying amount of an item that is being hedged, or may it be netted against the derivative?

PwC response

The initial margin represents a current receivable from the broker and should not be included as part of the carrying amount of the hedged item.

However, initial margin may be netted against the fair value of the derivative if the requirements for netting of derivatives are met.

19.3.3 Presentation of hybrid financial instruments

A hybrid financial instrument includes a host contract and embedded features that may or may not need to be separately accounted for.

19.3.3.1 Presentation of embedded derivatives

ASC 815 requires reporting entities that have hybrid financial instruments with embedded derivative features meeting certain criteria to separately account for the embedded derivative feature and the host contract (see DH 4). Although this requires separate accounting, we do not believe this requires separate financial statement presentation.

For purposes of balance sheet presentation, we believe the embedded feature and host contract may be presented on a combined basis because the combined presentation is reflective of the overall cash flows for that instrument. However, when the host contract would be presented in equity or mezzanine equity, we generally believe the host contract and embedded derivative feature should be presented separately.

19.3.3.2 Hybrid financial instruments at fair value

A reporting entity may elect to measure a hybrid financial instrument that would otherwise be required to be separated and accounted for as a host contract and a separated derivative at fair value under a fair value option. An entity may also be required to measure a hybrid instrument at fair value when it cannot reliably identify and measure an embedded derivative that would otherwise need to be separated.

ASC 815-15-45-1 and ASC 825-10-45 each require these instruments to be presented on the balance sheet separate from assets and liabilities that are not measured at fair value. A reporting entity may (1) present separate line items for the fair value and non-fair value amounts or (2) present an aggregate amount and parenthetically disclose the amount at fair value included within the aggregate amount.

19.3.4 *Basis adjustments for portfolio layer method hedges*

This chapter assumes adoption of ASU 2022-01. There are specific balance sheet presentation requirements when entering into portfolio layer method hedges. For discussion of portfolio layer method hedges, refer to DH 6.5. As discussed in DH 6.5.3, basis adjustments for active portfolio layer method hedges are not allocated to the individual assets but are instead maintained against a closed portfolio of assets. In other fair value hedges, the basis adjustment is recorded at the individual asset or liability being hedged and becomes part of each individual asset's amortized cost basis and must be taken into account when accounting for that individual asset, such as when determining a CECL allowance.

For portfolio layer method hedges, even though the basis adjustments are not allocated to individual assets, the basis adjustment is maintained on the closed portfolio of assets and therefore adjusts the carrying amount of the balance sheet line item in which the closed portfolio of assets is presented. If the closed portfolio of assets are available-for-sale debt securities, the basis adjustment will adjust the amount recorded in accumulated other comprehensive income, but will not adjust the fair value of the available for sale securities. If the assets included in the closed portfolio are presented in different balance sheet line items, the total basis adjustment should be allocated to the different financial statement lines in a systematic and rational method.

19.4 *Income statement presentation*

All derivatives should be recognized on the balance sheet at fair value unless the private company simplified approach (discussed in DH 11) is used.

19.4.1 *Presentation of fair value and cash flow hedges*

ASC 815 requires the change in the fair value of a derivative designated in a fair value or cash flow hedge to be presented in the same income statement line item as the hedged item. The change in fair value includes the gain or loss on the derivative included in the effectiveness assessment and any amount related to excluded components that are recognized in income.

Splitting gains and losses into more than one income statement line item is generally not appropriate unless the hedged item or hedged risk(s) impacts multiple line items. It is also generally not appropriate to "recycle" - report changes in fair value in one income statement line item in one period and then reclassifying the gains and losses into another line item in a later period when the derivative is settled in cash.

When the hedged item is a forecasted sale, and the earnings effect of the hedged item would be recorded in the revenue line item under ASC 606, *Revenue from Contracts with Customers*, the derivative gain or loss should be included in the same line item to comply with ASC 815. However, to comply with ASC 606, we believe that presentation should be accompanied by disclosure of the amount of revenue from contracts with customers. In addition, there should be disclosure of the derivative gains and losses included in each financial statement line item in accordance with the hedging disclosure requirements (see FSP 19.5.4).

If the hedging instrument offsets changes in fair value or cash flows that are reported in more than one income statement line item, the changes in fair value of the hedging instrument should be split among the line items that include the earnings effect of the hedged item. For example, a reporting entity may

have a highly effective hedge of the currency risk of interest and principal cash flows of a debt instrument denominated in a foreign currency. In this case, the hedged risk (foreign currency) may impact multiple line items (interest and foreign currency gains and losses). As a result, the changes in fair value of the hedging instrument that relate to the interest cash flows should be reported through interest expense and the changes in fair value that relate to principal cash flows should be recorded in the same line item as the foreign currency gains or losses related to the spot remeasurement of the debt.

See ASC 815-20-55-79W through ASC 815-20-55-79-AD for additional examples of income statement presentation.

19.4.2 Presentation of forecasted transactions

For cash flow hedges in which the forecasted transaction is probable of not occurring, ASC 815 does not provide guidance on the income statement presentation of amounts reclassified from accumulated other comprehensive income (AOCI) to earnings.

19.4.3 Presentation of net investment hedges

For qualifying net investment hedges, reporting entities are required to present amounts reclassified from AOCI to earnings in the same income statement line item that is used to present the earnings effect of the hedged net investment (e.g., gain on sale of subsidiary).

As for fair value and cash flow hedges, splitting gains and losses into more than one income statement line item or "recycling" the gains and losses by recognizing them in different line items in different periods is generally not appropriate for net investment hedges.

ASC 815 does not prescribe how to present excluded components in net investment hedges.

19.4.4 Presentation of derivatives not in hedges

ASC 815 does not provide specific guidance on the income statement presentation of gains and losses of derivatives that are not designated in a hedging relationship. Reporting entities may use derivatives for risk management purposes, but not designate them as hedges under the accounting literature. Some view these derivatives as "economic hedges" and believe they should follow similar income statement presentation as derivatives used in qualifying accounting hedges.

We believe a reporting entity may make a policy election regarding the income statement classification of derivatives that are economic hedges. A reporting entity may either report the fair value fluctuations associated with the derivative (1) in the same line as the hedged item or (2) in another reasonable income statement line item. For example, assume a reporting entity earns revenue in a currency other than its functional currency and executes a foreign currency derivative to hedge that exposure. Although it represents an economic hedge, the reporting entity chooses not to designate this derivative as a hedge under ASC 815. The reporting entity may elect to either report the changes in fair value associated with the derivative in the revenue line or in the income statement with other derivatives not designated in hedging relationships. We believe either is acceptable as long as the policy decision is reasonable, applied consistently, and disclosed.

Splitting gains and losses into more than one income statement line item or "recycling" the gains and losses by recognizing them in different line items in different periods is generally not appropriate.

Question FSP 19-3

Reporting entities may issue warrants that are classified as liabilities and recognized at fair value through net income. The terms of these warrants may entitle the holder to dividend payments when dividends are paid to common stockholders.

How should the issuer classify the dividend-equivalent payments to the warrant holder in its income statement?

PwC response

The warrant holder's right to dividend-equivalent distributions impacts the fair value of the warrant and should be included in determining the change in fair value of the warrant, which is recorded through the income statement. The payment in cash for the actual dividend reduces the recorded amount of the warrant on the balance sheet, representing a partial settlement of the warrant liability and therefore does not impact the income statement. Recognizing settlement payments in one income statement line with an offsetting change in fair value in another income statement line is generally not appropriate.

Question FSP 19-4

A reporting entity has two derivatives. The first, an interest rate swap, economically hedges the reporting entity's exposure to the variability in cash flows of a specific floating-rate asset. The second derivative, an interest rate cap, economically hedges the reporting entity's exposure to the variability in cash flows on a specific floating-rate liability should interest rates rise above a certain level.

The reporting entity did not apply hedge accounting under ASC 815. Because hedge accounting was not applied, these derivatives have been recorded at fair value on the balance sheet with changes in fair value recorded in current-period net income.

How should the gains and losses on the two derivatives be presented in the reporting entity's income statement?

PwC response

We believe the gain/loss can be presented in the same income statement line item as the economically hedged item or in a separate line item, such as "other income/expense." If the reporting entity took the former approach, the gains or losses on the two derivatives would be reported in different line items of the income statement. Gains or losses on the swap would be recognized in the "interest income" line item, while the gains or losses on the cap would be recognized in the "interest expense" line item. If the reporting entity took the latter approach, it would recognize the gains or losses on both derivatives in the "other income/expense" line of the income statement.

Whichever approach the reporting entity selects should be applied consistently. In addition, when derivatives are used as economic hedges of assets or liabilities, the reporting entity should disclose the purpose of the derivative activity and its accounting policy for the derivatives, including where the gains or losses are presented in the income statement and the amounts for each period.

19.4.5 *Presentation by investment companies*

The accounting guidance does not define "unrealized" or "realized" for the purposes of income statement presentation. An investment company may elect an accounting policy to present changes in the fair value of a centrally-cleared derivative (including futures) in which variation margin payments are considered settlements as an unrealized or realized gain or loss. Investment companies must apply this policy decision consistently. However, investment companies should ensure that their disclosures are transparent with respect to how derivatives are presented in the financial statements.

19.5 Disclosure

The disclosure guidance in ASC 815 applies to all interim and annual reporting periods for which a balance sheet (for balance sheet related disclosures) and income statement (for income statement related disclosures) are presented.

If information on derivatives (or nonderivative instruments that qualify and are designated as hedging instruments) is disclosed in more than one footnote, the reporting entity should cross-reference the derivative footnote to any other applicable footnotes.

Figure FSP 19-1 provides a mapping of some of the disclosure requirements in the authoritative guidance to the relevant sections in the guide.

Figure FSP 19-1
Disclosures

Disclosure requirement	Codification references	Guide reference
Objectives of derivatives and qualitative disclosures	815-10-50-1 and 50-1A 815-10-50-2 and 50-4 815-10-50-4I 815-10-50-5 and 50-5A	FSP 19.5.1
Accounting policy disclosures	235-10-50-1 815-10-50-4EEEE 815-10-50-7 and 50-9 Regulation S-X 4-08(n)	FSP 19.5.2
Volume of derivative activity	815-10-50-1B	FSP 19.5.3
Quantitative tables of balance sheet and income statement amounts	815-10-50-4A 815-10-50-4B 815-10-50-4E	FSP 19.5.4
- Fair value hedges	815-10-50-4C 815-10-50-4D 815-10-50-4EE and 4EEE	FSP 19.5.4.1 FSP 19.5.4.2 FSP 19.5.4.4
- Cash flow hedges	815-10-50-4C 815-10-50-4D 815-30-50-1 through 50-6	FSP 19.5.4.3FSP 19.5.4.4

Disclosure requirement	Codification references	Guide reference
- Net investment hedges	815-10-50-4CCC 815-10-50-4D	FSP 19.5.4.5
- Derivatives not designated in hedging relationships	815-10-50-4CC 815-10-50-4D 815-10-50-4F	FSP 19.5.4.6
Credit-risk-related contingent features	815-10-50-4H	FSP 19.5.5
Credit derivatives	815-10-50-4J through 50-4L	FSP 19.5.6
Offsetting of derivatives	815-10-50-7A and 50-8 210-20	FSP 19.5.7
Private company simplified approach	815-10-50-3	DH 11.2
Hybrid financial instruments measured at fair value	815-15-50-1 and 50-2	FSP 19.5.9
Embedded conversion options	815-15-50-3	FSP 19.5.10

19.5.1 *Disclosure objectives*

ASC 815-10-50-1 provides three primary disclosure objectives for a reporting entity's activity in derivative and nonderivative instruments that are designated and qualify as hedging instruments. Those objectives are to disclose information to help financial statement users understand:

- How and why a reporting entity uses derivatives
- How derivatives and related hedging items are accounted for
- How derivatives and related hedging activities affect a reporting entity's financial position, financial performance, and cash flows

In addition, as described in ASC 815-10-50-1A, a reporting entity that holds or issues derivatives (or nonderivative instruments that are designated and qualify as hedging instruments) should describe in the footnotes the objective, context, and strategies for issuing or holding derivatives. It also requires reporting entities to disclose information that enables users to understand the volume of activity of those instruments, as discussed in FSP 19.5.3. The purpose of these disclosures is to enhance the overall transparency of a reporting entity's derivative activity by helping stakeholders understand how and why a reporting entity uses derivatives and evaluate the success of those activities, their importance to the reporting entity, and their effect on the financial statements.

As discussed in ASC 815-10-50-2, 50-5, and 50-5A, the qualitative disclosures may be more meaningful if described in the context of a reporting entity's overall risk-management profile. The quantitative disclosures may be more meaningful if similar information is disclosed about other financial instruments or nonfinancial assets and liabilities to which the derivatives are related by activity. The reporting entity should clearly delineate objectives and strategies for derivatives used for

risk management purposes and those used for other purposes (at a minimum based on the instruments' primary underlying risk exposure, such as interest rate risk or credit risk).

The reporting entity should also state:

- The accounting designations of derivative instruments (e.g., cash flow hedging, fair value hedging, and net investment hedging relationships)

- Information by type of risk being hedged (e.g., interest rate, commodity price risk, foreign currency)

When hedge accounting is material, we believe a reporting entity should include disclosures that describe the specific methodology used to test hedge effectiveness for each type of hedge (other than economic hedges).

19.5.2 Accounting policy disclosures

ASC 235, *Notes to Financial Statements*, requires reporting entities to disclose significant accounting policies. Disclosures of accounting policies specifically required by ASC 815 include the following.

- ASC 815-10-50-4EEEE requires disclosure of the election to record changes in fair value of excluded components in current period earnings (as further discussed in DH 6.3.1.2 and DH 7.2.1.3), as opposed to amortizing the excluded components using a systematic and rational method. While the guidance is specific to fair value and cash flow hedges, we believe a similar disclosure should be made for net investment hedges.

- ASC 815-10-50-7 requires disclosure of the reporting entity's accounting policy to offset or not to offset in accordance with ASC 815-10-45-6.

- ASC 815-10-50-9 requires disclosure of the reporting entity's accounting policy for the premium paid to acquire options (that do not meet the definition of a derivative) classified as held to maturity or available for sale.

We also believe reporting entities should disclose their accounting policies if significant regarding:

- Income statement presentation of economic hedges (see FSP 19.4.4)

- Income statement presentation of gains and losses on excluded components in net investment hedges (see FSP 19.4.3)

- Balance sheet classification of derivatives (see FSP 19.3.1)

- Statement of cash flows treatment of derivatives (see FSP 6.7.1.5 and FSP 6.7.2.9)

Regulation S-X 4-08(n) prescribes minimum required disclosures for SEC registrants, when material, if they are not already disclosed under GAAP.

Regulation S-X 4-08(n)

Accounting policies for certain derivative instruments

Disclosures regarding accounting policies shall include descriptions of the accounting policies used for derivative financial instruments and derivative commodity instruments, and the methods of applying those policies that materially affect the determination of financial position, cash flows or results of operation. This description shall include, to the extent material, each of the following items:

1. A discussion of each method used to account for derivative financial instruments and derivative commodity instruments;

2. The types of derivative financial instruments and derivative commodity instruments accounted for under each method;

3. The criteria required to be met for each accounting method used, including a discussion of the criteria required to be met for hedge or deferral accounting and accrual or settlement accounting (e.g., whether and how risk reduction, correlation, designation, and effectiveness tests are applied);

4. The accounting method used if the criteria specified in paragraph (n)(3) of this section are not met;

5. The method used to account for terminations of derivatives designated as hedges or derivatives used to affect directly or indirectly the terms, fair values, or cash flows of a designated item;

6. The method used to account for derivatives when the designated item matures, is sold, is extinguished, or is terminated. In addition, the method used to account for derivatives designated to an anticipated transaction, when the anticipated transaction is no longer likely to occur; and

7. Where and when derivative financial instruments and derivative commodity instruments, and their related gains and losses, are reported in the statements of financial position, cash flows, and results of operations.

19.5.3 Volume of derivative activity

ASC 815-10-50-1A(d) requires disclosure about the volume of derivative activity. The format and specifics of these disclosures should be what is most relevant and practicable for the reporting entity's individual facts and circumstances. This might include the total notional amount of interest rate derivatives outstanding during a period, described and segregated in a meaningful way to allow a user to understand the gross or net financial implications.

This disclosure should include other directional information about the reporting entity's derivative positions (e.g., distinguishing receive-fixed interest rate swaps from pay-fixed interest rate swaps) in the context of each instrument's primary underlying risk exposure (for example, interest rate, credit, foreign exchange rate, interest rate and foreign exchange rate, or overall price).

19.5.4 Tabular disclosures

ASC 815-10-50-4A requires certain disclosures related to derivatives and hedging on the balance sheet and in the income statement (and in other comprehensive income) in a tabular format.

ASC 815-10-50-4A

An entity that holds or issues derivative instruments (and nonderivative instruments that are designated and qualify as hedging instruments pursuant to paragraphs 815-20-25-58 [fair value hedge of foreign currency risk] and 815-20-25-66 [net investment hedge]) shall disclose all of the following for every annual and interim reporting period for which a statement of financial position and statement of financial performance are presented:

a. The location and fair value amounts of derivative instruments (and such nonderivative instruments) reported in the statement of financial position

b. The location and amount of the gains and losses on derivative instruments (and such nonderivative instruments) and related hedged items reported in any of the following:

   1. The statement of financial performance.

   2. The statement of financial position (for example, gains and losses initially recognized in other comprehensive income).

c. The total amount of each income and expense line item presented in the statement of financial performance in which the results of fair value or cash flow hedges are recorded.

The FASB decided to prescribe a tabular format as it believed that using tables would improve the transparency of the disclosure and would help financial statement users understand the effects of derivatives on a reporting entity's balance sheet, income statement, statement of comprehensive income, and statement of cash flows. See ASC 815-10-55-181 and ASC 815-10-55-182 for example disclosures.

The fair values of the derivatives included in the tabular disclosure should be prepared using gross fair value amounts, even though their presentation in the balance sheet may be affected by applicable master netting arrangements and credit support arrangements with collateral not deemed a settlement (as discussed in FSP 19.3.2). Also, cash collateral payables and receivables associated with those instruments should not be added to or netted against the fair value amounts. The disclosure requirements for reporting entities that elect to net derivatives in the balance sheet are discussed in FSP 19.5.7.

Because ASC 815 requires the tabular disclosure to be prepared on a gross basis that disregards the effect of netting arrangements and collateral positions not deemed settlements, it is possible that individual amounts included in the disclosure will not agree with the amounts presented in the balance sheet. The FASB accepted this potential inconsistency because disclosing information on a net basis could provide misleading information about the types of risks being managed with derivatives.

A reporting entity that has multiple derivatives with a single counterparty subject to a master netting arrangement may incorporate certain risks (e.g., nonperformance risk) into its valuation of the

derivatives at the portfolio level. A reasonable allocation of those portfolio level adjustments may be necessary for purposes of preparing the contract-level tabular disclosures.

ASC 815-10-50-4D requires segregation by type of hedge and by major type of instrument: interest rate contracts, foreign exchange contracts, equity contracts, commodity contracts, credit contracts, other contracts. In addition, ASC 815-10-50-4B(c) requires derivative assets and liabilities should be segregated between those that are designated and qualifying as hedging instruments (FSP 19.5.4.1 through FSP 19.5.4.5) and those that are not (FSP 19.5.4.6). When segregating derivative assets and liabilities, a reporting entity should consider the classification within the classified balance sheet (i.e., current versus noncurrent). Also, if a proportion of a derivative is designated in a qualifying hedging relationship and a proportion is not designated, ASC 815-10-50-4E indicates that the reporting entity should allocate the related amounts to the appropriate categories in the disclosure tables.

Although not required by ASC 815, reporting entities may wish to enhance these tabular disclosures by including a reconciliation of the amounts in the table to the amounts in the balance sheet.

19.5.4.1 *Balance sheet information-fair value hedges*

ASC 815-10-50-4EE requires disclosure of balance-sheet-related information in tabular format for fair value hedges.

ASC 815-10-50-4EE

An entity shall disclose in tabular format the following for items designated and qualifying as hedged items in fair value hedges:

a. The carrying amount of hedged assets and liabilities recognized in the statement of financial position. For an available for sale debt security, the amount disclosed is the amortized cost basis.

b. The cumulative amount of fair value hedging adjustments to hedged assets and liabilities included in the carrying amount of the hedged assets and liabilities recognized in the statement of financial position

c. The line item in the statement of financial position that includes the hedged assets and liabilities

d. The cumulative amount of fair value hedging adjustments remaining for any hedged assets and liabilities for which hedge accounting has been discontinued.

The disclosures required by (b) and (d) shall exclude cumulative basis adjustments related to foreign exchange risk.

Example 20 in ASC 815-10-55-181 illustrates through footnote (a) that portfolio layer method hedges (discussed in DH 6.5) are included in the total amounts in this disclosure as well as broken out separately in disclosures required by ASC 815-10-50-4EEE.

Carrying amount (ASC 815-10-50-4EE(a))

ASC 815-10-50-4EE(a) includes the total carrying amount (inclusive of basis adjustments) of all active fair value hedged items and discontinued fair value hedged items on which a basis adjustment still remains. Although 50-4EE(a) is for “designated and qualifying [hedges], because ASC 815-10-50-

4EE(d) requires disclosure of the basis adjustment on discontinued hedges, we believe the carrying amount disclosure should include them as well.

For nonderivative instruments that are designated and qualify as hedging instruments of foreign currency risk under ASC 815-20-25-58, the carrying value of the instrument should be included in the tabular disclosure, inclusive of any foreign currency transaction gain or loss on the instrument.

If a proportion of an asset or liability is hedged (e.g., 50% of a debt instrument), we believe the carrying amount should be that proportion of the total carrying amount. This would require allocating components of amortized cost. While ASC 815 does not explicitly discuss allocation of portions of hedged items, 50-4EE(a) indicates that the carrying amount disclosed should relate to hedged assets/liabilities, and therefore should exclude any portion of the asset/liability not hedged, similar to the concept in ASC 815-10-50-4E (discussed in FSP 19.5.4) that explicitly references including a proportion of the hedging derivative.

For portfolio layer method hedges, the carrying value included in this disclosure is the amortized cost basis of the entire closed portfolio (or portfolios). This is not the same as the general principle that the carrying value disclosure only includes the proportion of the asset or liability hedged because in portfolio layer method hedges, the reporting entity will not know which assets will comprise the last layer(s).

When an available-for-sale debt security is hedged, the carrying amount per the ASC 815-10-50-4EE(a) disclosure is its amortized cost basis (inclusive of the basis adjustment), not its fair value.

Cumulative basis adjustments on all hedges (ASC 815-10-50-4EE(b))

This disclosure includes the cumulative basis adjustments (that do not impact cash flows – see below) made to the carrying values of hedged items in active hedges and hedges that have been discontinued on which a basis adjustment remains. (The basis adjustment on discontinued hedges is separately disclosed in ASC 815-10-50-4EE(d).)

Example FSP 19-3 illustrates disclosure of basis adjustments on a fair value hedging relationship that is dedesignated and redesignated.

EXAMPLE FSP 19-3

Disclosure of basis adjustments in active and discontinued hedges

DH Corp has dedesignated and redesignated a fair value hedge of interest rate risk in a single bond.

	Par amount	**Cumulative basis adjustment**
Total	$1,000	$100
Hedged since inception	$250	$30
Hedged since inception, dedesignated 2 years ago and redesignated in prior year	$600	$70 ($50 from original, $20 from current hedge)
Never hedged	$150	N/A

For the purposes of this example, the difference between the par amount of the instrument and its carrying amount is due to basis adjustments associated with fair value hedges.

What would DH Corp disclose as cumulative basis adjustments on active and discontinued hedges?

Analysis

DH Corp would disclose the following.

Disclosure requirement	Description	Amount
815-10-50-4EE(a)	Carrying amount of hedged assets and liabilities recognized on the balance sheet	$950 (250+600+100)
815-10-50-4EE(b)	Cumulative amount of fair value hedging adjustments to hedged assets and liabilities included in the carrying amount of the hedged assets and liabilities recognized on the balance sheet	$100 (30+70)
815-10-50-4EE(d)	Cumulative basis adjustments on discontinued hedges	$50

Basis adjustments that do not affect future cash flows

The basis adjustment disclosure only includes basis adjustments that do not affect future cash flows on the hedged item. As a result, basis adjustments from fair value hedges of foreign exchange risk would not be included while basis adjustments due to fair value hedges of interest rate risk would be included. However, the carrying amount of the hedged items in fair value hedges of foreign exchange risk would be included in the disclosure in ASC 815-10-50-4EE(a).

We believe reporting entities should split the basis adjustment in hedges of both interest rate and foreign currency risk into the parts that adjusted the carrying value due to (1) the interest rate risk hedge and (2) the foreign currency risk hedge. One way to do that is to subtract from the total basis adjustment what ASC 830 would adjust for without hedge accounting (i.e., only include in the disclosure the "cumulative amount of [true] fair value hedging adjustments").

Cumulative basis adjustments on discontinued hedges (ASC 815-10-50-4EE(d))

This disclosure includes the cumulative basis adjustments made to the carrying values of hedged items in hedges that have been discontinued on which a basis adjustment remains. (The total basis adjustment on is disclosed in ASC 815-10-50-4EE(b).)

Consistent with the basis adjustment disclosure for active hedges, basis adjustments on discontinued fair value hedges of foreign exchange risk would not be included while basis adjustments on discontinued fair value hedges of interest rate risk would be.

Similar to active hedges, for discontinued hedges of both interest rate and foreign currency risk, we believe reporting entities should split the basis adjustment into the parts that adjusted the carrying value due to (1) the interest rate risk hedge and (2) the foreign currency risk hedge. One way to do that is to subtract from the total basis adjustment what ASC 830 would adjust for without hedge accounting (i.e., only include in the disclosure the "cumulative amount of [true] fair value hedging adjustments").

19.5.4.2 Balance sheet information—portfolio layer method hedges

This chapter assumes adoption of ASU 2022-01. Additional disclosures are required by ASC 815-10-50-4EEE for fair value hedging relationships designated under the portfolio layer method approach. Consistent with the disclosures in ASC 815-10-50-4EE for all fair value hedges, we believe this disclosure should include all active and discontinued portfolio layer method hedges.

This disclosure need not be in tabular format. In Example 20 in ASC 815-10-55-181, the information is in a footnote to the table.

ASC 815-10-50-4EEE

For each line item disclosed in accordance with paragraph 815-10-50-4EE(c) that includes hedging relationships designated under the portfolio layer method in accordance with paragraph 815-20-25-12A, the following information shall be disclosed separately:

a. The amortized cost basis of the closed portfolio(s) of financial assets or the beneficial interest(s)

b. The amount that represents the hedged item(s) (that is, the hedged layer or layers)

c. The basis adjustment associated with the hedged item(s) (that is, the hedged layer or layers).

Example 20 (see paragraph 815-10-55-181) illustrates these disclosures.

In addition, ASC 815-10-50-5B states that reporting entities should not disclose the basis adjustment on a more disaggregated level than the closed portfolio level, including when meeting the disclosure requirements of other codification Topics. The only exception to this is if disaggregation is required under ASC 815-20-45-4 because the closed portfolio includes assets that are reported on different line items on the balance sheet. If disclosure requirements pertaining to the underlying assets in the closed portfolio require disclosure of the amortized cost basis on a disaggregated level, reporting entities should exclude the basis adjustment associated with the portfolio layer method hedge from the amortized cost basis of those assets, and separately disclose the total amount of portfolio layer method basis adjustments.

In the event of an actual breach (because the outstanding amounts of the closed portfolio are less than the hedged layer(s)), the corresponding amount of the portfolio layer basis adjustment is required to be recognized in interest income (see DH 10.3.8). ASC 815-10-50-5C requires disclosure of the amount of the hedge basis adjustment that was recognized in earnings in the current period, and the circumstances that led to the breach.

Example FSP 19-4 illustrates the requirements in ASC 815-10-50-4EE(a) and ASC 815-10-50-4EE(b) and ASC 815-10-50-4EEE if the only hedging relationship is a portfolio layer method hedge.

EXAMPLE FSP 19-4

Disclosure of portfolio layer method hedges

Assume DH Corp has one hedging relationship, a portfolio layer method hedge with the following facts.

- The hedged item is a closed portfolio of loans that are reported in a single line item on the balance sheet.
- Carrying amount of entire closed portfolio: $502 ($500 amortized cost basis of the individual loans without considering any basis adjustments + $2 of basis adjustments)
- Hedged balance (portfolio layer method): $100
- Basis adjustment: $2

What disclosures are required under ASC 815-10-50-4EE and ASC 815-20-50-4EEEpertaining to this hedge?

Analysis

DH Corp would disclose the following.

Disclosure requirement	Description	Amount
815-10-50-4EE(a)	Carrying amount of hedged assets and liabilities recognized on the balance sheet	$502
815-10-50-4EE(b)	Cumulative amount of fair value hedging adjustments to hedged assets and liabilities included in the carrying amount of the hedged assets and liabilities recognized on the balance sheet	2
815-10-50-4EEE(a)	Amortized cost basis of the closed portfolio	502
815-10-50-4EEE(b)	Amount that represents the hedged item (the hedged layer)	100
815-10-50-4EEE(c)	Basis adjustment associated with the hedged item (the hedged layer)	2

19.5.4.3 Balance sheet information—cash flow hedges

ASC 815-30-50-1 requires disclosure of balance-sheet-related information for cash flow hedges.

ASC 815-30-50-1

See Section 815-10-50 for overall guidance on disclosures. An entity's disclosures for every annual and interim reporting period for which a statement of financial position and a statement of financial performance is presented shall include all of the following for derivative instruments that have been designated and have qualified as cash flow hedging instruments and for the related hedged transactions:

a. Subparagraph not used

b. A description of the transactions or other events that will result in the reclassification into earnings of gains and losses that are reported in accumulated other comprehensive income

c. The estimated net amount of the existing gains or losses that are reported in accumulated other comprehensive income at the reporting date that is expected to be reclassified into earnings within the next 12 months

d. The maximum length of time over which the entity is hedging its exposure to the variability in future cash flows for forecasted transactions excluding those forecasted transactions related to the payment of variable interest on existing financial instruments

ASC 815-30-50-5 and ASC 815-30-50-6 provide guidance for determining the amount of gains and losses that will be reclassified into net income in the next 12 months for hedging relationships with multiple cash flow exposures that are designated as the hedged item for a single derivative. It indicates that the total amount reported in OCI should first be allocated to each of the forecasted transactions. The allocation method should be consistently applied. The sum of the amounts expected to be reclassified into net income in the next 12 months for each of those items would then be the amount disclosed, which could result in an amount greater than or less than the net amount reported in OCI.

A reporting entity should report, as a separate classification within OCI, (1) the net gain or loss on derivatives designated and qualifying as cash flow hedging instruments that are reported in OCI and (2) the difference between the change in fair value of an excluded component and the initial value of that excluded component recognized in earnings under a systematic and rational method for all hedges, in addition to the disclosure requirements associated with OCI, as described in FSP 4.5.

Reporting entities should also separately disclose a rollforward of the activity for such net gains and losses that are deferred through OCI pursuant to ASC 220, *Comprehensive Income* (as described in ASC 815-30-50-2).

ASC 815-30-50-2

As part of the disclosures of accumulated other comprehensive income, pursuant to paragraphs 220-10-45-14 through 45-14A, an entity shall separately disclose all of the following:

a. The beginning and ending accumulated derivative instrument gain or loss

b. The related net change associated with current period hedging transactions

c. The net amount of any reclassification into earnings

d. The difference between the change in fair value of an excluded component and the initial value of that excluded component recognized in earnings under a systematic and rational method in accordance with paragraph 815-20-25-83A.

See an example of an OCI rollforward in Example 12 in ASC 815-30-55-77 through ASC 815-30-55-80. Additionally, while ASC 815-30-50-2(b) only requires the net change associated with current period hedging activity, reporting entities may wish to enhance these disclosures by providing this information by type of derivative contract.

19.5.4.4 Gains/losses—fair value and cash flow hedges

ASC 815-10-50-4C includes the tabular disclosure requirements for income statement and comprehensive income information pertaining to derivative and nonderivative instruments designated and qualifying as fair value and cash flow hedges. The required disclosures include the location and amount of gains and losses on both the hedging instrument and hedged item (as indicated by the reference to ASC 815-10-50-4A), when applicable, by type of contract (interest rate contracts, foreign exchange contracts, commodity contracts, credit contracts, other contracts) and by income and expense line item when applicable.

ASC 815-10-50-4C

For qualifying fair value and cash flow hedges, the gains and losses disclosed pursuant to paragraph 815-10-50-4A(b) shall be presented separately for all of the following by type of contract (as discussed in paragraph 815-10-50-4D) and by income and expense line item (if applicable):

a. Derivative instruments (and nonderivative instruments) designated and qualifying as hedging instruments in fair value hedges and related hedged items designated and qualifying in fair value hedges.

b. The gains and losses on derivative instruments designated and qualifying in cash flow hedges included in the assessment of effectiveness that were recognized in other comprehensive income during the current period.

bb. Amounts excluded from the assessment of effectiveness that were recognized in other comprehensive income during the period for which an amortization approach is applied in accordance with paragraph 815-20-25-83A.

c. The gains and losses on derivative instruments designated and qualifying in cash flow hedges that are included in the assessment of effectiveness and recorded in accumulated other comprehensive income during the term of the hedging relationship and reclassified into earnings during the current period.

d. The portion of gains and losses on derivative instruments designated and qualifying in fair value and cash flow hedges representing the amount, if any, excluded from the assessment of hedge effectiveness that is recognized in earnings. When disclosing this amount, an entity shall disclose separately amounts that are recognized in earnings through an amortization approach in

accordance with paragraph 815-20-25-83A and amounts recognized through changes in fair value in earnings in accordance with paragraph 815-20-25-83B.

e. Subparagraph superseded by Accounting Standards Update No. 2017-12

f. The gains and losses reclassified into earnings as a result of the discontinuance of cash flow hedges because it is probable that the original forecasted transactions will not occur by the end of the originally specified time period or within the additional period of time discussed in paragraphs 815-30-40-4 through 40-5.

g. The amount of net gain or loss recognized in earnings when a hedged firm commitment no longer qualifies as a fair value hedge.

Fair value hedges

Consistent with the balance sheet disclosures, we believe the income statement and comprehensive income disclosure should include all active fair value hedges and discontinued fair value hedges that still impact the income statement (through amortization of remaining basis adjustments).

It should include all income statement (and OCI) impacts from fair value hedges by line item:

- Change in fair value of the derivative or nonderivative (ASC 815-10-50-4A(b) and ASC 815-10-50-4C(a))
- Change in fair value of the hedged item (or change due to the hedged risk) (ASC 815-10-50-40A(b))
- Accruals on the hedged item and hedging derivative or nonderivative (ASC 815-10-50-4A(b) and ASC 815-10-50-4C(a))
- Amortization of basis adjustments (ASC 815-10-50-4A(b) and ASC 815-10-50-4C(a))
    - All basis adjustments should be included. For active hedges, basis adjustments and amortization may be recorded together (i.e., the “FAS 138” method includes amortization) or separately (i.e., the “FAS 120(c)” method with separate amortization elected).
- Excluded components deferred through OCI using an amortization approach (ASC 815-10-50-4C(bb))
- Mark-to-market and amortization of excluded components in earnings, presented separately (ASC 815-10-50-4C(d))
- The amount of basis adjustment recognized in interest income due to an actual breach occurring on a portfolio layer method hedge and the circumstances that led to the breach (ASC 815-10-50-5C).

Cash flow hedges

Consistent with the balance sheet disclosures, we believe the income statement and comprehensive income disclosure includes all active cash flow hedges and discontinued cash flow hedges that still impact OCI or the income statement.

It should include all income statement (and OCI) impacts from cash flow hedges by line item:

- Change in fair value of the derivative deferred through OCI, including accruals (ASC 815-10-50-4A and ASC 815-10-50-4C(b))
- Accruals on the hedged transaction (ASC 815-10-50-4A and ASC 815-10-50-4C(b))
- Excluded components deferred through OCI using an amortization approach (ASC 815-10-50-4C(bb))
- Reclasses of gains/losses on derivatives from AOCI to earnings (ASC 815-10-50-4C(c))
- Mark-to-market and amortization of excluded components in earnings, presented separately (ASC 815-10-50-4C(d))
- Reclassifications of amounts in AOCI into earnings for discontinued hedges when the forecasted transaction is probable of not occurring (ASC 815-10-50-4C(f))

19.5.4.5 Gains/losses—net investment hedges

ASC 815-10-50-4CCC prescribes tabular disclosure of all of the following for derivative and nonderivative instruments designated and qualifying as net investment hedges by type of contract.

ASC 815-10-50-4CCC

For qualifying net investment hedges, an entity shall present the gains and losses disclosed in accordance with paragraph 815-10-50-4A(b) separately for all of the following by type of contract (as discussed in paragraph 815-10-50-4D):

a. The gains and losses on derivative instruments (and nonderivative instruments) designated and qualifying in net investment hedges that were recognized in the cumulative translation adjustment section of other comprehensive income during the current period

b. The gains and losses on derivative instruments (and nonderivative instruments) designated and qualifying in net investment hedges recorded in the cumulative translation adjustment section of accumulated other comprehensive income during the term of the hedging relationship and reclassified into earnings during the current period

c. The portion of gains and losses on derivative instruments (and nonderivative instruments) designated and qualifying in net investment hedges representing the amount, if any, excluded from the assessment of hedge effectiveness.

Also, ASC 815-10-50-4A requires disclosure of the location and amount of gains and losses on both the hedging instrument and hedged item, when applicable, by type of contract and by income and expense

line item when applicable. (ASC 815-10-50-4D(b) also requires disclosure of the line item in the income statement where gains and losses on net investment hedges are included.) Further, consistent with the requirement to disclose the location of gains and losses on hedging in the income statement in ASC 815-10-50-4A, reporting entities should also disclose the location in the income statement of the excluded components in net investment hedges recognized in income in the period.

19.5.4.6 Non-qualifying or non-designated derivatives

In accordance with ASC 815-10-50-4CC, a reporting entity should separately disclose by type of contract the amount of gains and losses related to derivatives not qualifying or designated as hedging instruments and the income statement line item in which they are included in a tabular format.

A reporting entity may elect a policy to include certain derivatives in its trading activities. The reporting entity's trading portfolio may include derivatives and cash instruments. In this situation, ASC 815-10-50-4F permits the reporting entity to not separately disclose gains and losses relating to these activities.

ASC 815-10-50-4F

For derivative instruments that are not designated or qualifying as hedging instruments under Subtopic 815-20, if an entity's policy is to include those derivative instruments in its trading activities (for example, as part of its trading portfolio that includes both derivative instruments and nonderivative or cash instruments), the entity can elect to not separately disclose gains and losses as required by paragraph 815-10-50-4CC provided that the entity discloses all of the following:

a. The gains and losses on its trading activities (including both derivative instruments and nonderivative instruments) recognized in the statement of financial performance, separately by major types of items, for example:

    1. Fixed income/interest rates

    2. Foreign exchange

    3. Equity

    4. Commodity

    5. Credit.

b. The line items in the statement of financial performance in which trading activities gains and losses are included

c. A description of the nature of its trading activities and related risks, and how the entity manages those risks.

If the disclosure option in this paragraph is elected, the entity shall include a footnote in the required tables referencing the use of alternative disclosures for trading activities. Example 21 (see paragraph 815-10-55-182) illustrates a footnote referencing the use of alternative disclosures for trading activities. Example 22 (see paragraph 815-10-55-184) illustrates the disclosure of the information required in items (a) and (b).

The FASB intends these disclosures to assist investors and creditors in understanding a reporting entity's objectives for all of its derivatives. As noted in FSP 19.5.1, when derivatives are used as economic hedges of assets or liabilities, preparers are required to disclose the purpose of the derivative activity. Further, we believe a reporting entity should disclose its accounting policy regarding the presentation of economic hedges, including where the gains or losses are presented in the income statement and the amounts for each period.

19.5.5 Credit-risk-related contingent features

ASC 815-10-50-4H provides the disclosure requirements related to credit-risk-related contingent features.

ASC 815-10-50-4H

An entity that holds or issues derivative instruments (or nonderivative instruments that are designated and qualify as hedging instruments pursuant to paragraphs 815-20-25-58 and 815-20-25-66) shall disclose all of the following for every annual and interim reporting period for which a statement of financial position is presented:

a. The existence and nature of credit-risk-related contingent features

b. The circumstances in which credit-risk-related contingent features could be triggered in derivative instruments (or such nonderivative instruments) that are in a net liability position at the end of the reporting period

c. The aggregate fair value amounts of derivative instruments (or such nonderivative instruments) that contain credit-risk-related contingent features that are in a net liability position at the end of the reporting period

d. The aggregate fair value of assets that are already posted as collateral at the end of the reporting period

e. The aggregate fair value of additional assets that would be required to be posted as collateral if the credit-risk-related contingent features were triggered at the end of the reporting period.

f. The aggregate fair value of assets needed to settle the instrument immediately if the credit-risk-related contingent features were triggered at the end of the reporting period.

Amounts required to be reported for nonderivative instruments that are designated and qualify as hedging instruments pursuant to ASC 815-20-25-58 and ASC 815-20-25-66 shall be the carrying value of the nonderivative hedging instrument, which includes the adjustment for the foreign currency transaction gain or loss on that instrument. Example 23 (see paragraph 815-10-55-185) illustrates a credit-risk-related contingent feature disclosure.

19.5.6 Credit derivatives

The seller or writer of a credit derivative is the party that assumes credit risk, which could be either a guarantor in a guarantee-type contract or any party that provides the credit protection in an option-type contract, a credit default swap, or any other credit derivative. For each balance sheet presented, the seller of credit derivatives (e.g., credit default swaps, credit spread options, credit index products) should disclose the information in ASC 815-10-50-4K for each credit derivative (or each group of

similar credit derivatives) and hybrid instrument that has an embedded credit derivative. These disclosures are required even if the likelihood of the seller having to make payment under the credit derivative is remote.

ASC 815-10-50-4K

A seller of credit derivatives shall disclose information about its credit derivatives and hybrid instruments (for example, a credit-linked note) that have embedded credit derivatives to enable users of financial statements to assess their potential effect on its financial position, financial performance, and cash flows. Specifically, for each statement of financial position presented, the seller of a credit derivative shall disclose all of the following information for each credit derivative, or each group of similar credit derivatives, even if the likelihood of the seller's having to make any payments under the credit derivative is remote:

a. The nature of the credit derivative, including all of the following:

    1. The approximate term of the credit derivative

    2. The reason(s) for entering into the credit derivative

    3. The events or circumstances that would require the seller to perform under the credit derivative

    4. The current status (that is, as of the date of the statement of financial position) of the payment/performance risk of the credit derivative, which could be based on either recently issued external credit ratings or current internal groupings used by the seller to manage its risk

    5. If the entity uses internal groupings for purposes of item (a)(4), how those groupings are determined and used for managing risk.

b. All of the following information about the maximum potential amount of future payments under the credit derivative:

    1. The maximum potential amount of future payments (undiscounted) that the seller could be required to make under the credit derivative, which shall not be reduced by the effect of any amounts that may possibly be recovered under recourse or collateralization provisions in the credit derivative (which are addressed in items (c) through (f))

    2. The fact that the terms of the credit derivative provide for no limitation to the maximum potential future payments under the contract, if applicable

    3. If the seller is unable to develop an estimate of the maximum potential amount of future payments under the credit derivative, the reasons why it cannot estimate the maximum potential amount.

c. The fair value of the credit derivative as of the date of the statement of financial position

d. The nature of any recourse provisions that would enable the seller to recover from third parties any of the amounts paid under the credit derivative

e. The nature of any assets held either as collateral or by third parties that, upon the occurrence of any specified triggering event or condition under the credit derivative, the seller can obtain and liquidate to recover all or a portion of the amounts paid under the credit derivative

f. If estimable, the approximate extent to which the proceeds from liquidation of assets held either as collateral or by third parties would be expected to cover the maximum potential amount of future payments under the credit derivative. In its estimate of potential recoveries, the seller of credit protection shall consider the effect of any purchased credit protection with identical underlying(s).

However, the disclosures required by this paragraph do not apply to an embedded derivative feature related to the transfer of credit risk that is only in the form of subordination of one financial instrument to another, as described in paragraph 815-15-15-9.

We believe the disclosures required by ASC 815-10-50-4K are also applicable to investments classified as trading and investments classified as available-for-sale. Therefore, investors should maintain an inventory of all investments in beneficial interests, including trading securities and those for which the fair value option has been applied. This inventory can be used to determine whether the investors are sellers of credit derivatives as a result of their investment, and thus subject to the disclosure requirements in ASC 815-10-50-4K.

When hybrid instruments have embedded credit derivatives, the seller of the embedded credit derivative should disclose the information for the entire hybrid instrument, not just the embedded feature.

According to ASC 815-10-50-4L, one way to present the information on credit derivatives would be to segregate the disclosures by major types of contract, and then within each type, provide subgroups for the major types of referenced (or underlying) asset classes.

We believe reporting entities should consistently apply a meaningful aggregation methodology for disclosing this information. That will enable financial statement users to understand, at a reasonable level of detail, the amount of credit risk the reporting entity is exposed to due to these instruments.

In certain situations, a reporting entity may engage in other risk management activities that could offset its maximum potential exposure. For example, a reporting entity may manage its risk on a net basis, or its derivatives may be subject to master netting arrangements that it uses to manage exposure to certain risks across multiple types of derivatives. In such instances, we believe reporting entities should consider providing additional disclosure that provides appropriate context for the disclosure of maximum potential future payments.

In traditional credit-linked notes, the repayment of note principal to the investor/credit derivative seller is not required upon default of the referenced obligation. Thus, the investor is exposed to the credit risk of both the issuer and the referenced obligation. Because the seller does not make any physical cash payment under the terms of the embedded credit derivative, questions have arisen as to whether disclosure of the maximum potential amount of future payments is required for credit-linked notes. Given the FASB’s intent to provide users with similar informative disclosures for instruments with similar economic risks, we believe reporting entities should disclose the outstanding principal balance as the maximum amount of future payments, consistent with the economics of the hybrid instrument. That is, if the seller of the credit derivative were to forgo the principal amount due under

the host contract, it may be viewed as "paying" to the insured party the host note principal upon default of the referenced obligation.

The disclosure requirements do not apply to embedded derivative features relating to the transfer of credit risk that are in the form of subordination of one financial instrument to another (i.e., when the subordination scope exception in ASC 815-15-15-9 applies). Therefore, an investor in, or issuer of, beneficial interests in a fully-funded cash vehicle would not be subject to these disclosures if there were no other written credit derivatives present in the vehicle.

19.5.7 Disclosure of offsetting of derivatives

A reporting entity should disclose its policy of entering into master netting arrangements to mitigate the credit risk of financial instruments. It should also disclose information about the arrangements to which the reporting entity is party and a brief description of the terms, including the extent to which they would reduce the reporting entity's maximum amount of loss due to credit risk. Reporting entities should describe the rights of setoff associated with their recognized assets and liabilities that are subject to an enforceable master netting arrangement or similar agreement, including the nature of those rights. Additionally, reporting entities may conclude that other qualitative disclosures are necessary for fulsome disclosure of the use of offsetting.

A reporting entity may make an accounting policy election to offset derivatives, including cash collateral (see FSP 19.3.2.2). The disclosures required in ASC 815-10-50-8 vary depending on the netting election.

ASC 815-10-50-8

A reporting entity shall disclose the amounts recognized at the end of each reporting period for the right to reclaim cash collateral or the obligation to return cash collateral as follows:

a. A reporting entity that has made an accounting policy decision to offset fair value amounts shall separately disclose amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral that have been offset against net derivative positions.

b. A reporting entity shall separately disclose amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral under master netting arrangements that have not been offset against net derivative instrument positions.

c. A reporting entity that has made an accounting policy decision to not offset fair value amounts shall separately disclose the amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral under master netting arrangements.

Refer to FSP 2.4 for general presentation requirements related to balance sheet offsetting and FSP 19.3 for balance sheet presentation requirements specific to derivatives.

In addition to the disclosure requirements in ASC 815, ASC 210-20-50-1 through ASC 210-20-50-6 provides the balance sheet offsetting disclosure requirements for derivatives (including separated embedded derivatives), repurchase agreements, reverse repurchase agreements, securities borrowing, and securities lending transactions.

These disclosures require the presentation of gross and net information about transactions that are (1) offset in the financial statements or (2) subject to an enforceable master netting arrangement or similar agreement, regardless of whether the transactions are actually offset in the balance sheet.

For these types of transactions, reporting entities are required to disclose certain quantitative information in a tabular format, separately for assets and liabilities. The information required includes:

- The gross amounts of those recognized assets and those recognized liabilities
- The amounts offset in accordance with the guidance in ASC 210-20-45 and ASC 815-10-45 to determine the net amounts presented in the balance sheet
- The net amounts presented in the balance sheet
- The amounts subject to an enforceable master netting arrangement or similar agreement not netted on the balance sheet, including:
  - The amounts related to recognized financial instruments and other derivatives when management makes an accounting policy election not to offset, or the amounts do not meet some or all of the guidance in either ASC 210-20-45 or ASC 815-10-45
  - The amounts related to financial collateral (including cash collateral)
- The net amount after deducting the amounts relating to the master netting arrangement from the amounts presented in the balance sheet

All transactions (in all currencies) subject to agreements that legal counsel has determined qualify as master netting arrangements and that are in scope of the disclosure requirements should be included in the tabular offsetting disclosure. Specifically, they should be included in the column “Gross amounts not offset in the statement of financial position” (if they are not offset in the balance sheet).

Figure FSP 19-2 contains an example of the tabular offsetting disclosure.

Figure FSP 19-2

Illustrative tabular disclosure of offsetting

This figure is excerpted from ASC 210-20-55-20 and explained in the sections that follow.

				Gross amounts not offset in the statement of financial position D		
Description	**Gross amounts of recognized assets**	**Gross amounts offset in the statement of financial position**	**Net amounts of assets presented in the statement of financial position**	**Financial instruments collateral**	**Cash collateral received**	**Net amount**
	A	B	C = A – B	Da	Db	F = C - D

19.5.7.1 *Disclosure of collateral*

The balances disclosed in column D may include both cash and financial instrument collateral. However, there are limits to the amounts reported in column D, such as for excess collateral. The guidance includes an example of a repurchase agreement that is accounted for as a collateralized lending whereby the carrying amount of the loan is $90 million and the fair value of the collateral received is $105 million. The example illustrates that the amount of collateral received included in the disclosure is limited to $90 million unless rights to collateral can be enforced across financial instruments. Given the exclusion of overcollateralization, collateral balances disclosed in column D in accordance with this guidance may not agree with other collateral disclosures, or may not provide financial statement users with a full appreciation of the nature of collateral received or posted. Reporting entities may wish to provide information on overcollateralization as a supplement to the required disclosures.

Additionally, the balances disclosed in the financial instrument collateral disclosures may not be included on the balance sheet due to the related recognition guidance for the instrument. Although such collateral is not recognized in the financial statements, it will be captured by the disclosure requirements (as illustrated in Example 1 in ASC 210-20-55-20 and Example 2 in ASC 210-20-55-21).

While not required, reporting entities may further disaggregate the collateral balances disclosed into additional categories, such as on-balance sheet collateral and off-balance sheet collateral. This supplemental disclosure may help financial statement users better understand how the amounts disclosed are reported in the financial statements.

Reporting entities should consider the legal characterization of variation margin through consultation with their legal counsel. Whether it is collateral or a partial settlement payment determines whether the variation is presented and disclosed as part of the derivative or separately as collateral.

19.5.7.2 Level of disaggregation

The guidance allows flexibility with respect to how certain items are disclosed. Reporting entities can choose to disclose items in columns C through F either by type of financial instrument (e.g., derivatives or reverse repurchases) or by counterparty.

ASC 210-20-55-22 provides an offsetting disclosure example for a sophisticated entity (one that engages in “significant derivative activity”). This example disaggregates derivatives by risk (e.g., interest rate, foreign exchange), as discussed in ASC 815-10-50-4D, and instrument type (e.g., swaps, options) and by clearing mechanism (i.e., exchange-traded versus exchange-cleared versus over-the-counter).

There will be judgment involved in determining the level of disaggregation required. We believe the extent of a reporting entity’s derivative activity and its business purpose should be the drivers of this determination, in addition to materiality. For example, a non-financial services reporting entity may engage in material derivative activity for hedging purposes, but the types of derivatives it enters into or the associated clearing mechanism may be relatively narrow in scope (e.g., solely foreign exchange derivative contracts). In contrast, a financial institution that has extensive derivative operations and transacts in multiple types of derivatives using multiple types of clearing mechanisms should consider providing more disaggregated disclosures.

For reporting entities that elect to disaggregate the disclosure by financial instrument type instead of by counterparty, collateral posted by or received from a given counterparty will need to be allocated to the respective financial instruments with that counterparty. While collateral may not be posted on an instrument-by-instrument basis (it may be posted in a pool across instrument types), we believe a reasonable allocation methodology should be utilized to allocate collateral received by instrument type for disclosure purposes. A similar approach may be taken to allocate the netting that is applied on the balance sheet by counterparty (i.e., column B in the disclosure).

The allocation method adopted is a matter of judgment and a variety of methods may be appropriate. Whatever method is adopted, reporting entities should apply it consistently (i.e., in the balance sheet and the disclosure so they reconcile to each other) and consider disclosing the methodology used. Methods of allocation of credit risk in the determination of fair value are discussed in FV 8.2.4.1 and FV 8.2.4.2.

The tabular disclosure of offsetting requires gross and net balances related to transactions that are subject to master netting arrangements, regardless of whether those balances are offset in the balance sheet. If a reporting entity has instruments that meet the scope of the disclosures, but that do not meet the offsetting guidance in ASC 210 or ASC 815, or that management does not elect to offset, the amounts required to be disclosed in column A would equal the amounts required in column C in Figure FSP 19-2.

The amounts disclosed in column C in Figure FSP 19-2 should reconcile to the individual financial statement line item on the balance sheet. To facilitate this reconciliation, reporting entities may elect to include all derivatives, repurchase agreements, and securities lending transactions in the disclosure, regardless of whether the transactions are subject to an enforceable master netting arrangement or similar agreement. Typically, reporting entities separate contracts that are subject to master netting arrangements or similar agreements from ones that are not, but still include them in the disclosure, to facilitate reconciliation to the balance sheet. When a reporting entity elects to include contracts that are not subject to master netting agreements in the disclosures, it should disclose that contracts are included in the disclosure that are not subject to master netting arrangements.

If a reporting entity only includes transactions subject to a master netting arrangement in its disclosure, and the balances in column C in Figure FSP 19-2 correlate to a financial statement line item that includes other balances (e.g., other assets or liabilities not subject to a master netting arrangement), the reporting entity should reconcile the disclosure to the total balance.

19.5.8 Simplified approach for private companies

Disclosure of settlement value is required when a private company uses the simplified approach to hedge accounting. See DH 11.2 and FSP 20.7.3.

19.5.9 Hybrid financial instruments at fair value

FSP 20.6.3 includes disclosures for instruments measured at fair value under the fair value option, including hybrid financial instruments. Further, ASC 815-15-50-2 requires that reporting entities disclose information that allows users to understand the effect of changes in the fair value of these instruments on net income, whether at fair value because of the fair value option or the guidance in ASC 815-15-30-1(b).

19.5.10 Embedded conversion options

When an embedded conversion option previously accounted for as a derivative no longer meets the separation criteria, ASC 815-15-50-3 indicates that a reporting entity should disclose:

- The changes causing the embedded conversion option to no longer require separation as a derivative
- The amount of the conversion option reclassified to stockholder's equity

19.6 Considerations for private companies

Most requirements for reporting and disclosing derivatives are applicable to both public and nonpublic reporting entities. Only one set of requirements, the accounting policy disclosures in Regulation S-X Rule 4-08(n), are not applicable to private companies. However, two of the accounting policy disclosures in Regulation S-X have similar requirements under ASC 815 that are applicable to private companies, as noted in FSP 19.5.2A.

Also, there is one election that simplifies hedge accounting for private companies in certain cases.

19.6.1 Private company alternative — hedge accounting

Private companies that are not financial institutions may elect a hedge accounting alternative (a simplified hedge accounting approach) for certain types of swaps that economically convert a variable-rate borrowing into a fixed-rate borrowing. This simplified approach is available when all six qualifying conditions within ASC 815-20-25-131D are met.

The simplified approach allows a private company to measure a designated swap at settlement value rather than at fair value. The disclosures for fair value measurements required by ASC 820 are still required for amounts disclosed at settlement value. Disclosures related to swaps measured at settlement value should be clearly designated separate from the fair value disclosures. All of the presentation and disclosure requirements of ASC 815 continue to apply. When a private company uses the simplified approach to hedge accounting, disclosure of settlement value is required. See FSP 20 for information on the disclosures for fair value measurements.

Chapter 20: Fair value—updated November 2019

20.1 *Fair value disclosure overview*

This chapter outlines the presentation and disclosure considerations for assets and liabilities measured or disclosed at fair value, for financial instruments not measured at fair value, and for assets and liabilities presented at fair value based on the fair value option.

20.2 *Scope and relevant guidance—updated September 2022*

ASC 820, *Fair Value Measurement* ("ASC 820" or the "fair value standard"), defines fair value and establishes a framework for measuring it. ASC 820 includes disclosure requirements for fair value measurements that are required or permitted by all accounting pronouncements. Requirements related to the presentation of assets and liabilities at fair value are addressed in other US GAAP and are not in the scope of ASC 820.

ASC 820-10-50-1C states that fair value disclosures are required for assets and liabilities measured at fair value. Fair value disclosures are required for fair value measurements after initial recognition (i.e., on "Day 2"), and therefore, are not required for assets and liabilities that are only initially recognized at fair value (e.g., in a business combination, asset retirement obligations under ASC 410, *Asset Retirement and Environmental Obligations*, or exit or disposal cost obligations under ASC 420, *Exit or Disposal Cost Obligations*).

ASC 820-10-50-2 indicates that measurements based on fair value (e.g., fair value less cost to sell) are also subject to the disclosure requirements in ASC 820.

ASC 825, *Financial Instruments*, includes incremental fair value disclosure requirements, including the fair value of financial instruments not measured at fair value for public business entities (see FSP 20.6) and enhanced disclosures for equity securities without readily determinable fair values (see LI 12.6.1).

New guidance

In June 2022, the FASB issued ASU 2022-03*, Fair Value Measurements of Equity Securities Subject to Contractual Sale Restrictions*. ASU 2022-03 clarified that a contractual restriction on the sale of an equity security (for example, an underwriter lock-up agreement) is not considered part of the unit of account of an equity security. As a result, such restriction is not considered in measuring the fair value of the equity security. ASU 2022-03 is effective for public business entities for fiscal years beginning after December 15, 2023, and interim periods within those fiscal years. For all other entities, the guidance is effective for fiscal years beginning after December 15, 2024, and interim periods within those fiscal years. Early adoption is permitted for both interim and annual financial statements that have not yet been issued or made available for issuance (see FSP 20.3.1.3).

ASU 2018-13, *Fair Value Measurement (Topic 820): Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement*, modifies the fair value disclosure requirements based on application of the disclosure framework issued in August 2018. The provisions that removed or amended certain disclosures could be adopted immediately, with retrospective application. This chapter has been updated to remove/amend those disclosures (see FSP 20.3.1, FSP 20.3.2.4, and FSP 20.4).

In some cases, the ASU requires additional disclosures for all public and nonpublic companies for fiscal years, and interim periods within those years, beginning after December 15, 2019. Early adoption of the additions is not required, even if early adoption is elected for the other amendments.

The new disclosure requirements are to be applied prospectively.

20.2.1 *Scope for fair value disclosures*

Various accounting pronouncements govern the reporting of balances at fair value. This section describes the fair value disclosure requirements related to several common balance sheet categories.

20.2.1.1 *Fair value disclosures- investments and cash equivalents*

All equity securities, except those under the “measurement alternative” in ASC 321, *Investments - Equity Securities,* and debt securities classified as trading or available-for-sale and therefore measured at fair value, are subject to the fair value disclosure requirements of ASC 820. Held-to-maturity (HTM) debt securities are carried at amortized cost and, for public business entities, the fair value should be disclosed as discussed ASC 825-10-50-10. This is true even when certain short-term debt and equity securities, such as treasury bills, money market funds, and commercial paper, are classified as cash equivalents. Entities that are not public business entities have no requirement to disclose the fair value of HTM securities.

ASC 825-10-50-1 indicates entities that are not public business entities have no requirement to disclose the fair value of instruments not measured at fair value, such as HTM securities.

When required, the fair values of HTM securities are required to be measured consistent with the provisions of ASC 820.

When applying the “measurement alternative” in ASC 321, whether cash equivalents or not, remeasurement events result in an equity investment being remeasured to fair value in accordance with ASC 820 on the date of the remeasurement event. As such, fair value disclosures for nonrecurring measurements are required. The ASC 820 disclosure requirements are incremental to the disclosures required by ASC 321.

20.2.1.2 *Fair value disclosures-servicing assets and liabilities*

When recorded at fair value at the reporting date, servicing assets and liabilities are subject to the disclosure requirements of ASC 820, in addition to the disclosures required by ASC 860-50-50 (see FSP 22).

20.2.1.3 *Fair value disclosures-hedged items*

For a hedged item that is reported at fair value or has been in a hedging relationship for changes in its overall fair value from inception such that it is essentially measured at its full fair value, we believe it would be appropriate to apply the disclosure requirements of ASC 820-10-50.

For a hedged item reported on a measurement basis other than fair value (in which the change in overall fair value is not the hedged risk), we do not believe the partial measurement of fair value, achieved through the adjustments of carrying value, requires fair value disclosures for the hedged item as a whole or for the adjustments to the carrying value separately.

20.2.1.4 Fair value disclosures-pension plan assets

Plan assets of a defined benefit pension or other postretirement plan accounted for under ASC 715, *Compensation—Retirement Benefits,* are excluded from the scope of ASC 820. However, these assets are subject to the disclosures required by ASC 715-20-50-1(d)(iv) for public entities and ASC 715-20-50-5(c)(iv) for nonpublic entities (see FSP 13).

20.2.1.5 Fair value disclosures-excess 401(k) plans

Excess 401(k) plans provide employees with an opportunity to increase savings beyond the limits of the reporting entity's qualified 401(k) plan. Employee contributions to an excess 401(k) plan are generally part of the general assets of the reporting entity but the amount due to the employee is tracked using a "phantom account."

We believe reporting entities can make a policy election to measure the phantom account at fair value. If the reporting entity measures the liability at fair value, the disclosures required by ASC 820 are necessary. If it is not measured at fair value, the phantom account is not subject to ASC 820 for measurement or disclosure.

20.2.1.6 Fair value disclosures-long lived assets held for sale—updated October 2022

ASC 820 disclosure requirements will apply each time the reporting entity adjusts the recorded amount of the long-lived assets held for sale, as discussed in PPE 5.3.

20.2.1.7 Fair value disclosures-asset impairments

When a long-lived asset is impaired, the reporting entity should include the nonrecurring measurement disclosures in (1) the quarter in which the impairment was recorded, (2) its subsequent quarterly filings for the year in which the impairment is recorded, and (3) the annual filings that include the quarter in which the charge was recognized. We believe the approach to include the disclosure in subsequent quarterly filings is consistent with the interim disclosure requirements in Rule 10-01 of Regulation S-X. The primary principle in S-X 10-01 is that the financial statement user will have read the prior year's annual financial statements and the quarterly financial statements should include disclosures for significant events that occurred during the current year, such as impairments. Also, because the year-to-date information is included in each quarterly report, an impairment in one quarter would be recognized in the following quarter's or quarters' year-to-date information, and thus disclosure when material would be required.

20.3 Fair value disclosure requirements

The fair value disclosure requirements for both recurring and nonrecurring measurements are discussed in the following sections:

- General disclosure requirements - Figure FSP 20-1
- Disclosures specific to valuation techniques and significant inputs - Figure FSP 20-2
- Disclosures for investments measured at net asset value - FSP 20.4
- Disclosures for financial instruments not measured at fair value - FSP 20.5

- Disclosures for instruments under the fair value option - FSP 20.6

The disclosure requirements in ASC 820 are intended to provide information about the following:

- The valuation techniques and inputs used to measure fair value, including judgments and assumptions made
- The uncertainty in the fair value measurements as of the reporting date
- How changes in fair value measurements affect performance and cash flows

To increase consistency and comparability in fair value measurements, the fair value standard establishes a hierarchy (addressed in FV 4) to prioritize the inputs used in valuation techniques. The level in the fair value hierarchy and the significant inputs used in a fair value measurement are two of the fundamental disclosure requirements of ASC 820. Further, disclosure requirements are largely based on the level in the hierarchy. As the level decreases, disclosure requirements increase, and certain required disclosures are applicable only to Level 3 fair value measurements.

20.3.1 Fair value disclosure general requirements

For all interim and annual reporting periods, there are specific quantitative and qualitative disclosures required for each class of assets and liabilities measured at fair value on the balance sheet. Reporting entities should make the disclosures with sufficient detail to permit reconciliation to the line items in the balance sheet. Quantitative disclosures should be presented in a tabular format in accordance with ASC 820-10-50-8.

Figure FSP 20-1 delineates certain fair value disclosure requirements for both recurring and nonrecurring measurements. Those specific to valuation techniques and unobservable inputs are included in Figure FSP 20-2 and to investments measured at net asset value are included in FSP 20.4. Disclosures for financial instruments not measured at fair value are discussed in FSP 20.5 and disclosures for instruments under the fair value option are in FSP 20.6.

Figure FSP 20-1 summarizes the general fair value disclosure requirements.

Figure FSP 20-1

General fair value disclosure requirements

Disclosure requirement for each class of asset and liability	ASC reference	Related information
The fair value measurement at the end of the reporting period For nonrecurring fair value measurements, the fair value measurement at the relevant measurement date and the reasons for the measurement	820-10-50-2(a)	For nonrecurring measurements at a date other than the end of the reporting period, the reporting entity should state the date of the measurement.

Disclosure requirement for each class of asset and liability	ASC reference	Related information
For both recurring and nonrecurring measurements, the total fair value in each level of the fair value hierarchy (Not applicable to investments measured at NAV as a practical expedient, but applicable to investments measured at NAV – see FSP 20.5)	820-10-50-2(b)	For public business entities, ASC 820-10-50-2E indicates that this disclosure is also applicable to assets and liabilities for which fair value is only disclosed. For further discussion of the disclosure requirements, see FSP 20.3.1.1.
For recurring Level 3 fair value measurements, a rollforward of the beginning and ending balances ("the Level 3 rollforward"), separating: □ Total gains or losses for the period in income □ Total gains or losses for the period in OCI □ The line item in the income statement or statement of comprehensive income that includes the gains and losses □ Purchases □ Sales □ Issues □ Settlements □ Transfers in to Level 3 and the reasons for the transfers □ Transfers out of Level 3 and the reasons for the transfers	820-10-50-2(c)	For further discussion, see FSP 20.3.1.2. Nonpublic entities are not required to do a full Level 3 rollforward. See FSP 20.7.
For recurring Level 3 fair value measurements: □ Unrealized gains or losses for the period included in income □ The line item in the income statement where the unrealized gains or losses are recognized □ Upon adoption of ASU 2018-13, the unrealized gains or losses for the period in OCI and the line item in the statement of comprehensive income where the unrealized gains or losses are recognized	820-10-50-2(d)	The amount disclosed as the unrealized gain/loss relating to assets and liabilities held at the end of the reporting period should be consistent with (1) the reporting entity's policy for the timing of transfers of securities into and out of Level 3 (e.g., beginning of the period or end of the period) and (2) the amount of total gains and losses included in the Level 3 rollforward table for that period. This is because the unrealized gain/loss should only be included for the period in which the instrument was Level 3. This is illustrated in Example 20-1.

Disclosure requirement for each class of asset and liability	ASC reference	Related information
For recurring and nonrecurring fair value measurements of nonfinancial assets, the highest and best use of a nonfinancial asset when it differs from its current use, and why	820-10-50-2(h)	ASC 820-10-50-2E indicates that the disclosure is also applicable to assets and liabilities for which fair value is only disclosed.
The accounting policy decision to use the exception applicable to financial assets and liabilities with offsetting positions in market risks or counterparty credit risk (the "portfolio exception")	820-10-50-2D	See FV 6 for discussion of the portfolio exception.
Existence of a credit enhancement (for issuers of debt with an inseparable third-party credit enhancement that is recorded as a liability that is measured at fair value)	820-10-50-4A	See FV 8 for discussion of the measurement of liabilities with inseparable third-party credit enhancements.

20.3.1.1 Fair value hierarchy disclosures

ASC 820-10-50-2(b) requires reporting entities to disclose the level that a fair value measurement falls in its entirety in the fair value hierarchy. A fair value measurement, which may be the result of multiple inputs, is categorized in its entirety by reference to its lowest level (i.e., least reliable) significant input. For a Level 1 measurement, there is only a Level 1 price with no adjustment.

20.3.1.2 Level 3 rollforward

See ASC 820-10-55-101 for an illustration of a rollforward disclosure for recurring Level 3 fair value measurements.

Question FSP 20-1 illustrates how a reporting entity should calculate unrealized gains and losses for an interest bearing security in the Level 3 rollforward.

Question FSP 20-1

How should a reporting entity calculate unrealized gains and losses for an interest bearing security (e.g., trading or available-for-sale debt securities) held at period end for purposes of the Level 3 rollforward?

PwC response

There are several acceptable methods for determining unrealized gains/losses for items still held at the reporting date.

- *Method A — Balance sheet view*

  Determine unrealized gains and losses as the fair value of the security less its amortized cost basis. This view holds that gains and losses are realized at maturity or sale date; thus the entire gain/loss is considered unrealized until maturity or sale.

- *Method B — Income statement view*

  Determine unrealized gains and losses as the total gains and losses during the period less the cash received or paid (i.e., what is realized) for those items. This view holds that each individual cash receipt or settlement represents a realized gain or loss.

- *Method C*

  First, determine any realized gains or losses as the difference between the beginning-of-period expected cash flows and actual cash flows for the period. Then, determine unrealized gains or losses as the difference between the remaining expected cash flows for future periods at the beginning and end of the period.

The fair value standard does not specify a particular method. As a result, we consider all views to be acceptable. Reporting entities should select a method, disclose which method is used, and apply it consistently.

Question FSP 20-2 evaluates the presentation of other-than-temporary impairments on available-for-sale debt securities in the Level 3 rollforward.

Question FSP 20-2

Are other-than-temporary impairments (OTTI) under ASC 320 on available-for-sale debt securities considered realized or unrealized in the Level 3 rollforward?

PwC response

We believe there are two acceptable views as to whether they are realized or unrealized in the Level 3 rollforward.

- *View A*

  Present OTTI losses as realized. This view is supported by the guidance in ASC 320, which describes the nature of OTTI losses as "realized." Also, OTTI is realized because it is excluded from the definition of a "holding gain or loss," which is unrealized, in ASC 320.

ASC 320-10-20

Holding gain or loss: The net change in fair value of a security. The holding gain or loss does not include dividend or interest income recognized but not yet received or write-downs for other-than-temporary impairment.

- *View B*

  Present OTTI losses and significant declines in value as unrealized. The overall objective of the Level 3 rollforward disclosures is to present the income statement impact of Level 3 fair value measurements that are not verified with an observable transaction (i.e., a sale in the marketplace). Proponents of this view believe that recognition of an OTTI is not an observable or realized transaction.

Because the fair value standard does not specify a particular method, we consider both views to be acceptable. Reporting entities should select a method, disclose which method is used, and apply it consistently.

Question FSP 20-3 evaluates the presentation of credit losses on available-for-sale debt securities in the Level 3 rollforward.

Question FSP 20-3

Are credit losses under ASU 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments,* on available-for-sale debt securities considered realized or unrealized in the Level 3 rollforward?

PwC response

Under the guidance in ASC 326, credit losses will be recorded as an allowance as opposed to a direct write-off of the value of the security. We believe there are two acceptable views as to whether they are realized or unrealized in the Level 3 rollforward.

- *View A*

  Present credit losses as realized because they are excluded from the definition of a "holding gain or loss," which is unrealized, in ASC 326.

ASC 326-30-20

Holding gain or loss: The net change in fair value of a security. The holding gain or loss does not include dividend or interest income recognized but not yet received, writeoffs, or the allowance for credit losses.

- *View B*

  Present credit losses and significant declines in value as unrealized. The overall objective of the Level 3 rollforward disclosures is to present the income statement impact of Level 3 fair value measurements that are not verified with an observable transaction (i.e., a sale in the marketplace). Proponents of this view believe that a credit loss is not an observable or realized transaction.

Because the fair value standard does not specify a particular method, we consider both views to be acceptable. Reporting entities should select a method, disclose which method is used, and apply it consistently.

Transfers into and out of Level 3 in the hierarchy

The level of a fair value measurement may change. Reporting entities should consistently follow a policy for determining when transfers between levels are recognized. The policy should be the same for transfers in and out of all levels. Examples of the different policies that can be used to record transfers include (1) the actual date of the transfer, (2) assuming the transfer occurs at the beginning of the period, or (3) assuming the transfer occurs at the end of the period.

There are implications of the reporting entity's policy regarding when transfers are recorded. For example, unrealized and realized gain and loss activity during the period would not be reflected in the Level 3 rollforward for the period if a reporting entity applies an end-of-period convention for transfers in.

As a practical matter, reporting entities may only have formal procedures for assessing the level in the hierarchy at the end of a reporting period. In this case, assuming end-of-period transfers in and out may be the most efficient.

A reporting entity's policy choice with respect to the timing of transfers in and out of the levels will also impact the relationship between the year-to-date disclosures and quarter disclosures. Use of end-of-period or beginning-of-period methods generally will result in quarterly information that does not sum to the year-to-date totals because the beginning and ending dates for timing of a transfer may be different in a year-to-date disclosure than in a quarterly disclosure.

Reporting entities need to disclose transfers *into* Level 3 separate from transfers *out of* Level 3. However, they may exclude from the Level 3 rollforward instruments purchased and sold or transferred in and out of Level 3 in the same period.

Example FSP 20-1 illustrates the requirements for disclosure of amounts transferred into Level 3 in the Level 3 rollforward.

EXAMPLE FSP 20-1

Transfers into Level 3 in the rollforward

For purposes of the Level 3 rollforward, FSP Corp's accounting policy is to show transfers into and out of Level 3 at the beginning of the quarter.

FSP Corp holds Investment A. The value of Investment A, a trading security, changes during the six-month period as follows:

1/1/20X8		$100
Unrealized loss	$(5)	
3/31/20X8		$95
Unrealized loss	$(10)	
6/30/20X8		$85

Investment A is classified as Level 2 at 1/1/20X8 and 3/31/20X8. Management transfers Investment A in the second quarter ending 6/30/20X8 and classifies it as Level 3 at that date. There are no other Level 3 securities.

What amounts should be included in the disclosure for the quarter and year-to-date periods for items transferred *into* Level 3 during the quarter?

Analysis

The rollforward table required to be disclosed would be as follows:

Level 3 rollforward	3 months ended 6/30/20X8	6 months ended 6/30/20X8
Beginning balance	$0	$0
Transfer in	$95	$95
Unrealized loss	$(10)	$(10)
Ending balance	$85	$85
Amount of unrealized loss for the period included in income relating to assets held at the end of the reporting period	$(10)	$(10)

Because FSP Corp has a policy that all transfers are deemed to occur at the beginning of the quarter, the unrealized loss while classified as a Level 3 investment is ($10), whereas a policy that considered the transfers as of the beginning of the period (1/1/20X8) would have reflected a cumulative year-to-date unrealized loss of ($15).

Transfer out of Level 3

Assume instead that Investment A is classified as Level 3 at 1/1/20X8 and 3/31/20X8. Management transfers Investment A out of a Level 3 measurement in the quarter ending 6/30/20X8 and classifies it as Level 2 at that date.

Example FSP 20-2 illustrates the disclosure of amounts transferred out Level 3 in the Level 3 rollforward.

EXAMPLE FSP 20-2

Transfers out of Level 3 in the rollforward

What amounts should be included in the disclosure for the quarter and year-to-date periods for items transferred *out of* Level 3 during the quarter?

Analysis

The rollforward table required to be disclosed would be as follows:

Level 3 rollforward	3 months ended 6/30/20X8	6 months ended 6/30/20X8
Beginning balance	$95	$100
Transfer out	$(95)	$(95)

Level 3 rollforward	3 months ended 6/30/20X8	6 months ended 6/30/20X8
Unrealized loss	$(0)	$(5)
Ending balance	$0	$0
Amount of unrealized loss for the period included in income relating to assets held at the end of the reporting period	$(0)	$(5)

Because FSP Corp recorded the transfer as of the beginning of the quarter (i.e., 4/1/20X8), the unrealized loss during the three months ended June 30, 20X8 is not part of the rollforward. For the same reason, the unrealized loss reported in the first quarter is reflected in the rollforward for the six month period ended June 30, 20X8.

In this example, if FSP Corp were to deem transfers as occurring at the beginning of the year-to-date period (January 1 for the year-to-date six months ended June 30), it would result in different disclosures.

20.3.1.3 *Contractually restricted equity securities – post adoption of ASU 2022-03 – added September 2022*

In June 2022, the FASB issued ASU 2022-03, *Fair Value Measurements of Equity Securities Subject to Contractual Sale Restrictions*. ASU 2022-03 clarified that a contractual restriction on the sale of an equity security (for example, an underwriter lock-up agreement) is not considered part of the unit of account of an equity security. As a result, such restriction is not considered in measuring fair value of the equity security. ASU 2022-03 also added the following new disclosure requirements:

- The fair value of equity securities subject to contractual sale restrictions reflected in the balance sheet
- The nature and remaining duration of the restriction(s)
- The circumstances that could cause a lapse in the restriction(s)

Equity securities that are included in other disclosures and that are restricted due to being pledged as collateral are not included in the information required to be provided in the above disclosures so as not to duplicate disclosures. We view the phrase "reflected in the balance sheet" to apply to all equity securities that are contractually restricted as of the balance sheet date and that are measured at fair value in accordance with ASC 820.

ASU 2022-03 notes the following when disclosing the above information: "Registrants should consider the guidance in 820-10-50-1D, including how much aggregation or disaggregation to undertake when disclosing that information. A reporting entity may have multiple investments in equity securities subject to contractual sale restrictions, none of which are individually material or have distinct features that affect the nature or remaining duration of the restrictions. In that case, the reporting entity may decide to disclose the information required by the amendments in the aggregate. If one or a number of investments in equity securities were individually material or had distinct features that

would affect the nature or remaining duration of the restriction, a financial statement user may consider more disaggregated information to be decision useful."

An investment company, as defined in ASC 946, that continues to incorporate a discount in the valuation of equity securities subject to contractual sale restrictions that were executed prior to the adoption of ASU 2022-03 and not subsequently modified, in accordance with the specific transition guidance for investment companies, will be required to disclose the following:

- The fair value of equity securities subject to a contractual sale restriction on the statement of financial position to which the entity continues to apply a discount
- The nature and remaining duration of the contractual sale restriction
- The circumstances that could cause a lapse in the restriction

ASU 2022-03 is effective for public business entities for fiscal years beginning after December 15, 2023, and interim periods within those fiscal years. For all other entities, the guidance is effective for fiscal years beginning after December 15, 2024, and interim periods within those fiscal years. Early adoption is permitted for both interim and annual financial statements that have not yet been issued or made available for issuance.

See FV 4.8 for additional guidance on the fair value measurement of restricted securities.

20.3.2 Disclosures of valuation techniques and unobservable inputs

The following figure includes the qualitative and quantitative fair value disclosure requirements relating to valuation techniques and inputs. The concepts of valuation techniques and significant inputs are addressed in FV 4.

Figure FSP 20-2 summarizes fair value disclosure requirements for valuation techniques and significant unobservable inputs

Figure FSP 20-2

Fair value disclosure requirements for valuation techniques and significant unobservable inputs

Disclosure requirement for each class of asset and liability	ASC reference	Related information
For recurring and nonrecurring Level 2 and Level 3 fair value measurements, a description of the valuation technique(s) and the significant unobservable inputs used in measurement If the reporting entity has changed its valuation approach or valuation technique, the change and the reason for making it (For further discussion, see FSP 20.3.2.1.)	820-10-50-2(bbb)(1)	This does not apply to instruments for which fair value is only disclosed.

Disclosure requirement for each class of asset and liability	ASC reference	Related information
For Level 3 fair value measurements, quantitative information about all significant unobservable inputs used in the fair value measurement (the "table of significant unobservable inputs") Upon adoption of ASU 2018-13, the range and weighted average of the inputs disclosed	820-10-50-2(bbb)(2)	This does not apply to Level 3 instruments measured at fair value under the fair value option or assets and liabilities for which fair value is only disclosed. For further discussion, see FSP 20.3.2.2 through FSP 20.3.2.3.
For recurring Level 3 fair value measurements, a narrative description of the uncertainty of the fair value measurement at the reporting date from use of the significant unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement	820-10-50-2(g)	If there are interrelationships between those inputs and other significant unobservable inputs used in the fair value measurement, also provide a description of those interrelationships and how they might magnify or mitigate the effect of changes in unobservable inputs (i.e., the ones disclosed) on the fair value measurement. For further discussion, see FSP 20.3.2.4.

20.3.2.1 Change in valuation approach or valuation technique

ASC 820-10-50-2 requires reporting entities to disclose the valuation approach and technique used by class of instrument for valuations that fall in Levels 2 and 3 of the fair value hierarchy. In certain cases, a reporting entity's valuation policy may permit a choice among valuation techniques or approaches, or may require the use of multiple approaches and/or techniques depending on market conditions and the availability of data that maximizes the use of observable market information. For example, if a reporting entity observes a recent sale of a security that it holds (or a similar security), it may use that price as a basis for their valuation (a market approach). However, if there is not a recent transaction, the reporting entity may choose to use a discounted cash flow analysis (an income approach). If the reporting entity changes the valuation approach and/or technique, it should disclose the change for each class of instrument (not for each individual instrument). This disclosure requirement applies to both recurring and nonrecurring measurements characterized in Levels 2 and 3 of the fair value hierarchy.

Reporting entities may limit disclosure to only address changes from the established valuation policy for each class of instrument at the measurement date. They need not disclose a change in actual valuation approach or technique used if the approaches/techniques are consistent with the existing policy. In the example of an entity observing a recent sale of a security that it holds (or a similar security), no disclosure of the change in approach/technique would be required if both techniques were contemplated by the policy and disclosed.

20.3.2.2 Table of significant unobservable inputs

Quantitative disclosure of all significant unobservable inputs is required even though reporting entities only have to identify one significant unobservable input to conclude that a fair value measurement should be classified as Level 3. ASC 820's disclosure requirements, however, require reporting entities to identify *all* significant unobservable inputs and disclose quantitative information about them. For discussion of how to determine whether an input is significant, see FV 4.5.2.

Level of disaggregation — table of significant unobservable inputs

The quantitative disclosures of significant unobservable inputs are presented by class of asset and liability. Reporting entities need to apply judgment to determine the appropriate classes of assets and liabilities and should provide information sufficient to reconcile to the line items on the balance sheet. Although the disclosure requirements of the fair value standard do not specifically require disclosing such a reconciliation, it has become a leading practice.

The fair value standard does not prescribe the level of disaggregation (below the class level of asset and liability), but it does state that fair value measurements will often require greater disaggregation than the line items in the balance sheet and a reporting entity should determine classes based on the nature, characteristics, and risks of the assets and liabilities. The disclosure should contain sufficient detail to allow users to understand the significant unobservable inputs and how they vary over time.

When considering how detailed the quantitative disclosures should be, a reasonable starting point is an evaluation of the classes for each of the assets and liabilities included in other fair value disclosures (e.g., the fair value hierarchy), followed by consideration of the nature and risk of the types of assets and liabilities and inputs in each class. The objective of this exercise is to determine whether there are reasonable levels of homogenous pools of inputs for the Level 3 assets and liabilities that can be separated out of the related class.

The classification of measurements in the fair value disclosures as Level 3 assets or liabilities typically affects the level of disaggregation (i.e., the number of classes may need to be greater for fair value measurements using significant unobservable inputs). ASC 820-10-50-2B indicates that using the classes determined in other standards (e.g., ASC 320) is acceptable.

For example, a reporting entity's derivative assets and liabilities may be disaggregated at the class level (e.g., interest rate instruments, commodity instruments, and foreign exchange rate instruments). However, the reporting entity's commodity instruments may comprise a number of different types of commodities that do not share similar risk characteristics. The reporting entity may conclude that disaggregating its commodity derivatives by type of commodity would provide more meaningful information.

Similarly, a reporting entity may disaggregate mortgage-backed securities into residential and commercial securities, or disaggregate private equity securities by industry.

See ASC 820-10-55-100 for an example of disaggregation disclosure, including the reconciliation.

Inputs to inputs

Level 3 fair value measurements may contain a number of unobservable inputs. The unobservable inputs may be developed using a variety of assumptions and "underlying" unobservable inputs (e.g., a number of assumptions are used to arrive at a long-term growth rate input).

We would generally not expect these underlying inputs used to develop significant unobservable inputs ("inputs to inputs") to be included in the quantitative disclosures. Most inputs use underlying assumptions; the disclosure of these underlying assumptions could result in a significant amount of additional information being disclosed, adding unnecessary complexity to the disclosure. As a result, the overall disclosure could become less understandable. We believe inclusion of such information is beyond the scope of the disclosure requirement.

In addition, the example in ASC 820-10-55-103 includes disclosure of inputs such as weighted average cost of capital, long-term revenue growth rate, and long-term pretax operating margin. These unobservable inputs are based on a variety of assumptions. For example, a weighted average cost of capital input may include a number of assumptions such as the risk-free rate, effective tax rate, required equity rate of return, and the proportion of debt versus equity. These underlying inputs are not included in the example disclosure.

Derivative assets and liabilities and their related significant unobservable inputs

We believe that derivative assets and liabilities should generally be presented on a gross basis by type of derivative in the fair value hierarchy table and the table of significant unobservable inputs.

Range and weighted average of significant unobservable inputs

Upon adoption of ASU 2018-13, reporting entities will be required to disclose the range and weighted average of the significant unobservable inputs and the way it is calculated. This is to de-emphasize the impact of outliers. Assuming like portfolios, weighted averages aid in comparing disclosures for different reporting entities. If a weighted average is not meaningful for a particular asset class (e.g., derivatives), a reporting entity may disclose alternative quantitative information if the alternative quantitative information is a "more reasonable and rational method to reflect the distribution" of the inputs. It need not disclose the reason for omitting the weighted average.

Excerpt from ASC 820-10-50-2(bbb)(2)(i)

For certain assets and liabilities, a reporting entity may disclose other quantitative information, such as the median or arithmetic average, in lieu of the weighted average as described in this subparagraph, if such information would be a more reasonable and rational method to reflect the distribution of unobservable inputs used to develop the Level 3 fair value measurement.

20.3.2.3 Third-party pricing disclosure

Management is responsible for the valuation process and should perform sufficient diligence over the fair value measurements and inputs obtained externally, including the related fair value hierarchy level determinations.

However, ASC 820-10-50-2(bbb)(2) allows a reporting entity to omit certain quantitative disclosures if the significant unobservable inputs are not developed by the reporting entity. The "third-party pricing exception" may be applied if a reporting entity uses the price obtained from a prior transaction or a third party without significant adjustment. Consequently, significant adjustments would invalidate the third-party pricing exception and require the reporting entity to make the quantitative disclosures in ASC 820-10-50-2(bbb).

When contemplating use of the third-party pricing exception, a reporting entity should make a reasonable attempt to obtain information from third parties about unobservable inputs that are significant to the fair value measurement.

Even if the reporting entity elects the third-party exception, it should provide the qualitative uncertainty disclosures discussed in FSP 20.3.2.4 for any significant inputs if required by ASC 820-10-50-2(g) and reasonably available.

Under ASC 820-10-55-104(b), reporting entities that use third-party pricing for their fair value measurements should also consider whether it is appropriate to disclose how third-party information such as broker quotes, pricing services, net asset values, and relevant market data were considered in the measurement of fair value. Whenever a reporting entity uses unobservable inputs it has not developed, it should consider disclosing information to allow users of the financial statements to understand how it has used those inputs in its fair value measurements. Specific disclosures could include the following:

- How and the extent to which the reporting entity uses brokers and pricing services to determine its fair value measurements
- The nature and amount of assets valued using brokers or pricing services
- The classification of the assets and liabilities valued based on brokers or pricing services in the fair value hierarchy
- Information on the use of multiple broker quotes
- The reasoning and methodology for any adjustments made to prices from brokers or pricing services
- The extent to which the brokers are using observable market information as compared to proprietary models and unobservable data
- Whether the quotes are binding
- Procedures performed to validate the fair value measurements

20.3.2.4 Disclosure of measurement uncertainty

ASC 820-10-50-2(g), as amended by ASU 2018-13, requires a narrative disclosure about the uncertainty of recurring Level 3 fair value measurements to certain changes in significant unobservable inputs by asset class. This guidance requires the potential effect of changes in unobservable inputs to be described if the changes might have resulted in a significantly different fair

value measurement at the measurement date. The intention of the disclosure is to convey information about measurement uncertainty at the reporting date, not in the future.

Reporting entities are not required to quantify the potential changes in the inputs or the fair value measurements. They typically elaborate on the uncertainty of significant unobservable inputs associated with each type of classification included in the quantitative recurring Level 3 disclosure.

See ASC 820-10-55-106 for an example disclosure of the uncertainty analysis.

20.3.3 Concentrations of credit risk disclosures

Reporting entities are required to disclose all significant concentrations of credit risk arising from financial instruments. This disclosure applies to significant credit risk from an individual counterparty or groups of counterparties if those counterparties are engaged in similar activities and have similar economic characteristics (referred to as "group concentrations").

Figure FSP 20-3 identifies the required disclosures for each significant concentration. These requirements are not applicable to the financial instruments referenced in ASC 825-10-50-22, which include financial instruments of a pension plan and the securities described in ASC 825-10-50-8(a), ASC 825-10-50-8(c), ASC 825-10-50-8(e), and ASC 825-10-50-8(f), except for reinsurance recoverables and prepaid reinsurance premiums.

Figure FSP 20-3

Required disclosures for each significant concentration of credit risk

Disclosure requirement	Related information
Information that identifies group concentrations	Shared activity, region, or economic characteristic
Maximum amount of loss due to credit risk	Amount the reporting entity would incur if counterparties failed based on the gross fair value of the financial instrument, and assuming the collateral proved to be of no value to the reporting entity
Collateral	□ The reporting entity's policy of requiring collateral □ The reporting entity's access to that collateral □ The nature and description of the collateral
Master netting arrangements	□ The reporting entity's policy of entering into master netting arrangements □ The arrangements to which the reporting entity is a party at the balance sheet date □ A description of the terms of the arrangements, including their ability to reduce the reporting entity's maximum amount of loss

20.3.4 *Market risk of all financial instruments*

Reporting entities are encouraged to disclose quantitative information about the market risk of financial instruments, while taking into consideration its management of those risks. These disclosures will likely differ and evolve for each reporting entity. Example quantitative disclosures are included in ASC 825-10-50-23, and reporting entities are encouraged to develop others when appropriate. This is in addition to the information regarding market risk of financial instruments in the MD&A that is required by Financial Reporting Release 48.

20.4 *Fair value hierarchy for net asset value*

Investments in equity securities of investment companies are required to be measured at fair value just like equity investments in other types of entities in the scope of ASC 820. Many investment companies maintain a net asset value (NAV) for purposes of subscriptions and redemptions or solely for reporting purposes. NAV may or may not be equal to fair value depending on the ability to transact at NAV. If the investment does not have a readily determinable fair value, as discussed in FV 6.2.2, it may qualify for a practical expedient by which reporting entities may instead use NAV, without adjustment, to measure investments in certain funds (e.g., hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds, funds of funds).

FV 6.2.6 discusses when the NAV as a practical expedient is allowed. It is important for a reporting entity to determine whether it is using NAV as a practical expedient or NAV as fair value, since the required disclosures will differ depending on the answer.

Reporting entities with investments measured at NAV as a practical expedient need not disclose the investment's level in the fair value hierarchy or any of the related disclosures in ASC 820-10-50-2. For example, there is no requirement to include these investments in the Level 3 rollforward. As such, the total fair values by level in the fair value hierarchy will not agree to the balance sheet. Therefore, reporting entities are required to provide a reconciliation of the fair value hierarchy disclosure to the balance sheet by disclosing the fair value of investments measured at NAV as a practical expedient.

Figure FSP 20-4 summarizes the typical level in the fair value hierarchy of investments measured at NAV in various scenarios.

Figure FSP 20-4
Fair value hierarchy of investments measured at NAV

Investment measurement	Typical level in the fair value hierarchy
Fair value equals NAV	Level 1
Fair value equals NAV, adjusted	Level 2 or 3
NAV as a practical expedient, unadjusted	N/A measurements are not "fair value" under ASC 820

20.4.1 Disclosures related to investments measured at NAV

For investments measured using NAV as a practical expedient on a recurring or nonrecurring basis, ASC 820-10-50-6A requires the following disclosures for each interim and annual period for each class of investment:

- The nature and risks of the investments and whether the investments are probable of being sold at amounts different from NAV per share (for investments for which NAV per share is calculated)
- The fair value of the investments and a description of the significant investment strategies
- For each class of investments that can never be redeemed, but the reporting entity receives distributions through the liquidation of the underlying assets, the period of time over which the underlying assets are expected to be liquidated by the investee if the investee has communicated the timing to the reporting entity or announced the timing publicly. If the timing is unknown, the reporting entity should disclose that fact.
- The amount of the reporting entity's unfunded commitments related to the investments
- A general description of the redemption terms
- The circumstances when an otherwise redeemable investment may not be redeemable. For redeemable investments that are restricted from redemption, disclose when the restriction might lapse if the investee has communicated the timing to the reporting entity or announced the timing publicly. If the timing is unknown, the reporting entity should disclose that fact and how long the restriction has been in effect.
- Any other significant restriction on the ability to sell the investment
- If a group of investments is likely to be sold at an amount other than NAV, but the individual investments have not been identified so the investments continue to qualify to use NAV as a practical expedient, disclose the plans to sell and any remaining actions required to complete the sale

See ASC 820-10-55-107 for an illustration of the disclosure requirements.

20.5 Fair value of instruments not measured at fair value

ASC 825-10-50-10 requires that public business entities annually disclose the fair value of all financial instruments, whether or not recognized on the balance sheet at fair value, except for the instruments listed in ASC 825-10-50-8.

Excerpt from ASC 825-10-50-8

a. Employers' and plans' obligations for pension benefits, other postretirement benefits including health care and life insurance benefits, postemployment benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements (see Topics 710; 712; 715; 718; and 960)

b. Substantively extinguished debt subject to the disclosure requirements of Subtopic 405-20

c. Insurance contracts, other than financial guarantees (including financial guarantee insurance contracts within the scope of Topic 944) and investment contracts, as discussed in Subtopic 944-20

d. Lease contracts as defined in Topic 840 (a contingent obligation arising out of a cancelled lease and a guarantee of a third-party lease obligation are not lease contracts and are subject to the disclosure requirements in this Subsection)

e. Warranty obligations (see Topic 450 and the Product Warranties Subsections of Topic 460)

f. Unconditional purchase obligations as defined in paragraph 440-10-50-2

g. Investments accounted for under the equity method in accordance with the requirements of Topic 323

h. Noncontrolling interests and equity investments in consolidated subsidiaries (see Topic 810)

i. Equity instruments issued by the entity and classified in stockholders' equity in the statement of financial position (see Topic 505)

j. Receive-variable, pay-fixed interest rate swaps for which the simplified hedge accounting approach is applied (see Topic 815)

k. Fully benefit-responsive investment contracts held by an employee benefit plan

l. Investments in equity securities accounted for under the measurement guidance for equity securities without readily determinable fair values (see Topic 321)

m. Trade receivables and payables due in one year or less

n. Deposit liabilities with no defined or contractual maturities

o. Liabilities resulting from the sale of prepaid stored-value products within the scope of paragraph 405-20-40-3

If these disclosures are in more than one footnote, ASC 825-10-50-12 requires that one of the footnotes include a summary table listing fair value and the related carrying amounts and reference where the other disclosures can be found.

ASC 825-10-50-15 also indicates that the fair values of financial instruments should not be netted unless the conditions for offsetting under ASC 210, *Balance Sheet*, or ASC 815, *Derivatives and Hedging*, are met. These are addressed in FSP 2.4 (general conditions) and FSP 19.3.2 (conditions for derivatives).

New guidance

Upon adoption of ASU 2016-02, *Leases (Topic 842)*, ASC 825-10-50-8(d) will be amended. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years for (a) public business entities, (b) not-for-profit entities that have issued, or are a conduit bond obligor for, securities that are traded on an exchange or over-the-counter market, and (c)

employee benefit plans that file with or furnish financial statements to the SEC. For all other entities, the guidance is effective one year later. Early adoption is permitted.

The accounting and disclosure requirements of ASC 842 are covered in PwC's *Leasing* guide, and are not discussed in this guide.

20.5.1 Equity securities without readily determinable fair values

For equity securities without readily determinable fair values (for which a measurement event or impairment has not occurred during the period), reporting entities may elect to measure the securities at cost less impairment, adjusted for any changes in observable prices. If that election is made, the disclosures in ASC 321-10-50-3 are required, as discussed in LI 12.6.1.

20.6 Fair value option

In addition to the standards that require assets and liabilities to be reported at fair value, GAAP provides reporting entities with a fair value option (FVO) to measure certain financial instruments and other items on the balance sheet at fair value.

The key standards that have a FVO, as discussed in FV 5, include:

- ASC 815-15, *Derivatives and Hedging—Embedded Derivatives,* which provides a FVO for certain hybrid financial instruments that contain an embedded derivative that would otherwise require separation

- ASC 860-50, *Transfers and Servicing—Servicing Assets and Liabilities,* which permits a reporting entity to choose between the amortization method and the fair value measurement method for each class of separately-recognized servicing assets and servicing liabilities

- ASC 825-10, *Financial Instruments—Overall*, which provides a measurement basis election for most financial instruments (i.e., a choice of either historical cost or fair value), including equity method investments, allowing reporting entities to mitigate potential mismatches that arise under the current mixed measurement attribute model

Because the FVO is not a requirement, its election may result in reduced comparability of financial reporting, both among similar reporting entities and within a single entity, because similar assets or liabilities could be reported under different measurement attributes (i.e., some at historical cost and some at fair value). However, the disclosure provisions in those topics are intended to mitigate this by requiring (1) identification of instruments for which the option is elected, and (2) extensive information about the effects on the financial statements.

20.6.1 Presentation of FVO

ASC 825-10 permits reporting entities to apply the FVO on an instrument-by-instrument basis. Therefore, a reporting entity can elect the FVO for certain instruments, but not others, within a group of similar instruments (e.g., only a portion of an identical portfolio of corporate securities).

20.6.1.1 Presentation of instruments with FVO versus without FVO

ASC 825-10-45-2 permits reporting entities to present the fair value and non-fair-value amounts (1) aggregated in the same balance sheet line item (parenthetically disclosing the amount measured at fair value included in the aggregate amount), or (2) in two separate line items.

Securities for which the reporting entity elects the FVO are presented in the same category (i.e., trading, available for sale, or held-to-maturity) as other securities required to be measured at fair value with changes in fair value recorded in income. If a reporting entity elects the FVO for one or more investments, it may use terminology such as “securities carried at fair value” in describing these securities, instead of the “trading” terminology in ASC 320.

20.6.1.2 Presentation of changes in fair value under the FVO

ASC 825-10 does not include guidance on geography for items measured at fair value under the FVO, nor does it address how to present dividend income, interest income, or interest expense. However, for instruments within the scope of ASC 320-10, even if measured at fair value under the FVO, there is a prescribed method of calculating interest income that must be applied to those instruments. For all other instruments carried at fair value under the FVO for which GAAP does not prescribe a particular method of interest recognition, we believe a reporting entity may apply one (or some variation) of the following models for reporting interest income and expense, and should disclose its policy for recognition.

- Present the entire change in fair value of the FVO item, including the component related to accrued interest, in a single line item in the income statement.

  Some industries, such as investment companies, are required to show investment income separately, and therefore, can only apply this approach to a certain extent. For others, presenting investment income separately is common industry practice. When determining the amount to separately report as investment income from instruments for which the FVO is elected, if existing US GAAP prescribes a method of calculating interest income for identical instruments not carried at fair value, we believe the same model should be applied to instruments carried at fair value.

- Separate the interest income or expense from the full change in fair value of the FVO item and present that amount in interest income/expense. Present the remainder of the change in fair value in a separate line item in the income statement. Allocation of the change in fair value to interest income/expense should use an appropriate and acceptable method under GAAP.

  Examples of instances when interest income or expense is permitted to be broken out separate from other changes in fair value are: (1) derivatives that have been designated in qualifying hedging relationships, (2) certain investments in debt and equity securities, (3) certain originated or acquired loans (as referenced in ASC 825-10-50-28(e)(2)), and ASC 825-10-50-28(e)(4) certain debt.

Each presentation reflects the same net change in fair value, but the impact on individual line items in the income statement may differ significantly. When there is no method prescribed by other GAAP, we encourage reporting entities to use the single line presentation because the total change in fair value is a more meaningful number.

20.6.2 *Presentation of liabilities when the fair value option is elected*

Reporting entities are required to present the portion of the total change in the fair value of financial liabilities for which the fair value option is elected that results from a change in the instrument-specific credit risk separately in OCI.

The separate presentation in OCI is not applicable for financial liabilities of a consolidated collateralized financing entity (CFE) measured using the measurement alternative. Disclosures for CFEs are discussed in FSP 20.6.4.

20.6.3 *Disclosure of FVO*

FVO disclosures help financial statement readers understand the extent to which the reporting entity uses the FVO, management's reasons for electing the FVO, and how changes in fair values affect net income for the period.

The disclosures in ASC 825-10-50-28 through ASC 825-10-50-32 are required for instruments measured at fair value under the FVO in ASC 825 and the FVO in ASC 815-15. ASC 825-10-55-6 through ASC 825-10-55-13 includes a sample disclosure that presents one way to integrate FVO disclosure requirements with the fair value standard's requirements.

ASC 825-10-50-28 requires the following disclosures for instruments for which the fair value option is elected for each annual or interim period in which a balance sheet is presented:

- Management's reasons for electing the fair value option
- For each balance sheet line item that includes items for which the fair value option has been elected, both:
  - Disclosure of carrying amount and fair value reported in the balance sheet, and information to help users understand how each balance sheet line item relates to major classes of assets and liabilities in the fair value disclosures
  - The aggregate carrying amount of items included in each balance sheet line item that are not eligible for the fair value option, if any

If the FVO is elected for only some of the eligible items within a group of similar eligible items, ASC 825-10-50-28(b) requires the notes to include a description of those similar items and the reasons for partial election. In addition, the reporting entity should disclose how the group of similar items relates to what is recorded on the balance sheet.

When a reporting entity has elected the fair value option for loans, long-term receivables, long-term debt, or loans held as assets, ASC 825-10-50-28(d) requires specific disclosures related to these instruments:

- The difference between the aggregate fair value and the aggregate unpaid principal balance
- For loans held as assets
  - The aggregate fair value of loans that are 90 days or more past due

- The aggregate fair value of loans in nonaccrual status (if the entity's policy is to recognize interest income separate from other changes in fair value)

- The difference between the aggregate fair value and the aggregate unpaid principal balance for loans that are 90 days or more past due, in nonaccrual status, or both

ASC 825-10-50-30 requires the following disclosures for instruments for which the fair value option is elected for each annual or interim period in which an income statement is presented:

- For each balance sheet line item, the amounts of gains and losses from fair value changes included in earnings during the period, and which income statement line item includes those gains and losses

- A description of how interest and dividends are measured and where they are reported in the income statement

- For loans and other receivables held as assets, (1) the estimated amount of gains or losses included in earnings during the period attributable to changes in instrument-specific credit risk and (2) how the gains or losses attributable to changes in instrument-specific credit risk were determined

For annual periods, ASC 825-10-50-31 requires disclosure of the methods and significant assumptions used to estimate the fair value of financial instruments for which the FVO is elected. However, quantitative disclosure of significant unobservable inputs used in measuring the fair value of FVO instruments that are Level 3 (in Figure FSP 20-2) is not required.

20.6.3.1 Credit risk disclosure when the fair value option is elected

ASC 825-10-50-30(d) requires disclosure of information about instrument-specific credit risk for financial liabilities for which the FVO is elected. Reporting entities are required to disclose:

- The change in fair value of the liability that is attributable to instrument-specific credit risk (both during the period and cumulatively)

- How the gains and losses attributable to changes in instrument-specific credit risk were determined

- If a liability is settled during the period, any amount previously deferred through OCI that was ultimately recognized in net income at settlement

20.6.3.2 Disclosures for equity method investments using fair value option

ASC 825-10-50-28(f) requires reporting entities that have elected to account for certain equity method investments using the fair value option to also disclose certain equity method disclosures, specifically, the requirements of ASC 323-10-50-3, excluding ASC 323-10-50-3(a)(3), ASC 323-10-50-3(b) and ASC 323-10-50-3(d). Disclosure requirements for equity method investments are discussed in FSP 10.

20.6.4 Disclosures for collateralized financing entities

Typically, if a reporting entity elects the fair value option, financial assets and financial liabilities of a CFE are measured separately at their fair values. As a result, the aggregate fair value of the financial

assets might differ from the aggregate fair value of the financial liabilities. A measurement alternative in ASC 810 allows the reporting entity to measure both using the more observable of the fair value of the financial assets or the fair value of the financial liabilities. This eliminates the measurement difference that may exist when the financial assets and the financial liabilities are measured independently.

Reporting entities that elect the measurement alternative are required to follow the disclosure requirements in ASC 820 and ASC 825 for the CFE's financial assets and financial liabilities. As such, reporting entities will have to apply judgment to determine the level in the fair value hierarchy of the less observable financial element.

We believe a reporting entity needs to evaluate the significance of all of the unobservable inputs (in relation to the total fair value) of the more observable of the financial assets or financial liabilities when determining the appropriate level in the fair value hierarchy in which the less observable of the two would be disclosed.

For example, if the fair value of the financial liabilities are used to measure the financial assets, and a significant amount of the financial liabilities valuations are considered Level 3, the financial assets (considered one unit of account for measurement purposes) would be disclosed as Level 3. Since identical inputs are not used, the less observable will not be Level 1.

20.7 Considerations for private companies

Certain of the fair value disclosures are not required for nonpublic entities. The fair value standard refers to the first definition of a "nonpublic entity" in the Master Glossary of the FASB Codification.

Definition from ASC Master Glossary

Nonpublic Entity: Any entity that does not meet any of the following conditions:

a. Its debt or equity securities trade in a public market either on a stock exchange (domestic or foreign) or in an over-the-counter market, including securities quoted only locally or regionally.

b. It is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over the counter market, including local or regional markets).

c. It files with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market.

d. It is required to file or furnish financial statements with the Securities and Exchange Commission.

e. It is controlled by an entity covered by criteria (a) through (d).

Under ASC 820-10-50-2F, the disclosures not required for nonpublic entities include:

- The range and weighted average of significant unobservable inputs (ASC 820-10-50-2(bbb)(2)(i))

- The changes in unrealized gains or losses in income and OCI for the period (ASC 820-10-50-2(d))

- Information about the uncertainty of Level 3 fair value measurements to changes in unobservable inputs and interrelationships between those unobservable inputs (ASC 820-10-50-2(g))

Also, instead of a full rollforward of Level 3 instruments, ASC 820-10-50-2G requires nonpublic entities to disclose the following for each class of investments:

- Purchases and issuances (each disclosed separately)

- Transfers into or out of Level 3 and the reasons for those transfers

Like public companies, nonpublic entities must consistently follow their policy for determining when transfers are deemed to have occurred and disclose transfers into Level 3 separate from transfers out of Level 3.

20.7.1 Disclosures of instruments not measured at fair value

As noted in FSP 20.5, the disclosures for financial instruments that are not measured at fair value (in ASC 825-10-50) are not required for a reporting entity that is not a public business entity.

New guidance

In April 2019, the FASB issued ASU 2019-04, *Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments*. ASU 2019-04 clarifies the Board's intent in not requiring entities that are not public business entities to disclose the fair value of held-to-maturity debt securities. This amendment is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted in any interim period as long as the reporting entity has adopted all of the amendments in ASU 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities*. See FSP 9.6.3 for further information.

20.7.2 Interim disclosures

Reporting entities that are not public business entities are not required to provide the disclosures regarding concentrations of credit risk described in ASC 825-10-50-20 through ASC 825-10-50-23 in interim periods.

20.7.3 Private company alternative — hedge accounting

Reporting entities that are not public business entities may elect a hedge accounting alternative (a simplified hedge accounting approach) for certain types of swaps to economically convert a variable-rate borrowing into a fixed-rate borrowing. See FSP 19.6.1 for further discussion.

The guidance allows a private company to measure the designated swap at settlement value rather than fair value. All of the presentation and disclosure requirements of ASC 815 and ASC 820 for public business entities apply; however, as the simplified approach allows for the swap to be recorded at settlement value, the settlement value may be used in place of fair value for disclosure purposes. Any amounts disclosed at settlement value should be clearly designated as such, and disclosed separate from amounts disclosed at fair value.

Chapter 21: Foreign currency—updated May 2022

21.1 Foreign currency overview

In today's global business environment, it is common for a reporting entity to have transactions in foreign currencies and to have foreign operations.

This chapter addresses the key elements of presentation and disclosure related to the impact of foreign currency.

See FSP 6.11 for information on presenting the cash flows of foreign operations.

21.2 Scope and relevant guidance

ASC 830, *Foreign Currency Matters*, provides financial accounting and reporting guidance for foreign currency transactions and for translating foreign currency financial statements.

21.3 Transaction gains and losses

ASC 830-20-20 defines transaction gains and losses.

Definition from ASC 830-20-20

Transaction Gain or Loss: Transaction gains or losses result from a change in exchange rates between the functional currency and the currency in which a foreign currency transaction is denominated. They represent an increase or decrease in both of the following:

a. The actual functional currency cash flows realized upon settlement of foreign currency transactions

b. The expected functional currency cash flows on unsettled foreign currency transactions.

21.3.1 *Presentation and disclosure of transaction gains and losses*

As discussed in ASC 830-20-45-1, reporting entities are required to present aggregate foreign currency transaction gains and losses included in determining net income for the period on the face of the financial statements or disclose them in the footnotes.

Although ASC 830 does not specify where foreign currency transaction gains and losses should be presented in the income statement, we believe there are two acceptable approaches. Reporting entities should apply the selected approach consistently for all periods presented.

Reporting entities often elect to aggregate all transaction gains and losses and classify the net amount in a single caption in the income statement. We believe that under this approach, classification of the transaction gains and losses in operating income is reasonable given the general nature of the accounts that generate these gains and losses.

Alternatively, reporting entities may elect to report transaction gains and losses in the line items to which they relate. For example, transaction gains and losses related to balances associated with cost of sales could be recorded in the cost of sales line item. It may be inappropriate to classify foreign

exchange gains and losses related to cost of sales as part of cost of sales if foreign currency transaction amounts related to revenue are not similarly classified as part of revenue. When using this approach, reporting entities are still required to disclose the aggregate amount of transaction gains and losses.

A reporting entity should consistently apply and disclose its accounting policy election related to the presentation of foreign currency transaction gains and losses.

Question FSP 21-1

Can a reporting entity report certain transaction gains or losses in one line item while reporting all others on an aggregate basis?

PwC response

Generally no. However, in certain situations, the inclusion of the foreign currency transaction gains or losses on a reporting entity's income statement in a single line along with all other transaction gains and losses may not appropriately reflect the reporting entity's financial performance. One example is a foreign subsidiary that has the same functional currency as the parent (e.g., an extension of the parent or a subsidiary that is operating in a country experiencing high inflation) that has issued variable rate debt in the local currency. In these cases, the foreign subsidiary may choose to reflect the gains or losses on this remeasurement in a line item that they believe more accurately reflects the economic substance, such as interest expense. Generally, we would not object to this presentation.

21.3.1.1 Presentation of transaction gain/ loss on deferred taxes

Deferred tax assets and liabilities are considered monetary items and should be remeasured each reporting period at current exchange rates with the related gains and losses included in income. ASC 830-740-45-1 indicates that the transaction gain or loss on deferred tax assets and liabilities may be presented either (1) with other transaction gains and losses or (2) as a component of the deferred tax benefit or expense on the income statement if that presentation is more useful to financial statement users.

If the reporting entity chooses to present transaction gains and losses in the income tax line item on the income statement, it should still include such amounts in the disclosure of the aggregate transaction gain or loss for the period required by ASC 830-20-45-1.

21.3.1.2 Presentation option for dealer transactions

ASC 830-20-45-2 provides banks and other dealers in foreign currency an option to present gains and losses arising from foreign currency transactions as dealer gains or losses rather than as transaction gains or losses.

21.4 Cumulative translation adjustments

Cumulative translation adjustment (CTA) results from the process of translating financial statements from a foreign entity's functional currency into the reporting currency of the reporting entity. As discussed in ASC 830-30-45-12, unlike foreign currency transaction gains and losses, which are recorded in net income, CTA should be reported in OCI.

21.4.1 Presentation

When presenting CTA in the financial statements, the title of the line item should be clear so the reader understands that the balance is due to foreign currency translation. As discussed in ASC 830-30-45-19, the FASB has recommended the title "Equity Adjustment from Foreign Currency Translation" for this account.

ASC 830-30-45-18 indicates that an analysis of the changes in the CTA account during the period can be included in any of the following.

- A separate financial statement
- The footnotes
- The statement of changes in stockholders' equity

In the statement of stockholders' equity, CTA can be shown individually or aggregated with other items that affect OCI such as unrealized gains and losses on available-for-sale investments. Figure FSP 5-1 in FSP 5.3 presents an example statement of stockholders' equity with OCI as one line item.

If aggregated as in Figure FSP 5-1 in FSP 5.3, the reporting entity should present a detailed break-out of all components of other comprehensive income in the statement of comprehensive income or the footnotes.

In the statement of stockholders' equity, CTA may be included as its own line item or aggregated with other items in AOCI, with the detail presented in the statement of comprehensive income or the footnotes.

Figure FSP 4-2 in FSP 4.4.2 and Figure FSP 4-3 in FSP 4.4.3 illustrate the presentation of CTA in the statement of comprehensive income.

21.4.1.1 Release of CTA

ASC 830-30 precludes the release of CTA for derecognition events that occur *within* a foreign entity (i.e., when a reporting entity ceases to have a controlling financial interest in a subsidiary or a group of assets that by itself was not a foreign entity) unless such events represent a complete or substantially complete liquidation of the foreign entity. As discussed in ASC 830-30-40-1, the release of CTA is generally recorded as part of the gain or loss on sale, which is a component of operating income, although presentation in nonoperating income may also be acceptable. See FX 8 for more information on accounting for the release of CTA.

21.4.2 CTA disclosure

ASC 830-30-45-20 details what should be included in the CTA disclosure.

ASC 830-30-45-20

At a minimum, the analysis shall disclose all of the following:

a. Beginning and ending amount of cumulative translation adjustments

b. The aggregate adjustment for the period resulting from translation adjustments (see paragraph 830-30-45-12) and gains and losses from certain hedges and intra-entity balances (see paragraph 830-20-35-3)

c. The amount of income taxes for the period allocated to translation adjustments (see paragraph 830-30-45-21)

d. The amounts transferred from cumulative translation adjustments and included in determining net income for the period as a result of the sale or complete or substantially complete liquidation of an investment in a foreign entity (see paragraph 830-30-40-1).

Reporting entities should also consider disclosing a description of the translation principle employed in the financial statements. Figure FSP 21-1 includes a sample disclosure of a translation principle.

Figure FSP 21-1
Sample disclosure—translation principle

Note X—Significant accounting policies—Foreign currency

Assets and liabilities are translated into the reporting currency using the exchange rates in effect on the consolidated balance sheet dates. Equity accounts are translated at historical rates, except for the change in retained earnings during the year, which is the result of the income statement translation process. Revenue and expense accounts are translated using the weighted average exchange rate during the period. The cumulative translation adjustments associated with the net assets of foreign subsidiaries are recorded in accumulated other comprehensive income/loss in the accompanying consolidated statements of stockholders' equity.

21.5 Other disclosures

In addition to the required disclosures, reporting entities may consider disclosures in the following areas depending on materiality and facts and circumstances.

- The existence of foreign currency commitments and contingencies (FSP 21.5.1)
- The effects of changes in foreign currency exchange rates subsequent to period-end (FSP 21.5.2)
- The effects of changes in foreign currency exchange rates during the period on the results of operations (FSP 21.5.3)
- Foreign currency hedging policies (FSP 21.5.4)
- How functional currency is determined (FSP 21.5.5)
- Changes in functional currency (FSP 21.5.6)

- The use of multiple foreign currency exchange rates (FSP 21.5.7)
- Operations in highly inflationary economies (FSP 21.5.8)

Disclosures in these areas provide the users of the financial statements with increased transparency into how foreign currency impacts the operations and financial position of the business.

21.5.1 Foreign currency commitments and contingencies

As outlined in FSP 23, reporting entities are required to disclose commitments and contingencies in the footnotes. When commitments and contingencies (such as leases, dividend restrictions, or the income tax effect of unremitted earnings) are denominated in a foreign currency, the reporting entity should disclose these amounts in the reporting currency.

ASC 830 does not specify the exchange rate to be used to present the amounts in such instances; however, common practice is to present the amounts using the exchange rate at the balance sheet date, with disclosure of the fact that current rates have been used, as suggested by ASC 830-20-30-3 and ASC 830-20-35-2.

In certain instances, alternative exchange rates or disclosures may be more appropriate, including the following.

- *A singular, significant unrecognized contingency exists for a number of years (e.g., a foreign tax assessment)*

  The amount may be disclosed in the foreign currency with parenthetical disclosure of the reporting currency amount specified at current rates. This approach avoids the possible confusion resulting from the effects of subsequent rate changes.

- *Disclosure of foreign retained earnings (e.g., subject to either taxation on repatriation or dividend restrictions)*

  The amount may appear inappropriate if translated at current rates when the retained earnings themselves are translated at historical rates in the primary financial statements. In such cases, judgment and expanded disclosure (e.g., use of a dual translation) should resolve any potential confusion.

21.5.2 Effects of exchange rate changes subsequent to year-end

If significant exchange rate changes occur subsequent to the balance sheet date, ASC 830-20-50-2 indicates that a reporting entity should consider additional disclosure, including the effect on unsettled balances pertaining to foreign currency transactions. If it is not practical to determine the effects of changes on unsettled transactions, ASC 830-20-50-2 prescribes that the reporting entity state that fact in the footnotes.

Also, subsequent changes in exchange controls could significantly impact the ability of a reporting entity to transact in a foreign currency after the balance sheet date, due to restrictions on purchases and sales of foreign currency within a specific country. Reporting entities should consider disclosure in these situations.

For further discussion of subsequent events, see FSP 28.

21.5.3 Effects of foreign exchange rate changes

Reporting entities include the effects of all exchange rate changes occurring during the year either in income (for transaction gains and losses) or as a component of OCI (for translation gains and losses).

Reporting entities may consider additional disclosure regarding the broader economic circumstances surrounding rate changes to assist financial statement users in understanding the effects on the results of operations and to improve the comparability of current results with prior periods.

ASC 830-20-50-3 notes that this disclosure is "encouraged," and that it may include (1) the effects of translating revenue and expenses at different rates than used in the previous period, and (2) the economic effects of rate changes, including the effects on selling prices, sales volume, and cost structures.

21.5.4 Foreign currency hedging policy

A reporting entity should consider disclosing its foreign currency hedging policy when it has a material impact on the financial statements and/or disclosure will enhance the comparability and transparency of the financial statements. See FSP 19.5 (post ASU 2017-12) or FSP 19.5A (pre ASU 2017-12) for a discussion of derivatives and hedging disclosures.

21.5.5 Determination of functional currency

ASC 830 does not require disclosure of the factors considered in determining functional currency. Nevertheless, in some instances, disclosure of the factors may be helpful to provide comparability and improved understanding of the results of operations.

21.5.6 Changes in functional currency

The SEC staff has stated in their *Division of Corporation Finance: Frequently Requested Accounting and Financial Reporting Interpretations and Guidance*, dated March 31, 2001, that registrants with foreign operations in economies that have recently experienced economic turmoil should evaluate whether significant changes in economic facts and circumstances have occurred that warrant reconsideration of their functional currencies. Reconsideration of the functional currency is also required when the economy in which a foreign operation is located ceases to be highly inflationary.

The SEC staff has indicated that ASC 830 does not prescribe specific disclosures about a change in functional currency. However, the SEC staff believes that disclosures in the financial statements and MD&A may be necessary to permit an investor to understand the foreign operations and their impact on the registrant's results of operations, liquidity, and cash flows. Registrants should consider the need to disclose the nature and timing of the change, the actual and reasonably likely effects of the change, and the economic facts and circumstances that led management to conclude that the change was appropriate. The effects of those underlying economic facts and circumstances on the registrant's business should also be discussed in MD&A.

See FX 3.3.2 for additional considerations related to changes in functional currency.

21.5.7 *Multiple foreign currency exchange rates*

Often, in economies with high inflation, significant currency exchange controls exist. In these situations, governments sometimes allow multiple legal exchange rates to exist and different rates may be used to remeasure monetary balances denominated in a foreign currency and to translate balances from a foreign entity's functional currency to the reporting currency. This may occur when one exchange rate is available for use in exchanging funds to be used for payment of purchases and an alternative rate is required for the payment of dividends.

ASC 830-30-S99 outlines the minimum expected disclosure requirements for SEC registrants when different exchange rates are used for remeasurement of monetary balances and for the translation of functional currency financial statements.

Excerpt from ASC 830-30-S99-1

- Disclosure of the rates used for remeasurement and translation.
- A description of why the actual U.S. dollar denominated balances differ from the amounts reported for financial reporting purposes, including the reasons for using two different rates with respect to remeasurement and translation.
- Disclosure of the relevant line items (e.g., cash, accounts payable) on the financial statements for which the amounts reported for financial reporting purposes differ from the underlying U.S. dollar denominated values.
- For each relevant line item, the difference between the amounts reported for financial reporting purposes versus the underlying U.S. dollar denominated values.
- Disclosure of the amount that will be recognized through the income statement (as well as the impact on the other financial statements) as part of highly inflationary accounting…

21.5.8 *Operations in highly inflationary economies*

We encourage robust disclosure regarding operations in highly inflationary economies. Reporting entities should consider disclosing the following related to subsidiaries in highly inflationary economies:

- A description of the business (including the types and amounts of materials imported, plant and equipment in country, and the impact of regulations such as price controls on the business)
- Summarized financial information (including balance sheet, statement of cash flows, and income statement)
- Net monetary assets and liabilities by currency
- The amount of any gain or loss that resulted from exchange rates that have changed

21.6 Considerations for private companies

The requirements of ASC 830 apply equally to public and private companies. SEC requirements in ASC 830-30-S99 regarding disclosure in the case of multiple foreign currency exchange rates apply only to SEC registrants.

Chapter 22: Transferred financial assets, and servicing assets/liabilities—updated November 2019

22.1 Chapter overview

This chapter discusses the presentation and disclosure requirements for transfers of financial assets and provides sample disclosures for various types of transfers. It also discusses presentation and disclosure considerations relating to recognized servicing assets and liabilities.

First, the chapter addresses disclosure objectives and the aggregation of disclosures. Next, it discusses presentation and disclosure considerations applicable to various types of transfers, including those exchanges accounted for as sales and those reported as collateralized borrowings. The chapter concludes with a discussion of presentation and disclosure considerations pertinent to servicing assets and liabilities.

Disclosure samples included in this chapter address some of the more common types of financial asset transfers, including:

- An originator's sale of whole loans to a securitization trust that it does not consolidate, with the originator retaining servicing and holding an economic interest in the trust
- A lender's periodic sales of participations in certain loans to third-party investors that qualify as a participating interest under ASC 860, *Transfers and Servicing*
- A reporting entity's periodic transfers of trade receivables to a multi-seller commercial paper conduit in exchange for cash and a subordinated interest in the receivables sold
- Repurchase and securities lending transactions involving exchanges of securities for cash and reported as collateralized borrowing arrangements

22.2 Scope and relevant guidance

ASC 860 is the principal source of authoritative guidance for evaluating the financial reporting and disclosure implications of transfers of financial assets within its scope. Servicers of financial assets must also consider the financial statement presentation and disclosure requirements in ASC 860 that apply to recognized servicing assets and liabilities.

Also highlighted in the chapter are the presentation and disclosure requirements for SEC registrants in Rule 4-08(b) and Rule 4-08(m) of Regulation S-X, which deal with collateralized financing activities (principally transactions involving repurchase or reverse repurchase agreements).

Further, S-X 9-03 includes guidance on banks' presentation of receivables and payables arising from resale and repurchase agreements accounted for as secured financings.

22.3 Disclosure objectives and aggregation of disclosures

The disclosure requirements under US GAAP capture a broad array of transactions involving the transfer of a financial asset. As explained more fully in TS 3, a reporting entity first determines whether a transfer meets the criteria for sale accounting (derecognition) in ASC 860 or whether the transfer should be reported as a secured borrowing. This determination dictates the characterization of the transaction for financial statement purposes. The scope and content of the required disclosures

depend, in part, on the accounting for the transfer (sale or secured borrowing) and the extent to which the transferor continues to be involved with the asset(s) subsequent to the transfer.

For the most part, the disclosure provisions in ASC 860 are detailed and prescriptive. However, reporting entities should keep in mind the broader disclosure objectives of ASC 860 when applying the requirements in practice. This is particularly true when a reporting entity is evaluating how to summarize and present information about numerous complex transactions involving transfers of financial assets in a manner most useful to readers.

22.3.1 Disclosure objectives

ASC 860-10-50-3 cites four broad objectives that frame the specific disclosure requirements set forth elsewhere in ASC 860. A reporting entity may need to supplement those required disclosures with additional information to achieve the broad disclosure objectives. In this regard, ASC 860-10-50-4 emphasizes that a reporting entity should pay particular attention to disclosing the facts and circumstances of a transfer, the nature of its continuing involvement with transferred financial assets, and the effect that such involvement may have on the reporting entity's financial position, financial performance, and cash flows.

A reporting entity's "continuing involvement" with transferred assets can take many forms, consistent with the Master Glossary's broad definition.

Excerpt of definition from ASC 860-10-20

Continuing Involvement: Any involvement with the transferred financial assets that permits the transferor to receive cash flows or other benefits that arise from the transferred financial assets or that obligates the transferor to provide additional cash flows or other assets to any party related to the transfer.

Common forms of continuing involvement on the part of the transferor include:

- Contracts to service the assets subsequent to transfer
- Seller representations and warranties with respect to the assets sold
- Recourse or guarantee arrangements relating to the transferred assets, or similar undertakings
- Derivatives, such as interest rate swaps and call options, executed with the transferee contemporaneously with, or in contemplation of, the transfer
- Beneficial interests (e.g., debt securities and/or trust certificates) issued by a securitization vehicle that acquired the financial assets

TS 3.4 and ASC 860-10-05-4 provide additional examples of potential forms of continuing involvement by a transferor.

The ASC 860 sale accounting model requires consideration of all forms of involvement that the reporting entity (including consolidated affiliates and agents) has or expects to have with transferred financial assets. The underlying sale accounting analysis (including related legal opinions, if any) may

serve as a useful starting point for identifying elements of continuing involvement that may warrant disclosure.

22.3.2 Aggregation of disclosures

ASC 860-10-50-4A permits a reporting entity to aggregate disclosures for multiple transfers having similar characteristics if separate reporting of each transfer would not provide financial statement users with information that is more useful. However, at a minimum, aggregated disclosures generally should distinguish between transfers that are accounted for as sales and those that are accounted for as secured borrowings. Transfers that are accounted for as sales should also distinguish between (1) transfers to securitization entities and (2) all other transfers. Reporting entities should also disclose how similar transfers have been aggregated.

ASC 860-10-50-5 provides the following quantitative and qualitative considerations when determining how to aggregate:

- The nature of the transferor's continuing involvement
- The types of assets transferred
- Risks attributable to the transferred assets that the transferor continues to bear and how that risk profile changed because of the transfer
- Information regarding risks and uncertainties required to be disclosed in ASC 310-10-50-25 and concentrations involving loan product terms

We believe reporting entities that intend to provide aggregated information about multiple transfers of financial assets may also consider the following characteristics when evaluating the most meaningful basis on which to aggregate this information:

- The legal form of the financial assets transferred
- If receivables or loans have been transferred, whether they are collateralized and, if so, the type of collateral (e.g., first-lien residential mortgage loans, second-lien home equity loans, commercial real estate loans, and auto loans)
- The nature and extent of the transferor's continuing involvement with the transferred assets (e.g., subordinated or senior beneficial interests issued by securitization trusts, guarantees or similar credit support arrangements, or derivative instruments, such as interest rate or total return swaps)
- Similar valuation assumptions and techniques used to measure beneficial interests in the transferred assets

We understand that the SEC staff has required SEC registrants to provide the disclosures called for in ASC 860-20-50 (see FSP 22.4) by each *type* of asset sold in securitization transactions.

Striking a balance between disclosures that are too detailed or too aggregated can be highly facts-and-circumstances specific. However, ASC 860-10-50-6 reminds reporting entities that, regardless of their relative level of detail, the disclosures should "clearly and fully" explain the following:

- The transferor's risk exposure related to transferred financial assets
- Any restrictions on the assets of the reporting entity stemming from these transactions

22.3.3 Location of disclosures

In practice, we find that reporting entities sometimes incorporate ASC 860-related disclosures into footnotes that address broader topical matters or provide information required by other accounting pronouncements, including the following:

- Providing information about transfers of financial assets to securitization entities and describing the forms of involvement with those assets and beneficial interests retained in a footnote that also discloses information about variable interest entities required by ASC 810, *Consolidation* (see FSP 18)
- Disclosing information about repurchase and resale agreements, and securities lending activities, in a footnote that also addresses the reporting entity's collateralized financing activities more generally
- Providing information about the reporting entity's approach to valuing servicing assets and servicing liabilities in a footnote that also discloses information about fair value measurements for all asset classes in accordance with ASC 820, *Fair Value Measurement* (see FSP 20)

22.3.4 Considerations for consolidated financial statements

When evaluating the necessary disclosures, a reporting entity should consider not only the transferor's involvement with transferred financial assets, but also involvements on the part of the transferor's consolidated affiliates included in the financial statements presented and the transferor's agents. For disclosure purposes, involvement by consolidated affiliates and agents is considered equivalent to involvement by the transferor itself, as noted in ASC 860-10-50-7.

22.3.5 Accounting policy disclosures footnote

A reporting entity should describe its principal accounting policy for transfers of financial assets if such transactions are common and/or material. This policy disclosure should be tailored to address specific types of transfers that the reporting entity has undertaken or that remain outstanding.

Figure FSP 22-1 is a sample summary of a reporting entity's accounting policies relating to transfers of financial assets generally. More prescriptive accounting policy disclosures required by ASC 860 or Regulation S-X with respect to such transfers are discussed in the remainder of this chapter.

Figure FSP 22-1

Sample disclosure—summary of significant accounting policies for transfers of financial assets

Note X—Summary of Significant Accounting Policies

Transfers of Financial Assets

The Company accounts for transfers of financial assets as sales when it has surrendered control over the related assets. Whether control has been relinquished requires, among other things, an evaluation

of relevant legal considerations and an assessment of the nature and extent of the Company's continuing involvement with the assets transferred. Gains and losses stemming from transfers reported as sales are included in "[line item]" in the accompanying statements of income. Assets obtained and liabilities incurred in connection with transfers reported as sales are initially recognized in the balance sheet at fair value.

Transfers of financial assets that do not qualify for sale accounting are reported as collateralized borrowings. Accordingly, the related assets remain on the Company's balance sheet and continue to be reported and accounted for as if the transfer had not occurred. Cash proceeds from these transfers are reported as liabilities, with attributable interest expense recognized over the life of the related transactions.

22.4 Transfers with continuing involvement reported as sales

ASC 860-20-50-3 and ASC 860-20-50-4 prescribe the disclosures for securitizations, asset-backed financing arrangements, and similar transfers that meet the following two conditions:

Excerpt from ASC 860-20-50-2

a. The transfer is accounted for as a sale

b. The transferor has continuing involvement with the transferred financial assets.

Certain disclosures for these types of transfers are required for each income statement presented, while others must be made for each balance sheet presented.

22.4.1 Disclosures for each income statement presented

As discussed in ASC 860-20-50-3, for each period for which an income statement is presented, disclosure requirements for transfers reported as sales with transferors having continuing involvement include:

- *Characteristics of the transfer*

  This information should include (1) a description of the reporting entity's continuing involvement with the transferred assets, (2) the nature and initial fair value of proceeds obtained and liabilities incurred, and (3) the gain or loss on sale.

- *Information about initial fair value measurements of assets obtained and liabilities incurred in connection with the transfer*

  This should include their level within the fair value hierarchy, key inputs and assumptions used in measuring fair values, and valuation techniques used. The reporting entity should provide quantitative information about (1) assumed discount rates, (2) expected prepayments (including the expected weighted-average life of prepayable financial assets), and (3) anticipated credit losses, including expected static pool losses.

The reporting entity may report the range of assumptions used if it has aggregated its transfer-related disclosures.

- *Cash flows between the transferor and transferee(s)*

  There should be separate disclosures of (1) proceeds from new transfers, (2) proceeds from collections reinvested in revolving-period transfers, (3) purchases of previously transferred financial assets, (4) servicing fees, and (5) cash flows received from interests (including beneficial interests) in the transferred assets held by the transferor.

See Figure FSP 22-2 and Figure FSP 22-4 for an illustration of these disclosure requirements.

22.4.2 Disclosures for each balance sheet presented

As of each balance sheet date, regardless of when the related transfer occurred, ASC 860-20-50-4 requires a transferor to disclose the following information about its ongoing involvement with the financial assets sold:

- *Qualitative and quantitative information about the transferor's continuing involvement with transferred financial assets*

  Information to be disclosed includes:

  - With respect to the transferred assets, (1) the total amount of principal outstanding at the balance sheet date, (2) the amount that has been derecognized, and (3) the amount that continues to be recorded in the balance sheet

  - Contractual arrangements that could require the reporting entity to provide financial support (e.g., liquidity arrangements and obligations to purchase assets) to the transferee or its beneficial interest holders

  - A description of circumstances that could expose the reporting entity to loss, and the amount of maximum exposure to loss, stemming from contractual support arrangements

  - The type, amount and reason for any support–financial or otherwise—provided by the reporting entity to the transferee (or its beneficial interest holders) that was not previously contractually required. Additionally, if the reporting entity assisted the transferee (or its beneficial interest holders) in obtaining support, that should be disclosed.

  - A reporting entity is encouraged–but not required—to disclose any third-party liquidity arrangements, guarantees, and/or other commitments that may affect the fair value of the reporting entity's interest in the transferred assets.

  These disclosures should allow financial statement users to readily comprehend the reason(s) for the reporting entity's continuing involvement with the transferred financial assets and the risk profile of that involvement. The disclosures should also clarify whether and how the transfer altered the reporting entity's risk profile to those assets, including (but not limited to) credit and interest rate risk.

- *Information relating to subsequent measurements of assets or liabilities attributable to the reporting entity's continuing involvement with transferred financial assets*

  Information to be disclosed includes:

  - A discussion of relevant accounting policies

  - Key assumptions (or range of assumptions, if the disclosures have been aggregated) used to measure the fair value of such assets or liabilities, including, but not limited to, (1) discount rates, (2) expected prepayments (including the expected weighted-average life of prepayable financial assets), and (3) anticipated credit losses, including expected static pool losses, if applicable

- *Sensitivity analysis*

  This disclosure should include the hypothetical impact on the fair value of a transferor's interests in the transferred assets (including servicing assets and servicing liabilities) stemming from two or more unfavorable variations from expected levels for each key assumption, keeping all other key assumption(s) unchanged. Further, the reporting entity should describe the objectives, methodology, and limitations of the sensitivity analysis or stress test.

  In practice, although there is no explicit requirement, certain reporting entities stress their key assumptions using variations of 10% and 20%. However, a reporting entity should use the thresholds that it considers most meaningful in the circumstances.

- *Asset quality of transferred financial assets and managed assets*

  This includes:

  - Information about the asset quality of transferred financial assets and any other assets the reporting entity manages together with them (separated between assets that have been derecognized and assets that continue to be recognized)

  - For receivables, delinquencies at the end of the period and credit losses, net of recoveries, during the period

    This asset quality information is intended to provide financial statement users with an understanding of the risks inherent in the transferred financial assets within the broader context of other financial assets and liabilities (and the associated risks) the reporting entity manages together with transferred assets.

The disclosures in ASC 860-20-50-4 are in addition to those that may be required under other US GAAP. For example, a reporting entity that owns a beneficial interest in transferred financial assets in the form of an asset-backed security should also consider the disclosure requirements in ASC 320, *Investments in Debt Securities*, applicable to debt securities more generally. See FSP 9 for a discussion of those requirements.

Figure FSP 22-2 illustrates a sample disclosure for a securitization of receivables (in this case, loans secured by automobiles) reported as a sale with continuing involvement. For simplicity, this sample disclosure omits any required comparative amounts.

Figure FSP 22-2

Sample disclosure—securitizations of auto loans reported as sales with beneficial interests obtained and servicing retained

Note X—Securitization of Automobile Loans

During 20X7, the Company sold pools of automobile loans in various securitization transactions. In these securitizations, the Company retained servicing responsibilities and received beneficial interests in the form of subordinated asset-backed securities. The Company owns only an insignificant portion of these subordinated securities and receives annual servicing fees approximating x% of the outstanding principal balance of the loans serviced. The Company and other investors in the subordinated beneficial interests have rights to cash flows after the investors holding each securitization trust's senior securities have first received their contractual returns. The investors and the securitization trusts have no recourse to the Company's assets; holders of the securities issued by each trust can look only to the loans owned by the trust for payment. The beneficial interests held by the Company are subject principally to the credit risk stemming from the underlying transferred auto loans.

The securitization trusts used to effect these transactions are variable interest entities that the Company does not consolidate. See Note Z, "Variable Interest Entities," for more information about these trusts.

The asset-backed securities received in connection with these transactions are initially measured in the Company's balance sheet at their fair value. Related servicing assets are also initially recognized at fair value. Gains or losses arising from these securitizations are measured as the difference between the transferred loans' carrying values and the sum of (a) the initial fair value of the beneficial interests received and any servicing asset and (b) cash proceeds. In 20X7, the Company recognized pretax gains of $xx.x million attributable to the foregoing securitization activity. These gains are included in "[line item]" reported in the accompanying statements of income.

Quoted market prices are rarely available for beneficial interests obtained in connection with these transactions. Accordingly, the Company generally estimates the initial fair value of its subordinated interests based on the present value of expected future cash flows. These cash flows are calculated using best estimates of market-based assumptions—anticipated credit losses, prepayment speeds and weighted average lives of the related loans, and discount rates commensurate with the risks inherent in the interests. These estimates are sometimes developed based on inputs observable in relevant markets, in which case the beneficial interests may fall within Level 2 of the fair value hierarchy. In other instances, because certain of the inputs used are not observable, the beneficial interests fall within Level 3 of the hierarchy.

Key economic assumptions used in measuring the beneficial interests obtained at the securitization date resulting from securitizations completed during 20X7 were as follows:

- Expected credit losses on underlying loans: x.x% to x.x% (annual rate)
- Expected annual prepayment rate of underlying loans: x.x% to x.x%
- Weighted average life of underlying loans: x.x to x.x (years)
- Rates used to discount residual cash flows: xx.x% to xx.x%

The Company remeasures the carrying value of its subordinated beneficial interests and servicing assets at each reporting date to reflect their current fair value, with corresponding gains and losses credited or charged to income. At December 31, 20X7, key economic assumptions and the sensitivity of the current fair value of the subordinated beneficial interests held by the Company to 10% and 20% adverse changes in those assumptions are as follows ($ in millions):

	20X7
Carrying amount/fair value of subordinated beneficial interests	$x,xxx
Weighted average life of underlying loans (years)	x.x-x.x
Assumed prepayments (annual rate)	x.x-x.x%
Impact of 10% adverse change	$(xx)
Impact of 20% adverse change	$(xxx)
Expected credit losses (annual rate)	x.x-x.x%
Impact of 10% adverse change	$(xx)
Impact of 20% adverse change	$(xxx)
Annual rate used to discount residual cash flows	xx.x-xx.x%
Impact of 10% adverse change	$(xx)
Impact of 20% adverse change	$(xxx)

These sensitivities are hypothetical and should be viewed in that context. As the figures indicate, the change in fair value based on a stated percentage variation in an assumption generally cannot be extrapolated because the relationship between the change in an assumption and the change in fair value may not be linear. Also, the effect of a variation in a particular assumption on the fair value of the beneficial interests is calculated independently of any other assumption. In reality, changes in one assumption may result in changes to other(s), leading to a combined effect that could magnify or counteract the indicated change in value. For example, increases in market interest rates generally slow prepayments and may lead to increased credit losses.

The following table summarizes certain cash flows received from and paid to securitization trusts during 20X7 ($ in millions):

Proceeds from securitizations	$x,xxx
Servicing fees received	xx
Principal and interest collections received on subordinated beneficial interests	xxx
Purchases of delinquent loans, and payments relating to seller representation and warranty recourse obligations	(xx)

The following table presents quantitative information about automobile loans managed by the Company (including those owned and securitized) and related delinquent loans ($ in millions) as of December 31,20X7:

	Principal amount of loans	Principal amount of loans 60 days or more past due	Net credit losses (charge offs) during 20X7
Total loans managed (owned and securitized)	$x,xxx	$xxx	$xx
Components of managed loans:			
Securitized loans	x,xxx	xx	xx
Loans held in portfolio or for sale	xxx	xx	x

22.4.3 *Disclosure of sales that retain economic exposure*

ASC 860-20-50-4D requires reporting entities to disclose certain information about transactions that (1) involve a transfer of a financial asset reported as a sale and (2) are accompanied by an agreement (entered into with the transferee in contemplation of the transfer) that results in the reporting entity retaining substantially all of the exposure to the economic risk and returns of the transferred asset during the transaction's term. Examples of these transactions include:

- Cash-settled repurchase agreements having a fixed or determinable redemption price that settle prior to the maturity date of the transferred financial asset
- Transfers of financial assets accompanied by an agreement under which the reporting entity retains substantially all of the transferred asset's economic returns through the term of the transaction (e.g., in the form of a total return swap that runs either to maturity of the financial asset or for a shorter time period during which economic exposure is maintained)

Transfers of financial assets meeting the two conditions cited in ASC 860-20-50-2 (see FSP 22.4) are scoped out of the disclosure requirements of ASC 860-20-50-4D. These transfers would be subject to the detailed disclosure requirements in ASC 860-20-50-3 and ASC 860-20-50-4 (see FSP 22.4.2).

Similarly, the disclosure provisions do not extend to repurchase agreements accounted for as sales because the financial assets to be reacquired fail to meet the conditions in ASC 860-10-40-24(a) to be considered "substantially the same."

Under ASC 860-20-50-4D, a reporting entity is required to disclose the following about transactions subject to its scope at each reporting date:

Excerpt from 860-20-50-4D

a. The carrying amount of assets derecognized as of the date of derecognition:

   1. If the amounts that have been derecognized have changed significantly from the amounts that have been derecognized in prior periods or are not representative of the activity throughout the period, a discussion of the reasons for the change shall be disclosed.

b. The amount of gross cash proceeds received by the transferor for the assets derecognized as of the date of derecognition.

c. Information about the transferor's ongoing exposure to the economic return on the transferred financial assets:

   1. As of the reporting date, the fair value of assets derecognized by the transferor.

   2. Amounts reported in the statement of financial position arising from the transaction (for example, the carrying value or fair value of forward repurchase agreements or swap contracts). To the extent that those amounts are captured in the derivative disclosures presented in accordance with paragraph 815-10-50-4B, an entity shall provide a cross-reference to the appropriate line item in that disclosure.

   3. A description of the arrangements that result in the transferor retaining substantially all of the exposure to the economic return on the transferred financial assets and the risks related to those arrangements.

22.5 Sales of loans and trade receivables

ASC 860-20-50-5 requires reporting entities to present separately in the income statement or disclose in the footnotes the aggregate amount of gains or losses on sales of loans or trade receivables (including adjustments to record loans held for sale at the lower of cost or fair value) for each period presented. In certain instances, the reporting entity may find it appropriate to integrate this information into the disclosures required for loans and trade receivables by ASC 310, *Receivables*. See FSP 8.3 for more information about those disclosure requirements.

Figure FSP 22-3 illustrates a sample disclosure about periodic sales of participating interests in certain loans to institutional investors. Disclosures of loans are addressed in FSP 8. For simplicity, this sample disclosure omits any required comparative amounts.

Figure FSP 22-3

Sample disclosure—sales of loans (transfers of participating interests)

Note X—Sales of Loan Participations

During 20X7, the Company sold participations in certain commercial and construction development loans in transactions negotiated with various institutional investors. In each case, the Company retains servicing responsibilities for the underlying loan as well as a participating interest in the loan. Interests sold and retained are pari passu, and entitle each holder (including the Company) to all cash flows received from the underlying loan proportionate to its interest, net of the servicing fee. The Company receives annual servicing fees approximating x% (for commercial loans) and x% (for construction development loans) of the outstanding loan balance owned by others.

The investors have no recourse to the Company for failure of the underlying debtors to pay amounts contractually due. Since all participating interests are pari passu, the Company's retained interests are subject to the same credit, prepayment, and interest rate risks as the transferred interests, and mirror the risks of each loan as a whole. These interests are included in the Company's loan portfolio and are accounted for at amortized cost, net of an allowance for loan losses.

In 20X7, the Company recognized pretax gains of $xx.x million on sales of participations in commercial loans and $x.x million on similar sales involving construction development loans.

Figure FSP 22-4 illustrates a sample disclosure about sales of trade receivables to a multi-seller commercial paper conduit under a revolving financing facility. For simplicity, this sample disclosure omits any required comparative amounts.

Figure FSP 22-4

Sample disclosure—sales of trade receivables (under a revolving financing facility with a multi-seller commercial paper conduit)

Note X—Sales of Trade Receivables

In 20X7, the Company entered into a revolving accounts receivable financing arrangement with a multi-seller commercial paper conduit managed by a major domestic bank. The facility, whose maximum capacity is $xxx million, is scheduled to expire in October 20X8 unless renewed by the mutual consent of the parties.

Under the arrangement, the Company may sell eligible short-term trade receivables to the conduit on a monthly basis in exchange for cash and a subordinated interest. The transfers are reported as sales in the accompanying financial statements. The subordinated interest, a receivable from the conduit, is referred to as the "deferred purchase price (DPP)." Generally, at the transfer date, the Company receives cash equal to approximately 90% of the value of the sold receivables. The Company continues to service the receivables sold in exchange for a fee.

The DPP is carried at fair value, which is remeasured monthly to take into account activity during the period (the Company's interest in newly-transferred receivables and collections on previously transferred receivables attributable to the DPP), as well as changes in estimates of future interest rates and anticipated credit losses. Changes in the DPP's value attributable to fluctuations in interest rates and revised estimates of anticipated credit losses have been and are expected to be immaterial, as the underlying receivables are short-term and of high credit quality. The valuation estimate of the DPP falls within Level 3 of the fair value hierarchy.

During 20X7, the Company sold receivables having an aggregate face value of $xx million to the conduit in exchange for cash proceeds of $xx million, of which $xx million was funded by re-invested collections. Losses incurred on these sales during the year amounted to $x.x million, and are included in "[line item]" in the accompanying statements of income. Related servicing fees for the period were immaterial.

At December 31, 20X7, the outstanding principal amount of receivables sold under this facility amounted to $xx million. The carrying amount of the related DPP receivable in the accompanying balance sheet was $x.x million and is classified within "[line item]."

22.6 Collateral and transfers reported as secured borrowings

A borrower may grant a security interest in financial assets to a lender (the secured party) that serves as collateral for the borrower's obligation(s). Under these arrangements, the debtor frequently is required to transfer the collateral to the lender or to a custodian. This section assumes that this transfer of collateral would not result in derecognition of the collateral under ASC 860-30-40. ASC 860-30 and Regulation S-X prescribe certain presentation and disclosure requirements for reporting entities involved in these transactions.

22.6.1 Balance sheet presentation — general considerations

If a secured party (transferee of collateral) has the right by contract or custom to sell or repledge collateral received, ASC 860-30-45-1 requires the transferor of the collateral to report the asset on its balance sheet separately from other assets not encumbered or pledged (e.g., as "securities pledged to creditors"). However, ASC 860-30-45-3 clarifies that a transferor has discretion regarding the classification and terminology used to comply with this requirement.

Similarly, ASC 860-30-45-2 directs that liabilities incurred by either the secured party or obligor arising from securities lending transactions or repurchase agreements (also referred to as "repos") be separately classified on its balance sheet. However, once again, ASC 860 does not prescribe how a reporting entity should characterize these liabilities. In practice, we have seen the following descriptions used:

- "Securities loaned or sold under repurchase agreements" or "Securities loaned or sold under agreements to repurchase"
- "Repurchase agreements"
- "Securities sold under agreements to repurchase" or "Securities sold under repurchase agreements"

Similarly, we have seen reporting entities use the following terms to describe receivables relating to resale agreements (also referred to as "reverse repurchase agreements" or "reverse repos") and securities borrowing transactions:

- "Securities borrowed or purchased under resale agreements" or "Securities borrowed or purchased under agreements to resell"
- "Resale agreements" or "Securities borrowed"
- "Securities purchased under agreements to resell" or "Securities purchased under resale agreements"

Reporting entities that prepare their financial statements in accordance with Regulation S-X should also consider these presentation requirements (see FSP 22.6.5):

- Under S-X 4-08(m), if the aggregate carrying amount (or market value, if higher) of securities or other assets sold under repurchase agreements exceeds 10% of total assets, a registrant is required to present the aggregate related liability separately on the balance sheet. Similarly, if the aggregate

carrying amount of reverse repurchase agreements exceeds 10% of total assets, a registrant is required to present the aggregate related receivable separately on the balance sheet.

- Banks subject to the reporting requirements in S-X 9-03 frequently combine amounts owed by them (due to them) under repurchase agreements or securities lending agreements with the liability (receivable) arising from borrowing (selling) federal funds, and report the aggregate liability (receivable) amount as a single line item on the balance sheet. S-X 9-03 prohibits any net presentation of these obligations and receivables.

22.6.2 Balance sheet presentation — offsetting considerations

A reporting entity may offset (present net) receivables and payables if a right of setoff exists, as defined in ASC 210-20-45-1. Contractual terms and settlement conventions prevalent in the securities lending markets usually preclude these transactions from meeting the four conditions cited in that paragraph. Thus, receivables and payables stemming from securities lending and borrowing activities are often reported gross on the balance sheet.

Notwithstanding the criterion in ASC 210-20-45-1(c) regarding intention to setoff, payables and receivables arising from repurchase and reverse repurchase agreements may also qualify for balance sheet offset if the contractual terms and related settlement arrangements meet the six criteria cited in ASC 210-20-45-11. These conditions are specific to repos/reverse repos, and are not applicable by analogy to other transactions. Further, the reporting entity's choice to offset (or not) is to be applied consistently.

Excerpt from ASC 210-20-45-11

...[A]n entity may, but is not required to, offset amounts recognized as payables under repurchase agreements accounted for as collateralized borrowings and amounts recognized as receivables under reverse repurchase agreements accounted for as collateralized borrowings if all of the following conditions are met:

a. The repurchase and reverse repurchase agreements are executed with the same counterparty.

b. The repurchase and reverse repurchase agreements have the same explicit settlement date specified at the inception of the agreement.

c. The repurchase and reverse repurchase agreements are executed in accordance with a master netting arrangement.

d. The securities underlying the repurchase and reverse repurchase agreement exist in book entry form and can be transferred only by means of entries in the records of the transfer system operator or securities custodian…

e. The repurchase and reverse repurchase agreements will be settled on a securities transfer system…, and the entity must have associated banking arrangements in place…

f. The entity intends to use the same account at the clearing bank or other financial institution at the settlement date in transacting both the cash inflows resulting from the settlement of the reverse repurchase agreement and the cash outflows in settlement of the offsetting repurchase agreement.

A reporting entity may not offset payables and receivables arising from repurchase and reverse repurchase agreements based solely on the existence of a master netting arrangement with the counterparty.

22.6.3 Disclosure of offsetting and master netting

A reporting entity that offsets amounts attributable to (1) repurchase and reverse repurchase agreements and/or (2) securities borrowing and lending transactions is subject to the disclosure requirements in ASC 210-20-50. The disclosures in ASC 210-20-50 also extend to reverse repurchase and repurchase agreements, and to securities borrowing and lending transactions, subject to enforceable master netting arrangements regardless of whether the related receivables and payables are offset in the reporting entity's balance sheet.

See FSP 19.5.7 for information about the disclosures required by ASC 210-20-50.

22.6.4 Collateralized financing transactions: obligors' disclosures

For repurchase agreements, repurchase-to-maturity transactions, and securities lending agreements reported as secured borrowings, ASC 860-30-50-7 directs obligors (i.e., reporting entities that have transferred financial assets (collateral)) to provide the following information for each interim and annual period:

Excerpt from ASC 860-30-50-7

[A]n entity shall disclose the following information for each interim and annual period about the collateral pledged and the associated risks to which the transferor continues to be exposed after the transfer:

a. A disaggregation of the gross obligation by the class of collateral pledged. An entity shall determine the appropriate level of disaggregation and classes to be presented on the basis of the nature, characteristics, and risks of the collateral pledged.

    1. Total borrowings under those agreements shall be reconciled to the amount of the gross liability for repurchase agreements and securities lending transactions disclosed in accordance with paragraph 210-20-50-3(a) before any adjustments for offsetting. Any difference between the amount of the gross obligation disclosed under this paragraph and the amount disclosed in accordance with paragraph 210-20-50-3(a) shall be presented as reconciling item(s).

b. The remaining contractual maturity of the repurchase agreements, securities lending transactions, and repurchase-to-maturity transactions. An entity shall use judgment to determine an appropriate range of maturity intervals that would convey an understanding of the overall maturity profile of the entity's financing agreements.

c. A discussion of the potential risks associated with the agreements and related collateral pledged, including obligations arising from a decline in the fair value of the collateral pledged and how those risks are managed.

ASC 860-30-55-4 illustrates one approach for meeting the quantitative disclosure requirements of ASC 860-30-50-7.

22.6.5 Regulation S-X disclosures for repos and reverse repos

If the aggregate carrying amount (or market value, if higher) of securities or other assets sold under repurchase agreements exceeds 10% of total assets, S-X 4-08(m) requires a registrant to disclose in the footnotes:

- The carrying value and market value of the assets sold (exclusive of trading assets or assets obtained under reverse repurchase agreements), segregated by security type and grouped by ranges of the agreements' maturity dates, along with the associated liability and related interest rate(s), presented in a tabular format
- If the amount at risk under these agreements (as defined in the rule) with any single counterparty (or group of related counterparties) exceeds 10% of stockholders' equity, the counterparty's (or group's) name, the amount at risk with each, and the weighted average maturity of the underlying agreements

If the aggregate carrying amount of reverse repurchase agreements exceeds 10% of total assets, a registrant is required to provide the following disclosures:

- The registrant's policy with regard to taking possession of the securities or assets under the agreements
- Provisions to ensure that the market value of the underlying assets remains sufficient to protect the registrant in the event of counterparty default and disclosures about the nature of those provisions
- If the amount at risk under these agreements (as defined in the rule) with any single counterparty (or group of related counterparties) exceeds 10% of stockholders' equity (or net asset value, if an investment company), the counterparty's (or group's) name(s), the amount at risk, and the weighted average maturity of the underlying agreements

22.6.6 Collateral-related disclosures

ASC 860-30-50-1A requires the following disclosures about collateral:

- The reporting entity's policy for requiring collateral or other security in repurchase agreements and securities lending transactions
- As of the latest balance sheet date presented, the carrying amount and classification of assets pledged as collateral that are not reclassified and separately reported on the balance sheet, and associated liabilities
- As of the latest balance sheet date presented, qualitative information about the relationship between the pledged assets and associated liabilities (e.g., restrictions on the use of the collateral pledged to secure certain obligations)
- With respect to collateral the reporting entity is permitted to sell or repledge:
    - The fair value of the collateral and the fair value of any portion sold or repledged for each balance sheet presented

- Information about the sources and uses of the collateral

S-X 4-08(b) also requires registrants to provide information about assets mortgaged, pledged, or otherwise subject to lien, and identify the obligations collateralized for the most recent balance sheet filed. This information may appear on the face of the balance sheet or in the footnotes.

Figure FSP 22-5 illustrates a sample disclosure of accounting and reporting policies relating to repurchase (resale) agreements and securities lending (borrowing) transactions, accompanied by a discussion of its policies regarding related collateral. For simplicity, this sample disclosure omits any required comparative amounts.

Figure FSP 22-5

Sample disclosure—summary of significant accounting policies: repurchase and securities lending transactions and related collateral arrangements

This sample disclosure illustrates the application of certain of the requirements in ASC 860-30-50-1A.

Note X—Summary of Significant Accounting Policies

Securities Financing Arrangements

Securities purchased under agreements to resell and securities sold under agreements to repurchase are reported as financing transactions, and thus the related receivables and payables are presented in the accompanying balance sheets at the amounts at which the securities subsequently will be resold or reacquired as specified in the respective agreements. Such amounts include accrued interest. Receivables and payables arising from these agreements are offset in the balance sheet when permitted under applicable accounting standards. It is the Company's policy to take possession of securities purchased under agreements to resell. On a daily basis, the Company monitors the fair value of the underlying securities as compared to the related receivable, including accrued interest, and requests additional collateral as necessary. The Company's agreements with third parties specify their rights to request additional collateral. All collateral is held by the Company or a custodian.

Securities borrowed and securities loaned transactions also are reported as financing transactions, and thus the related receivable and payables are carried at the amounts of cash advanced and received, respectively, plus accrued interest. The Company measures the fair value of the securities borrowed and loaned against the cash collateral on a daily basis. Additional cash collateral is obtained as necessary to ensure such transactions are adequately collateralized. The Company's agreements with third parties specify their rights to request additional collateral. All collateral is held by the Company or a custodian. It is the Company's policy to accept only cash collateral in connection with these transactions.

For certain resale agreements and securities-borrowed transactions, securities received qualify for recognition on the balance sheet, in which case they are recorded at fair value, along with a corresponding obligation to return them. Cash collateral received in connection with repurchase agreements and securities-lending arrangements is recorded on the Company's balance sheet, along with the related obligation to reacquire the securities. Securities sold under repurchase agreements and securities loaned that the transferee-borrower may sell or repledge are reclassified and reported separately on the accompanying balance sheet.

22.7 Servicing assets and servicing liabilities

Inherent in all financial assets, servicing comprises activities such as collecting principal and interest, maintaining escrow accounts, pursuing workouts and restructurings of delinquent loans, and initiating foreclosures. A reporting entity may recognize a servicing asset or a servicing liability arising from a contractual undertaking to service a financial asset or group of financial assets. TS 6.3 discusses the circumstances under which a servicing asset or liability should be recognized.

22.7.1 Balance sheet presentation

Servicing assets and liabilities are initially measured at fair value, consistent with the guidance in ASC 860-50-30.

Servicing assets are to be reported separately from servicing liabilities on the reporting entity's balance sheet. Offsetting is not permitted. Further, ASC 860-50-45-1 requires that a reporting entity's balance sheet distinguish between servicing assets/liabilities subsequently measured at fair value and those measured using the amortization method.

ASC 860-50-45-2 provides two options for how a reporting entity may meet the separate reporting requirement:

- Presenting separate line items for the amounts subsequently measured at fair value versus those subsequently measured under the amortization method

- Combining all amounts in one line, with parenthetical disclosure of the amount measured at fair value

22.7.2 Disclosures applicable to all servicing assets and liabilities

Recognized servicing assets and/or liabilities are subject to the applicable disclosure requirements in ASC 860-50-50. The scope and content of the disclosures depends, in part, on whether the servicer measures the assets and liabilities at amortized cost or fair value, which is an accounting policy election. TS 6.3 discusses the principal accounting and measurement considerations relative to these assets and liabilities.

A reporting entity should first consider the disclosure requirements in ASC 860-50-50-2, which are generally applicable to servicing assets and liabilities, and then apply the specific disclosure requirements predicated on how these assets and liabilities are subsequently measured.

Excerpt from ASC 860-50-50-2

For all servicing assets and servicing liabilities, all the following shall be disclosed:

a. Management's basis for determining its classes of servicing assets and servicing liabilities.

b. A description of the risks inherent in servicing assets and servicing liabilities and, if applicable, the instruments used to mitigate the income statement effect of changes in the fair value of the servicing assets and servicing liabilities.

c. The amount of contractually specified servicing fees, late fees, and ancillary fees recognized for each period for which results of operations are presented, including a description of where each amount is reported in the statement of income.

d. Quantitative and qualitative information about the assumptions used to estimate fair value (for example, discount rates, anticipated credit losses, and prepayment speeds).

See TS 6.3.4 for matters a reporting entity should consider when identifying classes of servicing assets and liabilities. The remaining disclosure requirements in ASC 860-50-50 are class-specific, so the reporting entity's determination of the appropriate classes of servicing assets and liabilities has both accounting and disclosure implications.

ASC 860-50-50-2 also encourages, but does not require, a reporting entity to disclose quantitative information about instruments used to manage the risks inherent in servicing assets and liabilities. This information may include the fair value of the instruments at the beginning and end of the period and the assumptions used to estimate the fair value. As part of this discussion, reporting entities may find it useful to explain why certain instruments were chosen to execute related risk management strategies, and how they are used in the context of those strategies.

See Figure FSP 22-6 for an illustration of certain of these required disclosures.

22.7.3 Disclosure of servicing rights measured at fair value

Servicing assets and liabilities that are subsequently measured at fair value are subject to the fair value disclosure requirements in ASC 820 (see FSP 20). In addition, for each income statement period presented, with respect to servicing assets and liabilities subsequently measured at fair value, the reporting entity should disclose the activity in the balance of each class of servicing assets and liabilities in accordance with ASC 860-50-50-3, including, but not limited to:

- Beginning and ending balances
- Additions (purchases of servicing assets, assumptions of servicing liabilities, and recognition of servicing obligations that result from transfers of financial assets)
- Disposals
- Changes in fair value during the period attributable to (1) changes in valuation inputs or assumptions or (2) other changes in fair value and a description of those changes
- Other changes that affect the balance and a description of those changes

The disclosure should include a description of where changes in fair value are reported in the income statement. See Figure FSP 22-6 for an illustration of certain of these required disclosures.

22.7.4 Disclosure of servicing rights under the amortization method

ASC 860-50-50-4 requires the following disclosures for servicing assets and liabilities subsequently measured under the amortization method for each period for which an income statement is presented:

- The activity in the balance of each class of servicing assets and liabilities including but not limited to:
  - Beginning and ending balances
  - Additions (purchases of servicing assets, assumptions of servicing liabilities, and recognition of servicing obligations resulting from transfers of financial assets)
  - Disposals
  - Amortization
  - Valuation allowance to adjust the carrying value of servicing assets
  - Other-than-temporary impairments
  - Other changes that affect the balance and a description of those changes

  This disclosure should include a description of where changes in the carrying amount are reported in the income statement for each period.
- The fair value for each class of recognized servicing assets and liabilities at the beginning and end of the period
- The risk characteristics used to stratify servicing assets for purposes of measuring impairment. If the predominant risk characteristics and corresponding strata are changed, the reporting entity should disclose that fact and the reasons for those changes.
- For each period for which an income statement is presented, the activity by class in any valuation allowance of servicing assets, including:
  - Beginning and ending balances
  - Aggregate additions charged and recoveries credited to operations
  - Aggregate write-downs charged against the allowance

Figure FSP 22-6 illustrates a sample disclosure of accounting and reporting policies relating to servicing assets and liabilities, and the disclosures about the changes in the balances of those assets and liabilities during the reporting period. For simplicity, this sample disclosure omits any required comparative amounts. Although presented here as a single footnote, a reporting entity may prefer instead to include some of the information in its summary of significant accounting policies.

Figure FSP 22-6

Sample disclosure—servicing assets and servicing liabilities

This sample disclosure illustrates the application of certain of the requirements in ASC 860-50-50-2 through ASC 860-50-50-4.

Note X: Servicing Assets and Servicing Liabilities

In accordance with applicable accounting standards, the Company records a separate servicing asset or servicing liability representing the right or obligation to service third-party mortgage loans or mortgage loans that it has securitized in transactions accounted for as a sale. If servicing is retained in connection with these securitizations, the resulting servicing asset or liability is initially recorded at its fair value as a component of the transaction's sale proceeds. Initial measurement is based on an analysis of discounted cash flows based on assumptions that market participants use to estimate fair value including, but not limited to, estimates of prepayment rates, default rates, discount rates, contractual servicing fee income, escrow account earnings, and ancillary income and late fees.

Servicing assets and servicing liabilities are subsequently measured at either fair value or amortized in proportion to, and over the period of, estimated net servicing income. The Company elects one of those methods on a class basis. A class is determined based on (1) the availability of market inputs used in determining the fair value of servicing assets and servicing liabilities, and/or (2) our method for managing the risks of servicing assets and servicing liabilities. Based on consideration of these factors, the Company currently applies the fair value method when accounting for servicing rights related to residential real estate loans. The amortization method is followed with respect to servicing rights for commercial mortgage loans.

Servicing assets and servicing liabilities relating to commercial mortgage loans are amortized in proportion to, and over the period of, estimated net servicing income. The impairment of those servicing assets or increases in fair values of servicing liabilities (above carrying values) are evaluated through an assessment of the fair value of those assets and liabilities via a disaggregated, discounted cash flow method under which the assets and liabilities are disaggregated into various strata, based on predominant risk characteristics. The net carrying value of each stratum is compared to its estimated fair value to determine whether adjustments should be made to carrying values or amortization schedules. Impairment of a servicing asset is recognized through a valuation allowance and a charge to current period earnings if it is considered to be temporary or through a direct write-down of the asset and a charge to current period earnings if it is considered other-than-temporary. An increase in the fair value of a servicing liability above its carrying value is recognized through an increase in the liability and a charge to current period earnings. The predominant risk characteristics of the underlying commercial mortgage loans that are used to stratify the servicing assets and liabilities for impairment purposes generally include the (1) loan origination date, (2) loan rate, (3) loan type and size, (4) loan maturity date, and (5) geographic location.

The rate of prepayment of loans serviced (both commercial and residential) is the most significant estimate involved in the measurement process. Estimates of prepayment rates consider prepayment history, projections observed or inferred in the marketplace, industry trends, and other considerations. Actual prepayment rates frequently differ from those projected by management due to changes in a variety of economic factors, including prevailing interest rates and the availability of alternative financing sources to borrowers. If actual prepayments of the loans being serviced were to occur more quickly than projected, the Company may be required to write down the carrying value of servicing through a charge to earnings (or in the case of a servicing liability, reduce the carrying value

through a credit to earnings in certain circumstances) in the current period. Conversely, if actual prepayments of the loans being serviced were to occur more slowly than had been projected, the carrying value of servicing assets could increase, and servicing income would exceed previously projected amounts; in the case of a servicing liability, a charge to earnings may be required in these circumstances. Accordingly, the servicing assets actually realized, or the servicing liabilities actually incurred, could differ from the amounts initially recorded.

Changes in the balances of servicing assets and servicing liabilities for residential mortgage loans measured using the fair value method for the year ended December 31, 20X7 were:

	Residential mortgage loans	
	Servicing assets	**Servicing liabilities**
Fair value as of January 1, 20X7	$xx,xxx	$xxx
Additions:		
Purchases of servicing assets	x,xxx	N/A
Assumption of servicing obligations	x,xxx	xx
Servicing obligations that result from transfers of financial assets	xx,xxx	xx
Subtractions—disposals	(xx)	(x)
Changes in fair value:		
Due to change in valuation inputs or assumptions used in valuation model	xx/(xx)	xx/(xx)
Other changes in value	xx/(xx)	xx/(xx)
Fair value as of December 31, 20X7	$xxx,xxx	$xx

Changes in the balances of servicing assets and servicing liabilities for commercial mortgage loans subsequently measured using the amortization method for the year ended December 31, 20X7 are as follows:

	Commercial mortgage loans	
	Servicing assets	**Servicing liabilities**
Carrying amount as of January 1, 20X7	$xx,xxx	$xxx
Additions:		
Purchases of servicing assets	xxx	N/A
Assumption of servicing obligations	xx	x
Servicing obligations that result from transfers of financial assets	x,xxx	x
Subtractions:		
Disposals	(xx)	(x)
Amortization	(x,xxx)	(xx)
Other-than-temporary impairments	(xx)	N/A
Recognition of additional servicing liability stemming from increase in fair value	N/A	x
Carrying amount before valuation allowance	xx,xxx	xxx
Valuation allowance for servicing assets:		
Beginning balance	xxx	N/A
Provision charged to operations	xx	N/A
Other-than-temporary impairments	(xx)	N/A
Sales and disposals	(xx)	N/A

	Commercial mortgage loans	
	Servicing assets	Servicing liabilities
Ending balance	xxx	N/A
Carrying amount as of December 31, 20X7	$xx,xxx	$xxx
Fair value as of January 1, 20X7	$xx,xxx	$xxx
Fair value as of December 31, 20X7	$xx,xxx	$xxx

22.7.5 *Subsequent election to measure servicing rights at fair value*

ASC 860-50-35-3(d) allows a reporting entity, at the beginning of its fiscal year, to subsequently measure at fair value a class of servicing assets or liabilities previously accounted for under the amortization method. ASC 860-50-50-5 requires separate disclosure of the amount of the cumulative-effect adjustment to retained earnings resulting from the election, which is irrevocable.

22.8 *Considerations for private companies*

The presentation and disclosure considerations required in ASC 860 are applicable to both public and private entities.

The presentation and disclosure requirements in S-X 4-08(b), S-X 4-08(m), and S-X 9-03 (see FSP 22.6) pertain only to financial statements filed with the SEC.

Chapter 23: Commitments, contingencies, and guarantees—updated November 2023

23.1 Commitments, contingencies, and guarantees—overview

This chapter discusses the presentation and disclosure considerations related to commitments, contingencies, and guarantees. See also FSP 23.9 for cross references to other chapters that include additional information on certain types of commitments, contingencies, and guarantees.

In addition, certain commitments are unique to certain industries and are discussed in the accounting guidance specific to that industry. Because this guide is intended for a broad array of reporting entities, industry-specific guidance is not covered.

23.2 Commitments, contingencies, and guarantees—scope and relevant guidance

ASC 440, *Commitments*, provides general guidance for commitments. The guidance within ASC 440 is broken down into two categories of commitments: general commitments and unconditional purchase obligations. Both categories are covered in this chapter.

ASC 450, *Contingencies*, contains guidance on the recognition, measurement, presentation and disclosure requirements related to loss contingencies. Disclosures of gain and loss contingencies continue to be an area of focus for the SEC, investors, and auditors.

ASC 460, *Guarantees,* provides guidance on a guarantor's recognition, measurement, and disclosures for certain guarantees, including financial guarantees, performance guarantees, indemnifications, indirect guarantees of indebtedness of others, and product warranties. The required disclosures include information on the nature of the guarantees, potential maximum payments under the guarantees, as well as possible recoveries.

23.3 Commitments

Although ASC 440 is the prevailing guidance related to commitments, it does not address presentation matters. For SEC registrants, S-X 5-02 (25) requires commercial and industrial companies to include the caption "Commitments and contingent liabilities" on the balance sheet. The SEC staff requires this caption to appear on the balance sheet whenever a footnote bears such a title or one that is similar. If no such footnote exists or the only disclosed commitments are, immaterial items, then the caption need not appear on the balance sheet.

23.3.1 General commitments

As discussed in ASC 440-10-50-1, the financial statement footnotes must include disclosure of the following items:

- Unused letters of credit (see FSP 12)
- Leases (see FSP 14)
- Assets pledged as security for loans (see FSP 12)
- Pension plans (see FSP 13)

- The existence of cumulative preferred stock dividends in arrears (see FSP 5)

Additionally, as discussed in ASC 440-10-50-1(f), reporting entities should disclose commitments, including those related to a commitment to acquire a plant, an obligation to reduce debts, an obligation to maintain working capital, or an obligation to restrict dividends.

23.3.2 *Unconditional purchase obligations*

Unconditional purchase obligations, such as take-or-pay contracts and through-put contracts, are types of commitments for which specific disclosures are required. An unconditional purchase obligation that has **all** of the following characteristics is required to be disclosed:

Excerpt from ASC 440-10-50-2

a. It is noncancelable, or cancelable only in any of the following circumstances:

    1. Upon the occurrence of some remote contingency

    2. With the permission of the other party

    3. If a replacement agreement is signed between the same parties

    4. Upon payment of a penalty in an amount such that continuation of the agreement appears reasonably assured.

b. It was negotiated as part of arranging financing for the facilities that will provide the contracted goods or services or for costs related to those goods or services (for example, carrying costs for contracted goods). A purchaser is not required to investigate whether a supplier used an unconditional purchase obligation to help secure financing, if the purchaser would otherwise be unaware of that fact.

c. It has a remaining term in excess of one year

As discussed in ASC 440-10-50-3, future lease payments that might otherwise constitute an unconditional purchase obligation using the criteria in ASC 440-10-50-2 are not required to be disclosed as long as the required lease disclosures are met. See Question FSP 23-1 and FSP 14.3.3.2A.

The nature and extent of the required disclosures related to unconditional purchase obligations will vary depending on whether these commitments are unrecognized or recognized.

23.3.2.1 *Unrecognized unconditional purchase obligations*

As discussed in ASC 440-10-50-4, the following disclosures are required for unconditional purchase obligations that have not been recognized on the balance sheet, unless the aggregate commitment for all such obligations is immaterial:

- The nature and term of the commitment

- The aggregate amount of the purchase obligation that is fixed and determinable as of the balance sheet date and for each of the five succeeding years (if determinable)

- The nature of any variable components of the commitment
- The amounts purchased under the purchase obligation for each period that an income statement is presented

ASC 440-10-50-5 encourages, but does not require, reporting entities to disclose the amount of imputed interest necessary to reduce the unrecognized unconditional purchase obligations to present value. The discount rate should be the initial effective interest rate of the borrowings that financed the facility that will provide the goods or services, if known. If the discount rate is not known, the reporting entity should use its incremental borrowing rate at the time the commitment originated.

An unconditional purchase obligation may also be subject to the provisions of ASC 815, *Derivatives and Hedging*, if the obligation meets the definition of a derivative. In this instance, reporting entities would follow the disclosure requirements of both ASC 440 and ASC 815, as discussed in ASC 440-10-50-7. See DH 2 and DH 3 for discussion of purchase commitments as derivatives.

23.3.2.2 Recognized unconditional purchase obligations

For unconditional purchase obligations recorded on the balance sheet, reporting entities must disclose the aggregate amount of payments for the obligations for each of the five years following the balance sheet date, as discussed in ASC 440-10-50-6.

23.3.3 Other unrecognized commitments

A reporting entity may also have unrecognized commitments other than unconditional purchase obligations that may require disclosure based on other guidance depending on the nature of the underlying obligation. For example, there are specific disclosure requirements for leases, as illustrated by question FSP 23-1 for a lease that has not yet commenced.

Question FSP 23-1

Is a lease not yet recorded by the lessee (because the lease term has not yet commenced) subject to disclosure requirements?

PwC response

Yes. While general lease disclosure requirements are provided under ASC 440-10-50-1, ASC 842-20-50-3 requires specific disclosure of information about leases that have not yet commenced but that create significant rights and obligations for the lessee. For example, consider a lease that is signed on November 1; however, the term of the lease and usage of the leased property begin the following February 1 and the lessor will retain possession and control of the property through January 31. The classification of the lease, as either finance or operating, should be determined as of November 1, the date of the inception of the lease. The lessee should record the lease at the beginning of the lease term, February 1; however, the lease represents a commitment that, if material, should be disclosed at any intervening financial statement dates.

23.4 Contingencies

US GAAP defines a contingency as follows:

Definition from ASC 450-20-20

Contingency: An existing condition, situation, or set of circumstances involving uncertainty as to possible gain (gain contingency) or loss (loss contingency) to an entity that will ultimately be resolved when one or more future events occur or fail to occur.

The following sections discuss the disclosure considerations for loss and gain contingencies as provided by ASC 450.

23.4.1 Loss contingencies

Loss contingencies are relatively common. As discussed in ASC 450-20-05-3, examples include product warranties and litigation exposure.

There are three separate potential recognition, presentation and disclosure outcomes with regard to loss contingencies. Depending on the facts and circumstances, loss contingencies may require a reporting entity to (1) accrue a liability and disclose the nature of the contingency (FSP 23.4.1.1), (2) disclose the loss contingency, but not accrue a liability (FSP 23.4.1.2), or (3) neither accrue nor disclose (FSP 23.4.1.3).

23.4.1.1 Accrual and disclosure required

A loss contingency should be accrued if it is both (1) probable and (2) reasonably estimable.

ASC 450-20-20 defines "probable" as "the future event or events are likely to occur," which is generally considered a 75% threshold.

Reporting entities should evaluate any information available prior to issuance of the financial statements to determine whether a loss contingency is probable at the balance sheet date. Events giving rise to new information often occur in the period between the balance sheet date and financial statement issuance. However, it is important to distinguish between events that provide additional information with respect to conditions that existed at the balance sheet date and events that provide information with respect to conditions that did not exist at the balance sheet date. Although ASC 450-20-50-9 generally requires disclosure of these events, it is not appropriate to accrue a liability at the balance sheet date for a loss contingency related to a condition that did not exist at the balance sheet date. ASC 855, *Subsequent Events,* and FSP 28 provide further guidance on subsequent events.

ASC 450-20-30-1 provides guidance on the amount to be accrued.

Excerpt from ASC 450-20-30-1

If some amount within the range of loss appears at the time to be a better estimate than any other amount within the range, that amount shall be accrued. When no amount within the range is a better estimate than any other amount, however, the minimum amount in the range should be accrued.

The amount of a contingent liability should be estimated and evaluated independent from any claim for recovery. See FSP 23.4.3.1.

Discounting the accrued liability

Accrued liabilities for contingencies are generally not discounted. However, as discussed in ASC 835-30-15-2, discounting a liability is acceptable when the aggregate amount of the liability and the timing of cash payments for the liability are fixed or reliably determinable. For example, this may occur when a large volume of relatively small claims has a highly predictable settlement pattern (e.g., workers compensation claims).

ASC 450-20-S99-1 (SAB Topic 5.Y, *Accounting and Disclosures Relating to Loss Contingencies*) specifies that the discount rate used should produce an amount at which the liability could be settled in an arm's length transaction with a third party.

The guidance in SAB Topic 5.Y also indicates that the discount rate used should not exceed the interest rate on monetary assets that are essentially risk-free and have maturities comparable to that of the liability. In many instances, it is difficult in practice to determine the discount rate that would result from an insurance company or other third party settlement/transfer transaction. The insurance company or third party would expect to be compensated for the risks assumed along with a profit; therefore, the rate to assume the liability is generally less than the risk-free rate. However, because these settlement rates are often not determinable, practice has gravitated toward using the risk-free rate of monetary assets that have comparable maturities. We believe the guidance on discounting should apply to all contingent liabilities, and to private and public companies.

Conceptually, the discount rate applied to a liability should not change from period to period if the liability is not recorded at fair value. However, liabilities recorded for contingencies may consist of numerous claims that are established and settled in multiple periods.

Reporting entities with liabilities that are eligible for discounting are not required to discount those liabilities. The decision of whether to discount is a matter of accounting policy that should be consistently applied and disclosed. If a reporting entity wishes to discount liabilities related to contingencies, it should have sufficient historical information with which to reasonably estimate the amount and timing of ultimate settlement costs, as described in ASC 835-30-15-2, *Interest - Imputation of Interest*, ASC 450-20-S99-1 (SAB Topic 5.Y), and ASC 410-30, which addresses the discounting of environmental remediation liabilities.

Switching from not discounting liabilities to discounting liabilities should be treated as a change in the method of applying an accounting principle, subject to preferability. However, a change from discounting to not discounting because there has been a change in the facts and circumstances regarding the inherent predictability in the timing and amount of the payments is not considered a change in the method of applying an accounting principle.

Classification of the accrual

The balance sheet classification of the accrual should consider when the contingency will be settled. If the period of expected settlement is within one year of the balance sheet date, the reporting entity should classify the contingency as a short-term liability. Otherwise, it should be classified as long-term.

The income statement classification of the accretion of a discounted liability to its settlement amount is an accounting policy decision that should be consistently applied and disclosed.

Disclosure

As discussed in ASC 450-20-50-1, because contingency accruals are estimates, the FASB recommends that reporting entities use terms such as "estimated liability" or "a liability of an estimated amount" in describing the nature of the accrual. The term "reserve" should not be used. A reporting entity should disclose any losses that may be incremental to what was accrued if the additional loss is reasonably possible and materially different from the amount accrued.

23.4.1.2 No accrual, but disclosure required

As discussed in ASC 450-20-50-5, disclosure is required when the loss contingency is not both probable and reasonably estimable:

- *A material loss contingency is probable but not reasonably estimable.*

  A reporting entity is required to disclose the nature of the contingency and the fact that an estimate cannot be made.

- *A material loss contingency is reasonably possible but not probable.*

  A reporting entity is required to disclose the nature of the contingency and an estimate of the possible loss, range of loss, or disclose the fact that an estimate cannot be made.

For material loss contingencies that are reasonably possible but not probable, the SEC frequently comments on reporting entities that have incomplete or omitted disclosures pursuant to ASC 450, specifically related to the lack of disclosures regarding the nature of the contingency and the possible range of loss amounts or the statement that an estimate cannot be made. The SEC staff also cautions reporting entities that the recording of a material accrual for a contingent liability should typically not be the first disclosure regarding the material contingency. A foreshadowing disclosure that precedes an accrual for a material contingent liability is typically expected.

ASC 450 does not provide specific guidance as to the level of disclosures required (that is, individual contingency or some other aggregate level). However, it requires that reporting entities disclose information to keep the financial statements from being misleading.

Excerpt from ASC 450-20-50-1

Disclosure of the nature of an accrual made pursuant to the provisions of paragraph 450-20-25-2, and in some circumstances the amount accrued, may be necessary for the financial statements not to be misleading. Terminology used shall be descriptive of the nature of the accrual, such as estimated liability or liability of an estimated amount.

One way to alleviate some of this tension is to aggregate losses. The SEC staff has accepted this approach, which enables users to have sufficient data, but does not provide such specific information that it could prejudice a legal matter.

As discussed in ASC 450-20-50-9, if a material loss contingency arises after the balance sheet date but before the financial statements are issued, disclosure may be necessary. Assessment of whether disclosure is necessary should be based on the principles articulated in ASC 855. If disclosure is deemed necessary, a reporting entity should describe the nature of the loss contingency and an estimate of the loss or range of possible losses. If no estimate can be made, then the reporting entity should disclose that fact. Refer to FSP 28 for further information on subsequent events disclosures.

Unasserted claims

An unasserted claim is one that has not yet been asserted either because the potential claimant is unaware of the matter or has not yet pursued it. As discussed in ASC 450-20-50 and ASC 450-20-55-14 through 55-15, if assertion of a claim is judged probable, a reporting entity should accrue and/or disclose the amount, depending on the probability of, and ability to estimate, any loss arising from the claim. ASC 450-20-50-6 indicates that disclosure is required when assertion of the claim is considered probable and there is a reasonable possibility the outcome will be unfavorable; however, we believe the reporting entity should consider disclosure even if the claim is not considered probable.

Reporting entities should also evaluate the need for accrual or disclosure of a loss contingency when broader circumstances indicate that the potential exists for claims against the company. For example, the restatement of prior annual or interim financial statements to correct an error may be indicative of an unasserted claim because of the possibility that shareholders may make claims against the company for having issued allegedly false and misleading financial statements. Any restatements to correct an error in previously-issued financial statements should be evaluated in this light. See ASC 450-20-55-14 for other examples of how unasserted claims might arise.

23.4.1.3 Neither accrual nor disclosure required

As discussed in ASC 450-20-50-6, disclosure is generally not required for a loss contingency involving an unasserted claim or assessment if it is not probable that a claim will be asserted. Additionally, ASC 450 does not require disclosure of loss contingencies when the possibility of loss is remote. However, reporting entities should consider disclosing information in the footnotes if the disclosure would keep the financial statements from being misleading. Though ASC 450 does not require disclosure of remote contingencies, ASC 460 requires certain remote loss contingencies to be disclosed. Refer to FSP 23.6.1 for further discussion related to these contingencies.

23.4.2 Accruing legal costs

As discussed in ASC 450-20-S99-2, there is no definitive guidance on whether legal defense costs should be accrued. Some believe that the accrual of the loss contingency should factor in all costs, including legal costs if they are reasonably estimable, regardless of whether a liability can be estimated for the contingency itself. Others contend that legal fees should be recognized as incurred when the legal services are provided, and therefore should not be recognized as part of a loss contingency accrual. As specified in ASC 450-20-S99-2, how a reporting entity treats legal costs is an accounting policy choice that should be consistently applied and disclosed.

Question FSP 23-2

In a two-step income statement, where should a reporting entity classify litigation expense?

PwC response

Generally, litigation expense should be classified as an operating expense.

23.4.3 Recovery of a loss

A claim for loss recovery (e.g., an insurance claim) generally can be recognized when a loss event has occurred and recovery is considered probable. If the claim is subject to dispute or litigation, a rebuttable presumption exists that recoverability of the claim is not probable. If the potential recovery exceeds the loss recognized in the financial statements or relates to a loss not yet recognized in the financial statements, such recovery should be recognized under the gain contingency model discussed in FSP 23.5.

ASC 450-20-S99 (SAB Topic 5.Y) includes the SEC staff's view that there is a rebuttable presumption that an asset should not be recognized for a claim for recovery from a party that asserts that it is not liable to the registrant. Registrants that overcome that presumption should disclose the amount of recorded recoveries that are being contested and discuss the reasons for concluding that the amounts are probable of recovery. Although discussed in the context of environmental liabilities, we believe these concepts are equally applicable to other non-environmental liabilities and related recoveries (e.g., asbestos claims and related insurance coverage).

23.4.3.1 Insurance recoverables

Reporting entities often manage risk by purchasing insurance. Although a reporting entity transfers risk through an insurance policy, it generally has the primary obligation with respect to any losses. Therefore, a reporting entity is typically required to accrue and present the gross amount of a loss even if it purchased insurance to cover the loss.

Generally, amounts receivable under an insurance contract should not be offset against the reporting entity's liability, as purchasing insurance generally does not relieve the purchaser of its primary obligation to make payments related to losses that result from risk.

ASC 720-20-45-1

Unless the conditions of ASC 210-20-45-1 are met, offsetting prepaid insurance and receivables for expected recoveries from insurers against a recognized incurred but not reported liability or the liability incurred as a result of a past insurable event would not be appropriate.

Sometimes, an insurance company may agree to pay the *harmed* party directly, on the insured's behalf, but this does not typically extinguish or provide a legal release from the insured's obligation prior to payment to the harmed party, as is required for liability extinguishment.

For example, most states require an employer to provide its employees with workers' compensation coverage if they are injured on the job. Accordingly, an employer has an obligation to its employees. The employer may choose to purchase insurance for some or all of its workers' compensation risk. The employer's decision in this respect generally does not change its legal obligation to its employees,

although its decision could affect whether there is an asset to record when an employee is injured. In addition, an employer's legal obligation is not altered if the purchased insurance contract includes all claims handling and direct contact with employees. Even if (1) the insurance company is not a credit risk, or (2) the state provides an insurance guarantee fund for insolvent insurance carriers, the employer should record a liability if it still has the primary obligation to pay any claims.

However, laws in certain jurisdictions (especially certain state laws related to workers' compensation) may dictate that a reporting entity is relieved from being the primary obligor when it purchases insurance policies for certain claims, because the insurer has assumed that role. Reporting entities with this fact pattern may need to seek assistance from legal counsel to understand whether the primary obligor designation has been transferred to the insurance company, and whether the related liability has been extinguished by purchasing workers' compensation insurance.

23.4.3.2 Financial statement classification of recovery

Several pieces of guidance govern the presentation and disclosure of insurance recoveries:

- ASC 610-30, *Gains and losses on involuntary conversions*
- ASC 410-30, *Environmental Obligations*
- ASC 220-30, *Income Statement – Business Interruption Insurance*

Other income model (ASC 610-30)

ASC 610-30 provides guidance on involuntary conversions of nonmonetary assets (such as property or equipment) to monetary assets (such as insurance proceeds). It requires recognition of a gain or loss on this type of involuntary conversion, measured as the difference between the carrying amount of the nonmonetary asset and the amount of monetary assets received. As such, insurance recoveries are recorded in the same financial statement line as the related loss up to the amount of loss. If insurance proceeds are in excess of the related loss, which may occur with replacement cost insurance, the gain is typically included in other income. In a two-step income statement, it is often shown as nonoperating income.

Most insurance proceeds are typically not refundable and do not require any further action from the insured; therefore, full or partial deferral of recognition of the proceeds should be rare.

Example FSP 23-1 illustrates the recognition, measurement, and disclosure of a loss of equipment with a potential insurance recovery.

EXAMPLE FSP 23-1

Considerations for casualty loss with a potential insurance recovery

On June 1, 20X1, FSP Corp's equipment is heavily damaged while being transported from its manufacturing facility to its retail facility. Due to the nature of the damage, FSP Corp determines that there is a total loss. The equipment had a net book value of $7 million and an estimated replacement value of $6 million as of the date of loss. FSP Corp files a property and casualty claim with its insurer for recovery of $6 million. Based on its discussions with the insurer and review of the policy by in-house experts, FSP Corp concludes that it has a covered loss under the policy and that it is probable the insurer will settle the claim for at least $5 million. However, the insurer has communicated to FSP

Corp that the amount of final settlement is subject to verification of the identity of the equipment damaged and the receipt of additional market data regarding its value.

How should FSP Corp recognize, measure, and disclose the loss of the equipment and the potential insurance recovery?

Analysis

FSP Corp should write off the net book value of the equipment of $7 million and recognize an asset of $5 million for the probable recovery of its loss (a loss recovery asset on the balance sheet), resulting in a net initial loss of $2 million. FSP Corp should recognize any remaining recovery (i.e., any excess over $5 million) when recovery of an additional amount is probable (e.g., when the identity of the damaged equipment has been established and additional market data confirm its value).

FSP Corp should record the insurance recovery in the same financial statement line item in the income statement as the related loss was recorded. To the extent the loss is material, FSP Corp should disclose the nature of the events leading to the loss and additional amounts that are expected to be recovered.

Insurance recoveries of environmental obligations

ASC 410-30-35-8 and ASC 410-30-35-9 address insurance recoveries related to environmental obligations. The guidance indicates that an asset related to an insurance recovery should be recognized only when realization of the claim underlying the recovery is probable. It further stipulates that there is a rebuttable presumption that realization of the claim is not probable if the claim is the subject of litigation.

Probable recoveries should be reflected separately as an asset in the balance sheet and not netted against the remediation liability, consistent with ASC 210-20, *Balance Sheet—Offsetting*. ASC 410-30-45-2 states that it would be rare, if ever, that the facts and circumstances surrounding environmental remediation liabilities and related receivables and potential recoveries would meet the criteria of ASC 210-20. The financial statements should also include a discussion of material uncertainties that may affect the measurement and realization of the asset and liability.

Business interruption insurance

ASC 220-30 provides guidance related to the presentation and disclosure of business interruption insurance proceeds. Business interruption insurance is insurance that a reporting entity might purchase to cover losses caused by the loss of use of property or equipment. This insurance typically provides for reimbursement of qualifying costs while a reporting entity rebuilds, repairs, or replaces the damaged property. The guidance allows a reporting entity to determine the classification of recoveries as long as the classification does not conflict with existing US GAAP.

ASC 220-30-45-1

An entity may choose how to classify business interruption insurance recoveries in the statement of operations, as long as that classification is not contrary to existing generally accepted accounting principles (GAAP).

ASC 220-30-50-1 also requires a reporting entity to disclose certain information in the footnotes for period(s) in which recoveries are recognized. These include:

The nature of the event that caused the business interruption losses

- The aggregate amount of business interruption insurance recoveries recognized each period and the income statement line item in which the recoveries were included

23.4.4 *Lawsuits covered by insurance*

SEC staff comment letters have questioned the completeness of disclosures related to pending settlements regarding lawsuits that are covered by insurance. Specifically, reporting entities have been asked to disclose how insurance arrangements have affected conclusions concerning settlements and the likely effect that litigation and future settlements will have on the financial statements. Accordingly, it is important for reporting entities to ensure that any liabilities that are covered by insurance are properly disclosed in accordance with ASC 450.

23.5 *Gain contingencies*

ASC 450 indicates that contingent gains should not be recognized prior to the gain being "realized" or "realizable."

ASC 450-30-25-1

A contingency that might result in a gain usually should not be reflected in the financial statements because to do so might be to recognize revenue before its realization.

A realized gain is one where cash (or other assets, such as claims to cash) has been received without expectation of repayment. A gain is realizable when assets are readily convertible to known amounts of cash or claims to cash. We believe the recognition of a gain is appropriate at the earlier of when the gain is realizable or realized. The assessment of whether a gain is realizable requires significant judgment and should include the evaluation of relevant factors including the following:

- Whether there is a signed agreement or legally enforceable contract that stipulates the terms of the gain or settlement, and whether the settlement is subject to any pending or expected appeal

- Whether the counterparty has the ability or wherewithal to pay the amount

As discussed in FSP 23.4.3, a claim for loss recovery (e.g., an insurance claim) generally can be recognized when a loss event has occurred and recovery is considered probable. If the potential recovery exceeds the loss recognized in the financial statements or relates to a loss not yet recognized in the financial statements, such recovery should be evaluated under the gain contingency model.

23.5.1 *Recoveries representing gain contingencies*

An anticipated insurance recovery in excess of the recognized loss is considered a gain contingency and is subject to the guidance in ASC 450-30. Consistent with that guidance, a gain related to an insurance recovery should not be recognized until any contingencies relating to the insurance claim have been resolved (as the gain would not be realized until the related contingencies have been resolved).

AICPA TPA 5100.35 illustrates the treatment of a gain relating to an insurance recovery for an involuntary conversion of a building caused by a natural disaster that was not in dispute and that is realized after the date of the balance sheet but before the release of the financial statements.

AICPA TPA 5100.35

Inquiry —A tornado virtually destroys a company's building on June 12, 20X0. The company has insurance and expects to be reimbursed for costs incurred to refurbish the building. The company's fiscal year-end is June 30, 20X0. On August 15, 20X0, prior to the issuance of the financial statements, the company receives a check in excess of the carrying amount of the building. Should the company recognize the gain on the involuntary conversion in the June 30, 20X0 financial statements?

Reply —No. Since the company was reimbursed for an amount in excess of the carrying amount of the building there was no loss to record on June 30, 20X0. The gain, which was received on August 15, 20X0, was a gain contingency on June 30, 20X0. Per FASB ASC 450-30-25-1, contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization.

This guidance does not explicitly address the recognition of the insurance proceeds equal to the carrying value of the destroyed building (the loss recognized in the financial statements), although the example implies that a receivable was recorded equal to the recognized loss by noting that “there was no loss to record” at the balance sheet date.

A gain contingency may be considered “realizable” prior to the receipt of cash, depending on the facts and circumstances. For example, a gain could be recorded at the balance sheet date if (1) it is acknowledged by the insurance company that a payment is due, (2) information is received prior to the release of the financial statements that will confirm the amount, and (3) collection is probable. However, if the existence of the claim is being disputed by the insurance company, there is a presumption that recoverability of the claim is not probable. Therefore, the amount would not be considered realizable and should only be recognized upon settlement of the dispute.

If the reporting entity expects a possible gain contingency, disclosure is required:

ASC 450-30-50-1

Adequate disclosure shall be made of a contingency that might result in a gain, but care shall be exercised to avoid misleading implications as to the likelihood of realization.

23.6 Guarantees

With a few exceptions, ASC 460 applies to the following type of guarantee contracts.

Excerpt from ASC 460-10-15-4

a. Contracts that contingently require a guarantor to make payments… to a guaranteed party based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party…

b. Contracts that contingently require a guarantor to make payments… to a guaranteed party based on another entity's failure to perform under an obligating agreement (performance guarantees)…

c. Indemnification agreements (contracts) that contingently require an indemnifying party (guarantor) to make payments to an indemnified party (guaranteed party) based on changes in an underlying that is related to an asset, a liability, or an equity security of the indemnified party.

d. Indirect guarantees of the indebtedness of others, even though the payment to the guaranteed party may not be based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party.

ASC 460 does not apply to the following types of guarantee contracts.

Excerpt from ASC 460-10-15-7

a. A guarantee or an indemnification that is excluded from the scope of Topic 450 (see paragraph 450-20-15-2—primarily employment-related guarantees)

b. A lessee's guarantee of the residual value of the underlying asset at the expiration of the lease term under Topic 842

c. A contract that meets the characteristics in paragraph 460-10-15-4(a) but is accounted for as variable lease payments under Topic 842

d. A guarantee (or an indemnification) that is issued by either an insurance entity or a reinsurance entity and accounted for under Topic 944 (including guarantees embedded in either insurance contracts or investment contracts)

e. A contract that meets the characteristics in paragraph 460-10-15-4(a) but provides for payments that constitute a vendor rebate (by the guarantor) based on either the sales revenues of, or the number of units sold by, the guaranteed party

f. A contract that provides for payments that constitute a vendor rebate (by the guarantor) based on the volume of purchases by the buyer (because the underlying relates to an asset of the seller, not the buyer who receives the rebates)

g. A guarantee or an indemnification whose existence prevents the guarantor from being able to either account for a transaction as the sale of an asset that is related to the guarantee's underlying or recognize in earnings the profit from that sale transaction

h. A registration payment arrangement within the scope of Subtopic 825-20 (see Section 825-20-15)

i. A guarantee or an indemnification of an entity's own future performance (for example, a guarantee that the guarantor will not take a certain future action)

j. A guarantee that is accounted for as a credit derivative at fair value under Topic 815.

k. A sales incentive program in which a manufacturer contractually guarantees to reacquire the equipment at a guaranteed price or guaranteed prices at a specified time, or at specified time periods (for example, the entity is obligated to reacquire the equipment or the entity is obligated at

the customer's request to reacquire the equipment). That program shall be evaluated in accordance with Topic 606 on revenue from contracts with customers, specifically the implementation guidance on repurchase agreements in paragraphs 606-10-55-66 through 55-78.

For guarantees that fall within the scope of ASC 460, guarantors are required to recognize a liability equal to the fair value of the guarantee upon its issuance and to provide specific disclosures related to the guarantee. Guarantors may be excluded from the scope of the initial liability recognition provisions included in ASC 460-10-25-1 depending on the type of guarantee; however, the disclosure requirements outlined in ASC 460 may still be required.

The disclosures required by ASC 460 do not eliminate or affect disclosure requirements under other applicable guidance, such as disclosures required under:

- ASC 825 related to disclosures of the fair value of financial guarantees
- ASC 450 related to disclosures for contingent losses that have a reasonable possibility of occurring
- ASC 815 related to guarantees accounted for as derivatives
- ASC 275 for disclosures of significant risks and uncertainties that could significantly affect the amounts reported in the financial statements in the near term

23.6.1 ASC 460 disclosure requirements

Guarantors are required to disclose certain information about each guarantee, or group of similar guarantees. ASC 460 is silent as to whether the disclosures relate to the current period only, or to comparative periods presented in the financial statements. Our view is that comparative disclosures are required for each of the following for all periods for which a balance sheet is presented:

- The nature of the guarantee including:
  - Approximate term
  - How it originated
  - Events and circumstances that would require performance
  - Current status (as of the balance sheet date) of the payment/performance risk

  If a reporting entity uses internal groupings for disclosure of the payment/performance risk status of its guarantees, it must disclose how such groupings are determined and used for managing risk.

- The maximum potential amount of future payments (undiscounted) that the guarantor could be required to make under the guarantee. With regard to this disclosure:
  - The amount of potential future payments should not be reduced by any potential recoveries under collateralization or recourse provisions in the guarantee.
  - If there is no limitation to the maximum potential future payments based on the terms of the guarantee, then this fact must be disclosed.

    - If the amount of the maximum estimated future payments under the guarantee cannot be estimated, the guarantor must disclose this fact along with the reasons for why an estimate cannot be determined.

- The current carrying amount of any guarantor's obligations under the guarantee (including any amount recognized under the contingency guidance within ASC 450 or ASC 326-20 on financial instruments measured at amortized cost). This disclosure is required regardless of whether the guarantee is freestanding or embedded within another contract.

- The nature of recourse provisions, if any, that would allow the guarantor to recover amounts paid under the guarantee. A reporting entity should also consider disclosing the value of any recovery that could occur, such as from the guarantor's right to proceed against an outside party, if the amount is estimable.

- The nature of any assets held either by third parties or as collateral that the guarantor could obtain to recover amounts paid under the guarantee, upon the occurrence of any triggering event or condition.

- The approximate extent to which the proceeds from the liquidation of assets held either by third parties or as collateral would cover the maximum potential future payments under the guarantee, if such amount is estimable.

The information outlined above is required to be disclosed even when there is a remote probability of the guarantor making any payments under the guarantee or group of guarantees. ASC 460 states the following:

ASC 460-10-50-2

An entity shall disclose certain loss contingencies even though the possibility of loss may be remote. The common characteristic of those contingencies is a guarantee that provides a right to proceed against an outside party in the event that the guarantor is called on to satisfy the guarantee. Examples include the following:

a. Guarantees of indebtedness of others, including indirect guarantees of indebtedness of others

b. Obligations of commercial banks under standby letters of credit

c. Guarantees to repurchase receivables (or, in some cases, to repurchase the related property) that have been sold or otherwise assigned

d. Other agreements that in substance have the same guarantee characteristic.

Guarantees issued by a reporting entity to benefit related parties, such as equity method investees and joint ventures, require incremental disclosures pursuant to ASC 850, *Related Party Disclosures*. Additionally, guarantees of a reporting entity's indebtedness by its principal shareholders or other related parties should be disclosed, if material, as required by ASC 850-10-50. Although not in the scope of ASC 460, we believe that guarantees obtained by a reporting entity (as opposed to those made by it) should also be disclosed, as such disclosures may indicate that the reporting entity is not able to obtain financing without the guarantees of others.

ASC 460-10-50-2 requires disclosure of guarantees of the indebtedness of others, including indirect guarantees as defined therein. In addition, the recognition and disclosure requirements of ASC 460 apply to such indirect guarantees if they are legally binding.

The following is an example of the disclosure requirements for a parent's guarantee of a subsidiary's debt.

EXAMPLE FSP 23-2

Intercompany guarantees

FSP Corp, the parent, guarantees repayment of a loan that its subsidiary, Sub Co, receives from a third-party bank. FSP Corp issues consolidated financial statements that include Sub Co and Sub Co issues standalone financial statements.

Which reporting entity's financial statements should include disclosure about the guarantee?

Analysis

In the consolidated financial statements, the guarantee issued by FSP Corp on the loan that Sub Co received from the third-party bank is eligible for the scope exception in ASC 460-10-15-7(i) as described in ASC 460-10-55-18(c) and, therefore, would not require disclosure. If FSP Corp issues parent-only financial statements, however, disclosure of the guarantee would be required. Although Sub Co is not required to disclose FSP Corp's guarantee of its debt in Sub Co's standalone financial statements, we believe Sub Co should consider disclose the parent's guarantee so users of Sub Co's financial statements have an understanding of Sub Co's liquidity.

See FSP 31 for additional presentation and disclosure requirements for parent company financial statements. See FSP 26 for further discussion of related party transactions.

23.6.2 Fair value disclosures

Reporting entities that issue guarantees must also consider the disclosure requirements set forth in ASC 825, *Financial Instruments*. The disclosure requirements vary depending on whether a reporting entity is an SEC registrant or a private company.

See FSP 20 for more on fair value disclosure requirements.

23.6.3 Joint and several liability

Under joint and several liability, the total amount of an obligation is enforceable against any of the parties to the arrangement. For example, under joint and several liability in a lending arrangement, the lender can demand payment in accordance with the terms of the arrangement for the total amount of the obligation from any of the obligors or any combination of the obligors. An obligor cannot refuse to perform on the basis that it individually only borrowed a portion of the total, nor that other parties are also obligated to perform. However, the paying obligor may be able to pursue repayment from the other obligors, depending on the agreement among the co-obligors and the laws covering the arrangement.

ASC 405-40, *Obligations Resulting from Joint and Several Liability Arrangements*, addresses disclosure of obligations resulting from joint and several liability arrangements for which the total

amount under the arrangement is fixed at the reporting date. The guidance does not address obligations resulting from joint and several liability arrangements that are specifically addressed within other existing guidance, such as asset retirement and environmental obligations (see FSP 11), contingencies (see FSP 23.4), compensation retirement benefits (see FSP 13), and taxes (see FSP 16).

23.6.3.1 Disclosure requirements

As discussed in ASC 405-40-50-1, a reporting entity is required to disclose for each liability or each group of similar liabilities resulting from joint and several liability arrangements:

- The nature of the arrangement, including how the liability arose, the relationship with other co-obligors, and the terms and conditions of the arrangement
- The total amount outstanding, which cannot be reduced by the effect of any amounts that may be recoverable from other co-obligors, under the arrangement
- The carrying amount, if any, of the reporting entity's liability and the carrying amount of any receivable recognized
- The nature of any recourse provision that would allow for recovery from other entities of amounts paid, including any limitations on the potential recovery of amounts
- In the period of initial recognition and measurement or in a period the measurement of the liability changes significantly, the corresponding entry and where it was recorded in the financial statements

While not addressed in the guidance, we would encourage reporting entities to disclose the undiscounted amount of the liability, as well as the discount rate used, if discounted.

23.7 Off-balance sheet considerations

Off-balance sheet credit risk refers to the credit risk related to off-balance sheet loan commitments, standby letters of credit, certain financial guarantees, and other similar instruments (except for derivative instruments).

23.7.1 Off-balance-sheet credit risk

ASC 942-825, *Financial Services—Depository and Lending,* requires the following disclosures for financial instruments with off-balance-sheet credit risk (except for those instruments in the scope of ASC 815, *Derivatives and Hedging*):

Excerpt from ASC 942-825-50-1

a. The face or contract amount

b. The nature and terms, including, at a minimum, a discussion of the:

    1. Credit and market risk of those instruments

    2. Cash requirements of those instruments

3. Related accounting policy

c. The entity's policy for requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments.

In addition to the disclosure requirements discussed above, a reporting entity should evaluate whether there are credit losses related to these instruments. If the conditions of ASC 450-20 are met, a liability for the credit loss on these instruments should be recognized and reported separately from the allowance for loan and lease losses.

23.8 Self-insurance

Some reporting entities may choose to self-insure all or a portion of their insurance coverage. A reporting entity that is self-insured retains the risk of loss instead of paying a third-party insurance company to assume that risk. A reporting entity generally takes on self-insurance risk because (1) the type of coverage needed is not available or (2) it believes it can administer the insurance coverage at a lower cost, either on its own or by dealing directly with a reinsurance company.

Self-insurance is essentially no insurance, leaving the reporting entity responsible for specific business risks. Examples of the types of risks a reporting entity may self-insure include:

- Liabilities that do not fall under an insurance policy as a result of policy limits
- Insurance policy deductibles
- Liabilities that do not fall under the "excess" or "catastrophic" coverage
- Experience-based premium adjustments leading the reporting entity to effectively reimburse insurers for losses

Reporting entities should accrue losses for the total cost of both asserted and unasserted claims in accordance with ASC 450. Reporting entities with significant self-insurance liabilities will most likely need to retain the assistance of an actuary when estimating those liabilities. Discounting self-insurance liabilities may be appropriate when the timing and amount of payments can be reliably estimated.

When a reporting entity has some external insurance coverage, it may need to record a receivable for insured losses, depending on the nature of the insurance contract. The reporting entity should use estimates for the insurance recoverable that are consistent with those it uses to record the liability.

Certain excess-of-loss insurance policies may require a reporting entity to pre-fund its self-insurance obligation through a trust vehicle. When this occurs, the expense for the period should not be based on the amount required to be funded. A reporting entity should evaluate whether the trust should be consolidated under the variable interest entities guidance in ASC 810, *Consolidation*. Often, the trust must be consolidated because the reporting entity is the primary beneficiary. See CG 2 for information on the consolidation of variable interest entities.

Insurers, including non-insurance entities that self-insure for certain risks (e.g., workers' compensation and medical malpractice), are subject to guaranty-fund and other insurance-related assessments.

23.9 Interaction with other guidance

US GAAP requires reporting entities to disclose other commitments and contingencies related to specific accounting topics. Refer to the following chapters for further presentation and disclosure considerations on these topics:

- Commitments to make future ESOP contributions (see FSP 15)
- Environmental costs (see FSP 11)
- Leases, including guarantees (see FSP 14)
- Product and extended warranty programs (see FSP 11)
- Subsequent events (see FSP 28)

23.10 Commitments, contingencies, and guarantees—considerations for private companies

The SEC requirement for a specific balance sheet caption for commitments and contingent liabilities in S-X 5-02(25) applies only to SEC registrants. The guidance in ASC 450-20-S99-1 on the rate to be used to discount loss contingencies and in ASC 450-20-S99-2 on accruing legal costs is specific to SEC registrants. Based on limited authoritative guidance, we believe that private companies should consider applying these concepts as well.

Chapter 24: Risks and uncertainties—updated November 2023

24.1 Risks and uncertainties—overview

Risks and uncertainties represent conditions that may impact a reporting entity's financial results in future periods. Providing information about these conditions to financial statement users is therefore useful to enable them to assess a reporting entity's future prospects.

This chapter covers the following topics:

- Scope of ASC 275, *Risks and Uncertainties*
- Disclosures required by ASC 275
- Interaction of ASC 275 with other guidance
- Going concern disclosure considerations required by ASC 205-40
- Considerations for private companies

24.2 Risks and uncertainties—scope and relevant guidance

ASC 275 requires that financial statements include disclosures about the risks and uncertainties existing as of the date of the financial statements with respect to:

- The nature of the reporting entity's operations (see FSP 24.3.1)
- The use of estimates in preparing the financial statements (see FSP 24.3.2)
- Certain significant estimates (see FSP 24.3.3)
- Current vulnerability related to certain concentrations (see FSP 24.3.4)

These required disclosures apply to all reporting entities that issue financial statements prepared in accordance with US GAAP.

The assessment of a reporting entity's ability to continue to operate as a going concern also falls under the umbrella of risks and uncertainties. Going concern is a specific uncertainty related to the assumption that a reporting entity is viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading, or seeking protection from creditors pursuant to laws or regulations. ASC 205-40, *Presentation of Financial Statements – Going Concern*, provides management with direct guidance on going concern assessments and disclosures.

The disclosure requirements do not encompass risks and uncertainties that may be associated with the following:

- Management or key personnel
- Proposed changes in government regulations or accounting principles
- Internal control deficiencies

- Impacts of acts of war, God, or sudden catastrophes

24.3 Risks and uncertainties—Disclosure

Reporting entities should assess the disclosure requirements of ASC 275 at each reporting date, considering changes to internal operations as well as changes to the industry and broader macroeconomic environment.

ASC 275 does not require disclosures to be segregated in the financial statements or otherwise identified as being provided to comply with ASC 275. The required disclosures may be grouped together in one footnote or included in other footnote disclosures as appropriate. When comparative periods are presented, the disclosure requirements of ASC 275 apply only to the most recent period presented.

24.3.1 Nature of the reporting entity's operations

A reporting entity should disclose the following within the financial statements related to the nature of its operations:

- Major products or services sold or provided
- Principal markets, including the locations of those markets
- For reporting entities that operate in more than one business, the relative importance (without quantification) of each business and the basis for such determination. For example, a reporting entity may disclose that its two business lines generate equal amounts of revenue or that one business line accounts for substantially all net income.

Typically, SEC registrants combine this information with their segment disclosures. Not-for-profit entities should describe their principal services performed and the revenue sources for those services.

If a reporting entity has not commenced principal operations, it should provide disclosures about the risks and uncertainties related to the activities in which it is currently engaged and discussion of what those activities are being directed towards.

Refer to Examples 1 and 2 within ASC 275-10-55 for examples of disclosures related to the nature of the reporting entity's operations.

24.3.2 Use of estimates in preparing the financial statements

Accounting estimates represent a reporting entity's judgment about the outcome of future events. As discussed in ASC 275-10-50-4, a reporting entity should disclose that management's application of US GAAP requires the pervasive use of estimates. This disclosure is intended to inform users of the inherent uncertainties present in the financial statements of all reporting entities, and that subsequent resolution of some matters could differ significantly from the resolution that is currently expected. Typically this disclosure is included in the basis of presentation footnote, though it is not required to be included there.

Example 3 within ASC 275-10-55 provides an example of this disclosure. While this example provides generic language for this required disclosure, reporting entities will often tailor this disclosure to list

specific accounting policies that are subject to estimates (e.g., pension and benefit plans, valuation of goodwill and intangible assets, and allowance for credit losses. Additionally, reporting entities should consider disclosing how estimates are developed (e.g., historical experience or other assumptions believed to be reasonable given the facts and circumstances). In practice, these disclosures are typically included within the relevant financial statement footnotes.

24.3.3 Certain significant estimates

As discussed in ASC 275-10-50-7, a reporting entity should disclose certain significant estimates that affect the carrying amount of assets and liabilities, as well as those that were used in developing the disclosures related to gain or loss contingencies. ASC 275 provides criteria to help determine which estimates must be disclosed.

Excerpt from ASC 275-10-50-8

Disclosure regarding an estimate shall be made when known information available before the financial statements are issued or are available to be issued…indicates that both of the following criteria are met:

a. It is at least **reasonably possible** that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the **near term** due to one or more future confirming events…

b. The effect of the change would be material to the financial statements.

A reporting entity should consider all information available before the financial statements are issued or available to be issued as defined in ASC 855, *Subsequent Events*, in assessing the above criteria. The assessment of the criteria for disclosure under ASC 275 should be performed separately from any assessment under ASC 855. For example, an event subsequent to the balance sheet date may not meet the criteria for disclosure under ASC 855, but disclosure may still be required under ASC 275. As discussed in ASC 275-10-50-9, such a disclosure should include a description of the uncertainty and indicate that it is at least reasonably possible that a change in the estimate will occur in the near term. Refer to FSP 28 for a further discussion of disclosure requirements related to subsequent events.

ASC 275-10-20 indicates that “reasonably possible” should be interpreted to mean that the likelihood of occurrence is more than remote but less than likely. As defined in ASC 275-10-20, “near term” should be interpreted as not exceeding one year from the date of the financial statements.

Reporting entities should consider risk-reduction activities when assessing whether the above criteria have been met. Disclosure is not required if a reporting entity concludes that the impact of a change in estimate would not be material as a result of risk-reduction activities. For example, a reporting entity may conclude that a change in the allowance for credit losses estimate would not have a material impact on the financial statements because of a requirement that customers prepay for orders if they do not pass a credit check. A reporting entity should assess materiality based on the magnitude of the *potential* change in the recorded amount and not the amount currently recorded (which could be zero).

Additionally, ASC 275-10-50-15A clarifies how to assess materiality when considering the change in useful life of an intangible asset. The criterion would be met if a change in useful life of an intangible

asset or a change in expected likelihood of renewal or extension of an intangible asset would be material either individually or in the aggregate by major intangible asset class.

ASC 275 includes a list of areas where these types of disclosures may be more common, though the list is not intended to be comprehensive.

Excerpt from ASC 275-10-50-15

The following are examples of assets and liabilities and related revenues and expenses, and of disclosure of gain or loss contingencies included in financial statements that, based on facts and circumstances existing at the date of the financial statements, may be based on estimates that are particularly sensitive to change in the near term:

a. Inventory subject to rapid technological obsolescence

b. Specialized equipment subject to technological obsolescence

c. Valuation allowances for deferred tax assets based on future taxable income

d. Capitalized motion picture film production costs

e. Capitalized computer software costs

f. Deferred policy acquisition costs of insurance entities

g. Valuation allowances for commercial and real estate loans

h. Environmental remediation-related obligations

i. Litigation-related obligations

j. Contingent liabilities for obligations of other entities

k. Amounts reported for long-term obligations, such as amounts reported for pensions and postemployment benefits

l. Estimated net proceeds recoverable, the provisions for expected loss to be incurred, or both, on disposition of a business or assets

m. Amounts reported for long-term contracts.

Part of the challenge in determining the need for disclosure is assessing whether an estimate is subject to change in the near term. Example 24-1 illustrates the evaluation of whether a risk is subject to disclosure under ASC 275.

EXAMPLE FSP 24-1

Disclosure of percentage-of-completion contract estimates

FSP Corp enters into a material long-term construction contract with a customer that is accounted for under the percentage-of-completion (POC) method in accordance with ASC 605-35, *Construction-Type and Production-Type Contracts*. Prior to year end, FSP Corp identifies an issue with the building site that may require additional construction costs of up to 50% of the original budget. Further survey of the land is required to determine the extent of additional construction and should be completed within six months. FSP Corp considers it reasonably possible that the additional costs will be incurred. The additional costs, if required, would represent a material increase in the budgeted amount.

Is disclosure required under ASC 275?

Analysis

Yes. This estimate would meet the criteria for disclosure under ASC 275-10-50-8. FSP Corp considers the likelihood of incurring the additional costs as reasonably possible and the confirming event (the land survey) will occur in the near term. Additionally, the additional costs would be material. FSP Corp should disclose that it is at least reasonably possible that completion costs for the contract will materially increase in the near-term.

Based on the above facts, this change in estimate does not represent an error as contemplated by ASC 250, *Accounting Changes and Error Corrections*. Refer to FSP 30 for disclosure requirements related to errors in previously issued financial statements.

The SEC staff has frequently commented on significant estimates related to:

- Business combinations (estimates used in the valuation of acquired intangible assets and contingent consideration)
- Goodwill and asset impairments (estimates driving fair value in goodwill and asset impairment analysis)
- Contingencies (estimates of reasonably possible loss/range of reasonably possible losses or an explanation of why the reporting entity is unable to make such an estimate)
- Income taxes (valuation allowances and permanent reinvestment of foreign undistributed earnings assertion)

For more information on disclosure considerations related to business combinations, goodwill and asset impairments, contingencies, and income taxes, see FSP 17, FSP 8, FSP 23, and FSP 16, respectively.

Also refer to ASC 275-10-60 for references to additional examples of disclosures.

24.3.4 Current vulnerability related to certain concentrations

Vulnerabilities from concentrations arise when a reporting entity is exposed to a greater risk of loss than if it had mitigated that risk through diversification. As discussed in ASC 275-10-50-16, a reporting entity should disclose such concentrations when all of the following criteria are met:

- Concentration exists at the financial statement date
- Concentration results in vulnerability to a near-term severe impact
- It is at least reasonably possible that the events that could result in the severe impact will occur in the near team

Concentrations meeting these criteria should be disclosed in sufficient detail to inform users of the general nature of the associated risk.

As defined in ASC 275-10-20, "severe impact" in this context means a significant financially disruptive effect on a reporting entity's normal functioning. Severe impact is a higher threshold than material. Matters may be material in that they impact the decisions of a financial statement user but do not disrupt the operations of a reporting entity. For example, the loss of business from a large customer may materially impact a reporting entity's results but not disrupt the entity's operations. The concept of severe impact, however, would include matters that are less than catastrophic. "Reasonably possible" and "near term" should be interpreted consistent with the discussion in FSP 24.3.3.

ASC 275-10-50-18 requires disclosure of the following defined concentrations (as opposed to a broader set of potential concentrations about which management may be aware) if they meet the criteria listed in the first set of bullets above in this section:

- Volume of business transacted with a specific customer, supplier, or lender (disclosure is required for public entities (as defined in ASC 280) when revenue from a specific customer equals 10% or more of total revenue; however, a reporting entity should still consider disclosure in cases where the threshold has not been met)
- Revenue from particular products or services for which a severe impact may result due to volume or price changes or the loss of patent protection
- Available sources of supply for materials, labor, or services
- Market or geographic area in which a reporting entity conducts its operations

ASC 275-10-50-18 states that it is always considered at least reasonably possible that any customer, grantor, or contributor will be lost in the near term and that operations located outside the reporting entity's home country may be disrupted in the near term.

ASC 275 includes additional disclosure requirements for concentrations of labor subject to collective bargaining agreements and concentrations of operations outside of a reporting entity's home country if the criteria for disclosure of concentrations are met.

Excerpt from ASC 275-10-50-20

For those concentrations of labor…subject to collective bargaining agreements and concentrations of operations located outside of the entity's home country…the following specific disclosures are required:

a. For labor subject to collective bargaining agreements, disclosure shall include both the percentage of the labor force covered by a collective bargaining agreement and the percentage of the labor force covered by a collective bargaining agreement that will expire within one year.

b. For operations located outside the entity's home country, disclosure shall include the carrying amounts of net assets and the geographic areas in which they are located.

Sufficient disclosure of concentrations is a challenge for many reporting entities. As a result, the SEC staff has commented on certain risks related to concentrations. Frequent areas of comment include:

- Concentration of significant customers or class of customers, including identifying the magnitude of receivables by foreign governments
- Concentration of cash or operations in specific countries or regions, and whether there are government regulations in those countries protecting the balances (similar to Federal Deposit Insurance Corporation (FDIC) insurance)
- Existence of concentrations of credit risk including specific counterparties or groups of counterparties that are similarly impacted by macroeconomic factors

Refer to Examples 2 and 4 through 8 in ASC 275-10-55 for examples of disclosures related to concentrations.

24.3.5 Assessment of disclosure criteria

Significant judgment is required to determine whether a material change in estimate or near-term severe impact from a concentration is reasonably possible. The outcome of future events alone should not be used to determine whether the reporting entity's inclusion or exclusion of a particular disclosure was an error. For example, if the reporting entity discloses a significant estimate, but that estimate is not followed by a material change, it does not imply that the disclosure should not have been made. Likewise, if the reporting entity experiences a severe impact related to a concentration that was not previously disclosed, it would not suggest that the reporting entity failed to comply with the disclosure requirements if an appropriate judgment had been made that the concentration did not meet the requirements for disclosure.

24.4 Interaction of ASC 275 with other guidance

Disclosures required by ASC 275 are not mutually exclusive with those required by other US GAAP, as many of the requirements are similar to or overlap with other required disclosures. In addition, certain disclosure requirements in ASC 275 supplement the requirements of other authoritative pronouncements. While there are many pieces of accounting guidance that address disclosures of risks and uncertainties, the following topics are specifically referenced by ASC 275.

24.4.1 *ASC 450, Contingencies*

ASC 450 requires the disclosure of loss contingencies as discussed in FSP 23. ASC 275 does not change those requirements but supplements them. For example, ASC 450 does not differentiate between near- and long-term contingencies. Therefore, if an estimate within the scope of ASC 450 meets the criteria for disclosure under ASC 275 as discussed in FSP 24.3.3, the reporting entity should also disclose that it is at least reasonably possible that a change in the estimate will occur in the near term.

In addition, estimates that do not require disclosure in accordance with ASC 450 should be assessed under ASC 275. For example, estimates associated with long-term operating assets and amounts reported under profitable long-term contracts that are not within the scope of ASC 450 should be considered for disclosure under ASC 275. Disclosures related to the estimate of gain on a contract accounted for under the percentage-of-completion method would not be within the scope of ASC 450, but may meet the criteria discussed in FSP 24.3.3 above.

24.4.2 *ASC 360, Property, Plant, and Equipment*

The disclosure requirements of ASC 275 are applicable to potential near-term impairments of long-lived assets accounted for under ASC 360. ASC 360 includes examples of events or changes in circumstances that indicate when the carrying amount of such assets may not be recoverable. However, a reporting entity should not base its conclusion on the need for disclosure on the outcome of an impairment test performed under ASC 360. Disclosure may be required under ASC 275 even if a reporting entity concludes that an impairment charge is not required. See FSP 8 for further discussion.

24.4.3 *ASC 280, Segment Reporting*

Disclosure of some concentrations, such as assets or operations located outside the reporting entity's home country, may be made to comply with ASC 280. Such disclosures need not be repeated to comply with ASC 275 and may be combined with segment footnote disclosures. See FSP 25 for further discussion.

24.4.4 *ASC 825, Financial Instruments*

Disclosures of the concentration of credit risks and other financial instruments are not required under ASC 275. However, disclosure of these concentrations may be required pursuant to ASC 825. See FSP 20 for further discussion.

24.5 Going concern

ASC 205-40, *Presentation of Financial Statements – Going Concern*, requires management to assess the reporting entity's ability to continue as a going concern.

24.5.1 *Assessing going concern*

Financial reporting under US GAAP assumes that a reporting entity will continue to operate as a going concern until its liquidation becomes imminent. This is commonly referred to as the going concern basis of accounting.

If a reporting entity faces conditions that give rise to uncertainties about its ability to continue to operate (e.g., recurring operating losses), it may be necessary to make adjustments in its financial statements (e.g., record asset impairment losses) and provide related disclosures. Nevertheless,

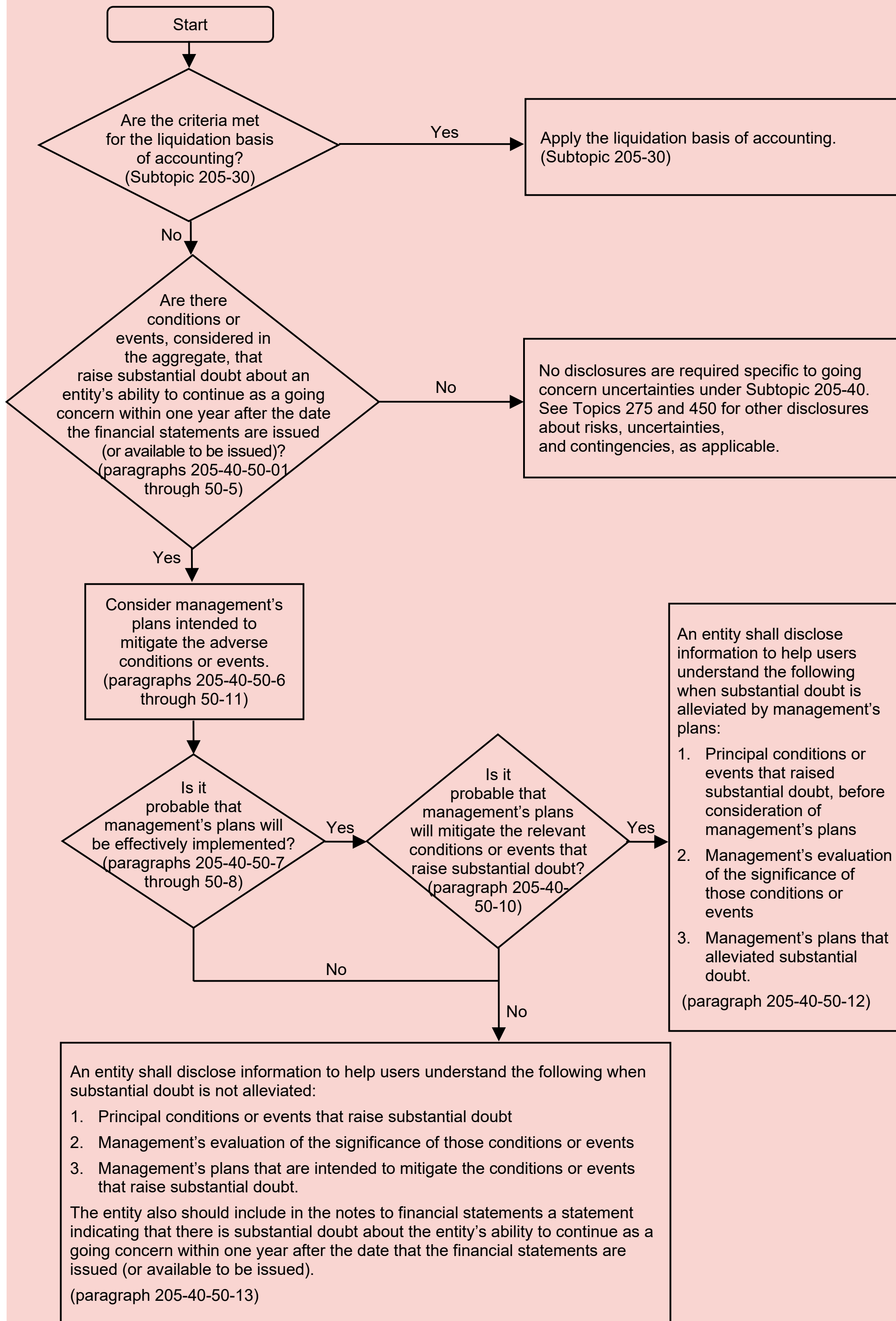
financial statements should continue to be prepared using the going concern basis of accounting, even when the going concern uncertainties are significant. Disclosures may be required to alert investors about the underlying financial conditions and management's plans to address them.

ASC 205-40 provides management with direct guidance on going concern assessments and disclosures. ASC 205-40:

- Requires management to assess going concern each annual and interim reporting period with a look-forward period of one year from the financial statement issuance date (or the date the financial statements are available to be issued)
- Defines substantial doubt (see FSP 24.5.2)
- Requires disclosures when there is substantial doubt about the company's ability to continue as a going concern, even when an initially-identified substantial doubt is alleviated by management's plans (see FSP 24.5.3). ASC 205-40-55-1 provides a flowchart to help navigate the accounting and disclosure requirements related to going concern assessments

ASC 205-40-55-1

The following flowchart depicts the decision process to follow for evaluating whether there is substantial doubt about an entity's ability to continue as a going concern and determining the related disclosure requirements.



24.5.2 Disclosure threshold: Substantial doubt

Under ASC 205-40, the emergence of substantial doubt about a reporting entity's ability to continue as a going concern is the trigger for providing footnote disclosure. For each annual and interim reporting period, management should evaluate whether there are conditions that give rise to substantial doubt within one year from the financial statement issuance date (or the date the financial statements are available to be issued), and if so, provide related disclosures.

The guidance indicates that conditions that give rise to substantial doubt ordinarily relate to a reporting entity's ability to meet its obligations as they become due. The ASC Master Glossary defines substantial doubt as follows:

Definition of Substantial Doubt from ASC Master Glossary

Substantial doubt about an entity's ability to continue as a going concern exists when conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued when applicable).

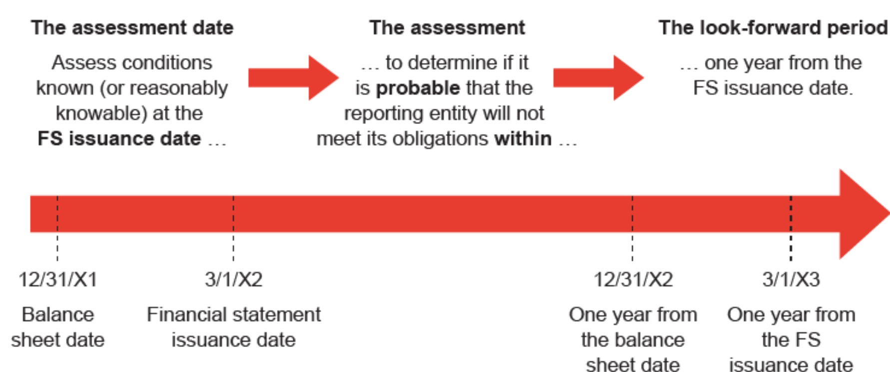
The likelihood threshold of probable is defined in ASC 205-40-20 as "the future event or events are likely to occur," which is consistent with how the term is used in US GAAP applicable to loss contingencies.

Management's assessment should be based on the relevant conditions that are "known and reasonably knowable" at the issuance date (or the date the financial statements are available to be issued), rather than at the balance sheet date. This means that the assessment should consider the most current information available before the financial statements are issued (or available to be issued), requiring companies to consider all relevant subsequent events after the balance sheet date. The term "reasonably knowable" was introduced to emphasize that a reporting entity should make a reasonable effort to identify conditions that it may not readily know, but that could be identified without undue cost and effort.

Figure FSP 24-1 illustrates the look-forward period over which conditions impacting an entity's ability to continue as a going concern should be assessed.

Figure FSP 24-1

Look-forward period



The definition of substantial doubt is principally based on likelihood. ASC 205-40-50-5 indicates that both quantitative and qualitative information should be considered in the assessment. The assessment of a reporting entity's ability to meet its obligations is inherently judgmental. The guidance indicates that a reporting entity should assess relevant conditions in the aggregate, and weigh the likelihood and magnitude of their potential impact on the reporting entity's ability to meet obligations within the assessment period.

ASC 205-40-50-5

When evaluating an entity's ability to meet its obligations, management shall consider quantitative and qualitative information about the following conditions and events, among other relevant conditions and events known and reasonably knowable at the date that the financial statements are issued:

a. The entity's current financial condition, including its liquidity sources at the date that the financial statements are issued (for example, available liquid funds and available access to credit)

b. The entity's conditional and unconditional obligations due or anticipated within one year after the date that the financial statements are issued (regardless of whether those obligations are recognized in the entity's financial statements)

c. The funds necessary to maintain the entity's operations considering its current financial condition, obligations, and other expected cash flows within one year after the date that the financial statements are issued

d. The other conditions and events, when considered in conjunction with (a), (b), and (c) above, that may adversely affect the entity's ability to meet its obligations within one year after the date that the financial statements are issued. See paragraph 205-40-55-2 for examples of those conditions and events.

ASC 205-40-55-2 provides several examples of other conditions to consider.

Excerpt from ASC 205-40-55-2

a. Negative financial trends, for example, recurring operating losses, working capital deficiencies, negative cash flows from operating activities, and other adverse key financial ratios

b. Other indications of possible financial difficulties, for example, default on loans or similar agreements, arrearages in dividends, denial of usual trade credit from suppliers, a need to restructure debt to avoid default, noncompliance with statutory capital requirements, and a need to seek new sources or methods of financing or to dispose of substantial assets

c. Internal matters, for example, work stoppages or other labor difficulties, substantial dependence on the success of a particular project, uneconomic long-term commitments, and a need to significantly revise operations

d. External matters, for example, legal proceedings, legislation, or similar matters that might jeopardize the entity's ability to operate; loss of a key franchise, license, or patent; loss of a principal customer or supplier; and an uninsured or underinsured catastrophe such as a hurricane, tornado, earthquake, or flood.

24.5.3 Consideration of management's plans

If conditions give rise to substantial doubt in the initial assessment, ASC 205-40-50-6 requires management to consider its plans and their mitigating impact. In doing so, management should assess whether its plans to mitigate the adverse conditions, when implemented, will alleviate substantial doubt. Whether an initially-identified substantial doubt is alleviated or not will determine the nature of required disclosures.

ASC 205-40-50-7 sets a high bar for a reporting entity to be able to take credit for the mitigating impact of management's plans. Management's plans should be considered only to the extent that information available as of the issuance date indicates both of the following:

- It is probable that the plans will be effectively implemented within the assessment period

- It is probable that management's plans, when implemented, will mitigate the conditions that give rise to substantial doubt within the assessment period

In assessing effective implementation, management should evaluate the feasibility of the plans in light of the reporting entity's specific facts and circumstances. Management's ability to successfully implement the plans is important in this evaluation. As discussed in ASC 205-40-50-8, generally, to be considered probable of being effectively implemented, management (or others with the appropriate authority, such as the board of directors) must have approved the plan before the issuance date.

As discussed in ASC 205-40-50-10, management should further assess its plans to determine whether it is probable that those plans will mitigate the conditions that give rise to substantial doubt. In this assessment, management should consider the expected magnitude and timing of the mitigating effect of its plans (e.g., the amount and timing of cash proceeds from the planned sale of a building) in relation to the magnitude and timing of the relevant conditions or events that those plans intend to mitigate (e.g., the amount and timing of additional cash necessary to pay down anticipated obligations).

If management concludes that the initially-identified substantial doubt is alleviated by its plans, ASC 205-40-50-12 still requires certain disclosures about the underlying conditions and management's plans. However, such disclosures would not express that there is substantial doubt. Only if substantial doubt remains despite management's plans does ASC 205-40-50-13 require an express statement that there is substantial doubt about the reporting entity's ability to continue as a going concern.

ASC 205-40-55-3 provides examples of plans that management may implement to mitigate the conditions that give rise to substantial doubt and identifies the types of information that management should consider in evaluating their feasibility. The examples are not intended to be all inclusive.

- Plans to dispose of an asset or business: consider the restrictions on such disposal, such as covenants that limit disposal, or encumbrances against the asset. Also consider marketability of the asset and direct or indirect effects of disposal

- Plans to borrow money or restructure debt: consider the availability and terms of new or existing debt, existing guarantees, commitments, and subordination clauses

- Plans to reduce or delay expenditure: consider the feasibility of plans to reduce overhead or expenditures, to postpone research or maintenance, or to lease rather than purchase

- Plans to increase ownership equity: consider the feasibility of raising additional capital from affiliates or other investors, or arrangements to reduce current dividends

The guidance also clarifies that any mitigating effect resulting from a plan to liquidate the reporting entity (e.g., cash infusions through liquidation of a business) should not be considered in the assessment, even if the liquidation is probable of occurring.

24.5.4 Required disclosures

Disclosures are required if conditions give rise to substantial doubt, whether or not the substantial doubt is alleviated by management's plans. No disclosures are required specific to going concern uncertainties if an assessment of the conditions does not give rise to substantial doubt.

Figure FSP 24-2 illustrates the disclosures required by ASC 205-40 for an entity with conditions that give rise to substantial doubt.

Figure FSP 24-2

Going concern disclosures required by ASC 205-40

Required disclosures	
As discussed in ASC 205-40-50-12, if the initially-identified substantial doubt is alleviated by management's plans, disclose:	As discussed in ASC 205-40-50-13, if the substantial doubt is not alleviated by management's plans, disclose:
□ Principle conditions or events that initially gave rise to substantial doubt	□ A statement indicating that there is substantial doubt about the reporting entity's ability to continue as a going concern within one year after the issuance date
□ Management's evaluation of the significance of those conditions or events in relation to the reporting entity's ability to meet its obligations	□ Principal conditions or events giving rise to substantial doubt
□ Management's plans that alleviated substantial doubt	□ Management's evaluation of the significance of those conditions or events in relation to the reporting entity's ability to meet its obligations
	□ Management's plans that are intended to mitigate those conditions or events

As discussed in ASC 205-40-50-14, in subsequent annual and interim periods, a reporting entity should continue to provide the disclosures if conditions continue to give rise to substantial doubt in those periods. Disclosures should become more extensive as additional information becomes available about the reporting entity's financial condition and about management's plans. Reporting entities should provide appropriate context and continuity in explaining how conditions have changed between reporting periods. In the period substantial doubt no longer exists (before or after consideration of management's plans), the accounting guidance indicates that companies should disclose how the relevant conditions were resolved.

24.5.5 Example application

Figure FSP 24-3 provides an example of application of the going concern guidance.

Figure S 24-3
Example application

Relevant conditions	Management's assessment results	Management's plans to mitigate adverse conditions	Do conditions raise substantial doubt?	Is substantial doubt alleviated by management's plans?	Disclosures
Negative financial trends No significant debt coming due within the assessment period Substantial liquid resources (cash and line of credit)	Cash flow forecasts demonstrate the reporting entity will meet its obligations within the assessment period	Cost cutting measures	No, because it is not probable that the entity will be unable to meet obligations within the next year	N/A	No disclosures specific to going concern required
Negative financial trends No significant debt coming due within the assessment period Limited liquid resources (cash and line of credit)	Cash flow forecasts demonstrate the reporting entity will run out of cash (and available line of credit) within the assessment period	Sell Division A – Plan approved by the board before the issuance date and it is probable within the assessment period that the plan: □ will be effectively implemented, and □ will mitigate the conditions (that is, sufficient cash will be generated from the transaction)	Yes, because it is probable that the entity will not meet obligations within the next year – unless it sells Division A.	Yes	Disclose conditions, management's evaluation, and management's plans that alleviated substantial doubt
Positive financial trends and positive working capital Significant debt is coming due within the next year The reporting entity does not have the ability to repay all debt at maturity The reporting entity has a history of refinancing debt and nothing indicates it cannot refinance again	Absent a refinancing, the reporting entity would not be able to meet its obligations within the next year With refinancing, it would meet its obligations	Refinance debt The plan is deemed to be probable of being implemented and probable of mitigating adverse conditions	Yes, because it is probable that the entity will not meet its obligations within the next year – unless it refinances	Yes	Limited incremental disclosures: refer to debt footnote, mention the plan to refinance

Relevant conditions	Management's assessment results	Management's plans to mitigate adverse conditions	Do conditions raise substantial doubt?	Is substantial doubt alleviated by management's plans?	Disclosures
Negative financial trends and limited liquidity Significant debt is coming due within the next year The reporting entity does not have the ability to repay all debt at maturity The reporting entity does not have a history of refinancing debt	Absent a refinancing, the reporting entity will not meet its obligations within the next year With refinancing, it would meet its obligations	Refinance debt Plan is not probable of being implemented due to negative financial trends and lack of refinancing history	Yes, because it is probable that the entity will not meet its obligations within the next year – unless it refinances	No	Express that there is sub-stantial doubt. Also disclose conditions, management's evaluation, and management's plans.

24.6 Risks and uncertainties—considerations for private companies

ASC 205-40 and ASC 275 are applicable to both SEC registrants and private companies. However, the different environments in which SEC registrants and private companies operate may affect their considerations regarding the adequacy of disclosures of risks and uncertainties. Filings of SEC registrants are subject to review by the SEC staff and the registrants are accountable to shareholders who must rely on publicly disclosed information. Private company stakeholders are often lending institutions and shareholders who typically have more access to management to obtain information that may not be disclosed in the financial statements. While this difference may potentially influence the level of transparency in financial statement disclosures, both types of reporting entities should take care to provide an appropriate level of disclosure to meet their reporting objectives.

Private companies are subject to the general concentration disclosure requirements of ASC 275-10-50-16 to ASC 275-10-50-22. In addition, private companies may identify vulnerabilities from concentrations more frequently. For example, it may be more likely that a private company has a concentration of accounts receivable from one customer or has cash held at one financial institution that exceeds FDIC limits.

Chapter 25:
Segment reporting—updated March 2024

25.1 Segment reporting—overview

The objective of ASC 280, *Segment Reporting*, is to provide information about the different types of business activities in which a reporting entity engages and the different economic environments in which it operates. This information is intended to help users of the financial statements (1) better understand the reporting entity's performance, (2) better assess its prospects for future net cash flows, and (3) make more informed judgments about the reporting entity as a whole.

This chapter outlines the application of ASC 280 and includes relevant examples and practical insights.

New guidance

In November 2023, the FASB issued ASU 2023-07, *Segment Reporting (Topic 280): Improvements to Reportable Segment Disclosures*. The new FASB guidance requires incremental disclosures in annual and interim periods related to a public entity's reportable segments (particularly on segment expenses) but does not change the definition of a segment, the method for determining segments, or the criteria for aggregating operating segments into reportable segments.

This chapter has been updated to reflect the new guidance. The new guidance is effective for annual financial statements of public entities for fiscal years beginning after December 15, 2023 (e.g., in 2024 year-end financial statements for calendar year entities) and in interim periods in fiscal years beginning after December 15, 2024 (e.g., in 2025 interim financial statements for calendar year entities) and should be adopted retrospectively unless impracticable. Early adoption is permitted.

This chapter reflects both the application of the new guidance after adoption of ASU 2023-07 (in FSP 25.2, FSP 25.7, and FSP 25.8) and before (in FSP 25.2A and FSP 25.7A).

ASU 2023-07 also updated the terminology used to refer to a change in previously reported segment information due to changes in facts and circumstances from a "restatement" to a "recasting," so as not to imply that the previously reported information was incorrect. All references in this chapter to such changes in previously reported information have been updated accordingly to "recast" or "recasting."

25.2 Segment reporting—scope and relevant guidance (after ASU 2023-07)

ASC 280 applies to public entities. The disclosure requirements of ASC 280 are not required for not-for-profit organizations or private companies.

ASC 280 provides the following guidance with regard to scope and the definition of a public entity.

Definition from ASC 280-10-20 Glossary

Public Entity:

A business entity or a not-for-profit entity that meets any of the following conditions:

a. It has issued debt or equity securities or is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).

b. It is required to file financial statements with the Securities and Exchange Commission (SEC).

c. It provides financial statements for the purpose of issuing any class of securities in a public market.

ASC 280-10-15-3

The guidance in this Subtopic does not apply to the following entities:

a. Parent entities, subsidiaries, joint ventures, or investees accounted for by the equity method if those entities' separate company statements also are consolidated or combined in a complete set of financial statements and both the separate company statements and the consolidated or combined statements are included in the same financial report. However, this Subtopic does apply to those entities if they are public entities and their financial statements are issued separately.

b. Not-for-profit entities (regardless of whether the entity meets the definition of a public entity as defined above).

c. Nonpublic entities.

ASC 280-10-50-20 confirms that all of the disclosures required in the segments guidance, including disclosing a measure of segment profit or loss (or multiple measures, if used to assess performance and decide how to allocate resources) and reporting significant segment expenses and other segment items, as well as the entity-wide disclosures described in FSP 25.7.7, apply to all public entities, including those with a single operating or reportable segment.

In certain instances, the financial statements of a private company may be included in the filing of an SEC registrant (e.g., due to SEC rules regarding significant equity method investments or acquired entities). In these situations, the private company is not required to disclose segment information in its separate financial statements because the private company itself is not required to file financial statements with the SEC.

For public entities, the proper application of ASC 280 is important for purposes of goodwill impairment testing because operating segments are the starting point for the identification of reporting units (the unit of account for goodwill impairment testing purposes). This is also true for private companies that have not elected to apply the goodwill accounting alternative in ASC 350-20, *Intangibles-Goodwill and Other*, or that have elected to apply the alternative but still test goodwill impairment at the reporting unit level. For additional private company segment reporting considerations, see FSP 25.9.

25.2A Segment reporting – scope and relevant guidance (before ASU 2023-07)

ASC 280 applies to public entities. The disclosure requirements of ASC 280 are not required for not-for-profit organizations or private companies.

ASC 280 provides the following guidance with regard to scope and the definition of a public entity.

Definition from ASC 280-10-20 Glossary

Public Entity:

A business entity or a not-for-profit entity that meets any of the following conditions:

a. It has issued debt or equity securities or is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).

b. It is required to file financial statements with the Securities and Exchange Commission (SEC).

c. It provides financial statements for the purpose of issuing any class of securities in a public market.

ASC 280-10-15-3

The guidance in this Subtopic does not apply to the following entities:

a. Parent entities, subsidiaries, joint ventures, or investees accounted for by the equity method if those entities' separate company statements also are consolidated or combined in a complete set of financial statements and both the separate company statements and the consolidated or combined statements are included in the same financial report. However, this Subtopic does apply to those entities if they are public entities and their financial statements are issued separately.

b. Not-for-profit entities (regardless of whether the entity meets the definition of a public entity as defined above).

c. Nonpublic entities.

In certain instances, the financial statements of a private company may be included in the filing of an SEC registrant (e.g., due to SEC rules regarding significant equity method investments or acquired entities). In these situations, the private company is not required to disclose segment information in its separate financial statements because the private company itself is not required to file financial statements with the SEC.

For public entities, the proper application of ASC 280 is important for purposes of goodwill impairment testing because operating segments are the starting point for the identification of reporting units (the unit of account for goodwill impairment testing purposes). This is also true for private companies that have not elected to apply the goodwill accounting alternative in ASC 350-20, *Intangibles-Goodwill and Other*, or that have elected to apply the alternative but still test goodwill

impairment at the reporting unit level. For additional private company segment reporting considerations, see FSP 25.9.

25.3 Application of segment reporting guidance—overview

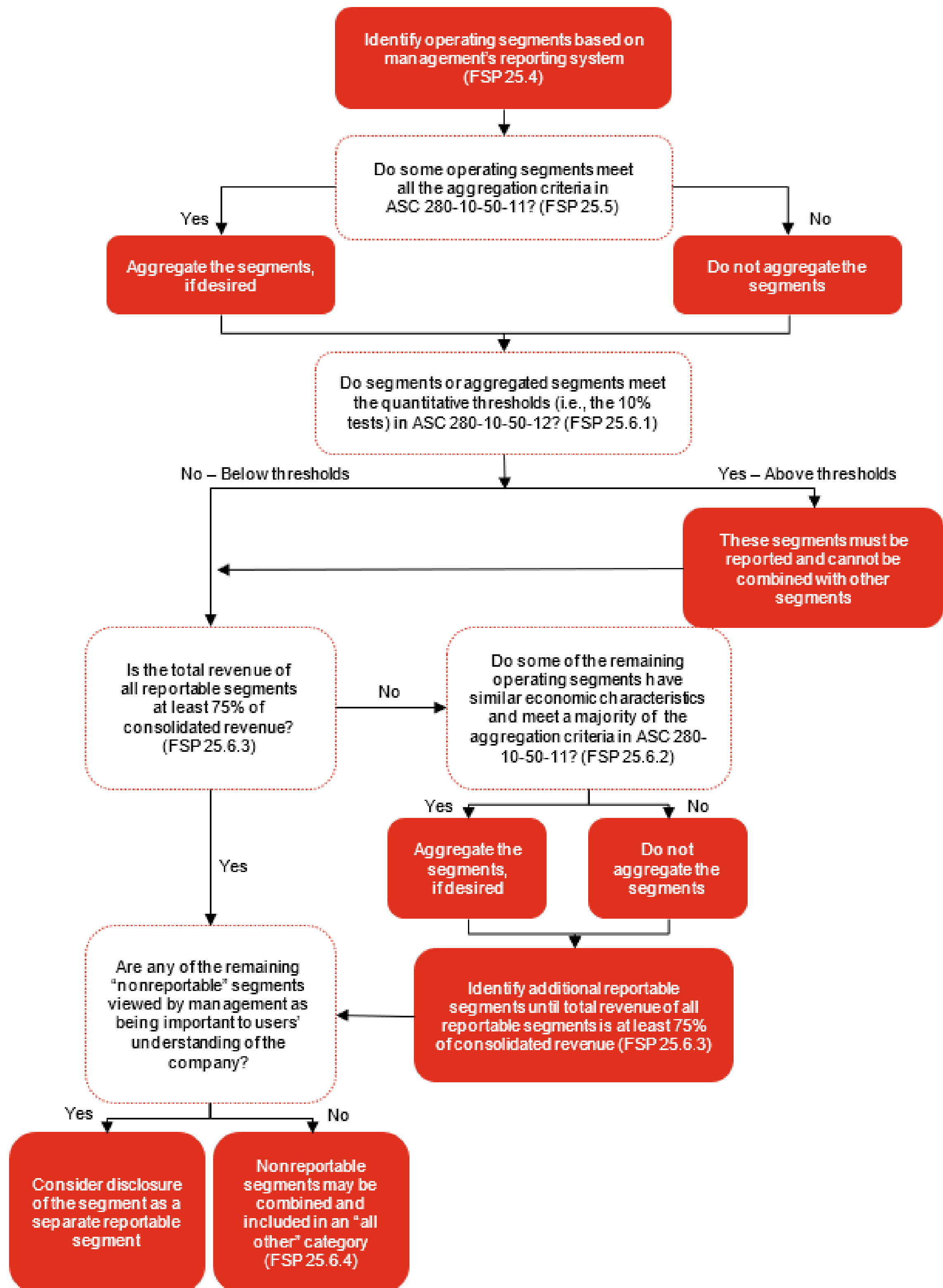
ASC 280 utilizes the "management approach," whereby external segment reporting is aligned with management's internal reporting. This approach is intended to provide financial statement users with an ability to see a reporting entity "through the eyes of management."

Reporting entities should apply the following steps when applying ASC 280:

- Step 1: Identify operating segments
- Step 2: Aggregate operating segments, if applicable, into reportable segments
- Step 3: Determine if reportable segments cover a sufficient amount of the reporting entity's operations
- Step 4: Determine if additional entity-wide disclosures are necessary

Figure FSP 25-1 depicts how these four steps are applied in determining reportable segments.

Figure FSP 25-1
Steps for determining reportable segments



25.4 Identifying operating segments

Identifying operating segments continues to be a common area of comments from the SEC staff. The proper determination of operating segments begins with understanding:

- the reporting entity's organizational structure and how individuals within the organization are compensated
- the reporting entity's operations, including its budgeting process
- the individual or individuals responsible for allocating resources and assessing performance (referred to as the chief operating decision maker, or CODM)
- the information regularly reviewed by the CODM to carry out this function

ASC 280-10-50-1 defines an operating segment as a component of a reporting entity with three characteristics. Figure FSP 25-2 lists these characteristics, along with references to the relevant guidance, and indicates where in this chapter those characteristics are discussed.

Figure FSP 25-2
Characteristics of an operating segment

Requirement	ASC reference	Section
It engages in business activities from which it may recognize revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same public entity).	ASC 280-10-50-1(a)	FSP 25.4.1
Its operating results are regularly reviewed by the public entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance.	ASC 280-10-50-1(b)	FSP 25.4.2
Its discrete financial information is available.	ASC 280-10-50-1(c)	FSP 25.4.3

25.4.1 *Business activities*

Business activities are ongoing economic and operating activities that create value for a reporting entity, such as the production and sale of a product to a customer. Identifying operating segments that engage in business activities is usually straightforward and is primarily based on a reporting entity's revenue streams and its organizational structure. As discussed in ASC 280-10-50-1(a), to engage in business activities, a component of a reporting entity does not require dedicated assets to recognize revenues and incur expenses and does not require externally-generated revenues and expenses (i.e., the transactions could be intercompany).

25.4.1.1 *Components without revenue*

As discussed in ASC 280-10-50-3, certain components may meet the requirement to engage in business activities even if they do not yet recognize revenue.

ASC 280-10-50-3

An operating segment may engage in business activities for which it has yet to recognize revenues, for example, start-up operations may be operating segments before recognizing revenues.

For example, research and development business units that do not recognize revenues, but whose results are regularly reviewed by the CODM, may be considered operating segments. Although research and development centers do not typically recognize revenues, their activities may not be incidental to the activities of the reporting entity, as they may serve as an integral component of the reporting entity's business.

Reporting entities may have a corporate headquarters that carries out centralized functions, such as accounting, treasury, information technology, legal, human resources, environmental, and internal audit. As discussed in ASC 280-10-50-4, corporate departments that do not recognize revenues or recognize revenues that are only incidental to the activities of the reporting entity would not be considered operating segments. If not considered an operating segment, the revenues and expenses of corporate departments should be reported in the reconciliation of reportable segment totals to the reporting entity's consolidated totals. For further guidance on the presentation of reconciling items in segment disclosures, see FSP 25.7.6.

In some cases, a manufacturing entity is managed as an operating cost center that does not recognize separate revenues because overall customer revenues are not allocated to it. Provided that all the other criteria under ASC 280-10-50-1 are met, the cost center would be considered an operating segment.

Question FSP 25-1

Can a vertically-integrated operation of a reporting entity that does not have external revenues (i.e., it sells primarily, or even exclusively, to other components of the same entity) be considered an operating segment?

PwC response

Generally, yes. In defining an operating segment as a component of a reporting entity that engages in business activities from which it may recognize revenues and incur expenses, the FASB acknowledged that not all business activities of a reporting entity may generate revenues. While, in many cases, transfer prices are charged by one component of an entity to another, the fact that transfer prices are not charged would not necessarily exempt such operations from being considered operating segments.

25.4.1.2 Run-off operations

A reporting entity may have a disposal strategy that involves a "run-off" of operations (i.e., it will cease accepting new business but continue to provide service under existing contracts until they expire or are terminated). Run-off operations should be evaluated to determine if they meet the definition of an operating segment.

Example FSP 25-1 illustrates the segment determination for a component that is being run off.

EXAMPLE FSP 25-1

Run-off operations or operations in liquidation

FSP Corp, an insurance reporting entity, discontinues its workers' compensation line of business and is no longer writing new workers' compensation policies. However, existing customers can continue to renew policies for indefinite periods under the original policies' conditions. The run-off operations do not meet the criteria for discontinued operations and the workers' compensation line of business is being maintained as a result of contractual requirements. For internal reporting, separate financial results are maintained for the run-off operations and are regularly reviewed by the CODM.

Does FSP Corp's workers' compensation line of business meet the definition of an operating segment?

Analysis

Because the workers' compensation line of business is engaged in business activities and the operating component's performance is regularly reviewed by the CODM, it meets the definition of an operating segment. See FSP 27.5.1.4 for information about the segment disclosure requirements of a discontinued operation.

25.4.2 Information regularly reviewed by the CODM

The information regularly reviewed by the CODM is integral to identifying operating segments.

At the 2023 AICPA & CIMA Conference on Current SEC and PCAOB Developments, the SEC staff provided supplemental commentary about this topic, indicating that quarterly reviews of operating results would generally be considered "regularly reviewed;" however, this does not mean that a frequency less than quarterly would not be considered "regularly reviewed." Rather, all facts and circumstances should be assessed in context.

25.4.2.1 Determination of the CODM

Proper determination of the CODM is critical to the application of ASC 280. As discussed in ASC 280-10-50-5, the CODM is a function (not necessarily an individual) that allocates the resources of the reporting entity and assesses the performance of its segments.

Often, the CODM will be an individual who is either the chief executive officer (CEO) or the chief operating officer (COO) of a reporting entity. Reporting entities should consider which individual is acting in this role and be able to explain the rationale for their conclusion. While the CEO or COO may receive input from others within the reporting entity, decisions to assess performance and allocate resources are usually made by one individual. However, in some cases, the decision-making power does rest with a group and not with any specific individual within the group. When considering whether a group is the CODM, it is important to evaluate how decisions are made, including in circumstances in which not all group members agree.

In some instances, the SEC staff has questioned whether an identified individual can act alone in the CODM function when the information used by the CODM to manage the business may not appear sufficient. In some of these cases, an additional member or group of members may be determined to be part of the CODM function.

When a group with joint decision-making authority is the CODM, consideration should be given to the information that the group uses to assess performance and allocate resources. Judgment is required to determine whether the information received by only certain members of the CODM group should be considered part of the information that is regularly reviewed by the CODM group.

The guidance does not require the CODM to have ultimate decision-making authority. The SEC has indicated that in certain instances, key operating decisions (e.g., expanding into new territories, pursuing new products, or entering into significant contracts) may not be made at the strategic or ultimate decision-maker level (e.g., by the CEO), but rather by someone responsible for running the day-to-day operations of the reporting entity (e.g., by the COO).

When preparing carve-out financial statements or separate financial statements of a subsidiary, determination of appropriate segment disclosures should be made at the carve-out entity or subsidiary level, which usually will not be the same as the segments reported in the parent company's consolidated financial statements. This analysis would entail identifying the CODM at the carve-out entity or subsidiary level and determining what information that CODM regularly reviews to allocate resources and assess performance.

25.4.2.2 Understanding the information regularly reviewed by the CODM

One of the requirements to be an operating segment is that operating results for the component must be regularly reviewed by the CODM to allocate resources and assess performance. We believe that the operating results regularly reviewed by the CODM would generally include a measure of profitability.

Understanding all of the information the CODM regularly reviews to assess performance and allocate resources is critical, regardless of how the CODM receives this information. In many instances, the information used by the CODM can be found in reports that are available in the reporting entity's information systems and/or distributed on a regular basis. The CODM might also receive information in periodic meetings with segment managers.

Determining what financial information the CODM uses to assess performance and allocate resources can be challenging because management typically has access to a significant amount of readily available information through the reporting entity's information systems. Information received by the CODM, regardless of how it is obtained, is generally used in some way to measure performance and/or make resource allocation decisions.

For certain components, the CODM may only receive limited financial information, such as revenue-only data by product line or by customer. For most reporting entities, revenue-only data would not be considered sufficient financial information for decision making related to resource allocation or performance evaluation. For instance, revenue-only information may be used to allocate resources within a component but may not be sufficient to evaluate the component's performance. However, for certain components, revenue-only data may serve as an adequate performance measure, such as when cost of sales or services are minimal. Therefore, for all components, it is important to obtain a thorough understanding of how they operate, what financial information is sufficient to measure performance, and how the CODM utilizes the information received.

Question FSP 25-2

If a CODM is accountable for Sarbanes-Oxley 302 and 906 certifications for wholly-owned subsidiaries that issue standalone financial statements, would that indicate that each separate subsidiary should be treated as an operating segment in the parent company's consolidated financial statements?

PwC response

Not necessarily. The existence of Sarbanes-Oxley 302 and 906 certifications for wholly-owned subsidiaries that issue standalone financial statements does not necessarily cause the subsidiaries to be considered operating segments if the consolidated reporting entity can demonstrate that resources are allocated and performance is assessed on a different basis. This evidence may include, among other things, the reporting entity's organizational structure, financial information regularly reviewed and used by the CODM, the compensation incentives for segment management, the level of information included in capital and operating budgets and the reporting package provided to the board of directors. For example, if a reporting entity demonstrates that a CODM regularly receives financial information at a more aggregated level than the subsidiary level at which the certifications are issued, and uses this information to assess performance and allocate resources, these more aggregated components may be considered the reporting entity's operating segments. However, in this circumstance, the reporting entity should also evaluate whether the information provided to the CODM for Sarbanes-Oxley 302 or 906 certifications is being used for resource allocation or performance assessment purposes.

Multiple sets of information received by the CODM

In some cases, the CODM may receive multiple sets of component operating results to assess performance and allocate resources. ASC 280-10-50-9 indicates that, in situations in which a reporting entity is geographically dispersed and has a variety of products, and the CODM reviews operating results by geography and by product line, the internal reporting based on product lines would constitute the operating segments.

In other cases, the CODM may receive multiple sets of component operating results based on something other than product line and geography. Other factors, including the nature of the business activities for each component, the existence of segment managers responsible for the components, and the information presented to the board of directors, may be helpful to identify the reporting entity's operating segments.

The nature of an entity's business activities is usually apparent from its external communications. Business activity discussions in the reporting entity's other publicly available information, such as press releases, the reporting entity's website, and other SEC filings, are important considerations when assessing how management views the business. However, external communications may not always align with how the CODM assesses performance and allocates resources. For example, if the CODM reviews operating results at a more disaggregated level, this could indicate the operating segments are also at a lower level.

As discussed in ASC 280-10-50-7, operating segments are typically managed by a segment manager who has direct accountability to, and maintains regular contact with, the CODM. Like the CODM, the segment manager is a function and not necessarily a manager with a specific title. In some instances, a

segment manager can manage more than one operating segment, or the CODM can also be a segment manager. Segment managers who are held accountable for the operating results of a segment usually have compensation arrangements that incorporate the segment's performance. ASC 280-10-50-8 indicates that if there is only one set of components for which segment managers are held responsible, that set of components constitutes the operating segments. However, there may be times when the CODM assesses performance and allocates resources at a level lower than that of the immediate segment managers reporting to the CODM. It would be difficult to conclude that the operating segments exist at a higher level (i.e., the level at which segment managers are identified) when performance is assessed and resources are allocated by the CODM at a lower level.

Additionally, if multiple sets of information are regularly reviewed by the CODM, the information provided to the reporting entity's board of directors could indicate the level at which performance is assessed and resources are allocated. It would be unusual for the board to receive information at a level below that of a reporting entity's operating segments. Conversely, reporting entities often have operating segments at a level lower than the information reviewed by the board of directors.

Example FSP 25-2 and Example FSP 25-3 illustrate the determination of operating segments when the CODM receives two overlapping sets of information.

EXAMPLE FSP 25-2

Matrix form of organization

FSP Corp has identified its CEO as the CODM. In assessing performance and deciding how to allocate resources, the CEO reviews two overlapping sets of financial information. The first set contains disaggregated information based on product lines, and the second set contains disaggregated information based on geographic area. The reporting entity has vice presidents who are responsible for each of the product lines and has other vice presidents who are responsible for the geographic areas. All vice presidents report directly to the CEO. In addition, both sets of information are provided to the reporting entity's board of directors.

How should FSP Corp determine which set of financial information is most indicative of its operating segments?

Analysis

ASC 280-10-50-9 indicates that, in situations in which a reporting entity has a matrix form of organization, the internal reporting based on product lines would constitute the operating segments. Therefore, in this example, the product lines would be the reporting entity's operating segments.

EXAMPLE FSP 25-3

Organization with overlapping sets of information

FSP Corp operates four product lines in North America and the same four product lines in several international markets. The North American operations comprise 90% of the reporting entity's revenue. The CODM reviews two overlapping sets of financial information—the first set contains information for North America disaggregated by product lines while the second set contains worldwide information disaggregated by location (i.e., each worldwide location, including North America). The reporting entity has vice presidents who are responsible for each of the four North American product lines as well as a vice president responsible for the North American market and a

vice president responsible for the remaining international markets. All vice presidents report directly to the CODM. In addition, both sets of information are provided to the reporting entity's board of directors.

How should FSP Corp determine which set of financial information is most indicative of its operating segments?

Analysis

Although product lines would typically constitute the operating segments, there could be circumstances in which a combination of the product lines and geographic locations are identified as operating segments. In this example, each of the four product lines in North America are most likely operating segments. Each of the international locations may be an operating segment, depending on the level at which performance is regularly reviewed and resources are allocated by the CODM, or the international market itself may be an operating segment.

CODM review of investments in unconsolidated entities

As discussed in ASC 280-10-55-2, reporting entities may have investments in unconsolidated entities that meet the definition of an operating segment. The assessment to determine this is the same as that used for identifying other operating segments.

Example FSP 25-4 illustrates the determination of whether activities of a reporting entity conducted through joint venture arrangements or equity method investees are operating segments.

EXAMPLE FSP 25-4

Joint venture arrangements and equity method investees

FSP Corp is a multinational telecommunications provider whose foreign wireless-service businesses are jointly owned by FSP Corp and various foreign companies. FSP Corp is not the sole shareholder of the foreign businesses due to local restrictions on US companies having a majority ownership. FSP Corp accounts for its investment in these joint venture arrangements using the equity method. The CODM, however, reviews the full financial results of each joint venture for decision-making purposes and has a vice president in charge of managing and monitoring the foreign wireless services.

Do the joint venture operations qualify as operating segments?

Analysis

To the extent FSP Corp manages its joint venture operations separately and conditions (a) through (c) of ASC 280-10-50-1 are met (see FSP 25.4), the joint venture operations would qualify as operating segments. When the full financial results of an equity method investee are regularly reviewed by the CODM, the asset and operating measures regularly reviewed should be disclosed.

If the financial results regularly reviewed by the CODM are prepared on a proportionate basis (i.e., based on FSP Corp's proportionate ownership of the investee), the external segment reporting of the joint venture activities should also be presented on a proportionate basis.

Since the total of all reportable segments' financial amounts must be reconciled to the corresponding amounts reported in the consolidated financial statements, appropriate eliminations would need to be reflected to reconcile amounts reported for segment purposes to those amounts reflected in the consolidated financial statements. For example, since the joint ventures' revenue information is not included in the revenue amount reported in the consolidated financial statements under the equity method, an elimination of the revenue amount disclosed for the joint ventures would need to be reflected as a reconciling item. For further guidance on the presentation of reconciling items in segment disclosures, see FSP 25.7.6.

The analysis would be the same for an equity method investment that is not a joint venture.

Question FSP 25-3

Do the segment disclosures a reporting entity provides for separately managed joint ventures or other equity method investees also satisfy the disclosure requirements of ASC 323, *Investments—Equity Method and Joint Ventures*?

PwC response

Not necessarily. ASC 323-10-50-3(c) requires that summarized financial information of joint ventures and other investments accounted for under the equity method be provided if certain thresholds are met. Accordingly, the disclosures required by ASC 323 may need to be provided in addition to any segment disclosures.

25.4.3 *Discrete financial information*

One of the requirements to be an operating segment is that discrete financial information must be available for the component. Discrete financial information can consist of limited operating information, such as revenue and operating expenses, and need not include balance sheet information. However, solely receiving revenue information, such as revenue by product, would likely not be considered discrete financial information.

25.5 *Aggregation of operating segments*

Once the operating segments of a reporting entity are identified, the guidance permits aggregation of two or more operating segments if they exhibit similar economic characteristics and other operating similarities.

The FASB decided that if operating segments have characteristics so similar that they were expected to have essentially the same future prospects, separate reporting of segment information would not add significantly to an investor's understanding of the reporting entity. Therefore, aggregation of two or more operating segments is permitted if they have similar economic characteristics (referred to in this chapter as the quantitative aggregation criteria) and have similarity in all of the other areas identified in ASC 280-10-50-11 (referred to in this chapter as the qualitative aggregation criteria). However, a reporting entity is not required to aggregate operating segments even if all of the aggregation conditions are met.

ASC 280-10-50-11 details the criteria that must be met in order to aggregate operating segments.

Excerpt from ASC 280-10-50-11

Operating segments often exhibit similar long-term financial performance if they have similar economic characteristics. For example, similar long-term average gross margins for two operating segments would be expected if their economic characteristics were similar. Two or more operating segments may be aggregated into a single operating segment if aggregation is consistent with the objective and basic principles of this Subtopic, if the segments have similar economic characteristics, and if the segments are similar in all of the following areas:

a. The nature of the products and services

b. The nature of the production processes

c. The type or class of customer for their products and services

d. The methods used to distribute their products or provide their services

e. If applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities.

Through comment letters to registrants and public statements, the SEC staff has stressed that meeting the quantitative and qualitative criteria is a high hurdle and their tolerance for differences in performance metrics and other qualitative characteristics is relatively low when assessing whether operating segments can be aggregated.

25.5.1 Quantitative aggregation criteria

The similarity of economic characteristics of two operating segments should be carefully evaluated from both a historical and expected future performance perspective. In practice, several years of historical and estimated future financial data are typically used for purposes of this evaluation. A reporting entity should consider not only the similarity of financial performance but also the economic conditions, exchange control regulations, and underlying currency risks, if applicable. If a reporting entity cannot demonstrate similar economic characteristics, then aggregation is not permitted. That is, it would not be appropriate to rely on the similarity of the qualitative aggregation criteria provided by ASC 280-10-50-11 to aggregate operating segments if they do not meet the quantitative criteria.

For example, assume a reporting entity sells centrally produced, identical products to similar classes of customers in two different countries in which the regulatory environments are the same. Operating results for each country are separately reported internally and meet the qualitative aggregation criteria. However, due to differences in selling price, and therefore profit margin, as well as differences in currency risk and exchange control, it may be difficult to support an assertion of similar economic characteristics. As a result, it may be challenging to support aggregating the individual country operating segments.

Through comments to registrants, the SEC staff has questioned whether the “similar economic characteristics” test was met when measuring the difference in financial performance between operating segments. We believe a reporting entity should consider the relative percentage difference of the operating measure and not just the absolute difference. For example, when the CODM uses gross margin to evaluate operating segment performance, the difference between a gross margin of 55% and

50% is a 5% absolute value difference but represents a 10% relative difference. Although there is no "bright line" when assessing similarity, operating segments with relative differences between performance measures of 5% or less likely would be considered economically similar, whereas relative differences in excess of 10% may not meet the economic similarity criterion for aggregation.

In some cases, a high percentage difference in the relative operating measure can result from a relatively narrow range in the actual, or absolute, operating measure (e.g., a reporting entity with operating segments having gross margins of 2% and 3% would differ by only 1% in terms of absolute value, but that 1% would represent a 50% difference in relative values). In these circumstances, a reporting entity may want to consider other factors in addition to the relative operating measure to evaluate the similarity of economic characteristics, including trends in sales growth, return on assets employed, and operating cash flows, as well as any other performance measures regularly reviewed by the CODM.

While the similarity of long-term average gross margins is a particularly important factor and is included as an example in ASC 280-10-50-11, when a reporting entity is determining whether the economic characteristics of its operating segments are similar, other relevant factors should also be considered. For instance, the similarity of the performance measures that are regularly reviewed by the CODM, as well as other performance measures, such as trends in sales growth, returns on assets employed, and operating cash flows, should also be evaluated. Competitive and operating risks associated with each operating segment should be considered as these factors could impact prospective results of the segments. When assessing similarities and differences between operating segments, the evaluation should be made considering how wide or narrow the reporting entity's breadth of business activities is and the economic environment in which they operate. Two or more operating segments considered to have similar long-term performance should be impacted similarly by events that have significant economic consequences.

Management should document its basis for concluding that operating segments are economically similar and should update the analysis on an annual basis, or more frequently if conditions that affect economic similarity change. In some circumstances, "temporary" dissimilarity in economic characteristics among operating segments may not necessarily preclude aggregation of operating segments if long-term economic similarity can still be demonstrated based on credible projections of future operations. Accordingly, a current change in operating performance may not necessarily result in a change to the composition of the reportable segments.

A reporting entity should monitor and consider whether its operating segment determinations are consistent with its publicly available information and disclosures. For example, press releases, investor presentations, analyst conference calls, and non-financial statement sections of SEC filings often include information regarding the nature of products and services, the type and class of customers, and how the reporting entity addresses its various market segments. If such information is not consistent with a reporting entity's operating segment determinations, it may call into question those segment determinations.

Question FSP 25-4

Assuming all other qualitative aggregation criteria are met, would a reporting entity be precluded from aggregating a start-up business with mature businesses based solely on the fact that the current economic characteristics of the start-up business differ from those of its mature businesses?

PwC response

No. One of the objectives of segment disclosures is to help users assess the future prospects of a reporting entity's business. Further, ASC 280-10-50-11 indicates that operating segments with similar economic characteristics often exhibit similar long-term financial performance. Accordingly, to the extent that the future financial performance (including the competitive and operating risks) of the start-up business is expected to be similar to that of a reporting entity's mature businesses in the near term, the economic characteristics requirement for aggregation would be satisfied.

For example, a retail chain may have mature store locations in five major cities. In the current year, the retail chain opens additional stores in those cities. Each store constitutes a separate operating segment because the CODM of the retail chain reviews financial results and makes decisions on a store-by-store basis. The retail stores meet all of the qualitative aggregation criteria. These "start-up" stores may meet the economic similarities requirement for aggregation with mature stores if management can establish that the financial performance of the mature and new stores is expected to converge in the near term.

Question FSP 25-5

Assuming all other qualitative aggregation criteria are met, would a reporting entity be precluded from aggregating a newly-acquired operating segment with its existing operating segment if the historical economic characteristics of the acquired operating segment are not similar?

PwC response

It depends. The differing historical results of the newly-acquired operating segment compared to the reporting entity's existing operating segment may indicate that the economic characteristics of the two operating segments are not similar. However, the seller's historical results may not be relevant to future performance; therefore, the reporting entity should evaluate the newly-acquired operating segment's future prospects. This evaluation would include the newly-acquired operating segment's budget and the actions that management has taken or expects to take shortly after the acquisition. There should also be an evaluation of the achievability of management's proposed changes to the acquired operating segment. If, after evaluating the future prospects, the two operating segments are expected to be economically similar within the near term, the two operating segments may be aggregated.

25.5.2 Qualitative aggregation criteria

Operating segments must also be similar in five qualitative areas (i.e., 280-10-50-11(a) through ASC 280-10-50-11(e)) to be aggregated. The qualitative criteria are equally applicable to reporting entities with components organized based on products or services and those organized by geographic area.

ASC 280 includes the following five qualitative areas:

Excerpt from ASC 280-10-50-11

a. The nature of the products and services

b. The nature of the production processes

c. The type or class of customer for their products and services

d. The methods used to distribute their products or provide their services

e. If applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities.

The nature of products and services

Products and services are generally similar when they have the same customer utility. For example, two operating segments that produce products that can be substituted for each other may be considered similar.

Operating segments that represent different components of a vertically integrated operation require judgment and typically should not be aggregated solely on the basis that they comprise a single end product or service. This is because the specific product or service that each of the vertically integrated operating segments contributes to the end product could differ. The operations that produce each component of the end product should be evaluated separately, particularly if there is a separate market for each of the components.

The nature of production processes

Production processes include the types of machinery and facilities that produce a specific product and the types of labor and raw materials used in the production process. Production processes are often similar if operating segments (which sell similar products) produce the products in a central manufacturing facility. When operating segments source all or most of their products from external suppliers, the production processes of the outsourced items should be evaluated.

For reporting entities that provide services, the similarity of the service delivery process and the training and skills of the employees delivering the services should be evaluated.

The type or class of customer for the products and services

The type or class of customer may be distinguished by several different factors, including the customer's industry, type (e.g., business, governmental, consumer), use of the product and service, purchasing power and location, and the sales and marketing approach directed to the customer. Often, similar classes of customers will react to changes in economic events in a similar fashion. As such, reporting entities should consider whether they have similar strategies for reacting to economic events impacting their operating segments. Differences in approach between their operating segments may suggest that the segments are geared toward different classes of customers.

The methods used to distribute the products or services

For a reporting entity with product sales, different methods of distribution could be used for sales directly to end users versus those to wholesalers or distributors. Methods of distribution to end users should further be evaluated for similarities or differences based on whether the sales are made through the internet, by catalog, or through retail locations.

If applicable, the nature of the regulatory environment

Many industries and services have specific regulations to which they are subject. The regulatory environment criterion applies to those situations in which a unique regulatory environment relating to each operating segment exists. For example, in a situation in which a reporting entity has a banking operating segment and an insurance operating segment, each part of the business operates in a unique regulatory environment. In some cases, different regulatory agencies may still be considered similar if the nature and extent of the regulation are alike.

Example FSP 25-5 illustrates the regulatory environment qualitative criterion.

EXAMPLE FSP 25-5

Understanding the regulatory environment criterion

FSP Corp is a liquor retailer that operates stores in the New York and Florida regions, each of which meets the definition of an operating segment. The state regulations for liquor retailers differ from state to state (e.g., licensing, purchases, days of operation). However, the economic characteristics are similar, as are the nature of the products, production process, type of customer, and distribution methods. For internal purposes, management prepares, and the CODM reviews, separate financial results for each region (New York and Florida). The principal reason for preparing the results separately is to maintain the information necessary to comply with state requirements and for tax-return preparation purposes.

Could FSP Corp aggregate the New York and Florida operating segments?

Analysis

While the Florida and New York regions are each operating segments, FSP Corp would not be precluded from combining these segments solely on the basis that the state regulations differ. In this case, while the specific regulations may vary by state, the nature of regulation (i.e., controlling the sale of liquor products) is the same in New York and Florida.

25.6 Reportable segments—quantitative thresholds

Once a reporting entity identifies its operating segments and determines whether aggregation is appropriate, it should determine which of those operating segments (or aggregated operating segments) are required to be presented as reportable segments based on the quantitative thresholds established by ASC 280-10-50-12 and ASC 280-10-50-14 (referred to in this chapter as the 10% tests and the 75% revenue test). In addition, a reporting entity should identify any operating segment (or aggregation of operating segments) that it will elect to present as a reportable segment even though it is not required to be separately reported based on these quantitative thresholds.

25.6.1 *The 10% tests (reportable segments)*

The 10% tests established by ASC 280-10-50-12 are as follows:

Excerpt from ASC 280-10-50-12

A public entity shall report separately information about an operating segment that meets any of the following quantitative thresholds:

a. Its reported revenue, including both sales to external customers and intersegment sales or transfers, is 10 percent or more of the combined revenue, internal and external, of all operating segments.

b. The absolute amount of its reported profit or loss is 10 percent or more of the greater, in absolute amount, of either:

   1. The combined reported profit of all operating segments that did not report a loss

   2. The combined reported loss of all operating segments that did report a loss.

c. Its assets are 10 percent or more of the combined assets of all operating segments.

Operating segments that do not meet any of the quantitative thresholds may be considered reportable, and separately disclosed, if management believes that information about the segment would be useful to readers of the financial statements.

The 10% tests are based on the reported measures of revenue, profit, and assets that are used by the CODM to assess performance and allocate resources. A reporting entity must separately report a segment if the operating segment (or aggregated operating segment) meets any of the 10% tests.

Revenue

The revenue test is based on the reported measure of segment revenue, which may include or be comprised entirely of intersegment revenues. If an operating segment's reported revenue is 10% or more of the reporting entity's combined revenue, the operating segment is a reportable segment. Combined revenue is the sum of all operating segment revenue, including intersegment revenue, which may be greater than the reporting entity's consolidated revenues.

Profit

The profit test is based on the absolute amount of reported profit or loss for each operating segment. If an operating segment's absolute amount of profit or loss is 10% or more of the greater of either (1) the combined loss of all operating segments that reported a loss, or (2) the combined profit of all operating segments that reported a profit, then the operating segment is a reportable segment. This test will usually yield different results than simply comparing the operating segment's profit or loss to consolidated profit or loss. Figure FSP 25-3 details an example of the profit test.

Figure FSP 25-3

Example of segment profit test

Operating segment	Reported profit or (loss)	(Absolute value of reported profit or loss) / (absolute value of the greater of combined reported profit of all segments that did not report a loss or combined reported loss of all segments that reported a loss)	Is the operating segment a reportable segment?
A	$112	50%	Yes
B	$(15)	7%	No
C	$90	40%	Yes
D	$21	9%	No
Consolidated profit	$208		
Combined profit of all segments that did not report a loss	$223		
Combined loss of all segments that reported a loss	$(15)		

Assets

The asset test is based on segment assets reported to the CODM. If an operating segment's reported assets are 10% or more of the combined assets of all operating segments, the operating segment is a reportable segment. This test may yield different results than simply comparing the operating segment's total assets to consolidated assets. If a CODM does not review asset information, this test may not be applicable.

If different measures are reported by different operating segments, a consistent measure should be utilized to perform the 10% tests. Example FSP 25-6 illustrates how the 10% tests are applied when a reporting entity's operating segments report different measures of segment profitability and assets.

EXAMPLE FSP 25-6

Performing the 10% tests when profitability and asset measures are not the same for all segments

FSP Corp has three operating segments, none of which can be combined under the aggregation criteria. The following is reported to the CODM:

- Segment 1 measures profitability based on operating income, with pension expenses reported on a cash basis. Segment 1 is the only segment with allocated pension expense. Asset information is limited to the presentation of accounts receivable.

- Segment 2 measures profitability based on pretax income, which includes an internal cost-of-capital amount charged by "corporate" only to this segment. Asset information is limited to the presentation of accounts receivable and fixed assets.

- Segment 3 measures profitability based on after-tax income. Asset information is limited to the presentation of accounts receivable.

All segments of the reporting entity are profitable.

How should FSP Corp evaluate the operating segments using the 10% tests?

Analysis

If operating segments are evaluated based on different measures of profit or loss, the criterion of ASC 280-10-50-12(b) should be applied to a consistent measure of profit or loss that is determined for each segment even if that measure is not regularly provided to the CODM for all segments. In the above example, since operating income is available for all segments, it may be the most consistent measure for performing the 10% profit test.

Accounts receivable would be the most consistent asset measure on which to perform the 10% tests, as it is the only asset measure regularly reviewed by the CODM.

Question FSP 25-6

Is a reporting entity required to apply the 10% tests to its operating segments when determining their reportable segments for each interim period?

PwC response

Generally, the composition of reportable segments in an interim period does not change absent an internal reorganization; therefore, a reporting entity need not apply the quantitative thresholds in each interim period. However, if facts and circumstances suggest that the application of the quantitative thresholds would reveal additional reportable segments, those segments may need to be disclosed as new reportable segments. For example, an operating segment that was previously immaterial (i.e., did not meet the 10% tests) but now meets the 10% tests should be disclosed if management expects the segment will continue to be significant. A reporting entity may consider whether aggregation with other operating segments is appropriate. The reporting entity's prior years' interim segment information that is presented for comparative purposes must be recast to reflect the new reportable segment, unless impracticable.

Question FSP 25-7

How should the 10% tests be applied in determining the significance of an operating segment that is comprised solely of an equity method investment?

PwC response

We believe the 10% tests for both segment profitability and assets are measured using the amounts that most closely correspond to the amounts reflected in the reporting entity's consolidated financial

statements. Generally, the 10% revenue test is not applicable since equity method investments are presented as a net amount on both the balance sheet and income statement. The 10% revenue test would require the reporting entity to gross up a proportionate share of the investee's external revenues, which is not consistent with the measurements reflected in the reporting entity's consolidated financial statements.

As indicated in ASC 280-10-50-12, reporting entities are not precluded from voluntarily disclosing operating segments that, although not required to be reported based on the 10% tests, may contribute to a user's understanding of the reporting entity.

25.6.2 Immaterial operating segments

As discussed in ASC 280-10-50-13, immaterial operating segments and immaterial groups of aggregated operating segments (i.e., those that do not meet the 10% tests) may be combined with other immaterial operating segments to produce a reportable segment only if all three of the following are true:

- The aggregation is consistent with the objective and basic principles of ASC 280
- The segments have similar economic characteristics
- The operating segments share a majority of the qualitative aggregation criteria in ASC 280-10-50-11

As discussed in ASC 280-10-50-15, operating segments that are not reportable are required to be combined and disclosed in an "all other" category separate from other reconciling items.

Question FSP 25-8

To aggregate two or more operating segments that do not individually meet the 10% tests, do the immaterial operating segments need to share a majority of all of the items included in ASC 280-10-50-11, including similar economic characteristics?

PwC response

According to ASC 280-10-50-13, immaterial operating segments must always have similar economic characteristics and meet a majority of the remaining five aggregation criteria included in ASC 280-10-50-11 to produce a reportable segment. When immaterial operating segments are not aggregated because they do not meet these criteria, the immaterial operating segments should be combined and disclosed in an "all other" category (assuming the 75% revenue test, as discussed in FSP 25.6.3, has been met). The "all other" category is presented separately from other reconciling items in the reconciliation required for segment disclosures. See FSP 25.6.4 for a discussion of the "all other" category.

25.6.3 The 75% revenue test (reportable segments)

ASC 280-10-50-14 requires that reportable segment external revenues aggregate to at least 75% of a reporting entity's consolidated revenue. If aggregate reported revenue is less than this threshold, additional reportable segments should be identified, even if those additional operating segments do not meet the 10% tests, until at least 75% of consolidated revenue is included in reportable segments. While the 10% revenue test to identify reportable segments is based on the measure of revenue used by

the CODM to assess performance and allocate resources, the 75% revenue test is based on a reporting entity's consolidated revenue.

ASC 280 does not provide guidance as to which otherwise non-reportable operating segments should be selected as reportable segments to achieve the "75% threshold." Accordingly, the reporting entity may choose any segment to report and not necessarily the next largest. For example, a reporting entity with five operating segments that comprise 74%, 9%, 8%, 7%, and 2% of consolidated revenue, respectively, could choose to separately disclose any one or more of the four latter segments in addition to the first segment to achieve the 75% revenue test requirement. However, we believe the reporting entity should consider what is most meaningful to the financial statement users.

ASC 280-10-50-18 also indicates there may be a practical limit to the number of reportable segments.

ASC 280-10-50-18

There may be a practical limit to the number of reportable segments that a public entity separately discloses beyond which segment information may become overly detailed. Although no precise limit has been determined, as the number of segments that are reportable in accordance with paragraphs 280-10-50-12 through 50-17 increases above 10, the public entity should consider whether a practical limit has been reached.

A reporting entity may not limit the number of reportable segments to 10 segments if it has not met the 75% revenue test. In particular, ASC 280-10-50-14 states that "additional operating segments shall be identified as reportable segments until at least 75 percent of total consolidated revenue is included in reportable segments." Accordingly, if a reporting entity has 20 different operating segments, all of which are the same size and none of which meet the aggregation criteria in ASC 280-10-50-11, it would be expected to disclose at least 15 operating segments as reportable (i.e., 15 segments each having 5% of consolidated revenue).

25.6.4 "All other" segments category

The remaining non-reportable operating segments and other business activities that are not identified as operating segments should be combined and disclosed in an "all other" standalone category. Non-reportable segments should not be combined with a reportable segment unless the aggregation criteria in ASC 280-10-50-11 have been met. The "all other" category should be presented alongside the reporting entity's reportable segments. However, the "all other" category should not be identified as a reportable segment itself. Additionally, the "all other" category should not include, or be a part of, the other reconciling items. See FSP 25.7.6 for further discussion of reconciling items that are needed to bridge the totals from reportable segments and the "all other category" to consolidated financial statement totals.

While ASC 280 allows for combined reporting of non-reportable operating segments in an "all other" category, a reporting entity is not precluded from separately presenting an operating segment that is below the quantitative thresholds if the reporting entity believes it is important to financial statement users.

25.7 Segment disclosures (after ASU 2023-07)

Disclosures are required by ASC 280 for each period for which an income statement is presented, except for reconciliations of balance sheet amounts to the consolidated totals (which are only required for each year that a balance sheet is presented). Therefore, segment asset disclosures (excluding the reconciliations to the consolidated balance sheet totals) are required for each period an income statement is presented, even if a balance sheet is not presented for that particular period. Although a suggested format is presented in ASC 280-10-55-48, the guidance allows for flexibility. As discussed in ASC 280-10-50-27, segment disclosures follow the management approach, meaning they show the measures used by the CODM to assess performance and allocate resources. As such, adjustments, eliminations, and allocations that are made in the preparation of information for use by the CODM should be included in the reported segment information.

ASC 280 requires disclosure of certain general information related to segments. This includes information about the factors used to identify reportable segments, the types of products and services from which reportable segments generate revenues, and whether operating segments have been aggregated.

In addition, ASC 280 requires disclosure of the following:

- *Information about profit or loss and assets*
  As discussed in ASC 280-10-50-22 through ASC 280-10-50-24, this includes disclosures of the asset and certain income statement captions, including the performance measures regularly reviewed by the CODM.

- *Information about investments and expenditures*
  As discussed in ASC 280-10-50-25, this includes disclosures about investments in equity method investees and expenditures for additions to long-lived assets.

- *Information about the measurement of segment profit or loss and assets*
  As discussed in ASC 280-10-50-27 through ASC 280-10-50-29, this includes disclosures about transactions between segments, differences between segments, changes from prior year measurements, and asymmetrical segment allocations.

- *Reconciliations*
  As discussed in ASC 280-10-50-30 and ASC 280-10-50-31, this includes disclosures of reconciliations of the specific segment information to the amounts included in the consolidated financial statements.

- *Entity-wide information*
  As discussed in ASC 280-10-50-38, this includes disclosures of financial and other qualitative information categorized based on products and services, geographic areas, and customers, if not already provided elsewhere in the segment disclosures.

Single reportable segment entities

ASC 280-10-50-20 clarifies that all of the disclosures required in the segments guidance, including disclosing a measure of segment profit or loss (or multiple measures, if used to assess performance

and decide how to allocate resources) and reporting significant segment expenses and other segment items, apply to public entities with a single reportable segment.

ASC 280-10-55-15D through 280-10-55-15F indicate that a reported measure of segment profit or loss used to manage the business and assess performance can be a measure that is not directly determined from the face of the consolidated financial statements (e.g., EBITDA or a measure based on different measurement methodologies). Similarly, the operating segment may not represent the entire entity; for example, it may exclude certain functional departments or a corporate headquarters. Accordingly, the segment disclosures required under ASC 280 may differ from the consolidated totals.

However, at the 2023 AICPA & CIMA Conference on Current SEC and PCAOB Developments, the SEC staff commented that it would expect the required measure of segment profit or loss to be consolidated net income for an entity with a single reportable segment managed on a consolidated basis.

If the operating segment is the entire entity, there may be a duplication of information in the segments footnote. In that case, the entity may reference the primary financial statements in the segments footnote rather than duplicating the information.

An example of the required disclosures for a single reportable segment entity is included in ASC 280-10-55-53 to 55, Example 4.

25.7.1 Segment disclosures—general information

ASC 280-10-50-21 provides the requirements for general segment information disclosures.

Excerpt from ASC 280-10-50-21

A public entity shall disclose the following general information:

a. Factors used to identify the public entity's reportable segments, including the basis of organization (for example, whether management has chosen to organize the public entity around differences in products and services, geographic areas, regulatory environments, or a combination of factors and whether operating segments have been aggregated)

b. Types of products and services from which each reportable segment derives its revenues.

c. The title and position of the individual or the name of the group or committee identified as the chief operating decision maker.

If a reporting entity combines non-reportable operating segments into an "all other" category, the types of products and services within the "all other" category should also be disclosed.

25.7.2 Segment disclosures—information about profit or loss and assets

ASC 280-10-50-22 through ASC 280-10-50-24 require disclosure of certain amounts that are either included in the measure of segment profit or loss or are separately regularly provided to the CODM, along with certain specified asset information, as follows. Also see FSP 25.7.5 for a further discussion of disclosure of expenses that are included in the measure of segment profit or loss.

Excerpt from ASC 280-10-50-22

A public entity shall report a measure of profit or loss and total assets for each reportable segment. A public entity also shall disclose all of the following about each reportable segment if the specified amounts are included in the measure of segment profit or loss reviewed by the chief operating decision maker or are otherwise regularly provided to the chief operating decision maker, even if not included in that measure of segment profit or loss:

a. Revenues from external customers

b. Revenues from transactions with other operating segments of the same public entity

c. Interest revenue

d. Interest expense

e. Depreciation, depletion, and amortization expense

f. Unusual items as described in paragraph 220-20-45-1

g. Equity in the net income of investees accounted for by the equity method

h. Income tax expense or benefit

i. Subparagraph superseded by Accounting Standards Update No. 2015-01

j. Significant noncash items other than depreciation, depletion, and amortization expense.

A public entity shall report interest revenue separately from interest expense for each reportable segment unless a majority of the segment's revenues are from interest and the chief operating decision maker relies primarily on net interest revenue to assess the performance of the segment and make decisions about resources to be allocated to the segment. In that situation, a public entity may report that segment's interest revenue net of its interest expense and disclose that it has done so. Nonetheless, a public entity shall separately disclose interest expense if it is a significant segment expense in accordance with paragraph 280-10-50-26A.

ASC 280-10-50-23

Disclosure of interest revenue and interest expense included in reported segment profit or loss is intended to provide information about the financing activities of a segment.

ASC 280-10-50-24

If a segment is primarily a financial operation, interest revenue probably constitutes most of segment revenues and interest expense will constitute most of the difference between reported segment revenues and reported segment profit or loss. If the segment has no financial operations or only immaterial financial operations, no information about interest is required unless interest expense is a significant segment expense to be disclosed in accordance with paragraph ASC 280-10-50-26A.

25.7.2.1 Information about profit or loss

Any of the segment information specified in ASC 280-10-50-22 that is regularly provided to the CODM would need to be disclosed, even if the performance measure used by the CODM does not include the item. For example, if operating income is the measure of segment profitability used by the CODM to assess performance but segment interest expense is regularly provided to the CODM, segment interest expense should be disclosed because interest expense is one of the specific items identified for disclosure in ASC 280-10-50-22. Similarly, if any of the required disclosure items is included in the measure of segment profit or loss, it must be disclosed, even if it is not individually provided regularly to the CODM.

ASC 280 consistently uses the term “regularly provided” to the CODM when discussing the required disclosures. The FASB decided that using that term would likely result in more segment information being disclosed rather than focusing on information that is “regularly reviewed” by the CODM, which is the term used when determining operating segments, as described in FSP 25.4.2. The FASB also noted that the CODM may receive segment information by different means, for example by hardcopy, electronic means, or in regularly scheduled meetings. Given the focus on this phrase in the ASC, public entities should consider advances in their management information systems, which may easily provide more detailed information to the CODM that could potentially result in additional segment disclosures.

As noted in ASC 280, the disclosures are required at the reportable segment level. However, a reporting entity is not precluded from disclosing this information at a more detailed level if the more detailed presentation meets the objectives of ASC 280. For example, a reportable segment with three different but similar external revenue streams can choose to voluntarily provide disclosure of the different revenue streams.

Lastly, a public entity is required to disclose how the CODM uses each reported measure of segment profit or loss to assess performance and allocate resources to the segment, whether it discloses only one measure or multiple measures of segment profit or loss (see FSP 25.7.4.1).

Example FSP 25-7 illustrates when a reporting entity may need to separately report information that is not individually provided regularly to the CODM but included in the performance measure used by the CODM.

EXAMPLE FSP 25-7

Disclosing information not regularly provided to the CODM

FSP Corp internally reports the following discrete financial information to its CODM: revenue, operating income, total assets, volumes, and various industry statistics. Depreciation and amortization expense are components of both (1) cost of sales and (2) selling, general, and administrative expense, none of which are identified and reported separately to the CODM but are included in operating income. Operating income is the measure of segment profitability used by the CODM to assess performance and allocate resources of the segments.

Is FSP Corp required to disclose depreciation and amortization expense for its reportable segments?

Analysis

Yes. ASC 280-10-50-22 requires the disclosure of specified items that are included in the measurement of segment profit or loss that is regularly reviewed by the CODM, notwithstanding the fact that the individual items may not be separately identified for the CODM. Therefore, separate disclosure of depreciation and amortization expense by reportable segment is required since depreciation and amortization are components of operating income — the measure of profit or loss used by the CODM.

In addition, if the measure of segment profit or loss regularly reviewed by the CODM did not include depreciation and amortization, but depreciation and amortization were regularly provided separately to the CODM, then the amounts would still need to be disclosed.

25.7.2.2 Information about assets

Reportable segment-level asset information regularly provided to the CODM is required to be disclosed and included in the 10% asset test calculation consistent with ASC 280-10-55-12 through ASC 280-10-55-15, which indicates that items required by paragraph ASC 280-10-50-22 and ASC 280-10-50-25 that are regularly provided to the CODM must be disclosed. In some instances, a reporting entity's CODM may not receive total assets information for each segment. For example, the CODM may only receive select asset data, such as inventory and accounts receivable. In this instance, total assets need not be disclosed for each reportable segment; rather, the sum of inventory and accounts receivable must be disclosed. This total should be disclosed as "segment assets," and the total segment assets should be reconciled to the reporting entity's total consolidated assets. A reporting entity should also disclose the composition of "segment assets."

Ratios or a combination of financial information may be regularly reviewed by the CODM. For example, a reporting entity's CODM may review net working capital but not its gross components (i.e., current assets and current liabilities). Although working capital has an asset component, the current asset component is not what is used by the CODM to assess performance and allocate resources. Therefore, the asset information is not required to be reported, nor is working capital required to be disclosed. Nonetheless, a reporting entity could elect to voluntarily report net working capital by reportable segment if it meets the objectives and basic principles of ASC 280. If it does so, the total of all reportable segments' working capital should be reconciled to total consolidated working capital.

If no asset information is disclosed for a reportable segment, the fact and reason should be disclosed. Example FSP 25-8 illustrates segment reporting considerations when asset information is not regularly provided to the CODM.

EXAMPLE FSP 25-8

Segment reporting considerations when asset information is not regularly provided to the CODM

FSP Corp internally reports the following financial information to its CODM for each of its operating segments: revenue, operating income, net income, volume, and various industry statistics. Asset and other balance sheet information is not reported to the CODM.

Is FSP Corp required to disclose asset information for its reportable segments since that information is not reported to the CODM?

Analysis

No. Because asset information is not regularly provided to the CODM, the reporting entity would not be required to disclose segment asset information. If asset information is not reported, the fact and the reasons for not providing the information should be disclosed. ASC 280-10-50-27 states that "only those assets that are included in the measure of the segment's assets that is used by the chief operating decision maker shall be reported for that segment."

FSP Corp is required to disclose long-lived assets by geographic area pursuant to the entity-wide disclosure requirements of ASC 280-10-50-41, even if such information is not regularly provided to the CODM. See FSP 25.7.7.2.

25.7.3 Information about investments and expenditures

ASC 280-10-50-25 provides the required segment disclosures for investments in equity method investees and expenditures for additions to long-lived assets.

Excerpt from ASC 280-10-50-25

A public entity shall disclose both of the following about each reportable segment if the specified amounts are included in the determination of segment assets reviewed by the chief operating decision maker or are otherwise regularly provided to the chief operating decision maker, even if not included in the determination of segment assets:

a. The amount of investment in equity method investees

b. Total expenditures for additions to long-lived assets other than any of the following:

   1. Financial instruments

   2. Long-term customer relationships of a financial institution

   3. Mortgage and other servicing rights

   4. Deferred policy acquisition costs

   5. Deferred tax assets.

ASC 280 requires these investment and expenditure disclosures because they improve a financial statement user's ability to estimate the cash-generating potential and cash requirements of reportable segments.

An example disclosure is included in ASC 280-10-55-48, which illustrates a suggested format for certain disclosures required by ASC 280-10-50-22 and ASC 280-10-50-25.

25.7.4 *Segment disclosures–information about measurement of segment profit/loss and assets*

ASC 280-10-50-29 provides the disclosure requirements for information about the measurement of segment profit or loss and assets.

Excerpt from ASC 280-10-50-29

A public entity shall provide an explanation of the measurements of segment profit or loss and segment assets for each reportable segment. A public entity shall disclose all of the following:

a. The basis of accounting for any transactions between reportable segments.

b. The nature of any differences between the measurements of the reportable segments' profits or losses and the public entity's consolidated income before income taxes and discontinued operations (if not apparent from the reconciliations described in paragraphs 280-10-50-30 through 50-31). Those differences could include accounting policies and policies for allocation of centrally incurred costs that are necessary for an understanding of the reported segment information.

c. The nature of any differences between the measurements of the reportable segments' assets and the public entity's consolidated assets (if not apparent from the reconciliations described in paragraphs 280-10-50-30 through 50-31). Those differences could include accounting policies and policies for allocation of jointly used assets that are necessary for an understanding of the reported segment information.

d. The nature of any changes from prior periods in the measurement methods used to determine reported segment profit or loss, including significant changes from prior periods to the measurement methods of expenses, the method for allocating expenses to a segment, or changes in the method for allocating centrally incurred expenses, and the effect, if any, of those changes on the measure of segment profit or loss.

e. The nature and effect of any asymmetrical allocations to segments. For example, a public entity might allocate depreciation expense to a segment without allocating the related depreciable assets to that segment.

f. How the chief operating decision maker uses the reported measure(s) of segment profit or loss in assessing segment performance and deciding how to allocate resources.

When the measure of segment profitability is not consistent across operating segments, the public entity should provide a description of how segment profitability is measured for each reportable segment.

Question FSP 25-9

Because the premise of the management approach is that external segment reporting should correspond to a reporting entity's internal reporting, would segment profit or loss information need to be modified if a reporting entity's internal reporting is not in conformity with US GAAP?

PwC response

No. ASC 280-10-50-27 requires information to be reported on the same basis it is reported internally, even if the segment information is not in conformity with US GAAP or the accounting policies used in the consolidated financial statements. Examples of such situations include segment information reported on a cash basis or on a local GAAP basis for segments comprised of foreign subsidiaries, or when management uses EBITDA as its measure of segment profitability. The reporting entity should disclose the nature of any differences between the reportable segment's measurements of profit or loss and assets and those measurements used in the consolidated financial statements for each reportable segment, as prescribed by ASC 280-10-50-29.

However, at the 2023 AICPA & CIMA Conference on Current SEC and PCAOB Developments, the SEC staff indicated that revenue from external customers is a specified amount that is defined in ASC 606, *Revenue from Contracts with Customers*. As a result, the SEC staff indicated that the disclosure of revenues from external customers for purposes of the segment disclosures under ASC 280 should generally align with the defined amounts in ASC 606, and noted that it has objected to amounts prepared under different measurement methods that may be regularly provided to the CODM being referred to as segment revenue, since those amounts are not consistent with what ASC 606 requires as revenue from external customers.

25.7.4.1 Information about measures of segment profit or loss

ASC 280-10-50-28A provides guidance on reporting measures of segment profit or loss used by the CODM in assessing segment performance.

ASC 280-10-50-28A

If the chief operating decision maker uses only one measure of a segment's profit or loss in assessing segment performance and deciding how to allocate resources, segment profit or loss shall be reported at that measure. If the chief operating decision maker uses more than one measure of a segment's profit or loss in assessing segment performance and deciding how to allocate resources, a public entity may report one or more of those additional measures of segment profit. However, at least one of the reported segment profit or loss measures (or the single reported measure, if only one is disclosed) shall be that which management believes is determined in accordance with the measurement principles most consistent with those used in measuring the corresponding amounts in a public entity's consolidated financial statements.

If a CODM uses only one measure of a segment's profit or loss to assess segment performance and decide how to allocate resources, segment profit or loss is reported at that measure in accordance with ASC 280-10-50-28A.

If a CODM uses multiple measures of a segment's profit or loss to assess segment performance and decide how to allocate resources, ASC 280-10-50-28A allows the public entity to disclose multiple

measures of segment profit or loss for each reportable segment. However, the public entity will have to disclose, at a minimum, the measure of segment profit or loss that is most consistent with the amounts included in its consolidated financial statements. For example, if the CODM uses gross profit and EBITDA as the measures of segment profit or loss, the public entity could only disclose gross profit since it represents the measure most consistent with the amounts included in its consolidated financial statements, or it could disclose gross profit and EBITDA, but it may not only disclose EBITDA.

ASC 280-10-50-28B

If a public entity discloses more than one measure of a segment's profit or loss in the current period, it shall report the additional measure or measures for the prior periods in which the measure or measures were provided to the chief operating decision maker. For example, if a public entity reports an additional measure in the current period for gross profit for a reportable segment, it should disclose gross profit for the reportable segment in the prior comparative periods if gross profit was provided to the chief operating decision maker in those periods. A public entity is not precluded from reporting the additional measure or measures for the prior periods in which the measure or measures were not provided to the chief operating decision maker.

In accordance with ASC 280-10-50-28B, if a public entity discloses an additional measure of segment profit or loss in the current period, it is required to disclose the measure for all periods presented if the measure was previously regularly provided to the CODM. It is also acceptable to disclose the additional measure of segment profit or loss for the prior periods even if the measure was not previously provided regularly to the CODM.

ASC 280-10-50-28C

The disclosure requirements in paragraphs 280-10-50-22 through 50-24, paragraphs 280-10-50-26A through 50-26C, and paragraph 280-10-50-29 apply to each reported measure of a segment's profit or loss. The reconciliation requirement in paragraph 280-10-50-30(a) applies to the total of the reportable segments' revenues to a public entity's consolidated revenues. The reconciliation requirement in paragraph 280-10-50-30(b) applies to the total of the reportable segments' amount for each measure of profit or loss.

If a public entity chooses to disclose multiple measures of segment profit or loss, significant segment expenses, other segment items, and the disclosures in ASC 280-10-50-22 through ASC 280-10-50-24 and ASC 280-10-50-29 are required to be disclosed for each measure. Also, the total of each reported measure of segment profit or loss is required to be reconciled to the consolidated amount of income before taxes and discontinued operations. This reconciliation may be voluminous when a public entity has multiple reportable segments with each reportable segment having multiple measures of segment profit or loss. ASC 280 includes an example of a reconciliation for an entity with multiple measures of segment profit or loss in ASC 280-10-55-48, Example 3, Case B.

At the 2023 AICPA & CIMA Conference on Current SEC and PCAOB Developments, the SEC staff expressed a view that additional measures of segment profit or loss would be considered non-GAAP financial measures if the measures are not calculated in accordance with GAAP because ASC 280 does not require or expressly permit the disclosure of additional prescribed measures. Accordingly, these measures would not qualify for the exception in Regulation S-K Item 10(e) and therefore be subject to specific presentation, disclosure, and reconciliation requirements; prohibitions on certain

adjustments; and a prohibition on the inclusion of a non-GAAP financial measure in the financial statements, including the footnotes. The SEC staff stated that registrants planning to early adopt the new segments guidance and present an additional measure of segment profit or loss that is not calculated in accordance with GAAP should contact the staff for further discussion.

As mentioned in FSP 25.7.2, a public entity is required to disclose how the CODM uses each reported measure of segment profit or loss to assess performance and allocate resources to the segment, whether it discloses only one measure or multiple measures of segment profit or loss.

25.7.4.2 Information about measures of segment assets

ASC 280-10-50-28 provides guidance on reporting measures of segment assets used by the CODM in assessing segment performance.

ASC 280-10-50-28

If the chief operating decision maker uses only one measure of a segment's assets in assessing segment performance and deciding how to allocate resources, segment assets shall be reported at that measure. If the chief operating decision maker uses more than one measure of a segment's assets, the reported measure shall be that which management believes is determined in accordance with the measurement principles most consistent with those used in measuring the corresponding amounts in the public entity's consolidated financial statements.

If a CODM uses only one measure of a segment's assets to assess segment performance and decide how to allocate resources, segment assets are reported at that measure in accordance with ASC 280-10-50-28.

If a CODM uses more than one measure of a segment's assets to assess segment performance and decide how to allocate resources, ASC 280-10-50-28 requires the public entity to disclose the reported measure that which management believes is determined in accordance with the measurement principles most consistent with those used in measuring the corresponding amounts in the public entity's consolidated financial statements.

25.7.5 Segment expenses

Along with the explicitly required categories for amounts that are either included in the measure of segment profit or loss or are separately regularly provided to the CODM, as described in ASC 280-10-50-22 through ASC 280-10-50-24 (see FSP 25.7.2), ASC 280 also requires a public entity to disclose expenses for each reportable segment that are included in the measure of segment profit or loss.

25.7.5.1 Significant segment expenses

A public entity is required to disclose its significant segment expense categories and amounts for each reportable segment.

ASC 280-10-50-26A

A public entity shall disclose for each reportable segment the significant expense categories and amounts that are regularly provided to the chief operating decision maker and included in reported segment profit or loss. When determining the segment expense categories and amounts that shall be disclosed, a public entity shall first identify the expenses from the segment level information that is regularly provided to the chief operating decision maker and then disclose those segment expense categories and amounts that are significant. A public entity shall consider relevant qualitative and quantitative factors when determining whether segment expense categories and amounts are significant. When applying this guidance, a public entity shall evaluate for disclosure a segment expense that is regularly provided to the chief operating decision maker as well as a segment expense that is easily computable from information that is regularly provided to the chief operating decision maker. Paragraphs 280-10-55-15A through 55-15B provide additional guidance on determining whether segment expense amounts can be easily computed for purposes of applying the guidance in this paragraph.

A significant segment expense is an expense that is:

- significant to the segment,
- regularly provided to or easily computed from information regularly provided to the chief operating decision maker (CODM), and
- included in the reported measure of segment profit or loss.

A significant segment expense is any significant expense incurred by the segment, including direct expenses, shared expenses, allocated corporate overhead, or interest expense that is regularly reported to the CODM and is included in the measure of segment profit or loss. If interest expense is a significant segment expense, it is required to be disclosed separately, even if the public entity otherwise discloses net interest income. This scenario may be more likely to exist for financial services entities.

If a public entity does not disclose any significant segment expenses for a reportable segment, it is required to disclose narratively the nature of the expenses used by the CODM to manage the segment's operations in accordance with ASC 280-10-50-26C.

ASC 280-10-50-26C

An amount and qualitative description of the composition of other segment items shall be disclosed for each reportable segment even when a public entity does not separately report significant segment expense categories and amounts in accordance with paragraph 280-10-50-26A for one or more of its reportable segments. Additionally, if a public entity does not disclose significant expense categories and amounts for one or more of its reportable segments, it shall explain the nature of the expense information the chief operating decision maker uses to manage operations (see paragraph 280-10-55-15G).

A significant segment expense category may be disclosed for one reportable segment but not for others. Similarly, reportable segments may have different significant segment expense categories due to the nature of their operations.

If a segment expense is significant for one of the periods presented, we believe it should be disclosed for all periods presented even if it was not significant for all periods presented.

The total amount of significant segment expenses is not required to be reconciled to the reported amounts in the consolidated financial statements.

Significant

ASC 280 does not define the term "significant," nor does it prescribe a specific quantitative threshold to assess significance. Rather, it requires significance to be assessed using both quantitative and qualitative factors depending on the facts and circumstances.

In addition, the significance of a segment item should generally be determined by reference to the segment's results, not solely by reference to the amounts included in the entity's consolidated financial statements. In the Basis for Conclusions of ASU 2023-07, the FASB stated that an item of segment information may be considered significant if its omission would change an investor's understanding of the segment results to a degree that it would cause the investor to change its investment decisions. Additionally, the FASB observed that "if segment expense categories are regularly provided to the CODM on a disaggregated basis and included in the measure of segment profit or loss, investors also would likely find that information useful," which creates an expectation that amounts regularly provided to the CODM would be significant.

To assess whether that expectation could be overcome, we believe a public entity should consider all its facts and circumstances, including:

- the qualitative and quantitative importance of the segment to the overall operations of the public entity,
- the size and importance of the expense item to the segment's results,
- the variability (in relation to revenue) and volatility (period to period) of the expense item,
- the size of the segment compared to other segments,
- whether a segment is expected to grow significantly, or whether other relevant expected economic changes are expected for the segment,
- whether segments are sharing or incurring the same expense,
- the type of industry or business in which the segment is engaged and the associated key expense categories associated with it, and
- the focus of stakeholders (e.g., during earnings calls).

A determination that an expense that is regularly provided to the CODM is not significant should be made on a holistic basis, as no one factor is determinative in assessing what would impact an investor's decision making.

Regularly provided

ASC 280 consistently uses the term "regularly provided" to the CODM when discussing the required disclosures. The FASB decided that using that term would likely result in more segment information being disclosed rather than focusing on information that is "regularly reviewed" by the CODM, which is the term used when determining operating segments as described in FSP 25.4.2. The FASB also noted that the CODM may receive segment information by different means, for example by hardcopy, electronic means, or in regularly scheduled meetings. Given the focus on this phrase in ASC 280, public entities should review their reporting processes to confirm their understanding of what segment information is regularly provided to the CODM. Also, public entities should consider advances in their management information systems, which may easily provide more detailed information to the CODM that would potentially result in additional segment disclosures.

Easily computed

The term "easily computed" is not defined in ASC 280. However, it provides examples of when a segment expense would be considered easily computed. For example, if a segment revenue amount and a segment gross margin percentage are regularly provided to the CODM, segment cost of sales can be easily computed. If segment cost of sales is significant and included in the reported measure of segment profit or loss, it would be disclosed as a significant segment expense.

Another example, which is described in the Basis for Conclusions of ASU 2023-07, relates to interest revenue and net interest margin being regularly provided to the CODM for a financial segment, with interest expense considered easily computable from this information.

The FASB noted in the Basis for Conclusions of ASU 2023-07 that there could be other ways in which information can be considered easily computed.

25.7.5.2 Other segment items

A public entity is required to disclose, for each reportable segment, an aggregate amount and description of other segment items included in each reported measure of segment profit or loss beyond the significant segment expenses (as discussed in FSP 25.7.5.1), calculated as follows:

Other segment items	=	Reported segment revenues minus Significant segment expenses (disclosed) minus Reported segment profit or loss

In other words, the amount of other segment items is the difference necessary to calculate the reported segment profit or loss measure.

ASC 280-10-50-26B

A public entity shall disclose for each reportable segment an amount for other segment items. The amount for other segment items is the difference between reported segment revenues less the segment expenses disclosed in accordance with paragraph 280-10-50-26A and reported segment profit or loss. A qualitative description of the composition of other segment items also shall be disclosed. Other segment items may include:

a. The total of a reportable segment's expenses that are included in the reported measure(s) of a segment's profit or loss but are not regularly provided to the chief operating decision maker.

b. The total of a reportable segment's expenses that are included in the reported measure(s) of a segment's profit or loss but are not disclosed in accordance with paragraph 280-10-50-26A. A public entity is not precluded from separately disclosing an expense that is not significant for one reportable segment but is significant for another of its segments. However, if a segment expense that is not significant is not separately disclosed, it shall be included as part of other segment items.

c. The total of a reportable segment's gains, losses, or other amounts that also are included in each reported measure of a segment's profit or loss.

d. The items and amounts required by paragraph 280-10-50-22 when those specified items and amounts are included within the reported measure of segment profit or loss but are not disclosed in accordance with paragraph 280-10-50-26A. For example, a public entity may report net income as the measure of a segment's profit or loss. In that case, if income tax expense by segment is not regularly provided to the chief operating decision maker, it may be included within other segment items. However, income tax expense is still required to be disclosed in accordance with paragraph 280-10-50-22.

ASC 280-10-50-26C

An amount and qualitative description of the composition of other segment items shall be disclosed for each reportable segment even when a public entity does not separately report significant segment expense categories and amounts in accordance with paragraph 280-10-50-26A for one or more of its reportable segments. Additionally, if a public entity does not disclose significant expense categories and amounts for one or more of its reportable segments, it shall explain the nature of the expense information the chief operating decision maker uses to manage operations (see paragraph 280-10-55-15G).

A public entity is required to qualitatively describe the composition of its other segment items included in each reported measure of segment profit or loss for each reportable segment, even if the entity does not disclose any significant segment expenses. Also, if a public entity does not disclose any significant segment expenses for a reportable segment, it is required to disclose the nature of the expenses used by the CODM to manage the segment operations.

Similar to significant segment expenses, the total amount of other segment items is not required to be reconciled to the reported amounts in the consolidated financial statements.

An example of a disclosure of significant segment expenses and other segment items is included in ASC 280-10-55-48, Example 3, Case B.

25.7.6 *Segment disclosures—reconciliations*

Certain information included in the segment disclosures must be reconciled to the reporting entity's consolidated financial measures. ASC 280-10-50-30 and ASC 280-10-50-31 provide the requirements for these reconciliations.

Excerpt from ASC 280-10-50-30 and ASC 280-10-50-31

A public entity shall provide reconciliations of all of the following:

a. The total of the reportable segments' revenues to the public entity's consolidated revenues.

b. The total of the reportable segments' amount for each measure of profit or loss to the public entity's consolidated income before income taxes and discontinued operations. However, if a public entity allocates items such as income taxes to segments, the public entity may choose to reconcile the total of the segments' measures of profit or loss to consolidated income after those items.

c. The total of the reportable segments' assets to the public entity's consolidated assets.

d. The total of the reportable segments' amounts for every other significant item of information disclosed to the corresponding consolidated amount (except for the segment disclosures required by paragraphs 280-10-50-26A through 50-26B). For example, a public entity may choose to disclose liabilities for its reportable segments, in which case the public entity would reconcile the total of reportable segments' liabilities for each segment to the public entity's consolidated liabilities if the segment liabilities are significant.

All significant reconciling items shall be separately identified and described. For example, the amount of each significant adjustment to reconcile accounting methods used in determining segment profit or loss to the public entity's consolidated amounts shall be separately identified and described.

Reconciliations related to segment revenue and profit measures are required for each year that an income statement is presented, and reconciliations of balance sheet amounts are required for each year that a balance sheet is presented. An example is included in ASC 280-10-55-49, which illustrates the disclosures required by ASC 280-10-50-30(a) through ASC 280-10-50-30(c).

Question FSP 25-10

If a reporting entity's measure of segment profitability is net income, should the segment's total net income be reconciled to consolidated net income or to consolidated pretax income?

PwC response

ASC 280-10-50-30(b) allows a reporting entity whose measure of segment profitability is below the pretax income line (e.g., net income) to reconcile that measure, in aggregate for its reportable segments, to the corresponding consolidated total or the consolidated pretax total. In this case, we believe that the more meaningful presentation would be a reconciliation of the total of segment net income to the total consolidated net income.

ASC 280-10-50-30(b) requires that measures of segment profitability that are above the pretax line (e.g., operating profit) be reconciled to consolidated pretax income.

Question FSP 25-11

Can a reporting entity reconcile a non-GAAP measure of segment profitability (e.g., EBITDA) to the reporting entity's consolidated EBITDA if that measure is further reconciled to pretax income?

PwC response

No. The following presentation of consolidated EBITDA would not be appropriate.

Reportable segment 1 EBITDA	$200
Reportable segment 2 EBITDA	150
Reportable segment 3 EBITDA	100
Subtotal reportable segments	450
Unallocated corporate overhead	(50)
Unallocated pension expense	(20)
Consolidated EBITDA	$380
Depreciation and amortization	(30)
Interest	(50)
Consolidated pretax income	$300

Under SEC rules, it is not appropriate to present the "Consolidated EBITDA" amount (i.e., $380), while it would be acceptable to present the "Subtotal reportable segments" amount (i.e., $450). Regulation S-K Item 10(e)(1)(ii)(C) precludes non-GAAP measures in the financial statements or financial statement footnotes. This Regulation S-K item indicates that non-GAAP measures exclude financial measures required to be disclosed by US GAAP. As such, the prohibition is not applicable to the measures of reportable segment EBITDA, as these amounts are required to be disclosed under ASC 280. However, this regulation and the SEC's related interpretations would preclude use of consolidated EBITDA because such disclosure is not required by US GAAP. Rather, ASC 280-10-50-30 generally requires reconciliation to consolidated pretax income. In addition, if the reporting entity only has one reportable segment, similar prohibitions would apply. For additional guidance, refer to questions 104.01 through 104.06 of the SEC staff's Compliance and Disclosure Interpretations on the use of non-GAAP financial measures.

A public entity is required to reconcile the total of each reported measure of segment profit or loss to the consolidated amount of income before taxes and discontinued operations. See Example 3, Case B in ASC 280-10-55-48 for an example of a reconciliation for an entity with multiple measures of segment profit or loss.

The total amount of significant segment expenses is not required to be reconciled to the reported amounts in the consolidated financial statements.

Similar to significant segment expenses, the total amount of other segment items is not required to be reconciled to the reported amounts in the consolidated financial statements.

25.7.7 Entity-wide segment disclosures

ASC 280-10-50-38 through ASC 280-10-50-42 require certain entity-wide disclosures, which include information about a reporting entity's products and services, geographic areas, and major customers.

In some cases, these requirements may already be met through other disclosures in ASC 280, which requires these entity-wide disclosures even if the information is not regularly reviewed by the CODM, and even if the reporting entity has only one reportable segment.

The entity-wide disclosures are only required in annual financial statements.

Question FSP 25-12

Is there a threshold at which entity-wide disclosures are considered immaterial?

PwC response

Unlike reportable segment disclosures, there is no quantitative threshold for determining when entity-wide disclosures are required. Assessing what is material is a matter of judgment. Both qualitative and quantitative factors should be considered. When assessing entity-wide disclosures from a quantitative perspective, we believe it would be reasonable to apply a threshold similar to the 10% tests provided in ASC 280-10-50-12. For example, a reporting entity would disclose revenues from external customers attributed to an individual foreign country if revenues from that country are greater than 10% of consolidated revenues. However, qualitative factors may indicate that information is material even if it does not exceed 10% of the consolidated total.

25.7.7.1 Entity-wide segment information about products and services

ASC 280-10-50-40 requires entity-wide disclosures related to products and services.

ASC 280-10-50-40

A public entity shall report the revenues from external customers for each product and service or each group of similar products and services unless it is impracticable to do so. The amounts of revenues reported shall be based on the financial information used to produce the public entity's general-purpose financial statements. If providing the information is impracticable, that fact shall be disclosed.

Some reporting entities have segment revenues that are derived from a broad range of different products and services. These reporting entities are still required to provide revenue information for the entity-wide disclosures related to its products and services, including when there is only one reportable segment.

Missing or inadequate disclosures of revenues from external customers for each product and service is a common issue raised in SEC staff questions. The SEC staff may also question entity-wide disclosures that are not consistent with how products are described or grouped in other sections of the reporting entity's filings (e.g., Form 10-K, Item 1, Business, ASC 606 disaggregated revenue disclosure) or other external communications.

When determining the level at which products and services should be reported, it may be helpful to consider whether a majority of the characteristics described in ASC 280-10-50-11 for determining whether segments can be aggregated are met. For example, if all products have similar production processes, classes of customers, and economic characteristics as evidenced by similar rates of profitability, similar degrees of risk, and similar opportunities for growth, a reporting entity may conclude that all of its products are similar and that no additional disclosures by product type are necessary.

Question FSP 25-13

If a reporting entity has two operating segments based on products and services, and the two operating segments meet all of the criteria required for aggregation into a single reportable segment, must the entity-wide disclosures related to products and services be presented under ASC 280-10-50-40?

PwC response

It depends. Since the two operating segments meet the aggregation criteria, the nature of the products and services in each operating segment could be similar, and therefore the entity-wide disclosures related to products and services need not be provided. However, if the two segments each sold a range of products and services, the reporting entity would be required to present the entity-wide products and services-related disclosures.

Question FSP 25-14

If a reporting entity has one operating segment, and therefore one reportable segment, must the information required for entity-wide disclosures related to products and services be presented under ASC 280-10-50-40?

PwC response

It depends. A reporting entity may have only one operating segment (and thus only one reportable segment) that sells a range of products and services. In this case, the reporting entity would be required to present the entity-wide products and services-related disclosures. However, the reporting entity may conclude the entity-wide products and services-related disclosures are not necessary if it can demonstrate that its products and services are essentially similar using the aggregation criteria in ASC 280-10-50-11.

25.7.7.2 Entity-wide segment information about geographic areas

One of the purposes of entity-wide disclosures is to provide information about the geographic areas in which the reporting entity generates its revenues and holds its long-lived assets. ASC 280-10-50-41 provides the entity-wide disclosure requirements for geographic areas.

Excerpt from ASC 280-10-50-41

A public entity shall report the following geographic information unless it is impracticable to do so:

a. Revenues from external customers attributed to the public entity's country of domicile and attributed to all foreign countries in total from which the public entity derives revenues. If revenues from external customers attributed to an individual foreign country are material, those revenues shall be disclosed separately. A public entity shall disclose the basis for attributing revenues from external customers to individual countries.

b. Long-lived assets other than financial instruments, long-term customer relationships of a financial institution, mortgage and other servicing rights, deferred policy acquisition costs, and deferred tax assets located in the public entity's country of domicile and located in all foreign countries in total in which the public entity holds assets. If assets in an individual foreign country are material, those assets shall be disclosed separately.

The amounts reported shall be based on the financial information that is used to produce the general-purpose financial statements. If providing the geographic information is impracticable, that fact shall be disclosed. A public entity may wish to provide, in addition to the information required by the preceding paragraph, subtotals of geographic information about groups of countries.

An example is included in ASC 280-10-55-51 that illustrates the disclosures required by ASC 280-10-50-41. In addition to disclosure of material revenues and long-lived assets by country, a reporting entity may wish to provide subtotals of revenues and long-lived assets based on groups of countries in a geographic region, such as Europe, Asia, or North America. The guidance in ASC 280-10-55-22 allows for flexibility in determining how revenue can be attributed to geographic areas. Reporting entities may choose to attribute revenue on the basis of (1) the location of the customer, (2) the location to which the product is shipped (which may differ from the location where the customer resides), or (3) the location where the sale originated. The attribution method should be reasonable and consistently applied, and a reporting entity must disclose the basis it has selected for attributing revenue to geographic areas.

One of the reasons for requiring disclosure of long-lived assets (rather than total assets) in geographic areas is that long-lived assets are potentially at greater risk than current assets because they are difficult to move and relatively illiquid. ASC 280-10-55-23 indicates that a reporting entity can exercise judgment in defining long-lived assets but also indicates that the phrase "long-lived assets" implies tangible assets that cannot be readily removed, which would exclude intangible assets. Accordingly, goodwill and other intangible assets should not be included in the entity-wide disclosure of long-lived assets.

Example FSP 25-9 illustrates how to determine long-lived asset disclosures by geographic area.

EXAMPLE FSP 25-9

Reporting long-lived assets by geographic area

FSP Corp, a US-domiciled reporting entity with operations in 25 countries, has determined that it has two reportable segments (US and International) and that its long-lived assets located in two individual foreign countries (England and China) are material.

For which geographic areas should FSP Corp disclose tangible long-lived assets?

Analysis

FSP Corp should separately disclose tangible long-lived assets for the US, England, China, and all other foreign countries combined. Although the long-lived assets in the US may not be material, the guidance requires disclosure related to the reporting entity's country of domicile.

Question FSP 25-15

If a reporting entity has reportable segments represented by the geographic areas US, Canada, and Asia, would the reporting entity be required to disclose revenue and long-lived asset information for each country in Asia, if material?

PwC response

Yes. Revenue and long-lived assets must be disclosed for each country in which such amounts are material. The individual country disclosures are required even if the Asian operations are not managed on an individual country basis (i.e., even if the CODM does not review or assess performance on an individual country basis).

If it is impracticable to provide the individual country information, that fact should be disclosed. These circumstances, however, are expected to be rare.

Question FSP 25-16

Should right of use (ROU) assets be included in the disclosure of long-lived assets by geography required by ASC 280-10-50-41?

PwC response

In many circumstances, an ROU asset would be included within the long-lived assets disclosure in ASC 280. An ROU asset is within the scope of ASC 360 and is similar to a tangible asset. ASC 280-10-55-23 does not define what is required to be included in long-lived assets and allows an entity to apply judgment. The reasons for requiring disclosure of long-lived assets (rather than total assets) in geographic areas is that long-lived assets are potentially at greater risk than current assets because they are difficult to move and relatively illiquid. For this reason, we believe ROU assets (e.g., buildings) should be included in the disclosure.

25.7.7.3 Entity-wide segment information about major customers

ASC 280-10-50-42 provides the entity-wide disclosure requirements for major customers.

Excerpt from ASC 280-10-50-42

A public entity shall provide information about the extent of its reliance on its major customers. If revenues from transactions with a single external customer amount to 10 percent or more of a public entity's revenues, the public entity shall disclose that fact, the total amount of revenues from each such customer, and the identity of the segment or segments reporting the revenues. The public entity need not disclose the identity of a major customer or the amount of revenues that each segment reports

from that customer. For purposes of this Subtopic, a group of entities known to a reporting public entity to be under common control shall be considered as a single customer, and the federal government, a state government, a local government (for example, a county or municipality), or a foreign government each shall be considered as a single customer.

One of the objectives of disclosing information about major customers is to provide a measure of the concentration of credit risk to the reporting entity. Neither the identity of a major customer or the amount of revenues that each segment reports from that customer is required to be disclosed.

ASC 280-10-55-52 includes an example that illustrates the disclosures required by ASC 280-10-50-42.

25.7.8 Interim period segment information

ASC 280-10-50-32 requires that nearly all of the annual numerical segment disclosures also be made on an interim basis. These include reported measures of segment profit or loss, total assets, revenues, interest revenue and expense, depreciation, depletion and amortization, unusual items, equity in income of investees, income tax expense or benefit, significant non-cash items other than depreciation depletion and amortization, equity method investments, and total additions to long-lived assets. Significant segment expenses and other segment items disclosures are also required for interim periods.

The reconciliation of the total of reportable segments' measures of profit or loss to consolidated income before income taxes and discontinued operations is also required for interim periods. However, the reconciliations of the total of reportable segments' revenues and assets to their corresponding consolidated totals are not required for interim periods.

ASC 280-10-50-32 and ASC 280-10-50-33 provide the disclosure requirements for condensed financial statements of interim periods including:

Excerpt from ASC 280-10-50-32

e. A description of differences from the last annual report in the basis of segmentation or in the basis of measurement of segment profit or loss

ee. The segment information required by paragraphs 280-10-50-22 through 50-26C and 280-10-50-28A through 50-28B

f. A reconciliation of the total of the reportable segments' amount for each measure of profit or loss, including the total of the reportable segments' amount for any additional measure of profit or loss disclosed in accordance with paragraph 280-10-50-28A, to the public entity's consolidated income before income taxes and discontinued operations. However, if a public entity allocates items such as income taxes to segments, the public entity may choose to reconcile the total of the segments' measures of profit or loss to consolidated income after those items. Significant reconciling items shall be separately identified and described in that reconciliation.

ASC 280-10-50-33

Interim disclosures are required for the current quarter and year-to-date amounts. The information in paragraph 280-10-50-32 with respect to the current quarter and the current year-to-date or the last 12 months to date should be furnished together with comparable data for the preceding year.

Entity-wide disclosures, including disclosures about major customers, are not required in interim periods. However, if a reporting entity were to transact a significant amount of business with a new (or previously insignificant) customer during an interim period that was expected to continue in future periods, management should consider providing the disclosures required by ASC 280-10-50-42.

During an interim period, a reporting entity may change its organizational structure, or a previously immaterial segment may become material. See FSP 25.7.9.2 for guidance.

25.7.9 Recasting of information for changes in segments

The information regularly reviewed by the CODM may change for a number of reasons, including when a reporting entity changes the structure of its internal organization. This could result in changes to operating segments and changes to the determination of reportable segments. If a reporting entity's reportable segments change in the current period, corresponding information for earlier periods should be recast and disclosed in the current period financial statements. This would include information for interim periods so that all segment disclosures are comparable. This requirement applies to all disclosures unless it is impracticable to do so. A change in reportable segments should be accompanied by disclosure of the reasons for the change and, when appropriate, that the change has been reflected retrospectively.

ASC 280 does not specify how to analyze organizational changes to determine when a change in operating or reportable segments is necessary. However, the determination of operating segments is based on the information regularly reviewed by the CODM. As a result, if there are changes in how the CODM allocates resources and assesses performance, or changes to how the information is presented to the CODM, a reporting entity will likely need to reassess its operating and reportable segments.

When determining whether there has been a change that could impact the determination of its operating segments, the reporting entity may consider whether there has been a change in the following:

- The CODM
- The information regularly reviewed by the CODM
- The organizational structure
- The individuals who regularly meet with the CODM
- The budgeting process or level at which budgets are reviewed by the CODM
- The information regularly reported to the board of directors
- The information the reporting entity communicates to external parties such as investors, creditors, and customers

There are several situations that require recasting of segment information unless it is impracticable to do so, including:

- *When there is a change in the composition of reportable segments*

  We believe this is the case whether there is an increase or decrease in reportable segments.

- *When there is a change in the identification of significant segment expenses*

  For example, if research and development (R&D) expense is determined to be a significant expense in the current period, but was not in the prior period, the segment information would be recast to reflect R&D expense as a significant expense in the prior period.

Recasting of prior period information is not required for a change in the measurement of a reported segment profit or loss measure; however, ASC 280 encourages public entities to show all segment information on a comparative basis to the extent practicable. If the information is not recast for such a change, ASC 280-10-50-36 requires additional disclosure of the nature of any changes from prior periods in the measurement methods, including significant changes from prior periods to the measurement methods of expenses, the method for allocating expenses to a segment, or changes in the method for allocating centrally incurred expenses, used to determine reported segment profit or loss, and the effect, if any, of those changes on the measure of segment profit or loss.

Example FSP 25-10 illustrates a change in segment performance measures.

EXAMPLE FSP 25-10

Change in segment performance measures

FSP Corp has five operating segments, which are also its reportable segments. Historically, the internal reporting package regularly reviewed by the CODM included certain unallocated items, such as interest income/expense and pension service costs. These unallocated items were disclosed in FSP Corp's footnotes as part of its reconciliation of total segment profits/losses to consolidated net income. The CODM recently requested that pension service costs be allocated to the five operating segments based on employee head count as the CODM believes pension service cost should be considered in assessing segment performance and in making resource allocation decisions. The internal reporting package for the period reflected this change.

How should FSP Corp reflect this in its segment disclosures?

Analysis

The change in allocation represents a change in the measure of segment performance. FSP Corp should reflect this new segment measure in the period the change occurred. Because this is not a change in the identified reportable segments, FSP Corp is not required to recast prior periods to reflect this change, but it would be preferable to do so. In either case, FSP Corp should disclose the nature of the change in the segment performance measure and the effect the change has on the measure of segment profit or loss, as required by ASC 280-10-50-29(d).

While the entity-wide disclosure provisions of ASC 280 do not discuss the recasting of entity-wide disclosures, we believe that the entity-wide information from period to period should be comparable. Accordingly, we believe that the guidance contained in ASC 280-10-50-16 and ASC 280-10-50-17, as well as the recasting provisions of ASC 280-10-50-34 and ASC 280-10-50-35, should be applied to entity-wide disclosures.

ASC 280-10-50-17 also requires recasting of prior period segment information (unless impracticable) when a previously insignificant operating segment becomes significant (i.e., the operating segment meets one of the 10% tests).

Example FSP 25-11 illustrates an analysis of segments when their relative significance changes year over year.

EXAMPLE FSP 25-11

Change in segment significance

FSP Corp has eight operating segments, none of which qualify for aggregation. Five of the segments were disclosed as reportable segments in 20X1, based on the 10% tests. The aggregate external revenues of these reportable segments exceeded 75% of FSP Corp's consolidated revenues. The remaining three operating segments were combined in an "all other" category. In 20X2, one of the three operating segments that was included in the "all other" category in 20X1 became quantitatively material (i.e., it exceeded the threshold for one of the 10% tests). Also, in 20X2, one of the five 20X1 reportable segments was no longer quantitatively material.

How should FSP Corp reflect these changes in its segment disclosures?

Analysis

The operating segment that is now material should be presented as a reportable segment. Pursuant to ASC 280-10-50-17, when FSP Corp presents prior period segment data in the 20X2 financial statements, segment data for all prior periods must be recast to reflect the new reportable segment as a separate reportable segment, unless it would be impracticable to do so.

For the operating segment that no longer meets the quantitative thresholds (assuming the operating segment is not considered to be of continuing significance), disclosure of its individual results need not be made in 20X2. In this case, prior period segment disclosures could also be recast to conform to the current period presentation (provided the threshold for the 75% revenue test is met for all periods). In accordance with ASC 280-10-50-16, if management views the segment to be of continuing significance, that segment's disclosures should continue to be made.

Example FSP 25-12 illustrates factors to consider in assessing whether to recast previous periods' segment information when a reporting entity changes its internal financial reporting without changing its organizational structure.

EXAMPLE FSP 25-12

Consideration of changes in internal financial reporting without changes in organizational structure

FSP Corp has four operating segments. It has decided to move one of its product lines from one operating segment (Segment X) to another (Segment Z) for internal reporting purposes. FSP Corp did not change its management structure and has determined that it still has the same four operating segments. The only change to the CODM package as a result of the internal financial reporting change is the inclusion of the product line's financial information within Segment Z reporting and its removal from Segment X reporting as of the date of the change.

How should this change in internal financial reporting be considered in FSP Corp's segment assessment?

Analysis

FSP Corp should consider recasting its previously disclosed segment information if the changes to the segment assets and operating results as a result of reclassifying the assets, liabilities, and results of operations materially affect the trend in asset balances and/or the reported results. If, however, the segment information does not materially change the segments' financial information, generally a reporting entity is not expected to recast the previously-reported segment information.

In determining whether the change to the Segment X and Z financial information is material, FSP Corp might consider, among other things, whether the CODM package (or other information regularly reviewed by the CODM) has been adjusted retrospectively or whether the product line is considered a separate asset group (as defined in ASC 360). If the product line is a separate asset group, this may indicate that the composition of the segments has changed significantly and prior period segment information should be recast.

25.7.9.1 When to reflect changes in segment reporting

Changes in reportable segments as a result of changes in organization, the information regularly reviewed by the CODM, the significance of an operating segment (from immaterial to material), or the aggregation of operating segments should only be reflected when the financial statements include the period in which the change occurred. Changes in reportable segments arising after a reporting entity's period-end but before the issuance of the reporting entity's financial statements should be treated as an unrecognized (i.e., "Type II") subsequent event (see FSP 28.6). However, the reporting entity should disclose that a change in reportable segments will occur in subsequent periods and the reasons for the change.

Example FSP 25-13 and Example FSP 25-14 provide illustrations of the timing of disclosure of segment reporting changes.

EXAMPLE FSP 25-13

Change in segment structure subsequent to year end

In the fourth quarter of 20X1, FSP Corp's management determined that it will change the way it manages and operates the reporting entity and is in the process of modifying FSP Corp's information system to produce financial information to support the new structure. The changes will require FSP Corp to recast its segment reporting. It is anticipated that the modification to the system will be completed in the first quarter of 20X2, at which point management will reorganize its operations and reporting structure and begin to manage its operations under its new segment structure.

How should this planned change affect FSP Corp's 20X1 segment disclosures?

Analysis

FSP Corp should disclose its 20X1 reportable segment information under the reporting structure in place during 20X1. It should not recast its segment disclosure using the new reporting structure until

the first quarter of 20X2, the period in which management changes the way it manages and operates the business.

EXAMPLE FSP 25-14

Changing operating segments for financial reporting purposes prior to changing the CODM package

FSP Corp manufactures watches in three product lines: low-, medium-, and high-end. Each of these product lines has two distinct watch types (sport and formal). FSP Corp identified each product line as an operating segment. Each of the product lines has a vice president who reports to the CEO, who is the CODM. Monthly meetings are held between the vice presidents of the three product lines and the CODM to discuss the results for each product line. The CODM package and information regularly reviewed at the monthly meetings consists of revenue and expenses by product line.

During 20X1, the existing CEO retired and the new CEO became the new CODM. The new CODM changed certain aspects of FSP Corp's internal reporting roles and marketing strategy and began meeting with the product managers to assess performance of each of the watch types (sport and formal) within each product line in order to gain better insight into how the business is operating. In addition, the CODM implemented a new marketing campaign which focused on the sport and formal type watches versus the previous marketing campaign, which focused only on the three distinct product lines. The new CODM began allocating resources at the watch-type level (sport and formal) rather than at the product-line level (low-, medium-, and high-end). Although no changes have yet been made to the CODM reporting package, the CODM is now regularly receiving watch-type operating profitability information through regular meetings with the six product managers. The product managers oversee the financial results of each watch type and provide additional reports to the CODM. In the first quarter of 20X2, FSP Corp intends to change the formal CODM package to reflect the information on the six distinct businesses that the new CEO is regularly reviewing, rather than just the three that the previous CEO regularly reviewed.

What impact should the change in information being regularly reviewed by the CODM have on FSP Corp's determination of operating segments?

Analysis

The change in the CODM warrants a review of the operating segments given the new CODM's different management style and regular review of new or different information when assessing performance and allocating resources. In order to support a change in operating segments prior to a formal change in the CODM package, FSP Corp would need to demonstrate that significant changes have been made in how the CODM is managing the business.

In this example, FSP Corp changed the manner in which operating results are regularly reviewed by the CODM in 20X1. In addition to meeting with the vice presidents of the three distinct product lines, the new CODM now also meets with the product managers of the six individual watch types. Additionally, FSP Corp changed the way that it markets its products, and the CODM is using more disaggregated financial information to manage the business. FSP Corp does not view these changes as temporary and intends to make the change to the CODM package in the near future to reflect the way the new CODM views the business.

Based on these factors, it would appear appropriate to conclude that FSP Corp had a change in its operating segments during 20X1.

25.7.9.2 *Changes of reportable segments during an interim period*

As discussed in ASC 280-10-50-34, a reporting entity may change its organizational structure during an interim period. Alternatively, a previously immaterial segment may become material. If that change results in a change in reportable segment information in the interim period, the financial statements should be prepared on the basis of the reportable segments in use during the current interim period for both the current and comparative interim periods. The previously issued interim financial statements of the current fiscal year are not required to be amended. However, the interim information for those previously filed quarters will need to be recast (unless it is immaterial or impracticable) when the quarters are presented for comparative purposes in the following year's interim filings.

Question FSP 25-17

If changes in a reporting entity's internal management reporting structure changes its basis for segment reporting during an interim period, must full footnote disclosure be provided in the interim period condensed financial statements as if the recasting had been reported in a complete set of annual financial statements included in the Form 10-K?

PwC response

No. Full footnote disclosures are not required. However, ASC 280-10-50-34 and ASC 280-10-50-35 require that the limited interim period information be recasted and provided in the quarterly report. ASC 280-10-50-32(e) also requires the interim financial statements to describe differences in the basis of segmentation or in the basis of measurement of segment profit or loss from the last annual report. Certain line items required for the annual footnote disclosure by ASC 280-10-50-22 and ASC 280-10-50-25 may be omitted from the condensed financial statements included in the interim period quarterly report.

25.7.9.3 *Recasting of prior period segment information is impracticable*

ASC 280-10-50-35 requires additional disclosures when retrospective application of changes to segment information is impracticable.

ASC 280-10-50-35

If a public entity has changed the structure of its internal organization in a manner that causes the composition of its reportable segments to change or has changed the segment information that is regularly provided to the chief operating decision maker in a manner that causes the identification of significant segment expenses to change, and if segment information for earlier periods, including interim periods, is not recast to reflect the change, the public entity shall disclose in the year in which the change occurs segment information for the current period under both the old basis and the new basis of segmentation or the old and new significant segment expense categories, respectively, unless it is impracticable to do so.

ASC 280-10-50-17 states that "information is impracticable to present if the necessary information is not available and the cost to develop it would be excessive." We expect such situations to be rare as it is usually possible to obtain the necessary prior period information. The SEC staff has been skeptical that recasting prior periods is impracticable.

Similar to changes to reportable segments made during annual periods, if prior year interim segment information is not recast, then the current period segment disclosures should be presented on both the old basis and new basis, unless it would prove impracticable to do so.

25.7.9.4 Partial disposal of a reportable segment

A reporting entity may sell or dispose of a part of a reportable segment that does not qualify for presentation as a discontinued operation. After the sale or disposal, the remaining portion of the reportable segment continues to be a reportable segment. ASC 280 does not specifically address whether any changes should be made to the segment disclosures for such a transaction, either for the period of disposition or the comparative prior periods. We believe that the presentation is dependent on the facts and circumstances. Generally, we would expect that it would not be necessary to recast the reportable segments to exclude the disposal group. However, if the time between when the decision was made to dispose of the disposal group and the actual disposition was relatively long, senior management was separately monitoring or managing the operation to be sold or disposed of, and/or management changed its reporting and organizational structure over the business to be disposed of, it may be appropriate to conclude that there had been a change in operating segments when such a change was made and recast the affected reportable segments.

25.7A Segment disclosures (before ASU 2023-07)

Disclosures are required by ASC 280 for each period for which an income statement is presented, except for reconciliations of balance sheet amounts to the consolidated totals (which are only required for each year that a balance sheet is presented). Therefore, segment asset disclosures (excluding the reconciliations to the consolidated balance sheet totals) are required for each period an income statement is presented, even if a balance sheet is not presented for that particular period. Although a suggested format is presented in ASC 280-10-55-48, the guidance allows for flexibility. As discussed in ASC 280-10-50-27, segment disclosures follow the management approach, meaning they show the measures used by the CODM to assess performance and allocate resources. As such, adjustments, eliminations, and allocations that are made in the preparation of information for use by the CODM should be included in the reported segment information.

ASC 280 requires disclosure of certain general information related to segments. This includes information about the factors used to identify reportable segments, the types of products and services from which reportable segments generate revenues, and whether operating segments have been aggregated.

In addition, ASC 280 requires disclosure of the following:

- *Information about profit or loss and assets*
  As discussed in ASC 280-10-50-22 through ASC 280-10-50-24, this includes disclosures of the asset and certain income statement captions, including the performance measures regularly reviewed by the CODM.

- *Information about investments and expenditures*
  As discussed in ASC 280-10-50-25, this includes disclosures about investments in equity method investees and expenditures for additions to long-lived assets.

- *Information about the measurement of segment profit or loss and assets*
  As discussed in ASC 280-10-50-27 through ASC 280-10-50-29, this includes disclosures about transactions between segments, differences between segments, changes from prior year measurements, and asymmetrical segment allocations.

- *Reconciliations*
  As discussed in ASC 280-10-50-30 and ASC 280-10-50-31, this includes disclosures of reconciliations of the specific segment information to the amounts included in the consolidated financial statements.

- *Entity-wide information*
  As discussed in ASC 280-10-50-38, this includes disclosures of financial and other qualitative information categorized based on products and services, geographic areas, and customers, if not already provided elsewhere in the segment disclosures.

25.7A.1 Segment disclosures—general information

ASC 280-10-50-21 provides the requirements for general segment information disclosures.

Excerpt from ASC 280-10-50-21

A public entity shall disclose the following general information:

a. Factors used to identify the public entity's reportable segments, including the basis of organization (for example, whether management has chosen to organize the public entity around differences in products and services, geographic areas, regulatory environments, or a combination of factors and whether operating segments have been aggregated)

b. Types of products and services from which each reportable segment derives its revenues.

If a reporting entity combines non-reportable operating segments into an "all other" category, the types of products and services within the "all other" category should also be disclosed.

25.7A.2 Segment disclosures—information about profit or loss and assets

ASC 280-10-50-22 through ASC 280-10-50-24 provides the required disclosures for segment profit or loss and assets.

Excerpt from ASC 280-10-50-22

A public entity shall report a measure of profit or loss and total assets for each reportable segment. A public entity also shall disclose all of the following about each reportable segment if the specified amounts are included in the measure of segment profit or loss reviewed by the chief operating decision maker or are otherwise regularly provided to the chief operating decision maker, even if not included in that measure of segment profit or loss:

a. Revenues from external customers

b. Revenues from transactions with other operating segments of the same public entity

c. Interest revenue

d. Interest expense

e. Depreciation, depletion, and amortization expense

f. Unusual items as described in paragraph 220-20-45-1

g. Equity in the net income of investees accounted for by the equity method

h. Income tax expense or benefit

i. Subparagraph superseded by Accounting Standards Update No. 2015-01

j. Significant noncash items other than depreciation, depletion, and amortization expense.

A public entity shall report interest revenue separately from interest expense for each reportable segment unless a majority of the segment's revenues are from interest and the chief operating decision maker relies primarily on net interest revenue to assess the performance of the segment and make decisions about resources to be allocated to the segment. In that situation, a public entity may report that segment's interest revenue net of its interest expense and disclose that it has done so.

ASC 280-10-50-23

Disclosure of interest revenue and interest expense included in reported segment profit or loss is intended to provide information about the financing activities of a segment.

ASC 280-10-50-24

If a segment is primarily a financial operation, interest revenue probably constitutes most of segment revenues and interest expense will constitute most of the difference between reported segment revenues and reported segment profit or loss. If the segment has no financial operations or only immaterial financial operations, no information about interest is required.

25.7A.2.1 Information about profit or loss

Any of the segment information specified in ASC 280-10-50-22 that is regularly provided to the CODM would need to be disclosed, even if the performance measure used by the CODM does not include such items. For example, if operating income is the measure of segment profitability used by the CODM to assess performance but segment interest expense is regularly reported to the CODM, segment interest expense should be disclosed because interest expense is one of the specific items identified for disclosure in ASC 280-10-50-22. Similarly, if any of the required disclosure items are included in the measure of segment profit or loss, it must be disclosed, even if it is not individually provided regularly to the CODM.

As noted in ASC 280, the disclosures are required at the reportable segment level. However, a reporting entity is not precluded from disclosing this information at a more detailed level if the more detailed presentation meets the objectives of ASC 280. For example, a reportable segment with three different but similar external revenue streams can choose to voluntarily provide disclosure of the different revenue streams.

Example FSP 25-7A illustrates when a reporting entity may need to separately report information that is not individually provided regularly to the CODM but included in the performance measure used by the CODM.

EXAMPLE FSP 25-7A

Disclosing information not regularly provided to the CODM (before adoption of ASU 2023-07)

FSP Corp internally reports the following discrete financial information to its CODM: revenue, operating income, total assets, volumes, and various industry statistics. Depreciation and amortization expense are components of both (1) cost of sales and (2) selling, general, and administrative expense, none of which are identified and reported separately to the CODM but are included in operating income. Operating income is the measure of segment profitability used by the CODM to assess performance and allocate resources of the segments.

Is FSP Corp required to disclose depreciation and amortization expense for its reportable segments?

Analysis

Yes. ASC 280-10-50-22 requires the disclosure of specified items that are included in the measurement of segment profit or loss that is regularly reviewed by the CODM, notwithstanding the fact that the individual items may not be separately identified for the CODM. Therefore, separate disclosure of depreciation and amortization expense by reportable segment is required since depreciation and amortization are components of operating income — the measure of profit or loss used by the CODM.

In addition, if the measure of segment profit or loss regularly reviewed by the CODM did not include depreciation and amortization, but depreciation and amortization were regularly provided separately to the CODM, then the amounts would still need to be disclosed.

25.7A.2.2 Information about assets

Reportable segment-level asset information regularly provided to the CODM is required to be disclosed and included in the 10% asset test calculation consistent with ASC 280-10-55-12 through ASC 280-10-55-15, which indicates that items required by paragraph ASC 280-10-50-22 and ASC 280-10-50-25 that are regularly provided to the CODM must be disclosed. In some instances, a reporting entity's CODM may not receive total assets information for each segment. For example, the CODM may only receive select asset data, such as inventory and accounts receivable. In this instance, total assets need not be disclosed for each reportable segment; rather, the sum of inventory and accounts receivable must be disclosed. This total should be disclosed as "segment assets," and the total segment assets should be reconciled to the reporting entity's total consolidated assets. A reporting entity should also disclose the composition of "segment assets."

Ratios or a combination of financial information may be regularly reviewed by the CODM. For example, a reporting entity's CODM may review net working capital but not its gross components (i.e., current assets and current liabilities). Although working capital has an asset component, the current asset component is not what is used by the CODM to assess performance and allocate resources. Therefore, the asset information is not required to be reported, nor is working capital required to be disclosed. Nonetheless, a reporting entity could elect to voluntarily report net working capital by

reportable segment if it meets the objectives and basic principles of ASC 280. If it does so, the total of all reportable segments' working capital should be reconciled to total consolidated working capital.

If no asset information is disclosed for a reportable segment, the fact and reason should be disclosed. Example FSP 25-8A illustrates segment reporting considerations when asset information is not regularly provided to the CODM.

EXAMPLE FSP 25-8A

Segment reporting considerations when asset information is not regularly provided to the CODM (before adoption of ASU 2023-07)

FSP Corp internally reports the following financial information to its CODM for each of its operating segments: revenue, operating income, net income, volume, and various industry statistics. Asset and other balance sheet information is not reported to the CODM.

Is FSP Corp required to disclose asset information for its reportable segments since that information is not reported to the CODM?

Analysis

No. Because asset information is not regularly provided to the CODM, the reporting entity would not be required to disclose segment asset information. If asset information is not reported, the fact and the reasons for not providing the information should be disclosed. ASC 280-10-50-27 states that "only those assets that are included in the measure of the segment's assets that is used by the chief operating decision maker shall be reported for that segment."

FSP Corp is required to disclose long-lived assets by geographic area pursuant to the entity-wide disclosure requirements of ASC 280-10-50-41, even if such information is not regularly provided to the CODM. See FSP 25.7A.7.2.

25.7A.3 Segment disclosures about investments and expenditures

ASC 280-10-50-25 provides the required segment disclosures for investments in equity method investees and expenditures for additions to long-lived assets.

Excerpt from ASC 280-10-50-25

A public entity shall disclose both of the following about each reportable segment if the specified amounts are included in the determination of segment assets reviewed by the chief operating decision maker or are otherwise regularly provided to the chief operating decision maker, even if not included in the determination of segment assets:

a. The amount of investment in equity method investees

b. Total expenditures for additions to long-lived assets other than any of the following:

    1. Financial instruments

    2. Long-term customer relationships of a financial institution

3. Mortgage and other servicing rights
4. Deferred policy acquisition costs
5. Deferred tax assets.

ASC 280 requires these investment and expenditure disclosures because they improve a financial statement user's ability to estimate the cash-generating potential and cash requirements of reportable segments.

An example disclosure is included in ASC 280-10-55-48, which illustrates a suggested format for certain disclosures required by ASC 280-10-50-22 and ASC 280-10-50-25.

25.7A.4 Segment disclosures–information about measurement of segment profit/loss and assets

ASC 280-10-50-29 provides the disclosure requirements for information about the measurement of segment profit or loss and assets.

Excerpt from ASC 280-10-50-29

A public entity shall provide an explanation of the measurements of segment profit or loss and segment assets for each reportable segment. At a minimum, a public entity shall disclose all of the following:

a. The basis of accounting for any transactions between reportable segments.

b. The nature of any differences between the measurements of the reportable segments' profits or losses and the public entity's consolidated income before income taxes and discontinued operations (if not apparent from the reconciliations described in paragraphs 280-10-50-30 through 50-31). Those differences could include accounting policies and policies for allocation of centrally incurred costs that are necessary for an understanding of the reported segment information.

c. The nature of any differences between the measurements of the reportable segments' assets and the public entity's consolidated assets (if not apparent from the reconciliations described in paragraphs 280-10-50-30 through 50-31). Those differences could include accounting policies and policies for allocation of jointly used assets that are necessary for an understanding of the reported segment information.

d. The nature of any changes from prior periods in the measurement methods used to determine reported segment profit or loss and the effect, if any, of those changes on the measure of segment profit or loss.

e. The nature and effect of any asymmetrical allocations to segments. For example, a public entity might allocate depreciation expense to a segment without allocating the related depreciable assets to that segment.

When the measure of segment profitability is not consistent across operating segments, the reporting entity should provide a description of how segment profitability is measured for each reportable segment.

In addition, if the CODM uses more than one measure of segment profit or loss or segment assets to assess performance and allocate resources, the reporting entity should determine which measure is most consistent with that presented in the consolidated financial statements and disclose that measure as the reported segment profitability measure. For example, assume a CODM uses both operating income and pretax income to assess performance and allocate resources. Segment operating profit is determined based on the same measurement principles that are used in the determination of consolidated operating profit. However, segment pretax income includes certain internal cost-of-capital charges that are eliminated in consolidation. In this situation, segment operating profit should be the measure reported externally because operating profit most closely aligns with the measure reported in the consolidated financial statements. However, if segment pretax income was determined based on the same measurement principles as consolidated pretax income, then segment pretax income would be the measure reported externally because this is the measure that is most similar to consolidated pretax income, which is the measure ASC 280-10-50-30(b) requires to be reconciled to segment profit/loss. See FSP 25.7A.6 and Question FSP 25-10A for more information about the reconciliations required by ASC 280-10-50-30 and ASC 280-10-50-31.

In either case, disclosures should be made for interest income and expense because that information is included in the pretax income measure regularly provided to the CODM (consistent with ASC 280-10-55-12 through ASC 280-10-55-15). The disclosure requirements specific to segment interest income and expense are discussed in FSP 25.7A.2.

Question FSP 25-9A

Because the premise of the management approach is that external segment reporting should correspond to a reporting entity's internal reporting, would segment profit or loss information need to be modified if a reporting entity's internal reporting is not in conformity with US GAAP?

PwC response

No. ASC 280-10-50-27 requires information to be reported on the same basis it is reported internally, even if the segment information is not in conformity with US GAAP or the accounting policies used in the consolidated financial statements. Examples of such situations include segment information reported on a cash basis or on a local GAAP basis for segments comprised of foreign subsidiaries, or when management uses EBITDA as its measure of segment profitability. The reporting entity should disclose the nature of any differences between the reportable segment's measurements of profit or loss and assets and those measurements used in the consolidated financial statements for each reportable segment as prescribed by ASC 280-10-50-29.

However, at the 2023 AICPA & CIMA Conference on Current SEC and PCAOB Developments, the SEC staff indicated that revenue from external customers is a specified amount that is defined in ASC 606, Revenue from Contracts with Customers. As a result, the SEC staff indicated that the disclosure of revenues from external customers for purposes of the segment disclosures under ASC 280 should generally align with the defined amounts in ASC 606, and noted that it has objected to amounts prepared under different measurement methods that may be regularly provided to the CODM being referred to as segment revenue, since those amounts are not consistent with what ASC 606 requires as revenue from external customers.

25.7A.5 Not used

25.7A.6 Segment disclosures—reconciliations

Certain information included in the segment disclosures must be reconciled to the reporting entity's consolidated financial measures. ASC 280-10-50-30 and ASC 280-10-50-31 provide the requirements for these reconciliations.

Excerpt from ASC 280-10-50-30 and ASC 280-10-50-31

A public entity shall provide reconciliations of all of the following:

a. The total of the reportable segments' revenues to the public entity's consolidated revenues.

b. The total of the reportable segments' measures of profit or loss to the public entity's consolidated income before income taxes and discontinued operations. However, if a public entity allocates items such as income taxes to segments, the public entity may choose to reconcile the total of the segments' measures of profit or loss to consolidated income after those items.

c. The total of the reportable segments' assets to the public entity's consolidated assets.

d. The total of the reportable segments' amounts for every other significant item of information disclosed to the corresponding consolidated amount. For example, a public entity may choose to disclose liabilities for its reportable segments, in which case the public entity would reconcile the total of reportable segments' liabilities for each segment to the public entity's consolidated liabilities if the segment liabilities are significant.

All significant reconciling items shall be separately identified and described. For example, the amount of each significant adjustment to reconcile accounting methods used in determining segment profit or loss to the public entity's consolidated amounts shall be separately identified and described.

Reconciliations related to segment revenue and profit measures are required for each year an income statement is presented, and reconciliations of balance sheet amounts are required for each year that a balance sheet is presented. An example is included in ASC 280-10-55-49, which illustrates the disclosures required by ASC 280-10-50-30(a) through ASC 280-10-50-30(c).

Question FSP 25-10A

If a reporting entity's measure of segment profitability is net income, should the segment's total net income be reconciled to consolidated net income or to consolidated pretax income?

PwC response

ASC 280-10-50-30(b) allows a reporting entity whose measure of segment profitability is below the pretax income line (e.g., net income) to reconcile that measure, in aggregate for its reportable segments, to the corresponding consolidated total or the consolidated pretax total. In this case, we believe that the more meaningful presentation would be a reconciliation of the total of segment net income to the total consolidated net income.

ASC 280-10-50-30(b) requires that measures of segment profitability that are above the pretax line (e.g., operating profit) be reconciled to consolidated pretax income.

Question FSP 25-11A

Can a reporting entity reconcile a non-GAAP measure of segment profitability (e.g., EBITDA) to the reporting entity's consolidated EBITDA if that measure is further reconciled to pretax income?

PwC response

No. The following presentation of consolidated EBITDA would not be appropriate.

Reportable segment 1 EBITDA	$200
Reportable segment 2 EBITDA	150
Reportable segment 3 EBITDA	100
Subtotal reportable segments	450
Unallocated corporate overhead	(50)
Unallocated pension expense	(20)
Consolidated EBITDA	$380
Depreciation and amortization	(30)
Interest	(50)
Consolidated pretax income	$300

Under SEC rules, it is not appropriate to present the "Consolidated EBITDA" amount (i.e., $380), while it would be acceptable to present the "Subtotal reportable segments" amount (i.e., $450). Regulation S-K Item 10(e)(1)(ii)(C) precludes non-GAAP measures in the financial statements or financial statement footnotes. The Regulation S-K item indicates that non-GAAP measures exclude financial measures required to be disclosed by US GAAP. As such, the prohibition is not applicable to the measures of reportable segment EBITDA, as these amounts are required to be disclosed under ASC 280. However, this regulation and the SEC's related interpretations would preclude use of consolidated EBITDA because such disclosure is not required by US GAAP. Rather, ASC 280-10-50-30 generally requires reconciliation to consolidated pretax income. In addition, if the reporting entity only has one reportable segment, similar prohibitions would apply. For additional guidance, refer to questions 104.01 through 104.06 of the SEC staff's Compliance and Disclosure Interpretations on the use of non-GAAP financial measures.

25.7A.7 Entity-wide segment disclosures

ASC 280-10-50-38 through ASC 280-10-50-42 require certain entity-wide disclosures, which include information about a reporting entity's products and services, geographic areas, and major customers.

In some cases, these requirements may already be met through other disclosures in ASC 280, which requires these entity-wide disclosures even if the information is not regularly reviewed by the CODM, and even if the reporting entity has only one reportable segment.

The entity-wide disclosures are only required in annual financial statements.

Question FSP 25-12A

Is there a threshold at which entity-wide disclosures are considered immaterial?

PwC response

Unlike reportable segment disclosures, there is no quantitative threshold for determining when entity-wide disclosures are required. Assessing what is material is a matter of judgment. Both qualitative and quantitative factors should be considered. When assessing entity-wide disclosures from a quantitative perspective, we believe it would be reasonable to apply a threshold similar to the 10% tests provided in ASC 280-10-50-12. For example, a reporting entity would disclose revenues from external customers attributed to an individual foreign country if revenues from that country are greater than 10% of consolidated revenues. However, qualitative factors may indicate that information is material even if it does not exceed 10% of the consolidated total.

25.7A.7.1 Entity-wide segment information about products and services

ASC 280-10-50-40 requires entity-wide disclosures related to products and services.

ASC 280-10-50-40

A public entity shall report the revenues from external customers for each product and service or each group of similar products and services unless it is impracticable to do so. The amounts of revenues reported shall be based on the financial information used to produce the public entity's general-purpose financial statements. If providing the information is impracticable, that fact shall be disclosed.

Some reporting entities have segment revenues that are derived from a broad range of different products and services. These reporting entities are still required to provide revenue information for the entity-wide disclosures related to its products and services, including when there is only one reportable segment.

Missing or inadequate disclosures of revenues from external customers for each product and service is a common issue raised in SEC staff questions. The SEC staff may also question entity-wide disclosures that are not consistent with how products are described or grouped in other sections of the reporting entity's filings (e.g., Form 10-K, Item 1, Business, ASC 606 disaggregated revenue disclosure) or other external communications.

When determining the level at which products and services should be reported, it may be helpful to consider whether a majority of the characteristics described in ASC 280-10-50-11 for determining whether segments can be aggregated are met. For example, if all products have similar production processes, classes of customers, and economic characteristics as evidenced by similar rates of profitability, similar degrees of risk, and similar opportunities for growth, a reporting entity may

conclude that all of its products are similar and that no additional disclosures by product type are necessary.

Question FSP 25-13A

If a reporting entity has two operating segments based on products and services, and the two operating segments meet all of the criteria required for aggregation into a single reportable segment, must the entity-wide disclosures related to products and services be presented under ASC 280-10-50-40?

PwC response

It depends. Since the two operating segments meet the aggregation criteria, the nature of the products and services in each operating segment could be similar, and therefore the entity-wide disclosures related to products and services need not be provided. However, if the two segments each sold a range of products and services, the reporting entity would be required to present the entity-wide products and services-related disclosures.

Question FSP 25-14A

If a reporting entity has one operating segment, and therefore one reportable segment, must the information required for entity-wide disclosures related to products and services be presented under ASC 280-10-50-40?

PwC response

It depends. A reporting entity may have only one operating segment (and thus only one reportable segment) that sells a range of products and services. In this case, the reporting entity would be required to present the entity-wide products and services-related disclosures. However, the reporting entity may conclude the entity-wide products and services-related disclosures are not necessary if it can demonstrate that its products and services are essentially similar using the aggregation criteria in ASC 280-10-50-11.

25.7A.7.2 Entity-wide segment information about geographic areas

One of the purposes of entity-wide disclosures is to provide information about the geographic areas in which the reporting entity generates its revenues and holds its long-lived assets. ASC 280-10-50-41 provides the entity-wide disclosure requirements for geographic areas.

Excerpt from ASC 280-10-50-41

A public entity shall report the following geographic information unless it is impracticable to do so:

c. Revenues from external customers attributed to the public entity's country of domicile and attributed to all foreign countries in total from which the public entity derives revenues. If revenues from external customers attributed to an individual foreign country are material, those revenues shall be disclosed separately. A public entity shall disclose the basis for attributing revenues from external customers to individual countries.

d. Long-lived assets other than financial instruments, long-term customer relationships of a financial institution, mortgage and other servicing rights, deferred policy acquisition costs, and deferred tax

> assets located in the public entity's country of domicile and located in all foreign countries in total in which the public entity holds assets. If assets in an individual foreign country are material, those assets shall be disclosed separately.
>
> The amounts reported shall be based on the financial information that is used to produce the general-purpose financial statements. If providing the geographic information is impracticable, that fact shall be disclosed. A public entity may wish to provide, in addition to the information required by the preceding paragraph, subtotals of geographic information about groups of countries.

An example is included in ASC 280-10-55-51 that illustrates the disclosures required by ASC 280-10-50-41. In addition to disclosure of material revenues and long-lived assets by country, a reporting entity may wish to provide subtotals of revenues and long-lived assets based on groups of countries in a geographic region, such as Europe, Asia, or North America. The guidance in ASC 280-10-55-22 allows for flexibility in determining how revenue can be attributed to geographic areas. Reporting entities may choose to attribute revenue on the basis of (1) the location of the customer, (2) the location to which the product is shipped (which may differ from the location where the customer resides), or (3) the location where the sale originated. The attribution method should be reasonable and consistently applied, and a reporting entity must disclose the basis it has selected for attributing revenue to geographic areas.

One of the reasons for requiring disclosure of long-lived assets (rather than total assets) in geographic areas is that long-lived assets are potentially at greater risk than current assets because they are difficult to move and relatively illiquid. ASC 280-10-55-23 indicates that a reporting entity can exercise judgment in defining long-lived assets but also indicates that the phrase "long-lived assets" implies tangible assets that cannot be readily removed, which would exclude intangible assets. Accordingly, goodwill and other intangible assets should not be included in the entity-wide disclosure of long-lived assets.

Example FSP 25-9A illustrates how to determine long-lived asset disclosures by geographic area.

EXAMPLE FSP 25-9A

Reporting long-lived assets by geographic area

FSP Corp, a US-domiciled reporting entity with operations in 25 countries, has determined that it has two reportable segments (US and International) and that its long-lived assets located in two individual foreign countries (England and China) are material.

For which geographic areas should FSP Corp disclose tangible long-lived assets?

Analysis

FSP Corp should separately disclose tangible long-lived assets for the US, England, China, and all other foreign countries combined. Although the long-lived assets in the US may not be material, the guidance requires disclosure related to the reporting entity's country of domicile.

Question FSP 25-15A

If a reporting entity has reportable segments represented by the geographic areas US, Canada, and Asia, would the reporting entity be required to disclose revenue and long-lived asset information for each country in Asia, if material?

PwC response

Yes. Revenue and long-lived assets must be disclosed for each country in which such amounts are material. The individual country disclosures are required even if the Asian operations are not managed on an individual country basis (i.e., even if the CODM does not review or assess performance on an individual country basis).

If it is impracticable to provide the individual country information, that fact should be disclosed. These circumstances, however, are expected to be rare.

Question FSP 25-16A

Should right of use (ROU) assets be included in the disclosure of long-lived assets by geography required by ASC 280-10-50-41?

PwC response

In many circumstances, an ROU asset would be included within the long-lived assets disclosure in ASC 280. An ROU asset is within the scope of ASC 360 and is similar to a tangible asset. ASC 280-10-55-23 does not define what is required to be included in long-lived assets and allows an entity to apply judgment. The reasons for requiring disclosure of long-lived assets (rather than total assets) in geographic areas is that long-lived assets are potentially at greater risk than current assets because they are difficult to move and relatively illiquid. For this reason, we believe ROU assets (e.g., buildings) should be included in the disclosure.

25.7A.7.3 Entity-wide segment information about major customers

ASC 280-10-50-42 provides the entity-wide disclosure requirements for major customers.

Excerpt from ASC 280-10-50-42

A public entity shall provide information about the extent of its reliance on its major customers. If revenues from transactions with a single external customer amount to 10 percent or more of a public entity's revenues, the public entity shall disclose that fact, the total amount of revenues from each such customer, and the identity of the segment or segments reporting the revenues. The public entity need not disclose the identity of a major customer or the amount of revenues that each segment reports from that customer. For purposes of this Subtopic, a group of entities known to a reporting public entity to be under common control shall be considered as a single customer, and the federal government, a state government, a local government (for example, a county or municipality), or a foreign government each shall be considered as a single customer.

One of the objectives of disclosing information about major customers is to provide a measure of the concentration of credit risk to the reporting entity. Neither the identity of a major customer or the amount of revenues that each segment reports from that customer is required to be disclosed.

ASC 280-10-55-52 includes an example that illustrates the disclosures required by ASC 280-10-50-42.

25.7A.8 Interim period segment information

Reduced disclosures are permitted in condensed financial statements of interim periods. However, if a complete set of financial statements is presented in an interim period, then the full disclosure requirements of ASC 280 apply.

ASC 280-10-50-32 and ASC 280-10-50-33 provide the disclosure requirements for condensed financial statements of interim periods.

ASC 280-10-50-32

A public entity shall disclose all of the following about each reportable segment in condensed financial statements of interim periods:

a. Revenues from external customers

b. Intersegment revenues

c. A measure of segment profit or loss

d. Total assets for which there has been a material change from the amount disclosed in the last annual report

e. A description of differences from the last annual report in the basis of segmentation or in the basis of measurement of segment profit or loss

f. A reconciliation of the total of the reportable segments' measures of profit or loss to the public entity's consolidated income before income taxes and discontinued operations. However, if a public entity allocates items such as income taxes to segments, the public entity may choose to reconcile the total of the segments' measures of profit or loss to consolidated income after those items. Significant reconciling items shall be separately identified and described in that reconciliation.

ASC 280-10-50-33

Interim disclosures are required for the current quarter and year-to-date amounts. Paragraph 270-10-50-1 states that when summarized financial data are regularly reported on a quarterly basis, the information in the previous paragraph with respect to the current quarter and the current year-to-date or the last 12 months to date should be furnished together with comparable data for the preceding year.

Entity-wide disclosures, including disclosures about major customers, are not required in interim periods. However, if a reporting entity were to transact a significant amount of business with a new (or

previously insignificant) customer during an interim period that was expected to continue in future periods, management should consider providing the disclosures required by ASC 280-10-50-42.

During an interim period, a reporting entity may change its organizational structure, or a previously immaterial segment may become material. See FSP 25.7A.9.2 for guidance.

25.7A.9 Recasting of information for changes in segments

The information regularly reviewed by the CODM may change for a number of reasons, including when a reporting entity changes the structure of its internal organization. This could result in changes to operating segments and changes to the determination of reportable segments. If a reporting entity's reportable segments change in the current period, corresponding information for earlier periods should be recast and disclosed in the current period financial statements. This would include information for interim periods so that all segment disclosures are comparable. This requirement applies to all disclosures unless it is impracticable to do so. A change in reportable segments should be accompanied by disclosure of the reasons for the change and, when appropriate, that the change has been reflected retrospectively.

ASC 280 does not specify how to analyze organizational changes to determine when a change in operating or reportable segments is necessary. However, the determination of operating segments is based on the information regularly reviewed by the CODM. As a result, if there are changes in how the CODM allocates resources and assesses performance, or changes to how the information is presented to the CODM, a reporting entity will likely need to reassess its operating and reportable segments.

When determining whether there has been a change that could impact the determination of its operating segments, the reporting entity may consider whether there has been a change in the following:

- The CODM
- The information regularly reviewed by the CODM
- The organizational structure
- The individuals who regularly meet with the CODM
- The budgeting process or level at which budgets are reviewed by the CODM
- The information regularly reported to the board of directors
- The information the reporting entity communicates to external parties such as investors, creditors, and customers

A reporting entity may choose to change its measure of segment profit and loss (e.g., from operating income to EBITDA). In contrast to an organizational change that causes a change to segment reporting, a change in a segment performance measure may not require recasting to previously reported segment disclosures. However, additional disclosure is required if prior years' information is not recast, as described in ASC 280-10-50-36.

ASC 280-10-50-36

Although restatement is not required to reflect a change in measurement of segment profit and loss, it is preferable to show all segment information on a comparable basis to the extent it is practicable to do so. If prior years' information is not restated, paragraph 280-10-50-29(d) nonetheless requires disclosure of the nature of any changes from prior periods in the measurement methods used to determine reported segment profit or loss and the effect, if any, of those changes on the measure of segment profit or loss.

Example FSP 25-10A illustrates a change in segment performance measures.

EXAMPLE FSP 25-10A

Change in segment performance measures

FSP Corp has five operating segments, which are also its reportable segments. Historically, the internal reporting package regularly reviewed by the CODM included certain unallocated items, such as interest income/expense and pension service costs. These unallocated items were disclosed in FSP Corp's footnotes as part of its reconciliation of total segment profits/losses to consolidated net income. The CODM recently requested that pension service costs be allocated to the five operating segments based on employee head count as the CODM believes pension service cost should be considered in assessing segment performance and in making resource allocation decisions. The internal reporting package for the period reflected this change.

How should FSP Corp reflect this in its segment disclosures?

Analysis

The change in allocation represents a change in the measure of segment performance. FSP Corp should reflect this new segment measure in the period the change occurred. Because this is not a change in the identified reportable segments, FSP Corp is not required to recast prior periods to reflect this change, but it would be preferable to do so. In either case, FSP Corp should disclose the nature of the change in the segment performance measure and the effect the change has on the measure of segment profit or loss, as required by ASC 280-10-50-29(d).

While the entity-wide disclosure provisions of ASC 280 do not discuss the recasting of entity-wide disclosures, we believe that the entity-wide information from period to period should be comparable. Accordingly, we believe that the guidance contained in ASC 280-10-50-16 and ASC 280-10-50-17, as well as the recasting provisions of ASC 280-10-50-34 and ASC 280-10-50-35, should be applied to entity-wide disclosures.

ASC 280-10-50-17 also requires recasting of prior period segment information (unless impracticable) when a previously insignificant operating segment becomes significant (i.e., the operating segment meets one of the 10% tests).

Example FSP 25-11A illustrates an analysis of segments when their relative significance changes year over year.

EXAMPLE FSP 25-11A

Change in segment significance

FSP Corp has eight operating segments, none of which qualify for aggregation. Five of the segments were disclosed as reportable segments in 20X1, based on the 10% tests. The aggregate external revenues of these reportable segments exceeded 75% of FSP Corp's consolidated revenues. The remaining three operating segments were combined in an "all other" category. In 20X2, one of the three operating segments that was included in the "all other" category in 20X1 became quantitatively material (i.e., it exceeded the threshold for one of the 10% tests). Also, in 20X2, one of the five 20X1 reportable segments was no longer quantitatively material.

How should FSP Corp reflect these changes in its segment disclosures?

Analysis

The operating segment that is now material should be presented as a reportable segment. Pursuant to ASC 280-10-50-17, when FSP Corp presents prior period segment data in the 20X2 financial statements, segment data for all prior periods must be recast to reflect the new reportable segment as a separate reportable segment, unless it would be impracticable to do so.

For the operating segment that no longer meets the quantitative thresholds (assuming the operating segment is not considered to be of continuing significance), disclosure of its individual results need not be made in 20X2. In this case, prior period segment disclosures could also be recast to conform to the current period presentation (provided the threshold for the 75% revenue test is met for all periods). In accordance with ASC 280-10-50-16, if management views the segment to be of continuing significance, that segment's disclosures should continue to be made.

Example FSP 25-12A illustrates factors to consider in assessing whether to recast previous periods' segment information when a reporting entity changes its internal financial reporting without changing its organizational structure.

EXAMPLE FSP 25-12A

Consideration of changes in internal financial reporting without changes in organizational structure

FSP Corp has four operating segments. It has decided to move one of its product lines from one operating segment (Segment X) to another (Segment Z) for internal reporting purposes. FSP Corp did not change its management structure, and has determined that it still has the same four operating segments. The only change to the CODM package as a result of the internal financial reporting change is the inclusion of the product line's financial information within Segment Z reporting and its removal from Segment X reporting as of the date of the change.

How should this change in internal financial reporting be considered in FSP Corp's segment assessment?

Analysis

FSP Corp should consider recasting its previously disclosed segment information if the changes to the segment assets and operating results as a result of reclassifying the assets, liabilities, and results of

operations materially affect the trend in asset balances and/or the reported results. If, however, the segment information does not materially change the segments' financial information, generally a reporting entity is not expected to recast the previously reported segment information.

In determining whether the change to the Segment X and Z financial information is material, FSP Corp might consider, among other things, whether the CODM package (or other information regularly reviewed by the CODM) has been adjusted retrospectively or whether the product line is considered a separate asset group (as defined in ASC 360). If the product line is a separate asset group, this may indicate that the composition of the segments has changed significantly and prior period segment information should be recast.

25.7A.9.1 When to reflect changes in segment reporting

Changes in reportable segments as a result of changes in organization, the information regularly reviewed by the CODM, the significance of an operating segment (from immaterial to material), or the aggregation of operating segments should only be reflected when the financial statements include the period in which the change occurred. Changes in reportable segments arising after a reporting entity's period-end but before the issuance of the reporting entity's financial statements should be treated as an unrecognized (i.e., "Type II") subsequent event (see FSP 28.6). However, the reporting entity should disclose that a change in reportable segments will occur in subsequent periods and the reasons for the change.

Example FSP 25-13A and Example FSP 25-14A provide illustrations of the timing of disclosure of segment reporting changes.

EXAMPLE FSP 25-13A

Change in segment structure subsequent to year end

In the fourth quarter of 20X1, FSP Corp's management determined that it will change the way it manages and operates the reporting entity and is in the process of modifying FSP Corp's information system to produce financial information to support the new structure. The changes will require FSP Corp to recast its segment reporting. It is anticipated that the modification to the system will be completed in the first quarter of 20X2, at which point management will reorganize its operations and reporting structure and begin to manage its operations under its new segment structure.

How should this planned change affect FSP Corp's 20X1 segment disclosures?

Analysis

FSP Corp should disclose its 20X1 reportable segment information under the reporting structure in place during 20X1. It should not recast its segment disclosure using the new reporting structure until the first quarter of 20X2, the period in which management changes the way it manages and operates the business.

EXAMPLE FSP 25-14A

Changing operating segments for financial reporting purposes prior to changing the CODM package

FSP Corp manufactures watches in three product lines: low-, medium-, and high-end. Each of these product lines has two distinct watch types (sport and formal). FSP Corp identified each product line as an operating segment. Each of the product lines has a vice president who reports to the CEO, who is the CODM. Monthly meetings are held between the vice presidents of the three product lines and the CODM to discuss the results for each product line. The CODM package and information regularly reviewed at the monthly meetings consists of revenue and expenses by product line.

During 20X1, the existing CEO retired and the new CEO became the new CODM. The new CODM changed certain aspects of FSP Corp's internal reporting roles and marketing strategy and began meeting with the product managers to assess performance of each of the watch types (sport and formal) within each product line in order to gain better insight into how the business is operating. In addition, the CODM implemented a new marketing campaign which focused on the sport and formal type watches versus the previous marketing campaign, which focused only on the three distinct product lines. The new CODM began allocating resources at the watch-type level (sport and formal) rather than at the product-line level (low-, medium-, and high-end). Although no changes have yet been made to the CODM reporting package, the CODM is now regularly receiving watch-type operating profitability information through regular meetings with the six product managers. The product managers oversee the financial results of each watch type and provide additional reports to the CODM. In the first quarter of 20X2, FSP Corp intends to change the formal CODM package to reflect the information on the six distinct businesses that the new CEO is regularly reviewing, rather than just the three that the previous CEO regularly reviewed.

What impact should the change in information being regularly reviewed by the CODM have on FSP Corp's determination of operating segments?

Analysis

The change in the CODM warrants a review of the operating segments given the new CODM's different management style and regular review of new or different information when assessing performance and allocating resources. In order to support a change in operating segments prior to a formal change in the CODM package, FSP Corp would need to demonstrate that significant changes have been made in how the CODM is managing the business.

In this example, FSP Corp changed the manner in which operating results are regularly reviewed by the CODM in 20X1. In addition to meeting with the vice presidents of the three distinct product lines, the new CODM now also meets with the product managers of the six individual watch types. Additionally, FSP Corp changed the way that it markets its products, and the CODM is using more disaggregated financial information to manage the business. FSP Corp does not view these changes as temporary and intends to make the change to the CODM package in the near future to reflect the way the new CODM views the business.

Based on these factors, it would appear appropriate to conclude that FSP Corp had a change in its operating segments during 20X1.

25.7A.9.2 *Changes of reportable segments during an interim period*

As discussed in ASC 280-10-50-34, a reporting entity may change its organizational structure during an interim period. Alternatively, a previously immaterial segment may become material. If that change results in a change in reportable segment information in the interim period, the financial statements should be prepared on the basis of the reportable segments in use during the current interim period for both the current and comparative interim periods. The previously issued interim financial statements of the current fiscal year are not required to be amended. However, the interim information for those previously filed quarters will need to be recast (unless it is immaterial or impracticable) when the quarters are presented for comparative purposes in the following year's interim filings.

Question FSP 25-17A

If changes in a reporting entity's internal management reporting structure changes its basis for segment reporting during an interim period, must full footnote disclosure be provided in the interim period condensed financial statements as if the recasting had been reported in a complete set of annual financial statements included in the Form 10-K?

PwC response

No. Full footnote disclosures are not required. However, ASC 280-10-50-34 and ASC 280-10-50-35 require that the limited interim period information be recasted and provided in the quarterly report. ASC 280-10-50-32(e) also requires the interim financial statements to describe differences in the basis of segmentation or in the basis of measurement of segment profit or loss from the last annual report. Certain line items required for the annual footnote disclosure by ASC 280-10-50-22 and ASC 280-10-50-25 may be omitted from the condensed financial statements included in the interim period quarterly report.

25.7A.9.3 *Recasting of prior period segment information is impracticable*

ASC 280-10-50-35 requires additional disclosures when retrospective application of changes to segment information is impracticable.

ASC 280-10-50-35

If a public entity has changed the structure of its internal organization in a manner that causes the composition of its reportable segments to change and if segment information for earlier periods, including interim periods, is not restated to reflect the change, the public entity shall disclose in the year in which the change occurs segment information for the current period under both the old basis and the new basis of segmentation unless it is impracticable to do so.

ASC 280-10-50-17 states that "information is impracticable to present if the necessary information is not available and the cost to develop it would be excessive." We expect such situations to be rare as it is usually possible to obtain the necessary prior period information. The SEC staff has been skeptical that revising prior periods is impracticable.

Similar to changes to reportable segments made during annual periods, if prior year interim segment information is not revised, then the current period segment disclosures should be presented on both the old basis and new basis, unless it would prove impracticable to do so.

25.7A.9.4 Partial disposal of a reportable segment

A reporting entity may sell or dispose of a part of a reportable segment that does not qualify for presentation as a discontinued operation. After the sale or disposal, the remaining portion of the reportable segment continues to be a reportable segment. ASC 280 does not specifically address whether any changes should be made to the segment disclosures for such a transaction, either for the period of disposition or the comparative prior periods. We believe that the presentation is dependent on the facts and circumstances. Generally, we would expect that it would not be necessary to recast the reportable segments to exclude the disposal group. However, if the time between when the decision was made to dispose of the disposal group and the actual disposition was relatively long, senior management was separately monitoring or managing the operation to be sold or disposed of, and/or management changed its reporting and organizational structure over the business to be disposed of, it may be appropriate to conclude that there had been a change in operating segments when such a change was made and recast the affected reportable segments.

25.8 Case study—applying ASC 280 (after ASU 2023-07)

Example FSP 25-15 is a case study in how to apply the provisions of ASC 280. It also provides example disclosures based on the outcome of the case study. Example FSP 25-15 applies ASC 280 as updated for ASU 2023-07.

EXAMPLE FSP 25-15

Illustrative application of ASC 280 and related disclosures

The following example provides general background information relating to FSP Corp, a fictitious consumer products company. The general background is followed by an analysis regarding the determination of FSP Corp's CODM, its operating segments, the operating segments that qualify for aggregation, and which operating segments or aggregated operating segments are reportable segments. An example footnote is also provided.

General background

FSP Corp's operations include manufacturing, marketing, and distribution of luggage and related accessories. The products consist of four types of branded luggage, as well as handbags, briefcases, sports bags, and storage cases (i.e., other accessories). FSP Corp is a global organization with sales in Europe, Asia, and the Americas. FSP Corp is organized as 12 marketing units, each with its own Vice President who is accountable for unit sales and performance. These marketing units are grouped into three divisions, and the Vice Presidents of the 12 marketing units report to their respective Division President. Approximately 50% of sales are from the four marketing units that compose the "Luggage Americas Division." Approximately 30% of sales come from the four marketing units that comprise the "International Division." The remaining 20% of sales are from the four marketing units that compose the "Other Accessories Americas Division."

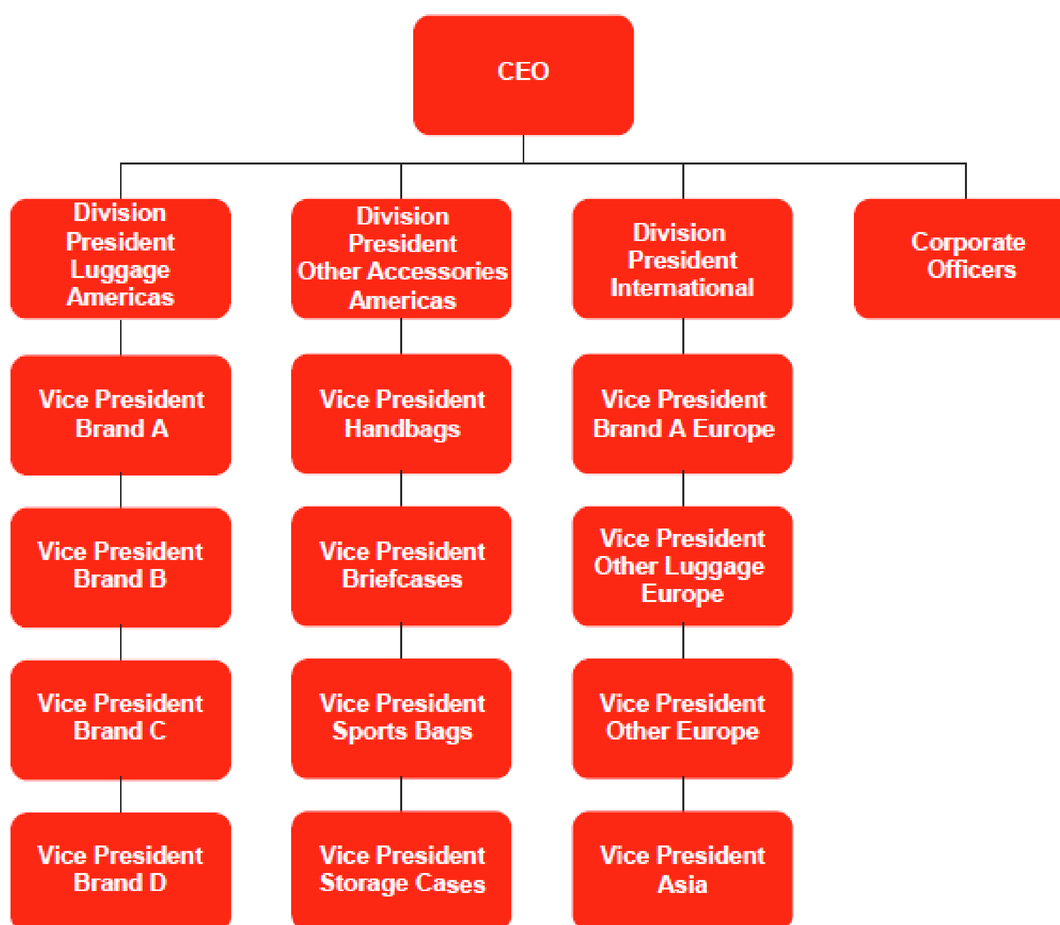
FSP Corp produces its luggage products through a network of six owned manufacturing facilities. The other accessories are produced by various independent suppliers. Other Accessories Americas Division

is primarily a domestic operation, although the accessories are also sold internationally through the International Division's marketing units. FSP Corp's product lines are sold primarily to retailers who, in turn, sell the items to individual customers. FSP Corp also owns eight handbag retail locations in the US that sell handbag products directly to customers (handbags are also sold through third-party retailers). The results of these locations are included in the handbag marketing unit.

FSP Corp does not have any investments accounted for under the equity method and has a December 31 year-end.

The following is an organization chart for FSP Corp:

FSP Corp organization chart



The CEO allocates resources and assesses the performance of FSP Corp primarily based on the results of each marketing unit. The CEO regularly receives information from the three Division Presidents, as well as the Corporate Officers (Chief Financial Officer, General Counsel, and Vice President of Human Resources) who report directly to the CEO.

Information reported to the CODM

Each marketing unit prepares a monthly "Operating Report," which is sent to the applicable Division President. It reflects the marketing unit's current-month and year-to-date sales; gross margin; operating income; and working capital. Gross margin and operating income are the most important measurements used by the marketing unit Vice Presidents, Divisional Presidents, and CEO to assess performance of the marketing units, divisions, and FSP Corp as a whole. Most incentive compensation is based on gross margin and operating income at the marketing unit level.

The monthly Operating Reports are regularly reviewed by the Division Presidents. Divisional results are prepared for each division and sent to the Division Presidents and CEO. The Operating Reports are also made available to the CEO, who may not review these reports in as much detail as the Division Presidents but finds it useful to have the disaggregated information available to analyze specific performance questions.

Additionally, the CEO is apprised of each marketing unit's performance by:

- A monthly all-day meeting with the Division Presidents and marketing unit Vice Presidents that is devoted to a discussion of recent operating results. The marketing unit Operating Reports and the consolidated division level reports are typically used as information sources during these meetings.

- Frequent phone calls with the Division Presidents

- Quarterly strategy meetings with marketing unit Vice Presidents, at which forecasts, business issues, opportunities, and competitors are discussed.

Each quarter, the board of directors is provided with a report that summarizes sales, operating income, gross margin, and working capital for each of the Divisions.

The following tables represent information reported in the Operating Reports.

LUGGAGE AMERICAS DIVISION
Information reported as of and for the year ended December 31, 20X2
($ in thousands)

	Brand A	Brand B	Brand C	Brand D	Division total
Sales	$420	$220	$180	$100	$920
Gross margin	$126	$69	$57	$32	$284
Percentage of sales	30%	31%	32%	32%	
Operating income	$80	$40	$32	$18	$170
Working capital	$200	$200	$150	$60	$610

OTHER ACCESSORIES AMERICAS DIVISION
Information reported as of and for the year ended December 31, 20X2
($ in thousands)

	Handbags	Briefcases	Sports bags	Storage cases	Division total
Sales	$100	$80	$75	$75	$330
Gross margin	$41	$31	$29	$19	$120
Percentage of sales	41%	39%	39%	25%	
Operating income	$25	$20	$20	$15	$80
Working capital	$20	$20	$15	$15	$70

INTERNATIONAL DIVISION
Information reported as of and for the year ended December 31, 20X2
($ in thousands)

	Brand A Europe	Other Luggage Europe	Other Europe	Asia	Division total
Sales	$300	$160	$100	$50	$610
Gross margin	$93	$51	$20	$7	$171
Percentage of sales	31%	32%	20%	14%	
Operating income	$60	$33	$15	$6	$114
Working capital	$150	$60	$20	$10	$240

CONSOLIDATED
Information reported as of and for the year ended December 31, 20X2
($ in thousands)

	Total divisions before eliminations	Eliminations	Consolidated
Sales	$1,860	$(60)	$1,800
Gross margin	$575	$(10)	$565
Percentage of sales	31%	17%	31%
Operating income	$364	$(10)	$354
Working capital	$920		$920

Segment analysis

Determination of the CODM

The CODM of FSP Corp is the CEO. Although the Division Presidents and Corporate Officers assist in the decision-making process, the CEO has historically made and is expected to continue to make the overall decisions about FSP Corp's resource allocation. The CEO also assesses the performance of FSP Corp's segments.

Determination and identification of operating segments

FSP Corp's operating segments are its 12 marketing units. Based on the preceding tables that reflect FSP Corp's internal reporting, each marketing unit recognizes revenue, incurs expenses, and has discrete financial information readily available. In addition, the monthly Operating Reports are regularly provided to and regularly reviewed by the CODM, and the CODM regularly meets with both the division presidents and the marketing unit vice presidents to discuss operating results, forecasts, business issues, etc. The CEO uses the information related to all 12 marketing units as the basis for assessing the marketing units' performance and deciding what resources are to be allocated to them.

Determination of reportable segments

Assessing which operating segments meet all of the aggregation criteria

Since FSP Corp aligns its business by division, management first considers whether the marketing units within each division met all of the required aggregation criteria. Management prepares a long-term economic analysis for each marketing unit using gross margin, operating income, sales growth, and operating cash flows for the last three years plus forecasted results for the next three years. The impacts of foreign currency are also considered for the international operating segments.

Based on the analysis of past, current, and future expected results considering the guidance outlined in FSP 25.5.1, management concludes the operating segments representing the marketing units (Brands A, B, C, and D) of the Luggage Americas Division are quantitatively similar. Management assesses the similarity of the qualitative characteristics as follows:

- *The nature of the products and services*
  All of these operating segments market luggage and, in many cases, the same types of soft shell luggage (the points of difference tend to be the price of the products, style, and external material).

- *The nature of the production processes*
  The nature of the production processes is similar across all four operating segments. The production of the different brands uses common machinery and equipment in FSP Corp's owned US facilities. In many cases, raw materials are sourced from the same suppliers and used across brands, and some piece parts are produced centrally for different operating segments in the same manufacturing facility. There are no significant technology differences in the production processes across brands.

- *The type or class of customer for their products and services*
  Each brand shares similar classes of customers, which are primarily US retail department stores. US retail department stores usually carry many of FSP Corp's brands.

- *The methods used to distribute their products or provide their services*
  Each brand shares similar distribution methods, which primarily involve shipments to retail department stores by common carriers directly from FSP Corp's manufacturing facilities.

- *The nature of the regulatory environment*
  There are no specific differences in the regulatory environment for any of the four operating segments.

Management determines the operating segments meet all of the qualitative aggregation criteria. FSP Corp will aggregate the four operating segments in the Luggage Americas Division to produce a reportable segment called "Luggage Americas."

Based on the analysis of past, current, and future expected results, considering the guidance outlined in FSP 25.5.1, management concludes the Brand A Europe and the Other Luggage Europe marketing units of the International Division are quantitatively similar. Management assesses the similarity of the qualitative characteristics as follows.

- *The nature of the products and services*
  These operating segments market luggage and, in many cases, the same types of soft shell luggage (the points of difference tend to be the price of the products, style, and external material).

- *The nature of the production processes*
  The nature of the production processes is similar for both segments. The luggage is manufactured in the same US plants as those described in the "Luggage Americas" reportable segment.

- *The type or class of customer for their products and services*
  Each brand shares similar classes of customers, which are primarily European retail department stores.

- *The methods used to distribute their products or provide their services*
  Each brand shares similar distribution methods, which primarily involve shipments to retail department stores by common carriers directly from FSP Corp's manufacturing facilities.

- *The nature of the regulatory environment*
  Although the marketing units operate in different countries, there are no significant differences in the regulatory environment.

Management determines these operating segments meet all of the qualitative aggregation criteria. FSP Corp will aggregate the Brand A Europe and the Other Luggage Europe operating segments to produce a reportable segment called "Luggage Europe."

Although some of the other marketing units share similar economic characteristics with each other, none of the other marketing units meet all of the aggregation criteria listed in ASC 280-10-50-11. Therefore, no other operating segments are aggregated with each other.

Quantitative thresholds

FSP Corp next performs the quantitative assessments necessary to determine which of its operating segments or aggregated operating segments are required to be presented separately as reportable segments in its segment disclosures. The quantitative threshold tests should be based on the combined total of FSP Corp's operating segments. In this example, the total is not adjusted for intersegment items that are otherwise eliminated in consolidation, since the operating segments' results are reported to the CODM inclusive of such items (i.e., segment performance measures used to assess marketing unit performance include intercompany transactions).

Assessments of the 10% tests are as follows:

A. 10% test – revenue

($ in thousands)	Luggage Americas	Luggage Europe	Handbags	Briefcases	Sports bags	Storage cases	Other Europe	Asia	Total
Total sales, excluding eliminations	$920	$460	$100	$80	$75	$75	$100	$50	$1,860
Percentages									
Total sales, excluding eliminations	49%	25%	5.5%	4%	4%	4%	5.5%	3%	100%

Only the Luggage Americas and Luggage Europe reportable segments meet the 10% revenue test that requires separate presentation in FSP Corp's segment disclosures.

B. 10% test - profit (Operating income)

($ in thousands)	Luggage Americas	Luggage Europe	Handbags	Briefcases	Sports bags	Storage cases	Other Europe	Asia	Total
Operating income	$170	$93	$25	$20	$20	$15	$15	$6	$364
Percentage	47%	26%	7%	5%	5%	4%	4%	2%	100%

As previously mentioned, FSP Corp uses both gross margin and operating income as its measures of segment profit or loss. However, for the 10% test, FSP Corp chose operating income as this metric applies to all segments and most closely aligns with the overall profit measure reported in the consolidated financial statements.

The Luggage Americas and the Luggage Europe reportable segments are the only segments that meet the 10% segment profit test requiring separate presentation in FSP Corp's segment disclosures. In this example, all of the segments had a profit, making the calculations easier. As noted in FSP 25.6.1, if some segments report a profit and others report a loss, the calculations must be done separately for all those with a profit and all those with a loss.

C. 10% test – assets

Because a measure of operating segment assets is not reported to FSP Corp's CODM, the 10% asset test is not applicable.

Immaterial operating segments which meet the majority of the aggregation criteria

Following aggregation of operating segments that meet all of the aggregation criteria in ASC 280-10-50-11 and the application of the 10% tests, only the Luggage Americas and the Luggage Europe segments meet any of the 10% tests requiring separate presentation as a reportable segment. FSP Corp then determines which remaining immaterial operating segments share similar long-term economic characteristics and meet the majority of the qualitative criteria in ASC 280-10-50-11.

Based on the analysis of past, current, and future expected results considering the guidance outlined in FSP 25.5.1, management concludes the Handbags, Briefcases, and Sports Bags marketing units have similar long-term economic characteristics and assesses the similarly of the qualitative characteristics as follows:

- *The nature of the products and services*
  The Handbags, Briefcases, and Sports Bags operating segments all represent a similar type of product (personal accessories) and the points of difference tend to be the type and style of accessory.

- *The nature of the production processes*
  The nature of the production processes across the operating segments is dissimilar. Handbags are sourced from several independent suppliers. The majority of the Handbags are produced in factories; however, several lines of handbags are entirely handmade. The production process for Sports Bags is primarily through an external supplier factory. The raw materials for Sports Bags primarily consist of synthetic fabrics and zippers. Briefcases are entirely handmade by a number of different independent family businesses. The raw materials for handbags primarily consist of leather, silver, and brass, all of which have had significant price fluctuations in recent years.

- *The type or class of customer for their products and services*
  Each of the operating segments shares similar classes of customers, which are primarily retail department stores. The Handbags segment, however, does operate some retail locations which sell products directly to the end customers.

- *The methods used to distribute their products or provide their services*
  Each brand shares similar distribution methods, which primarily involve shipments to retail department stores by common carriers.

- *The nature of the regulatory environment*
  There are no significant differences in the regulatory environment for any of these operating segments.

Management determines the operating segments meet a majority of the aggregation criteria. Based on this analysis, FSP Corp will aggregate the Handbags, Briefcases, and Sport Bags segments to produce a reportable segment "Other Accessories."

D. The 75% revenue test

Because the Luggage Americas reportable segment represents 48% of consolidated sales, the Luggage Europe reportable segment represents 26% of consolidated sales, and the Other Accessories reportable segment represents an additional 14% of external sales, total revenues of all identified reportable segments exceeds the 75% threshold. No further reportable segments are required to be disclosed. However, if the 75% threshold was not reached, FSP Corp would need to identify which of the operating segments, which otherwise would have been included in the "All Other" category, to present as a separate reportable segment until the 75% threshold was achieved.

<u>All Other</u>

Management analyzes the remaining operating segments (Storage Cases, Other Europe, and Asia) and concludes that none of these segments warrants separate presentation as a reportable segment as they would not provide additional useful information to the readers of the financial statements. Therefore, the remaining segments are aggregated into an "All Other" category.

Accordingly, FSP Corp has three reportable segments (Luggage Americas, Luggage Europe, and Other Accessories) and an additional All Other category, which together account for 100% of FSP Corp's total consolidated revenues.

Measurement

FSP Corp's measures of segment profitability that are used by management are gross margin and operating income. Management has determined that, in accordance with ASC 280-10-50-28A, it would like to report both measures of segment profit or loss. Thus, gross margin and operating income will be reported as the measures of segment profit in the segment disclosure. In accordance with ASC 280-10-50-30, it must reconcile aggregate gross margin and operating income for the reportable segments to consolidated income before income taxes.

Had management elected to only report one measure of segment profit or loss, it would have needed to evaluate which one it believed is determined in accordance with the measurement principles most consistent with those used in measuring the corresponding amounts in a public entity's consolidated financial statements. In FSP Corp's situation, this would be operating income as it is closest to consolidated income before income taxes.

Information about profit or loss and assets

Gross margin and operating income are the measures of segment profitability regularly reviewed by the CODM. No segment-level disclosure is required of interest expense, unusual charges, and income tax expense/benefit, since these amounts are not included in gross margin or operating income and they are not separately provided regularly to the CODM. Further, FSP Corp does not have any investments accounted for under the equity method.

Since asset information by operating or reportable segment is not reported to the CODM, the individual asset disclosures described in ASC 280-10-50-22 are not applicable to FSP Corp.

Information about significant segment expenses

FSP Corp determined that its significant segment expense categories are Cost of sales, Depreciation and amortization, and Marketing expense, as these reflect the segment-level expense information that is regularly provided to the CODM and included in the reported amounts of segment gross margin and segment operating income. FSP Corp considered relevant qualitative and quantitative factors when determining whether these segment expense categories and amounts were significant.

Entity-wide disclosures

A. Information about products and services

The CODM has access to and regularly reviews internal financial reporting by marketing unit, which are primarily organized by product. Furthermore, operating segments are aggregated into reportable segments based on similar products, and FSP Corp does not generate any service revenues. Therefore, entity-wide disclosures of information about products and services are not required.

B. Information about geographic areas

Other than the US, Germany, and Italy, no other country's revenues from external customers are significant enough to require separate disclosure. FSP Corp will disclose revenues for these countries and remaining revenues from external customers as a single line for its other foreign operations. For this disclosure, FSP Corp determines that foreign sales will be reported by the country in which the legal subsidiary is domiciled.

As FSP Corp has no assets in an individual foreign country that are significant enough to require separate disclosure, FSP Corp will disclose long-lived assets from its United States and foreign operations.

C. Information about major customers

FSP Corp has no single customer representing greater than 10% of its consolidated revenues, and therefore this disclosure is not required.

Sample footnote

Segment information[1]

FSP Corp is organized primarily on the basis of products and operates 3 divisions which comprise 12 separate marketing units. These 12 marketing units are our operating segments, and each of these segments is led by a Vice President. Resources are allocated and performance is assessed by our CEO, whom we have determined to be our Chief Operating Decision Maker (CODM).

Certain of our operating segments have been aggregated as they contain similar products managed within the same division, are economically similar, and share similar types of customers, production, and distribution. Four of our marketing units have been aggregated to form the "Luggage Americas" reportable segment, and two of our marketing units have been aggregated to form the "Luggage Europe" reportable segment. Three of our otherwise non-reportable marketing units have been aggregated to form the "Other Accessories" reportable segment, and the remaining three marketing units have been combined and included in an "All Other" category. The following is a brief description of our reportable segments and a description of business activities conducted by All Other.

Luggage Americas — Segment operations consist of product design, manufacturing, marketing, and sales of soft shell luggage in the US

Luggage Europe — Segment operations consist of manufacturing, marketing, and sales of soft shell luggage in Europe.

Other Accessories — Segment operations consist of product design, marketing, and sales of handbags, briefcases, and sports bags, primarily in the US

All Other — Operations consist of marketing and sales of luggage and accessories in certain international markets and the design, marketing, and sales of storage cases.

The accounting policies of the segments are the same as those described in the "Summary of Significant Accounting Policies" for FSP Corp. FSP Corp evaluates the performance of its segments and allocates resources to them based on gross margin and operating income. Segment gross margin and segment operating income includes intersegment revenues, as well as a charge allocating all corporate headquarters costs.

For all of the segments, the CODM uses segment gross margin and segment operating income in the annual budgeting and forecasting process.

The CODM considers budget-to-actual variances on a monthly basis for both profit measures when making decisions about allocating capital and personnel to the segments.

The CODM also uses segment gross margin for evaluating product pricing and segment operating income to assess the performance for each segment by comparing the results and return on assets of each segment with one another.

The CODM uses segment gross margin and segment operating income in determining the compensation of certain employees.

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[1] Note: For this illustrative example, only two years of segment results are presented. SEC registrants typically require the presentation of three years of segment results.

The table below presents information about reported segments for the years ending December 31:

20X2

($ in thousands)

	Luggage Americas	Luggage Europe	Other accessories	All other	Total
Sales	$920	$460	$255	$225	$1,860
Gross margin	$284	$144	$101	$46	$575
Operating income	$170	$93	$65	$36	$364

20X1

($ in thousands)

	Luggage Americas	Luggage Europe	Other accessories	All other	Total
Sales	$885	$425	$230	$202	$1,742
Gross margin	$273	$133	$91	$41	$538
Operating income	$164	$86	$58	$32	$340

A reconciliation of total segment sales to total consolidated sales and of total segment gross margin and segment operating income to total consolidated income before income taxes, for the years ended December 31, 20X2 and 20X1, is as follows:

20X2

($ in thousands)

	Luggage Americas	Luggage Europe	Other accessories	All other	Total
Sales from external customers	$860	$460	$255	$225	$1,800
Intersegment sales	60	-	-	-	60
Total segment sales	920	460	255	225	$1,860
Reconciliation of sales					
Elimination of intersegment sales					(60)

($ in thousands)

	Luggage Americas	Luggage Europe	Other accessories	All other	Total
Total consolidated sales					$1,800
Less:					
Cost of sales	636	316	154	179	1,285
Segment gross margin	284	144	101	46	$575
Less:					
Depreciation and amortization	20	14	12	4	50
Marketing expense	62	31	21	2	116
Other segment items (a)	32	6	3	4	45
Segment operating income	170	93	65	36	$364
Reconciliation to income before income taxes					
Other income (expense), net					(50)
Intersegment profit					(15)
Interest income (expense), net					(80)
Income before income taxes					$219

20X1

($ in thousands)

	Luggage Americas	**Luggage Europe**	**Other accessories**	**All other**	**Total**
Sales from external customers	$845	$425	$230	$202	$1,702
Intersegment sales	40	-	-	-	40
Total segment sales	885	425	230	202	$1,742
Reconciliation of sales					
Elimination of intersegment sales					(40)
Total consolidated sales					$1,702
Less:					
Cost of sales	612	292	139	161	1,204
Segment gross margin	273	133	91	41	$538
Less:					
Depreciation and amortization	18	13	11	3	45
Marketing expense	61	28	19	2	110
Other segment items (a)	30	6	3	4	43
Segment operating income	164	86	58	32	$340
Reconciliation to income before income taxes					
Other income (expense), net					(45)

($ in thousands)

	Luggage Americas	Luggage Europe	Other accessories	All other	Total
Intersegment profit					(11)
Interest income (expense), net					(70)
Income before income taxes					$214

(a) Other segment items for each reportable segment includes:

- Luggage Americas – selling and administrative expenses, research and development expenses, professional services expense and certain overhead expenses
- Luggage Europe – selling and administrative expenses, professional services expense, and certain overhead expenses
- Other Accessories – travel expenses, research and development expenses, and certain overhead expenses
- All Other – maintenance expense, professional services expense and certain overhead expenses

The following tables present sales and long-lived asset information by geographic area for the years ended December 31, 20X2 and 20X1. Asset information by segment is not reported internally or otherwise regularly reviewed by the CODM.

Sales ($ in thousands)	**20X2**	**20X1**
United States	$1,260	$1,191
Germany	177	170
Italy	180	175
All Other Foreign	183	166
	$1,800	$1,702

Long-lived Assets ($ in thousands)	**20X2**	**20X1**
United States	$1,090	$1,035
Foreign	260	245
	$1,350	$1,280

Foreign revenue is based on the country in which the legal subsidiary is domiciled.

25.9 Segment reporting considerations for private companies

If a private company elects to apply the goodwill accounting alternative in ASC 350-20, *Intangibles-Goodwill and Other*, and further elects to test goodwill for impairment at the entity level (rather than at a reporting unit level), the application of ASC 280 (to identify operating segments as a starting point for determining reporting units) would not be applicable. See FSP 25.2 (after ASU 2023-07) and FSP 25.2A (before ASU 2023-07) for discussion of private companies that have not elected to apply the goodwill accounting alternative in ASC 350-20 or that have elected to apply the alternative but still test goodwill impairment at the reporting unit level.

While the disclosures of ASC 280 are not required for private companies, some private companies believe these elective disclosures are meaningful to the financial statement users, particularly those that anticipate an initial public offering in the near term. A private company that chooses to disclose segment information need not apply the disclosure requirements of ASC 280 in their entirety.

Chapter 26: Related parties—updated February 2022

26.1 Related parties overview

Transactions with parties related to a reporting entity are relatively common. However, transactions involving related parties cannot be presumed to be carried out on an arm's-length basis. As such, disclosure of related party transactions enables users of financial statements to evaluate their impact to the financial statements. ASC 850, *Related Party Disclosures,* is the primary accounting guidance on this topic, coupled with certain SEC guidance. This chapter describes the presentation and disclosure requirements and provides examples of common related party relationships and transactions.

26.2 Related party scope and relevant guidance

ASC 850 covers transactions and relationships with related parties. It applies to all reporting entities, including the separate financial statements of a subsidiary, as discussed in ASC 850-10-15-2. Identifying related party relationships and transactions requires a reporting entity to first determine whether a party meets the definition of a "related party."

ASC 850-10-20

Related parties include:

a. Affiliates of the entity

b. Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825-10-15, to be accounted for by the equity method by the investing entity

c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management

d. Principal owners of the entity and members of their immediate families

e. Management of the entity and members of their immediate families

f. Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests

g. Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests

Certain terms used in the definition of related parties are specifically defined by ASC 850.

Definitions from ASC 850-10-20

Affiliate: A party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an entity.

Control: The possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an entity through ownership, by contract, or otherwise.

Immediate family: Family members who might control or influence a principal owner or a member of management, or who might be controlled or influenced by a principal owner or a member of management, because of the family relationship.

Management: Persons who are responsible for achieving the objectives of the entity and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management normally includes members of the board of directors, the chief executive officer, chief operating officer, vice presidents in charge of principal business functions (such as sales, administration, or finance), and other persons who perform similar policy making functions. Persons without formal titles also may be members of management.

Principal owners: Owners of record or known beneficial owners of more than 10% of the voting interests of the entity.

Question FSP 26-1

Do any of the rules and regulations addressing related parties that have been issued by the SEC impact the ASC 850 definition of a related party?

PwC response

No. For purposes of the financial statements, S-X 1-02 refers to the definition of related parties in US GAAP. Other SEC rules (e.g., S-K 404) contain interpretations or definitions of certain terms that, while similar to those used in ASC 850, only apply to the term as used in those specific rules and, therefore, do not impact how a related party is defined in ASC 850.

The SEC believes that reporting entities should consider whether to disclose information about parties that fall outside the definition of a related party, but with whom a relationship exists that enables the parties to negotiate terms of material transactions that may not be available for other, more clearly independent, parties on an arm's-length basis. This could include, for example, doing business with former management. The SEC believes that reporting entities should disclose such circumstances when a user of the financial statements may not be able to understand the reporting entity's results of operations without a clear explanation of these arrangements and relationships.

Question FSP 26-2

If an individual is a member of the board of directors for both Entity A and Entity B, should Entity A and Entity B be considered related parties?

PwC response

Generally, Entity A and Entity B would not be considered related parties to one another based solely on the fact that they have a common board member. The board member would meet the definition of a

related party of both Entity A and Entity B as board members are typically considered "management" as defined by ASC 850. However, the definition of a related party does not result in Entity A and Entity B being related parties simply because of a common director. We believe that a member of the board of directors of two separate reporting entities—taking into account both the rights conveyed to directors via their board seat as well as their fiduciary responsibilities to shareholders—would generally not have the ability to control or significantly influence the management or operating policies of either entity to an extent that one or both of the entities might be prevented from fully pursuing their own separate interests. However, additional analysis should be performed to determine if the entities meet any of the other aspects of the definition of a related party. For example, further consideration would generally be needed if the board member, through other relationships, rights, or interests, can control or significantly influence the management or operating policies of one or both entities.

Question FSP 26-3

Does ASC 850 specify who should be considered an immediate family member of a member of management or a principal owner?

PwC response

No. ASC 850-10-20 provides a broad definition of the term "immediate family," but the definition is not prescriptive. Therefore, judgment should be applied in evaluating whether an immediate family member might control or influence a principal owner or a member of management or whether an immediate family member might be controlled or influenced by a principal owner or a member of management.

The SEC has defined the term "immediate family" in S-X 2-02 and 9-03 and S-K 404. Each of these definitions are more prescriptive than the ASC 850 definition. We believe that these definitions may influence a reporting entity's process for identifying related parties; however, given that the definition in ASC 850 is not explicit and allows for judgment to be exercised, we do not necessarily believe that all individuals included in the SEC definitions are required to be designated as related parties of the reporting entity to comply with ASC 850. However, SEC registrants are required to utilize the relevant definitions of immediate family within Regulations S-X and S-K for all specific SEC reporting requirements, where applicable.

Question FSP 26-4

Does ASC 850 specify which individuals should be considered members of management?

PwC response

No. ASC 850-10-20 defines the term management; however, this definition is not prescriptive and allows for judgment to be exercised in determining which members within a reporting entity constitute members of management.

The following factors, which are not meant to be all inclusive, are helpful to consider when evaluating which individuals constitute management for purposes of applying ASC 850:

- *The structure of the reporting entity*

  Similar to segment reporting, understanding the structure of the reporting entity is important to ensure the appropriate identification of those individuals who may constitute management. For instance, a reporting entity with a flat structure generally will have more individuals who are considered management compared to a reporting entity with multiple management layers. There are no bright lines with regard to the minimum or maximum position an individual needs to hold within a reporting entity to be considered management. Rather, identifying members of management is based on identifying those individuals who are responsible for achieving the objectives of the reporting entity and who have the authority to establish policies and make decisions by which those objectives are to be pursued.

- *Management over principal owners*

  The management of principal owners should be considered, as well as any other relationships identified at a level above the reporting entity, such as parties that control or significantly influence the reporting entity. For example, individuals at a private equity fund level may participate in the policy making and key decisions of portfolio companies and should be considered as potential members of management at the portfolio company.

- *The board of directors*

  Although members of the board of directors are typically independent from management, members of the board of directors would be considered management based on the definition in ASC 850.

26.3 Related party presentation matters

S-X 4-08(k) requires reporting entities to identify material related party transactions on the face of the balance sheet, income statement, or statement of cash flows to draw attention to their existence. SEC guidance also specifically requires disclosure of receivables due from related parties, securities of related parties, and indebtedness of related parties on the face of the balance sheet.

In addition, certain US GAAP topics also require separate identification of material items on the face of the financial statements, including receivables (ASC 310), investments (ASC 323), payables (ASC 405), and equity (ASC 505).

For example, a reporting entity should separately identify amounts of revenue earned from or expenses incurred to a related party on the face of its income statement. ASC 850 also specifies that a reporting entity should separately identify accounts or notes receivable from officers, employees, or affiliated entities on its balance sheet and not include such items under a general heading such as accounts receivable or notes receivable.

26.4 Related party disclosures

The disclosure provisions of ASC 850 are intended to enable users of financial statements to evaluate the nature and financial effects of related party relationships and transactions. In general, the disclosures outlined below are required when the financial statements include material related party

transactions. However, related party transactions are subject to these disclosure requirements even if they are not given accounting recognition in the financial statements.

Related party transactions that occur in the ordinary course of business may not require the same extent of disclosure. In some situations, the relationship's effect on the financial statements may be pervasive enough that disclosing the relationship alone is sufficient. Regardless, SEC registrants need to include sufficient disclosure to address SEC requirements, including S-X 4-08(k).

It may be appropriate to aggregate similar transactions by type of related party. Before aggregating, the reporting entity should consider whether disclosure of the name of a related party is necessary for a user to understand the relationship.

Related party transactions eliminated in the preparation of consolidated or combined financial statements are not required to be disclosed in those statements.

ASC 850 provides guidance on related party disclosures.

Excerpt from ASC 850-10-50-1

The disclosures shall include:

a. The nature of the relationship(s) involved

b. A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, for each of the periods for which income statements are presented, and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements

c. The dollar amounts of transactions for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period

d. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement

e. The information required by paragraph 740-10-50-17

ASC 740-10-50-17

An entity that is a member of a group that files a consolidated tax return shall disclose in its separately issued financial statements:

a. The aggregate amount of current and deferred tax expense for each statement of earnings presented and the amount of any tax-related balances due to or from affiliates as of the date of each statement of financial position presented

b. The principal provisions of the method by which the consolidated amount of current and deferred tax expense is allocated to members of the group and the nature and effect of any changes in that method (and in determining related balances to or from affiliates) during the years for which the above disclosures are presented

The above disclosures are incremental to the identification of related party transactions on the face of the financial statements.

26.4.1 *Disclosures about common control relationships*

A reporting entity may also need to consider whether to disclose common control ownership or common management with other entities, even if there have not been any transactions with those entities.

ASC 850-10-50-6

If the reporting entity and one or more other entities are under common ownership or management control and the existence of that control could result in operating results or financial position of the reporting entity significantly different from those that would have been obtained if the entities were autonomous, the nature of the control relationship shall be disclosed even though there are no transactions between the entities.

26.4.2 *Disclosures about arm's-length basis of transactions*

Transactions involving related parties cannot be presumed to be at arm's length. As discussed in ASC 850-10-50-5, a reporting entity should only disclose that a transaction was at arm's length when it can substantiate such a representation.

For example, a reporting entity may want to disclose that a loan arrangement between the reporting entity and a related party is at arm's length. Such disclosure would only be appropriate if the reporting entity is able to substantiate that the terms of the loan are equivalent to terms it would have obtained with an unrelated lender. Similarly, a reporting entity may sell services to third parties and related parties at the same rate. In this situation, the reporting entity may be able to substantiate that the transactions occur at arm's length.

26.5 *Common related party transactions*

In order to comply with the related party disclosure requirements, a reporting entity must identify all of its transactions with related parties.

ASC 850 provides examples of common transactions with related parties.

ASC 850-10-05-4

Transactions between related parties commonly occur in the normal course of business. Examples of common transactions with related parties are:

a. Sales, purchases, and transfers of real and personal property

b. Services received or furnished, such as accounting, management, engineering, and legal services

c. Use of property and equipment by lease or otherwise

d. Borrowings, lendings, and guarantees

e. Maintenance of compensating bank balances for the benefit of a related party

f. Intra-entity billings based on allocations of common costs

g. Filings of consolidated tax returns.

As noted in ASC 850-10-05-4, this is not an all-inclusive list. A reporting entity may identify additional related parties based on analysis of its individual circumstances. Once a related party transaction is identified, a reporting entity should determine the appropriate presentation and disclosure based on the requirements in ASC 850, SEC guidance (if applicable), and other relevant guidance, if any. Reporting entities should consider the substance of the related party transaction, which could be different than the legal form of the arrangement, when determining the appropriate presentation and disclosure.

The following sections discuss presentation and disclosure considerations for some common related party relationships.

26.5.1 Disclosure of related party equity method investments

Equity method investees are, by definition, related parties of the equity holder. A reporting entity could also hold investments in other related parties, including partnerships or joint ventures. In addition to the disclosures in FSP 26.4, refer to FSP 10 for information about disclosures for such investments. Application of the ASC 825-10-15 fair value option to an equity method investment does not generally reduce disclosure requirements.

Example FSP 26-1 illustrates the determination of whether transactions between a reporting entity's equity method investments should be disclosed in the reporting entity's financial statements.

EXAMPLE FSP 26-1

Transactions between equity method investees

FSP Corp owns 20% of Investee A, a manufacturer, and 30% of Investee B, a retailer. Investee A and Investee B are unrelated entities. Investee A sells finished goods to Investee B in the ordinary course of business.

Should FSP Corp disclose the transactions between Investee A and Investee B as related party transactions in its consolidated financial statements?

Analysis

No. Investee A and Investee B are related parties to FSP Corp; however, Investee A and Investee B would not be considered related parties to one another as the relationship between these entities does not meet the definition of a related party in ASC 850-10-20. FSP Corp has an ownership interest in both entities and can significantly influence the management and operating policies of both entities; however, FSP Corp does not control either entity and, therefore, is unable to prevent one or both of the entities from fully pursuing its own separate interests. Accordingly, any transactions between Investee A and Investee B would not be reflected as related party transactions in FSP Corp's consolidated financials.

26.5.2 Related party leasing arrangements

Use of a reporting entity's property and equipment by a related party, or use of a related party's property and equipment by the reporting entity, is often subject to the terms of a lease. In addition to the disclosures in FSP 26.4, a reporting entity with related party leases should include the required lease disclosures (see FSP 14).

26.5.3 *Disclosure of related party debt*

Related parties may also have borrowing and lending relationships. Common examples include lending relationships between parents and subsidiaries, among subsidiaries, between advisors and funds they advise, and between shareholders and the companies in which they invest, among others. A reporting entity should disclose the terms of related party lending relationships upon issuance and while the debt remains outstanding, consistent with the disclosures discussed in FSP 12.

As discussed in ASC 470-50-40-2, upon modification or extinguishment of related party debt, a reporting entity should consider whether the modification or extinguishment transaction is, in substance, a capital transaction. Refer to FG 3.3.5 for further discussion. If the reporting entity concludes that it is a capital transaction, it should provide the disclosures discussed in FSP 5.

If affiliates' securities constitute a substantial portion of the collateral for any class of an SEC-registered (or to be registered) reporting entity's securities, the reporting entity may need to include the affiliates' separate financial statements in certain SEC filings, as required by S-X 3-16.

Question FSP 26-5

Are there disclosures that a reporting entity should consider with regard to related party debt arrangements that are incremental to the debt disclosures required by ASC 470?

PwC response

Yes. Because related party debt may not be issued in an arm's-length transaction, a reporting entity should consider disclosure of certain information in addition to the lending terms required to be disclosed by ASC 470—for example, commitment fees or fees incurred to structure the debt. A reporting entity should also consider disclosing circumstances in which unused commitments for long-term financing arrangements may be withdrawn. For example, an investor may lend to an equity method investee but limit the capacity of the loan to the amount that it has available on its line of credit with a third-party lender.

Question FSP 26-6

Is a loan to a related party subject to an allowance for current expected credit losses (for an entity has adopted ASU 2016-13, *Measurement of Credit Losses on Financial Instruments*)?

PwC response

Maybe. The current expected credit losses model does not apply to loans and receivables between entities under common control. However, there is no scope exemption for loans and receivables from related parties that do not have a common controlling shareholder.

26.5.4 *Related party guarantees*

A reporting entity may make guarantees for the benefit of related parties. In those cases, the guarantor is required to comply with the related party disclosure requirements discussed in FSP 26.4, as well as the disclosures included in other applicable GAAP, including those applicable to guarantees (see FSP 23), equity method investments (see FSP 10), and variable interest entities (see FSP 18), as applicable.

Under US securities laws, a guarantee (whether registered or to be registered) of a security that is registered or to be registered is considered to be a security separate and apart from the security it guarantees. Reporting entities with these circumstances should consider the guidance in S-X 3-10 and FSP 12.

26.5.5 Equity held by related parties

Related party arrangements are common between a reporting entity and its shareholders. Securities held by related parties may be different classes of common or preferred equity, or have different rights such as liquidation preferences, voting rights, or dividend rights. These special terms may need to be disclosed as related party transactions.

The SEC requires certain disclosures when a reporting entity is restricted in its ability to transfer or dividend assets (cash or other assets) from its subsidiaries. SEC registrants should comply with the disclosure requirements in S-X 4-08(e).

26.5.6 Advances to and receivables from related parties

A reporting entity may enter into arrangements that result in advances to, or receivables from, shareholders that could have presentation or disclosure implications. Refer to FG 4.5 for further discussion.

Related party receivables from the sale of equity have specific presentation and disclosure requirements. Refer to FSP 5 for further discussion.

26.5.7 Related party business combinations

A business combination may include the settlement of a preexisting relationship such as between a vendor and customer, licensor and licensee, or plaintiff and defendant. If the counterparty in the preexisting relationship was a related party before the business combination, a reporting entity should consider appropriate disclosure in accordance with the principles underlying ASC 850. For disclosures related to business combinations, including those related to the settlement of a preexisting relationship, refer to FSP 17. If the business combination involves entities under common control, the measurement of the transaction may also be impacted. See further discussion in FSP 26.5.11.

26.5.8 Deconsolidation of a subsidiary

ASC 810 provides guidance for deconsolidation of a subsidiary that meets the definition of a business on a prospective basis as a result of an event. In the period that a subsidiary that meets the definition of a business is deconsolidated, it requires the reporting entity to disclose: (1) whether the transaction that resulted in the deconsolidation or derecognition was with a related party and (2) whether the former subsidiary or entity acquiring the assets will be a related party after deconsolidation. See FSP 18.7.2 for further discussion.

26.5.9 Compensation arrangements among related parties

Compensation arrangements among related parties can take many forms, including royalty arrangements or payments made or received for various services, such as accounting, management, engineering, marketing, and legal services. They can include payments of cash, other assets, or equity.

These arrangements can result in compensation at levels that are not commensurate with market rates.

In addition to the disclosures described in FSP 26.4, SEC FRM 7220.1 also requires a reporting entity to provide quantified disclosure of significant related party compensation arrangements that resulted in below market compensation expense.

As noted in ASC 850-10-50-1, certain compensatory arrangements between related parties may occur in the ordinary course of business, such as compensation arrangements, expense allowances, and other similar items, and may not meet the requirement for disclosure. For example, a private company whose only employees are its owners may not need to provide detail about compensation arrangements beyond their existence even though compensation is being paid to related parties.

26.5.10 Related party franchisor relationships

A franchise arrangement may constitute a related party relationship. For example, a franchisor may own outlets that it also operates, or significantly influence the management or operating policies of the franchisee such that the franchisee might be prevented from fully pursuing its own separate interests. ASC 952-605-45 requires franchisors to distinguish revenue and costs related to franchisor-owned outlets from revenue and costs related to franchised outlets where practicable. ASC 952-605-50-3 also requires disclosures about significant changes in franchisor-owned outlets.

26.5.11 Common control transactions

Some related party transactions involve transactions between entities under common control, such as a transfer of a business or a combination of businesses. These transactions could result in a change in the reporting entity. For more on the presentation and disclosure requirements associated with a change in reporting entity, refer to FSP 30. See BCG 7 for details on assessing whether common control exists and for additional guidance on accounting for combinations between entities or businesses under common control.

Question FSP 26-7

Should expenses incurred by a parent on behalf of its subsidiary be disclosed as a related party transaction in the separate financial statements of the subsidiary?

PwC response

Yes. All transactions entered into between the parent and its subsidiary, including the allocation of any expenses incurred by the parent on behalf of its subsidiary (as required by SAB Topic 1.B), should be considered related party transactions because the two entities meet the definition of affiliates. The treatment of such transactions is consistent with the guidance in ASC 850-10-05-4, which specifically identifies intra-entity billings based on allocations of common costs as a common related party transaction.

26.6 Related party considerations for private companies

The guidance in ASC 850 applies equally to public and private companies. SEC requirements discussed in this chapter apply only to SEC registrants. Figure FSP 26-1 summarizes the SEC requirements discussed in this chapter.

Figure FSP 26-1

Presentation and disclosure requirements applicable only to SEC registrants

Description	Reference	Section
Disclose certain information about parties that fall outside of the definition of a related party	SEC FRM 9610.3	FSP 26.2
Identify the related party transaction on the face of the financial statements[1]	S-X 4-08(k)	FSP 26.3
Include a related party's separate financial statements in certain SEC filings if a related party's securities constitute a substantial portion of the collateral for any class of an SEC-registered reporting entity's securities	S-X 3-16	FSP 26.5.3
Include the financial statements of a guarantor who guarantees a registered security	S-X 3-10	FSP 26.5.4
Disclose certain information when a reporting entity is restricted in its ability to transfer or dividend assets from its subsidiaries	S-X 4-08(e)	FSP 26.5.5
Include quantified disclosure of significant compensation arrangements with related parties that result in below market compensation expense	SEC FRM 7220.1	FSP 26.5.9

Other areas of US GAAP may require disclosure of related party transactions on the face of the financial statements for both public and private companies. Refer to FSP 26.3.

Chapter 27: Discontinued operations—updated May 2023

27.1 Discontinued operations—overview

US GAAP requires presentation of discontinued operations in financial statements in certain circumstances. The objective of the requirement is to provide users with information about the portion of a reporting entity's operations that will not continue and to provide historical financial results comparable with a company's continuing operations.

This chapter provides guidance on evaluating whether a component of a reporting entity meets the criteria for discontinued operations reporting, and the presentation and disclosure requirements for reporting discontinued operations.

The guidance on presenting discontinued operations in the statement of cash flows is addressed in FSP 6 and the impact on earnings per share is addressed in FSP 7. For guidance on the held-for-sale accounting model of long-lived assets, see PPE 5.3.

27.2 Discontinued operations—scope and relevant guidance

A reporting entity that disposes of a component or has a component that qualifies as held for sale may meet the criteria for presentation as a discontinued operation in accordance with ASC 205-20, *Presentation of financial statements—Discontinued operations*. The guidance applies to business entities and not-for-profit entities. However, oil and gas properties that are accounted for using the full-cost method of accounting are not in the scope of the guidance. Once determined to be within the scope of ASC 205-20, the discontinued operations disclosure requirements should be followed in lieu of, and not in addition to, other disclosure requirements.

27.3 Criteria for reporting discontinued operations

A component is defined in ASC 205-20-20.

Definition from ASC 205-20-20

Component of an entity: A component of an entity comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. A component of an entity may be a reportable segment or an operating segment, a reporting unit, a subsidiary, or an asset group.

We do not believe that a component can be at a lower level than an asset group because, in order to be a component, the cash flows must be clearly distinguishable from the rest of the reporting entity.

For a component to qualify as a discontinued operation at the balance sheet date, it must meet the criteria in ASC 205-20-45-1B which states the component must either be disposed of (e.g., through sale, abandonment, or spin-off), or meet the held-for-sale criteria of ASC 205-20-45-1E. It must also represent a strategic shift that has (or will have) a major effect on the reporting entity's financial results.

Long-lived assets may be disposed of individually or as part of a disposal group. The guidance defines a disposal group.

Definition from ASC 205-20-20

Disposal group: A disposal group for a long-lived asset or assets to be disposed of by sale or otherwise represents assets to be disposed of together as a group in a single transaction and liabilities directly associated with those assets that will be transferred in the transaction. A disposal group may include a discontinued operation along with other assets and liabilities that are not part of the discontinued operation.

Question FSP 27-1 addresses whether an entity can consider an operation a component when the entity sells the operation but retains certain assets.

Question FSP 27-1

Can a reporting entity that sells an operation but retains certain assets associated with the operation (e.g., working capital or a facility) consider the operation a component of the reporting entity?

PwC response

It depends. Although the retained assets would not be part of the disposal group, the operations and cash flows associated with the assets to be sold may still constitute a component of a reporting entity as defined in ASC 205-20-20. In that situation, the results of operations of the component would be classified as discontinued operations provided the conditions of ASC 205-20 are met.

A reporting entity's assessment of whether a component qualifies for discontinued operations reporting should occur when the component initially meets the criteria to be classified as held for sale in accordance with ASC 205-20-45-1E. The held for sale criteria in ASC 205-20-45-1E are the same six criteria as those set forth in ASC 360-10-45-9 (see FSP 8.6.2). Changes in circumstances that occur after the balance sheet date, but prior to issuance of the financial statements, should not be considered in evaluating whether the component would be classified as held for sale at the balance sheet date.

For abandonments, spin-offs, and exchanges, the assessment should take place when the component is disposed of. If a reporting entity has a disposal strategy that involves the "run-off" of operations (e.g., the reporting entity will cease accepting new business but will continue to provide services under existing contracts until they expire or terminate), discontinued operations should not be reported until substantially all operations, including run-off operations, cease.

27.3.1 Strategic shift and major effect

A component (or a group of components) of a reporting entity that is disposed of or meets the criteria to be classified as held for sale should be reported in discontinued operations if the disposal represents a strategic shift that has (or will have) a major effect on a reporting entity's operations and financial results. ASC 205-20-45 provides examples of what may qualify as a strategic shift.

Excerpt from ASC 205-20-45-1C

Examples of a strategic shift that has (or will have) a major effect on an entity's operations and financial results could include a disposal of a major geographical area, a major line of business, a major equity method investment, or other major parts of an entity.

A reporting entity's assessment of whether a disposal of a component represents a strategic shift that has (or will have) a major effect on its operations and financial results should consider quantitative and qualitative factors. No single factor is determinative. As such, the less significant a component is from a quantitative perspective, the more persuasive the qualitative evidence should be to support discontinued operations reporting.

The assessment of what qualifies as a strategic shift is based on qualitative and quantitative factors specific to the reporting entity. For example, a reporting entity that only operates in the Northeast region of the US may conclude that each state represents a major geographical area. In contrast, a multinational reporting entity may conclude that each continent represents a major geographical area.

A component may be a reportable segment, an operating segment, a reporting unit, a subsidiary, or an asset group. Disposing of an entire reportable segment is a strong qualitative factor supporting that a strategic shift has occurred. A reporting entity should consider all relevant factors, including the extent to which the component's performance was previously disclosed in MD&A, earnings releases, and other communications, in determining whether the disposal represents a strategic shift.

Once a reporting entity determines that a disposal constitutes a strategic shift, it must determine whether the disposal has had (or will have) a major effect on the reporting entity's operations and financial results for the disposal to be considered a discontinued operation. A reporting entity should consider key financial metrics when evaluating the quantitative impact of a disposal, including assets, net assets, revenues, operating income, pretax income, net income, operating cash flows, and key non-GAAP measures. In terms of the evaluation period, we believe the emphasis should be placed on the most recently completed, current, and next annual reporting periods. The guidance does not provide any "bright lines" on what qualifies as a major effect. However, it does include five examples:

- The sale of a product line that represents 15% of total revenues
- The sale of a geographical area that represents 20% of total assets
- The sale of all of one type of a reporting entity's store formats that historically provided 30% to 40% of the reporting entity's net income and 15% of current period net income
- The sale of an equity method investment that represents 20% of the reporting entity's total assets
- The sale of 80% of a product line that accounts for 40% of total revenue, but the seller retains 20% of its ownership interest

Significant continuing involvement with or continuing cash flows related to a disposed component does not preclude a reporting entity from presenting those components as discontinued operations. However, reporting entities should consider the nature and extent of continuing involvement in evaluating whether there has been a strategic shift that has (or will have) a major effect on their operations and financial results.

A discontinued operation may be a single component or a group of components. When a reporting entity disposes of multiple components, each component should generally be evaluated individually, and only components that meet the criteria for discontinued operations treatment should be reported as discontinued operations. However, there may be circumstances when a group of components should be evaluated together to determine whether the criteria for discontinued operations have been met. Such circumstances may include instances when multiple components are being sold under a single disposal plan, in a single transaction, or to a single buyer.

Example FSP 27-1 addresses when the disposal of two components should be combined for purposes of determining whether they constitute a discontinued operation.

EXAMPLE FSP 27-1

Evaluating a group of components in a single plan of disposal

In the first quarter of 20X1, FSP Corp's board of directors approved the sale of a major business line, which consists of Component A and Component B. The business line to be sold is a reportable segment. FSP Corp announced the disposal plan as a single plan but will sell Component A and Component B in two separate transactions to different buyers. While neither Component A nor Component B would meet the criteria for discontinued operations individually, together they represent a strategic shift that has a major effect on FSP Corp's operations and financial results. Based on the held-for-sale criteria in ASC 205-20-45-1E, Component A was classified as held-for-sale beginning March 31, 20X1, while Component B was classified as held-for-sale beginning June 30, 20X1.

Should Component A and Component B be presented as discontinued operations and, if so, in which period is such classification appropriate?

Analysis

As Component A and Component B were part of a single plan of disposal and both met the held-for-sale criteria within a short period of time, we believe FSP Corp should present Component A and Component B as discontinued operations as of June 30, 20X1, as this is the date on which both components comprising the disposal plan were considered held for sale and therefore met the criteria to be classified as discontinued operations.

If a plan of disposal involves one component to be disposed of through multiple disposal transactions, discontinued operations is only appropriate at the point-in-time that the entire component meets the criteria for discontinued operations. If significant time passes between the disposals of portions of the component (e.g., a year or more), it may be difficult to conclude that the disposals are part of a single component.

Reporting entities that prepare subsidiary financial statements should separately evaluate whether a strategic shift has occurred and whether it has (or will have) a major effect on the reporting entity's operations and financial results at each level. A subsidiary may reach a different conclusion than its parent.

27.3.1.1 Acquired business that qualifies as held for sale upon acquisition

Any business or nonprofit activity that upon acquisition meets the held for sale criteria is required to be presented as a discontinued operation regardless of whether it represents a strategic shift that has (or will have) a major effect on a reporting entity's operations and financial results. The held-for-sale criteria in ASC 205-20-45-1E(d) is the only criteria required to be met at the acquisition date, but the remaining criteria should be probable of being met within a short period of time following the acquisition date, which is usually within three months.

The objective of this requirement is to include in discontinued operations those businesses that will never be considered part of a reporting entity's continuing operations.

27.4 Discontinued operations—presentation

This section provides guidance on the balance sheet and income statement presentation requirements when reporting discontinued operations. The statement of stockholders' equity is not impacted by discontinued operations reporting. For reporting on the statement of cash flows, see FSP 6.

27.4.1 Discontinued operations—balance sheet

ASC 205-20-45-10 includes guidance on the presentation of discontinued operations in the statement of financial position.

Excerpt from ASC 205-20-45-10

In the period(s) that a discontinued operation is classified as held for sale and for all prior periods presented, the assets and liabilities of the discontinued operation shall be presented separately in the asset and liability sections, respectively, of the statement of financial position.

Even if a discontinued operation is disposed of by sale before the end of a reporting period and therefore there are no assets and liabilities held for sale to be presented at the current balance sheet date, the assets and liabilities of the discontinued operation must be presented separately in the prior period balance sheet. See FSP 8.6.2 for guidance on the balance sheet classification of assets held for sale that do not qualify for discontinued operations.

Reporting entities must disclose separately, either on the balance sheet or in the footnotes, the major classes of assets and liabilities of a discontinued operation for all periods presented. While the guidance does not specify how to determine which classes of assets and liabilities held for sale should be considered major, an example included in the guidance included cash, trade receivables, inventories, property, plant and equipment, trade payables, and short-term borrowings.

ASC 205-20 does not provide specific guidance on current and noncurrent classification of assets held for sale. However, assets and liabilities are usually further disaggregated and presented with separate line items for current and noncurrent assets, and current and noncurrent liabilities. To classify all assets and liabilities as current, reporting entities should consider whether the transaction is expected to be consummated within one year of the balance sheet date and the guidance in ASC 210-10-45-4 about whether the reporting entity expects to use the proceeds from the sale to reduce long-term borrowings. If the transaction is expected to be completed within one year and the proceeds are not expected to be used to pay down long-term borrowings, current classification is acceptable. However,

even when current classification is acceptable for the current period balance sheet, balance sheets for prior periods should present current and noncurrent assets and liabilities.

If the major classes of assets and liabilities of a discontinued operation classified as held for sale are disclosed in the footnotes, reporting entities must reconcile the disclosure to the total assets and total liabilities of the disposal group classified as held for sale presented on the face of the balance sheet for all periods presented. If the disposal group includes assets and liabilities that are not part of the discontinued operation, the reconciliation should show them separately from the assets and liabilities of the discontinued operation.

In a spin-off transaction that qualifies as a discontinued operation, ASC 205-20-45-10 requires retrospectively separating the assets and liabilities of the entity being spun off (similar to if the entity had been held for sale) in the prior period balance sheets. However, because the assets disposed of through a spin-off transaction are required to remain classified as held and used until the spin-off has occurred, reclassification of the prior year balance sheet would not be appropriate until the spin-off is completed.

27.4.2 Discontinued operations—income statement

A reporting entity with a component that meets the conditions for discontinued operations should report the results of operations of the component, less applicable income taxes (benefit), as a separate component of income before cumulative effect of change in accounting principles (if applicable). A reporting entity should separately present the gain or loss recognized on the disposal (and/or any loss recognized upon and during classification as held for sale) of the discontinued operation either on the face of the income statement or in the footnotes. Figure FSP 27-1 illustrates an income statement when a reporting entity reports a discontinued operation:

Figure FSP 27-1

Income statement presentation of discontinued operations

	Amount
Income from continuing operations, net	$xxx,xxx
Discontinued operations:	
Loss from operations of discontinued Component X	
(including loss on disposal of $xxx,xxx)	(xxx,xxx)
Income tax benefit	xxx,xxx
Loss on discontinued operations	(xxx,xxx)
Net income	$xxx,xxx

Costs associated with an exit or disposal of a discontinued operation are required by ASC 420-10-45-2 to be included in the results of discontinued operations. Additionally, losses (as measured under the held for sale model) that directly involve a discontinued operation should be included in the loss on disposal of discontinued operations.

The expenses that qualify for inclusion in discontinued operations are the direct operating expenses incurred by the disposed component that may be reasonably segregated from costs of the ongoing reporting entity. Indirect expenses, such as allocated corporate overhead, should not be included in discontinued operations based on ASC 205-20-45-9. Generally, costs and expenses that are expected to continue in the ongoing reporting entity after the disposal date should not be allocated to discontinued operations and instead should be included in the results of continuing operations.

Examples of direct costs that may be reported in discontinued operations include:

- Personnel expenses for employees employed by the disposed component
- Intangible asset amortization associated with intangible assets disposed of in the transaction
- Lease-related costs for facilities that were used by the disposed component
- Interest expense associated with debt to be assumed by the buyer or repaid in conjunction with the disposal (see FSP 27.4.2.4)
- Third-party transaction costs associated with the disposal

Although usually an allocation, income tax amounts associated with the component being disposed of should be reported in discontinued operations. See TX 12 for additional information on the intraperiod allocation of income tax amounts to discontinued operations.

If sales have been made to the discontinued operation by a consolidated affiliate and have been eliminated in consolidation, it would be appropriate to recast these sales (and the related costs) in continuing operations for periods prior to the disposal or held-for-sale date only if these sales will be made to third parties (e.g., the disposed component that is now a third party) subsequent to the disposition.

Example FSP 27-2 illustrates the income statement presentation of an intercompany transaction with a disposed component that will continue after the disposal.

EXAMPLE FSP 27-2

Presentation of intercompany transactions with a disposed component

FSP Corp enters into a sale agreement with Buyer to sell FSP Corp's wholly-owned subsidiary (Subsidiary X). Subsidiary X historically performed certain services for FSP Corp. Subsidiary X's fee for the services is $100 and the cost to deliver those services is $80. This intercompany transaction, determined to be at fair value, is eliminated in consolidation. Subsequent to disposal, the services are expected to continue between Subsidiary X and FSP Corp for approximately two years pursuant to a contractual agreement with Buyer. Through review of the guidance in ASC 205, FSP Corp concludes that Subsidiary X is a component and that it meets all of the criteria to be classified as held for sale and reported as a discontinued operation.

How should FSP Corp present this transaction before and after Subsidiary X is classified as held for sale?

Analysis

We believe FSP Corp may present the intercompany transaction as a gross-up in its pre-disposal income statement by reporting the $100 service fee charged by Subsidiary X as an operating expense in continuing operations and reporting the fee revenue of $100 and related costs of $80 (net $20 profit) as a component of discontinued operations of Subsidiary X. This presentation provides consistent reporting of results from continuing operations since FSP Corp will continue to pay—and record in continuing operations—the service fees to Subsidiary X after the disposition pursuant to the two-year contractual agreement with Buyer.

Situations arise where the working capital of the disposed component is retained by the reporting entity. These working capital accounts would therefore not be presented as discontinued operations on the reporting entity's balance sheet. However, the results of operations of the disposed component, which would include the prior revenues and expenses related to the working capital accounts retained by the ongoing reporting entity, would be reported in discontinued operations on the income statement for the current and prior periods in accordance with ASC 205-20-45-3. Example FSP 27-3 illustrates a situation where the working capital of the disposed component is retained by a reporting entity.

EXAMPLE FSP 27-3

Working capital of disposed component retained

On March 1, 20X1, FSP Corp executes a definitive agreement to sell Component X. Assets to be sold include equipment, customer relationships, and other intangible assets. As part of the sale, FSP Corp retains working capital of Component X, which includes trade and non-trade accounts receivable, and certain accrued expenses arising from operations before closing. All retained working capital is short-term and expected to liquidate within a few months after the closing.

Component X meets the definition of a discontinued operation under ASC 205-20-45. While the sale of certain assets of Component X will not close until April 30, 20X1, they meet the held for sale criteria under ASC 205-20-45-1E as of the quarter ended March 31, 20X1.

What effect should the disposal of Component X have on FSP Corp's balance sheet and income statement in its March 31, 20X1 financial statements?

Analysis

The working capital that is retained by FSP Corp should not be presented as discontinued operations on the balance sheet. While retained working capital was part of Component X, which constituted the discontinued operations, it is not a part of the disposal group. The assets and liabilities of Component X that will be sold should be presented as discontinued operations at March 31, 20X1 and any comparable periods presented. The results of operations of Component X (which include prior revenues and expenses related to the above working capital items) should be reported in discontinued operations on the income statement of FSP Corp for the current period and prior periods.

27.4.2.1 *Gain or loss on disposal*

The gain or loss on a disposed component is calculated as the consideration received from the disposal of the component less its carrying value, costs incurred to sell the component, and any loss recognized upon and during its classification as held for sale. See PPE 6.4.1 for discussion of the types of costs that may be included in costs to sell a disposal group.

When a portion of a reporting unit that constitutes a business (as defined in ASC 805-10-20) is to be disposed of, goodwill associated with that business should be included in the carrying amount of the business in determining the gain or loss on disposal in accordance with ASC 350-20-40-2. In situations where a portion of a reporting unit's goodwill is allocated in determining the gain or loss, we believe it may also be appropriate to allocate, in the same proportion, any prior year goodwill impairment charge related to the reporting unit to discontinued operations. Impairment charges related to property, plant, equipment, and intangible assets of the disposal group should also be included in discontinued operations in the current and prior periods.

Under ASC 205-20-45-11, any loss recognized for the discontinued operations should not be allocated among the major classes of assets and liabilities within the discontinued operations. We believe this guidance was intended to simplify the allocation of the loss because the unit of account has been determined to be the discontinued operations, not the underlying assets or liabilities within that discontinued operations.

ASC 205-20-45-11

For any discontinued operation initially classified as held for sale in the current period, an entity shall either present on the face of the statement of financial position or disclose in the notes to financial statements (see paragraph 205-20-50-5B(e)) the major classes of assets and liabilities of the discontinued operation classified as held for sale for all periods presented in the statement of financial position. Any loss recognized on a discontinued operation classified as held for sale in accordance with paragraphs 205-20-45-3B through 45-3C shall not be allocated to the major classes of assets and liabilities of the discontinued operation.

27.4.2.2 *Earnings per share*

See FSP 7 for guidance on the calculation and presentation of earnings per share when a reporting entity presents a discontinued operation.

27.4.2.3 *Transition service agreements*

Income and expenses associated with transition services provided by a reporting entity to a disposed component should be reflected in continuing operations of the ongoing reporting entity. Reporting entities must use judgment to determine the classification of income and expense (i.e., which income statement line items to include them in) within continuing operations. Income recognized from transition services should be recorded in other income (which might be included in operating income) unless the services meet the definition of revenue (see RR 1.2). Any related expenses should be recorded in their natural expense classification. Disclosure of the amount, nature, and classification of the cash flows should also be considered. See FSP 27.5 for further details.

27.4.2.4 Debt and debt-related items

Debt is not included in the disposal group unless the debt will be assumed by the buyer in the transaction. For example, if the debt obligation is required to be repaid by the seller as a result of the sale transaction, the debt is not classified as part of the disposal group.

However, if debt of a discontinued operation is to be assumed by the buyer or is required to be repaid as a result of the disposal transaction, interest related to such debt should be allocated to the discontinued operation. The allocation to discontinued operations of other consolidated interest that is not directly attributable to or related to other operations of the reporting entity is permitted but not required. Other consolidated interest that cannot be directly attributed to other operations of the reporting entity is allocated based on the following ratio:

Net assets of discontinued operation

Less: Debt required to be paid off as part of disposal transaction

Divided by

Net assets of consolidated reporting entity

Plus: Consolidated debt

Less: Debt of the discontinued operation that will be assumed by buyer

Less: Debt required to be paid off as part of the disposal transaction

Less: Debt that is directly attributed to other operations

Excerpt from ASC 205-20-45-8

This allocation assumes a uniform ratio of consolidated debt to equity for all operations (unless the assets to be sold are atypical — for example, a finance company — in which case a normal debt to equity ratio for that type of business may be used). If allocation based on net assets would not provide meaningful results, then the reporting entity should allocate interest to the discontinued operations based on debt that can be identified as specifically attributed to those operations.

The method used to allocate interest is considered an accounting policy election which should be applied consistently to all discontinued operations.

The SEC staff expects registrants to disclose their accounting policy for allocating interest to a discontinued operation, which should include the method of allocation. The amount of interest allocated to discontinued operations should also be disclosed for all periods presented.

Example FSP 27-4 illustrates how to allocate interest to discontinued operations that is not directly attributable to or related to other operations of a reporting entity.

EXAMPLE FSP 27-4

Allocation of interest to discontinued operations

FSP Corp sells Component Y on June 30, 20X1 and determines that it should report Component Y's operations as discontinued operations in its consolidated financial statements for the year ended December 31, 20X1. FSP Corp's borrowing arrangement requires that a portion of the proceeds of the sale of Component Y be used to repay FSP Corp's consolidated debt, and FSP Corp allocates interest expense for the repaid debt to discontinued operations in accordance with ASC 205-20-45-6. FSP Corp also makes an accounting policy decision to allocate interest on other consolidated debt not directly attributable to its other operations to discontinued operations as permitted by ASC 205-20-45-7.

For purposes of determining the amount of interest to allocate, assume a uniform ratio of consolidated debt to equity for all operations and:

For FSP Corp:

- Net assets: $50,000
- Consolidated debt: $15,000—comprised of $1,000 at 8% interest (required to be repaid from proceeds of sale of Component Y) and $14,000 at 6% interest
- Portion of consolidated debt directly attributable to other operations of FSP Corp: $8,000 at 6% interest

For Component Y:

- Gross assets: $13,000 (after considering any impairment)
- Debt to be assumed by the buyer: $2,000 at 6% interest
- Net assets to be sold: $11,000 (gross assets less debt to be assumed by the buyer)
- Debt required to be repaid from sale proceeds: $1,000 at 8% interest

How should FSP Corp allocate interest expense to discontinued operations?

Analysis

FSP Corp should allocate interest expense of $122 to discontinued operations.

This is calculated as follows:

Part I: Calculate interest on debt to be assumed and debt required to be repaid:

Interest on debt to be assumed by the buyer:	
$2,000 x 6% x 6 / 12 months	$60
Interest on debt required to be repaid:	
$1,000 x 8% x 6 / 12 months	40
	$100 **(A)**

Part II: Calculate interest on other consolidated debt that is not directly attributable to other operations of FSP Corp.

Step 1: Calculate the percentage of interest on other consolidated debt that is not directly attributable to other operations of FSP Corp to be allocated to Component Y.

Net assets sold (after recognizing any impairment) less debt required to be repaid from sale proceeds: $11,000 — $1,000 = $10,000 **(B)**

—to—

Net assets of FSP Corp:		$50,000
Plus:	Consolidated debt	15,000
Less:	Debt to be assumed by the buyer	(2,000)
	Debt required to be repaid from sale proceeds	(1,000)
	Debt that is directly attributed to other operations of FSP Corp	(8,000)
		$54,000 **(C)**

(B) ÷ **(C)** = $10,000 ÷ $54,000 = 18.5% **(D)**

Step 2: Calculate interest on other consolidated debt that is not directly attributable to other operations of FSP Corp.

Consolidated debt	$15,000
Debt to be assumed by the buyer	(2,000)
Debt required to be repaid from sale proceeds	(1,000)
Debt that is directly attributed to other operations of FSP Corp	(8,000)
Debt not directly attributable to other operations of FSP Corp	$4,000 **(E)**

(D) x (E) x interest rate x months / 12 = 18.5% x $4,000 x 6% x 6 / 12 = $22 **(F)**

Step 3: Calculate total interest expense to be allocated to discontinued operations = **(A)** + **(F)** = $100 + $22 = $122

Gains or losses from the extinguishment of corporate-level debt obligations (i.e., those that are not specific to the disposed component) in connection with the sale transaction should not be included in discontinued operations. Even when the debt is required to be extinguished in connection with a sale, gains or losses from the extinguishment of corporate-level debt is not considered to be directly associated with the disposed component. In addition, such debt would not be classified within the held-for-sale category of the balance sheet as it is not part of the disposal group. However, amortization of discounts, premiums, or debt issuance costs, and prepayment penalties incurred on debt that is directly related to the disposed component should be reported in discontinued operations.

27.4.2.5 Pension settlements and curtailments

The impact of a settlement or curtailment that is directly related to the disposal transaction should be recognized in discontinued operations. The settlement of a pension benefit obligation is considered directly related to the disposal transaction if there is a demonstrated cause-and-effect relationship between the two events and if the settlement occurs no later than one year following the disposal transaction.

If a settlement has occurred as a result of the disposal transaction (e.g., there is a transfer of a pension benefit obligation to the buyer), the reporting entity should recognize in discontinued operations the net gain or loss included in accumulated other comprehensive income associated with the plan, plus any transition asset remaining in accumulated other comprehensive income from the initial application of ASC 715-30. If only part of the projected benefit obligation is settled, the reporting entity should recognize a pro rata portion of the settlement equal to the percentage reduction in the projected benefit obligation.

A reporting entity will recognize in discontinued operations the prior service cost included in accumulated other comprehensive income associated with the years of service no longer expected to be rendered as a result of a curtailment, and any decrease (gain) or increase (loss) in the projected benefit obligation associated with the plan. Additionally, if an employer disposes of a component that results in a termination of some employees' services earlier than expected, but does not significantly reduce the expected years of future service of present employees covered by the pension plan, measuring the effects of the reduction in the workforce in the same manner as a curtailment is appropriate for purposes of determining the gain or loss on the disposal.

27.4.2.6 Income tax allocation and adjustments

Discontinued operations have certain income tax accounting implications that must be considered. Such implications must be considered both in the year of the discontinued operation, and potentially in periods afterward. See TX 12 (intraperiod tax allocation) and TX 16.6.2 for further discussion of tax considerations for discontinued operations.

27.4.2.7 *Derivatives*

The following sections provide guidance on the classification between continuing operations and discontinued operations of gains and/or losses related to cash flow hedges, fair value hedges, and foreign currency forward contracts that may be associated with the component being disposed.

Cash flow and fair value hedges

If a reporting entity had cash flow or fair value hedges related to the operations of a component that is being disposed of, management should assess whether gains or losses previously recognized in income from the hedging relationship should be reclassified into discontinued operations as well as whether subsequent gains or losses through the disposal date should be reported in discontinued operations.

For a cash flow hedge, if the hedged cash flows specifically relate to the group of assets and liabilities or operations being disposed, gains and/or losses resulting from the cash flow hedges should be classified as part of discontinued operations. Similarly, for a fair value hedge, if the hedged item is part of the component being disposed of, gains and/or losses resulting from the application of hedge accounting (including changes in fair value of the hedged item for the risk being hedged and changes in the fair value of the hedging instrument) should be classified as part of discontinued operations. This assessment should be performed even if the derivative instruments are not included in the disposal group.

In addition, for cash flow hedges, management should consider the original hedge documentation of the cash flows being hedged to determine whether amounts remaining in AOCI should be released to income. Refer to DH 10.4.6 for further discussion.

Foreign currency forward contracts

A reporting entity may enter into a foreign currency forward contract to mitigate exchange rate risks from the sale of a component transacted in a currency other than the reporting entity's functional currency. Any gains or losses on these forward contracts should be reported in continuing operations as these amounts do not qualify as direct operating expenses incurred by the disposed component under the guidance in ASC 205-20 and these contracts would not qualify for hedge accounting.

27.4.2.8 *Noncontrolling interest*

As discussed in ASC 205-20-50-5B(d), when a reporting entity disposes of a majority-owned consolidated subsidiary that is classified as discontinued operations, it needs to consider the impact when presenting the controlling and noncontrolling interests' operating results. See FSP 18 for additional details on presentation matters related to noncontrolling interest.

27.4.2.9 *Cumulative effect of changes in accounting principles*

Generally, the cumulative effect of changes in accounting principles is not allocated between continuing and discontinued operations and should be presented as a single line item, net of the related income tax effects. No portion of this item is required to be reclassified into discontinued operations. This treatment is based on the view that an accounting change is not part of a reporting entity's normal operations. Therefore, its effect need not be allocated between those operations that are continuing and those that have been discontinued.

27.4.2.10 *Predecessor financial statements*

When a reporting entity is a successor to a predecessor entity, questions arise as to whether a discontinued operation of the successor should be presented as a discontinued operation in the predecessor's income statement. An example of an event that gives rise to a predecessor/successor reporting scenario is the push-down of the parent's basis as a result of the acquisition of the successor company, or the application of fresh-start reporting by a reporting entity upon emergence from bankruptcy. Since the successor entity is considered a new reporting entity for accounting purposes, one might conclude that the predecessor financial statements should not be retrospectively adjusted to reflect the successor's discontinued operations.

As discussed in SEC FRM 13210.2, predecessor financial statements are required to be retrospectively adjusted to reflect the impact of a successor's discontinued operations. ASC 205 does not provide any exceptions to retrospectively adjusting all periods presented to reflect the impact of a discontinued operation. This view achieves comparability for the discontinued operation for all fiscal periods presented, which the SEC staff believes is an important and useful factor for readers to assess trend information in financial statements. However, the SEC staff noted that SEC registrants should contact the SEC staff if unusual facts and circumstances may inhibit a reporting entity from reclassifying a discontinued operation in predecessor fiscal periods. This guidance is specific to SEC registrants. However, based on limited authoritative guidance, we believe private companies should consider applying the underlying concept of comparability between periods as well.

Notwithstanding the SEC staff's views expressed above, we generally do not believe that other successor changes in accounting policies (e.g., a change from the LIFO method of inventory costing to FIFO) should be reflected in predecessor financial statements.

27.4.3 *Other presentation matters*

The following subsections cover the presentation of spin-off transactions and considerations for presenting discontinued operations when a reporting entity reissues financial statements.

See FSP 8.6.2 for disclosure requirements of individually significant disposals that do not qualify for discontinued operations reporting.

27.4.3.1 *Presentation of spin-off transactions*

When a reporting entity completes a spin-off transaction, a question arises whether it is appropriate for the parent company to view the spin-off of the subsidiary as a change in the reporting entity, or present the spun-off entity in discontinued operations if it meets the discontinued operations criteria. If presented as a change in reporting entity, the parent's historical financial statements would be retrospectively adjusted as if the reporting entity never had an investment in the subsidiary. See FSP 30.6 for further discussion of presenting a change in reporting entity.

The SEC generally will not allow a parent reporting entity to retrospectively adjust its financial statements to reflect a spin-off as a change in the reporting entity (i.e., sometimes referred to as a "de-pooling"). If the parent reporting entity was required to file periodic reports under the 1934 Exchange Act within one year prior to the spin-off, the SEC staff believes the reporting entity should reflect the disposition as held for sale in conformity with ASC 360 as this presentation most fairly and completely depicts for investors the effects of the previous and current organization of the reporting entity. However, in limited circumstances involving the initial registration of a reporting entity under the

Exchange Act or Securities Act, the SEC staff has not objected to financial statements that retrospectively reflect the reorganization of the business as a change in the reporting entity if the spin-off transaction occurs prior to effectiveness of the registration statement. The criteria the SEC staff considers when determining whether a "de-pooling" is acceptable in an initial registration as found in SAB Topic 5.Z, *Accounting and Disclosure Regarding Discontinued Operations,* are that the reporting entity and subsidiary:

- Are in dissimilar businesses
- Have been managed and financed historically as if they were autonomous
- Have no more than incidental common facilities and costs
- Will be operated and financed autonomously after the spin-off
- Will not have material financial commitments, guarantees, or contingent liabilities to each other after the spin-off

All of the criteria listed above should be met to "de-pool" a transferred business retroactively from its historical financial reporting periods. This guidance is specific to SEC registrants involved in a spin-off transaction. Based on limited authoritative guidance, we believe private companies should consider applying these underlying concepts as well.

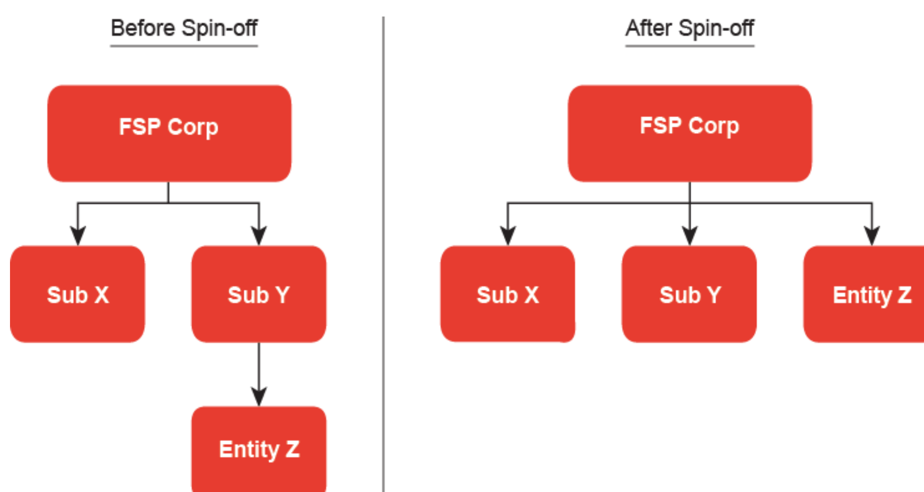
See PPE 6.3.2 for further details on the disposal of long-lived assets by spinoff.

Example FSP 27-5 illustrates the presentation in the income statement of a spin-off transaction.

EXAMPLE FSP 27-5

Spin-off presentation

FSP Corp is comprised of two-wholly owned operating subsidiaries, Subsidiary X and Subsidiary Y. In July 20X1, Subsidiary Y spins off one of its legal entities, Entity Z, to parent FSP Corp by distributing the stock of Entity Z to its sole shareholder, FSP Corp. Entity Z is a component under ASC 205-20-20, as its operations and cash flows can be clearly distinguished from Subsidiary Y, both operationally and for financial reporting purposes. Both Subsidiary Y and Entity Z have similar businesses. Entity Z meets the criteria for discontinued operations presentation. The following is a diagram of the organizational structure of FSP Corp before and after the spin-off.



How should Subsidiary Y present the spin-off of Entity Z in its standalone financial statements?

Analysis

Subsidiary Y should account for the spin-off by presenting the operations of Entity Z as discontinued operations upon successful completion of the spin-off. Retrospectively adjusting Subsidiary Y's financial statements to reflect the spin-off of Entity Z as a change in reporting entity (i.e., de-pooling) would not be appropriate since they operate in similar businesses.

Spin-off costs

Generally, costs that are incurred to accomplish a spin-off should be classified as part of discontinued operations once the spin-off is completed. Such costs are similar to transaction costs incurred in connection with a sale, which are classified as discontinued operations. However, bonuses paid by the reporting entity to the reporting entity's employees (not employees of the spun-off entity) for the successful completion of the spin-off transaction should be reflected in continuing operations. Such payments are not considered "costs to sell" under ASC 360-10-35-38 and, therefore, would not be reported in discontinued operations.

27.4.3.2 Reissuance of financial statements

For SEC registrants, financial statements are "issued" when complete financial statements are first issued to the public for general use and reliance in a format that conforms with US GAAP (with an audit report in the case of annual financial statements). Issuance can occur when the financial statements appear in a shareholder's report, a proxy statement, or a filing with the SEC. The issuance of an earnings release does not constitute financial statement issuance. Refer to ASC 855-10-S99-2 for a complete discussion of the "issuance date" of financial statements.

When previously released financial statements are reissued (e.g., in connection with a new or amended registration statement or proxy/information statement), the SEC staff's view is that the reclassification to reflect a discontinued operation should not be made in the historical financial statements until the financial statements are issued for the period in which the event triggering discontinued operations occurred. However, pro forma financial information might be required at an earlier point in time in accordance with S-X Article 11.

Example FSP 27-6 highlights the requirements for presenting discontinued operations when financial statements are reissued.

EXAMPLE FSP 27-6

Discontinued operations presentation in reissued financial statements

FSP Corp is a calendar year-end SEC registrant that on September 29, 20X1 decided to sell a component of its business. FSP Corp is going to reissue its financial statements in connection with a registration of securities on October 10, 20X1, but will not have released its financial statements for the period ended September 30, 20X1. The component will qualify as a discontinued operation as of September 30, 20X1.

Should FSP Corp reflect the discontinued operations in its reissued financial statements for periods prior to September 30, 20X1?

Analysis

No. Although the event which will trigger discontinued operations treatment will have occurred at the time the registration statement is filed, the financial statements have not been filed for the period in which the trigger to present the component as a discontinued operation occurred (i.e., the Form 10-Q for the period ended September 30, 20X1 has not been filed). As such, the annual financial statements and any prior interim periods included in the October 10, 20X1 registration statement should not include discontinued operations presentation for the component. Any financial statements issued or reissued after the financial statements for the period ended September 30, 20X1 have been issued should give retrospective effect to the discontinued operations.

27.5 Disclosure

The minimum disclosure requirements for discontinued operations are prescribed by ASC 205-20-50. Individually significant disposals may not be eligible for discontinued operations in some instances (e.g., when it does not represent a strategic shift). In such circumstances, additional disclosures are required in accordance with ASC 360-10-50-3A. For guidance on these disclosure requirements, refer to FSP 8.6.2.

27.5.1 *Financial statement disclosures*

Disclosures required in periods in which disposal groups have been sold or are classified as held for sale that qualify as a discontinued operation are described below:

ASC 205-20-50-1

The following shall be disclosed in the notes to financial statements that cover the period in which a discontinued operation either has been disposed of or is classified as held for sale under the requirements of paragraph 205-20-45-1E:

a. A description of both of the following:

   1. The facts and circumstances leading to the disposal or expected disposal.

   2. The expected manner and timing of that disposal.

b. If not separately presented on the face of the statement where net income is reported (or statement of activities for a not-for-profit entity) as part of discontinued operations (see paragraph 205-20-45-3B), the gain or loss recognized in accordance with paragraph 205-20-45-3C.

c. Subparagraph superseded by Accounting Standards Update No. 2014-08.

d. If applicable, the segment(s) in which the discontinued operation is reported under Topic 280 on segment reporting

When a business or nonprofit activity is classified as held for sale upon acquisition and therefore is reported as a discontinued operation, no additional disclosures are required beyond those described above. A reporting entity that disposes of an equity method investment that qualifies as a discontinued operation should consider the additional disclosures in FSP 27.5.1.1. A reporting entity with component(s) that result in discontinued operations for any other reason should make the following disclosures to the extent the information is not presented on the face of its financial statements:

Excerpt from ASC 205-20-50-5B

An entity shall disclose, to the extent not presented on the face of the financial statements as part of discontinued operations, all of the following in the notes to financial statements:

a. The pretax profit or loss (or change in net assets for a not-for-profit entity) of the discontinued operation for the periods in which the results of operations of the discontinued operation are presented in the statement where net income is reported (or statement of activities for a not-for-profit entity).

b. The major classes of line items constituting the pretax profit or loss (or change in net assets for a not-for-profit entity) of the discontinued operation (for example, revenue, cost of sales, depreciation and amortization, and interest expense) for the periods in which the results of operations of the discontinued operation are presented in the statement where net income is reported (or statement of activities for a not-for-profit entity).

Reporting entities must reconcile both (1) pretax profit or loss and (2) the major line items constituting pretax profit or loss to the after-tax profit or loss from discontinued operations that is presented on the face of the income statement. The reconciliation must be provided for all periods in which the results of the discontinued operation are presented. The example reconciliation provided in ASC 205-20-55-103 includes the line items of revenue, cost of sales, selling, general and administrative expenses, and interest expense.

A reporting entity may not have owned the entire discontinued operation prior to its disposal. If the discontinued operation includes a noncontrolling interest, the pretax profit or loss attributable to the parent should be separately disclosed for each of the periods that an income statement is presented.

27.5.1.1 Equity method investment discontinued operations disposals

When a reporting entity disposes of an equity method investment that qualifies to be presented as a discontinued operation, the reporting entity should disclose summarized information about the assets, liabilities, and results of operations of the investee if that information was disclosed in financial reporting periods before the disposal based on ASC 323-10-50-3(c), as further discussed in FSP 10.

27.5.1.2 Changes to a plan of disposal

A reporting entity may change its plan of sale of a component that was previously classified as a discontinued operation. In the period in which the decision is made to change the plan for disposing of the component, a reporting entity should determine if the revised plan impacts the component's classification as a discontinued operation. If as a result of the revised plan the component no longer qualifies as a discontinued operation, the reporting entity should disclose a description of the facts and circumstances leading to the decision to change the plan. It should also disclose the change's effect on the results of operations for the period and any prior periods presented. The results of operations should be reclassified from discontinued operations to income from continuing operations for all periods presented. Any loss on measurement at the reclassification date should be reported in continuing operations. Any loss recognized when the component was first classified as held for sale should not be adjusted in the prior period financial statements. See FSP 8.6.2 for the disclosure requirements of disposal groups that no longer meet the held-for-sale criteria.

Disclosures required when a reporting entity retains significant continuing involvement are discussed in the following subsections.

27.5.1.3 Continuing cash flows and continuation of activities

A reporting entity is required to disclose information about its significant continuing involvement with a discontinued operation after the disposal date. It must continue to make these disclosures until the results of operations of that discontinued operation are no longer presented in the income statement.

Excerpt from ASC 205-20-50-4B

An entity shall disclose the following in the notes to financial statements for each discontinued operation in which the entity retains significant continuing involvement after the disposal date:

a. A description of the nature of the activities that give rise to the continuing involvement.

b. The period of time during which the involvement is expected to continue.

c. For all periods presented, both of the following:

    1. The amount of any cash inflows or outflows from or to the discontinued operation after the disposal transaction

    2. Revenues or expenses presented, if any, in continuing operations after the disposal transaction that before the disposal transaction were eliminated in consolidated financial statements as intra-entity transactions.

A reporting entity may retain a noncontrolling investment in a disposed component and account for the component under the equity method prospectively. In those situations, there are additional disclosures required related to the equity method investment retained.

Excerpt from ASC 205-20-50-4B

d. For a discontinued operation in which an entity retains an equity method investment after the disposal (the investee), information that enables users of financial statements to compare the financial performance of the entity from period to period assuming that the entity held the same equity method investment in all periods presented in the statement where net income is reported (or statement of activities for a not-for-profit entity). The disclosure shall include all of the following until the discontinued operation is no longer reported separately in discontinued operations:

  1. For each period presented in the statement where net income is reported (or statement of activities for a not-for-profit entity) after the period in which the discontinued operation was disposed of, the pretax income of the investee in which the entity retains an equity method investment

  2. The entity's ownership interest in the discontinued operation before the disposal transaction

  3. The entity's ownership interest in the investee after the disposal transaction

  4. The entity's share of the income or loss of the investee in the period(s) after the disposal transaction and the line item in the statement where net income is reported (or statement of activities for a not-for-profit entity) that includes the income or loss.

27.5.1.4 Segment disclosures

As discussed in ASC 280-10-55-7, a reporting entity is not required to disclose the information required by ASC 280, *Segment Reporting,* for a reportable segment that qualifies for discontinued operations reporting. In addition, segment information for periods prior to the disposal of the reportable segment is not required to be restated in the comparative periods.

A discontinued operation that is a portion of a reportable segment (e.g., one of three product lines that make up a reporting segment) would not be included in the segment disclosures in the period it is classified as a discontinued operation. Furthermore, prior periods would need to be restated for comparative purposes.

27.5.1.5 Adjustments to amounts reported in discontinued operations

Certain adjustments to amounts previously reported in discontinued operations should also be classified in discontinued operations in accordance with ASC 205-20-45-4 through ASC 205-20-45-5, ASC 205-20-50-3A, and ASC 205-20-S99-2. The nature and amount of such adjustments should be disclosed. Circumstances that could give rise to presenting amounts as discontinued operations in subsequent periods include:

- Resolution of contingencies related to the disposal transaction, such as the resolution of the purchase price and indemnification agreements

- Resolution of the disposed component's contingencies, such as environmental and product warranty obligations retained by the seller
- Settlement of employee benefit obligations directly related to the disposal transaction

This guidance also applies to amounts not previously reported in discontinued operations that are directly related to the disposal component.

Developments subsequent to the disposal date that are not directly related to the disposal of the component are reported within continuing operations. For example, subsequent changes in the carrying value of assets received upon disposition of a component do not affect the determination of gain or loss at the disposal date, but represent the consequences of management's subsequent decisions to hold or sell those assets. Gains and losses, dividend and interest income, and portfolio management expenses associated with assets received as consideration for discontinued operations are other examples of amounts not directly related to the disposal component.

27.6 Discontinued operations—considerations for private companies

Certain items discussed in this chapter are prescribed by the SEC for SEC registrants. However, we believe private companies should consider applying these concepts. Those requirements are summarized in Figure FSP 27-2.

Figure FSP 27-2
Presentation and disclosures required for public business entities that should be considered by private companies

Description	Reference	Section
Allocation of interest to a discontinued operation	ASC 205-20-S99-3	FSP 27.4.2.4
Application of discontinued operations to predecessor's financial statements for successor's disposal activity	SEC FRM 13210.2	FSP 27.4.2.10
De-pooling the results of a spun-off component	SAB Topic 5.Z	FSP 27.4.3.1

Chapter 28: Subsequent events—updated November 2021

28.1 Subsequent events—overview

This chapter describes what subsequent events are and the types of subsequent events. It explains the distinction between recognized and nonrecognized subsequent events and describes the disclosure requirements for subsequent events in financial statements and reissued financial statements. Finally, it includes a number of common examples of each type of subsequent event. The examples are not all-inclusive, but are intended to provide a framework for evaluating and categorizing subsequent events as recognized or nonrecognized, which can require significant judgment.

28.2 Subsequent events—scope and relevant guidance

The scope of ASC 855, *Subsequent Events*, is broad and encompasses all subsequent events that are not addressed in other parts of US GAAP. For example, US GAAP specifically addresses the presentation and disclosure of subsequent events for income taxes (ASC 740-10-25-15), EPS (ASC 260-10-55-12), and gain contingencies (ASC 450-30-25-1). US GAAP also includes industry-specific subsequent events guidance, such as ASC 926-855, which addresses the treatment of a specific subsequent event in the film industry.

In addition to the FASB guidance, SEC registrants are required to evaluate the guidance within SAB Topic 4.C, *Change in Capital Structure* (see FSP 28.5.2).

New guidance

ASU 2016-13

ASU 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, changes the estimation of credit losses from an "incurred loss" model to an "expected loss" model (the Current Expected Credit Loss model, or CECL), which resulted in certain clarifications to ASC 855. Representatives from the FASB staff and the staff of the SEC's Office of the Chief Accountant jointly provided their perspectives on the application of ASC 855 to several specific situations related to the CECL model. Refer to LI 7.9 for further details.

For public business entities that are SEC filers, ASU 2016-13 is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. For all other entities, ASU 2016-13 is effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. All entities may early adopt ASU 2016-13 as of fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

The accounting and disclosure requirements of ASU 2016-13 are covered in PwC's *Loans and investments* guide, and are not discussed in this guide.

28.3 Evaluation of subsequent events

The date through which a reporting entity evaluates subsequent events differs depending on whether it is an SEC filer or a conduit bond obligor, or a non-SEC filer.

ASC 855 defines an SEC filer as follows.

Partial definition from ASC 855-10-20

Securities and Exchange Commission (SEC) filer: An entity that is required to file or furnish its financial statements with either of the following:

a. The Securities and Exchange Commission (SEC)

b. With respect to an entity subject to Section 12(i) of the Securities Exchange Act of 1934, as amended, the appropriate agency under that Section.

This definition specifically excludes financial statements of other reporting entities that are included in SEC filings, such as financial statements of acquired businesses or equity investees that are not otherwise SEC filers.

A conduit bond obligor is an entity that issues conduit debt securities, as defined in ASC 825.

Partial definition from ASC 825-10-20

Conduit Debt Securities: Certain limited-obligation revenue bonds, certificates of participation, or similar debt instruments issued by a state or local governmental entity for the express purpose of providing financing for a specific third party (the conduit bond obligor) that is not a part of the state or local government's financial reporting entity.

If a reporting entity is a conduit bond obligor for conduit debt securities that are traded in a public market, the reporting entity is required to evaluate subsequent events through the date the financial statements are issued, similar to an SEC filer.

For an SEC filer or a conduit bond obligor, ASC 855-10-25-1A indicates that subsequent events are events or transactions that occur after the balance sheet date but before the reporting entity issues its financial statements. Voluntary filers should follow the same guidance as SEC filers. When a reporting entity has no registered securities but voluntarily files financial statements with the SEC, the filings should comply with all of the SEC's requirements. A voluntary filer cannot choose which regulations to comply with in its filings.

Financial statements of acquired businesses or equity investees that are not otherwise SEC filers should evaluate subsequent events through the date that the financials are available for issuance, rather than up to the date the financial statements are issued.

An entity that files for an IPO does not become an SEC filer until its registration statement goes effective. As a result, a reporting entity that had previously reached the cutoff for recognizing subsequent events does not reopen and extend its subsequent events period when it files a registration statement with the SEC for an IPO.

The SEC staff provided its view as to when financial statements are considered "issued" in ASC 855-10-S99-2.

Excerpt from ASC 855-10-S99-2

…Generally, the staff believes that financial statements are "issued" as of the date they are distributed for general use and reliance in a form and format that complies with generally accepted accounting principles (GAAP) and, in the case of annual financial statements, that contain an audit report that indicates that the auditors have complied with generally accepted auditing standards (GAAS) in completing their audit. Issuance of financial statements then would generally be the earlier of when the annual or quarterly financial statements are widely distributed to all shareholders and other financial statement users or filed with the Commission. Furthermore, the issuance of an earnings release does not constitute issuance of financial statements because the earnings release would not be in a form and format that complies with GAAP and GAAS.

For non-SEC filers, ASC 855-10-25-2 indicates that subsequent events are events that occur after the balance sheet date but before the reporting entity's financial statements are available to be issued. Financial statements are "available to be issued" when they are prepared in accordance with US GAAP and the reporting entity has obtained all necessary approvals (e.g., from management and the board of directors) for issuance.

For purposes of this chapter, the period from the balance sheet date to the date the financial statements are either issued (SEC filer or conduit bond obligor) or available to be issued (non-SEC filers) is referred to as the subsequent events measurement period. Figure FSP 28-1 summarizes the subsequent events measurement period by type of filer.

Figure FSP 28-1

Subsequent events measurement period by type of filer

Type of filer	Subsequent events measurement period
SEC filer, including voluntary filers	The period from the balance sheet date to the date the financial statements are issued
Conduit bond obligor for conduit debt securities that are traded in a public market	The period from the balance sheet date to the date the financial statements are issued
Non-SEC filer	The period from the balance sheet date through the date that the financials are available for issuance
Financial statements of acquired business or equity investees that are not otherwise SEC filers	The period from the balance sheet date through the date that the financials are available for issuance

28.4 Types of subsequent events

As discussed in ASC 855-10-20, there are two types of subsequent events:

Excerpt of definition from ASC 855-10-20

a. The first type consists of events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements (that is, recognized subsequent events).

b. The second type consists of events that provide evidence about conditions that did not exist at the date of the balance sheet but arose subsequent to that date (that is, nonrecognized subsequent events).

Recognized subsequent events (see FSP 28.5) are pushed backed and recorded in the financial statements to be issued. Examples include the realization of a loss on the sale of inventory or property held for sale when the subsequent act of sale confirms a previously existing unrecognized loss. See FSP 28.5 for other examples.

Nonrecognized subsequent events (see FSP 28.6) are considered for disclosure based on their nature to keep the financial statements from being misleading. An example is a natural disaster that destroys a facility after the balance sheet date. See FSP 28.6.3 and 855-10-55-2 for other examples.

28.5 Recognized subsequent events

As discussed in ASC 855-10-25-1, recognized subsequent events are reflected in the financial results of the reporting entity. The reporting entity should also evaluate the events for additional disclosures based on the applicable standards governing the events.

Figure FSP 28-2 includes some examples of subsequent events that reporting entities should evaluate to determine whether they need to be recognized in the financial statements and indicates where in this guide those examples are discussed.

Figure FSP 28-2
Examples of recognized subsequent events

Description	Reference
Settlements of litigation related to events giving rise to a claim that took place before the balance sheet date	FSP 28.5.1
Change in capital structure (stock dividends, splits, or reverse splits)	FSP 28.5.2
Changes in lower of cost or net realizable value considerations related to inventory valuation	FSP 28.5.3
Certain other postemployment benefit costs	FSP 28.5.4

Description	Reference
Covenant violations occurring or anticipated after the balance sheet date	FSP 12.3.3.5
Refinancing short-term borrowings	FSP 12.3.4

The remainder of this section discusses considerations in recognizing certain types of subsequent events.

28.5.1 Litigation settlements

The settlement of litigation can result in loss contingencies or gain contingencies.

28.5.1.1 Loss contingencies

A settlement of litigation resulting in a loss related to events that took place prior to the balance sheet date is typically considered a recognized subsequent event.

28.5.1.2 Gain contingencies

As discussed in ASC 855-10-15-5(c), a settlement resulting from a claim that existed at the balance sheet date that results in a gain and the related receivable are typically not reflected as a recognized subsequent event. Rather, gain contingencies are recognized in the period the asset is realized or realizable. Therefore, the reporting entity would not adjust the financial statements for a gain contingency related to litigation, although disclosure may be appropriate.

28.5.2 Change in capital structure

SAB Topic 4.C (codified in ASC 505-10-S99-4) provides guidance on the recognition of a change in capital structure. A change in a registrant's capital structure due to a stock dividend, stock split, or reverse split occurring after the date of the latest reported balance sheet, but before the issuance of the financial statements or the effective date of the registration statement, whichever is later, should be given retroactive effect on the balance sheet. There are two approaches to achieve the retroactive effect: retrospective adjustment or recording the change in the period consummated. Historically, the SEC has not objected to utilizing either approach, except in an IPO, when the reporting entity should give retrospective effect in the balance sheet.

If a reporting entity retroactively reflects a change in capital structure, it should disclose the retroactive treatment, explain the change made, and state the date that the change became effective in a footnote. If a reporting entity records the change in capital structure in the period consummated, it should consider disclosing the change.

Similarly, ASC 260-10-55-12 requires retrospective presentation and disclosure of such changes in capital structure in the calculation of earnings per share. See FSP 7.6.1 for further discussion.

28.5.3 *Lower of cost or net realizable value of inventory*

ASC 330-10-35 establishes the guidance related to losses from the subsequent measurement of inventory. A loss may be required, for example, due to damage, physical deterioration, obsolescence, changes in price levels, or other causes. Also, ASC 855-10-55-1(b), as amended by ASU 2016-13, provides the following guidance.

ASC 855-10-55-1(b)

Subsequent events affecting the realization of assets, such as inventories, or the settlement of estimated liabilities, should be recognized in the financial statements when those events represent the culmination of conditions that existed over a relatively long period of time.

Sales of inventory or other events after the balance sheet date may provide additional evidence about conditions that existed at the balance sheet date that could impact a reporting entity's valuation of inventory at the lower of cost or net realizable value (NRV). Determining the net realizable value at the balance sheet date is a matter of judgment. A reporting entity should consider all data available, including future demand and subsequent changes in product prices that may provide additional information about the valuation at the balance sheet date. For example, increases in selling prices during the reporting entity's subsequent events measurement period (see FSP 28.3) would likely demonstrate that a decline in selling prices at the balance sheet date was temporary, which may indicate that a lesser or no write-down is required.

28.5.4 *Other postemployment benefit costs*

ASC 712 prescribes the accounting for the estimated cost of other postemployment benefits provided by an employer to former or inactive employees after employment but before retirement. These benefits include salary continuation, supplemental unemployment benefits, severance benefits, disability-related benefits (including workers' compensation), job training and counseling, and the continuation of benefits such as health care benefits and life insurance coverage. They are generally viewed as part of the compensation provided to employees in exchange for service.

If a post-balance sheet date event confirms that payment of a benefit covered by ASC 712 was probable at the balance sheet date, a reporting entity should record a reasonable estimate of the probable amount at the balance sheet date. The estimate should take into account all information available through the reporting entity's subsequent events measurement period (see FSP 28.3), to the extent it reflects facts that existed at the balance sheet date.

Conversely, if a post-balance sheet date event confirms, and all other evidence similarly supports, that the payment of benefits was not probable at the balance sheet date, a reporting entity should not record an accrual at the balance sheet date.

Example FSP 28-1 illustrates when an event occurs after the balance sheet that does not relate to conditions that existed as of the balance sheet date.

EXAMPLE FSP 28-1

Unrecognized subsequent event

FSP Corp, a calendar year-end SEC filer, has a severance plan under which benefits do not accumulate or vest. The plan provides for a payment of $5,000 to each employee who is involuntarily terminated without cause. At December 31, 20X1, FSP Corp determined that it was not probable that severance benefits under the plan would be paid.

On January 13, 20X2, one of FSP Corp's facilities was destroyed by an earthquake.

On February 5, 20X2, FSP Corp's board of directors decided that the facility would not be rebuilt and management decided to terminate all employees that worked at the site. The company intends to file its 20X1 Form 10-K on February 15, 20X2.

Should FSP Corp record the liability to pay severance benefits in its 20X1 financial statements?

Analysis

No. The facts indicate that the payment of severance benefits was not probable at the balance sheet date (December 31, 20X1). Accordingly, the appropriate period in which to record the liability is the first quarter of 20X2. If the amount of severance benefits (and the impact of the earthquake damage) is material, FSP Corp should disclose the matter in the 20X1 financial statements.

28.6 Nonrecognized subsequent events

Because ASC 855 does not provide any bright line tests for determining which subsequent events require disclosure, the decision regarding when to disclose a subsequent event is based on specific facts and circumstances and requires judgment. Generally, there are two criteria that are both required for a subsequent event to need disclosure.

- The event should have a determinable significant effect on the balance sheet at the time of occurrence or on the future operations of the reporting entity.
- Without disclosure of it, the financial statements would be misleading.

Consider the following examples:

- A regular quarterly cash dividend declared after the balance sheet date at the same rate per share as dividends declared during the period being reported on may not be worthy of disclosure. However, if a reporting entity that had paid dividends regularly for several years decided to eliminate cash dividends after the balance sheet date, disclosure may be warranted.
- Cancellation of a sales contract after the balance sheet date may not need to be disclosed, unless it is reasonably certain that the financial effect will be significant. For example, if the reporting entity reasonably anticipates replacement of the customer or additional sales to present customers, it may not need to disclose the cancellation. However, disclosure may be appropriate if reduced income appeared reasonably certain, a major factory were to be closed, or other significant changes in operations were expected to result.

28.6.1 *Disclosure requirements for nonrecognized subsequent events*

If a reporting entity determines that disclosure is necessary, ASC 855-10-50-2 indicates that it should include:

- the nature of the event, and
- an estimate of the impact on the financial statements or an assertion that an estimate cannot be made.

The guidance within ASC 855 does not require a reporting entity to present all required subsequent events disclosures in one footnote. Rather, management may determine where to include the disclosures within the financial statements.

28.6.2 *Pro forma financial data*

As discussed in ASC 855-10-50-3, depending on the nature and magnitude of the nonrecognized subsequent event, a reporting entity may include pro forma financial data in the footnotes. Alternatively, in certain more significant situations, the reporting entity may include a pro forma column on the historical balance sheet that reflects the transaction as if it occurred on the balance sheet date. For example, a reporting entity that is undergoing an IPO will often include pro forma financial data on the balance sheet to reflect the conversion of preferred stock to common stock.

28.6.3 *Examples of nonrecognized subsequent events*

Because nonrecognized subsequent events generally do not relate to conditions existing at the balance sheet date, they are not recognized in the financial statements. However, depending on the nature of the event and whether the financial statements would be misleading without disclosure of it, a reporting entity should consider footnote disclosure. Figure FSP 28-3 includes some examples of nonrecognized subsequent events and indicates where in this guide those examples are discussed.

Figure FSP 28-3
Examples of nonrecognized subsequent events

Description	Reference
Business combinations	FSP 28.6.3.1
Exercise of a call option on debt after the balance sheet date	FSP 28.6.3.2
Debt extinguishments after the balance sheet date	FSP 28.6.3.3
Changes in the classification of long-lived assets	FSP 28.6.3.4
Changes in the conditions of contingently redeemable instruments after the balance sheet date	FSP 28.6.3.5
Acceptance by an employee of special termination benefits	FSP 28.6.3.6
Subsequent events impacting construction-type or production-type revenue contracts	FSP 28.6.3.7

Description	Reference
Changes in ownership interest after the balance sheet date	FSP 28.6.3.8
Sales of securities at a loss after the balance sheet date	FSP 28.6.3.9 through FSP 28.6.3.11
Liquidation of a reporting entity becomes imminent after the balance sheet date	FSP 28.6.3.12
Bankruptcy filing after the balance sheet date	FSP 28.6.3.13
Litigation settlements resulting in a gain	FSP 28.5.1.1
Changes in segments	FSP 25.7.8

Reporting entities should also consider whether there are other subsequent events that warrant disclosure such as:

- Certain changes in capital structure after the balance sheet date (see FSP 28.5.2 for a discussion of changes in capital structure that are recognized subsequent events)
- Settlements of litigation related to events giving rise to a claim that took place after the balance sheet date
- Changes in the fair value of assets or liabilities (financial or nonfinancial) or foreign exchange rates after the balance sheet date
- Issuance of new notes, bonds, or other indebtedness after the balance sheet date
- Damage from fire, flood, or other casualty after the balance sheet date
- Adoption of welfare, pension, compensation, or stock option plans after the balance sheet date

Considerations related to disclosure of the items in Figure 28-3 are further discussed in the following sections.

28.6.3.1 Business combinations

ASC 805, *Business Combinations*, requires a reporting entity to disclose information that enables financial statement users to evaluate the nature and financial effect of a business combination. The guidance applies to business combinations that occur either in the current reporting period or through the subsequent events measurement period (see FSP 28.3). However, as discussed in ASC 805-10-50-4, disclosure is not required for the specific aspects (e.g., purchase price allocation) of a business combination in which the accounting is incomplete at the time the financial statements are issued or are available to be issued.

ASC 805-10-50-4

If the acquisition date of a business combination is after the reporting date but before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25), the acquirer shall disclose the information required by paragraph 805-10-50-2 unless the initial accounting for the business combination is incomplete at the time the financial statements are issued or are available to be issued. In that situation, the acquirer shall describe which disclosures could not be made and the reason why they could not be made.

See FSP 17.4 for further discussion of disclosures in a business combination.

28.6.3.2 *Exercise of a call option on debt after the balance sheet date*

The announcement and execution of a call option by the borrower after the balance sheet date, with no violation of covenants at the balance sheet date, does not impact the debt's classification at the balance sheet date. For further discussion, see FSP 12.3.1. However, the reporting entity may need to disclose the exercise of the call option after the balance sheet date as a nonrecognized subsequent event.

28.6.3.3 *Debt extinguishments after the balance sheet date*

ASC 470-50-55-9 indicates that announcement of intent to call debt is not recognized as a debt extinguishment. An extinguishment should not be recognized prior to its occurrence. Therefore, a reporting entity should not recognize a debt extinguishment occurring during the subsequent events measurement period (see FSP 28.3). Any gain or loss associated with the debt extinguishment should be recorded in the period when the debt is considered extinguished (see FG 3.7). However, a reporting entity should consider disclosing the likely effect of a planned extinguishment or an extinguishment that occurred during the subsequent events measurement period.

28.6.3.4 *Changes in the classification of long-lived assets*

ASC 360-10-45-13 does not permit a reporting entity to consider new information resulting from a change in circumstances that occurred after the balance sheet date in evaluating whether long-lived assets held for use should be classified as held for sale at the balance sheet date.

However, if the criteria for classification of the assets as held for sale are met after the balance sheet date during the subsequent events measurement period (see FSP 28.3), ASC 360-10-45-13 indicates that the reporting entity should provide the disclosures in ASC 205-20-50-1(a):

- a description of the facts and circumstances leading to the expected disposal
- the expected manner and timing of the disposal

Additionally, the reporting entity should consider disclosing the carrying amount(s) of the major classes of assets and liabilities included as part of a disposal group.

28.6.3.5 *Changes related to contingently redeemable instruments*

A reporting entity may receive information that a contingently redeemable instrument has become unconditionally redeemable after the balance sheet date, but before the issuance date or the date the financial statements are available for issuance.

We believe this matter should be treated the same as any other subsequent event. If the information received indicates the instrument was unconditionally redeemable on the balance sheet date, the reporting entity should reclassify the instrument as a liability in the financial statements.

However, if the information received indicates that the event that caused the instrument to become unconditionally redeemable occurred after the balance sheet date, the reporting entity should not adjust the financial statements. In this circumstance, the reporting entity should consider appropriate disclosures.

28.6.3.6 Acceptance by an employee of special termination benefits

Special termination benefits arise when the employer offers, for a short period of time, to provide certain additional benefits to employees electing voluntary termination, including early retirement. There may be situations when a special termination benefits offer extends beyond the balance sheet date. Consistent with ASC 712-10-25-1, the termination liability should only include amounts for irrevocable acceptances at the balance sheet date. Reporting entities should consider disclosing the impact of irrevocable acceptances after the balance sheet date.

28.6.3.7 Sub events impacting construction-type revenue contracts

For construction-type or production-type revenue contracts, reporting entities should consider disclosing events occurring after the date of the financial statements that are outside the normal exposure and risk aspects of a contract.

28.6.3.8 Changes in ownership interest after the balance sheet date

As discussed in FSP 10.4, a consolidated reporting entity may report one or more equity method investees or subsidiaries on a lag of up to three months. A question may arise related to the accounting or disclosure of a change of ownership interest in the equity method investee or subsidiary during the lag period. The change of ownership interest may occur as a result of:

- Transactions in which control is maintained, gained, or lost
- Transactions involving equity investees, or
- A complete disposition of all holdings by a parent.

When the reporting period of the subsidiary financial statements precede the reporting period of the parent, generally, the transaction should be recorded in the period of occurrence in the consolidated financial statements, irrespective of any differences between the dates of the financial statements of the equity investee or subsidiary and the consolidated financial statements. See CG 4.5.7 for further discussion.

28.6.3.9 Sales of debt securities at a loss

When a reporting entity sells a debt security at a loss during the subsequent events measurement period (see FSP 28.3), it should assess (1) whether an other-than-temporary impairment may have existed at the balance sheet date and (2) whether its assertions as to whether or not it had the “intent to sell” the security were accurate as of the balance sheet date. Generally, the sale should not be

reflected in the value at the balance sheet date; however, a reporting entity should consider disclosing the subsequent sale as a nonrecognized subsequent event.

New guidance

ASU 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments,* includes a new model for determining whether debt securities are impaired. Financial statement preparers and other users of this publication are encouraged to consider the implications of ASU 2016-13 on accounting for subsequent events.

28.6.3.10 Sales of equity measured at fair value through income

If an equity security measured at fair value with changes in fair value recorded in income is sold at a loss during the subsequent events measurement period (see FSP 28.3), the loss is not a recognized subsequent event.

28.6.3.11 Sales of securities using the measurement alternative

When a reporting entity sells an equity security measured under ASC 321's measurement alternative (see LI 2.3.2) at a loss during the subsequent events measurement period (see FSP 28.3), it should assess whether an indicator of impairment may have existed at the balance sheet date. Generally, the sale should not be reflected in the value at the balance sheet date; however, a reporting entity should consider disclosing the subsequent sale as a nonrecognized subsequent event.

28.6.3.12 Liquidation becomes imminent

In accordance with ASC 205-30, *Presentation of Financial Statements – Liquidation Basis of Accounting*, the liquidation basis of accounting should be applied prospectively from the day that liquidation becomes imminent.

ASC 205-30-25-2

Liquidation is imminent when either of the following occurs:

a. A plan for liquidation has been approved by the person or persons with the authority to make such a plan effective, and the likelihood is remote that any of the following will occur:

    1. Execution of the plan will be blocked by other parties (for example, those with shareholder rights)

    2. The entity will return from liquidation.

b. A plan for liquidation is imposed by other forces (for example, involuntary bankruptcy), and the likelihood is remote that the entity will return from liquidation.

If this date occurs after the balance sheet date, the reporting entity should continue presenting its financial statements on a going concern basis. However, the reporting entity should consider providing additional disclosures.

28.6.3.13 *Bankruptcy filing after the balance sheet date*

If a reporting entity files for bankruptcy after the balance sheet date, but prior to the issuance date or the date the financial statements are available for issuance, it should treat the filing as a nonrecognized subsequent event. In that case, the financial statements would not reflect any accounting under ASC 852-10, *Reorganizations*, nor would they include the debtor-in-possession label (see BLG 3.2). The reporting entity should include appropriate disclosures, including pro forma disclosures, to keep the financial statements from being misleading.

28.7 Parent/subsidiary financial statements

A question often arises as to how a reporting entity that is a subsidiary of another entity should determine the date to be used when evaluating subsequent events in its standalone financial statements. That is, should the reporting entity utilize (1) the issuance date of the parent company consolidated financial statements, (2) the date the standalone financial statements are issued, or (3) the date the standalone financial statements are available for issuance?

Generally, our view is that when the parent company has issued financial statements or the financial statements are available to be issued, it is acceptable for the subsidiary reporting entity to utilize the issuance date of the parent company consolidated financial statements in determining the date through which to evaluate subsequent events for adjustment to the financial statements.

Example FSP 28-2 illustrates our view on recording a recognized subsequent event that arises for a subsidiary after its parent company's financial statements are issued.

EXAMPLE FSP 28-2

Impact of subsequent events on subsidiary financial statements

Parent Co consolidates a non-SEC filer subsidiary, Sub Co, into its consolidated audited financial statements filed with the SEC. The consolidated Parent Co's calendar year-end financial statements were issued on March 10, 20X1.

Following the issuance of the Parent Co's financial statements, Sub Co was required to issue audited Sub Co financial statements (Sub Co financial statements had not been previously prepared). On May 1, 20X1, litigation brought against Sub Co was settled for a material amount in excess of the liability recorded in the parent company consolidated financial statements. The calendar year-end financial statements of Sub Co were available to be issued on May 15, 20X1.

How should this subsequent event impact the financial statements of the parent and the subsidiary?

Analysis

Parent Co's financial statements are not affected as the subsequent event occurred after Parent Co's financial statements were issued on March 10, 20X1.

We believe an acceptable view is to consider Sub Co's financial statements as issued when the parent company statements were issued. Following that view, Sub Co should consider the issuance of its financial statements to constitute a reissuance and, therefore, evaluate subsequent events for

disclosure only. Sub Co would consider disclosing the settlement of the litigation in its financial statements as a nonrecognized subsequent event.

28.8 Reissuance of financial statements

ASC 855 defines revised financial statements.

Definition from ASC 855-10-20

Revised financial statements: Financial statements revised only for either of the following conditions:

a. Correction of an error

b. Retrospective application of U.S. GAAP.

A reporting entity may need to revise and reissue financial statements in reports filed with the SEC, other regulatory agencies, or other stakeholders.

This typically leads to the question of whether an updated evaluation of subsequent events is required at the time of reissuance of the financial statements. A reporting entity should consider whether subsequent events have occurred that warrant disclosure. However, ASC 855-10-25-4 prohibits a reporting entity from recognizing additional subsequent events unless the adjustment is required by US GAAP or regulatory requirements. For example, the retrospective application of an accounting standard such as discontinued operations or a segment change would be reflected in the financial statements. However, the subsequent settlement of a lawsuit at a loss greater than reflected in the financial statements as originally issued would not be recognized in the reissued financial statements; rather, it would be disclosed.

28.9 Subsequent events—considerations for private companies

The majority of the requirements of ASC 855 apply equally to public and private companies. In addition, ASC 855 requires non-SEC filers to include additional disclosures.

28.9.1 Disclosures not required for private companies

The disclosure of a change in a registrant's capital structure in ASC 505-10-S99-4 (see FSP 28.5.2) is required only for SEC filers.

28.9.2 Additional disclosure requirements for private companies

ASC 855 requires the following additional disclosures for reporting entities that are not SEC filers:

- The date through which subsequent events were evaluated
- Whether the disclosed date is the date the financial statements were issued or the date the financial statements were available to be issued (see FSP 28.3)
- The date through which subsequent events were evaluated in revised (reissued) financial statements (see FSP 28.8)

Chapter 29: Interim financial reporting—updated November 2021

29.1 Interim financial reporting overview

Presentation and disclosure requirements are often applicable for both interim and annual financial statements. However, in some instances, interim financial statements may include condensed presentation and fewer disclosures. This chapter provides guidance on the financial statement presentation and disclosure requirements for interim reporting periods. The chapter distinguishes between general recurring disclosure requirements and transaction-specific disclosure requirements, and indicates instances in which interim disclosure requirements are identical to the annual requirements. In situations in which the interim disclosure requirements are different than those required in annual reporting periods, the specific interim requirements are discussed.

29.2 Interim financial reporting—scope and relevant guidance

Interim financial information is intended to provide users with timely information about a reporting entity. Because each interim period is an integral part of an annual period, interim financial statements are generally prepared based on the expectation that users will read the interim financial statements in conjunction with the annual financial statements. In general, interim financial information is not expected to repeat annual financial information but, rather, provide an update from the prior year-end. Therefore, interim financial information may be condensed and include limited footnote disclosures.

ASC 270, *Interim Reporting*, and Article 10 of Regulation S-X ("Article 10") are the two primary sources for presentation and disclosure requirements for interim financial reporting. ASC 270 provides minimum disclosure requirements for all reporting entities that prepare interim financial statements. Article 10 provides reporting requirements for SEC registrants, including the financial statements that should be presented and the periods that should be covered by each respective financial statement.

Certain other guidance includes considerations for interim financial reporting; the more significant guidance is discussed in this chapter.

Note about ongoing standard setting

The FASB has an active project on interim reporting that may affect interim presentation and disclosure requirements. Financial statement preparers and other users of this publication are, therefore, encouraged to monitor the status of the project. Once finalized, financial statement preparers and users should evaluate the effective date of the new guidance and the implications on presentation and disclosure.

29.3 Presentation of interim financial information

US GAAP includes minimal presentation requirements for interim financial reporting. As such, many reporting entities follow Article 10, although that guidance is only required for SEC registrants. Interim financial information prepared in accordance with US GAAP, and if applicable, Article 10, may, at the option of the reporting entity, be either of the following:

- A complete set of financial statements with either (1) full footnote disclosures, or (2) limited footnote disclosures as required by US GAAP (see FSP 29.4), and if applicable, Article 10, and other disclosures that update the most recently audited footnotes for significant changes

- Condensed financial statements with limited footnote disclosures as required by US GAAP (see FSP 29.4), and if applicable, Article 10

Reporting entities qualifying for smaller reporting company status (as defined by S-K 10(f)) may follow the requirements of S-X 8-03 rather than Article 10.

29.3.1 Article 10 interim financial statement requirements

If Article 10 is followed, the interim financial statements are usually labeled as "condensed." This is because the financial statement line items are not shown in the same level of detail and/or there are fewer footnotes as compared to annual financial statements.

If certain line item captions are required to be presented separately, but were permitted to be combined in prior interim financial statements (e.g., due to immateriality), the comparative periods should be retroactively reclassified to conform to the current period presentation.

SEC regulations do not require interim financial statements to be audited. However, if the interim financial statements are unaudited, S-X 10-01(b)(8) require reporting entities to disclose that all adjustments necessary for a fair statement of the results for the periods presented have been included and that such adjustments are of a normal recurring nature. If applicable, the reporting entity should describe any other-than-normal recurring adjustments. Reporting entities should also clearly disclose that certain information was derived from the prior annual audited financial statements. Figure FSP 29-1 provides an example of this disclosure.

Figure FSP 29-1

Example disclosure—unaudited interim financial statements

Note X

In the opinion of the Company, the accompanying unaudited condensed financial statements contain all adjustments, consisting of only normal recurring adjustments, necessary for a fair statement of its financial position as of September 30, 20X2, and its results of operations for the three months and nine months ended September 30, 20X2, and 20X1, and cash flows for the nine months ended September 30, 20X2, and 20X1. The condensed balance sheet at December 31, 20X1, was derived from audited annual financial statements but does not contain all of the footnote disclosures from the annual financial statements.

Although there are no requirements specifying where in the footnotes to disclose the description of unaudited interim financial statements, we suggest that such disclosure be included as a separate section in the accounting policy footnote or in a separate footnote immediately preceding the accounting policy footnote.

The use of the words "fair statement" rather than "fair presentation" in the example disclosure is intentional. Unless the interim financial statements are accompanied by complete footnote

disclosures, the phrase "fairly presented" should not be used as that wording is only appropriate in the context of full US GAAP financial statements and footnotes.

29.3.2 Balance sheet

Article 10 requires interim financial information to include balance sheets as of the end of the most recent quarter and the preceding fiscal year. An interim balance sheet for the comparable prior year quarter does not need to be included unless it is necessary to understand seasonal fluctuations.

Article 10 allows certain balance sheet line items to be condensed, as described in the following excerpt:

S-X 10-01(a)(2)

Interim balance sheets shall include only major captions (i.e., numbered captions) prescribed by the applicable sections of this Regulation with the exception of inventories. Data as to raw materials, work in process and finished goods inventories shall be included either on the face of the balance sheet or in the notes to the financial statements, if applicable. Where any major balance sheet caption is less than 10% of total assets, and the amount in the caption has not increased or decreased by more than 25% since the end of the preceding fiscal year, the caption may be combined with others.

In practice, many reporting entities start with their annual balance sheet and identify line items that can be combined with other line items using the thresholds outlined in Article 10 (i.e., 10% of total assets, 25% change since preceding fiscal year). However, as discussed in the excerpt above, reporting entities are required to disclose the components of inventory on an interim basis even if the change from the annual reporting period is not significant. The interim presentation of inventory is further discussed in ASC 270-10-S99-2 (SAB Topic 6.G.2a, Question 2).

29.3.3 Comprehensive income

ASC 270 requires publicly-traded reporting entities to report sales or gross revenues, provision for income taxes, net income, and comprehensive income. A publicly-traded company is defined by the ASC Master Glossary.

Definition from ASC Master Glossary

Publicly Traded Company: A business entity that has any of the following characteristics:

a. Whose securities are traded in a public market on a domestic stock exchange or in the domestic over-the-counter market (including securities quoted only locally or regionally)

b. That is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets)

c. Whose financial statements are filed with a regulatory agency in preparation for the sale of any class of securities in a domestic market

Additionally, ASC 220, *Comprehensive Income*, requires a reporting entity to report a total for comprehensive income in condensed financial statements of interim periods, either as a single continuous statement with the income statement or as two separate consecutive statements. ASC 220 does not require disclosure of the components of comprehensive income. However, if there is a significant difference in the components of comprehensive income from the prior year end or a significant difference in comprehensive income compared with net income, the major components should be disclosed.

Article 10 requires interim financial information to include statements of comprehensive income for the most recent quarter, the corresponding quarter in the preceding year, and the year-to-date periods for both years. The reporting entity may also present a statement of comprehensive income for the cumulative 12-month period ended during the most recent fiscal quarter and for the corresponding preceding period if that information would be meaningful to financial statement users.

Article 10 allows the statement of comprehensive income to condense certain line items presented in the annual period.

S-X 10-01(a)(3)

Interim statements of comprehensive income shall also include major captions prescribed by the applicable sections of Regulation S-X. When any major statement of comprehensive income (or statement of net income if comprehensive income is presented in two separate but consecutive financial statements) caption is less than 15% of average net income attributable to the registrant for the most recent three fiscal years and the amount in the caption has not increased or decreased by more than 20% as compared to the corresponding interim period of the preceding fiscal year, the caption may be combined with others. In calculating average net income, loss years should be excluded. If losses were incurred in each of the most recent three years, the average loss shall be used for purposes of this test. Notwithstanding these tests, Rule 4-02 of Regulation S-X applies and de minimis amounts therefore need not be shown separately, except that registrants reporting under Article 9 shall show investment securities gains or losses separately regardless of size.

Reporting entities should also present the changes in the components of accumulated other comprehensive income (AOCI) for the current period as required by ASC 220. They are required to present separately the amount of the change that is due to reclassifications and the amount that is due to other comprehensive income in the current period. These changes may be shown either before or net of tax and displayed either on the face of the financial statements or in the footnotes. Although ASC 220 indicates that the information should be presented for the current period, we believe that providing comparative information is also useful to financial statement users.

ASC 220 also requires that reporting entities present (either in a single footnote or parenthetically on the face of the financial statements) the effect of significant amounts reclassified from each component of AOCI based on its source (e.g., related to cash flow hedges from interest rate contracts) and the income statement line items affected by the reclassification (e.g., interest income or interest expense). If a component is not required to be reclassified to net income in its entirety (e.g., net periodic pension cost), reporting entities should instead cross reference to the related footnote for additional information (e.g., the pension footnote).

Question FSP 29-1 addresses whether the disclosure of the change in each component of AOCI should be reported on a year-to-date and a quarter-to-date basis for SEC registrants.

Question FSP 29-1

Is an SEC registrant required to disclose the change in each component of AOCI as noted in ASC 220-10-45-14A on both a quarter-to-date and year-to-date basis?

PwC response

Article 10, as amended, requires disclosure of changes in stockholders' equity, but not the changes in each component of AOCI. However, the disclosure of changes in each component of AOCI is required by ASC 220-10-45-14A. Registrants can elect to either break out each component of AOCI on the face of the statement of changes in stockholders' equity or in the footnote. This information should be provided on a year-to-date and quarter-to-date basis.

Question FSP 29-2 addresses whether an entity can present net income and other comprehensive income in a single statement format for interim reporting and a two statement format for annual reporting.

Question FSP 29-2

ASC 220 requires reporting entities to present net income and other comprehensive income in either a single continuous statement of comprehensive income or in two separate, but consecutive, statements.

Is it possible to use a single statement format for interim reporting and a two-statement format for annual reporting?

PwC response

Yes. Some reporting entities elect to provide the minimum information required for interim reporting and only present total comprehensive income in a single statement format. However, because of the additional annual reporting requirements, a reporting entity may prefer to use a two-statement format at year end. Because both formats provide the same information, there is no requirement to use the same format in interim and annual periods.

29.3.4 Cash flow statement

Article 10 requires the statement of cash flows to be presented for the year-to-date period and for the corresponding period of the prior year. The reporting entity may also present a statement of cash flows for the cumulative 12-month period ended during the most recent fiscal quarter and for the corresponding preceding period if that information would be meaningful to financial statement users.

Similar to the balance sheet and income statement, the statement of cash flows may also be presented on a condensed basis as described below.

S-X 10-01(a)(4)

The statement of cash flows may be abbreviated starting with a single figure of net cash flows from operating activities and showing cash changes from investing and financing activities individually only when they exceed 10% of the average of net cash flows from operating activities for the most recent three years. Notwithstanding this test, Rule 4-02 applies and de minimis amounts therefore need not be shown separately.

As discussed in ASC 270-10-S99-2 (SAB Topic 6.G.2a), if operations resulted in a net outflow of cash and cash equivalents during any of the three years, such amount should be excluded from the computation of the average unless operations resulted in a net outflow of cash and cash equivalents in all three years.

Interim cash flow statements do not require separate disclosure of the amounts of cash interest and taxes paid during the interim periods. While Article 10 allows the statement of cash flows to start with a single figure for cash flows from operating activities, reporting entities may want to consider whether stakeholders would benefit from expanded cash flows from operating activities, similar to annual presentations, rather than the abbreviated presentation.

Further, as discussed in ASC 230-10-50-3, reporting entities with non-cash investing or financing activities should disclose these amounts as supplemental disclosures in any period in which they occur. These disclosures *may* be provided in a narrative format or summarized in a schedule.

29.3.5 Presentation requirements- statement of stockholders' equity

Article 10 requires reporting entities to provide an analysis of changes in each caption of stockholders' equity and noncontrolling interests, which will need to be accompanied by dividends per share and in the aggregate for each class of shares. These disclosures are required to be provided for the most recent quarter, the corresponding quarter in the preceding year, and the year-to-date periods for both years.

There is no specified format that must be followed to present the interim information about changes in stockholders' equity. We believe, for example, that a calendar year-end company reporting for the third quarter can comply with the requirement by either:

- presenting an analysis of changes in each caption from January 1 to September 30 and a separate analysis from July 1 to September 30 for each year; or
- "stacking" each of the quarter-to-date analyses (January 1 to March 31, April 1 to June 30, and July 1 to September 30) to build a year-to-date analysis for each year.

There may be other acceptable presentations; however, the disclosure must be presented in the form of a reconciliation either as a separate statement or in the footnotes.

29.4 Interim footnote disclosures

Since interim periods are an integral part of an annual period, reporting entities can assume stakeholders have access to annual financial information and can prepare most of their disclosures in the context of an update to the most recently filed annual financial statements. ASC 270 also

acknowledges the need to balance the timeliness of interim financial reporting and the amount of detail disclosed, and therefore provides more limited disclosure requirements for interim financial information as compared to annual financial statements.

As such, interim reporting generally should not simply repeat information disclosed in the previous annual financial statements (e.g., significant accounting policies or details of account balances that have not changed significantly). Instead, disclosures should typically focus on items that have changed significantly since year end or events that occurred subsequent to the annual financial statements (e.g., new borrowings, business combinations or dispositions, debt or equity issuances, debt modifications, etc.). S-X 10-01(a)(5) further discusses the types of items that should be disclosed.

In addition, there may be circumstances in which information is not significant in the context of the annual results of operations but is material in the context of the interim results. This information should be discussed in the interim report.

Certain disclosures may also be necessary to ensure comparability with prior periods.

ASC 270-10-45-8(b)

Some costs and expenses incurred in an interim period, however, cannot be readily identified with the activities or benefits of other interim periods and shall be charged to the interim period in which incurred. Disclosure shall be made as to the nature and amount of such costs unless items of a comparable nature are included in both the current interim period and in the corresponding interim period of the preceding year.

Although the interim footnote disclosures should be prepared using this overarching guidance, US GAAP also requires specific interim disclosures. The following subsections discuss certain interim footnote disclosures required by ASC 270 and Article 10. FSP 29.4.1 through FSP 29.4.8 includes general recurring interim disclosure requirements. FSP 29.4.10 includes disclosure requirements for certain transactions.

29.4.1 Consistent interim and annual reporting requirements

Figure FSP 29-2 lists the more significant accounting topics that have consistent interim and annual reporting requirements. It also provides references of where to find more information about the annual disclosure requirements.

Figure FSP 29-2

General recurring topics with consistent interim and annual disclosure requirements

Topic	Reference
Contingencies	FSP 23 and FSP 29.4.1.1
Debt and equity securities	FSP 9
Derivatives and hedging	FSP 19

Topic	Reference
Earnings per share	FSP 7
Financial instruments	FSP 20
Guarantees, including product warranties	FSP 11 and FSP 23
Registered guarantors/guarantees	FSP 12 and FSP 31.3
Related parties	FSP 26
Taxes collected from customers and remitted to government authorities	FSP 3
Noncontrolling interests	FSP 2
Variable interest entities	FSP 18

29.4.1.1 *Contingencies*

ASC 270-10-50-6 indicates that contingencies and other uncertainties that could affect the fairness of presentation of interim financial data should be disclosed in interim reports in the same manner as required for annual reports. Disclosures should be repeated or updated as applicable in all reporting periods until the contingencies have been removed, resolved, or have become immaterial. However, since interim financial statements include year-to-date information, contingencies resolved during one quarter of a fiscal year should continue to be disclosed in the subsequent quarterly financial statements of the same fiscal year. When assessing whether a transaction or uncertainty is material for purposes of disclosure, materiality should be assessed in relation to the annual financial statements.

29.4.2 *Defined benefit plans and other postemployment benefits*

The following interim disclosures should be provided for defined benefit pension plans and other defined benefit postretirement benefit plans of publicly traded reporting entities in interim periods.

Excerpt from ASC 270-10-50-1(j)

1. The amount of net periodic benefit cost recognized, for each period for which a statement of income is presented, showing separately the service cost component, the interest cost component, the expected return on plan assets for the period, the gain or loss component, the prior service cost or credit component, the transition asset or obligation component, and the gain or loss recognized due to a settlement or curtailment
2. The total amount of the employer's contributions paid, and expected to be paid, during the current fiscal year, if significantly different from amounts previously disclosed.... Estimated contributions may be presented in the aggregate combining all of the following:
   i. Contributions required by funding regulations or laws
   ii. Discretionary contributions
   iii. Noncash contributions.

The disclosures should be provided for all periods presented. The amounts should reflect the actual expense recorded and should not be changed to reflect "normalized" expense for the year.

As discussed in ASC 715-60-50-1 through ASC 715-60-50-6, reporting entities should also disclose certain information about the Medicare subsidy effects on its postretirement health care benefit plan. See FSP 13 for further information on these disclosures.

29.4.3 Equity method investees

Article 10 requires certain disclosure for equity method investees.

S-X 10-01(b)(1)

Summarized statement of comprehensive income information shall be given separately as to each subsidiary not consolidated or 50 percent or less owned persons or as to each group of such subsidiaries or fifty percent or less owned persons for which separate individual or group statements would otherwise be required for annual periods. Such summarized information, however, need not be furnished for any such unconsolidated subsidiary or person which would not be required pursuant to Rule 13a-13 or 15d-13 to file quarterly financial information with the Commission if it were a registrant.

While SEC registrants are required to disclose interim comprehensive income information, as discussed in S-X 10-01(b)(1), it is not necessary to disclose interim balance sheet information of equity method investees.

See FSP 10 for further information on disclosures required for equity method investments in interim periods.

29.4.4 Financial assets and allowances for credit losses

ASC 270-10-50-1(p) requires reporting entities to disclose the following information about the credit quality of financing receivables and the allowance for credit losses:

- Nonaccrual and past due financial assets
- Allowance for credit losses related to financial assets
- Credit-quality information for instruments within the scope of ASC 326-20
- Modifications of financing receivables

The disclosures should be provided for all periods presented (see FSP 29.3).

The disclosures related to past-due and nonaccrual status financial assets are not required for trade receivables that are due in less than a year and that result from revenue transactions in the scope of ASC 606, except for credit card receivables. They are also not required for receivables measured at the lower of amortized cost basis or fair value.

29.4.4A *Financing receivables and allowances for credit losses (pre-ASC 326)*

ASC 270-10-50-1(p) requires reporting entities to disclose the following information about the credit quality of financing receivables and the allowance for credit losses:

- Nonaccrual and past due financing receivables
- Allowance for credit losses related to financing receivables
- Impaired loans
- Credit-quality information related to financing receivables
- Modifications of financing receivables

The disclosures should be provided for all periods presented (see FSP 29.3).

29.4.5 *Reportable operating segments*

Reduced segment disclosures discussed in ASC 280-10-50-32 may be presented when condensed financial statements of interim periods are issued. If a complete set of financial statements is presented in an interim period, then the full disclosure requirements of ASC 280 apply. Refer to FSP 25.7.7 for discussion of presentation and disclosure requirements for segments in interim periods.

29.4.6 *Seasonal revenue, costs, or expenses*

Certain reporting entities are subject to seasonal variations, which could cause interim results to not be indicative of the estimated results for the full fiscal year. Reporting entities subject to material seasonal variations should disclose the seasonal nature of their activities. They should also consider supplementing interim financial information with information from the 12-month period ended as of the most recent interim date along with comparative data from the corresponding 12-month period of the prior year.

For example, per S-X 10-01(c)(4), certain agricultural reporting entities may present rolling 12-month statements of comprehensive income and cash flows in lieu of year-to-date statements if management believes it is more appropriate and necessary for an understanding of the impact of seasonal fluctuations.

Some SEC registrants may also elect to present balance sheets as of the end of the prior year quarter as supplemental disclosure for comparative purposes.

29.4.7 *Revenue from contracts with customers*

ASC 270 requires reporting entities to provide certain disclosures about revenue from contracts with customers in interim financial statements. Interim reporting requirements for revenue, receivables, contract assets, contract liabilities, and remaining performance obligations arising from contracts with customers are as follows:

Excerpt from ASC 270-10-50-1A

a. A disaggregation of revenue for the period…

b. The opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers (if not otherwise separately presented or disclosed)…

c. Revenue recognized in the reporting period that was included in the contract liability balance at the beginning of the period…

d. Revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (for example, changes in transaction price)…

e. Information about the entity's remaining performance obligations as of the end of the reporting period

Refer to FSP 33 for a summary of the presentation and disclosure guidance related to ASC 606, Revenue from Contracts with Customers.

29.4.8 Leases

A lessor is required to disclose its lease income in a tabular format in each interim reporting period (ASC 270-10-50-6A).

For sales-type and direct financing leases, this tabular disclosure should include the following:

- Profit or loss recognized at the commencement date, disclosed on either a gross or net basis based on its business model
- Interest income, either in aggregate or separated by components of the net investment in the lease
- Lease income relating to variable lease payments not included in the measurement of the lease receivable

A lessor should also disclose the components of its aggregate net investment in sales-type leases and direct financing leases including:

- The carrying amount of its lease receivables
- Its unguaranteed residual assets
- Any deferred selling profit in direct financing leases (which is a reduction to the net investment)

For operating leases, this tabular disclosure should include lease income relating to lease payments, including lease income relating to variable lease payments.

Refer to FSP 14 for a summary of the annual presentation and disclosure guidance related to ASC 842, Leases.

29.4.9 Supplier finance programs after adoption of ASU 2022-04 – added September 2022

ASU 2022-04, *Disclosure of Supplier Finance Program Obligations*, requires disclosures about supplier finance programs, including an interim disclosure. ASC 405-50-50-4 requires reporting entities to disclose in interim periods the amount of obligations under a supplier finance program that have been confirmed as valid and remain outstanding at the end of the period.

In addition, during the fiscal year of adoption, the information on the key terms and balance sheet presentation, which are annual disclosure requirements, should also be disclosed in each interim period. For all entities, the amendments are effective for fiscal years beginning after December 15, 2022 with early adoption permitted. The requirements related to the interim disclosures should be applied retrospectively to each period in which a balance sheet is presented.

See FSP 11.3.1.5 for further information on supplier finance programs.

29.4.10 Other interim reporting requirements

Additional disclosure may be necessary as a result of events or transactions that occur in the interim period. The following subsections discuss several of these situations.

29.4.10.1 Business combinations

The disclosure requirements of ASC 805, *Business Combinations*, are applicable for business combinations that occur either during the current reporting period, or after the reporting date but before the financial statements are issued. Therefore, the required disclosures should be included in interim financial statements, as applicable.

If the transaction is reflected as a combination of entities under common control, S-X 10-01(b)(3) requires supplemental disclosure of the separate results of the combined entities for periods prior to the combination. See FSP 30.6 for further discussion regarding entities under common control or change in reporting entities.

29.4.10.2 Change in accounting principle or change in estimate

Reporting entities may make a change in accounting principle (e.g., adopt a new accounting standard or acknowledge the impact of a change for a standard not yet adopted) or change an accounting estimate during an interim reporting period. FSP 30.4.3 discusses the presentation and disclosure requirements for both of these events.

29.4.10.3 Identification of an error

Reporting entities may identify an error during an interim reporting period. FSP 30.7 discusses the presentation and disclosure requirements for error corrections.

In addition, the SEC staff requires registrants that adopt a new accounting standard during an interim period to include all required annual disclosures in any interim financial statements that are prepared until the next annual financial statements are filed. This is true even if the disclosure requirements of new accounting standards are only applicable for annual periods.

Article 10 requires certain disclosures for retroactive prior period adjustments made during any period covered by interim financial statements.

S-X 10-01(b)(7)

Any material retroactive prior period adjustment made during any period covered by the interim financial statements shall be disclosed, together with the effect thereof upon net income - total and per share - of any prior period included and upon the balance of retained earnings. If results of operations for any period presented have been adjusted retroactively by such an item subsequent to the initial reporting of such period, similar disclosure of the effect of the change shall be made.

29.4.10.4 Discontinued operations

Reporting entities may meet the requirements to report discontinued operations during an interim reporting period. The disclosure requirements of ASC 205-20-50-1 through ASC 205-20-50-7 should be followed for interim reporting periods. See FSP 27 for discussion of these disclosure requirements.

If discontinued operations are reported net of tax in the annual financial statements, they should be similarly reported in the interim financial statements. See FSP 27.4.2.

29.4.10.5 Disposal of reporting entity component and unusual items

As discussed in ASC 270-10-45-11A, material effects of disposals of a component of a reporting entity and unusual and infrequently occurring transactions and events should be reported separately.

29.4.10.6 Significant change in estimates for income taxes

Reporting entities should make their best estimate of the effective tax rate expected to be applicable for the full fiscal year for interim reporting purposes and, as discussed in ASC 270-10-50-1(d), should disclose any significant changes in such estimates from period to period. If a reporting entity determines that it is unable to reliably estimate its annual effective tax rate, the discrete-period computation method may be used. The reporting entity's assertion that it cannot reliably estimate its annual effective tax rate should be disclosed so that financial statement users can understand the manner in which the interim tax provision was determined.

When a reporting entity applies the requirements of ASC 740, *Income Taxes*, in interim periods, a significant variation in the customary relationship between income tax expense and pretax income may result. The reasons for significant variations during interim periods should be disclosed, unless the reasons are apparent from the financial statements or the nature of the reporting entity's business.

In addition, as discussed in ASC 270-10-50-3, reporting entities should disclose if important developments occur during the year, including those impacting tax-related balances. Reporting entities should also consider disclosure if the tax amounts reported for the interim periods do not adequately reflect events that the reporting entity expects to occur later in the year. Interim period disclosures related to income taxes often include:

- Tax effects of significant unusual or infrequent items that are recorded separately or items that are reported net of their related tax effect
- Significant changes in estimates or provisions for income taxes (e.g., changes in the assessment of the need for a valuation allowance that occur during the period)

- Material changes to (1) uncertain tax benefits, (2) amounts of uncertain tax benefits that if realized would affect the estimated annual effective tax rate, (3) total amounts of interest and penalties recognized in the balance sheet, (4) positions for which it is reasonably possible that the total amount of uncertain tax benefits will significantly increase or decrease within the next 12 months, and (5) the description of tax years that remain open by major tax jurisdiction

Material changes in unrecognized tax benefits that occur during an interim period should be disclosed during the interim period. A reporting entity should not delay disclosure of material changes until the end of the annual reporting period.

29.4.10.7 Other interim reporting requirements for certain non-recurring transactions that are consistent with annual reporting requirements

ASC 270-10-50-6 requires disclosure in the interim financial statements of material, non-recurring events occurring subsequent to the end of the most recent fiscal year.

Figure FSP 29-3 lists the more significant accounting topics that are non-recurring in nature that have consistent interim and annual reporting requirements, and includes references to the discussion of the annual disclosure requirements.

Figure FSP 29-3

Non-recurring topics with consistent interim and annual disclosure requirements

Topic	Reference
Early warning and changes to risks and uncertainties	FSP 24
Going concern	FSP 24
Issuance of equity	FSP 5
New debt arrangements	FSP 12
Restructuring	FSP 11
Share-lending arrangements	FSP 12
Deconsolidation of a subsidiary	FSP 18
Subsequent events	FSP 28

In addition, reporting entities are required to make disclosures about collaborative arrangements in the period in which they commence and all subsequent annual periods (see FSP 3).

29.5 Fourth quarter considerations

SEC registrants are required to file a Form 10-Q reporting interim financial information for the first three quarters of each fiscal year. A Form 10-Q does not need to be filed for the fourth quarter of any fiscal year; however, S-K 302 requires most public reporting entities to disclose certain interim information, including fourth quarter information, within the annual report. Exceptions to these

disclosure requirements are noted in S-K 302(a)(5). It is not necessary to disclose the fourth quarter information as part of the audited financial statements. If a reporting entity separately issues fourth quarter financial statements, it should follow the format and content of earlier quarterly financial statements.

If a public reporting entity is not subject to the requirements of Regulation S-K 302 and has not disclosed the results of the fourth quarter in a separate section of its annual report, or has not separately issued a fourth quarter report, certain fourth quarter disclosures are still required. ASC 270-10-50-2 requires the following to be disclosed in a footnote to the annual financial statements:

- Unusual or infrequently occurring items recognized during the fourth quarter
- Disposal of a component(s) during the fourth quarter
- Aggregate effect of year-end adjustments that are material to that fourth quarter
- Changes to accounting principles made during the fourth quarter

29.6 Interim financial reporting considerations for private companies

The primary guidance for the form and content of condensed interim financial information is Article 10, which applies to SEC registrants. Private companies that provide interim information should comply with the provisions of ASC 270 that are applicable to nonpublic companies. In addition, they may also consider complying with the provisions of ASC 270 that are applicable to publicly traded entities, as well as the form and content guidance of Article 10. Private company interim financial information should include a footnote advising that the financial information should be read in conjunction with the latest annual financial statements.

Private company interim financial reporting is often driven by bank covenants or private equity reporting requirements. Not-for-profit entities are often subject to continuing disclosure agreements in connection with tax-exempt financing, which may require the provision of interim financial information. While being mindful of the interim reporting requirements of Article 10 and ASC 270, private and not-for-profit entities should follow the specific financial reporting requirements as mandated by their bank, investor, or continuing disclosure agreements.

The following subsections discuss specific differences in disclosure requirements for private entities as compared with publicly-traded companies.

29.6.1 Accumulated other comprehensive income (private companies)

Private companies are not required to present, either parenthetically on the face of the financial statements or in a single footnote, amounts reclassified out of each component of AOCI on an interim basis. However, private companies are required to follow the reporting requirements related to AOCI during interim periods.

29.6.2 Defined benefit plans and other postemployment benefits (private companies)

Private companies are not required to provide all of the interim disclosures about defined benefit pension plans and other defined benefit postretirement benefit plans described in FSP 29.4.2. Private company disclosure requirements are as follows:

ASC 715-20-50-7

A nonpublic entity shall disclose in interim periods for which a complete set of financial statements is presented the total amount of the employer's contributions paid, and expected to be paid, during the current fiscal year, if significantly different from amounts previously disclosed. . . . Estimated contributions may be presented in the aggregate combining all of the following:

a. Contributions required by funding regulations or laws

b. Discretionary contributions

c. Noncash contributions.

29.6.3 Financial instruments not measured at fair value (private companies)

Interim disclosures for financial instruments not measured at fair value (discussed in FSP 20), but for which fair value is disclosed, are not required for entities that do not meet the Master Glossary's definition of a publicly traded company (see FSP 29.3.3).

29.6.4 Revenue from contracts with customers (private companies)

The interim financial statement disclosures described in FSP 29.4.7 are optional for nonpublic entities.

Chapter 30: Accounting changes—updated February 2022

30.1 Chapter overview–accounting changes

An accounting change generally results from a change in accounting principle, change in estimate, or change in reporting entity. The correction of an error in previously issued financial statements is not an accounting change. However, because the correction of an error requires adjustments to previously issued financial statements, similar to those required when applying an accounting change retrospectively, the guidance for error corrections is also included in ASC 250, *Accounting Changes and Error Corrections*. Distinguishing between each scenario can be difficult, but the distinction is critical to applying the appropriate reporting framework.

This chapter provides guidance on how to distinguish between a change in accounting principle, a change in estimate, and the correction of an error, and addresses the presentation and disclosure considerations for each. It also discusses the presentation and disclosure related to changes in a reporting entity.

30.2 Scope and relevant guidance–accounting changes

ASC 250, *Accounting Changes and Error Corrections*, is the primary guidance governing accounting changes and error corrections, though other provisions of US GAAP and SEC guidance also impact specific aspects of accounting changes. The US GAAP guidance is applicable to all reporting entities, including not-for-profit and private companies.

30.3 Change in accounting principle or estimate, or correction of an error

Determining whether a change is a change in accounting principle, a change in estimate, or the correction of an error can be difficult and require judgment.

In several areas of US GAAP, reporting entities can elect from more than one acceptable accounting principle. As defined in ASC 250-10-20, a change in accounting principle is a change from one acceptable accounting principle to another when there are two or more generally accepted accounting principles. Examples include changing the accounting method for amortizing actuarial gains and losses in net periodic pension expense and changing the method of inventory valuation.

In contrast, as defined in ASC 250-10-20, a change in accounting estimate results from incorporating new information or modifying the estimating techniques affecting the carrying amount of assets or liabilities as of the date the change is made. Changing inputs for estimating uncollectible receivables based on new information is an example of a change in the estimating technique.

The distinction between a change in accounting principle and a change in accounting estimate is important because a change in accounting principle is generally applied retrospectively (by recasting prior periods), while a change in accounting estimate is applied prospectively, affecting only current and future periods. In addition, reporting entities cannot change accounting principles unless the new method is preferable.

Distinguishing a change in accounting estimate from the correction of an error is also important and can be challenging. While a change in accounting estimate results from new information since a previous financial reporting date, an error reflects the misapplication of information that was available

at a previous financial statement reporting date. If the information was known, or could have been known, as of the prior period, it is generally indicative of an error in the previous accounting. ASC 250-10-20 includes examples of errors in previously issued financial statements, such as mathematical mistakes, mistakes in the application of GAAP principles, or oversight or misuse of facts that existed at the time the financial statements were issued. Additionally, a change from an accounting principle that is not generally accepted to one that is generally accepted is the correction of an error.

Reporting entities should consider the following questions to help differentiate among a change in accounting principle, a change in estimate, or the correction of an error:

- What was the rationale for the accounting change?
- Did the estimation model change, or just the inputs?
- Why did the inputs to the estimation model change and when was the change in inputs supportable?
- Is the reporting entity applying the accounting principle to a new business, new balances, or new transactions, or is the accounting principle applicable to balances and transaction streams to which it should have been applied in the past?
- If the accounting results have changed significantly, can the changes be substantiated by developments in the business?

30.4 Change in accounting principle—updated May 2022

ASC 250-10-20 defines a change in accounting principle.

Definition from ASC 250-10-20

A change from one generally accepted accounting principle to another generally accepted accounting principle when there are two or more generally accepted accounting principles that apply or when the accounting principle formerly used is no longer generally accepted. A change in the method of applying an accounting principle also is considered a change in accounting principle.

A change in accounting principle can be required by newly issued guidance or as the result of a decision by the reporting entity to adopt a different accounting principle on the basis that it is preferable.

New accounting guidance generally provides specific transition requirements (e.g., prospective application, full retrospective application, modified retrospective application, etc.). Accordingly, the provisions of ASC 250 do not apply when a reporting entity is adopting a new accounting pronouncement that specifies the manner of adopting the change. However, if transition requirements are not provided by the new accounting guidance, a change in accounting principle should be reported in accordance with ASC 250.

In certain situations, a reporting entity may elect to change its financial statement presentation from one acceptable alternative to another (e.g., a change from presenting accumulated depreciation and amortization on the face of the financial statements to the footnotes or changing from a “one-step”

income statement to a "two-step" income statement). We believe a change in financial statement presentation does not constitute a change in accounting principle and thus would not require a preferability assessment. However, a reporting entity should have consistent presentation for all periods presented within the financial statements.

The adoption of accounting principles in certain situations are outside the scope of ASC 250.

Excerpt from ASC 250-10-45-1

Neither of the following is considered to be a change in accounting principle:

a. Initial adoption of an accounting principle in recognition of events or transactions occurring for the first time or that previously were immaterial in their effect

b. Adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring.

Some examples of scenarios that would not constitute a change in accounting principle under ASC 250-10-45-1a may include the selection of a date for the annual goodwill impairment test after completing a business combination that resulted in recording goodwill for the first time or conforming the accounting policies of an acquired business to those of the acquirer.

An example of a scenario that may not be deemed a change in accounting principle under ASC 250-10-45-1b is when changes in the contractual relationship between the reporting entity and other parties result in a conclusion that the reporting entity is no longer the principal in a revenue transaction and should present that revenue on a net basis.

Generally, accounting principles that are not material are not disclosed in the footnotes. Therefore, it would be unusual for an accounting principle that is disclosed in previously-issued financial statements to be deemed immaterial for the purpose of considering ASC 250-10-45-1a. However, in certain instances, reporting entities may have historically disclosed immaterial accounting principles for comparability with peers or for consistency with prior years. In these situations, reporting entities should perform an assessment of the materiality of the accounting principle that they are changing, the materiality of the change, and the preferability of the change to determine what level of disclosure, if any, is warranted. Even if a reporting entity concludes that a change is immaterial and retrospective application is not required (refer to FSP 30.4.2 and discussion of SAB Topic 5.F), if the change is disclosed, an SEC registrant may still be required to file a preferability letter from their independent registered public accountants. See FSP 30.4.1 and FSP 30.4.2.

Once an accounting principle is adopted, it should be applied consistently when accounting for similar events and transactions because the consistent use of accounting principles is critical to the utility of financial statements. A reporting entity that wants to voluntarily change an accounting principle must justify that the alternative accounting principle is preferable. For example, a change in a reporting unit's annual goodwill impairment test date is a change in the method of applying an accounting principle requiring a preferability assessment (see BCG 9.5.1.2).

Preferability may vary depending upon the circumstances of the reporting entity. For example, one reporting entity may consider the LIFO inventory method to be preferable due to the nature of its

inventory costs, while for others, FIFO may be preferable. The disclosure should include an explanation of why the newly adopted change is preferable.

SAB Topic 6.G.2.b, *Reporting Requirements for Accounting Changes* (codified in ASC 250-10-S99-4), provides guidance on assessing the justification for a change in accounting principle. It includes considerations such as whether an authoritative body has deemed an accounting principle preferable, how the change impacts business judgment and planning, and whether the change results in improved financial reporting.

Question FSP 30-1 discusses whether a preferability assessment is required when a private company changes accounting principles upon filing an IPO registration statement.

Question FSP 30-1

When a private company changes accounting principles to conform with public company accounting principles in connection with filing an IPO registration statement, does the change require a preferability assessment?

PwC response

No. When a private company is required to change accounting principles to conform with public company accounting requirements (e.g., discontinuing the application of the Private Company Council (PCC) goodwill alternative), a preferability assessment is not necessary. This is because such a change in accounting principle is not "voluntary" and is required by a regulator to conform to GAAP.

Question FSP 30-2 discusses whether a private company is required to perform a preferability assessment when adopting a PCC accounting alternative for the first time.

Question FSP 30-2

When a private company voluntarily adopts a PCC accounting alternative for the first time, is a preferability assessment required?

PwC response

No. Although the adoption of a PCC accounting alternative is a voluntary change in accounting principle, ASU 2016-03, *Intangibles—Goodwill and Other (Topic 350), Business Combinations (Topic 805), Consolidation (Topic 810), Derivatives and Hedging (Topic 815)*, allows private companies to forgo a preferability assessment the first time they elect any of the PCC accounting alternatives within the scope of the ASU. However, after the initial election of a PCC accounting alternative, any future accounting changes require a preferability assessment, except when a private company changes accounting principles to conform with public company accounting principles in connection with filing an IPO registration statement (see Question FSP 30-1).

30.4.1 Preferability letters (change in accounting principle)

For public reporting entities (except for foreign private issuers) that make material accounting changes, the registrant's independent accountant is required to provide a letter, commonly referred to as a "preferability letter." The preferability letter indicates whether or not the change to an alternative

principle is, in the accountant's judgment, preferable under the circumstances. S-X 10-01(b)(6) and S-K Item 601 provide guidance on the form and content of preferability letters.

If there has been a material change in an accounting principle or its method of application, the auditor is required to discuss the change in an explanatory paragraph in the auditor's report. The explanatory paragraph must identify the nature of the change and refer to the financial statement footnote that discusses it.

30.4.2 Presentation and disclosure considerations (change in accounting principle)

ASC 250-10-45-5 requires that a change in accounting principle be reported through retrospective application, unless impracticable. Retrospective application requires the following:

- The cumulative effect of the change to the accounting principle on periods prior to those presented should be reflected in the carrying amounts of assets and liabilities as of the beginning of the earliest period presented.
- The effect, if any, must be reflected in the opening balance of retained earnings (or other appropriate components of equity or net assets) for the earliest period presented.
- Financial statements for prior periods presented should be adjusted to reflect the period-specific effects of applying the new accounting principle.

SAB Topic 5.F, *Accounting Changes Not Retroactively Applied Due to Immateriality* (codified in ASC 250-10-S99-3), provides the SEC staff's view when an accounting change that is required to be adopted by retrospective application is considered to be immaterial to prior period financial statements. The SEC staff believes the amount should be reflected in the results of operations for the period in which the change is made, unless the cumulative effect is material to current operations or to the trend of the reported results of operations. In this case, the individual income statements of the earlier years should be retrospectively adjusted. See SAB 99, *Materiality,* for evaluating materiality.

ASC 250-10-50-1 requires specific financial statement disclosures with respect to a change in accounting principle.

Excerpt from ASC 250-10-50-1

An entity shall disclose all of the following in the fiscal period in which a change in accounting principle is made:

a. The nature of and reason for the change in accounting principle, including an explanation of why the newly adopted accounting principle is preferable.

b. The method of applying the change, including all of the following:

   1. A description of the prior-period information that has been retrospectively adjusted, if any.

   2. The effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item, and any affected per-share amounts for the current period and any prior periods retrospectively adjusted. Presentation of the effect on

financial statement subtotals and totals other than income from continuing operations and net income (or other appropriate captions of changes in the applicable net assets or performance indicator) is not required.

3. The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented.

Financial statements of subsequent periods need not repeat the disclosures required by this paragraph. If a change in accounting principle has no material effect in the period of change but is reasonably certain to have a material effect in later periods, the disclosures required by (a) shall be provided whenever the financial statements of the period of change are presented.

ASC 250-10-50-1 indicates that the disclosure generally does not need to be repeated in subsequent period financial statements. However, when an accounting change occurs and prior periods are not retrospectively adjusted due to impracticability, the disclosures should be included in subsequent periods until all periods are prepared using the new principle.

SAB Topic 6.I.3, *Net of Tax Presentation* (codified in ASC 740-10-S99-1), clarifies that when cumulative effect adjustments related to changes in accounting principle are reported on a net of tax basis, additional disclosure of the nature of the tax component should be provided. This is accomplished by reconciling the tax component associated with the cumulative effect adjustment to the applicable statutory income tax rate.

Question FSP 30-3 illustrates the effect of a retrospective change in accounting principle on column labels in financial statements.

Question FSP 30-3

Do the columns in the financial statements need to be labelled "As adjusted" when there has been a retrospective change in accounting principle?

PwC response

No. Although the example in ASC 250-10-55-10 illustrating a retrospective change in accounting principle uses the label "As adjusted," ASC 250 does not require such labeling in the financial statements. However, use of the "As adjusted" label is encouraged as a best practice. Additionally, when there has been a retrospective change in accounting principle, the financial statements should include clear disclosure about the effect of the change on the affected financial statement line items and any per-share amounts as required by ASC 250-10-50-1.

The "As restated" label should generally be used only when the financial statements reflect the correction of a material error.

30.4.2.1 Impracticability (change in accounting principle)

In certain scenarios, it may not be practical for reporting entities to determine the retrospective impact of an accounting change (e.g., due to lack of available information). ASC 250-10-45-9 acknowledges this complication and provides criteria that a reporting entity must meet to consider retrospective application impracticable.

ASC 250-10-45-9

It shall be deemed impracticable to apply the effects of a change in accounting principle retrospectively only if any of the following conditions exist:

a. After making every reasonable effort to do so, the entity is unable to apply the requirement.

b. Retrospective application requires assumptions about management's intent in a prior period that cannot be independently substantiated.

c. Retrospective application requires significant estimates of amounts, and it is impossible to distinguish objectively information about those estimates that both:

   1. Provides evidence of circumstances that existed on the date(s) at which those amounts would be recognized, measured, or disclosed under retrospective application

   2. Would have been available when the financial statements for that prior period were issued.

Sometimes it may be impracticable to determine the period-specific effects of a change on all prior periods presented, even when the cumulative effect can be determined. In these situations, the carrying amounts of assets and liabilities as of the beginning of the earliest period to which the new accounting principle can be applied should be adjusted for the cumulative effect of the change. Any offsetting adjustment should be made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position).

If it is impracticable to determine the cumulative effect of applying a change in accounting principle, then the new accounting principle should be applied prospectively as of the earliest date practicable. In this scenario, the disclosures discussed in FSP 30.4.2 are still required.

30.4.2.2 Indirect effects of a change in accounting principle

ASC 250 indicates that retrospective application should include only the direct effects of a change in accounting principle, including any related income tax effects. Indirect effects (e.g., a royalty payment that is based on a reported amount such as revenue or net income) that would have been recognized if the newly adopted accounting principle had been followed in prior periods should not be included in the retrospective application. If indirect effects are actually incurred, they should be reported in the period in which the accounting change is made. Specific disclosures relating to the indirect effects of changes in accounting principles are outlined in ASC 250-10-50-1(c).

ASC 250-10-50-1(c)

If indirect effects of a change in accounting principle are recognized both of the following shall be disclosed:

1. A description of the indirect effects of a change in accounting principle, including the amounts that have been recognized in the current period, and the related per-share amounts, if applicable.

2. Unless impracticable, the amount of the total recognized indirect effects of the accounting change and the related per-share amounts, if applicable, that are attributable to each prior period presented. Compliance with this disclosure requirement is practicable unless an entity cannot comply with it after making every reasonable effort to do so.

Example FSP 30-1 illustrates an indirect effect of an accounting change.

EXAMPLE FSP 30-1

Indirect effect of an accounting change

FSP Corp changes to a preferable accounting principle in 20X2. The retrospective application of the change results in an increase in reported net income for 20X1. FSP Corp's bonus plan is tied to reported net income, and the 20X1 bonus payment would have been higher if the new accounting principle had been adopted in 20X1. Though not required to do so under the bonus plan, FSP Corp elects to pay the incremental bonus amount in 20X2.

Should FSP Corp report the incremental bonus payment in the retrospective application of the change in accounting principle?

Analysis

No. The incremental bonus payment is an indirect effect of the accounting change and would not be included in the retrospective application in 20X1. Instead, the additional bonus expense should be recognized and reported in 20X2. Had FSP Corp chosen not to pay the incremental bonus, there would be no impact on 20X1 or 20X2.

30.5 Change in accounting estimate

A change in accounting estimate results from new information or modifications to the estimating techniques affecting the carrying amount of assets or liabilities.

ASC 250-10-45-17 indicates that changes in accounting estimates should not be accounted for by restating or retrospectively adjusting the amounts reported in prior period financial statements or by reporting pro forma amounts. Instead, a change in accounting estimate should be accounted for in the period of change and prospective periods, if applicable.

It is important for reporting entities to maintain sufficient documentation to support changes to estimates and the timing of such changes. A change to an accounting estimate should be based on events, facts, or circumstances that occurred during the period in which the estimate was changed.

ASC 250 requires specific financial statement disclosures with respect to changes in accounting estimates.

ASC 250-10-50-4

The effect on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), and any related per-share amounts of the current period shall be disclosed for a change in estimate that affects several future periods, such as a change in service lives of depreciable assets. Disclosure of those effects is not necessary for estimates made each period in the ordinary course of accounting for items such as uncollectible accounts or inventory obsolescence; however, disclosure is required if the effect of a change in the estimate is material. When an entity effects a change in estimate by changing an accounting principle, the disclosures required by paragraphs 250-10-50-1 through 50-3 also are required. If a change in estimate does not have a material effect in the period of change but is reasonably certain to have a material effect in later periods, a description of that change in estimate shall be disclosed whenever the financial statements of the period of change are presented.

At times, a change in estimate can result from a change in accounting principle. A common example is a change in the method of depreciation applied to fixed assets, which is effectively a change in the estimate of the future benefit or pattern of consumption. In such cases, the effect of the change in accounting principle, or the method of applying it, may be inseparable from the effect of the change in accounting estimate. Such a change should be accounted for as a change in estimate. However, the disclosures for both a change in accounting principle and a change in accounting estimate would be required. As with changes in accounting principles, this type of change may only be made if it is preferable. As discussed in SEC FRM 4230.2 (c)(4), a preferability letter is not required for a change in estimate effected by a change in accounting principle. Other changes in estimates do not require an assessment of preferability.

30.6 Change in a reporting entity and common control transactions

A change in reporting entity is a change that results in financial statements that, in effect, are those of a different reporting entity. Examples include presenting consolidated or combined financial statements in place of financial statements of individual entities, changing subsidiaries within a consolidated group for which consolidated financial statements are presented, or changing the entities included in a set of combined financial statements.

Business combinations accounted for by the acquisition method and consolidation of variable interest entities pursuant to Topic 810, *Consolidation*, are not considered changes in a reporting entity.

Excerpt from ASC 250-10-50-6

When there has been a change in the reporting entity, the financial statements of the period of the change shall describe the nature of the change and the reason for it. In addition, the effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), other comprehensive income, and any related per-share amounts shall be disclosed for all periods presented. Financial statements of subsequent periods need not repeat the disclosures required by this paragraph. If a change in reporting entity does not have a material effect in the period of change but is reasonably certain to have a material effect in later periods, the nature of and reason for the change shall be disclosed whenever the financial statements of the period of change are presented.

Transfers between entities that are under common control are included within the *Transactions Between Entities Under Common Control* subsections of ASC 805-50. Common control transactions occur frequently, particularly in the context of reorganizations, spin-offs, and initial public offerings. In certain scenarios, common control transactions may result in a change in reporting entity, requiring that the guidance of ASC 250-10-50-6 be applied. See BCG 7.1.2 for further information in assessing the nature of common control transactions, including whether such transactions result in a change in reporting entity.

30.6.1 Change in reporting entity – receiving entity (common control)

If a transaction combines two or more entities under common control that historically have not been presented together, the resulting financial statements may be considered to be those of a different reporting entity. The change in reporting entity requires retrospective combination of the entities for all periods presented as if the combination had been in effect since inception of common control in accordance with ASC 250-10-45-21. See BCG 7.1.2 for further information on presenting a change in reporting entity resulting from a common control transaction.

30.6.2 Change in reporting entity – transferring entity (common control)

ASC 805-50-05-5 indicates that certain common control transactions are changes in the reporting entity and provides accounting guidance for the reporting entity that receives the net assets in a common control transaction. However, ASC 805 is silent regarding the accounting by the reporting entity that contributes the net assets or equity interests.

Some infer from the receiving entity guidance that the same financial reporting should be applied to the transferring entity. This method is often referred to as a “de-pooling.” In a de-pooling, the assets, liabilities, and related operations of the transferred business are retrospectively removed from the financial statements of the transferring entity at their historical carrying values.

Alternatively, some believe the transferring entity should report the transfer as a disposal pursuant to ASC 360-10. The guidance in ASC 360-10-45-15 indicates that the disposal group of long-lived assets that are to be disposed of other than by sale should continue to be classified as held and used until the disposal date. If the disposal group qualifies as a component of the transferring entity, it should be assessed for discontinued operations reporting on the disposal date.

For public companies, the SEC staff has issued SAB Topic 5-Z.7, *Miscellaneous Accounting, Accounting and Disclosure Regarding Discontinued Operations, Accounting for the Spin-off of a*

Subsidiary, which addresses accounting for the spin-off of a subsidiary. While this topic is not written in the context of a change in reporting entity that results from a common control transaction, reporting entities should consider this guidance in determining the appropriate accounting by the transferring entity in a common control transaction. The topic provides a number of stringent criteria, all of which must be met to "de-pool" a transferred business retroactively from its historical financial reporting periods. The SEC staff often challenges a reporting entity's assertion that all the requirements of the SAB have been met. Therefore, the more frequently applied accounting by the transferring entity has been to reflect the contribution as a disposal under ASC 360-10. Although this guidance is specific to public companies, we believe the underlying concepts are applicable to private companies as well.

See BCG 7.1.4 for further information on presenting a common control transaction in the financial statements of the transferring entity.

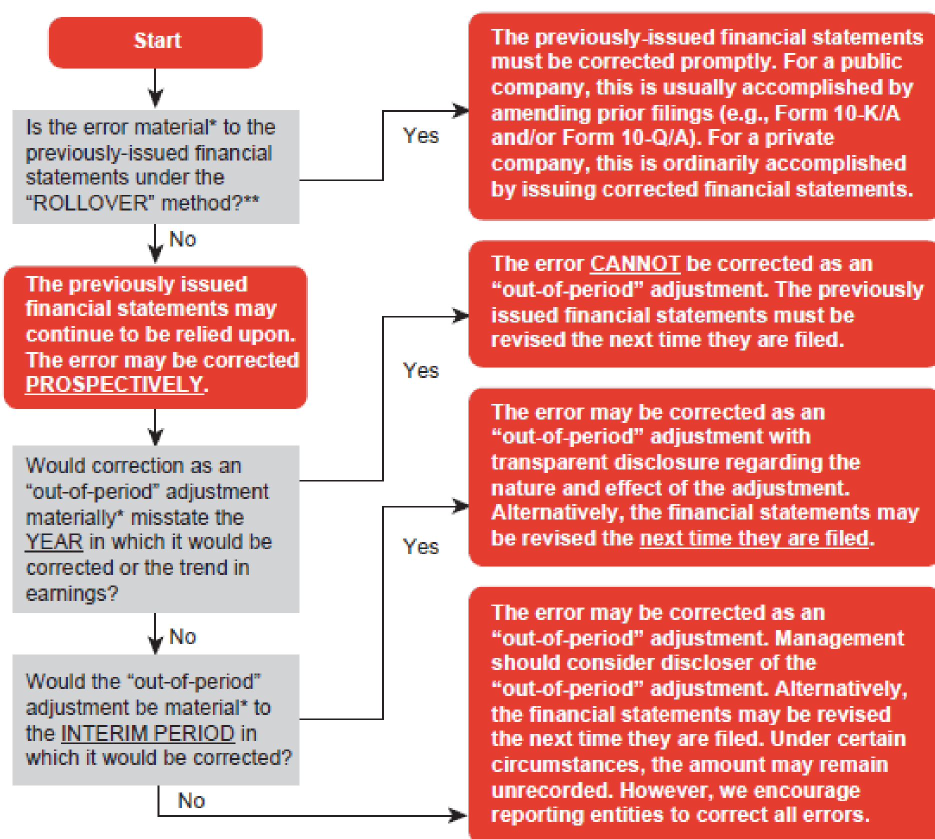
30.7 Correction of an error

A reporting entity should evaluate the materiality of errors, individually and in the aggregate, relative to the period of origination and correction to determine whether a restatement or revision of the previously issued annual or interim financial statements is required.

When a reporting entity identifies an error in previously issued financial statements, the first step is to consider whether the error is material to any previously issued financial statements. If not, the reporting entity must then evaluate whether the correction of the error in the current period would result in a material misstatement of the current period's financial statements. For SEC registrants (and as a best practice for all reporting entities), SAB 99, *Materiality*, (codified in ASC 250-10-S99), requires both a qualitative and quantitative assessment of materiality. Figure FSP 30-1 depicts the materiality framework for evaluating errors in previously issued financial statements.

Figure FSP 30-1 illustrates a framework to evaluate errors in previously issued financial statements.

Figure FSP 30-1
Framework for evaluating errors in previously issued financial statements



** The materiality evaluation requires significant professional judgment and includes consideration of all relevant qualitative and quantitative factors.*

*** The "rollover" method is used to evaluate whether previously issued financial statements are materially misstated. The "rollover method" involves an analysis of the error(s) on all of the financial statements presented. The "iron curtain" error method does not impact the decision regarding whether or not previously issued financial statements are materially misstated.*

Materiality analyses require significant judgment. A materiality analysis must consider all relevant qualitative and quantitative factors (including company and industry-specific factors). Qualitative factors may cause misstatements of quantitatively small amounts to be material.

In accordance with SAB 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in the Current Year Financial Statements* (codified in ASC 250-10-S99-2), errors in financial statements filed with the SEC must be evaluated using both the "iron curtain" method (for the current period) and the "rollover" method (for prior periods) to consider whether the errors are quantitatively significant.

- The "rollover" method assesses income statement errors based on the amount by which the income statement for the period is misstated—including the reversing effect of any prior period errors. Identified misstatements in the previous period that were not corrected need to be considered to determine any "carryover effects."

- The “iron curtain” method assesses income statement errors based on the amount by which the income statement would be misstated if the accumulated amount of the errors that remain in the balance sheet at the end of the period were corrected through the income statement during that period.

Many reporting entities whose financial statements are not filed with the SEC also evaluate errors using both methods. The use of both methods is commonly referred to as the “dual” method of evaluating errors.

The quantified materiality of an error must be evaluated with respect to each affected financial statement, as well as each financial statement line item and financial statement disclosure. For example, in addition to considering the income statement, a materiality evaluation under the "rollover" method would also include consideration of the impact on the statement of cash flows. It would also consider whether the cumulative unadjusted errors in the balance sheet result in a material misstatement of the balance sheet or the statement of stockholders' equity.

30.7.1 Restatements (error corrections)

Upon determination that the previously issued financial statements are materially misstated, they should be corrected promptly.

- For an SEC registrant, the correction of a material misstatement is ordinarily accomplished by performing both of the following:
  - Filing an Item 4.02 Form 8-K to indicate that the previously issued financial statements should no longer be relied upon. The reporting entity should consult with its counsel to determine the appropriate steps and timing for providing notice that the financial statements should no longer be relied upon.
  - Amending prior filings (e.g., filing Form 10-K/A and/or Form 10-Q/A, or, in limited circumstances, a Form 10-K when filing of the subsequent year’s Form 10-K is imminent)
- For a private company, the correction of a material misstatement is ordinarily accomplished by the company issuing corrected financial statements that indicate that they have been restated and include its auditor’s reissued audit report. Alternatively, it is permissible to reflect the restatement in the soon-to-be issued comparative financial statements. When the restatement is to be reflected in the soon-to-be issued comparative financial statements, the financial statements and auditor’s report would indicate that the prior periods have been restated. Users of the previously issued financial statements also must be notified that they should no longer rely on those financial statements.

Excerpt from ASC 250-10-45-23

Restatement requires all of the following:

a. The cumulative effect of the error on periods prior to those presented shall be reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented.

b. An offsetting adjustment, if any, shall be made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period.

c. Financial statements for each individual prior period presented shall be adjusted to reflect correction of the period-specific effects of the error.

When only a single period is presented, the cumulative effect of the error should be recorded as an adjustment to beginning retained earnings.

Further, ASC 250 requires specific financial statement disclosures with respect to a correction of an error.

ASC 250-10-50-7

When financial statements are restated to correct an error, the entity shall disclose that its previously issued financial statements have been restated, along with a description of the nature of the error. The entity also shall disclose both of the following:

a. The effect of the correction on each financial statement line item and any per-share amounts affected for each prior period presented

b. The cumulative effect of the change on retained earnings or other appropriate components of equity or net assets in the statement of financial position, as of the beginning of the earliest period presented.

ASC 250-10-50-8

When prior period adjustments are recorded, the resulting effects (both gross and net of applicable income tax) on the net income of prior periods shall be disclosed in the annual report for the year in which the adjustments are made and in interim reports issued during that year after the date of recording the adjustments.

ASC 250-10-50-9

When financial statements for a single period only are presented, this disclosure shall indicate the effects of such restatement on the balance of retained earnings at the beginning of the period and on the net income of the immediately preceding period. When financial statements for more than one period are presented, which is ordinarily the preferable procedure, the disclosure shall include the effects for each of the periods included in the statements. (See Section 205-10-45 and paragraph 205-10-50-1.) Such disclosures shall include the amounts of income tax applicable to the prior period adjustments. Disclosure of restatements in annual reports issued after the first such post-revision disclosure would ordinarily not be required.

These disclosures are required in the financial statements of the interim (if applicable) and annual period of the change, but do not need to be repeated when the subsequent period annual financial statements are issued.

While including only narrative disclosure is not prohibited, a tabular format, supplemented with a narrative discussion, may be clearer given the amount of information that usually needs to be disclosed. Consistent with current practice, we recommend prominent placement of the restatement disclosure in the footnotes to ensure that readers understand the impact of the changes to the financial statements and any related footnotes.

The reporting entity may be required to present historical, statistical-type summaries of financial data for a number of periods—commonly 5 or 10 years. Whenever an error correction has been recorded, the corresponding financial data should be restated and include disclosures as appropriate.

The reporting entity should also consider how the error impacts its conclusion regarding internal control over financial reporting and/or disclosure controls and procedures, as appropriate. This analysis of the control implications should be for the most recent annual and current year interim period.

30.7.2 Revisions and out-of-period adjustments (error corrections)

If the previously issued financial statements are not materially misstated, then the error may be corrected prospectively. While ASC 250 only contemplates reporting the correction of an error by restating the previously issued financial statements, many identified errors do not result in a material misstatement to previously issued financial statements. In that case, the error may be corrected in one of two ways:

- Recording an out-of-period adjustment, with appropriate disclosure, in the current period, if such correction does not create a material misstatement in the current year

- Revising the prior period financial statements the next time they are presented

When the correcting amounts are material to current operations or trends, reporting entities should revise the previously issued financial statements the next time they are issued.

A revision disclosure is similar to a restatement disclosure. However, the financial statement columns should not be labeled "as restated." Further, revising prior year financial statements would not require previously issued auditor reports to be corrected as users can continue to rely on those previously issued financial statements. The reporting entity should consult with its counsel to determine whether it should provide disclosure of prospective corrections that are expected to be made in future financial statements. It may not be necessary to file a Form 8-K under Item 4.02 because the previously issued financial statements are not materially misstated (i.e., they can continue to be relied upon). However, there may be other situations in which separate disclosure would be appropriate. For example, if securities are to be offered based on the uncorrected financial statements, the prospectus/offering materials may need to include additional disclosure (including quantification) of the impending correction.

Example FSP 30-2 illustrates the evaluation of an identified error.

EXAMPLE FSP 30-2

Example of the error evaluation process

FSP Corp is a calendar year-end SEC registrant. In early April 20X5, FSP Corp identified a long-term incentive compensation obligation for one of its salespeople which it had inadvertently neglected to record since 20X1. If FSP Corp had properly accounted for the bonus, it would have recorded an additional $30 of compensation expense in each of the years 20X1 through 20X4.

- FSP Corp's reported income in each of the years 20X1 through 20X4 was $1,000.
- FSP Corp projects its 20X5 income will be $1,000.

Note: Income tax effects are ignored for purposes of this example. Additionally, this example assumes that there are no other errors affecting any of the years. If there were additional errors (whether unadjusted or recorded as "out-of-period" adjustments), those errors would also need to be considered in the materiality analysis.

What analysis should FSP Corp perform to consider if the errors are material?

Analysis

Quantifying the errors in the previously issued financial statements

FSP Corp has quantified the errors under both the "rollover" and the "iron curtain" methods as follows:

Year	Reported income	Rollover method	Iron curtain method
20X1	$1,000	$30 (3%)	N/A
20X2	$1,000	$30 (3%)	N/A
20X3	$1,000	$30 (3%)	N/A
20X4	$1,000	$30 (3%)	N/A
20X5	$1,000 (Projected)	N/A	$120 (12%)

Evaluating whether the affected financial statements are materially misstated

FSP Corp should consider whether the errors quantified under the "rollover" method (i.e., $30 or 3% of income per year) are material to the financial statements for any of the years 20X1 through 20X4. In making this analysis, FSP Corp should consider all relevant qualitative and quantitative factors.

Note: The above analysis focuses on the effects of the errors on the income statement. However, the analysis must also consider the impact of the error on the full financial statements, including disclosures (e.g., segment reporting).

Determining how to correct the errors

If FSP Corp determines that any of the years 20X1 through 20X4 are materially misstated when the errors are evaluated under the "rollover" method, then those years must be promptly corrected (as discussed in FSP 30.7.1).

If FSP Corp determines that none of the years 20X1 through 20X4 (or quarters for 20X4) are materially misstated when the errors are quantified under the "rollover" method, then the errors can be corrected prospectively in current or future filings (as discussed in FSP 30.7.2). Depending on the circumstances, prospective correction may be accomplished in one of two ways:

- FSP Corp may correct the errors as an "out-of-period" adjustment in its first quarter 20X5 interim financial statements if the correction would not result in a material misstatement of the estimated fiscal year 20X5 earnings ($1,000) or to the trend in earnings. This is true even if the "out-of-period" adjustment is material to the first quarter 20X5 interim financial statements. If the "out-of-period" adjustment is material to the first quarter 20X5 interim financial statements (but not material with respect to the estimated income for the full fiscal year 20X5 or to the trend of earnings), then the correction may still be recorded in the first quarter, but should be separately disclosed (in accordance with ASC 250-10-45-27).

- If FSP Corp cannot correct the errors as an "out-of-period" adjustment without causing a material misstatement of the estimated fiscal year 20X5 earnings ($1,000) or to the trend in earnings, then the errors must be corrected by revising the previously issued financial statements the next time they are filed (e.g., for comparative purposes). For instance, the quarterly financial statements for the first quarter of 20X4 and the December 31, 20X4 balance sheet presented in FSP Corp's March 31, 20X5 Form 10-Q should be revised to correct the error. The revised financial statements should include transparent disclosure regarding the nature and amount of each error being corrected. The disclosure should provide insight into how the errors affect all relevant periods (including those that will be revised in subsequent filings).

30.7.3 Misclassifications (error corrections)

A change in classification to correct an error should be evaluated using the framework discussed in FSP 30.7 and should be clearly disclosed as an error.

30.8 Reclassifications (accounting changes)

Sometimes it is necessary for reporting entities to reclassify an amount from a prior period from one financial statement caption to another for comparability with the current period. For example, if a balance becomes large enough to require a separate line item in the current period financial statements, the prior period balance should also be shown on the same line item for comparability. In these circumstances, as discussed in ASC 205-10-50-1, the basis of presentation note should include disclosure to indicate that the change in the prior period was made to conform to the current period presentation and explain the nature and magnitude of the change.

30.9 Interim reporting considerations (accounting changes)

Accounting changes may occur at any time during the year. This section discusses the disclosure requirements when changes occur during an interim period.

30.9.1 Changes in accounting principle (interim periods)

Interim financial statements should disclose any changes in accounting principle made during the current period from the accounting principles previously applied in any of the following prior periods:

- The comparable interim period of the prior annual period
- The preceding interim periods in the current annual period
- The prior annual period

An accounting change that affects only interim periods (such as in the method of recognizing advertising expenses in interim periods) is acceptable only if it is preferable in the circumstances. Such a change does not require any reference in the auditor's report on the annual financial statements (as there is no effect on the annual financial statements).

As discussed in ASC 250-10-45-16, whenever possible and permitted by the applicable guidance, reporting entities should adopt accounting changes during the first interim period of a fiscal year (unless adoption is expressly permitted in any interim period). If it is impracticable to make a change in the first interim period, the impracticability exception discussed in FSP 30.4.2.1 may not be applied to prior interim periods of the fiscal year in which the change is made. Therefore, if the retrospective application to pre-change interim periods is impracticable, the change may only be made as of the beginning of a subsequent fiscal year. See FSP 30.4.2.1 for further information on the impracticability exception of retrospective application when a reporting entity changes an accounting principle.

The materiality of changes in accounting principle should be assessed in relation to the estimated full fiscal year income rather than interim income. Changes that are only material to the interim period of adoption but not to the estimated full year financial results should be separately disclosed in the interim period.

30.9.2 Recently adopted standards (interim periods)

As discussed in ASC 250-10-50-2, when a reporting entity adopts a new accounting standard in an interim period, both annual and interim period financial statement disclosures prescribed by the new accounting standard are expected in each interim report in the year of adoption, to the extent not duplicative of other disclosures.

30.9.3 Change in estimates (interim periods)

As discussed in ASC 250-10-45-17, the effect of a change in estimate, including a change in the estimated annual effective tax rate, should be accounted for in the period in which the change in estimate is made. Prior interim periods should not be restated. Further, the effect on earnings of a

change in estimate in a current interim period should be disclosed in both the current period and subsequent interim periods, if material to any period presented.

To the extent all prior periods presented do not reflect the change in estimate, the change should also be disclosed in the interim period financial statements of the subsequent year to avoid misleading comparisons.

30.9.4 *Errors related to prior interim periods*

Errors related to prior interim periods should be assessed using the framework discussed in FSP 30.7.

As discussed in ASC 250-10-45-23, when an error is identified and it has been determined that prior interim period financial statements are materially misstated, they should be corrected promptly (i.e., restated).

When an error is identified and it has been determined that prior interim periods are not materially misstated, for the purpose of determining how to correct the error (i.e., by recording an out-of-period adjustment or revising the prior period financial statements), amounts should be compared to the estimated income for the full fiscal year.

As discussed in FSP 30.7.2 and shown in Figure FSP 30-1, corrections that are material with respect to the estimated income for the full fiscal year or to the trend of earnings should be corrected by revising the prior period financial statements the next time they are presented. Further, as discussed in ASC 250-10-45-26 and ASC 250-10-50-11, corrections that are material with respect to an interim period, but not material with respect to the estimated income for the full fiscal year or to the trend of earnings, can be corrected as an out-of-period adjustment and separately disclosed in the interim period. Alternatively, the previously issued financial statements may be revised the next time they are issued.

Previously reported interim financial data should not be restated because of year-end adjustments made in the normal course of the year-end close process, unless errors related to prior interim periods are identified from the process. The effect of significant year-end adjustments, such as changes in provisions for doubtful accounts, that are not error corrections should be included in fourth quarter income.

30.10 *Other matters (accounting changes)*

Accounting changes may arise as part of a spin-off, sale, or business combination. Presentation and disclosure considerations vary depending on the circumstances.

30.10.1 *Spin-off or sale of a subsidiary of an SEC-registered reporting entity*

Reporting entities sometimes sell or spin-off divisions or subsidiaries. A spin-off is a transaction in which a portion of a reporting entity (e.g., division or subsidiary) becomes a new, separate reporting entity and the shareholders of the original reporting entity receive a pro rata ownership in the spun-off reporting entity.

When a division or subsidiary is preparing its financial statements to facilitate a sale or spin-off, the division or subsidiary usually follows the accounting principles of its parent. When a division or subsidiary is spun-off, it can change to an accounting principle different from that used by its parent,

provided that the change is preferable. Such a change in accounting principle should be retrospectively applied in the financial statements.

The spun-off reporting entity must disclose the nature of the change in accounting principle and explain why the newly adopted accounting principle is preferable.

A spun-off reporting entity cannot, however, retrospectively reflect changes in estimates. Such changes should be reflected in the period in which they occur in both the consolidated (if applicable) and spun-off reporting entity's financial statements.

30.10.2 Conforming accounting policies of acquired entities

The need to conform the accounting policies of an entity acquired in a business combination to those of the acquiring reporting entity is discussed in BCG 2.12.

30.11 SAB 74 disclosures (change in accounting principle)

SAB 74, *Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period* (codified in ASC 250-10-S99-5), discusses the SEC staff's view regarding required disclosures when a new accounting standard has been issued but is not yet effective. The SEC staff emphasizes that reporting entities should provide meaningful (non-boilerplate) disclosures based on known information. Because financial statement and nonfinancial statement disclosure objectives are different, the disclosures included therein should not be duplicative. Although there will be exceptions, the SEC staff's view suggests a general principle that the retrospective effects of a new accounting standard would most likely be disclosed in the financial statements while the future/prospective effects would most likely be discussed in MD&A.

Often, a reporting entity will initially disclose that it is assessing the impact of a new standard and begin to provide more detailed disclosures as the information is available. SAB Topic 74 describes the disclosures to be made.

Excerpt from SAB Topic 74

- A brief description of the new standard, the date that adoption is required and the date that the registrant plans to adopt, if earlier.
- A discussion of the methods of adoption allowed by the standard and the method expected to be utilized by the registrant, if determined.
- A discussion of the impact that adoption of the standard is expected to have on the financial statements of the registrant, unless not known or reasonably estimable. In that case, a statement to that effect may be made.
- Disclosure of the potential impact of other significant matters that the registrant believes might result from the adoption of the standard (such as technical violations of debt covenant agreements, planned or intended changes in business practices, etc.) is encouraged.

Each new accounting standard must be analyzed to determine the appropriate disclosure. The level of information available may differ based on the nature of the standard and from one reporting entity to another.

If a recently issued standard will impact the presentation of, but not materially affect the financial statements, SAB 74 encourages the reporting entity to disclose that a standard has been issued and that its adoption will not have a material effect on the reporting entity's financial position or results of operations.

30.12 Considerations for private companies (accounting changes)

The guidance in ASC 250 is applicable to private reporting entities. Although the SEC guidance is only required to be applied by reporting entities whose financial statements are filed with the SEC, private companies are encouraged to consider the SEC guidance as well.

Chapter 31: Parent company financial statements—updated November 2023

31.1 Parent company financial statements overview

This chapter discusses the circumstances under which presentation of parent company financial statements may be appropriate or required. Parent company financial statements present the parent company's investment in its subsidiaries as a single line item on the balance sheet. The amount recorded as the investment reflects the parent's proportionate share of the subsidiary's net assets. Similarly, the parent company financial statements reflect the results of operations of the subsidiary as a single line item reflecting the parent's proportionate results. In addition to covering presentation and disclosure requirements, the chapter also outlines methodologies to be applied in preparing and presenting parent company financial statements.

31.2 Parent company financial statement relevant guidance

The primary sources of guidance on parent company financial statements include:

- ASC 810-10, *Consolidation—Overall*
- Regulation S-X Rule 5-04, *What schedules are to be filed*
- Regulation S-X Rule 12-04, *Condensed financial information of registrant*
- SEC FRM 2810, *Parent-only Financial Statements (Condensed)*

Consolidated financial statements are the general-purpose financial statements of a parent company that has one or more subsidiaries. In certain circumstances, parent company-only financial statements may be required in addition to consolidated financial statements. The existence of preferred stockholders, loan or other agreements, or other special requirements (e.g., reporting requirements for not-for-profit entities such as healthcare providers and statutory reporting requirements for downstream noninsurance holding companies) may necessitate the preparation of financial statements for the parent company on a stand-alone basis. Additionally, as further discussed below, Regulation S-X Rule 5-04 requires parent company financial statements (Schedule I) when certain conditions are met.

Parent company financial statements should not be used as a substitute for consolidated financial statements. Parent company financial statements should generally be presented in the same report with the reporting entity's consolidated financial statements (e.g., SEC filings). ASC 810-10-45-11 provides the authoritative basis for parent company financial statements under US GAAP:

ASC 810-10-45-11

In some cases parent-entity financial statements may be needed, in addition to consolidated financial statements, to indicate adequately the position of bondholders and other creditors or preferred shareholders of the parent. Consolidating financial statements, in which one column is used for the parent and other columns for particular subsidiaries or groups of subsidiaries, often are an effective means of presenting the pertinent information. However, consolidated financial statements are the general-purpose financial statements of a parent having one or more subsidiaries; thus, parent-entity financial statements are not a valid substitute for consolidated financial statements.

Regulation S-X Rule 5-04 requires parent company financial statements (Schedule I) when the restricted net assets of consolidated subsidiaries exceed 25% of consolidated net assets as of the most recent fiscal year end. When the significance threshold is met, SEC registrants should present condensed financial information as prescribed by Regulation S-X Rule 12-04 for the parent company in Schedule I as of the same dates and for the same periods as the consolidated financial statements. SEC FRM 2810.1 stipulates that "registrants should present the information required by S-X 12-04 as an S-X schedule, except bank holding companies, which must present the S-X 12-04 information in the financial statement footnotes." Irrespective of the presentation alternative, the parent company-only financial statements should be audited. Refer to SEC FRM 2810 for additional guidance.

31.3 Presentation requirements for parent company financial statements

There is no prescribed format for preparing parent company financial statements other than as described in Regulation S-X Rule 12-04. SEC registrants preparing parent company financial statements should follow these requirements unless another format is specified by a legal agreement or other special requirement.

Regulation S-X Rule 12-04 states that this financial information need not be presented in greater detail than what is required for interim condensed statements by Regulation S-X Rule 10-01 as it relates to the balance sheet, income statement, and statement of cash flows (see FSP 29.3). The presentation of earnings per share, while permitted, is not required in parent company financial statements. The condensed financial information should also include a total for comprehensive income presented in either a single continuous statement or in two separate but consecutive statements.

31.3.1 Parent company financial statements footnote disclosures

Parent company financial statements should include a statement in the footnotes explaining the fact that they are not the general-purpose financial statements of the reporting entity. In rare instances where parent company financial statements are presented without accompanying consolidated financial statements (e.g., prepared for limited distribution in accordance with requirements of a contractual agreement), the footnotes should indicate that the financial statements are not presented in accordance with US GAAP.

If parent company financial statements are included within the same SEC filing as the consolidated financial statements, detailed footnote disclosures are not required. However, disclosures of material contingencies, significant provisions of long-term obligations, mandatory dividend or redemption requirements of redeemable stocks, and guarantees of the parent, including a five-year schedule of debt maturities, are always required. If the required disclosures are already provided in the consolidated financial statements, the footnotes may cross-reference to the related disclosures and they need not be repeated in the parent company financial statements.

Figure FSP 31-1 illustrates how parent company financial statements can reference information in the consolidated financial statements.

Figure FSP 31-1
Sample disclosure —basis of presentation

Basis of Presentation. The parent company financial statements [information] should be read in conjunction with the Company's consolidated financial statements and the accompanying notes thereto. For purposes of these [this] condensed financial statements [information], the Company's wholly owned and majority owned subsidiaries are recorded based upon its proportionate share of the subsidiaries' net assets (similar to presenting them on the equity method).

Additional footnotes to parent company information may be required to supplement the disclosures in the consolidated financial statements. In addition, Regulation S-X Rule 12-04 requires SEC registrants to disclose separately the amounts of cash dividends paid to the parent for each of the last three fiscal years by consolidated subsidiaries, unconsolidated subsidiaries, and 50% or less owned persons accounted for by the equity method. The disclosure of dividends paid may be made either within the footnotes or on the face of the statement of cash flows, if clearly labeled.

Parent company financial statements should include disclosure of any guarantees issued between a parent and its subsidiaries (e.g., parent guarantees debt between sister entities) under ASC 460. In addition, if a subsidiary guarantees the parent's third party debt, or if the parent guarantees a subsidiaries' third party debt, the guarantee should be disclosed in the parent company financial statements. See Example FSP 23-2 in FSP 23.6.1 for an intercompany guarantee disclosure example.

31.4 Subsidiary and investee presentation in parent company financials

In parent company financial statements, investments in consolidated subsidiaries are presented as investments using the parent's proportionate share of the investee or subsidiary.

31.4.1 Investments in noncontrolled entities

A parent company's investment in a noncontrolled entity is accounted for on the same basis applied in preparing the consolidated financial statements. Therefore, investments measured at fair value or accounted for using the equity method should be accounted for in a similar manner in the parent company financial statements. As a result, the carrying amount of an investment is the same in both the consolidated and parent company financial statements.

31.4.2 Investments in consolidated subsidiaries

In consolidated financial statements, the net carrying amount of a subsidiary attributable to the parent equals the carrying amounts of the subsidiary's assets and liabilities measured using the parent's basis less any noncontrolling interest. In parent company financial statements, the net carrying amount of a subsidiary attributable to the parent should equal the amount reported in the parent company's balance sheet as its investment in the underlying net assets of the subsidiary measured using the parent's basis less any noncontrolling interest. In addition, total stockholders' equity, net income and comprehensive income amounts presented in the parent company financial statements should equal the corresponding amounts attributable to the parent in the consolidated financial statements.

Although the presentation of consolidated subsidiaries in parent company financial statements is similar to the equity method guidance prescribed by ASC 323, *Investments—Equity Method and Joint*

Ventures, it may not yield the same result because certain items are handled differently under ASC 323 than they are in consolidation. In other words, recording subsidiaries at the net amount attributable to the parent does not always result in presentation of the parent company's investment as if the consolidated subsidiary were accounted for under the equity method.

Figure FSP 31-2 outlines selected differences in subsidiary presentation in parent company financial statements versus the equity method of accounting.

Figure FSP 31-2

Selected differences in subsidiary presentation in parent company financial statements versus the equity method of accounting

Transaction	Equity method investment in accordance with ASC 323	Subsidiary presented in parent company financial statements
Impairment losses	Recognize if the investment's carrying amount exceeds its fair value and the decline in fair value is deemed to be other-than-temporary.	Recognize proportionate share of the consolidated subsidiary's impairment losses.
Acquisition costs	Include in consideration transferred to acquire an equity method investment and capitalize as a component of the cost of the assets acquired.	In a business combination, expense and do not include as part of the consideration transferred.
Capitalized interest on investee's qualifying assets	Capitalize interest on the investment only to the extent that the investee has qualifying activities as described in ASC 835-20.	As long as qualifying assets and interest cost exist within the consolidated group, record proportionate share of the consolidated subsidiary's capitalized interest.
Losses in excess of investment	Discontinue recording losses when the investment (and net advances) is reduced to zero unless the investor has committed to provide further financial support to the investee.	Continue recording losses, as discontinuation would result in the carrying amount of the investment not equaling the parent company's share of the subsidiary's net assets.

Transaction	Equity method investment in accordance with ASC 323	Subsidiary presented in parent company financial statements
Change in previously held equity interest	Treat a change in interest (e.g., increase in an equity method investment from 30% to 40%) as a step acquisition or as a disposition with the gain or loss recognized in the income statement.	Treat a change in interest (not constituting a change in control) as an equity transaction.
	If a reporting entity sells a portion of a foreign entity that is accounted for using the equity method, and its retained interest will also be accounted for using the equity method, it should recognize a pro rata portion of the accumulated CTA account attributable to the equity method investment when measuring the gain or loss on the sale.	If the consolidated subsidiary represents an entire foreign entity, none of the CTA balance is reclassified unless the parent company ceases to have a controlling financial interest.

Example FSP 31-1 illustrates the differences between the equity method of accounting and accounting for investments in consolidated subsidiaries in parent company financial statements when there is a change in ownership during the period.

EXAMPLE FSP 31-1

Increase in ownership in a less than wholly owned consolidated subsidiary

Company A owns a 70% interest in Subsidiary B which is consolidated in Company A's general purpose financial statements. Company A is also required to prepare parent company financial statements. At 12/31/20X1, Subsidiary B has net assets of $100. In the consolidated financial statements, Company A reflects 100% of the assets and liabilities of Subsidiary B and a noncontrolling interest of $30. In the parent company financial statements Company A reflects its investment in Subsidiary B of $70.

During 20X2, Company A purchases an additional 10% interest in Subsidiary B for its fair value of $30. Subsidiary B is consolidated in Company A's general purpose financial statements before and after the transaction (i.e., there is no change in control as a result of the transaction).

How should this transaction be reflected in Company A's parent company financial statements?

Analysis

In its parent company financial statements, Company A should reflect an investment in Subsidiary B of $80, reflecting its proportionate share of Subsidiary B's net assets of $100. In the consolidated financial statements, the additional cash paid to acquire a portion of the noncontrolling interest is an equity transaction as the transaction does not result in a change of control (see BCG 5.4). Since the total stockholders' equity, net income, and comprehensive income amounts presented in the parent

company financial statements should equal the corresponding amounts attributable to the parent in the consolidated financial statements, the difference of $20 should be recorded as an adjustment to Company A's APIC.

The journal entry in Company A's parent company financial statements is as follows:

Dr. Investment in Subsidiary B	$10	
Dr. Company A Equity/ APIC	$20	
Cr. Cash		$30

In contrast, under the equity method of accounting, Company A's additional investment in Subsidiary B would be recorded at the cost of the additional investment. Any basis differences between the cost of the investor's incremental share of the investee's net assets and its interest in the investee's carrying value of those net assets should be identified and recorded in the memo accounts and subsequently accounted for based on its respective characterization (see EM 5.3.2).

31.5 Other parent company financial statement considerations

A number of items should be considered when preparing parent company financial statements. The following discussion covers certain of these considerations but is not intended to be all-inclusive.

31.5.1 Accounts and adjustments recorded at the parent company level

Some reporting entities maintain certain accounts related to subsidiaries in the parent company's books and records. The parent company's presentation of these amounts should be the same as if the accounts or adjustments had been recorded directly in the books and records of the subsidiary entity. This is particularly important for subsidiaries that are foreign entities due to the impact of foreign currency translation.

Examples of accounts that may be recorded at the parent company level include reserves for income tax or environmental exposures, deferred income taxes, goodwill, intangible assets, and acquisition accounting adjustments. Additionally, some reporting entities record audit adjustments or other post-closing adjustments at the parent level without pushing them down to the accounting records of the subsidiary. To the extent these adjustments relate to subsidiaries that are foreign entities, the functional currency equivalent of such amounts, based upon historical exchange rates, should be assumed to be "pushed down" to the financial statements of the foreign entity for purposes of foreign currency translation.

31.5.2 Accounting changes in parent company financial statements

Similar to any other adjustments, any amounts reported by a subsidiary as a cumulative effect of a change in accounting principle should be reflected in the income statement of the parent company as its share of that cumulative effect as if the parent had made the change directly.

31.5.3 Discontinued operations in parent company financial statements

ASC 205-20 requires a disposal to be reported in discontinued operations if it represents a strategic shift that has (or will have) a major effect on a reporting entity's operations and financial results. A subsidiary that is not consolidated in its parent company's financial statements should be presented by the parent as a discontinued operation if it meets the discontinued operation criteria from the perspective of the parent (see FSP 27). A portion of a subsidiary can also qualify as a discontinued operation.

If an unconsolidated subsidiary reports a discontinued operation, the parent company should consider whether those operations also meet the discontinued operations criteria from the perspective of the parent. If the criteria are met from the parent's perspective, discontinued operations reporting would be required in the parent company financial statements. If these criteria are not met from the perspective of the parent, the parent company would report its share of the subsidiary's discontinued operations in the income statement line used for parent's share of the unconsolidated subsidiary's earnings or losses.

It is rare that the conclusion of whether a disposition meets the criteria for discontinued operations presentation would be different in parent company financial statements from the consolidated financial statements.

31.5.4 Cash dividends received from subsidiaries

As discussed in FSP 31.4.2, the parent's subsidiaries are treated similar to equity method investments in the parent company financial statements, including the statement of cash flows. Cash dividends received from subsidiaries should be classified within operating activities or investing activities on the statement of cash flows, depending on whether they are a return on investment or a return of investment. This determination should be made according to the parent company's policy on distributions received from equity method investees (cumulative earnings approach or nature of the distribution approach). Refer to FSP 6 for further discussion of the presentation of dividends received in the statement of cash flows.

31.6 Parent company statement considerations for private companies

There are no special presentation or disclosure considerations for private companies. Private companies that are required to prepare parent company financial statements should follow the format that is specifically prescribed by the entity or agreement requiring the statements. However, private companies may look to SEC guidance for additional information.

Chapter 32: LLCs, GPs, and LPs—updated November 2019

32.1 Chapter overview

The presentation and disclosure guidance in this chapter applies to financial statements of limited liability companies (LLCs), general partnerships, limited partnerships (LPs), and other partnerships. The guidance also applies to LLCs that elect to be treated as partnerships for tax purposes unless otherwise indicated in this chapter. Master Limited Partnerships (MLPs) should apply the presentation and disclosure requirements of LPs unless otherwise indicated in this chapter. The guidance in this chapter does not apply to reporting entities that have investments in partnerships (see FSP 9 and FSP 18).

Many of the SEC's presentation and disclosure requirements for partnerships also apply to LLCs. Due to the nature of a partnership (i.e., owned by partners as opposed to stockholders), there are incremental and different presentation and disclosure requirements versus those of a corporation. This chapter focuses on the incremental requirements in Regulation S-X for both LLCs and partnerships. The primary differences between the financial statements of these various legal entities are the presentation of owners' equity and the reconciliation of US GAAP to other bases of accounting, as applicable. Depending on the legal structure of the entity, the term "owners' equity" may be replaced, for example, by the term "members' equity" for LLCs. We use the term "owner" and "member" interchangeably in this chapter unless specific requirements apply to one legal structure and not another, in which case we will explicitly indicate the appropriate terminology.

This chapter also addresses the calculation of earnings per unit (EPU) for master limited partnerships and the presentation and disclosure requirements of a newly-formed partnership.

32.2 Scope and relevant guidance

Limited partnership accounting records are often maintained consistent with applicable provisions of the Internal Revenue Code and support the preparation of income-tax basis financial statements. Such financial statements are prepared primarily for the purpose of providing income tax data to the limited partners. However, partnerships that are SEC registrants should comply with Regulation S-X and clearly disclose equity and income data for the general partners on a US GAAP basis.

Limited liability companies often elect to be treated as partnerships for federal tax purposes. ASC 272, *Limited Liability Entities*, states that in order to be classified as a partnership for federal income tax purposes, an LLC should lack at least two of the four characteristics present in a corporation. As discussed in ASC 272-10-05-6, these characteristics are: (1) limited liability, (2) free transferability of interests, (3) centralized management, and (4) continuity of life.

LLCs that are subject to income taxes are also subject to ASC 740.

Other relevant guidance in this chapter for partnerships and for LLCs that report as partnerships and are SEC registrants includes:

- SAB Topic 4.E, *Receivables from sale of stock* (codified in ASC 310-10-S99-2)
- SAB Topic 4.F, *Limited Partnerships* (codified in ASC 505-10-S99-5)
- FRP 405

- Rule 502(b) of Regulation D
- SEC FRM 3410.1 - SEC FRM 3410.4
- S-X Article 8, *Financial statements of smaller reporting companies*
- Section 15(d) of the Securities Exchange Act of 1934

LLCs often have many of the characteristics of both corporations and partnerships, and significant judgment may be required to determine the appropriate presentation model (ASC 205 or ASC 272).

32.3 Presentation

In order to apply the appropriate presentation and disclosure requirements, a reporting entity should first determine its identity as an LP or LLC.

Question FSP 32-1 addresses the characteristics a reporting entity should consider to determine if the entity is an LP or LLC.

Question FSP 32-1

What are some of the characteristics a reporting entity should consider to help it determine its identity as an LP or LLC?

PwC response

While there is limited guidance on LPs in the FASB codification, ASC 272 includes guidance on LLCs. As discussed in ASC 272-10-05-02, an LLC generally has the following characteristics:

- It is an unincorporated association of two or more persons.
- Its members have limited personal liability for the obligations or debts of the entity.
- It is classified as a partnership for federal income tax purposes.

Once a reporting entity has determined its identity as an LP or LLC, it should adhere to the appropriate presentation and disclosure requirements.

32.3.1 *Basis of accounting — LPs and LLCs that are partnerships*

The SEC staff has indicated in FRP 405 that LPs (or LLCs that report as partnerships) that are SEC registrants should present US GAAP-basis financial statements as their primary financial statements using Form 10-K, except in certain circumstances (based on the size of the offering) as specified by Rule 502(b) of Regulation D. This is even if their accounting records are maintained under a separate basis of accounting.

ASC 205-10-45-1A indicates that a full set of financial statements includes: balance sheet, income statement, statement of comprehensive income, statement of cash flows, and statement of changes in owners' equity (see FSP 32.3.4).

If a reporting entity that does not present US GAAP-basis financial statements wishes to issue securities under Regulation D, an exception under Rule 502(b) of that regulation may apply. Although it would be unusual, an LP may be permitted to prepare financial statements on a federal income tax basis if it cannot obtain US GAAP financial statements without unreasonable expense or effort.

32.3.2 *Basis of accounting — LLCs that are not partnerships*

LLCs that do not report as partnerships should provide a complete set of financial statements including a balance sheet, income statement, statement of cash flows, statement of changes in members' equity (may be an individual statement, combined with the income statement, or in the footnotes), and footnotes.

An LLC's financial statements should clearly indicate that the financial statements presented are those of an LLC in the heading of each statement. Although ASC 272 does not explicitly include a statement of comprehensive income, practice indicates that reporting entities include the statement consistent with the requirements of ASC 205. Based on ASC 205, we believe a statement of comprehensive income should be presented to comply with US GAAP (see FSP 4).

32.3.3 *Comparative financial statements*

LLCs and partnerships that are SEC registrants are subject to the comparative financial statement requirements of S-X 3-01(a) (discussed in FSP 1.2.1). Presentation of comparative financial statements is encouraged for LLCs and partnerships that are not subject to SEC regulations, but not required under US GAAP.

32.3.4 *Owners' or members' equity*

The presentation of equity of an LLC and a partnership is similar given the parallels in the structure, principally the multiple owners (known as members and partners) in the reporting entity. The equity section of the balance sheet should be titled members' equity (LLCs) or owners' equity (partnerships) in contrast to shareholders' or stockholders' equity for a corporation.

Similar to reporting entities that have multiple classes of common or preferred stock (see FSP 5), LLCs and partnerships report the amounts of each class of members' equity separately, either on the face of the balance sheet within the equity section or within the footnotes. Each member class' rights, preferences, and privileges should be disclosed.

ASC 505-10-S99-5 (SAB Topic 4.F) clarifies the presentation of members' equity.

ASC 505-10-S99-5

Facts: There exist a number of publicly held partnerships having one or more corporate or individual general partners and a relatively larger number of limited partners. There are no specific requirements or guidelines relating to the presentation of the partnership equity accounts in the financial statements. In addition, there are many approaches to the parallel problem of relating the results of operations to the two classes of partnership equity interests.

Question: How should the financial statements of limited partnerships be presented so that the two ownership classes can readily determine their relative participations in both the net assets of the partnership and in the results of its operations?

Interpretive Response: The equity section of a partnership balance sheet should distinguish between amounts ascribed to each ownership class. The equity attributed to the general partners should be stated separately from the equity of the limited partners, and changes in the number of equity units authorized and outstanding should be shown for each ownership class. A statement of changes in partnership equity for each ownership class should be furnished for each period for which an income statement is included.

The income statements of partnerships should be presented in a manner which clearly shows the aggregate amount of net income (loss) allocated to the general partners and the aggregate amount allocated to the limited partners. The statement of income should also state the results of operations on a per unit basis.

If the LP maintains separate accounts for varying components within an individual members' equity account, it should present the balance within each component on the face of the balance sheet or in the footnotes. Examples of such components are undistributed earnings, earnings available for withdrawal, and unallocated capital.

Despite the limited economic risk for a participating member inherent in an LLC because of its legal structure, the results of the LLC's operations could cause some members to have a liability balance. The LLC should report this deficit. Further, both an LP and an LLC should disclose the legal limitations on liabilities for each member, whether in a net deficit position or not.

32.3.4.1 Capital contributions

After an LLC's formation, members may make contributions to grow the business or to infuse additional cash because of liquidity issues. When a member makes a cash contribution, it is classified in members' equity on the balance sheet.

Often, a member will issue a note to an LLC as a promise to contribute additional capital. The transaction may be a sale of capital stock or a contribution to paid-in capital. ASC 505-10-45-2 generally does not permit this note receivable to be presented as an asset, except in very limited circumstances.

ASC 505-10-45-2

An entity may receive a note, rather than cash, as a contribution to its equity. The transaction may be a sale of capital stock or a contribution to paid-in capital. Reporting the note as an asset is generally not appropriate, except in very limited circumstances in which there is substantial evidence of ability and intent to pay within a reasonably short period of time, for example, as discussed for public entities in paragraph 210-10-S99-1 (paragraphs 27 through 29), which requires a deduction of the receivable from equity. However, such notes may be recorded as an asset if collected in cash before the financial statements are issued or available to be issued (as discussed in Section 855-10-25).

ASC 310-10-S99-2 (SAB Topic 4.E) provides similar guidance. The SEC staff notes that a receivable may be considered an asset when cash is received before the financial statements are issued.

Excerpt from ASC 310-10-S99-2

The staff will not suggest that a receivable from an officer or director be deducted from stockholders' equity if the receivable was paid in cash prior to the publication of the financial statements and the payment date is stated in a note to the financial statements.

32.3.5 *Other presentation considerations*

The partnership should also present actual cash distributions per partnership unit.

32.4 Disclosure

There are some specific disclosures requirements for LLCs and partnerships, and some general requirements that are especially pertinent for them.

32.4.1 *Reconciliation between statements prepared on different bases*

For SEC registrants, FRP 405 indicates that it may be desirable to include financial data on the tax basis of accounting within the US GAAP-basis financial statements. Ordinarily, LPs distribute tax basis information to their partners after the balance sheet date because of the limited partners' personal tax reporting responsibilities. The annual report including audited US GAAP-basis financial statements may be distributed at a later date.

We encourage presentation in the footnotes of a reconciliation to the US GAAP-basis financial statements if the LP includes audited tax-basis statements in an SEC filing as additional information to the audited US GAAP-basis financial statements. A note or some similar reference in the tax-basis statements, if filed, should state that US GAAP-basis financials are included elsewhere in the filing.

If provided, the reconciliation of US GAAP-to tax-basis information should include, at a minimum:

- net income/loss on the US GAAP-basis to the tax-basis balance (frequently described as excess/deficit of revenue collected over/under expenses disbursed)

- total assets on the US GAAP basis to total assets on the tax basis, and

- partners' capital/deficit on the US GAAP basis to partners' capital/deficit on the tax basis.

32.4.2 *Income tax matters*

Designation of tax status is considered to be a tax position under ASC 740. Partnerships (and LLCs that are treated as partnerships for tax purposes) are generally not taxpayers; instead, the general and limited partners (or LLC members) pay taxes on their shares of the profits. The partnership or LLC should monitor its continued qualification as a non-tax-paying entity, with disclosure of any developments in the entity or in legislation that might subject it to corporate taxation.

US GAAP-basis financial statements of an LP (or an LLC treated as a partnership for tax purposes) should include a footnote indicating that the partnership itself is not subject to federal income tax.

Figure FSP 32-1 is a sample disclosure of a partnership's tax matters.

Figure FSP 32-1

Sample disclosure — partnership tax matters

Note X — Income taxes

No provision for federal income taxes is necessary in the financial statements of the partnership because, as a partnership, it is not subject to federal income tax and the tax effect of its activities accrues to the partners.

In certain circumstances, partnerships may be held to be associations taxable as corporations. The IRS has issued regulations specifying circumstances under current law when such a finding may be made, and management has obtained an opinion of counsel based on those regulations that the partnership is not an association taxable as a corporation. A finding that the partnership is an association taxable as a corporation could have a material adverse effect on the financial position and results of operations of the partnership.

LLCs that are subject to income taxes are also subject to ASC 740. See FSP 16.

32.4.2.1 Change in tax status

The tax implications of a change from (1) a partnership to a corporation or (2) a corporation to a partnership are subject to the recognition requirements of ASC 740. ASC 740 also applies for recording deferred tax assets and liabilities for temporary differences on the day the tax status changes to a corporation. See FSP 16. For changes from a corporation to a partnership, see FSP 32.7.

In SEC FRM 3410.1- SEC FRM 3410.4, the SEC also has incremental guidance for conversions of a partnership or similar tax-exempt entity to a corporation. Historical financial statements need to include pro forma information for tax and EPS on the face of the financial statements. If taxes are the only adjustments as a result of the formation of the corporation, the reporting entity is required to include pro forma EPS for only the latest fiscal year-end and current stub period. Also, reporting entities are encouraged, but not required, to include pro forma information for all periods presented. If other adjustments in addition to taxes are required, the reporting entity should show only the latest fiscal year and interim period. The reporting entity should continue to include such pro forma presentation in subsequent years until the year of conversion is no longer presented in the comparative financial statements. Undistributed earnings or losses of partnerships should be reclassified to paid-in capital in the pro forma statements, as if a distribution had been made to the owners with a subsequent contribution to equity within the new structure. Concurrent with the conversion, partnerships that pay distributions to owners from equity issuance proceeds (not from retained earnings) should present pro forma EPS for the latest year and interim period giving effect to the conversion (but not the offering) if the conversion will result in a material reduction to EPS (excluding the effects of the offering). See FSP 32.7 for further information on conversion to partnerships.

32.4.3 Related parties

As noted in FSP 26, ASC 850-10-50-1 requires disclosure of all material related party transactions and agreements. In the context of partnerships, related party disclosures include:

- the relationship of the general partner to the partnership;

- the extent of the general partner's equity interest;
- the nature of any management contract between the partnership and the general partner or other party; and
- any relationship between the general partner and other parties related to the partnership.

LLCs would be expected to include similar disclosures for transactions between its members.

FRP 405 promotes US GAAP-basis financial statements as the best available financial data. US GAAP requires inclusion of any related party amount on the face of the primary financial statements and disclosure of all related party transactions in the footnotes, particularly regarding the relationship and transactions between a general partner and other related parties.

Common related party transactions for MLPs include human resource and supply arrangements. Presentation and disclosure of related party transactions in general is addressed in FSP 26.

32.4.4 *Finite life of the entity*

If there is a finite life of the entity, it should disclose the date it will cease to exist.

32.5 General partnership financial statement disclosures

General partnership financial statements should include disclosure of any unusual commitments undertaken by the general partner or sponsor. In addition, GP financial statements should disclose any contingencies relating to guarantees or potential liability stemming from being the general partner. If the general partner/sponsoring entity retains an equity interest in the partnership and accounts for that interest on the equity method, it should follow the guidance for disclosure of equity method investments. See FSP 10.6.

32.6 Calculating earnings per unit for MLPs

MLPs with publicly held units should present earnings per partnership unit (EPU) on the face of the income statement under ASC 260-10-55-102 through ASC 260-10-55-110, *Earnings Per Unit*.

Publicly traded MLPs often issue multiple classes of securities that may participate in partnership distributions according to a formula specified in the partnership agreement. A typical MLP is generally formed by the general partner contributing mature assets with stable cash flows to the partnership in exchange for a general partner (GP) interest and incentive distribution rights (IDRs). The MLP then issues publicly-traded common units held by limited partners (the Common Units).

Generally, the IDRs are viewed as being a return on the GP's investment, whereby the GP has an additional mechanism to participate in the performance of the partnership and represent a separate class of nonvoting limited partner (LP) interest. However, some arrangements are structured such that the IDRs are not a separate LP interest, but are embedded within the GP interest. When the IDRs are a separate LP interest, then the holder of the IDRs (which is initially the GP) may transfer or sell the IDRs, subject to the consent of the LPs prior to a specified date.

When the IDRs are embedded within the GP interest, the IDRs cannot be detached and transferred. Except for the GP interest, the IDR holder does not have a separate residual ownership interest in the partnership. MLPs are predominately utilized in the energy industry and, more specifically, in the pipeline business because of the stable income generated by those businesses.

Regardless of whether the IDRs are embedded within the GP interest or are separate securities, MLPs are required to apply the two-class method to calculate EPU because of the differences between the Common Units and the GP interest. When applying the two-class method to the interests of the GP and LPs in MLPs, questions have arisen about the effect of IDRs on the computation of EPU. The effect will differ based on whether the IDR is embedded in or separate from the GP interest.

32.6.1 *IDRs that are separate securities*

IDRs that are a separate class of LP interest are participating securities because they have a right to participate in earnings with common equity holders. Therefore, to calculate EPU, current period earnings are allocated to the GP, LPs, and IDR holders using the two-class method in ASC 260. When calculating EPU under the two-class method, the MLP would reduce (or increase) net income (or loss) for the current reporting period by the amount of available cash that has been or will be distributed to the GP, LPs, and IDR holders for that reporting period.

The partnership agreement may contractually limit the amount of distributions to holders of the IDRs. Therefore, the MLP should allocate the undistributed earnings, if any, to the GP, LPs, and IDR holders, utilizing the distribution waterfall (i.e., a schedule included in the partnership agreement that prescribes distributions to the various interest holders at each threshold). The undistributed earnings should be allocated to the IDRs based on the contractual participation rights of the IDRs to share in current period earnings. Therefore, if the partnership agreement includes a "specified threshold" as described in ASC 260-10-55-30 in which the IDRs stop participating in earnings, an MLP should not allocate undistributed earnings to the IDRs once the specified threshold has been met. If the partnership agreement includes a "specified threshold," that threshold would generally recognize that a legal mechanism exists that allows the partnership to make a distribution to the LP interests outside the distribution waterfall.

The MLP should allocate any excess of distributions over earnings to the GP and LPs based on their respective sharing of losses specified in the partnership agreement (that is, the provisions for allocation of losses to the partners' capital accounts for the period presented). If the IDR holders do not share in losses, the MLP would not allocate the excess of distributions over earnings to the IDR holders. However, if the IDR holders have a contractual obligation to share in the losses of the MLP on a basis that is objectively determinable (as described in ASC 260-10-45-67), the MLP should allocate the excess of distributions over earnings to the GP, LPs, and IDR holders based on their respective sharing of losses specified in the partnership agreement for the period presented.

32.6.2 *IDRs that are embedded within the GP interest*

IDRs that are embedded in the GP interest are not separate participating securities. However, because the GP and LP interests are separate classes of equity, the MLP would still apply the two-class method in computing EPU for the GP and LP interests.

For purposes of the EPU calculation, in some cases, the MLP would reduce (or increase) net income (or loss) for the current reporting period by the amount of available cash that will be, but has not yet

been, distributed to the GP (including the distribution rights of the embedded IDRs) and LPs for that reporting period.

In addition, MLPs may have multiple classes of securities (see FSP 32.6). In these situations, EPU is only required for the common units, although the MLP is not precluded from calculating EPU for all classes. This is similar to reporting entities with both common and preferred stock, whereby entities are only required to report EPS for common stock but are not precluded from reporting EPS for preferred stock.

Example FSP 32-1 illustrates application of the two-class method of computing EPU.

EXAMPLE FSP 32-1

Two-class method of computing EPU

Assume a partnership agreement requires the GP to distribute available cash within 60 days following the end of each fiscal quarter. The MLP is required to file financial statements with a regulatory agency within 45 days following the end of each fiscal quarter.

How should the MLP compute EPU for the first quarter?

Analysis

To compute EPU for the first quarter, the GP should determine the amount of available cash that will be distributed to the GP and LPs for the quarter.

The MLP should reduce (or increase) net income (or loss) by that amount in computing undistributed earnings that will be allocated to the GP (including the distribution rights of the embedded IDRs) and LPs.

32.6.3 *Calculation of EPU after a common control transaction*

When assets and liabilities comprising a business are transferred between reporting entities under common control, ASC 805-50-45-2 through ASC 805-50-45-5 requires that financial statements of the receiving entity be presented as though the transfer occurred at the beginning of the period. Financial statements for prior years must also be retrospectively adjusted to provide relevant comparative information.

In addition, when an MLP is formed through a “drop-down” of assets and liabilities by a sponsor who retains control of the MLP (thus, the drop-down occurs under common control), ASC 260-10-55-111 requires that EPU for periods before the date of the drop-down be calculated assuming allocation of all of the earnings related to the transferred assets and liabilities to the general partner. Disclosure of how the rights to the earnings differ for purposes of the EPU calculation before and after the drop-down occurred is required.

32.7 Conversion of a corporation into a partnership

A partnership may be formed from an existing operation and may be the result of one of the following:

- *Conversion or reorganization*

  An existing corporation transfers substantially all of its business into a partnership and liquidates the corporation. Existing shareholders exchange their shares for units in the partnership.

- *Spin-off or roll out*

  An existing corporation places assets into a limited partnership and distributes the partnership units to the shareholders.

- *Carve-out or drop-down*

  An existing corporation carves out a portion of its operations and places them in a partnership. Some or substantially all of the partnership units are sold to new investors.

  Some transactions may include features of both a spin-off and a carve-out.

- *Rollup*

  Formation of a partnership could also be in the form of a rollup. A rollup does not involve the conversion of a corporation to a partnership. It is the merger of several existing limited partnerships, or limited partnership interests, into one larger limited partnership. Generally, a rollup is done for efficiency or liquidity purposes.

  There may be situations when rollup transactions qualify as a business combination that will require a new basis of accounting for the acquired assets and liabilities. An example includes a rollup in which the general partner of the new MLP was the general partner of some, but not all, of the predecessor limited partnerships.

The basis of accounting for a new LP will generally depend on the structure of the transaction. Once the partnership is formed, it should adhere to the financial statement reporting requirements for partnerships. Comparative financial statements for prior periods are the financial statements of the predecessor company. The new LP may present pro forma information for prior periods (as though the reporting entity had operated in partnership form - required in the initial registration statement for partnership units) as supplementary information, but that information cannot replace the predecessor entity's financial statements as the principal comparative financial information. The presentation in the footnotes of the supplemental information should be sufficient and clear to prevent any information from being misleading if users were to rely solely on the comparative statements.

Newly-formed LLCs that are not taxed as partnerships and that constitute a new reporting entity would fall within the scope of an accounting change and are subject to ASC 250. ASC 250 requires retrospective application for all years presented following the presentation of the new LLC reporting entity. For further detail on accounting changes, see FSP 30.

32.7.1 Tax considerations of the new entity

Taxes payable (currently or deferred) generally will not appear on the opening balance sheet of a carved-out or spun-off entity as such taxes remain the liability of the general partner/sponsor.

If, in a conversion, the new reporting entity is not deemed an association taxable as a corporation, it should eliminate deferred tax balances in the first financial statements following conversion to partnership form. As noted in TX 8.2, a deferred tax liability or asset should be eliminated at the date the entity ceases to be taxable by including the reversal in income from continuing operations as a current provision for income taxes.

The reporting entity may continue to need some provision for current taxes. In addition to tax liabilities that arise (e.g., recapture or capital gains) on partnership formation, some jurisdictions assess taxes on a partnership as if the entity were a corporation. Under current tax law, Congress allowed MLPs to annually elect to retain their partnership tax status in exchange for a 3.5% gross revenue tax. The MLP should consider appropriate presentation and disclosure of the gross revenue tax in its financial statements. This would include (1) recognition as current tax expense and (2) a description as to the nature of the tax (its qualifications under the current tax law).

32.8 Smaller reporting companies that are LPs

Smaller reporting companies (SRCs) are subject to S-X Article 8. If an LP is an SRC, it should include the balance sheet of the general partners within its financial statements in the following circumstances:

- If the general partner of the SRC is a corporation, it should disclose the audited balance sheet of that corporation as of the end of its most recently completed fiscal year. The SRC should deduct receivables, other than trade receivables, from affiliates of the general partner from the equity of the general partner. When an affiliate has committed to increase or maintain the general partner's capital, the SRC should also present the audited balance sheet of that affiliate.
- If the general partner of the SRC is a partnership itself, it should file an audited balance sheet of that partnership as of the end of its most recently completed fiscal year.
- If the general partner of the SRC is a natural person, it should include a recent balance sheet as supplemental information, although there is no requirement for this statement to be audited. The SRC should carry the assets and liabilities of the general partner at estimated fair value, with provisions for estimated income taxes on unrealized gains. The SRC should also disclose the net worth of the person in a registration statement. If there is more than one person as general partner, the SRC can present their net worth, as determined from the balance sheets, individually or in the aggregate.

32.9 Considerations for private companies

Private partnerships and LLCs are not subject to certain of the SEC requirements addressed in the chapter. Differences are explained in the following sections.

32.9.1 *Comparative financial statements*

Private companies are not subject to the guidance in Regulation S-X, which requires multiple years of financial statements; however, ASC 272-10-45-7 encourages comparative statements for private LLCs. If the nonpublic partnership or LLC voluntarily presents multiple years, amounts should be comparable with the most recent year shown in accordance with ASC 205-10-45, disclosing any exceptions to comparability.

Similarly, partnerships that are formed from corporations but do not file with the SEC are not required to present the pro forma comparative statements.

32.9.2 *Basis of accounting*

Partnerships and LLCs that do not file with the SEC are not subject to SEC disclosure requirements. For example, financial statements prepared on a basis of accounting other than US GAAP do not require a reconciliation of US GAAP to tax-basis or the presentation of US GAAP-basis statements.

32.9.3 *SEC filers that may not comply with SEC requirements*

A partnership that files with the SEC in connection with the sale of a portion of its interest to the public files an annual report on Form 10-K in the year the registration statement becomes effective. However, in subsequent years, the partnership may be exempt from such requirements if it meets Section 15(d) of the Securities Exchange Act of 1934 by having fewer than 300 individuals hold the securities of the partnership at the beginning of the fiscal year. Partnerships in this situation should nonetheless consider providing the SEC required disclosures even if they have no requirement to file financial statements with the SEC.

Chapter 33: Revenue and contract costs – updated May 2023

33.1 Revenue presentation and disclosure overview

This chapter addresses presentation and disclosure considerations related to revenue under ASC 606, *Revenue from Contracts with Customers* and ASC 340-40, *Other Assets and Deferred Costs—Contracts with Customers* (collectively, the "revenue standard"). For recognition and measurement topics related to the revenue standard, see PwC's *Revenue from contracts with customers* guide.

33.2 Revenue presentation

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

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

The revenue standard requires reporting entities to separately present or disclose revenue from contracts with customers from other sources of revenue. Other sources of revenue include, for example, revenue from interest, dividends, leases, etc. Interest income and interest expense recorded when a significant financing component exists (see RR 4.4) must be presented separately from revenue from contracts with customers in the statement of comprehensive income. A reporting entity might present interest income as revenue in circumstances in which interest income arises from a reporting entity's ordinary activities.

33.2.1 Thresholds for presenting separate revenue categories and related costs

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

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

- Other revenues
- Amounts earned from transactions with related parties (as required under Regulation S-X Rule 4-08(k))

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

Each category that is not more than 10% of the sum of the items may be combined with another category. If these items are combined, related costs and expenses shall be combined in the same manner. These threshold rules align with the principle described in Regulation S-X Rule 4-02, which indicates that items that are not material do not need to be shown separately.

These threshold requirements do not apply to interim financial statements, though they are often followed in practice. Interim-specific requirements are discussed in FSP 29.

Figure FSP 33-1 illustrates how revenue and cost of sales may be presented in the income statement.

Figure FSP 33-1

Presentation of revenue and related cost categories

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

Promises to provide more than one good or service to a customer might constitute a single performance obligation under ASC 606.

Question FSP 33-1

A single performance obligation may include multiple promised goods or services that are not distinct and are inputs into a combined item. Should a reporting entity present components of a single performance obligation as separate categories of revenue (e.g., product revenue and service revenue) in the statement of comprehensive income?

PwC response

It depends. We expect reporting entities will often conclude that revenue from a single performance obligation relates to a single revenue category. This is because promised goods or services that are inputs into a single performance obligation are often transformed when combined (e.g., a combination of goods and services that form a single service), which is why the reporting entity has

concluded the promised goods or services are not distinct. If a reporting entity concludes a single performance obligation includes components that relate to different categories of revenue (e.g., products and services), we believe it is acceptable to present revenue in separate revenue categories in the statement of comprehensive income using a systematic and rational allocation method that is consistently applied. If material to the financial statements, the reporting entity should provide transparent disclosures regarding the methodology and basis for separating the components for presentation purposes.

33.2.2 Revenues versus gains

Revenue is defined in the revenue standard as:

Definition from ASC 606-10-20

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

The distinction between revenue and other types of income, such as gains, is important as many users of financial statements focus more on revenue than other types of income. Income comprises revenue and gains, and includes all benefits (enhancements of assets or settlements of liabilities) other than contributions from equity participants. Revenue is a subset of income that arises from the sale of goods or rendering of services as part of a reporting entity's ongoing major or central activities, also described as its ordinary activities. Transactions that do not arise in the course of a reporting entity's ordinary activities do not result in revenue. For example, gains from the disposal of the reporting entity's fixed assets are not included in revenue.

The distinction between revenue and other types of income, such as gains, depends on the specific circumstances and may require judgment. Example FSP 33-1, Example FSP 33-2, and Example FSP 33-3 illustrate the assessment of whether a transaction results in the recognition of revenue.

EXAMPLE FSP 33-1

Revenue versus gains - sale of demonstration cars

A car dealership has cars available that can be used by potential customers for test drives ("demonstration cars"). The cars are used for more than one year and then sold as used cars. The dealership sells both new and used cars.

Is the sale of a demonstration car accounted for as revenue or as a gain?

Analysis

The car dealership is in the business of selling new and used cars. The sale of demonstration cars is therefore revenue since selling used cars is part of the dealership's ordinary activities.

EXAMPLE FSP 33-2

Revenue versus gains - sale of rental equipment

FSP Corp, an equipment rental entity, purchases equipment to be used to generate rental revenue. The costs to acquire the equipment are capitalized as revenue-generating equipment and depreciated over their useful lives. In 20X1, several pieces of equipment are sold to a third party at the end of their useful lives after being fully depreciated, resulting in an amount being recovered that exceeds the residual value.

Should FSP Corp present the total sale amount or the excess over the residual value as revenue?

Analysis

Based on the fact pattern, FSP Corp should not recognize any amount as revenue. If FSP Corp's "ongoing major or central operations" consist of renting equipment, proceeds from the sale of revenue-generating equipment generally should not be characterized as revenue. Rather, the activity constitutes the disposal of an asset for which an operating gain (in this case) should be recorded.

EXAMPLE FSP 33-3

Revenue versus gains - sale of a patent

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

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

Analysis

As FSP Corp is in the business of routinely licensing and selling patents in its patent portfolio, it would be appropriate to present the consideration received as revenue.

If FSP Corp was not in the business of routinely licensing and selling its patents, but nonetheless sold one of its patents to a third party, it would be appropriate to present a gain or loss on sale of the patent.

Question FSP 33-2

A reporting entity negotiates directly with third parties to sell the byproducts resulting from its manufacturing process. How should the reporting entity classify the sale of byproducts in its statement of comprehensive income?

PwC response

There is no specific guidance addressing the classification of the proceeds from sales of byproducts. Reporting entities should first consider whether these sales represent a contract with a customer and therefore are in the scope of the revenue standard. This assessment may require judgment. For example, sales of byproducts may represent revenue if these items are an output of the reporting

entity's recurring manufacturing process and the reporting entity negotiates contracts with counterparties to purchase the byproducts as part of its ongoing major or central operations. If a reporting entity concludes sales of byproducts do not meet the definition of revenue, then it may be appropriate to present the proceeds as "other income."

In other fact patterns, a reporting entity may sell scrap materials to third parties; for example, a reporting entity may take advantage of volume purchasing discounts by intentionally purchasing more raw materials than it needs for its own production and then sells the excess as scrap as a means of managing raw material costs. In that scenario, we believe it may be acceptable to present proceeds from those scrap sales as a reduction of costs of sales.

33.2.3 Income from litigation settlements

See RR 9.7.4 for discussion for the presentation of proceeds received from a patent litigation settlement. See FSP 23.5 for discussion of gain contingencies.

33.2.4 Gross versus net revenue presentation

See RR 10 for discussion of gross versus net revenue presentation under ASC 606, which is based on the assessment of whether a reporting entity is the principal or an agent in a transaction. RR 10 also includes discussion of presentation of shipping and handling fees, out-of-pocket reimbursements, and amounts (e.g., taxes) collected from a customer to be remitted to a third party.

33.2.5 Payments to customers

See RR 4 for discussion of the presentation of payments to customers, including sales incentives.

33.3 Presenting contract-related assets and liabilities

The revenue standard provides guidance on presentation of assets and liabilities generated from contracts with customers.

ASC 606-10-45-1

When either party to a contract has performed, an entity shall present the contract in the statement of financial position as a contract asset or a contract liability, depending on the relationship between the entity's performance and the customer's payment. An entity shall present any unconditional rights to consideration separately as a receivable.

A reporting entity will recognize an asset or liability if one of the parties to a contract has performed before the other. For example, when a reporting entity performs a service or transfers a good in advance of receiving consideration, the reporting entity will recognize a contract asset or receivable in its statement of financial position. A contract liability is recognized if the reporting entity receives consideration (or if it has the unconditional right to receive consideration) in advance of performance.

33.3.1 Contract assets and receivables

The revenue standard distinguishes between a contract asset and a receivable based on whether receipt of the consideration is conditional on something other than the passage of time.

Excerpt from ASC 606-10-45-3 [edits applicable upon adoption of ASU 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses Financial Instruments*]

A contract asset is an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer. An entity shall assess a contract asset for impairment in accordance with Topic 310 on receivables. [An entity shall assess a contract asset for credit losses in accordance with Subtopic 326-20 on financial instruments measured at amortized cost. A credit loss of a contract asset shall be measured, presented, and disclosed in accordance with Subtopic 326-20.]

Excerpt from ASC 606-10-45-4 [edits applicable upon adoption of ASU 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*]

A receivable is an entity's right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due.... An entity shall account for a receivable in accordance with Topic 310. […and Subtopic 326-20. Upon initial recognition of a receivable from a contract with a customer, any difference between the measurement of the receivable in accordance with Subtopic 326-20 and the corresponding amount of revenue recognized shall be presented as a credit loss expense.]

The revenue standard requires that a contract asset be classified as a receivable when the reporting entity's right to consideration is unconditional (that is, when payment is due only upon the passage of time). If a reporting entity transfers control of goods or services to a customer before the customer pays consideration, the reporting entity should record either a contract asset or a receivable depending on the nature of the reporting entity's right to consideration for its performance. The point at which a contract asset becomes an account receivable may be earlier than the point at which an invoice is issued.

The distinction between a contract asset and a receivable is important because it provides relevant information about the risks related to the reporting entity's rights in a contract, such as whether the reporting entity only has credit risk or if there are other risks, such as performance risk, remaining. Additionally, as discussed in FSP 33.3.4, contract assets and contract liabilities arising from the same contract are presented net as either a single net contract asset or single net contract liability for presentation purposes.

Reporting entities should follow ASC 310 when considering impairment (ASC 326, once adopted, when considering credit losses) of contract assets or receivables. Refer to FSP 8 for further discussion of presentation and disclosure of impaired receivables (prior to adopting ASC 326). Refer to LI 12 for discussion of presentation and disclosure of credit losses (post adoption of ASC 326).

Example FSP 33-4 illustrates the distinction between a contract asset and a receivable. This concept is also illustrated in Examples 39 and 40 of the revenue standard (ASC 606-10-55-287 through ASC 606-10-55-294).

EXAMPLE FSP 33-4

Distinguishing between a contract asset and a receivable

Manufacturer enters into a contract to deliver two products to Customer (Products X and Y), which will be delivered at different points in time. Product X will be delivered before Product Y. Manufacturer has concluded that delivery of each product is a separate performance obligation and that control transfers to Customer upon delivery. No performance obligations remain after the delivery of Product Y. Customer is not required to pay for the products until one month after both are delivered. Assume for purposes of this example that no significant financing component exists.

How should Manufacturer reflect the transaction in the statement of financial position upon delivery of Product X?

Analysis

Manufacturer should record a contract asset and corresponding revenue upon satisfying the first performance obligation (delivery of Product X) based on the portion of the transaction price allocated to that performance obligation. A contract asset is recorded rather than a receivable because Manufacturer does not have an unconditional right to the contract consideration until both products are delivered. A receivable and the remaining revenue under the contract should be recorded upon delivery of Product Y, and the contract asset related to Product X should also be reclassified to a receivable. Manufacturer has an unconditional right to the consideration at that time since payment is due based only upon the passage of time.

33.3.2 *Contract liabilities*

A reporting entity should recognize a contract liability if the customer's payment of consideration precedes the reporting entity's performance (e.g., by paying a deposit).

ASC 606-10-45-2

If a customer pays consideration or an entity has a right to an amount of consideration that is unconditional (that is, a receivable), before the entity transfers a good or service to the customer, the entity shall present the contract as a contract liability when the payment is made or the payment is due (whichever is earlier). A contract liability is an entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or an amount of consideration is due) from the customer.

Example FSP 33-5 illustrates when a reporting entity should record a contract liability. This concept is also illustrated in Example 38 of the revenue standard (ASC 606-10-55-284 through ASC 606-10-55-286).

EXAMPLE FSP 33-5

Recording a contract liability

Producer enters into a contract to deliver a product to Customer for $5,000. Customer pays a deposit of $2,000, with the remainder due upon delivery (assume delivery will occur three weeks later and a

significant financing component does not exist). Revenue will be recognized upon delivery as that is when control of the product transfers to the customer.

How should Producer present the advance payment prior to delivery in the statement of financial position?

Analysis

The $2,000 deposit was received in advance of delivery, so Producer should recognize a contract liability for that amount. The contract liability will be reversed and recognized as revenue (along with the $3,000 remaining balance) upon delivery of the product.

33.3.3 *Timing of invoicing and performance*

The timing of when a reporting entity satisfies its performance obligation and when it invoices its customer can affect the presentation of assets and liabilities on the statement of financial position. An unconditional right to receive consideration often arises after a reporting entity transfers control of a good or service and invoices the customer, because receipt of payment is based only on the passage of time.

A reporting entity could, however, have an unconditional right to consideration before it has satisfied a performance obligation. For example, a reporting entity that enters into a noncancellable contract requiring advance payment could have an unconditional right to consideration before it performs under the contract. In other words, the right to invoice and collect from the customer is not contingent upon performance, even though the reporting entity may have to refund all or a portion of the payment to the customer if it ultimately does not perform according to the contract. A receivable is recorded in these situations with a corresponding credit to a contract liability (which may be referred to as deferred revenue); however, revenue is not recognized until the reporting entity has transferred control of the goods or services promised in the contract.

The fact that a reporting entity has issued an invoice does not necessarily mean it has an unconditional right to consideration. A reporting entity that invoices the customer cannot record a receivable unless it has concluded it has an unconditional right to consideration.

A reporting entity could, on the other hand, have an unconditional right to consideration before it invoices its customer, in which case the reporting entity should record an unbilled receivable. For example, this could occur if a reporting entity has satisfied its performance obligations, but has not yet issued the invoice.

In certain contracts, including certain commodity arrangements, the transaction price varies based on future changes in the market price that occur after the reporting entity has satisfied its performance obligations. A reporting entity might conclude it has an unconditional right to consideration (and therefore, should recognize a receivable subject to the financial instruments guidance) before the variability arising from changes in the market price is resolved.

Example FSP 33-6 and Example FSP 33-7 illustrate the interaction between the timing of invoicing, performance, and recording a receivable. This concept is also illustrated in Example 38 of the revenue standard (ASC 606-10-55-284 through ASC 606-10-55-286).

EXAMPLE FSP 33-6

Balance sheet presentation — recording a receivable

On January 1, Producer enters into a contract to deliver a product to Customer on March 31. The contract is noncancellable and requires Customer to make an advance payment of $5,000 on January 31. Customer does not pay the consideration until March 1.

How should Producer reflect the transaction in the statement of financial position?

Analysis

On January 31, Producer should record a receivable as Producer has an unconditional right to consideration:

Dr. Receivable	$5,000	
Cr. Contract liability		$5,000

On March 1, upon receipt of the cash, Producer should record the following:

Dr. Cash	$5,000	
Cr. Receivable		$5,000

On March 31, upon satisfying the performance obligation, Producer should recognize revenue as follows:

Dr. Contract liability	$5,000	
Cr. Revenue		$5,000

Producer has an unconditional right to the consideration when the advance payment is due because the contract is noncancellable. As a result, Producer records a receivable on January 31.

Producer would not record a receivable on January 31 if the contract were cancellable because, in that case, it does not have an unconditional right to the consideration. Producer would instead record the cash receipt and a contract liability on the date the advance payment is received.

EXAMPLE FSP 33-7

Balance sheet presentation — unbilled receivable

On January 1, Producer enters into a contract to deliver a product to Customer. Producer delivers the product on March 31 and sends an invoice for $5,000 to Customer on April 15. Customer pays the consideration on April 30. There are no other performance obligations in the contract.

How should Producer reflect the transaction in the statement of financial position?

Analysis

On March 31, upon satisfying the performance obligation, Producer would recognize revenue and record a receivable:

Dr. Receivable	$5,000	
Cr. Revenue		$5,000

On April 15, there would be no entry for Producer to record when it issues the invoice.

On April 30, upon receipt of the cash, Producer would record the following:

Dr. Cash	$5,000	
Cr. Receivable		$5,000

Producer has an unconditional right to the consideration after it delivers the product. As a result, Producer would record a receivable on March 31. The receivable is "unbilled" because Producer has not yet issued an invoice; however, the balance should be included with receivables (as opposed to contract assets) because it is an unconditional right to consideration.

33.3.4 Netting of contract assets and contract liabilities

Reporting entities sometimes receive consideration from their customers in advance of performance on a portion of the contract and, on another portion of the contract, perform in advance of receiving consideration. Contract assets and liabilities related to rights and obligations in a contract are interdependent and therefore are recorded net in the statement of financial position.

Question FSP 33-3

Should contract assets and liabilities be presented net even if they arise from different performance obligations in a contract?

PwC response

Yes. We believe a net contract asset or liability should be determined and presented at the contract level, not at the performance obligation level. Refer to Revenue TRG Memo No. 7 and the related meeting minutes in Revenue TRG Memo No. 11 for further discussion of this topic.

Question FSP 33-4

Should contract assets and liabilities be recorded net in the statement of financial position for contracts that are combined in accordance with the revenue standard? Or should they be presented separately?

PwC response

We believe when contracts are combined and accounted for as a single contract, the presentation guidance should be applied to the combined contract. Contract assets and liabilities should therefore be presented net as either a single contract asset or a contract liability. Refer to Revenue TRG Memo

No. 7 and the related meeting minutes in Revenue TRG Memo No. 11 for further discussion of this topic.

Reporting entities should look to other standards on financial statement presentation to conclude if it is appropriate to net contract assets and contract liabilities if they arise from different contracts that are not combined in accordance with the revenue standard.

Question FSP 33-5

How should a reporting entity assess whether to present other balance sheet accounts resulting from accounting for contracts with customers on a net basis (other than contract assets and contract liabilities)?

PwC response

The revenue standard only specifically addresses the need to present contract assets and contract liabilities on a net basis. To determine whether it is appropriate to offset other balance sheet accounts (e.g., accounts receivable against refund liabilities), management should assess the general guidance on balance sheet offsetting included in ASC 210-20.

33.3.5 Presentation of contract assets and contract liabilities

The revenue standard does not specify whether a reporting entity is required to present its contract assets and contract liabilities, or other balance sheet accounts related to contracts from customers (e.g., refund liabilities), as separate line items in the statement of financial position. Reporting entities should look to other standards on financial statement presentation to determine if separate presentation is necessary.

While the revenue standard uses the terms "contract asset" and "contract liability," reporting entities can use alternative descriptions in the statement of financial position (e.g., deferred revenue). Certain industries, for example, have common terms that are used for these situations. Reporting entities can use these alternative descriptions as long as they provide sufficient information to distinguish between those rights to consideration that are conditional (that is, contract assets) from those that are unconditional (that is, receivables).

Question FSP 33-6

In a classified statement of financial position, should contract assets and contract liabilities be presented as current and non-current assets and liabilities?

PwC response

Yes. In a classified statement of financial position, reporting entities should refer to the guidance in ASC 210 to distinguish between the current and non-current portions of contract assets and contract liabilities.

Question FSP 33-7

A reporting entity records a refund liability, which is an estimate of cash that will be refunded to customers that return products. Should this refund liability be presented as a contract liability for purposes of disclosure and netting with contract assets?

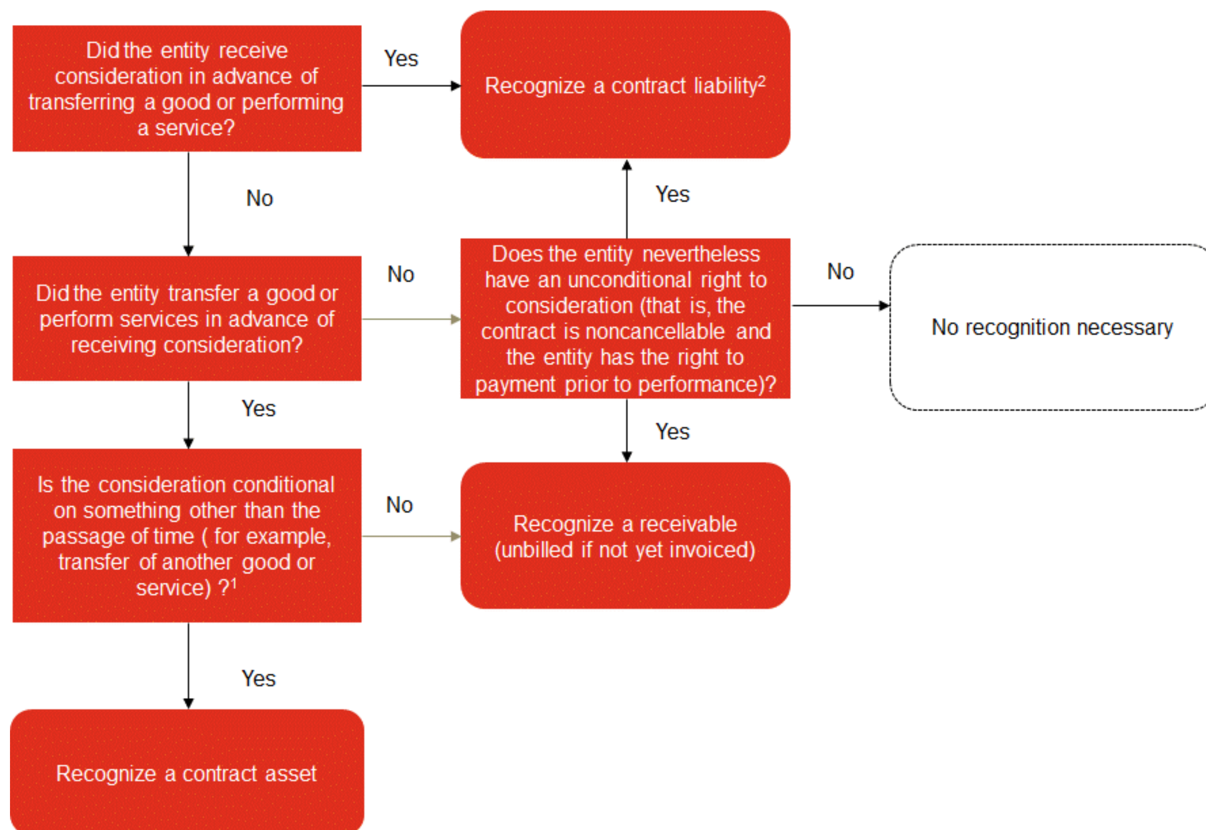
PwC response

No. The refund liability described above differs from a contract liability, which is an obligation to transfer goods or services. Therefore, the refund liability should not be included with contract liabilities for purposes of disclosure and netting with contract assets.

33.3.6 Recognition decision tree for contract assets and liabilities

Figure FSP 33-2 illustrates the decision tree used to determine when to recognize a contract asset, receivable, or contract liability.

Figure FSP 33-2
Recognition decision tree



[1]A reporting entity might conclude it has an unconditional right to consideration if the transaction price varies solely due to future changes in market price (e.g., after the reporting entity has already satisfied its performance obligations).
[2]If the customer can cancel the contract and receive a refund of the advance payment, the reporting entity should generally exclude such amounts from contract liabilities and record a "customer deposit" or similar liability.

33.4 Revenue disclosures

Reporting entities must disclose certain qualitative and quantitative information so that financial statement users can understand the nature, amount, timing, and uncertainty of revenue and cash flows generated from their contracts with customers. These disclosures can be extensive and may require significant management judgment.

Excerpt from ASC 606-10-50-1

An entity shall disclose qualitative and quantitative information about all of the following:

a. Its contracts with customers…

b. The significant judgments, and changes in those judgments, made in applying [the revenue standard] to those contracts…

c. Any asset recognized from the costs to obtain or fulfill a contract with a customer

Management should consider the level of detail necessary to meet the disclosure objective. For example, a reporting entity should aggregate or disaggregate information, as appropriate, to provide clear and meaningful information to a financial statement user. The level of disaggregation is subject to judgment.

Management must also disclose the use of certain practical expedients. A reporting entity that uses the practical expedient regarding the existence of a significant financing component (RR 4) or the practical expedient for expensing certain costs of obtaining a contract (RR 11), for example, must disclose that fact.

Disclosures are included for each period for which a statement of comprehensive income is presented and as of each reporting period for which a statement of financial position is presented. The requirements only apply to material items. Materiality judgments could affect whether certain disclosures are necessary or the extent of the information provided in the disclosure. Reporting entities need not repeat disclosures if the information is already presented as required by other accounting standards.

Figure FSP 33-3 summarizes the annual disclosures required by the revenue standard.

Figure FSP 33-3

Annual disclosure requirements

Disclosure type	Required information
Disaggregated revenue	Disaggregation of revenue into categories that show how economic factors affect the nature, amount, timing, and uncertainty of revenue and cash flows
Reconciliation of contract balances	□ Opening and closing balances and revenue recognized during the period from changes in contract balances □ Qualitative and quantitative information about the significant changes in contract balances
Performance obligations	□ Descriptive information about a reporting entity's performance obligations □ Information about the transaction price allocated to remaining performance obligations and when revenue will be recognized □ Revenue recognized from performance obligations satisfied (or partially satisfied) in previous periods
Significant judgments	□ Method used to recognize revenue for performance obligations satisfied over time and why the method is appropriate □ Significant judgments related to transfer of control for performance obligations satisfied at a point in time □ Information about the methods, inputs, and assumptions used to determine and allocate transaction price

Disclosure type	Required information
Costs to obtain or fulfill a contract	◻ Judgments made to determine costs to obtain or fulfill a contract, and method of amortization ◻ Closing balances of assets and amount of amortization/impairment
Practical expedients	Use of either of the following: ◻ The practical expedient regarding the existence of a significant financing component; see RR 4.4.2 ◻ The practical expedient for expensing certain costs of obtaining a contract; see RR 11.2.2

Disclosure requirements are discussed in more detail below.

33.4.1 Disaggregated revenue

The revenue standard does not prescribe specific categories for disaggregation, but instead provides examples of categories that might be appropriate. A reporting entity may need to disaggregate revenue by more than one type of category to meet the disclosure objective.

ASC 606-10-55-90

When selecting the type of category (or categories) to use to disaggregate revenue, an entity should consider how information about the entity's revenue has been presented for other purposes, including all of the following:

a. Disclosures presented outside the financial statements (for example, in earnings releases, annual reports, or investor presentations)

b. Information regularly reviewed by the chief operating decision maker for evaluating the financial performance of operating segments

c. Other information that is similar to the types of information identified in (a) and (b) and that is used by the entity or users of the entity's financial statements to evaluate the entity's financial performance or make resource allocation decisions.

ASC 606-10-55-91

Examples of categories that might be appropriate include, but are not limited to, all of the following:

a. Type of good or service (for example, major product lines)

b. Geographical region (for example, country or region)

c. Market or type of customer (for example, government and nongovernment customers)

d. Type of contract (for example, fixed-price and time-and-materials contracts)

e. Contract duration (for example, short-term and long-term contracts)

f. Timing of transfer of goods or services (for example, revenue from goods or services transferred to customers at a point in time and revenue from goods or services transferred over time)

g. Sales channels (for example, goods sold directly to consumers and goods sold through intermediaries).

Question FSP 33-8

Will a reporting entity's disaggregated revenue disclosure always be at the same level as its segment disclosures?

PwC response

No. The revenue standard requires reporting entities to explain the relationship between the disaggregated revenue required by the revenue standard and the information required by the accounting standard on operating segments. Management should not assume the two disclosures will be disaggregated at the same level. More disaggregation might be needed in the revenue footnote, for example, because the operating segments standard permits aggregation in certain situations. The revenue standard does not have similar aggregation criteria. However, if management concludes that the disaggregation level is the same in both standards and segment revenue is measured on the same basis as the revenue standard, then the segment disclosure would not need to be repeated in the revenue footnote.

This disclosure is illustrated in Example 41 of the revenue standard (ASC 606-10-55-296 through ASC 606-10-55-297).

33.4.2 *Reconciliation of contract balances*

The purpose of these disclosures is to provide information about contract balances and the changes in those balances. The revenue standard provides for flexibility in how this information is presented from a formatting perspective (that is, it does not mandate a tabular presentation), but it does require certain items to be disclosed.

Excerpt from ASC 606-10-50-8

An entity shall disclose all of the following:

a. The opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers, if not otherwise separately presented or disclosed

b. Revenue recognized in the reporting period that was included in the contract liability balance at the beginning of the period

ASC 606-10-50-10

An entity shall provide an explanation of the significant changes in the contract asset and the contract liability balances during the reporting period. The explanation shall include qualitative and quantitative information. Examples of changes in the entity's balances of contract assets and contract liabilities include any of the following:

a. Changes due to business combinations

b. Cumulative catch-up adjustments to revenue that affect the corresponding contract asset or contract liability, including adjustments arising from a change in the measure of progress, a change in an estimate of the transaction price (including any changes in the assessment of whether an estimate of variable consideration is constrained), or a contract modification

c. Impairment of a contract asset

d. A change in the time frame for a right to consideration to become unconditional (that is, for a contract asset to be reclassified to a receivable)

e. A change in the time frame for a performance obligation to be satisfied (that is, for the recognition of revenue arising from a contract liability).

A reporting entity should also explain how the timing of satisfaction of its performance obligations compares to the typical timing of payment and how that affects contract asset and liability balances. This information can be provided qualitatively.

33.4.3 Performance obligations

There are multiple quantitative and qualitative disclosures that reporting entities are required to provide about their performance obligations.

33.4.3.1 Description of performance obligations

Reporting entities must include information to help readers understand the nature of its performance obligations. These disclosures should not be "boilerplate" and should supplement the reporting entity's revenue accounting policy disclosures.

ASC 606-10-50-12

An entity shall disclose information about its performance obligations in contracts with customers, including a description of all of the following:

a. When the entity typically satisfies its performance obligations (for example, upon shipment, upon delivery, as services are rendered, or upon completion of service) including when performance obligations are satisfied in a bill-and-hold arrangement

b. The significant payment terms (for example, when payment typically is due, whether the contract has a significant financing component, whether the consideration amount is variable, and whether the estimate of variable consideration is typically constrained…)

c. The nature of the goods or services that the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (that is, if the entity is acting as an agent)

d. Obligations for returns, refunds, and other similar obligations

e. Types of warranties and related obligations.

33.4.3.2 *Remaining performance obligations*

The revenue standard requires disclosure of information about the transaction price allocated to remaining performance obligations and when revenue will be recognized related to these obligations. This could require judgment, as it might not always be clear when performance obligations will be satisfied, especially when performance can be affected by factors outside the reporting entity's control. Reporting entities should explain whether any amounts have been excluded from the transaction price and therefore excluded from the disclosure, such as variable consideration that has been constrained.

ASC 606-10-50-13

An entity shall disclose the following information about its remaining performance obligations:

a. The aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied (or partially unsatisfied) as of the end of the reporting period

b. An explanation of when the entity expects to recognize as revenue the amount disclosed [in (a) above], which the entity shall disclose in either of the following ways:

   1. On a quantitative basis using the time bands that would be most appropriate for the duration of the remaining performance obligations

   2. By using qualitative information.

The revenue standard is not prescriptive regarding the format of disclosure. Therefore, management has discretion regarding the nature and extent of information needed to achieve the objective of the disclosure, which will depend on the reporting entity's facts and circumstances. Examples 42 and 43 (ASC 606-10-55-298 through ASC 606-10-55-307) of the revenue standard illustrate a quantitative and qualitative approach, respectively, to satisfying this disclosure requirement.

Reporting entities can elect to omit disclosure of information about the transaction price allocated to remaining performance obligations and when revenue will be recognized when the related contract has a duration of one year or less.

Additionally, reporting entities may elect to exclude variable consideration from the disclosure in the following scenarios:

- the reporting entity recognizes revenue equal to what it has the right to invoice when that amount corresponds directly with the value to the customer of the reporting entity's performance to date (refer to RR 6.4.1.1).
- the variable consideration is a sales-based or usage-based royalty promised in exchange for a license of intellectual property (refer to RR 4.3.5).
- the variable consideration is allocated entirely to a wholly unsatisfied performance obligation or to a wholly unsatisfied distinct good or service within a series of distinct goods or services (refer to RR 5.5.1.1).

The option to exclude information in the above three scenarios applies only to variable consideration in a contract; that is, the reporting entity would be required to disclose any fixed transaction price in the contract that is allocated to remaining performance obligations.

Reporting entities that elect any of the permitted exemptions are required to disclose which exemptions have been applied, the nature of the performance obligations, the remaining duration, and a description of the variable consideration that has been excluded from their disclosures.

Question FSP 33-9

A reporting entity enters into a master services agreement (MSA) on March 31, 20X1 that includes the general terms and pricing for Product A and requires the customer to purchase a minimum of 1,000,000 units over a three-year term. The timing of purchases is not known until the customer submits purchase orders for a specified number of units. The pricing of units in excess of the minimum is not at a discount (i.e., there is no material right). What should the reporting entity include in its disclosure of remaining performance obligations as of March 31, 20X1?

PwC response

The transaction price related to the 1,000,000 unit minimum should be included in the disclosure of remaining performance obligations because the MSA commits the parties to the purchase and sale of these units. The reporting entity should not include in the disclosure the transaction price for any units in excess of the required minimum of 1,000,000 units, even if such orders are expected. The customer has not yet committed to the purchase of any units in excess of the minimum and therefore, these units are optional purchases.

33.4.3.3 Revenue from previously satisfied performance obligations

Reporting entities must also disclose revenue recognized in the current period that did not result from current period performance.

ASC 606-10-50-12A

An entity shall disclose revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (for example, changes in transaction price).

This disclosure would include items such as changes in estimates of variable consideration, changes in estimates related to the measure of progress for performance obligations satisfied over time, and sales or usage-based royalties related to a license for which control transferred in a prior period.

33.4.4 Significant judgments

A reporting entity must disclose its judgments, as well as changes in those judgments, that significantly impact the amount and timing of revenue from its contracts with customers.

ASC 606-10-50-18

For performance obligations that an entity satisfies over time, an entity shall disclose both of the following:

a. The methods used to recognize revenue (for example, a description of the output methods or input methods used and how those methods are applied)

b. An explanation of why the methods used provide a faithful depiction of the transfer of goods or services.

ASC 606-10-50-19

For performance obligations satisfied at a point in time, an entity shall disclose the significant judgments made in evaluating when a customer obtains control of promised goods or services.

ASC 606-10-50-20

An entity shall disclose information about the methods, inputs, and assumptions used for all of the following:

a. Determining the transaction price, which includes, but is not limited to, estimating variable consideration, adjusting the consideration for the effects of the time value of money, and measuring noncash consideration

b. Assessing whether an estimate of variable consideration is constrained

c. Allocating the transaction price, including estimating standalone selling prices of promised goods or services and allocating discounts and variable consideration to a specific part of the contract (if applicable)

d. Measuring obligations for returns, refunds, and other similar obligations.

33.4.5 Costs to obtain or fulfill a contract

Reporting entities must provide information about how assets are recognized from costs to obtain or fulfill a contract with a customer, and how the assets are subsequently amortized or impaired.

ASC 340-40-50-2

An entity shall describe both of the following:

a. The judgments made in determining the amount of the costs incurred to obtain or fulfill a contract with a customer…

b. The method it uses to determine the amortization for each reporting period.

ASC 340-40-50-3

An entity shall disclose all of the following:

a. The closing balances of assets recognized from the costs incurred to obtain or fulfill a contract with a customer…, by main category of asset (for example, costs to obtain contracts with customers, precontract costs, and setup costs)

b. The amount of amortization and any impairment losses recognized in the reporting period.

33.4.6 Additional disclosure requirements for long-term contracts

Regulation S-X Rule 5-02(3) and Regulation S-X Rule 5-02(6) include additional disclosure requirements for certain long-term contracts.

Regulation S-X Rule 5-02(3)(c) requires the following disclosures for receivables under long-term contracts, either on the balance sheet or in a footnote:

Excerpt from Regulation S-X Rule 5-02(3)(c)

1. Balances billed but not paid by customers under retainage provisions in contracts

2. Amounts representing the recognized sales value of performance and such amounts that had not been billed and were not billable to customers at the date of the balance sheet. Include a general description of the prerequisites for billing.

3. Billed or unbilled amounts representing claims or other similar items subject to uncertainty concerning their determination or ultimate realization. Include a description of the nature and status of the principal items comprising such amount.

4. With respect to (1) through (3) above, also state the amounts included in each item which are expected to be collected after one year. Also state, by year, if practicable, when the amounts of retainage (see (1) above) are expected to be collected.

Regulation S-X Rule 5-02(6)(d) requires the following disclosures relating to contract costs:

Excerpt from Regulation S-X Rule 5-02(6)(d)

i. The aggregate amount of manufacturing or production costs and any related deferred costs (e.g., initial tooling costs) that exceeds the total estimated cost of all units (whether in-process or delivered). This should be based on the estimated average cost of all units expected to be produced under long-term contracts and programs (even if not yet complete), as well as amounts that would not be absorbed in cost of sales based on existing firm orders at the latest balance sheet date. If practicable, also disclose the amount of deferred costs by type of cost (e.g., initial tooling, deferred production, etc.).

ii. The aggregate amount of contract claims or other similar items subject to uncertainty, including a description of the nature and status of the primary items comprising the amount.

iii. The amount of progress payments netted against inventory at the balance sheet date.

33.4.7 Interim disclosure requirements

Public reporting entities must include many of the same disclosures in their interim financial statements that are required in annual financial statements.

Excerpt from ASC 270-10-50-1A

a. A disaggregation of revenue for the period…

b. The opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers (if not otherwise separately presented or disclosed)…

c. Revenue recognized in the reporting period that was included in the contract liability balance at the beginning of the period…

d. Revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (for example, changes in transaction price)…

e. Information about the entity's remaining performance obligations as of the end of the reporting period

Interim financial reporting standards also require reporting entities to provide certain disclosures about significant changes in a reporting entity's financial position, which include changes relating to revenue. Refer to FSP 29 for further discussion of interim reporting requirements.

33.5 Revenue and related costs considerations for private companies

Certain exemptions are provided in the revenue standard to simplify the disclosure requirements for nonpublic reporting entities. Such reporting entities must follow the disclosure requirements described in FSP 33.4.1 through FSP 33.4.7 with some modifications. Figure FSP 33-4 summarizes the modifications to the disclosure requirements for nonpublic reporting entities.

Figure FSP 33-4

Nonpublic reporting entity disclosure considerations

Disclosure type	Related information
Disaggregated revenue	Nonpublic reporting entities may elect to not apply the quantitative disaggregation of revenue disclosure guidance discussed in FSP 33.4.1; however, if this election is made, the reporting entity must at a minimum disclose: □ Revenue disaggregated according to the timing of transfer of goods or services (e.g., at a point in time and over time) □ Qualitative information about how economic factors (e.g., type of customer, geographical location of customers, and type of contract) affect the nature, amount, timing, and uncertainty of revenue and cash flows
Reconciliation of contract balances	Nonpublic reporting entities can elect to disclose only the opening and closing balances of contract assets, contract liabilities, and receivables from contracts with its customers. The other disclosures described in FSP 33.4.2 (contract assets and contract liabilities) are optional.
Performance obligations	Descriptive disclosures of a reporting entity's performance obligations are required for nonpublic reporting entities; however, disclosures regarding remaining unsatisfied or partially satisfied performance obligations are optional. Disclosures regarding revenue recognized from performance obligations satisfied (or partially satisfied) in previous periods are optional. See FSP 33.4.3.
Significant judgments	Nonpublic reporting entities must disclose the following: □ The methods used to recognize revenue (e.g., a description of the input method or output method) for performance obligations satisfied over time □ The methods, inputs, and assumptions used to assess whether an estimate of variable consideration is constrained The other disclosures of significant judgments as described in FSP 33.4.4 are optional.
Costs to obtain or fulfill a contract	Disclosures of assets recognized from the costs to obtain or fulfill a contract with a customer described in FSP 33.4.5 are optional.
Practical expedients	Disclosures on the use of practical expedients described in FSP 33.4 are optional.
Interim financial statement disclosures	The interim financial statement disclosures described in FSP 33.4.7 are optional.