Annual FASB Update and Review

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FASB Accounting Standards Updates, Including the Activities of the PCC

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Learning objectives

After completing this chapter, you should be familiar with:

- Recently issued ASUs of greatest significance to smaller and medium-sized entities;
- Recently issued ASUs impacting SEC registrants and other public entities; and
- Items on the FASB's technical agenda.

I. Introduction

Accounting Standards Updates are used by the FASB to amend its Accounting Standards Codification™ (Codification or ASC), which was launched on July 1, 2009 as the single source of authoritative nongovernmental U.S. GAAP. However, ASUs are not authoritative; they are only used to update the FASB Codification.

This chapter will discuss in depth all significant Accounting Standards Updates (ASUs) issued by the FASB in 2024 and 2023, as well as those issued by the FASB prior to 2023 that are of most continuing significance to private entities. Some of the 2024 ASUs are of predominant interest to public entities.

II. ASU No. 2024-02, Codification Improvements – Amendments to Remove References to the Concepts Statements

A. Reason for issuance

ASU 2024-02 introduces amendments to the Codification to remove references to various FASB Concepts Statements. This action is part of the FASB's ongoing project to address suggestions from stakeholders for improvements and technical corrections to the Codification, facilitating updates for clarifications, simplifications, and minor improvements. By removing references to Concepts Statements, which are nonauthoritative, the FASB aims to clarify the Codification, correct any unintended applications of guidance, and draw a clear distinction between authoritative and nonauthoritative literature, ensuring that the Codification reflects current GAAP without implying the authoritativeness of the Concepts Statements, which are now removed.

B. Entities affected

The amendments impact various Topics within the Codification and apply to all reporting entities within the scope of the affected accounting guidance.

C. Main provisions

ASU 2024-02 seeks to refine and clarify the Codification by eliminating unnecessary references to nonauthoritative Concepts Statements, thereby enhancing the clarity and application of GAAP for all reporting entities. The main provisions of ASU 2024-02 involve the removal of references to Concepts Statements across a wide range of Codification Topics. These references are often extraneous and not essential for understanding or applying the guidance. In some cases, the references might imply the authoritativeness of Concepts Statements or refer to superseded documents, potentially leading to diverse interpretations. The amendments aim to simplify the Codification, emphasizing the distinction between authoritative guidance and conceptual frameworks that inform the FASB's standard-setting process. This clarification is expected to streamline the application of GAAP by eliminating potential confusion over the role of Concepts Statements in preparing financial statements.

D. Effective date and transition guidance

For public business entities, the amendments are effective for fiscal years beginning after December 15, 2024, including interim periods within those fiscal years. For all other entities, the amendments apply to fiscal years beginning after December 15, 2025. Early adoption is permitted for entities for any fiscal year or interim period for which financial statements have not yet been issued or made available for issuance. Entities adopting the amendments in an interim period must do so as of the beginning of the fiscal year that includes that interim period. The transition can be applied either prospectively to all new or modified transactions recognized on or after the date of first application or retrospectively to the beginning of the earliest comparative period presented.

III. ASU No. 2024-01, Compensation – Stock Compensation (Topic 718): Scope Application of Profits Interest and Similar Awards

A. Reason for issuance

The Financial Accounting Standards Board (FASB) issued ASU 2024-01 to clarify how entities should apply scope guidance in determining whether profits interest and similar awards should be accounted for under Topic 718, *Compensation – Stock Compensation*. This was in response to complexities and diversity in practice (even for similar fact patterns) identified by the PCC regarding the accounting of profits interest awards, which are used by entities to align compensation with performance and provide participants with future profits and/or equity appreciation. The update aims to add illustrative examples for clarity and improve consistency in applying GAAP.

B. Entities affected

The amendments affect all reporting entities that account for profits interest awards as compensation to employees or nonemployees in return for goods or services. Additionally, the amendments that clarify the scope and exceptions section of Topic 718 apply to all entities entering into share-based payment transactions.

C. Main provisions

ASU 2024-01 aims to provide clarity and reduce inconsistencies in how entities account for profits interest and similar awards, ensuring a more standardized approach across different entities and situations. ASU 2024-01 introduces an illustrative example with four fact patterns to demonstrate the application of scope guidance for determining whether a profits interest award falls under Topic 718. These examples focus on key considerations such as whether the award grants the right to equity instruments or cash payments based on the entity's share price, among other conditions. This guidance aims to reduce complexity and practice diversity by providing clear criteria for when profits interest awards should be accounted for under Topic 718. The example is comprehensive, covering cases where the awards are share-based payment arrangements and where they are not, based on various conditions like service requirements, participation in distributions, and settlement terms.

D. Effective date and transition guidance

For public business entities (PBEs), the amendments are effective for annual periods beginning after December 15, 2024, including interim periods within those annual periods. For all other entities, they are effective for annual periods beginning after December 15, 2025, and interim periods within those annual periods. Early adoption is permitted for both interim and annual financial statements not yet issued or available for issuance. Entities can apply the amendments retrospectively to all prior periods presented or prospectively to awards granted or modified after the first application date.

IV. ASU No. 2023-09, Income Taxes (Topic 740): Improvements to Income Tax Disclosures

A. Reason for issuance

This ASU was issued to help investors "better understand an entity's exposure to potential changes in jurisdictional tax legislation and the ensuing risks and opportunities." It will allow investors to better assess income tax information that relates to cash flow forecasts and capital allocation decisions and will also aid investors in identifying potential opportunities to increase future cash flows.

B. Entities affected

The ASU affects all entities, public and private, subject to ASC Topic 740.

C. Main provisions

The ASU improves transparency and expands what public and private entities must disclose regarding rate reconciliations, income taxes paid, amounts surrounding the disaggregation of foreign and domestic income before taxes, and income tax expense or benefit from continuing operations disaggregated by foreign, federal, and state. Public entities must disclose specific categories in the rate reconciliation and expand disclosures for all reconciling items that meet a quantitative threshold for items that are greater than or equal to 5 percent of pretax income (loss) by the applicable statutory income rate. Private entities require qualitative, not quantitative, disclosure about categories of reconciling items and tax jurisdictions that result in a "significant difference" between the statutory tax rate and the effective tax rate.

All entities must disclose "the amount of income taxes paid (net of refunds received) disaggregated by federal (national), state, and foreign taxes." They also must disclose "the amount of income taxes paid (net of refunds received) disaggregated by individual jurisdictions in which income taxes paid (net of refunds received) is equal to or greater than 5 percent of total income taxes paid (net of refunds received)." The ASU also provides that entities must disclose (1) income (or loss) from continuing operations before income tax expense (or benefit), disaggregated between domestic and foreign, and (2) income tax expense (or benefit) from continuing operations disaggregated by federal (national), state, and foreign.

Lastly, the ASU eliminates the requirement for all entities to (1) disclose the nature and estimate of the range of the reasonably possible change in the unrecognized tax benefits balance in the next 12 months or (2) make a statement that an estimate of the range cannot be made.

D. Effective date

ASU No. 2023-09 is effective for public entities for fiscal years beginning after December 15, 2024; for private entities, the effective date is for fiscal years beginning after December 15, 2025. Early adoption and retrospective application are permitted.

V. ASU No. 2023-08, Intangibles – Goodwill and Other – Crypto Assets (Subtopic 350-60)

A. Reason for issuance

This ASU was issued to establish balance sheet, income statement, and statement of cash flow reporting requirements for crypto assets and other intangible assets meeting the FASB's revised definition of a crypto asset. Prior to the release of the ASU, the best recommendation was for crypto assets to be classified as intangible assets subject to impairment testing and carried at cost less impairment. Gain recognition was disallowed. The ASU expands disclosure requirements for reporting holdings in crypto assets.

B. Entities affected

The ASU affects all entities holding or transacting in crypto assets.

C. Main provisions

The ASU establishes financial reporting guidelines for crypto assets. A crypto asset is defined in the standard as an asset that meets all of the following criteria to be in scope of the amendment:

1. Meets the ASC definition of an intangible asset;
2. Does not provide the asset holder with enforceable rights to or claims on underlying goods, services, or other assets;
3. Is created or resides on a distributed ledger based on blockchain or similar technology;
4. Is secured through cryptography;
5. Is fungible; and
6. Is not created by the reporting entity or its related parties.

The ASU establishes that intangible assets meeting the definition of a crypto asset must be reported separately from other intangible assets (further disaggregation by crypto asset is permitted). The asset must be measured and reported at fair value on the balance sheet. Changes resulting from remeasurement go directly to the income statement (or statement of activity) as a gain or loss on change in fair value from intangible assets, reported separately from other gains and losses.

The ASU further establishes disclosure requirements for entities subject to the guidance. Entities must disclose the name, cost basis, fair value, and number of units for each significant crypto asset holding and the aggregate fair values and cost bases of the crypto asset holdings that are not individually significant. For crypto assets that are subject to contractual sale restrictions, the fair value of those crypto assets, the nature and remaining duration of the restriction(s), and the circumstances that could cause the restriction(s) to lapse must be disclosed.

Other disclosures include:

- A roll forward, in the aggregate, of activity in the reporting period for crypto asset holdings, including additions (with a description of the activities that resulted in the additions), dispositions, gains, and losses.
- For any dispositions of crypto assets in the reporting period, the difference between the disposal price and the cost basis and a description of the activities that resulted in the dispositions.
- If gains and losses are not presented separately, the income statement line item in which those gains and losses are recognized.
- The method for determining the cost basis of crypto assets.

Annual reconciliation detailing the activity from the opening to the closing balances of crypto assets, separately listing:

- Additions;
- Dispositions;
- Gains included in net income for the period, determined on a crypto-asset-by-crypto-asset basis. Each crypto asset holding that has a net gain from remeasurement as included in net income for the period shall be included in the gains line; and
- Losses included in net income for the period, determined on a crypto-asset-by-crypto-asset basis. Each crypto asset holding that has a net loss from remeasurement as included in net income for the period shall be included in the losses line.

D. Effective date

ASU No. 2023-08 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 annual and interim financial statements. Entities are required to make a cumulative-effect adjustment to the opening balance of retained earnings as of the beginning of the period in which the entity adopts the amendment.

VI. ASU No. 2023-07, Segment Reporting (Topic 280): Improvements to Reportable Segment Disclosures

A. Reason for issuance

This ASU, which only applies to public entities, was issued in response to the FASB’s post-implementation review of Statement No. 131. Prior to the ASU, public entities were required to report segment revenue and profit or loss, with limited expense information disclosed. Investors wanted expanded disclosures about a segment’s expenses. The ASU expands such expense disclosure requirements and updates guidance on reportable segments, including disclosure of the title and position of the chief operating decision maker (CODM) and significant expenses reported to them.

B. Entities affected

The ASU only applies to public entities subject to segment disclosure requirements.

C. Main provisions

The main provisions of the ASU focus on mandatory disclosure requirements. The public entity must disclose significant segment expenses that are regularly provided to the CODM and included in segment profit or loss. They are required to disclose and break out other segment items not included in the significant expenses, and the other items should be the difference between segment revenue and segment reported profit or loss.

Entities must continue existing reporting requirements under ASC 280. In addition to reporting segment profit and loss that is most consistent under U.S. GAAP, a public entity may report additional profit and loss measures utilized by the CODM. The entity must disclose the title and position of the CODM and describe how they use the identified segment information.

Note that the ASU applies even if the public entity has only one reportable segment.

D. Effective date

ASU No. 2023-07 is effective for fiscal years beginning after December 15, 2023, and interim periods within fiscal years beginning after December 15, 2024. Early adoption is permitted, and retrospective application is required for all periods presented in the financial statements.

VII. ASU No. 2023-05, Business Combinations – Joint Venture Formations (Subtopic 805-60)

A. Reason for issuance

This ASU was issued as an amendment to provide clear guidance on accounting for contributions made to a joint venture, upon formation, in a joint venture's separate financial statements. Prior to the ASU, joint ventures took a diverse approach to measuring contributions at the formation date, with some electing to account for net asset contributions at fair value and others electing to account for net asset contributions at the venturer's carrying amount. The Update now provides consistent and decision-useful guidance to investors and reduces diversity in joint venture formation accounting.

B. Entities affected

The ASU applies only to entities that meet the FASB ASC Master Glossary definition of a joint venture or corporate joint venture.

C. Main provisions

The ASU establishes that newly formed joint ventures should initially measure assets and liabilities at fair value as of the formation date (with fair value measurement exceptions that are consistent with business combination guidance). This approach is consistent with the accounting result that would occur if the joint venture was treated as the acquirer of a business and subject to the guidance in FASB ASC Subtopic 850, *Business Combinations*.

Disclosures for joint venture formation should occur in the period in which the formation date occurs. Note that joint venture formation disclosure requirements are different from the requirements for disclosures in a business combination.

D. Effective date

The ASU is effective prospectively for all joint venture formations with a formation date beginning on or after January 1, 2025. Joint ventures formed prior to this date may elect to apply the ASU retrospectively if sufficient information exists. Early adoption is permitted for annual and interim periods for which financial statements have not been issued or made available for issuance, either prospectively or retrospectively.

VIII. ASU No. 2023-02, Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method

A. Reason for issuance

This ASU was issued to allow consistent accounting for equity investments made primarily for the purpose of receiving income tax credits and other income tax benefits. Previously, the proportional amortization method was limited to investments in low-income housing tax credit (LIHTC) structures, while equity investments in other tax credit structures were typically accounted for using the equity method or Topic 321. The ASU affects all entities that hold at least one of the following:

1. Tax equity investments that an entity has elected to account for using the proportional amortization method.
2. An investment in a LIHTC structure through a limited liability entity that is not accounted for using the proportional amortization method and to which certain LIHTC-specific guidance removed by ASU 2023-02 has been applied.

B. Entities affected

The ASU applies only to entities that meet the FASB ASC Master Glossary definition of a joint venture or corporate joint venture.

C. Main provisions

Entities can elect to account for their tax equity investments utilizing the proportional amortization method if all required conditions are met:

1. It is probable that the income tax credits allocable to the tax equity investor will be available;
2. The tax equity investor does not have significant influence over the operating and financial policies of the underlying project;
3. Substantially all of the projected benefits are from income tax credits and other income tax benefits. Projected benefits include income tax credits, other income tax benefits, and other nonincome tax-related benefits. The projected benefits are determined on a discounted basis using a discount rate consistent with the cash flow assumptions used by the tax equity investor in deciding to invest in the project;
4. The tax equity investor's projected yield is positive based solely on the cash flows from the income tax credits and other income tax benefits; and
5. The tax equity investor is a limited liability investor in the limited liability entity for both legal and tax purposes.

Furthermore, when a reporting entity makes the referenced election related to the proportional amortization method on a tax credit program by tax credit program basis, the entity should disclose the following:

1. The nature of its tax equity investments; and
2. The effect of its tax equity investments, related income tax credits, and other income tax benefits on its financial position and results of operations.

ASU 2023-02 also removes specialized guidance for LIHTC investments. LIHTC investments may elect the proportional amortization method if all conditions are met. However, if an entity does not elect this method, these investments will follow the appropriate GAAP guidance found in Topic 321 and Subtopic 323-10.

D. Effective date

For public business entities, the ASU is effective for fiscal years beginning after December 15, 2023, and interim periods within those fiscal years. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2024, and interim periods within those fiscal years. Early adoption is permitted.

IX. Key ASUs issued prior to 2024

A. ASU No. 2023-02, *Investments – Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method*

1. Reason for issuance

This ASU was issued to allow consistent accounting for equity investments made primarily for the purpose of receiving income tax credits and other income tax benefits. Previously, the proportional amortization method was limited to investments in low-income housing tax credit (LIHTC) structures, while equity investments in other tax credit structures were typically accounted for using the equity method or Topic 321. Stakeholders requested that the proportional amortization method be made available for investments that generate income tax credits through other tax credit programs. The proportional amortization method allows the cost of the investment to be amortized in proportion to income tax credits and other income tax benefits received. The amortization of the investment and the income tax credits are shown net on the income statement within the "income tax expense" line item.

2. Entities affected

The ASU affects all entities that hold at least one of the following:

- Tax equity investments that an entity has elected to account for using the proportional amortization method. The investments are required to meet all conditions related to this election.
- An investment in a LIHTC structure through a limited liability entity that is not accounted for using the proportional amortization method and to which certain LIHTC-specific guidance removed by ASU 2023-02 has been applied.

3. Main provisions

This ASU allows entities to elect to account for their tax equity investments utilizing the proportional amortization method if all required conditions are met. Entities will be able to make this election regardless of the tax credit program from which the income tax credits are received. The required conditions are listed below:

1. It is probable that the income tax credits allocable to the tax equity investor will be available.
2. The tax equity investor does not have significant influence over the operating and financial policies of the underlying project.
3. Substantially all of the projected benefits are from income tax credits and other income tax benefits. Projected benefits include income tax credits, other income tax benefits, and other nonincome tax-related benefits. The projected benefits are determined on a discounted basis using a discount rate consistent with the cash flow assumptions used by the tax equity investor in deciding to invest in the project.
4. The tax equity investor's projected yield is positive based solely on the cash flows from the income tax credits and other income tax benefits.
5. The tax equity investor is a limited liability investor in the limited liability entity for both legal and tax purposes.

A reporting entity makes the above election related to the proportional amortization method on a tax credit program by tax credit program basis. ASU 2023-03 requires entities that make the above election to account for the receipt of investment tax credits using the flow-through method under Topic 740, *Income Taxes*. Further, an entity that elects the proportional amortization method is required to follow the delayed equity contribution guidance. This guidance can be found in paragraph 323-740-25-3. ASU 2023-02 also removes specialized guidance for LIHTC investments. LIHTC investments may elect the proportional amortization method if all conditions are met. However, if an entity does not elect this method, these investments will follow the appropriate GAAP guidance found in Topic 321 and Subtopic 323-10.

When an entity elects to account for investments that generate income tax credits and other income tax benefits with the proportional amortization method, certain disclosures are required by ASU 2023-02. These disclosures should also include information related to investments within the elected tax credit program that do not meet the conditions to apply the proportional amortization method. The entity should disclose the following:

1. The nature of its tax equity investments; and
2. The effect of its tax equity investments, related income tax credits, and other income tax benefits on its financial position and results of operations.

4. Effective date and transition

The effective date for ASU No. 2023-02 is as follows:

- Public business entities – Fiscal years beginning after December 15, 2023, and interim periods within those fiscal years.
- All other entities – Fiscal years beginning after December 15, 2024, and interim periods within those fiscal years.

Early adoption is permitted for all entities in any interim period. ASU No. 2023-02 should be applied on either a modified retrospective or a retrospective basis. Specialized application guidance is provided for entities that have LIHTC investments that are affected by this ASU. This includes the possibility of prospective application. Entities or practitioners involved with LIHTC investments should reference ASU 2023-02 for further guidance.

B. ASU No. 2022-06, *Reference Rate Reform (Topic 848): Deferral of the Sunset Date of Topic 848*

1. Reason for issuance

This ASU was issued in response to the UK Financial Conduct Authority (FCA) extending the intended cessation date of the USD LIBOR interest rates. ASU 2020-04, *Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting* included a sunset provision related to exceptions and optional expedients for contract modifications and hedging relationships. This sunset provision assumed that the LIBOR rates would be discontinued by the end of 2021.

2. Entities affected

The ASU affects all entities that have contracts, hedging relationships, and other transactions that utilize the LIBOR rate or any other reference rate that is expected to be discontinued as a result of reference rate reform.

3. Main provisions

This ASU delays the sunset provision included in ASU 2020-04, *Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting.* ASU 2022-06 defers the sunset date of Topic 848 from December 31, 2022, to December 31, 2024. This deferment is based on the FCA delaying the intended cessation date of USD LIBOR rates to June 30, 2023. Entities should note that after December 31, 2024, the exceptions and optional expedients for contract modifications and hedging relationships will no longer be permitted.

4. Effective date

ASU No. 2022-06 was effective for all entities upon issuance.

C. ASU No. 2022-05, *Financial Services – Insurance (Topic 944): Transition for Sold Contracts*

1. Reason for issuance

The FASB issued this ASU in response to stakeholders noting certain provisions within ASU 2018-12, *Financial Services – Insurance: Targeted Improvements to the Accounting for Long-Duration Contracts (LDTI),* were not cost-effective. Practitioner feedback indicated that applying the LDTI guidance to contracts that were derecognized because of a sale or disposal of individual or a group of contracts or legal entities before the LDTI effective date would put an unnecessary burden on insurance entities. This ASU was implemented to reduce costs and complexity related to these transactions.

2. Entities affected

ASU 2022-05 affects insurance entities that have derecognized contracts before the LDTI effective date. Please see further details in the effective date section below.

3. Main provisions

The implementation of ASU 2018-12 requires insurance companies to apply a retrospective transition method from the beginning of the earliest period presented or the prior fiscal year if early application is chosen. This means that the provisions of ASU 2018-12 would apply to contracts that were derecognized prior to the effective date, which would be costly and would not provide useful information.
ASU 2022-05 allows insurance entities to make an accounting policy election on a transaction-by-transaction basis to exclude certain contracts from the application of ASU 2018-12. The derecognized contract must have been sold or disposed of, and the insurance company must have no continuing involvement with the contract to qualify for the accounting policy election.

4. Effective date

The effective dates of the amendments within ASU 2022-05 are consistent with the effective dates of the amendments in ASU 2020-11. ASU 2020-11 extended the effective dates noted in ASU 2018-12 due to the COVID-19 pandemic. Therefore, ASU 2018-12 and ASU 2022-05 are effective for public entities that meet the definition of an SEC filer and are not smaller reporting companies for fiscal years beginning after December 15, 2022, and interim periods within those fiscal years. For all other entities, the effective date is fiscal years beginning after December 15, 2024, and interim periods within fiscal years beginning after December 15, 2025. Early adoption is permitted.

D. ASU No. 2022-04, *Liabilities – Supplier Finance Programs (Subtopic 405-50): Disclosure of Supplier Finance Program Obligations*

1. Reason for issuance

ASU 2022-04 was issued to improve transparency related to supplier finance programs. Prior to the issuance of this update, GAAP did not include any disclosure requirements related to these arrangements. Financial statement users noted a lack of consistency with how entities were reporting payables that were included in supplier finance programs. This amendment provides users with additional information related to these programs.

2. Entities affected

This ASU affects all entities that utilize supplier finance programs when purchasing goods and services. An example of a supplier finance program is when an entity (buyer) offers suppliers the option to collect payment before the invoice due date from a third-party finance provider. Typically, the buyer has entered into an agreement with the third-party financer to provide this service to suppliers.

3. Main provisions

The ASU requires the buyer, as described above, to disclose qualitative and quantitative information about its supplier finance programs. Disclosures should allow users of the financial statements to understand the program's nature, activity during the period, changes from period to period, and potential magnitude.

This update explicitly requires the following information to be included in the disclosure:

1. Key terms of the program. This should include a description of the terms, which include payment timing and basis for its determination. The disclosure should include the assets pledged as security or other guarantees provided for the payment to the finance provider.
2. For the invoices the buyer has confirmed as valid to the third-party finance provider (intermediary):
    a. The amount outstanding at the end of the annual period.
    b. Description of where the outstanding obligations are presented on the balance sheet.
    c. Roll forward of those obligations during the annual period. This should include the amount of obligations confirmed and subsequently paid.

The buyer should also disclose, in each interim reporting period, the amount of obligations outstanding that have been confirmed as valid by the buyer to the finance provider as of the end of the interim period.

4. Effective date and transition

The amendments within ASU 2022-04 are effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. It is noted that the amendment related to roll-forward information is not effective until fiscal years beginning after December 15, 2023. Early adoption is permitted.

ASU 2022-04 should be applied retrospectively to each period in which a balance sheet is presented, except for the amendment on roll-forward information, which should be applied prospectively.

E. ASU No. 2022-03, *Fair Value Measurement (Topic 820): Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions*

1. Reason for issuance

This ASU was issued to clarify the guidance in Topic 820, *Fair Value Measurement* when measuring the fair value of an equity security subject to contractual restrictions that prohibit the sale of an equity security. The lack of clarity in the guidance has led to a diversity in practice in the accounting for such instruments.

The ASU also updates the related illustrative example of accounting for such restrictions and adds new disclosure requirements for equity securities subject to contractual sale restrictions that are measured at fair value in accordance with Topic 820.

2. Entities affected

The ASU affects all entities that have investments in equity securities measured at fair value that are subject to a contractual sale restriction.

3. Main provisions

Under this ASU, a contractual restriction on the sale of an equity security is not considered part of the unit of account of the equity security and, therefore, is not considered in measuring fair value. Also, an entity cannot, as a separate unit of account, recognize and measure a contractual sale restriction.

The ASU adds the following disclosures related to such securities:

1. The fair value of equity securities subject to contractual sale restrictions reflected in the balance sheet.
2. The nature and remaining duration of the restriction(s).
3. The circumstances that could cause a lapse in the restriction(s).

4. Effective date and transition

The effective date for ASU No. 2022-03 is as follows:

- Public business entities – Fiscal years beginning after December 15, 2023, and interim periods within those fiscal years.
- All other entities – Fiscal years beginning after December 15, 2024, and interim periods within those fiscal years.

Early adoption is permitted. ASU No. 2022-03 should be applied on a prospective basis.

Entities that apply ASC 946 should continue to apply their historical accounting to such investments until the contractual restrictions expire.

F. ASU No. 2022-02, *Financial Instruments – Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures*

1. Reason for issuance

This ASU addresses two issues raised by practitioners related to the application of ASC 326, *Credit Losses*. First, credit losses from loans modified as troubled debt restructurings (TDRs) have been incorporated into the allowance for credit losses under ASC 326. Investors and preparers observed that the additional designation of a loan modification as a TDR and the related accounting are unnecessarily complex and no longer provide decision-useful information.

Second, the ASU addresses feedback related to public business entities' disclosure of gross write-offs and gross recoveries by class of financing receivable and major security type in the vintage disclosures referenced in paragraph 326-20-50-6 and Example 15 in paragraph 326-20-55-79. Stakeholders observed that disclosing gross write-offs by year of origination provides important information that allows them to better understand changes in the credit quality of an entity's loan portfolio and underwriting performance.

2. Entities affected

The update impacting the accounting for TDRs impacts all entities that apply ASC 326. The update addressing vintage disclosures affects public business entities with investments in financing receivables.

3. Main provisions

The ASU eliminates the accounting guidance for TDRs by creditors in Subtopic 310-40, *Receivables – Troubled Debt Restructurings by Creditors*, while enhancing disclosure requirements for certain loan refinancings and restructurings by creditors when a borrower is experiencing financial difficulty. Under the new guidance, creditors would apply the guidance in ASC 310-20-35-9 through 35-11 to determine whether a modification results in a new loan or a continuation of an existing loan.

The ASU, for public business entities, requires that an entity disclose current-period gross write-offs by year of origination for financing receivables and net investments in leases within the scope of Subtopic 326-20, *Financial Instruments – Credit Losses – Measured at Amortized Cost*.

4. Effective date and transition

For entities that have adopted ASC 326, this ASU is effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. For entities that have not yet adopted ASC 326, the effective dates for this ASU are the same as the effective dates for ASC 326.

The ASU should be applied prospectively, except for the TRD updates, for which an entity has the option to apply a modified retrospective transition method of adoption.

Early adoption of the ASU is permitted if an entity has adopted ASC 326, including adoption in an interim period. If an entity elects to early adopt this ASU in an interim period, the guidance should be applied as of the beginning of the fiscal year that includes the interim period.

Also, an entity may elect to early adopt the amendments about TDRs and related disclosure enhancements separately from the amendments related to vintage disclosures.

G. ASU No. 2022-01, *Derivatives and Hedging (Topic 815): Fair Value Hedging – Portfolio Layer Method*

1. Reason for issuance

The FASB issued this ASU in order to address a variety of questions concerning use of the “last-of-layer” method when hedging a closed portfolio of prepayable financial assets or one or more beneficial interests secured by a portfolio of prepayable financial instruments. The ASU addressed the following questions:

1. Whether only a single hedged layer could be designated (one hedging relationship associated with the closed portfolio), or whether an entity could designate multiple hedged layers (that is, multiple hedging relationships associated with a single closed portfolio).
2. Whether the scope of last-of-layer hedging could be expanded.
3. To clarify what types of hedging instruments are permitted when a single hedged layer is designated and when multiple hedged layers are designated.
4. To provide additional guidance on how to account for and disclose hedge basis adjustments of an existing last-of-layer hedge, as there is no explicit guidance on how to recognize and present in the income statement the portion of the basis adjustment associated with a hedged layer if the closed portfolio falls below the amount of the hedged layer.
5. How the accounting for last-of-layer hedge basis adjustments interacts with the guidance on credit losses.

2. Entities affected

The ASU applies to all entities that elect to apply the portfolio layer method of hedge accounting in accordance with Topic 815.

3. Main provisions

The ASU addresses the above questions as follows:

1. The ASU allows nonprepayable financial assets to also be included in a closed portfolio hedged using the portfolio layer method. That expanded scope permits an entity to apply the same portfolio hedging method to both prepayable and nonprepayable financial assets, thereby allowing consistent accounting for similar hedges.
2. The ASU also allows multiple hedged layers to be designated for a single closed portfolio of financial assets or one or more beneficial interests secured by a portfolio of financial instruments. In applying hedge accounting to multiple hedged layers, an entity has the flexibility to achieve hedge accounting using different types of derivatives and layering techniques that best align with their individual circumstances. Furthermore, the ASU specifies that an entity hedging multiple amounts in a closed portfolio with a single amortizing-notional swap is executing a single-layer hedge, not hedges of multiple layers.
3. The ASU clarifies the accounting for and promotes consistency in the reporting of hedge basis adjustments applicable to both a single hedged layer and multiple hedged layers as follows:
    a. An entity is required to maintain basis adjustments in an existing hedge on a closed portfolio basis (that is, not allocated to individual assets).
    b. An entity is required to immediately recognize and present the basis adjustment associated with the amount of the redesignated layer that was breached in interest income. In addition, an entity is required to disclose that amount and the circumstances that led to the breach.
    c. An entity is required to disclose the total amount of the basis adjustments in existing hedges as a reconciling amount if other areas of GAAP require the disaggregated disclosure of the amortized cost basis of assets included in the closed portfolio.
4. An entity is prohibited from considering basis adjustments in an existing hedge when determining credit losses.

4. Effective date and transition

For public business entities, the ASU is effective for fiscal years beginning after December 15, 2022, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2023, and interim periods within those fiscal years. Early adoption is permitted on any date on or after the issuance of this update for any entity that has adopted the amendments in Update 2017-12 for the corresponding period.

If an entity adopts the ASU in an interim period, the effect of adopting the amendments related to basis adjustments should be reflected as of the beginning of the fiscal year of adoption (that is, the initial application date).

Upon adoption, any entity may designate multiple hedged layers of a single closed portfolio solely on a prospective basis. All entities are required to apply the portion of the ASU related to hedge basis adjustments under the portfolio layer method, except for those related to disclosures, on a modified retrospective basis by means of a cumulative-effect adjustment to the opening balance of retained earnings on the initial application date.

Entities have the option to apply the portion of the ASU related to disclosures on a prospective basis from the initial application date or on a retrospective basis to each prior period presented after the date of adoption of the amendments in Update 2017-12.

An entity may reclassify debt securities classified in the held-to-maturity category at the date of adoption to the available-for-sale category only if the entity applies portfolio layer method hedging to one or more closed portfolios that include those debt securities. The decision of which securities to reclassify must be made within 30 days after the date of adoption, and the securities must be included in one or more closed portfolios that are designated in a portfolio layer method hedge within that 30 day period.

X. Other ASUs effective in 2024 or beyond

The following table details ASUs issued by the FASB prior to 2024 that will become effective for public and nonpublic business entities in 2024 or beyond.

ASU	Title	Summary	Effective Date
ASU No. 2023-06	*Disclosure Improvements: Codification Amendments in Response to the SEC's Disclosure Update and Simplification Initiative*	Mainly amends requirements surrounding disclosure and presentation of Codification subtopics in an attempt to align SEC mandated disclosures with FASB disclosures. 14 of the SEC's 27 referred disclosures were accepted by the FASB.	The ASU will only become effective if the SEC removes their related disclosure requirements from the regulation by June 30, 2027.
ASU No. 2023-04	*Liabilities (Topic 405)*	Mainly addresses risks unique to holding customer/client crypto assets, including technological, legal, and regulatory risks. Entities hold these assets on behalf of the users as a part of their platform offering; therefore, the entities are responsible for safeguarding the assets. Such operations present a liability, measured at fair value, to these entities that should be reflected in the financial statements.	Effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years for public business entities. For all other entities, effective for fiscal years beginning after December 15, 2024, including interim periods within those fiscal years.
ASU No. 2023-03	*Presentation of Financial Statements (Topic 205), Income Statement – Reporting Comprehensive Income (Topic 220), Distinguishing Liabilities from Equity (Topic 480), Equity (Topic 505), and Compensation – Stock Compensation (Topic 718)*	Amends certain SEC paragraphs from the Codification regarding expenses paid for by a major shareholder.	Effective now (upon issuance).

ASU No. 2020-04 and 2021-01	*Reference Rate Reform (Topic 848) – Facilitation of the Effects of Reference Rate Reform on Financial Reporting and Reference Rate Reform (Topic 848): Scope*	ASUs provide elective guidance on accounting for the impact of reference rate reform on the following: • Convertible rate debt and receivables; • Leases; • Hedging transactions; and • HTM debt securities.	Elective guidance is available through December 31, 2024.
ASU No. 2018-12	*Financial Services – Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts*	Changes the accounting model for long-duration insurance contracts.	Years beginning on or after December 15, 2024.

Details on these previously issued ASUs can be found at the FASB website, www.FASB.org.

Discussion question:

Which of the FASB's new ASUs will have the most significant impact on either your clients or company?

XI. FASB's technical agenda

The FASB's technical agenda provides information related to current FASB projects. Projects typically go through a six-step process. These steps include:

1. Topic is added to the agenda;
2. Initial deliberations;
3. Exposure draft;
4. Exposure draft comment period;
5. Exposure draft redeliberation; and
6. Final standard/concept.

The current technical agenda includes the following:

- Framework projects (3);
- Recognition and measurement: narrow projects (11); and
- Presentation and disclosure projects (5).

A. Framework projects

Framework projects do not change the FASB's Accounting Standards Codification (ASC) per se, but rather update the theoretical underpinnings of the accounting standards found in the FASB Concepts Statements. These updated concepts are then applied to accounting topics, the changes to which would update the ASC.

Per the FASB website, The FASB Concepts Statements are intended to serve the public interest by setting the objectives, qualitative characteristics, and other concepts that guide selection of economic phenomena to be recognized and measured for financial reporting and their display in financial statements or related means of communicating information to those who are interested. Concepts Statements guide the Board in developing sound accounting principles and provide the Board and its constituents with an understanding of the appropriate content and inherent limitations of financial reporting. A Statement of Financial Accounting Concepts does not establish generally accepted accounting standards.

There are currently five Concepts Statements.

The objective of this conceptual framework project is to develop an improved conceptual framework that provides a sound foundation for developing future accounting standards. Such a framework is essential to fulfilling the Board's goal of developing standards that are principles-based, internally consistent, and that lead to financial reporting that provides the information capital providers need to make decisions in their capacity as capital providers. The new FASB framework will build on the existing framework.

With the issuance of the updated frameworks related to elements of financial statements and presentation in December 2021, the FASB currently has only one framework project on its agenda: measurement. Its project, dealing with its measurement conceptual framework, is focused on agreeing on the meanings of key terms and what the objectives and qualitative characteristics imply for measurement, identifying appropriate types of measurements, and determining which measurements to use in specific circumstances. This project is currently in initial deliberations, with no exposure documents issued.

The FASB completed its elements framework project in 2021 by updating its Conceptual Statement related to financial statement elements. The updated guidance provides an improved conceptual framework that provides a sound foundation for developing future accounting standards.

The FASB also completed its framework project on presentation in 2021. The new guidance provides the FASB with a framework for developing standards that summarize and communicate information on financial statements in a way that best meets the objective of financial reporting. Ultimately, it will become a basis for the Board when creating presentation requirements in future standards.

Following the issuance of the updated Concepts Statement related to disclosures, the FASB issued final ASUs that updated the disclosures related to the following:

- Fair value measurement; and
- Defined benefit plans.

B. Recognition and measurement projects: narrow projects

There are 10 active recognition and measurement projects the FASB considers to be narrow projects. New projects added to the technical agenda include:

- Accounting for investments in tax credit structures using the proportional amortization method;
- Accounting and disclosure of software costs – Exploring ways to narrow the differences between the current internal use and external use models;
- Accounting for environmental credit programs – Exploring how to improve the accounting for participants in programs that result in the creation of environmental credits;
- Business combination project; and
- Implementation issues related to ASC 606 and ASC 842.

Details on the status of all projects can be found on the FASB website.

C. Other presentation and disclosure projects

The FASB is continuing its work on five presentation and disclosure projects. Significant new presentation and disclosure projects include the following:

- Disaggregation of income statement expenses;
- Statement of cash flows targeted improvements; and
- Disaggregation of performance information – Further disaggregation of certain income statement items.

For a complete overview and all of the details of the FASB's current technical agenda, please refer to the FASB's website at www.fasb.org.

XII. Update on the FASB's Post-Implementation Review of ASC 606

A. The PIR process

Following the issuance of significant new accounting guidance, the FASB will implement a PIR to review the implementation of the new standard. These reviews have been previously performed following the issuance of new guidance related to derivative and share-based payment accounting. Both of these reviews have led to recent significant updates to both ASC 805 and 718, respectively.

The FASB has begun PIRs for the following recently issued standards that significantly altered the existing accounting and disclosure guidance in their respective areas:

- ASC 606 – *Revenue from Contracts with Customers*;
- ASC 842 – *Leases*; and
- ASC 326 – *Credit Losses*.

The FASB's PIR process is an evaluation of whether a standard is achieving its objective by providing financial statement users with relevant information in ways that justify the cost of providing it. The FASB does not perform PIRs following the implementation of all standards, only significant ones such as ASC 606. During the PIR process, the FASB solicits and considers diverse stakeholder input and other research to evaluate the standards that are issued and whether there are areas of improvement that the FASB should address. Feedback obtained in the ASC 606 PIR was obtained from the following:

- Financial statement preparers – The focus of the discussions with this stakeholder group generally addresses the clarity of the standard, its ease of understanding and application, and the level of effort in its adoption and ongoing application.
- Financial statement users – The focus of the discussions with this stakeholder group generally addresses the usefulness of the information obtained from application of the new standard.
- Auditors – The focus of the discussions with auditors concentrates on the level of audit effort necessary to provide assurance on the application of the new guidance, including the impact on hours spent, fees, and auditors' perception of how well their clients understood and applied the new standard.

The PIR process consists of the following three stages:

- Stage 1 – Post-issuance date implementation monitoring;
- Stage 2 – Post-effective date evaluation of the costs and benefits; and
- Stage 3 – Summary of research and findings.

In Stage 1, the post-issuance date implementation monitoring stage, the FASB performs the following tasks:

- Actively monitor practice as stakeholders prepare for initial implementation;
- Develop and disseminate implementation guidance and educational material; and
- Communicate and perform outreach with stakeholder organizations.

Following the issuance of ASU No. 2014-09, the FASB created a Transition Resource Group, or TRG, to provide guidance on implementation questions stakeholders had regarding the new standard. The TRG, comprising a varied group of stakeholders, including FASB representatives, wrote approximately 60 position papers detailing how to apply the guidance in ASC 606 in response to the various questions the TRG received. Further, the FASB determined that certain questions it received from stakeholders required additional standard setting to adequately address. As a result of this process, the FASB issued various additions to the original guidance on revenue recognition found in ASU No. 2014-09. These updates, unlike the TRG position papers, became part of the ASC codification and thereby authoritative guidance.

Additionally, other entities, such as the AICPA and various accounting firms, published nonauthoritative guidance on the application of ASC 606. While not officially "GAAP," these guides were extremely helpful in disseminating a consistent understanding of the key provisions of ASC 606 and how it is to be applied. Stage 2, a post-effective date evaluation of costs and benefits of the new standard, is complete with regard to public entities and is still ongoing with regard to nonpublic business entities. Stage 2 consists of the following activities:

- Understanding the costs that an entity incurred in applying the standard, as well as the costs that investors and other users incurred in analyzing and interpreting the information that the standard provides;
- Understanding the benefits of the standard to investors and other users as well as to entities; and
- Monitoring the ongoing application of the standard.

During Stage 2, a varied group of stakeholders provided responses on the cost/benefit question through a series of round-table discussions. The process will be repeated for similar stakeholders concerning nonpublic company implementation.

Stage 3 of the PIR process consists of publishing a summary of the research and developing suggestions for additional standard setting. There is no scheduled completion date for Stage 3 currently.

Stage 1 and 2 activities consisted of the following:

- Six meetings of the TRG;
- Variety of standard-setting activity;
- Responses to over 250 technical inquiries;
- Dissemination of technical materials;
- Various webcasts and other communication events; and
- Other activities outside a focus on 606:
  - Issuance of ASU No. 2021-03 and ASU No. 2021-09.

As mentioned, due to the later effective date of ASC 606 for nonpublic entities and subsequent deferral, the FASB's Stage 2 activities focused on gathering feedback from public company stakeholders. Activities in Stage 2 included:

- 42 company preparer surveys;
- Outreach to auditors and regulators;
- A focus on the impact of ASC 606 adoption on accounting systems;
- Gathering of feedback for advisory meetings;
- Performed analysis of XBRL;
- Stakeholder feedback;
- Investor-focused discussions;
- Feedback on cost-benefit analysis; and
- Academic research.

Stage 3 reporting will follow the completion of Stage 2 activities related to nonpublic companies.

B. Feedback from the PIR process

So, what were the results of the inquiries?

Overall feedback from stakeholders on ASC 606 adoption is favorable. The standard is generally achieving its objectives, namely creating a consistent revenue recognition approach applicable across industries and increasing the volume and consistency of disclosures related to revenue. Most PIR participants noted little to no material impact on reported financial results following the adoption of ASC 606. Additionally, they stated that the increased ASC 606 disclosures provide more useful and transparent information than those under ASC 605. As a result, the application of ASC 606 generally improved comparability of revenue across industries, with certain exceptions.

Stakeholders commented that, due to the differing revenue recognition models used by software providers for licensed software and usage-based software, revenue comparisons in that sector are actually hindered by the application of ASC 606's license guidance, especially when it is applied to functional intellectual property.

Similarly, application of the ASC 606 guidance on price concessions also yielded conflicting results, with some healthcare providers recording bad debt expense and an allowance for doubtful accounts related to self-pay balances, and some not. This made inter-sector comparisons challenging.

On the cost side, both financial statement preparers as well as their auditors noted increased compliance costs. However, most of the incremental costs were generally related to the year of adoption, with scope and related costs reducing in the following years.

The PIR participants did suggest improvements to the ASC 606 revenue recognition model in the following areas:

- Requiring or allowing software companies to combine term licenses with PCS into one performance obligation.
  - This suggestion acknowledged the challenges in determining whether a license is distinct as well as the level of effort required to unbundle PCS services for software, especially when such services are generally marketed as a bundled resource.
- Allowing more flexibility in determining standalone selling price (SSP).
  - While ASC 606 offers three methods to determine SSP, it may be challenging to obtain objective-based evidence for SSP. Respondents requested more options in developing SSP.
- Providing an exception for estimating variable consideration for sale of IP licenses.
  - It can be complex to estimate such consideration.
- Changes to the ASC 606 disclosure requirements.

C. Next steps

The FASB is already contemplating additional research to support standard setting in the following areas related to ASC 606:

- Principal vs. agent and related consideration payable to a customer.
  - While the model in ASC 606 generally yields a similar result as the one followed in ASC 605, it can be challenging to determine the proper accounting for such arrangements. Specifically, it is often difficult to identify the customer, determine which party controls the good or service, or determine which payments should be accounted for as a reduction to revenue. The FASB may explore options to simplify this accounting model.
- Licensing.
  - As mentioned above, for software offering similar functionality, entities will obtain a significantly different revenue recognition result based on whether they follow a license model, resulting in up-front revenue recognition, or a usage model, where revenue recognition is generally recognized over time. With the recent rise in cloud-based technology solutions, the impact of these two different approaches makes intra-industry comparisons challenging for investors. Further, determining whether a license is distinct, and thereby a performance obligation or not, can be challenging and is often based on a technical assessment that can be difficult for an accountant to comprehend. The FASB may consider potential simplifications to the model to increase comparability and ease of application.
- Variable consideration.
  - Application of the variable consideration guidance in ASC 606 is judgmental and can be difficult to apply, especially in the case of sales or usage-based royalties. The FASB may research attempts to simplify this model.
- Disclosures.
  - While no specific problems with the disclosure requirements were noted in the review, the FASB is considering research into ways to improve the information presented concerning revenue.

- Short-cycle contract manufacturing.
  - Some short-cycle or contract manufacturers were required to change their revenue recognition models to an over-time approach, as opposed to the point-in-time approach employed under ASC 605. The application of the guidance could result in the application of different revenue recognition approaches for similar contracts.
- Standalone selling price.
  - Determining SSP can be challenging, especially when the product is not sold separately. Also, the guidance on allocating discounts and using the residual method can be difficult to apply. The FASB may research methods that would ease the estimation of SSP when objective evidence does not exist.
- Identifying performance obligations.
  - In some instances, determining whether a promise is a performance obligation is highly subjective, while that determination can have a significant impact on revenue recognition. The FASB may research ways to make the performance obligation assessment less subjective.
- Incremental cost of obtaining a project.
  - Determining costs to capitalize and their amortization period can be challenging, especially when the costs relate to contract renewals. The FASB may explore ways to simplify this model.

In summary, the PIR process has generally concluded that the objectives of ASC 606 are being met at an acceptable cost. It is unlikely that the inclusion of nonpublic entity stakeholders in the PIR model will change this conclusion. So, the core of the ASC 606 model is here to stay.

XIII. Update on the FASB's Private Company Council

Since its creation, the PCC has become the sounding board for feedback from private companies concerning the costs and benefits of both proposed and enacted accounting standards. Additionally, the PCC has both influenced new standard setting with regard to the concerns of private companies as well as advanced several simplification initiatives that have lightened the existing financial reporting burden on private companies. The influence of these simplification initiatives can be seen as the FASB has adopted similar simplifications in the areas of goodwill impairment testing and hedging. Additionally, the influence of the PCC can be seen in the FASB's decision in 2018, through ASU No. 2018-17, *Consolidation (Topic 810): Targeted Improvements to Related Party Guidance for Variable Interest Entities*, to exempt nonpublic business entities from having to apply the variable interest entity (VIE) rules when determining whether to consolidate an entity, in certain situations. This influence can also be seen in the current direction of the FASB's proposed updated guidance on goodwill accounting, which mirrors the amortization election currently available for private companies.

A. Responsibilities

The PCC has two primary responsibilities:

1. To determine whether exceptions or modifications to existing nongovernmental U.S. GAAP are required to address the needs of users of private company financial statements; and
2. To serve as the primary advisory body to the FASB on the appropriate treatment for private companies for items under active consideration on the FASB's technical agenda.

The PCC has completed this first responsibility and is now generally serving in a consulting and advisory role to the FASB as the FASB progresses on its technical agenda.

B. Makeup of the PCC

The PCC consists of between 9 to 12 members, including a Chairman, all of whom will be selected and appointed by the FAF Board of Trustees. The PCC Chairman is affiliated with the FASB and will have had substantial experience with and exposure to private companies during the course of his or her career. The Chairman works cooperatively with the FASB liaison member, the FASB Chairman, and the FASB Technical Director to accomplish the functions of the PCC and to help facilitate the work of the FASB with respect to private company standard setting activities.

PCC members include users, preparers, and practitioners who have significant experience using, preparing, and auditing (and/or compiling and reviewing) private company financial statements. Members are appointed for a three-year term and may be reappointed for an additional term of two years. Membership tenure may be staggered for some members to establish an orderly rotation.
The PCC is still chaired by Jere G. Shawver, the managing partner for assurance and risk with Baker Tilly, a top-10 U.S. public accounting firm. The current members of the PCC can be found on the FASB's website.

As mentioned, the PCC still consults with the FASB on the impact of proposed changes to the accounting codification on smaller and nonpublic entities.

The PCC is currently consulting with the FASB on a number of projects, including the following:

- Business combination project;
- Accounting for and Disclosure of Software Costs project;
- Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method project;
- Accounting for Environmental Credit Programs project;
- Stock-Based Compensation project;
- Profits Interests and Their Interrelationship with Partnership Accounting project;
- FASB's Agenda consultation; and
- Implementation issues related to ASC 606 and 842.

Discussion question:

How successful do you feel the PCC has been in attempting to simplify GAAP for nonpublic business entities?

ASC 842, *Leases*

ASC 842, *Leases*

Learning objectives

After completing this chapter, you should be familiar with:

- Recently issued ASUs impacting ASC 842;
- Key differences between ASC 842 and the legacy lease standard (ASC 840); and
- Disclosures under ASC 842.

I. Effective for everyone…

Many years after its original issuance in 2016 and after two deferrals and a proposed third, ASC 842, *Leases* is effective for all entities.

The guidance of lease accounting for both lessees and lessors was effective as follows:

- Public business entities:
  - Effective since years beginning after December 15, 2018.
- Nonpublic business entities:
  - Effective since years beginning after December 15, 2021.

At this point in time, calendar year-end reporting entities should be recording new leases under the guidance of ASC 842. Further, they should have transitioned leases that existed at December 31, 2021 to ASC 842.

Implementation of ASC 842 has been difficult for many private companies. Therefore, this course is an in-depth review of ASC 842. Topics discussed include the accounting related to leases, the implementation guidelines, new ASUs related to ASC 842, and disclosure requirements.

To begin, both lessees and lessors should have applied a modified retrospective transition approach for finance/sales-type/direct finance and operating leases existing at or entered into after the beginning of the earliest comparative period presented in the financial statements. This approach does not require any transition accounting for leases that expired before this date. For calendar year-end reporting companies, this date would be December 31, 2020. Full retrospective treatment was not allowed.

However, in ASU No. 2018-11, the FASB issued an amendment to this transition guidance where an entity would have applied the guidance of Topic 842 at its effective date and not at the beginning of the earliest comparative period. For calendar year-end reporting companies, this date was December 31, 2021. Under this election, an entity does not need to apply the guidance of Topic 842 to leases that expired before the effective date of Topic 842.

Also, this amendment on applying the modified retrospective approach would be applicable for lessors as well. However, due to the mechanics of adoption for lessors, its impact would not be as significant as for lessees.

A. ASU No. 2021-05

While most of our discussion in this section will deal with lessee accounting, there was a significant update to the lessor accounting guidance issued by the FASB in 2021, which is discussed below.

As part of the FASB's Post-Implementation Review of ASC Topic 842, this ASU addressed an issue related to a lessor's accounting for certain leases with variable lease payments. When applying the guidance of ASC 842, lessors are often taking day-one losses on certain sales-type and direct financing leases with variable payments not tied to a rate or index. They subsequently record lease income when such payments are received over the term of the lease. As such, they believed that the application of ASC 842's guidance in this area does not reflect the economic reality of the lease arrangement.

Further, these stakeholders highlighted that lessors did not recognize a day-one loss under Topic 840, *Leases* because of the longstanding practice to account for certain leases with variable payments as operating leases based on an interpretation of a classification criterion in Topic 840. That classification criterion was not retained in Topic 842. Additionally, the resulting day-one loss issue was not identified or discussed by the Board in deliberations leading to the issuance of Update 2016-02.

ASU 2021-05 affected lessors with lease contracts that (1) have variable lease payments that do not depend on a reference index or a rate and (2) would have resulted in the recognition of a selling loss at lease commencement if classified as sales-type or direct financing.

The amendments in this update addressed stakeholders' concerns by amending the lease classification requirements for lessors to align them with practice under Topic 840. Lessors should classify and account for a lease with variable lease payments that do not depend on a reference index or a rate as an operating lease if both of the following criteria are met:

a. The lease would have been classified as a sales-type lease or a direct financing lease in accordance with the classification criteria in paragraphs 842-10-25-2 through 25-3; and
b. The lessor would have otherwise recognized a day-one loss.

This ASU was effective for fiscal years beginning after December 15, 2021 for all entities, including interim periods within those fiscal years for public business entities, and interim periods within fiscal years beginning after December 15, 2022 for all other entities.

Entities that adopted Topic 842 before the issuance date of this update have the option to apply the amendments in this update either (1) retrospectively to leases that commenced or were modified on or after the adoption of Update 2016-02 or (2) prospectively to leases that commence or are modified on or after the date that an entity first applies the amendments.

II. Similarities and differences between ASC 840 and 842

Although ASC 842 has been effective for all entities for at least one fiscal year, it is helpful to fully understand the similarities and differences between ASC 840 and ASC 842. Entities and practitioners have struggled with the implementation of ASC 842. Understanding the significant similarities and differences is crucial as we move forward with the updated lease accounting standards. The following chart summarizes these:

Differences	Similarities
Balance sheet recording of operating leases by lessees	Income statement treatment for lessees and lessors is unchanged.
Capital leases are now known as finance leases	Accounting for finance leases mirrors accounting for capital leases under ASC 840.
Principles-based lease classification guidance	Criteria for adding options to renew to lease term is similar: • ASC 840 – Reasonably assured criteria. • ASC 842 – Reasonably certain criteria.
No deferred or prepaid lease expense for operating leases	Lease modification and remeasurement accounting.
More stringent capitalization requirements for initial direct costs	
Significantly enhanced footnote disclosures	
Enhanced need for centralized recordkeeping	

A. Balance sheet recording of operating leases under ASC 842

Under ASC 840, operating lease payments were treated as financial commitments, not as a liability of the entity. Under ASC 842, payments related to the noncancelable term of the lease, plus those related to options to extend, for which it is reasonably certain that the option will be exercised, are recorded as a liability of the entity. While the criteria for considering options is similar between ASC 840 and 842, the underlying accounting for operating leases is significantly different between ASC 840 and 842.

Under ASC 840, no liability related to lessee operating lease obligations was recorded in the lessee's financial statements, and the obligation was merely disclosed, but under ASC 842, a liability and a corresponding right-of-use (ROU) intangible asset are recorded.

Under ASC 842, for both finance and operating leases, the lessee is required to recognize a lease liability equal to the present value of the lease payments. Lease payments consist of the following:

- Fixed payments, including in-substance fixed payments, less any lease incentives paid or payable to the lessee.
- Variable lease payments that depend on an index or a rate (i.e., Consumer Price Index), measured at the rate at lease commencement date. Fixed increases in variable lease payments are also included. However, true variable lease payments, such as a percent of sales, are not included. Variable payments not tied to such an index are also excluded and recognized in the period incurred.
- The exercise price of an option to purchase the underlying asset if the lessee is reasonably certain to exercise the option.
- Payments for penalties for terminating the lease if the lease term reflects the lessee exercising this option.
- Fees paid by the lessee to the owners of a special purpose entity for structuring the transactions.
- For lessees only, amounts probable of being owed by the lessee under residual value guarantees. This is typically the difference between the guaranteed residual value and the market value of the leased asset at the end of the lease term.

Initial measurement of the right-to-use asset includes the following:

- The initial measurement of the lease liability determined above;
- Any lease payment made at or before the lease commencement date, less any incentives received; and
- Any initial direct costs incurred by the lessee.

The discount rate used to discount the future cash flows is determined as follows:

- First, use rate implicit in the lease. The implicit rate is the rate where present value of lease payments and residual value equal fair value of leased asset at lease commencement.
- If the rate is not known by lessee, lessees can use the following:
  - Incremental borrowing rate; or
  - Nonpublic company option to use its risk-free interest rate.

With the issuance of ASU No. 2021-09, the election to use the risk-free rate or incremental borrowing rate can be made by class of asset.

Note that initial recognition is identical for finance and operating leases under ASC 842. Further, the accounting for finance leases by lessees under ASC 842 is essentially unchanged from that under ASC 840. However, leases known as capital leases under ASC 840 are now known as finance leases under ASC 842.

B. Lease classification under ASC 842

When it comes to classifying leases as either finance or operating, the factors of ASC 842 are similar to ASC 840, with one addition. These factors are:

- Payments represent substantially all of the asset fair value.
- The lease term is for a major portion of the asset's economic life.
- There is a bargain purchase option that the lessee is reasonably certain to exercise.
- Title transfers automatically at the end of the lease.

The one new lease classification criteria under ASC 842 is that when the underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term, the lease should be classified as a finance lease.

While no specific guidance is provided in ASC 842, thresholds for the fair value and economic life tests utilized by lessees are similar to the 90 percent and 75 percent tests pre-ASC 842, respectively. However, the bright lines of ASC 842 have been removed.

A key consideration in assessing the lease classification of a lease and its subsequent accounting under ASC 842 is determining the term of the lease. ASC 842 defines the term of a lease as the noncancelable period for which a lessee has the right to use an underlying asset, together with both of the following:

1. Periods covered by an option to extend the lease if the lessee has a significant economic incentive at the commencement date to exercise that option; and
2. Periods covered by an option to terminate the lease if the lessee has a significant economic incentive at the commencement date not to exercise that option.

The lease term begins at the commencement date and includes any rent-free periods provided to the lessee by the lessor. As a note of distinction, the lease inception date is the earlier of the date of the lease or the date of commitment by the parties for principle provisions of the lease.

When determining the lease term an entity should consider all relevant factors that create a significant economic incentive to exercise an option to extend, or not to terminate, a lease. An entity should include such an option in the lease term only if it is “reasonably certain” that the lessee will exercise the option having considered the relevant economic factors. Reasonably certain in this case is a high threshold. The lease term also includes periods covered by renewal or early termination options if their exercise is controlled by the lessor.

Classification guidance for lessors, determining whether the lease is either a sales-type, direct financing or operating lease, is virtually unchanged under ASC 842, though a requirement to consider the collectability of the lease payments has been added and is similar to that in ASC 606.

Lessees or lessors have not seen major changes in how they classify leases under ASC 842, as compared to ASC 840.

C. Other changes in the lessee accounting model under ASC 842

With the recording of the lease liability for virtually all leases under ASC 842, the recognition of prepaid or deferred rent is eliminated under ASC 842. These amounts were recorded when, in the case of prepaid rent, the cash payment of the lessee to the lessor exceeded the amount of the expense recognized by the lessee and, in the case of deferred rent, the expense recognized by the lessee exceeded the amount of the lease payment made by the lessee to the lessor.

Further, ASC 842 has introduced a more stringent capitalization policy for initial direct costs. Under this approach, only incremental costs qualify as initial direct costs subject to capitalization in both lessor and lessee accounting. These costs are those that the entity would not have incurred if the lease had not been entered into. These include commissions or payments to existing tenants to obtain the lease and are the same for both the lessor and lessee.

The lessee should include initial direct costs in its initial measurement of the right-to-use asset and amortize them over the term of the lease.

Lessor accounting for such costs varies based on the type of lease. For sales-type leases, the lessor expenses such costs at lease inception if the lessor recognizes selling profit at the inception of the lease. Alternatively, the lessor should include these costs in determining the lease receivable by considering them in its measurement of the net investment in the lease.

Initial direct costs are deferred and included in the net investment in the lease at its commencement date for direct financing leases.

For operating leases, such costs should be expensed over the term of the lease.

While there was the need for effective information flows under ASC 840, especially related to accumulating disclosure information, the need for centralized record keeping is significantly enhanced under ASC 842. Calculations supporting initial classification and recording, subsequent accounting, and the development of disclosure information required by ASC 842 generally require a more centralized approach to gathering and maintaining such information. Entities should consider the value of using lease accounting software to accumulate and manage this information.

D. Income statement treatment of leases

The income statement treatment for both lessees and lessors of leases is essentially unchanged under ASC 842, as compared to ASC 840.

For a finance lease, the lessee separately recognizes in the income statement (unless the costs are included in the carrying amount of another asset in accordance with other ASC Topics) the unwinding of the discount on the lease liability as interest and the amortization of the right-of-use asset.

The lessee determines the unwinding of the discount on the lease liability in each period during the lease term as the amount that produces a constant periodic discount rate on the remaining balance of the liability.

The lease liability is reduced by the amount of the annual lease payment less the amount of that payment attributable to interest expense, determined using the effective interest method detailed above.

The lessee amortizes the right-of-use asset on a straight-line basis (unless another systematic basis is more representative of the pattern in which the lessee expects to consume the right-of-use asset’s future economic benefits) from the commencement date to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term.

However, if the lessee has a significant economic incentive to exercise a purchase option, the lessee should amortize the right-of-use asset to the end of the useful life of the underlying asset.

For an operating lease, a lessee recognizes in profit or loss (unless the costs are included in the carrying amount of another asset in accordance with other ASC Topics) a single lease cost, combining the unwinding of the discount on the lease liability with the amortization of the right-of-use asset, calculated so that the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis.

However, the periodic lease cost should not be less than the periodic unwinding of the discount on the lease liability.

The lease liability is reduced by the amount of the annual lease payment less the amount of that payment attributable to interest expense, determined using the effective interest method (again, detailed above), while accumulated depreciation of the right-of-use asset is the difference.

As you can see from the above discussion, the initial recognition of and subsequent accounting for a finance lease is unchanged from that for a capital lease under ASC 840.

E. Consideration of lease modifications and remeasurement events

While there is some difference in the approach to the accounting for lease modifications and other remeasurement events between ASC 840 and 842, their treatment as activities to be accounted for on a subsequent basis is similar between the two standards. ASC 842 simplified the guidance in this area.

1. Lease remeasurements

Under ASC 842, after the lease commencement date, a lessee should remeasure the lease liability to reflect changes to the lease payments for any of the following:

a. The lease is modified and not accounted for as a new contract. Note that all assumptions should be updated when a lease is modified.

b. The contingency upon which some or all of the variable lease payments were excluded from the calculation of the lease liability has been resolved such as to meet the definition of a fixed payment.

c. A change in any of the following:

    i. The lease term (determine revised lease payments based on the revised lease term).

    ii. Relevant factors that result in the lessee having or no longer having a significant economic incentive to exercise an option to purchase the underlying asset (determine revised lease payments to reflect change in amounts payable under purchase option).

    iii. The amounts probable of being paid under residual value guarantees (determine revised lease payments to reflect change in amounts expected to be payable under residual value guarantees).

When a lessee remeasures the lease payments in accordance with the above, the variable payments based on an index or a rate used to determine lease payments should be measured using the rate or index at the remeasurement date (determine revised lease payments using index or rate at the end of the reporting period).

When one of the above events occurs, the lessee should remeasure the lease liability to reflect the changes to the lease payments due to these events. The amount of the remeasurement of the lease liability should be recorded as an adjustment to the right-of-use asset. However, if the carrying amount of the right-of-use asset is reduced to zero, any remaining amounts would be recorded in the income statement.

Also, when remeasuring, the lessee should update the discount rate for the lease at the date of the remeasurement, unless the discount rate already reflects the lessee's option to extend or terminate the lease or to purchase the underlying asset. The updated rate is the rate the lessor would charge the lessee at that date (or the lessee's incremental borrowing rate at that date if the rate the lessor would charge the lessee at that date is not readily determinable, or the risk-free rate at that date for a nonpublic entity that elected to use the risk-free rate) on the basis of the remaining lease term.

Also, if the remeasurement is due to a change in the amounts probable of being owed under a residual value guarantee or a change from the resolution of a contingency over variable lease payments, the lessee does not update the discount rate.

2. Lease modifications and contract combinations

ASC 842 defines a lease modification as any change to the contractual terms and conditions of a lease that was not part of the original terms and conditions of the lease. The substance of the modification should govern over its form.

Both lessees and lessors should account for lease modifications as a new lease, separate from the lease being modified, only when:

1. The modification grants the lessee an additional right of use that was not in the original lease; and
2. The additional right of use is priced commensurate with its standalone price.

When the modification is not accounted for as a new contract, as per the above, the lessee needs to reassess the lease classification as well as remeasure the lease liability after remeasuring and reallocating the consideration in the contract, if applicable, using the relevant assumptions at the date of the modification.

If the modification grants the lessee an additional right of use not in the original contract (i.e., use of an additional floor of a building), extends or reduces the term of an existing lease other than through exercise of an option (which is not a modification), or changes the consideration in the contract only, the lessee should adjust the value of the right-of-use asset for the amount of the change in the remeasured lease liability. When the modification partially or fully terminates a lease, the lessee should decrease the right-of-use asset proportionally to the impact that the termination of the existing lease has on the lease liability. Any difference between the reduction of the lease liability and the proportional reduction in the right-of-use asset would be recognized as a gain or loss.

F. Other considerations related to ASC 842

1. Preeffective date considerations

As a reminder, ASC 842 was effective for all calendar year-end private companies as of January 1, 2022. The following is a review of considerations entities should have made prior to implementation. Private companies have struggled with the implementation of ASC 842; therefore, the material below is pertinent to practitioners currently working with 2022 financials. Applying ASC 842 has many considerations, both before and after its effective date. While we will discuss transition accounting in greater detail later in this session, one of the most important considerations in transition accounting is consideration of the two transition practical expedients that ASC 842 offers. These are as follows:

- Package of three:
  - Reassessing classification;
  - Reassessing for embedded leases; and
  - Reassessing accounting for initial direct costs.
- Hindsight.

While each transition practical expedient can be selected individually, an entity must select all three elements of the “package of three” practical expedients when selecting the option.

The hindsight practical expedient allows an entity to ignore certain “hindsight” events such as modifications and impairment when transitioning to ASC 842. As the concept was challenging to apply, few public entities elected to apply it, and it is expected that few private entities will as well. We’ll discuss these in greater detail when we discuss transition to ASC 842 later in this session.

Under ASC 842, both in transitioning existing leases and in accounting for new leases, entities can elect to not apply ASC 842 to leases with terms, as defined in the standard, of 12 months or less. Applying this guidance may result in a significant number of leases not being recorded under ASC 842. However, when applying the guidance, recall these two points:

1. The measurement of the 12 months starts at lease commencement, the date when the entity gains control of the leased asset, not 12 months from the effective date of ASC 842.
2. The definition of term includes both the noncancelable term of the lease as well as options to extend that meet the "reasonably certain" criteria.

2. Post-transition date accounting considerations

Key post-effective date accounting considerations include the following:

- Lease classification;
- Accounting for initial direct costs;
- Accounting for nonlease components; and
- Definition of a lease and embedded leases.

Generally, lease components and nonlease components, such as services like common area maintenance, would be separated and accounted for under applicable guidance. However, lessees may elect to not separate lease and nonlease components, accounting for the entire cash flow as a lease payment.

Lessors may similarly elect to not separate lease from nonlease components if certain criteria are met. If electing to not separate the components, the lessor would follow the guidance related to whichever component is predominant.

Lease classification and initial direct cost considerations were previously discussed above, and we will discuss the definition of lease and the concept of embedded leases shortly.

III. Accounting surprises under ASC 842

Applying ASC 842 can result in several potential surprises, the impact of which could be significant. So, these issues should be assessed as quickly as possible.

A. Embedded leases

In order for a contract to be accounted for as a lease, the contract must be one that:

- Conveys the right to use a specific asset (the underlying asset); and
- The right must be for a period of time and provided in exchange for consideration.

So, in order for a contract to be accounted for under ASC 842, there must be a specific asset identified, with no right to substitution by the lessor, except for defects or repairs. Further, there must be a term associated with the contract and substantive consideration. So, a "lease" for the use of an asset in perpetuity or with no or nominal consideration would not be accounted for under ASC 842.

In addition to specific contracts for such arrangements, they may also be embedded in other contracts, such as third-party service revenue contracts. If so, the lease component of such contracts should be carved out of the broader contract and accounted for as a lease. Entities should have effective internal controls which would enable them to identify such provisions in contracts and account for them accordingly.

While the number of contracts with embedded leases may be low, the valuation of the lease component may be complex.

B. The scope of ASC 842

The scope of ASC 842 is expansive, covering all leases for assets, with only the following exceptions:

- Leases of intangible assets, inventory, and assets under construction;
- Leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources; and
- Leases of biological assets, including timber.

As such, application of ASC 842 could and often does have a significant impact on an entity's balance sheet, especially related to large leases that are classified as operating leases. For example, one or multiple operating leases for real estate assets could have a significant accounting impact.

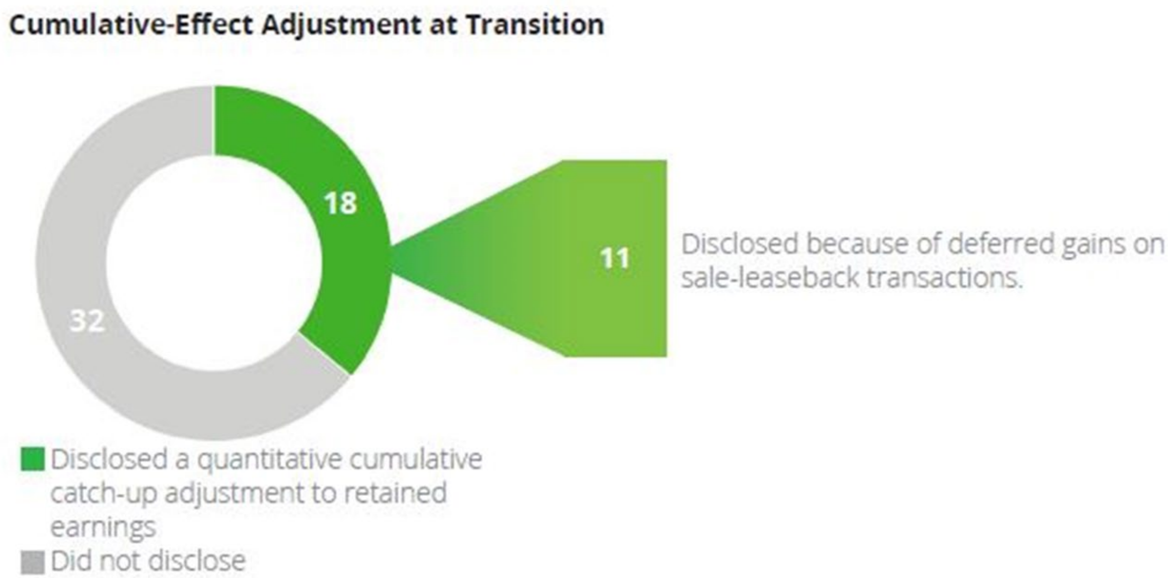
For example, a 10 year lease, $10,000 monthly payment lease would result in the recognition of a $1MM ROU asset and lease liability under ASC 842, when the same lease was off-balance sheet under ASC 840. Further, an entity may need some real estate expertise in order to apply ASC 842 to all aspects of these often-complex arrangements.

C. Equity is rarely affected when adopting ASC 842

While the impact of adopting ASC 842 can be significant, it often results in just an increase in the lease liability and the related ROU asset, and not a significant charge to equity.

While we will review transition accounting in detail, the combination of the transition guidance and impact of applying the package of three transition practical expedient generally results in no charge to beginning equity.

As per the following graphic, in a sample of public company entities that adopted ASC 842, most disclosed material charges to retained earnings as a result of the recognition of formerly deferred gains related to sales-leaseback arrangements, and not to the application of the guidance to more straightforward lease arrangements.



D. Inputs into calculations

There are many inputs into the lease accounting valuation model. While some, like fixed and variable payments, are objective, some are subjective and require judgment. These variables include the following:

- Incremental Borrowing Rate;
- Term and options to extend or terminate the lease;
- Economic life of the asset;
- Residual value guarantees; and
- Economic Life and fair value of the underlying asset.

There is a difference in determining the incremental borrowing rate under ASC 840 and 842. While both represent the rate at which an entity would borrow money to purchase the leased asset, the rate under ASC 842 is a secured or collateralized rate, while that under ASC 840 is an unsecured rate. So, all things being equal, an entity's incremental borrowing rate under ASC 842 would be lower than under ASC 840, resulting in the recognition of a larger lease liability and right-of-use asset.

Also, entities need to consider the impact of ASU No. 2021-09. The ASU allows lessees that are not public business entities to use the risk-free interest rate on a class of asset basis, as opposed to all assets for which the entity could not determine the rate implicit in the lease.

Prior to the issuance of ASU No. 2019-09, the election to use the risk-free rate was applied to all assets for which the rate implicit in the lease was not determinable. Now, it can be elected by class of asset, with the incremental borrowing rate used on other classes of assets for which the rate implicit in the lease is not determinable.

The entity making this election must disclose that it has made the election and the classes of underlying assets to which it was made.

As previously discussed, the term of the lease includes not just the noncancelable term but also consideration of options to extend or terminate the lease. Consideration of both could have a significant impact on the term of the lease, thereby impacting its classification and the accounting for the lease arrangement.

Residual value guarantees can also have a significant impact on both lessee and lessor accounting. A residual value guarantee insures the difference between the actual fair value of the asset at the end of the lease and its expected fair value at the end of the lease.

From a lessee perspective, the full amount of any residual value guarantee is considered in determining the payment stream under the lease when assessing lease classification. However, only the residual value guarantee expected to be paid by the lessee would be included in the lease liability.

Guaranteed and unguaranteed residual value guarantees are considered in determining a lessor's net investment in a lease, essentially its lease receivable.

Lastly, both the economic life of the leased asset and its fair value are key inputs into the lease's classification. The determination of both requires judgment, with both possibly not being readily available to the lessee, resulting in the need for the lessee to make estimates of either, or both.

E. Application of materiality under ASC 842

Unlike IFRS 16, which establishes a specific $5,000 materiality threshold, there is no explicit materiality threshold under ASC 842. However, entities can use judgment in applying materiality to leases.

Some entities have decided to follow a capitalization policy identical or similar to that used for PP&E. However, when applying the threshold, be sure to address the materiality of individual leases but also the impact of not applying ASC 842 to leases in the aggregate.

F. Applying ASC 842 to related party leases

The recognition and measurement requirements for all leases should be applied by lessees and lessors that are related parties based on the legally enforceable terms and conditions of the lease. The FASB is expected to release an update with a practical expedient for private companies related to "legally enforceable terms and conditions." Information on this expected update is discussed below. In addition, lessees and lessors will be required to apply the disclosure requirements for related party transactions in ASC 850, *Related Party Disclosures*.

Questions arise about applying the 12-month practical expedient to related party leases, which may often be month-to-month contractual arrangements or may not even have a written contract at all. In such instances, lessees should apply the written terms of the lease agreement in determining the term of the lease, considering whether the lessee has a significant economic incentive to extend the lease. Lessees should also consider verbal agreements with lessors, if applicable, to determine the true economic substance of the lease agreement. Please see below for an expected update related to common control leasing arrangements.

The FASB issued ASU 2023-01 in March 2023 related to private companies' common control leasing arrangements. The ASU addresses two issues with which stakeholders were concerned related to implementing ASC 842.

ASC 842 requires entities to account for related party leases, when both entities are under common control, in the same manner as leases with unrelated parties (on basis of legally enforceable terms and conditions). However, during the PIR process, stakeholders noted that it could be difficult to determine the enforceable terms and conditions of these arrangements. Private companies under common control could have lease terms between entities that might or might not be legally enforceable. These terms might not even be in writing.

The new amendment will provide a practical expedient that allows private companies and not-for-profit entities to use the written terms of the lease to determine whether a lease exists as well as the classification of and accounting for that lease. Basically, the “legally enforceable” caveat is avoided. This practical expedient does not apply to verbal leases.

Entities may apply the above practical expedient in two ways. The entity could apply the amendment prospectively to leases that commence or are modified on or after the date the entity first applies the amendment. The entity could also apply the amendment retrospectively to the beginning of the first period the entity applied ASC 842.

This new ASU also addresses leasehold improvements recognized by a lessee in a lease between parties under common control. ASC 842 requires leasehold improvements to be amortized over the shorter of the useful life of the improvements or the remainder of the lease term. Stakeholders noted that, within common control leases, leasehold improvements amortized over a lease term that is significantly shorter than the useful life of the improvements could result in financial reporting that is not fully representative of the economics of the arrangement. FASB noted that this is an issue for all entities with common control leases, as such amendments in this new update will add requirements related to leasehold improvements associated with leases between entities under common control. These requirements are listed below.

- Lessee will amortize the leasehold improvements over the useful life of the improvements, regardless of lease term, if the lessee controls the underlying asset through a lease. There is an exception if the lessor controls the underlying asset through a lease with an unrelated third party. In this scenario, the amortization period for the leasehold improvements cannot exceed the lease terms between the lessor and the unrelated entity.
- Once the lessee no longer controls the underlying asset, the unamortized portion of leasehold improvements will be transferred to the lessor through an adjustment to equity.

As noted previously, this amendment will apply to all entities under common control when leases are present, not just private companies. Entities that encounter the above scenario, where leasehold improvements will be amortized for a longer period than the lease term, should disclose the following:

- Remaining lease term;
- Leasehold improvements’ remaining useful life; and
- Unamortized balance of leasehold improvements.

Entities applying the amendments related to leasehold improvements that have already adopted ASC 842 have the following options for application:

- Prospectively to new leasehold improvements recognized on or after the date the above amendments are first applied.
- Prospectively as noted above, while also amortizing existing leasehold improvements over the remaining useful life determined at the date of application.
- Retrospectively, to the beginning of the first period the entity applied ASC 842 for leasehold improvements that exist at the date of adoption of a final update, with any leasehold improvements that otherwise would not have been amortized recognized through a cumulative-effect adjustment to the opening balance of retained earnings at the beginning of the fiscal year of adoption.

The effective date of ASU 2023-01 for both issues discussed above is fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted for both interim and annual financial statements that have not yet been made available for issuance.

IV. Avoiding common mistakes in applying ASC 842

One of the benefits of the gap between public company and private/NFP adoption of ASC 842 is that it allows for nonpublic business entities to learn from the mistakes of public companies in their adoption. Here is a summary of some of these common errors.

A. Timing of systems vs. processes

Adopting any new accounting standard is a process, not a one-time event. Good decisions made in developing and applying the process can significantly ease both transition and on-going accounting. Poor decisions made in developing and applying the process, or simply not developing a process at all, can have a significant negative impact both on transition and ongoing accounting.

One of the first considerations is to ensure the completeness of the lease population for transitioning to ASC 842. While this population should be complete when accumulating the current disclosure information under ASC 840, many entities have seen that they have missed some leases when developing their five-year table. This is especially the case with entities that account for leases in a decentralized environment. Take the time to identify all leases before calculating the transition adjustment.

The key is to not just leap into recording leases in a system, irrespective of what the system is. The entity should take appropriate time to consider its options when making policy elections, ensuring a thorough understanding of the lease accounting and payment process. Also, the entity will likely need to add accounts to its general ledger for operating leases. It should consider all applicable variables in establishing these general ledger accounts, considering not just the accounting but also the disclosure requirements of ASC 842.

Related to the process vs. systems is consideration of the appropriateness of the tools which an entity uses in its lease accounting process. While spreadsheets may have been sufficient in the ASC 840 environment to determine lease classification and lease expense, the calculations required to account for operating leases under ASC 842 are more complex. This is due to the need to amortize the lease liability and ROU asset over the term of the lease. The volume of these calculations may overwhelm the person, making them use a spreadsheet, potentially increasing the likelihood of error.

Further, a spreadsheet may not be sufficient to compute some of the disclosure requirements of ASC 842, especially related to weighted average remaining term and discount rate of the leases. Also, accounting for the remeasurement of leases using spreadsheets can be challenging. Collectively, the use of spreadsheets may not be well-controlled and could result in increased audit fees due to the entity's reliance on them. While ultimately a cost-benefit analysis, any process review related to ASC 842 adoption should consider the use of lease accounting software.

B. Potential trouble spots

While an entity can make errors in any number of areas when applying ASC 842, there are a few areas where errors are more likely.

First, when developing your transition cumulative-effect adjustment, if you are proposing to record an adjustment to retained earnings, its best to review your adjustment and the ASC 842 guidance before you record the entry. While the recording of an adjustment to retained earnings may occur when transitioning to ASC 842, it is usually due to the existence of specific circumstances, such as sales-leaseback transactions. Take the time to review your judgment or even run a question or two past your accounting firm to assure that your adjustment is correct. The extra time spent now reviewing the adjustment could pay dividends in avoiding more work down the road correcting an error.

Another common area for errors is the assessment of when to include options to extend a lease in its term. The guidance uses a "reasonably certain" threshold, which is similar to the "reasonably assured" in ASC 840. It is reasonable to apply similar judgment in applying this guidance under ASC 842 as you would when determining lease term under ASC 840. The "reasonably certain" threshold is a high bar. Just because a lease contains an option to extend, and the lessee has exercised a similar option in the past, does not necessarily mean that the option period should be added to the noncancelable term. An example of the "reasonably certain" threshold being met would be when an entity still requires a leased asset past the initial end date of the lease, and the lease contains a bargain renewal option. However, in all cases, judgment is required.

Lastly, the guidance is applied consistently to both arms-length and related party leases. The relationship between the parties doesn't matter when determining the term of the lease, only the facts and circumstances of the situation.

C. Unexpected business impacts

Adopting ASC 842 can have many business impacts, both expected and unexpected.

Remember that unless a lease meets an exception or is immaterial, all contracts containing leases must be recorded under ASC 842. While many companies justifiably focus on leases for significant items like real estate or large pieces of PP&E, the aggregation of many smaller leases may have a large impact on the financial statements. That is why it is so important to ensure the completeness of the lease population and to develop and apply a materiality threshold.

The impact of adopting ASC 842 could affect the calculation of debt covenants, especially ones that have liquidity or leverage calculations, such as a current ratio or debt/equity calculation. Entities adopting ASC 842 are very susceptible to such violations, as the standard results in the recording of a noncurrent ROU asset offset by a lease liability that is split between a current and noncurrent portion.

Entities should have a thorough understanding of their debt covenant or other contractual requirements, including any clauses which address new accounting standards. When it is not clear how the bank will treat the impact of ASC 842 on applicable covenants, it is best to discuss the issue with the banks as early as possible. Further, the entity should develop pro-forma results that include the adoption of ASC 842 as early as possible, so both the entity and the banks can assess the impact and negotiate any necessary adjustments to the covenants.

Lastly, ASC 842 provides increased transparency to the true cost of lease financing. Often entities default to lease financing because it is easier than to arrange for purchase financing, or that is what they have done in the past. With the full amount of lease commitments now visible, as well as their cost, entities may use this increased transparency around the full cost of lease financing to make better decisions concerning how to finance their purchases.

V. Lessee financial statement presentation

While it is important to complete all aspects of the ASC 842 transition successfully, many of the underlying calculations related to leases are already being performed under ASC 840. However, the capitalization of operating leases under ASC 842 will require specific consideration related to financial statement presentation under the updated standard.

A. Financial statement presentation

1. Statement of financial position

A lessee should present all of the following items in the statement of financial position (or disclose these items in the notes to the financial statements):

a. Right-of-use assets separately from other assets;
b. Right-of-use assets arising from finance leases separately from right-of-use assets arising from operating leases;
c. Lease liabilities separately from other liabilities; and
d. Lease liabilities arising from financing leases separately from lease liabilities arising from operating leases.

If a lessee does not present right-of-use assets and lease liabilities separately in the statement of financial position, the lessee should present right-of-use assets within the same line item where corresponding underlying assets would be presented if they were owned and disclose which line items in the statement of financial position include right-of-use assets and lease liabilities.

The following represents the results of a survey of ASC 842 adopters’ presentation of the short- and long-term lease liabilities:

This treatment generally represents the relative materiality of the account balances.

2. Statement of comprehensive income

A lessee should present both of the following items in the statement of comprehensive income:

a. For finance leases, the unwinding of the discount on the lease liability separately from the amortization of the right-of-use asset; and
b. For operating leases, the unwinding of the discount on the lease liability together with the amortization of the right-of-use asset.

3. Statement of cash flows

In the statement of cash flows, a lessee should classify:

a. Cash payments for the principal portion of the lease liability arising from finance leases within financing activities.
b. Cash payments for the interest portion of the lease liability arising from finance leases within operating activities.
c. Cash payments arising from operating leases within operating activities.
d. Variable lease payments and short-term lease payments not included in the lease liability within operating activities.

B. Disclosures

The objective of the disclosures required under ASC 842 is to allow financial statement users to assess the timing, amount, and uncertainty of cash flows arising from leases. As such, lease disclosures under ASC 842 are likely to be more detailed than before and are of both a quantitative and qualitative nature. A lessee should aggregate or disaggregate disclosures so that useful information is not obscured by including a large amount of insignificant detail or by aggregating items that have different characteristics.

Qualitative disclosures for lessees include the following:

1. Information about the nature of its leases (and subleases), including:
   a. A general description of those leases;
   b. The basis, and terms and conditions on which variable lease payments are determined;
   c. 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 the ROU assets and lease liabilities and those that are not;
   d. The existence, and terms and conditions of residual value guarantees provided by the lessee; and
   e. The restrictions or covenants imposed by leases.
2. Information about leases that have not yet commenced but that create significant rights and obligations for the lessee.
3. Information about significant assumptions and judgments made in applying the requirements of the leases standards, which may include the following:
   a. The determination of whether a contract contains a lease;
   b. The allocation of the consideration in a contract between leases and nonlease components; and
   c. The determination of the discount rate.
4. The main terms and conditions of any sale and leaseback transactions.
5. Whether an accounting policy election was made for the short-term lease exemption.

The FASB decided if the short-term lease expense does not reflect the lessee's short-term lease commitments, a lessee should disclose that fact and the amount of its short-term lease commitments.

The standard requires the following quantitative disclosures to be made by lessees:

1. Finance lease expense segregated between amortization of ROU assets and interest on lease liabilities.
2. Operating lease expense.
3. Short-term lease expense excluding expenses relating to leases with a lease term of one month or less.
4. Variable lease expense.
5. Sublease income.
6. Cash paid for amounts included in the measurement of lease liabilities, segregated between operating and financing cash flows and between finance and operating leases.
7. Supplemental noncash information on lease liabilities arising from obtaining ROU assets, segregated between finance and operating leases.
8. Weighted-average remaining lease term disclosed separately for finance and operating leases.
9. Weighted-average discount rate for finance and operating leases as of the reporting date.
10. Gains and losses arising from sale and leaseback transactions.

Expense items disclosed include any amounts capitalized as part of the cost of another asset. Additionally, a lessee must disclose a maturity analysis of its lease liabilities, showing the undiscounted cash flows on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years, and reconciling the undiscounted cash flows to the discounted lease liabilities recognized in the statement of financial position.

Lastly, both lessees and lessors are required to apply the disclosure requirements for related party transactions in accordance with Topic 850, *Related Party Disclosures*.

Note:

Nonpublic business entity considerations

The FASB decided **NOT** to provide any specified reliefs from the disclosure requirements for nonpublic business entities. Therefore, the lessee disclosure package is equally applicable to both public and nonpublic business entities. Nonpublic business entities should also review the SEC's EDGAR database in order to get industry-specific examples of ASC 842 disclosures for public companies on which they can mirror their own.

Examples of required lessee disclosures are found below:

	Year Ending December 31,	
	20X2	**20X1**
Lease cost		
Finance lease cost:	$XXX	$XXX
Amortization of right-of-use assets	XXX	XXX
Interest on lease liabilities	XXX	XXX
Operating lease cost	XXX	XXX
Short-term lease cost	XXX	XXX
Variable lease cost	XXX	XXX
Sublease income	(XXX)	(XXX)
Total lease cost	$XXX	$XXX
Other information		
(Gains) and losses on sale and leaseback transactions, net	$(XXX)	$XXX
Cash paid for amounts included in the measurement of lease liabilities	XXX	XXX
Operating cash flows from finance leases	XXX	XXX
Operating cash flows from operating leases	XXX	XXX
Financing cash flows from finance leases	XXX	XXX
Right-of-use assets obtained in exchange for new finance lease liabilities	XXX	XXX
Right-of-use assets obtained in exchange for new operating lease liabilities	XXX	XXX
Weighted-average remaining lease term—finance leases	X.X years	X.X years
Weighted-average remaining lease term—operating leases	X.X years	X.X years
Weighted-average discount rate—finance leases	X.X%	X.X%
Weighted-average discount rate—operating	X.X%	X.X%

The following is the lease disclosure from a public company adopter of ASC Topic 842:

We have operating and finance leases for datacenters, corporate offices, research and development facilities, retail stores, and certain equipment. Our leases have remaining lease terms of 1 year to 20 years, some of which may include options to extend the leases for up to 5 years, and some of which may include options to terminate the leases within 1 year. As of September 30, 2017 and June 30, 2017, assets recorded under finance leases were $3.4 billion and $2.7 billion, respectively, and accumulated depreciation associated with finance leases was $209 million and $161 million, respectively.

The components of lease expense were as follows:

(In millions)

Three Months Ended September 30,	2017	2016
Operating lease cost	**$ 388**	$ 260
Finance lease cost		
Amortization of right-of-use assets	**$ 48**	$ 15
Interest on lease liabilities	**30**	12
Total finance lease cost	**$ 78**	$ 27

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Other information related to leases was as follows:

(In millions, except lease term and discount rate)

Three Months Ended September 30,	2017	2016
Supplemental Cash Flows Information		
Cash paid for amounts included in the measurement of lease liabilities:		
Operating cash flows from operating leases	**$ 369**	$ 267
Operating cash flows from finance leases	**30**	12
Financing cash flows from finance leases	**25**	6
Right-of-use assets obtained in exchange for lease obligations:		
Operating leases	**391**	55
Finance leases	**728**	267
Weighted Average Remaining Lease Term		
Operating leases	**7 years**	5 years
Finance leases	**14 years**	12 years
Weighted Average Discount Rate		
Operating leases	**2.5%**	2.3%
Finance leases	**4.7%**	5.1%

Future minimum lease payments under non-cancellable leases as of September 30, 2017 were as follows:

(In millions)

Year Ending June 30,	Operating Leases	Finance Leases
2018 (excluding the three months ended September 30, 2017)	$ 1,110	$ 205
2019	1,385	281
2020	1,267	287
2021	1,022	293
2022	833	299
Thereafter	2,333	3,133
Total future minimum lease payments	7,950	4,498
Less imputed interest	(930)	(1,225)
Total	$ 7,020	$ 3,273
Reported as of September 30, 2017		
Other current liabilities	$ 1,252	$ 146
Operating lease liabilities	5,768	0
Other long-term liabilities	0	3,127
Total	$ 7,020	$ 3,273

As of September 30, 2017, we have additional operating and finance leases, primarily for datacenters, that have not yet commenced of $219 million and $2.3 billion, respectively. These operating and finance leases will commence between fiscal year 2018 and fiscal year 2019 with lease terms of 1 year to 20 years.

The following is an example of the ASC 842 disclosures of Tenet Healthcare, a for-profit operator of hospitals. Though it is from a for-profit entity, this disclosure example would serve as a good example for a not-for-profit entity as well, as the disclosure requirements are identical for both for and not-for-profit entities.

Example 2 – Tenet Healthcare Corp.

LEASES

The following table presents the components of our right-of-use assets and liabilities related to leases and their classification in our Condensed Consolidated Balance Sheet at March 31, 2019:

Component of Lease Balances	Classification in Condensed Consolidated Balance Sheet	March 31, 2019	
Assets:			
Operating lease assets	Investments and other assets	$	799
Finance lease assets	Property and equipment, at cost, less accumulated depreciation and amortization		441
Total leased assets		**$**	**1,240**
Liabilities:			
Operating lease liabilities:			
Current	Other current liabilities	$	146
Long-term	Other long-term liabilities		714
Total operating lease liabilities			860
Finance lease liabilities:			
Current	Current portion of long-term debt		141
Long-term	Long-term debt, net of current portion		224
Total finance lease liabilities			365
Total lease liabilities		**$**	**1,225**

We determine if an arrangement is a lease at inception of the contract. Our right-of-use assets represent our right to use the underlying assets for the lease term and our lease liabilities represent our obligation to make lease payments arising from the leases. Right-of-use assets and lease liabilities are recognized at commencement date based on the present value of lease payments over the lease term. We use our estimated incremental borrowing rate, which is derived from information available at the lease commencement date, in determining the present value of lease payments. For our Hospital Operations and other Conifer segments, we estimate our incremental borrowing rates for our portfolio of leases using documented rates included in our recent equipment finance leases or, if applicable, recent secured debt issuances that correspond to various lease terms. We also give consideration to information obtained from our bankers, our secured debt fair value, and publicly available data for instruments with similar characteristics. For our Ambulatory Care segment, we estimate an incremental borrowing rate for each center by utilizing historical and projected financial data, estimating a hypothetical credit rating using publicly available market data and adjusting the market data to reflect the effects of collateralization.

Our operating leases are primarily for real estate, including off-campus outpatient facilities, medical office buildings, and corporate and other administrative offices, as well as medical and office equipment. Our finance leases are primarily for medical equipment and information technology and telecommunications assets. Our real estate lease agreements typically have initial terms of five to 10 years, and our equipment lease agreements typically have initial terms of three years. We do not record leases with an initial term of 12 months or less (“short-term leases”) in our consolidated balance sheets.

Our real estate leases may include one or more options to renew, with renewals that can extend the lease term from five to 10 years. The exercise of lease renewal options is at our sole discretion. In general, we do not consider renewal options to be reasonably likely to be exercised, therefore renewal options are generally not recognized as part of our right-of-use assets and lease liabilities. Certain leases also include options to purchase the leased property. The useful life of assets and leasehold improvements is limited by the expected lease term unless there is a transfer of title or purchase option reasonably certain of exercise. The majority of our medical equipment leases have terms of three years with a bargain purchase option that is reasonably certain of exercise, so these assets are depreciated over their useful life, typically ranging from five to seven years. Similarly, some of our leases of information technology and telecommunications assets include a transfer of title and, therefore, have useful lives of 15 years.

Certain sections of our lease agreements for real estate include payments based on actual common area maintenance expenses and others include rental payments adjusted periodically for inflation. These variable lease payments are recognized in other operating expenses, net, but are not included in the right-of-use asset or liability balances. Our lease agreements do not contain any material residual value guarantees, restrictions, or covenants.

We have elected the practical expedient that allows lessees to choose to not separate lease and nonlease components by class of underlying asset and are applying this expedient to all relevant asset classes. We have also elected the practical expedient package to not reassess at adoption (i) expired or existing contracts for whether they are or contain a lease, (ii) the lease classification of any existing leases, or (iii) initial indirect costs for existing leases.

The following table presents the components of our lease expense and their classification in our Condensed Consolidated Statement of Operations for the three months ended March 31, 2019:

Component of Lease Expense	Classification on Condensed Consolidated Statements of Operations		Three Months Ended March 31, 2019
Operating lease expense	Other operating expenses, net	$	50
Finance lease expense:			
Amortization of leased assets	Depreciation and amortization		18
Interest on lease liabilities	Interest expense		5
Total finance lease expense			23
Variable and short term-lease expense	Other operating expenses, net		34
Total lease expense		**$**	**107**

The weighted-average lease terms and discount rates for operating and finance leases are presented in the following table:

	March 31, 2019
Weighted-average remaining lease term (years)	
Operating leases	6.7
Finance leases	6.1
Weighted-average discount rate	
Operating leases	5.2%
Finance leases	5.5%

Cash flow and other information related to leases is included in the following table:

		Three Months Ended March 31, 2019
Cash paid for amounts included in the measurement of lease liabilities:		
Operating cash outflows from operating leases	$	47
Operating cash outflows from finance leases	$	5
Financing cash outflows from finance leases	$	36
Right-of-use assets obtained in exchange for lease obligations:		
Operating leases	$	28
Finance leases	$	36

Future maturities of lease liabilities at March 31, 2019 are presented in the following table:

		Operating Leases		Finance Leases		Total
2019	$	144	$	120	$	264
2020		171		122		293
2021		152		64		216
2022		132		16		148
2023		110		13		123
Later years		339		123		462
Total lease payments		1,048		458		1,506
Less: Imputed interest		188		93		281
Total lease obligations		860		365		1,225
Less: Current obligations		146		141		287
Long-term lease obligations	**$**	**714**	**$**	**224**	**$**	**938**

Future maturities of lease liabilities at December 31, 2018, prior to our adoption of ASU 2016-02, are presented in the following table:

			Years Ending December 31,											
		Total		2019		2020		2021		2022		2023		Later Years
Capital lease obligations	$	425	$	140	$	95	$	57	$	37	$	21	$	75
Long-term non-cancelable operating leases	$	932	$	171	$	151	$	133	$	113	$	92	$	272

VI. Lessee transition to ASC 842

A. Lessee transition

As noted previously, ASC 842 has been effective for all entities for at least one fiscal year. The information below should be reviewed to confirm the accounting related to transitioning to ASC 842 was done correctly. A lessee should have applied a modified retrospective transition approach for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements (the date of initial application). The modified retrospective approach would not require any transition accounting for leases that expired before the date of initial application.

As mentioned previously, the FASB issued ASU No. 2018-11, which includes an amendment to this transition guidance where an entity could have applied the guidance of Topic 842 at its effective date and not at the beginning of the earliest comparative period. Under this election, an entity would not have needed to apply the guidance of Topic 842 to leases that expired before the effective date of Topic 842.

A full retrospective transition approach was not permitted.

1. Practical expedients

In transitioning to ASC 842 a lessee was permitted to elect the following specified reliefs, which must have been elected as a package and must have been applied to all of a lessee's leases (that is, they should not have been elected on a lease-by-lease or relief-by-relief basis), at the effective date:

- A lessee need not reassess whether any expired or existing contracts are or contain leases;
- A lessee need not reassess the lease classification for any expired or existing leases; and
- A lessee need not reassess initial direct costs for any existing leases (that is, whether those costs would have qualified for capitalization under ASC 842).

In addition, a lessee was also permitted to elect to use hindsight with respect to lease renewals and purchase options when accounting for existing leases. This specified relief could have been elected separately or in conjunction with the above-specified reliefs as an accounting policy election (that is, it cannot be elected on a lease-by-lease basis).

It is likely that most entities elected to employ these reliefs upon adopting ASC 842. As a result of not needing to reassess the classification of existing leases, many entities did not see a material impact on their retained earnings due to the adoption of ASC 842, unless due to other specific circumstances, such as preadoption sale-leaseback transactions. This result can be seen in this following transition survey:

Cumulative-Effect Adjustment at Transition

While there are four possible transition outcomes, the application of the "package of three" practical expedient reduces the potential outcomes to two, as an entity electing that expedient does not need to reassess lease classification. We'll review these two options now.

2. Transition accounting for existing operating leases under ASC 840

The modified retrospective transition approach should have been applied to existing **operating** leases that are classified as operating leases under Topic 842, as follows:

1. A lessee should have initially recognized a ROU asset and lease liability at the later of the date of the beginning of the earliest period presented in the financial statements and lease commencement.
2. Unless the lease is modified (and that modification is not a separate lease), or the lease liability is required to be remeasured, on or after the effective date, a lessee should have initially and subsequently measured the lease liability at the present value of the sum of:
    a. The remaining minimum rental payments (as defined under ASC 840) plus
    b. Any amounts the lessee expects to pay to satisfy a residual value guarantee, using a discount rate established in accordance with ASC 842 as of the "later of" date.
3. A lessee should have initially measured the operating ROU asset at an amount equal to the initial measurement of the lease liability, adjusted for any asset impairment, prepaid or accrued rent, lease incentives, or unamortized initial direct costs that would have qualified for capitalization under ASC 842, as well as the carrying amount of any liability recognized in accordance with Topic 420 on exit or disposal cost obligations for the lease.
4. Any unamortized initial direct costs at the "later of" date that would not have qualified for capitalization under ASC 842 should have been written off as an adjustment to equity.
5. Beginning on the effective date, if a lessee modifies the lease (and that modification is not a separate lease) or is required to remeasure the lease liability for any reason, it should follow the updated leases standard.

For existing operating leases that are classified as finance leases under ASC 842, the lessee should have measured the right-of-use asset as the applicable proportion of the lease liability at the commencement date, which can be imputed from the lease liability determined above. The applicable proportion is the remaining lease term at the beginning of the earliest comparative year presented relative to the total lease term. The lessee should have then adjusted the right-of-use asset recognized by the carrying amount of any pre-paid or accrued lease payments and the carrying amount of any liability recognized in accordance with Topic 420 for the lease. See the example of this transition that follows. However, as per above, if an entity uses the “package of three” practical expedients, it would not be in the situation of transitioning an operating lease under ASC 840 to a finance lease under ASC 842.

3. Transition accounting for existing capital leases under ASC 840

The modified retrospective transition approach should have been applied to existing **capital** leases that are accounted for as finance leases under Topic 842, as follows:

1. A lessee should have initially recognized a ROU asset and lease liability at the carrying amount of the leased asset and the capital lease obligation in accordance with ASC 840, *Leases*, at the later of the beginning of the earliest comparative period presented or the commencement date of the lease.
2. Any unamortized initial direct costs not included in the capital lease asset under ASC 840 that qualify for capitalization under ASC 842 should be included in the financing ROU asset; otherwise, those costs that would not have qualified for capitalization should be written off as an adjustment to equity.
3. Before the effective date, a lessee should have subsequently measured the ROU asset and lease liability in accordance with the subsequent measurement guidance in ASC 840.
4. Beginning on the effective date, a lessee should subsequently measure the ROU asset and lease liability in accordance with the subsequent measurement guidance in ASC 842 except that a lessee should not remeasure the ROU asset or lease liability for changes in the amount the lessee expects to pay under residual value guarantees unless it remeasures the asset or liability for other reasons (for example, because of a change in the lease term resulting from a reassessment).
5. Classify the assets and liabilities held under capital leases as right-of-use assets and lease liabilities arising from finance leases for purposes of presentation and disclosure.
6. Beginning on the effective date, if a lessee modifies the lease (and that modification is not a separate lease) or is required to remeasure the lease liability for any reason, it should follow guidance found in ASC 842.

ASC 842 contains additional transition guidance for leases classified as operating leases under ASU No. 2016-02 but as capital leases under Topic 840. This essentially involves derecognizing the carrying amount of the capital lease asset and related lease obligation at the later of the beginning of the earliest comparative period or the commencement date of the lease. Differences between the derecognized asset and liability should be recorded as prepaid or accrued rent. A ROU asset and liability should be recognized in accordance with the relevant guidance in Topic 842, depending on whether the lease commenced before or after the beginning of the earliest date presented in the financial statements and accounted for under Topic 842 subsequently. However, if an entity used the “package of three” practical expedients, it will not be in the situation of transitioning a capital lease under ASC 840 to an operating lease under ASC 842.

Discussion question:

Do you have any experiences with companies or clients utilizing the above reliefs with regard to transitioning to Topic 842?

4. Miscellaneous considerations in transition accounting

The following is guidance on certain transition accounting issues.

Variable lease payments included in the five-year minimum lease payment table

Under ASC 840, the five-year minimum lease payment disclosure includes variable payments based on a rate or index. The amount included in the five-year table is based on rate or index at lease inception. There is disparity in practice concerning whether an entity should update this disclosure for changes in rate or index at each accounting period. Some entities did update the amount of variable lease payments for changes in the rate or index while others did not update disclosure in the five-year table of minimum lease payments for such changes.

As the five-year minimum lease payment table is the basis for the transition adjustment for operating leases under ASC 842, questions have arisen as to which amounts to use when recording the cumulative-effect adjustment. However, ASC 842 is silent as to this issue.

The SEC issued guidance stating that if an entity was including minimum lease payments in its disclosure table based on the rate or index in effect at the inception of lease, it can either continue to do so at transition, or it may use the current rate or index when transitioning to ASC 842. However, if changing its approach, the entity should apply ASC 250 guidance to changes in accounting estimates.

If the entity already updates its five-year table of minimum lease payments for changes in the underlying rate or index, it should continue to use those amounts in its transition to ASC 842.

Discount rate considerations in transition

Discount rate to be used when determining the ASC 842 transition adjustment is the rate in effect at the application date. However, the application date will differ based on the transition method the entity elected.

When determining the rate that should have been used for recording the transition adjustment, the same discount rate options exist as when originally recording a lease under Topic 842:

- Use rate implicit in the lease, if known; or
- Use incremental borrowing rate, if not known. The entity can use the incremental borrowing rate either for original term of the lease or one for the remaining term of the lease, at transition. Approach should be consistently applied.

Nonpublic business entities can use the risk-free rate at transition, related to the remaining term of the lease.

5. Example transition options

The following are examples of several of these transition options.

The following example illustrates the practical application of the lease accounting guidance for lessee accounting for the transition of existing operating leases to an operating lease when applying the permitted alternative to a full retrospective transition approach. This is the most likely transition example for lessees to have to follow.

Lessee Transition – Operating Lease to Operating Lease

A lessee enters into a five-year lease of land on January 1, 20X1, with annual lease payments payable at the end of each year. The lessee originally accounts for the lease as an operating lease. On January 1, 20X2, before transition adjustments, the lessee has an accrued rent liability of $1,200 for the lease, reflecting rent that was previously recognized as an expense but was not paid at that date. Four lease payments remain: one payment of $31,000 followed by three payments of $33,000.

January 1, 20X2 is the beginning of the earliest comparative period presented in the financial statements in which the lessee first applies the requirements in FASB ASC 842, *Leases*. At the effective date, the lessee's incremental borrowing rate is six percent. The lessee classifies the lease of land as an operating lease. On January 1, 20X2, the lessee measures the lease liability at $112,462, the present value of one payment of $31,000 and three payments of $33,000, discounted at six percent.

The right-of-use asset is equal to the lease liability before adjustment for accrued rent. The lessee does not include initial direct costs in determining the right-of-use asset as permitted by the transition guidance in FASB ASC 842.

January 1, 20X2	Right-of-use asset	112,462	
	Lease liability		112,462

The lessee also makes an adjustment to the right-of-use asset for the amount of the previously recognized accrued rent.

January 1, 20X2	Accrued rent	1,200	
	Right-of-use asset		1,200

The following example illustrates the practical application of the lease accounting guidance for how a lessee would account for the transition of existing operating leases to a finance lease when applying the permitted alternative to a full retrospective transition approach. Such a transition is not expected to occur often.

Lessee Transition – Operating Lease to Operating Lease, Using Package of Three Practical Expedients

A lessee that is a calendar-year public business entity entered into a 10-year lease of equipment that commenced on 1 January 2017 and was classified as an operating lease under ASC 840. The lessee makes annual payments that it pays in arrears on 31 December each year. The initial payment was $10,000, and the terms call for a $1,000 increase each year.

The deferred rent liability on 31 December 2018 is $8,000. The lessee incurred $7,500 of initial direct costs (IDCs) and half of the remaining unamortized IDCs of $6,000 qualify for capitalization under ASC 842 at lease commencement (i.e., $3,000 of remaining unamortized IDCs qualify for capitalization under ASC 842 at lease commencement).

The lessee elects to apply the package of practical expedients at transition and does not elect to apply the hindsight practical expedient. Therefore, lease classification and the remaining unamortized IDCs of $6,000 are not reassessed. The lessee cannot determine the rate implicit in the lease, and its incremental borrowing rate (IBR) as of 1 January 2019 is five percent. Finally, the lessee elects to apply the transition provisions at the beginning of the period of adoption (i.e., 1 January 2019).

Analysis: in this example, the lessee records the following journal entry as of 1 January 2019:

Right-of-use asset	$96,529 (1)	
Deferred rent liability	8,000 (2)	
Lease liability		$98,529 (3)
Capitalized IDCs		6,000 (4)

(1) The ROU asset equals the lease liability determined in (3) less the deferred rent liability determined in (2) plus remaining unamortized IDCs ($98,529 – 8,000 + 6,000).
(2) The deferred rent liability is the difference between the cash payments of $21,000 for 2017 and 2018 and cumulative straight-line expense of $29,000 ($14,500 per year for 2017 and 2018).
(3) The lease liability is the present value of the eight remaining rental payments discounted at the incremental borrowing rate of five percent ($98,529).
(4) The unamortized portion of IDCs capitalized under ASC 840 ($7,500 – 1,500 for two years of amortization).

Not Using the Package of Three Practical Expedients

Assume the same facts as in Scenario A except the lessee does not elect to apply the package of practical expedients at transition.

Analysis: in this example, the lessee records the following journal entry as of 1 January 2019:

Right-of-use asset	$93,529 (1)	
Deferred rent liability	8,000 (2)	
Cumulative-effect adjustment	3,000 (3)	
Lease liability		$98,529 (4)
Capitalized IDCs		6,000 (5)

(1) The ROU asset equals the lease liability determined in (4) less the deferred rent liability determined in (2) plus remaining unamortized IDCs that qualify for capitalization under ASC 842 ($98,529 – $8,000 + $3,000).

(2) The deferred rent liability is the difference between the cash payments of $21,000 for 2017 and 2018 and cumulative straight-line expense of $29,000 ($14,500 per year for 2017 and 2018).

(3) The cumulative-effect adjustment is the portion of remaining unamortized IDCs that do not qualify for capitalization under ASC 842 [$6,000 remaining unamortized IDCs ($7,500 – $1,500 for two years of amortization) x 50 percent].

(4) The lease liability is the present value of the eight remaining rental payments discounted at the incremental borrowing rate of five percent ($98,529).

(5) The unamortized portion of IDCs capitalized under ASC 840 ($7,500 – $1,500 for two years of amortization) (half was included in the measurement of the ROU asset, and the portion that does not qualify for capitalization under ASC 842 was adjusted in (3)).

Discussion question:

How much incremental effort have you expended in implementing ASC 842?

ASC 326: CECL

ASC 326: CECL

Learning objectives

After completing this chapter, you should be familiar with:

- The FASB's financial instruments guidance relating to credit losses, ASU No. 2016-13;
- Key elements of the ASC 326 models; and
- Presentation, transition, and disclosure guidance under ASC 326.

I. Introduction

Responding to criticism following the 2008-09 financial market meltdown that entities were recognizing credit losses too late under existing GAAP, the FASB and the IASB began work on converged accounting guidance related to financial instruments, including credit losses. While the standard-setting boards ultimately went separate ways, both issued updated guidance on these topics. The IASB issued wholistic guidance related to financial instruments through IFRS No. 9, while the FASB issued piecemeal updates to the guidance for marketable equity securities, hedging transactions, and accounting for credit losses.

The FASB's updated guidance related to credit losses represents major changes in both the measurement of the credit loss and the timing of its recognition. The guidance in ASU No. 2016-13 sees an acceleration of the recognition of credit losses as compared to the current incurred loss model.

In this section, we will review this updated guidance, which is effective in 2023 for calendar year-end reporting private companies.

II. ASC 326, Credit Losses

A. Overview of ASC 326

ASU No. 2016-13 added new subtopics to Topic 326, *Financial Instruments – Credit Losses*, to the Accounting Standards Codification™ (ASC), as well as amended a variety of other Topics in the ASC. The final standard incorporated comments received on the exposure draft and represents a departure from the international accounting standards treatment of credit losses. We'll describe these differences later in the chapter.

The FASB's main objective in developing this ASU was to provide financial statement users with more decision-useful information about the expected credit losses on financial assets and other commitments to extend credit held by a reporting entity at each reporting date. This addressed the widely held belief that the failure to record losses on financial assets on a timely basis contributed to market conditions that were at the heart of the financial crisis of 2008-2009.

The heart of this objective was the replacement of the impairment model, which reflects incurred credit events, with a model that recognizes expected credit risks and by requiring consideration of a broader range of reasonable and supportable information to inform credit loss estimates. Essentially, ASC 326 replaces the "probable" threshold of loss on such instruments with one that requires a current estimate of such losses, irrespective of the current probability of such losses.

Pre-ASC 326, when credit losses were measured, an entity generally only considered past events and current conditions in measuring the incurred loss. ASU 2016-13 broadened the information that an entity is required to consider in developing its credit loss estimate. Specifically, an entity's estimate is required to be based on relevant information about past events, including historical loss experience with similar assets, current conditions, and reasonable and supportable forecasts that affect the expected collectability of the financial assets' remaining contractual cash flows.

As a result, an entity considers quantitative and qualitative factors specific to the borrower, including the entity's current evaluation of the borrower's creditworthiness. An entity also considers general economic conditions and an evaluation of both the current point in, and the forecasted direction of, the economic cycle (for example, as evidenced by changes in issuer or industry-wide underwriting standards).

ASU 2016-13 also reduced the complexity in credit loss reporting by replacing the numerous existing impairment models with a consistent measurement approach.

ASU No. 2016-13 had a tiered effective date, based on whether the entity is an SEC registrant, a public business entity but not an SEC registrant, or neither. For SEC registrants, the effective date of the Update was for reporting years beginning after December 15, 2019, including quarters. The effective date of the Update for all other entities is for reporting years beginning after December 15, 2022.

Early adoption was allowed for any fiscal year up until ASC 326's effective date.

The following table details the key differences between ASC 326 and legacy GAAP related to measuring and recording credit losses:

	Key Differences		**Financial Statement and Process Effects**
	Legacy GAAP	**ASC 326**	
Recognition threshold	When a loss is incurred as of the balance sheet date.	When lifetime credit losses are expected, considering the risk of loss, even if remote (i.e., in virtually all instances).	Earlier recognition of credit losses and credit losses on assets that had not had allowances under current GAAP.
Unit of measurement	Pooling permitted but not required.	Pooling required when assets share risk characteristics.	Need to reconsider whether current pools continue to share similar risk characteristics at each measurement date.
Consideration of economic circumstances	Consider current economic conditions.	Consider current economic conditions and management's expectations of future economic conditions.	Credit losses likely to be more volatile. Need to evaluate data availability and integrity and consider the use of external data to address incomplete or insufficient internal data.
Consideration of contractual term	Not part of the calculation of incurred losses at the balance sheet date.	Measure expected credit losses over the asset's contractual term. Lessors should consider the probability of term extensions in their assessment of lease term.	May be challenging to determine the life of the receivable in certain circumstances.

B. The “CECL” model and its applicability

In the aftermath of the global economic crisis, the overstatement of assets caused by a delayed recognition of credit losses was cited as a major weakness under current accounting standards. In this context, the FASB developed the Current Expected Credit Loss (CECL) model which, just as its name implies, is a forward-looking analysis used to estimate expected credit losses. This is a far cry from the previous “incurred loss” model, which generally delayed credit loss recognition until the loss had actually been incurred (i.e., expected future losses were not recorded). Additionally, the CECL model differs from that which was adopted by the IASB, which delays recognition of credit losses until there is a significant deterioration in credit risk. This model would result in a delayed recognition of such losses as opposed to the CECL model.

The CECL model requires an entity to measure the impairment of its existing financial assets on the basis of a current estimate of contractual cash flows not expected to be collected on financial assets held at the reporting date. This impairment is reflected as an allowance for expected credit losses. The CECL model removed the “probable” threshold from U.S. GAAP for recognizing credit losses and broadens the range of information that must be considered in measuring the allowance for expected credit losses. More specifically, the estimate of expected credit losses is based on relevant information about past events, including historical loss experience with similar assets, current conditions, and reasonable and supportable forecasts that affect the expected collectability of the assets’ remaining contractual cash flows. An estimate of expected credit losses would always reflect both the possibility that a credit loss results and the possibility that no credit loss results. Accordingly, the CECL prohibits an entity from estimating expected credit losses solely on the basis of a most likely outcome approach.

C. Scope of the CECL model

An entity should apply the CECL model to financial assets measured at amortized cost as well as certain off-balance sheet credit exposures. However, financial assets that are accounted for at fair value through net income are not included in the scope of the update. Additionally, available for sale (AFS) debt securities are not subject to the CECL model but rather follow a new impairment model under ASU No. 2016-13.

The scope of financial assets subject to the CECL model is broad and includes the following:

a. Loans.
b. Held to maturity (HTM) debt securities, including corporate bonds, mortgage-backed securities, municipal bonds, and other fixed income instruments.
c. Trade and reinsurance receivables.
d. Net investment in leases.
e. Loan commitments, including lines of credit.
f. Financial guarantees accounted for under ASC 460, *Guarantees.*

In essence, any financial asset not excluded from the scope of ASU No. 2016-13 that represents a contractual right to receive cash is covered by ASU No. 2016-13.

However, in addition to the items discussed above, the CECL model does not apply to the following:

- Loans made to participants by defined contribution employee benefit plans.
- Policy loan receivables of an insurance entity.
- Promises to give (pledges receivable) of a not-for-profit entity.
- Loans and receivables between entities under common control.

Many questions have arisen related to the scope of ASC 326. The following table addresses many of these questions regarding the scope of the guidance:

Financial asset	In the scope of ASC 326?
Cash equivalents	Yes
Loans and receivables to equity method investees	Yes
Tax receivables from tax authorities	No
Loans with officers	Yes
Forgivable employee loans	Yes, if they meet the definition of a financial asset

D. Key concepts in applying the CECL model

ASC 326 and the CECL model are complex. In this section, we'll discuss the key concepts in applying the CECL model. These key concepts are the following:

- An entity's estimate of its credit loss for a financial asset is the difference between the expected cash flows the entity expects to receive and the asset's amortized cost.
- As CECL requires the recognition of a credit loss before the loss is incurred or probable, the basis of the asset is not written down when the estimated credit loss is taken. Rather, an allowance is established, and it is adjusted over the term of the asset as updated information becomes available.
- While entities need to estimate credit losses, ASC 326 provides no specific guidance. We will explore different methodologies in estimating credit losses later in this section.
- As credit losses are established via an allowance account, the accounting for write-offs and recoveries also changes under ASC 326. An actual write-down of the asset is taken against the allowance while a recovery is recorded as a credit to the income statement in the period in which it is received.
- An entity can consider the value of collateral when determining its estimated credit losses, thereby limiting the amount of credit losses it records.
- Under ASC 326, impairment of available-for-sale (AFS) debt securities is not determined using the CECL model but by using a more simplified approach than previously employed under ASC 320.
- Transition to ASC 326 is done via a modified retrospective approach, determined as of the effective date of the guidance.
- ASC 326 has substantial disclosure requirements that are more rigorous than previous guidance, especially for nonfinancial institutions.

1. Amortized cost

Before getting into the mechanics of the CECL model, let's define the concept of amortized cost. The amortized cost basis of an asset is the amount at which a financing receivable or investment is originated or acquired, adjusted for applicable accrued interest, accretion or amortization of premium, discount, and net deferred fees or costs, collection of cash, write-offs, foreign exchange, and fair value hedge accounting adjustments.

The following table defines each element of amortized cost:

Component of amortized cost	Definition
Unpaid principal balance (UPB)	Par or face amount of a financing receivable, adjusted for cash collections applied to the principal.
Accrued interest	Interest on the financing receivable that has accumulated since the principal investment or since the previous coupon payment. Interest to be earned in the future should not be included.
Premium or Discount	Premium is the excess of the acquisition or origination price of a financing receivable over its face or par amount at maturity. Discount is the excess of the face or par amount at maturity of the receivable over the acquisition or origination price of a financing receivable.
Write-offs	Amount of the financial asset deemed uncollectible.
Foreign exchange adjustment	The effect on the functional-currency-equivalent cash flows of change in foreign currency exchange rates when the financial receivable is denominated in a currency other than the entity's functional currency.
Fair value hedging	Basis adjustment applied to the financing receivable when the receivable is hedged as a fair value hedge.

For short-term receivables, their amortized cost will generally be their carrying amount.

As we saw above, determination of a financial asset's amortized cost is critical to applying the CECL model. The estimate of credit loss can be measured several ways, all of which involve using the asset's amortized cost. First, credit losses can be measured by measuring all components of amortized cost on a combined basis. This will result in the estimated credit loss being the difference between the total expected cash flows and the asset's total amortized cost.

However, as certain banks face regulatory guidance with regard to accruing and subsequently reserving against accrued interest, ASC 326 also allows the determination of a financial asset's credit loss by measuring accrued interest separately from unpaid principal balance (UPB) and all other components. However, this approach can be used only if a nondiscounted cash flow (DCF) model is used to estimate credit losses.

Lastly, entities are required to determine which elements of amortized cost are addressed in its loss rate estimates of credit loss and potentially adjust the estimate to consider all elements of amortized cost, as required by the standard. For example, if historical loss rates only reflect the write-off of UPB, they would need to be adjusted to include other elements of amortized cost when determining estimated credit losses.

2. Use of the allowance approach

Under the CECL model, credit losses are captured through the establishment of an allowance account, the allowance for loan and lease losses (ALLL). This account is presented as an offset to the financial asset, which is presented at amortized cost, or as a liability in the instances of off-balance sheet exposures. The net effect of this presentation is that such assets are presented at the net amount expected to be collected.

The CECL model requires an estimate of expected credit losses (ECL) over the life of an exposure, or pool of exposures. This estimate should consider historical information, current information, and reasonable and supportable forecasts of future events and circumstances, as well as estimates of prepayments. When estimating expected credit losses an entity is required to evaluate financial assets on a collective (pool) basis when similar risk characteristics exist (or on an individual basis if a financial asset does not share similar risk characteristics with other financial assets). However, the current guidance does not prescribe any specific method to estimate such losses.

The CECL model requires the recognition of ECL upon initial recognition of a financial asset. With the exception of certain purchased assets with credit deterioration (PCD), which we will discuss later, the day one recognition of the ALLL will result in charge to current earnings. At each accounting period, the ECL is evaluated, with both positive and negative changes to the estimate recognized as an adjustment to both the ALLL and current earnings.

Originated and purchased financial assets include compensation for credit risk in yield or investment return of the assets. The recognition of the effective yield of the security will occur over time, through application of the interest recognition models under U.S. GAAP. As estimated credit losses are recognized in net income on day one, there is a mismatch between the recording of expected credit losses and the entity's compensation for credit risk, which would be in the form of a higher interest rate.

ASU No. 2016-13 requires that the ALLL be determined based on the amortized cost of the financial asset. As we saw, amortized cost includes all premiums, discounts, net deferred fees or costs, foreign exchange adjustments, and fair value hedge accounting adjustments. Some approaches commonly used to estimate ECL, such as a discounted cash flows, already consider the amortized cost of the asset. However, others, such as a loss rate approach, are most likely applied to the par value of the investment. Accordingly, they do not meet the requirement discussed above. If an entity uses such a model, it will need to adjust it for such items as premiums and discounts, etc., so that the ALLL is based on the amortized cost of the asset. This requirement balances the FASB's desire to allow entities to continue to use their existing credit models but also achieve a level of consistency with regard to what the ALLL account represents. However, application of this requirement may prove tricky for entities and does require judgment.

In responding to feedback that applying the CECL guidance to accrued interest, which is part of the financial asset's amortized cost basis, would potentially impose unintended costs to implement ASC 326, the FASB, in ASU No. 2019-04, proposed the following alternative for an entity, namely regulated financial institutions, in recording its credit loss on accrued interest.

The amendments to Subtopic 326-20 allow an entity to:

- Measure the ACL on accrued interest receivable balances separately from other components of the amortized cost basis of associated financial assets.
- Make an accounting policy election not to measure an ACL on accrued interest receivable amounts if an entity writes off the uncollectible accrued interest receivable balance in a timely manner and makes certain disclosures.
- Make an accounting policy election to write off accrued interest amounts by reversing interest income or recognizing credit loss expense, or a combination of both. The entity also is required to make certain disclosures.
- Make an accounting policy election to present accrued interest receivable balances and the related allowance for credit losses for those accrued interest receivable balances separately from the associated financial assets on the balance sheet. If the accrued interest receivable balances and the related allowance for credit losses are not presented as a separate line item on the balance sheet, an entity should disclose the amount of accrued interest receivable balances and the related allowance for credit losses and where the balance is presented.
- Elect a practical expedient to disclose separately the total amount of accrued interest included in the amortized cost basis as a single balance to meet certain disclosure requirements.

As mentioned above, an entity is required to estimate ECL on a pooled basis when financial assets have similar characteristics. The ECL would otherwise be estimated on a standalone basis. The entity needs to reassess at each reporting period whether this "shared characteristic" assumption is still applicable. If not, the asset should be removed from the pool when determining the ECL. The removed asset(s) may be added to another group with shared characteristics or the ECL for that asset can be estimated on a standalone basis. Risk characteristics that entities should consider in making this determination include past due status, collateral type, credit scores and ratings, term, borrower's industry, subordination, origination vintage, geographical location of the borrower, and other relevant information about the creditor and the instrument.

3. Measuring credit losses

In applying the CECL model, an entity estimates expected losses over the life of the exposure, using historical, current, and forecasts of future conditions. In developing these estimates, entities may need to make adjustments to historical information to reflect current and expected future conditions. Such adjustments do require significant judgment and should be well documented.

For periods beyond which it can reasonably develop a good forecast of expected losses, an entity should look to historical loss information for assets of the same contractual term. For example, for a 20-year receivable for which the entity can reasonably forecast ECL for the first five years, the entity should consider historical loss rates for similar 20-year loans in developing its ECL for the periods beyond five years. The guidance does not prescribe a specific methodology for developing the estimate, so the selection of a model is one of the key decisions for entities to make in adopting the guidance. As a result of this discretion, entities employing different methodologies may record different estimates of credit loss for assets with similar characteristics. However, the methodology should consider the contractual term of the asset as well as prepay behavior. Renewals, modifications, or extensions would generally not be considered in this process.

ASC 326 prescribes no specific approach to estimating credit losses, only that the method an entity uses meets the objectives of the standard.

Measuring credit losses can be a very complex exercise. It generally entails the following activities:

- Pooling of assets;
- Determining the term of the financial asset;
- Consideration of collateral;
- Use of historical data and estimates; and
- Estimation methods.

4. Pooling of assets

Under ASC 326, entities must measure credit losses on a pooled basis when similar risk characteristics exist. Accordingly, risk and related credit losses are considered separately, by pool. Assets in each pool are relatively homogeneous. However, an entity should reassess its pooling of assets when risk characteristics change.

Credit losses are only estimated on individual assets when similar risk characteristics do not exist for these assets. Generally, a nonpooled approach would only be employed for assets that have experienced a deterioration in credit quality. In such circumstances, the asset(s) should be removed from the pool, along with the related allowance, based on a "with and without" approach.

There is no set number, minimum or maximum, of asset pools which an entity should use. Common characteristics for pooling included the following:

- Internal or external credit score or credit rating;
- Financial asset type;
- Collateral type;
- Size;
- Effective interest rate;
- Term;
- Geographic location;
- Industry of borrower;
- Vintage;
- Historical or expected credit loss pattern; and
- Reasonable and supportable forecast period.

5. Determining the term of a financial asset

An entity should estimate the credit loss of a financial asset over its term. Generally, the term is the asset's contractual term, but an entity should consider prepayments as an input or a consideration embedded into its ECL model. Per ASU No. 2020-05, entities should use the term of a lease utilizing the guidance for term under ASC 842, which includes consideration of options to renew in a lease's term if it is reasonably certain that the option will be exercised.

If the entity is not using discounted cash flows (DCF) method to estimate its credit losses, it should use the contractual term of the asset in its estimation.

If the entity is using a DCF model to estimate its credit losses, the entity should consider both principal and interest prepayments in its model. This will likely result in a smaller estimate of credit losses.

FASB recently issued ASU 2022-02, which eliminated TDR recognition and measurement guidance for creditors utilizing the CECL model. A TDR is any modification of an instrument for a borrower experiencing financial difficulty that results in the lender granting a concession. Prior to ASU 2022-02, entities had to consider whether there was a reasonable expectation of a troubled debt restructuring (TDR), and if so, whether the contractual term would be extended. With the issuance of ASU 2022-02, all modifications will be accounted for under ASC 310-20.

6. Credit mitigation strategies and collateral

Further, an entity can consider credit mitigation strategies that it may employ both with regards to its estimate of credit losses as well as its determination of the term of the instrument. For instance, an entity should also consider credit enhancements, such as guarantees or insurance contracts, in its estimate unless such enhancements are freestanding contracts. However, to be considered in the estimate, the enhancement must be embedded in the instrument at inception or purchase. For example, an entity should not consider a separately purchased credit default swap (CDS) contract when estimating its estimate of credit losses as the CDS was not already embedded in the instrument.

Additionally, the entity should consider the impact of collateral in its estimate but cannot merely assume no credit losses just because of the existence of collateral. The entity should consider the current value of the collateral as well as its nature, potential future changes in value, and historical loss rates for assets secured with similar collateral. When factoring in the value of collateral when developing its ECLs, the entity should estimate losses based on the fair value of the collateral when the entity determines that foreclosure is probable. Further, when repayment of a loan is expected to be provided substantively through the operation or sale of the collateral, the entity should estimate the fair value of the collateral, or its fair value less costs to sell, in developing its ECL, when it expects to either operate the collateral for repayment or sell the collateral for repayment, respectively.

ASU No. 2019-04 clarified that an entity should consider estimated costs to sell collateral when foreclosure of the financial asset is probable.

Lastly, some financial assets require collateral to be replenished periodically. The entity should consider such replenishments in its ECL. If the contract requires replenishment to a point equal to or in excess of the amortized cost of the underlying asset, the entity can conclude that the ECL on that asset is zero. However, careful consideration and judgment regarding items such as contractual terms for the collateral, liquidity of the collateral, valuation techniques to be employed, and others should be used in these situations.

Even with the existence of collateral and credit enhancements, it may be difficult for an entity to conclude that there is zero nonpayment risk related to a financial asset. Per ASC 326-20-30-10, an entity is not required to measure expected credit losses on an individual or group of financial assets in which historical credit loss information adjusted for current conditions and reasonable and supportable forecasts results in an expectation that nonpayment of the amortized cost basis is zero. The FASB expects these situations to be rare and essentially consist of only investments in U.S. Treasury securities.

However, if the financial asset is collateral dependent, an entity may elect to compare the fair value of the collateral to the asset’s amortized cost basis to determine its allowance. A collateral-dependent financial asset is one for which the repayment is expected to be provided substantially through the operation or sale of the collateral when the borrower is experiencing financial difficulty. If the fair value of the collateral for such asset is greater than the amortized cost of the financial asset, the entity may expect credit losses of zero. If the fair value of the collateral for such asset is less than the amortized cost of the financial asset, the expected credit loss is the amount of that difference.

The following is an example of applying the collateral guidance of ASC 326:

Assume that a bank lends money to a builder developing a condominium project. The builder has no assets other than the proceeds of the loan and its construction in progress.

Due to a significant recent downturn in the real estate market, the builder has not been able to pre-sell as many units as expected. Accordingly, the bank believes that the developer will not be able to repay its loan. However, the bank believes that it will be able to recover substantially all of its investment through the sale of the real estate.

The loan has an amortized cost of $1,500,000. A certified external appraisal of the value of the loan collateral is $1,200,000. Costs to sell the units are estimated to be $100,000.

In this circumstance, the financial asset, the loan, appears to be collateral dependent. As such, the bank can elect to measure impairment using the collateral-dependent financial asset practical expedient. If the bank uses the expedient to measure the impairment of its loan to the developer, the amount of the impairment would be calculated as follows:

Amortized cost of the loan:		$1,500,000
Fair value of property	$1,200,000	
Estimated costs to sell	100,000	
		1,100,000
Impairment		$ 400,000

Further, the Update does offer a practical expedient when assets are secured by collateral and the amount of the collateral is continually adjusted as a result of changes in the fair value of the collateral. When the borrower is required to replenish the collateral so its fair value is equal to or exceeds the amortized cost of the investment, the entity can conclude the risk of nonpayment of the financial asset is zero and no estimate for credit losses need be recorded.

E. Estimating credit losses

While ASC 326 does not prescribe a specific model to estimate credit losses, an entity makes certain judgments when estimating credit losses, irrespective of the model it uses. These are the following:

- Definition of default.
  - While the concept of default, or nonpayment when due, is pretty straightforward, many jurisdictions and financial asset types have regulatory schemes which dictate when an actual default event occurs. Plus, there may be consumer protection and/or bankruptcy protection laws which can also impact when a "legal" default has occurred. As always, be sure to read and understand any and all applicable guidance related to the financial asset.
- The approach for measuring the historical loss amount for loss-rate statistics.
  - ASC 326 provides flexibility as to how entities can measure credit losses. Entities should assure that the method they use is consistent with the objectives of ASC 326.
- Determination of appropriate historical period.
  - The allowance estimation process begins with an analysis of historical data. Entities need to decide both which data to use and whether it is still representative of its loss profile and risk.
- Approach for adjusting historical credit loss information to reflect current conditions and reasonable and supportable forecasts.
  - Entities identify which adjustments to the historical data are needed, how to obtain the necessary data to support the adjustments, and for how long the current information is reasonable and supportable.
- Methods of using historical experience.
  - In addition to determining which data to use, entities determine how to use it in their estimation process.
- Method of adjusting loss statistics for recoveries.
  - Entities both estimate recoveries of previously reserved losses, as well as develop an accounting policy for the actual receipt of payment.
- Impact of prepayments on estimating credit losses.
  - Prepayments can significantly impact an estimation model, especially one which uses a DCF approach. The model an entity uses must appropriately account for interest and estimated prepayments of interest.
- Revision to historical information when estimates are no longer reasonable and historical.
  - As per above, the entity decides when to revert to its historical trends.
- Similarity of risk characteristics.
  - The entity revisits its pooling assessments periodically to assure that the risk characteristics within each pool are still valid.

1. Use of historical data

ASC 326 provides wide leeway for entities to develop their estimates of expected credit losses. In its guidance, ASC 326 requires entities to consider both internal and external data as well as consider historical information and reasonable and supportable forecasts. ASC 326-20-30-9 specifically states that an entity cannot solely rely on past events to estimate expected credit losses. Adjustments to historical loss information may be qualitative in nature and should reflect changes related to relevant data, such as unemployment rates, property values, commodity values, delinquency, or other factors associated with credit losses for the financial asset.

An entity is not required to develop estimates of credit losses for the entire term of the financial asset, though it may if it can do so. If it can't develop reasonable estimates, it should revert to historical information for periods beyond which it is able to make such forecasts. Entities cannot adjust historical loss information for existing or expected economic conditions for periods that are beyond the reasonable and supportable period.

ASC 326-20-30-8 states that historical credit loss experience of financial assets with similar risk characteristics generally provides a basis for an entity's assessment of expected credit losses. Such information can be either internal or external, or a combination of both. However, an entity should consider changing this historical information for difference in current asset-specific risk characteristics, such as changes in underwriting standards, portfolio mix or asset term, or when an entity's historical loss information is not reflective of the contractual term of the financial asset.

When developing its estimate of current credit losses, an entity considers how historical data differs from current conditions and reasonable and supportable forecasts. Examples of risk factors that may be considered include:

- Unemployment rates;
- Sources of income available to debt issuers;
- Collateral valuations;
- Underwriting policies;
- Payment status or structure;
- Regulatory and legal environment;
- Local and macro-economic and business conditions; and
- Conditions of market segments in connection with the analysis of financial asset concentrations.

2. Other considerations in estimating credit losses

In estimating credit losses an entity may need to adjust historical models to reflect current or expected trends. For example, its historical data may reflect certain macroeconomic conditions which are no longer applicable. Further, the historical data may reflect certain lending patterns of the entity which have changed over the years; for example, going from residential to commercial lending, or secured to unsecured loans.

However, particularly with regard to changing macroeconomic trends, an entity's ability to effectively estimate these trends may be limited to a relatively short time period. Per ASC 326, for periods beyond which an entity can develop a good forecast, an entity would need to revert back to its historical approach, adjusted as need be.

As mentioned, renewals, modifications, or extensions would generally not be considered when developing the credit loss estimation, even if the entity can reasonably estimate them. Only the reasonably certain exercise of options to extend leases can be considered by lessors estimating their credit losses.

The following is an example of how an entity would consider the application of reasonable and supportable estimates in the development of its credit losses estimate.

Assume that Company A sells high-end auto parts on credit to auto repair shops and that there is a high correlation between the unemployment rate and credit losses. There is a historical trend of linkage of credit losses to unemployment rate.

The current unemployment rate is 7.0 percent but is expected to be 6.0 percent in the forecast period. The following chart represents the historical linkage between the unemployment rate and the entity's cumulative loss experience:

Year	Unemployment Rate	Cumulative Loss Experience
Year – 4	5.0%	3.5%
Year – 3	4.5%	3.0%
Year – 2	5.5%	4.0%
Year – 1	6.0%	4.5%
Year – 0	7.0%	5.0%

Given this fact pattern, the entity would adjust its historical cumulative loss percentage of 5.0 percent to 4.5 percent for the periods for which it is reasonable and supportable that the unemployment rate will be 6.0 percent. When that estimate is no longer reasonable and supportable, the entity would revert back to its historical loss rate.

3. Models used to estimate credit losses

ASC 326 provides flexibility with regard to the model an entity uses to estimate its credit losses. Generally, the type of lending activity will dictate the appropriateness of the model, with entities not necessarily needing to change the model they are currently using to estimate credit losses, though how they use it may change.

Common models used to estimate credit losses are as follows:

- Discounted cash flow models;
- Loss-rate methods;
- Roll-rate methods;
- Probability of default methods; and
- Aging schedules.

Current guidance requires an entity to use a DCF model to estimate credit losses for certain financial assets. Irrespective of the model used, the entity should consider the following:

- The recorded allowance represents the difference between amortized cost of the financial asset and present value of the financial asset, discounted at original effective interest rate of the asset. However, an entity can consider the impact of prepayments on the effective interest rate, as well as estimate an effective interest rate when estimating credit losses for variable rate lending arrangements.
- Non-DCF models should incorporate premiums and discounts into the estimate of expected credit losses.
- When using loss rate approach, numerator includes the expected credit losses on the amortized cost basis.
- A discount should not offset the expectation of credit losses.

The following are common methods of estimating credit losses listed in ASC 326, though other appropriate models are permissible:

Approach	Description
Methods that use an aging schedule	Impairment is based on number of days receivable has been outstanding.
Loss-rate methods	Impairment is calculated using an estimated loss rate and multiplying it by the asset's amortized cost at the balance sheet date.
Roll-rate methods	Expected losses are projected using historical trends in credit quality indicators (i.e., delinquency).
Probability of default (PD) and loss given default (LGD) methods	Impairment is calculated by multiplying the Probability of Default by the LGD, the percentage of the asset not expected to be collected due to default.
Discounted cash flow method	Impairment is the difference between the asset's amortized cost and the present value of the future cash flows.

<u>Aging approach</u>

It is expected that entities would continue to use an aging analysis to estimate credit losses for accounts receivable. The key difference is that an estimated credit loss should be recorded on all credit sales, not just those for which a loss is probable, or incurred. The following is an example of the application of this guidance.

Estimating Expected Credit Losses for Trade Receivables

Background

- ABC manufactures and sells toys to a broad range of customers, primarily retail toy stores.
- Customers are typically provided payment terms of 2/60, net 90.

Quantitative factors

ABC has tracked its historical loss experience over the past five years as follows:

.03% for receivables that are current
8% for receivables that are 1-30 days past due
26% for receivables that are 31-60 days past due
58% for receivables 61-90 days past due
82% for receivables > 90 days past due

Qualitative factors

ABC believes this historical loss experience is consistent with what will be experienced for financial assets held at the reporting date because the composition of receivables at the reporting date is consistent with that used in developing the historical statistics (i.e., risk characteristics of customers has not changed significantly over time) and the economic conditions under which the historical statistics were calculated are generally consistent with the economic conditions expected over the remaining lives of the receivables.

Estimated expected credit losses

At the reporting date, ABC develops the following provision matrix to estimate current expected credit losses on its receivables portfolio.

Past-Due Status	Carrying Value	Loss Rate	Expected Credit Loss Estimate
Current	$ 5,984,698	0.3%	$ 17,954
1–30 days past due	8,272	8%	662
31–60 days past due	2,882	26%	749
61–90 days past due	842	58%	488
More than 90 days past due	1,100	82%	902
	$ 5,997,794		$ 20,755

In this example, the entity should have an allowance for credit losses totaling $20,755 at its reporting date.

Loss rates and roll rates

Loss rates and roll rates to estimate credit losses are similar in their approach. In a loss-rate approach, an entity multiplies the amortized cost of the asset by an estimated annual loss rate, while in a roll-rate estimation process, the entity essentially does the same, though the rate applied reflects historical trends in credit quality indicators across the duration of the borrowing. The following is an example of applying a loss-rate approach when estimating credit losses.

The entity has the following historical credit loss information related to its lending activity:

- It has determined that its historical loss rate is 1.43 percent, based on the average of prior-year history, per below;
- Its average receivables balance at the reporting date is $14,000,000; and
- Due to expected increases in the unemployment rate during the term of the receivable, its reasonable and supportable forecast is 1.45 percent.

	Year 1	Year 2	Year 3	Year 4
Annual net write-off	$ 160,000	$ 175,000	$ 187,500	$ 190,000
Annual average receivable	$11,000,000	$12,250,000	$13,250,000	$13,500,000
Annual loss rate	1.45%	1.43%	1.42%	1.41%

The entity's estimated credit loss would be $203,000, obtained by multiplying the receivables balance of $14,000,000 by its estimated loss rate of 1.45 percent.

<u>Discounted cash flow approaches</u>

Estimated credit losses of a discrete receivable, such as a HTM debt security may be best estimated via a DCF model, whereby the expected cash flows and the contractual cash flows are both discounted using the effective interest rate. The difference between the two is the estimated credit loss. The following is an example of applying a DCF model to estimate credit losses for a HTM debt security, using the CECL model:

Assumptions:

- On January 1, 2019, Entity A invests $10,000 in a debt security with a face amount of $10,000, a coupon interest rate of 4.5 percent, and a term of five years. Entity A classifies the security as held to maturity. The ACL at the acquisition date was immaterial.
- During 2019, the issuer experienced financial difficulty.
- At December 31, 2019, Entity A estimated the fair value of the investment to be $8,800.
- Entity A has prepared the following cash flows analysis of the amount it expects to collect from the security, using its single best estimate approach. To calculate the present value of the security, Entity A discounts the cash flows at 4.5 percent, the original effective interest rate on the security.

Year	Contractual Cash Flows	Cash Flows Expected at December 31, 2018	Decrease in expected cash flows
2019	$450	$450	-
2020	450	450	-
2021	450	450	-
2022	450	450	-
2023	10,450	9,050	$1,400
Total Cash Flows	12,250	10,850	1,400
Present Value of cash flows	$10,000	$8,880	$1,120

Per the above analysis, at December 31, 2019, the entity should have an allowance for credit losses of $1,120 for this HTM investment.

The journal entries to record this series of transactions are as follows:

- The journal entry to record the purchase of this investment at January 1, 2019 would be as follows:

  Investment 10,000
  Cash $10,000
- At December 31, 2019, the entry to adjust the carrying value of the investment would be as follows:

  Impairment loss (credit loss expense) $1,120
  ACL $1,120

The carrying amount of the HTM debt security at the date of acquisition would be $8,880.

4. Application of ASC 326 to lessors

ASC 326-20 also applies to lessors' net investment in sales-type and direct financing leases, recorded under ASC 842. Lessors can use the estimation models detailed above to estimate their credit losses. Note that operating leases are not within the scope of ASC 326 and will be discussed separately.

When lessors use a DCF model to estimate credit losses, the interest rate used in the model is the same one used in measuring the original lease receivable. Further, the lessor can consider the inclusion of collateral in determining the allowance for credit losses, such as residual value guarantees or others.

For sale-leasebacks where the transfer of the asset is not a sale and the transaction is accounted for as a lessor financing (a failed sale-leaseback), amounts to be paid to the lessor, by the lessee are within the scope of ASC 326.

Under ASC 842, the net investment in a sales-type or direct financing lease consists of the following:

- Lease receivable – Payment stream and guaranteed residual value;
- Unguaranteed residual value – Amount lessor expects to derive from the leased asset at the end of the lease term which is not guaranteed; and
- Deferred selling profit – For direct financing leases only.

In determining the net investment in the lease, the above are discounted at the rate implicit in the lease, which should be known to the lessor.

When applying the guidance in ASC 842, note that the net investment in a lease is a single unit of account for determining the credit allowance. This means that the estimated credit losses for the net investment in leases should include an estimate of credit losses for each of the above components, including the underlying asset's unguaranteed residual value.

Accordingly, the estimated credit loss for a net investment in a lease must consider both of the following:

- The risk of a default during the lease term, including the risk of lost rental payments, the benefits of guarantees on the residual assets, and the risk of losses on unguaranteed residual assets; and
- The risk of loss if a default does not occur, which relates exclusively to losses on the unguaranteed residual assets due to changes in their value or their obsolescence.

The contractual term of the receivable is determined under ASC 842-10-30-1, which includes consideration of options to extend the lease. Further, if an entity recognizes receivables for nonlease components, as a lessor may do, if certain conditions are met, those receivables, in addition to the actual contractual lease payments, are also subject to CECL.

The following is an example of applying this guidance, as well as an example of applying the probability of default (PD) and loss given default (LGD) methods of estimating credit losses. In this example, assume the following:

- Lessor enters into a 10-year lease, with annual lease payments of $12,000;
- Expected unguaranteed residual value of asset included in Net Investment in Lease is $23,000. There is no guaranteed residual value from the lessee or a third party;
- Net investment in lease is $111,000;
- Lessor has determined that the lease should be accounted for as a sales-type lease;
- Historically the lessor has a loss experience on such leases of three percent;
- Its reasonable estimate is that the loss experience will rise to five percent over the term of this lease;
- Historical losses upon default are 10 percent of the receivable balance; and
- Expected loss rate on residual value of eight percent.

An estimated credit loss should be calculated for both the lease payment streams as well as the unguaranteed residual value, which are part of the net investment in the lease. These would be calculated as follows, using a PD and LGD approach:

- The risk of a default during the lease term, including the risk of lost rental payments, the benefits of guarantees on the residual assets, and the risk of losses on unguaranteed residual assets:
    - $110,000 (net investment in lease) x 5% (PD) x 10% (LGD), or $550.
- The risk of loss if a default does not occur, which relates exclusively to losses on the unguaranteed residual assets due to changes in their value or their obsolescence:
    - $23,000 (unguaranteed residual value) x 95% x 8%, or $1,746.

Accordingly, the total estimated credit loss for this net investment in a sales-type lease is $2,296.

As mentioned, ASC 326 does not apply to lessor’s operating leases, as no receivable is recorded by the lessor at lease commencement. However, a lessor must assess the collectability of the lease revenue stream in such leases, similarly to how one would apply ASC 606, with regard to revenue transactions.

If the collectability of the lease payments on an operating lease, plus any amount necessary to satisfy a residual value guarantee (provided by either the lessee or any other unrelated third party) is not probable at the commencement date of the lease, the amount of lease income that the lessor recognized shall be limited to the lesser of the following:

- The sum of the following:
  - Lease payments as income in profit or loss over the lease term on a straight-line basis subject to paragraph 842-30-25-12; and
  - Variable lease payments as income in profit or loss in the period in which the changes in facts and circumstances on which the variable lease payments are based occur; or
- The lease payments, including variable lease payments, which have been collected from the lessee.

The assessment of collectability of lease payments may change after lease commencement. If the assessment of collectability changes after the commencement date, any difference between the lease income that would have been recognized per the above and the lease payments, including variable lease payments, that have been collected from the lessee shall be recognized as a current-period adjustment to lease income.

F. Recording the estimated credit losses

1. Recording the allowance for credit losses

The CECL model requires the recognition of ECL upon initial recognition of a financial asset. With the exception of certain purchased assets with credit deterioration (PCD), which are not covered in this section, the day one recognition of the ALLL will result in charge to current earnings. At each accounting period the ECL is evaluated, with both positive and negative changes to the estimate recognized as an adjustment to both the ALLL and current earnings.

Originated and purchased financial assets include compensation for credit risk in yield or investment return of the assets. The recognition of the effective yield of the security occurs over time through application of the interest recognition models under U.S. GAAP. As estimated credit losses are recognized in net income on day one, there is a mismatch between the recording of expected credit losses and the entity's compensation for credit risk, which would be in the form of a higher interest rate.

Remember that ASU No. 2016-13 requires that the ALLL be determined based on the amortized cost of the financial asset. If an entity uses a model to estimate credit losses which aren't based on amortized cost, such as a loss-rate model, it will need to adjust it for such items as premiums and discounts, etc., so that the ALLL is based on the amortized cost of the asset. This requirement balances the FASB's desire to allow entities to continue to use their existing credit models but also achieve a level of consistency with regard to what the ALLL account represents. However, application of this requirement may prove tricky for entities and requires judgment.

As mentioned above, an entity is required to estimate ECL on a pooled basis when financial assets have similar characteristics. The ECL would otherwise be estimated on a standalone basis. The entity needs to reassess at each reporting period whether this "shared characteristic" assumption is still applicable. If not, the asset should be removed from the pool when determining the ECL. The removed asset(s) may be added to another group with shared characteristics or the ECL for that asset can be estimated on a standalone basis. Risk characteristics that entities should consider in making this determination include past due status, collateral type, credit scores and ratings, term, borrower's industry, subordination, origination vintage, geographical location of the borrower, and other relevant information about the creditor and the instrument.

2. Write-offs and recoveries

An entity should apply the existing write-off principle in U.S. GAAP to all financial assets, including available-for-sale debt securities. That is, an entity would write off a financial asset in the period in which the financial asset is deemed uncollectible, with a corresponding adjustment to the allowance account. Post-write-down recoveries would be recorded to the allowance and considered in the assessment of the sufficiency of the allowance at the reporting date.

However, entities should continue to follow guidance provided by regulatory agencies with regard to when write-offs are appropriate or required.

ASU No. 2019-04, in responding to stakeholder implementation questions, clarified that an entity should include recoveries estimating its ACLs.

The update clarifies that the expected recoveries of amounts previously written off and expected to be written off should be included in the valuation account and should not exceed the aggregate of amounts previously written off and expected to be written off by the entity.

Recoveries can be accounted for in one of two ways:

1. The recovery can be recorded as an increase in the ALLL; or
2. The recovery can be recorded directly to earnings.

Either method has the net effect of resulting in a credit to earnings.

In addition, for collateral dependent financial assets, ASU No. 2019-04 clarifies that an ACL that is added to the amortized cost basis of the financial asset(s) should not exceed amounts previously written off.

The following are the journal entries to record the initial allowance, the write-off of a receivable, and its subsequent recovery:

- Recording credit loss and allowance

Dr. Credit loss expense	XXXX	
CR. Allowance for credit losses		XXXX

- Recording write-offs

Dr. Allowance for credit losses	YYYY	
Cr. Asset		YYYY

- Recording recoveries

Dr. Cash	ZZZZ	
Cr. Credit losses or allowance		ZZZZ

III. Applying ASC 326 to available-for-sale (AFS) debt securities

A. Overview of the accounting model found in ASC 326

As was mentioned, AFS debt securities are not within the scope of the CECL model. ASU No. 2016-13 introduced an impairment model for entities with such securities to follow. ASU No. 2016-13 applies to all debt securities classified as AFS, including corporate bonds, mortgage-backed securities, municipal bonds, and other fixed income instruments.

Prior to ASU No. 2016-13, both AFS and HTM debt securities followed the same impairment model. However, in recognition of the different investment strategies inherent in the classifications of each type of debt security, the FASB decided to measure their impairment differently, with HTM debt securities using the CECL model and AFS debt securities using the approach outlined below.

Under the model found in ASC 326, an entity assesses an AFS debt security for impairment only when its fair value is below its amortized cost. This model eliminated the requirement for the entity to consider the length of time during which the AFS debt security's fair value was below its amortized cost in determining whether impairment exists. Additionally, recoveries or further declines in fair value that occur after the balance sheet date should not be considered in determining whether impairment exists.

ASU 2016-13, as it relates to AFS debt securities, does not allow for pooling of assets, though similar assumptions concerning impairment may be used for assets with similar characteristics. Additionally, the entity must use a present value of expected cash flows model to measure impairment.

Further, entities must first determine if the fair value of the AFS debt security is below its carrying value. If not, no impairment exists. If so, then an impairment exists and the entity next needs to measure it.

Similar to current pre-ASC 326 guidance, if the entity either has the intent to sell the investment or will more likely than not be required to sell the impaired investment before recovery of its amortized cost basis, the entity should record the entire impairment loss, the difference between the investment's fair value, and its amortized cost, in earnings. The impairment must be written off against the amortized cost basis of the security, resulting in no remaining ALLL. After this write-off, any difference between the amortized cost basis and the expected cash flows to be collected should be accreted as interest income.

If neither of the two above conditions exist, the entity must determine if the decline of fair value below amortized cost is credit related or not. An ALLL is recorded for the portion of this difference that is credit related. The credit loss related to this ALLL would be recorded though earnings. To determine the portion of the decline in fair value that is credit related, the entity would compare the present value of the expected cash flows of the security with its amortized cost basis. The amount of the ALLL is limited to this amount, the "fair value floor." Any difference between the AFS debt investment's fair value and its amortized cost basis, less the ALLL, would be recorded in OCI.

The ALLL is presented as an allowance, as under the CECL model, with recoveries in subsequent periods due to improvements in credit recognized through a reversal of ALLL and corresponding credit to earnings, up to the amount of the ALLL recognized.

In applying this model, note that the model which the entity follows either when it intends to sell the investment or when it is more likely than not to be required to sell the impaired investment before recovery of its amortized cost basis results in both credit- and noncredit-related losses being recorded in earnings. However, only credit-related earnings are recorded in earnings, and the related allowance when neither of these two conditions are met.

The recognition of credit losses through an ALLL is a significant change introduced by ASU No. 2016-13 for AFS debt securities. Under prior guidance, increases in estimates of credit losses resulted in basis adjustments to the underlying assets. Now, such losses are recorded as an ALLL. Perhaps more significantly, recoveries under the prior model were recorded as an adjustment to the effective yield of the security. Under ASC 326, such recoveries, up to the amount of the ALLL, are recorded through the reversal of the ALLL and a credit to earnings.

Accounting for AFS debt securities that are PCD assets is similar to the PCD model discussed above, with a gross-up for the expected credit deterioration at the date of purchase. Such assets would follow the AFS debt security model for subsequent impairment accounting.

B. Example of applying the ASC 326 AFS debt security impairment model

Let’s use the fact pattern that we previously saw to apply the AFS debt security impairment model under ASC 326. Note that in this example and under ASC 326, the determination of whether the impairment is temporary or not is not a relevant input into the accounting.

Assume on January 1, 2019, Entity A invests in a debt security for $10,000, with a coupon interest rate of 4.5 percent, and a term of 5 years. Entity A classifies the security as an available for sale security. On December 31, 2019, the fair value of the debt security is $7,000. Entity A has determined that it does not intend to sell the security and that it is not more likely than not that it will be required to sell the security.

Entity A has prepared the following cash flows analysis of the amount it expects to collect from the security, using its single best estimate approach. To calculate the present value of the security, Entity A discounts the cash flows at 4.5 percent, the original effective interest rate on the security.

Year	Contractual Cash Flows	Cash Flows Expected at December 31, 2018	Decrease in expected cash flows
2019	$450	$450	-
2020	450	450	-
2021	450	450	-
2022	450	450	-
2023	10,450	9,050	$1,400
Total Cash Flows	12,250	10,850	1,400
Present Value of cash flows	$10,000	$8,880	$1,120

As the fair value of the investment at December 31, 2019, $7,000, is less than its carrying value, $10,000, the investment is impaired.

Next, Entity A needs to determine if the impairment is credit or noncredit related. As the present value of the cash flows expected to be collected, $8,880, is less than the amortized cost of the loan, $10,000, a credit loss exists.

The impairment of $3,000, representing the difference between the amortized cost of the security, $10,000 and its fair value, $7,000, would be split as follows:

Impairment due to credit loss (Charged to NI)	$1,120
Impairment due to noncredit loss (Charged to OCI)	$1,880

The journal entity to record impairment at December 31, 2019 would be as follows:

Impairment loss	$1,120	
OCI	$1,880	
ALLL		$1,120
AFS security – unrealized loss		$1,880

Entity A would run a similar analysis at each reporting period, adjusting the amount of the allowance by the amount of the change in the credit-related impairment. The change in the allowance would be charged to net income.

IV. Effective date and transition

For nonpublic business entities, ASC 326 is effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years.

An entity applies the amendments in this update through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective (that is, a modified-retrospective approach).

A prospective transition approach is required for debt securities for which an other-than-temporary impairment had been recognized before the effective date. The effect of a prospective transition approach is to maintain the same amortized cost basis before and after the effective date of this Update.

Amounts previously recognized in accumulated other comprehensive income as of the date of adoption that relate to improvements in cash flows expected to be collected should continue to be accreted into income over the remaining life of the asset. Recoveries of amounts previously written off relating to improvements in cash flows after the date of adoption should be recorded in earnings when received.

When using the modified retrospective approach to adopt a new accounting pronouncement, an entity should disclose the following:

- Nature of change in accounting principle, including an explanation of newly adopted accounting principle.
- Method of applying change.
- If material – Effect of adoption on any Balance Sheet line item as of beginning of first period guidance is effective:
    - Cumulative effect of change on retained earnings or other components of equity as of beginning of first period guidance is effective.
    - Presentation of effect on F/S subtotals not required.

These disclosures should be made at year end and in any interim financial statements issued in the year of adoption.

ASC No. 2019-05 provides targeted transition relief to those adopting ASC 326. Some entities, especially lessors, may elect to apply the fair value option to certain receivables which are within the scope of ASC 326. While this irrevocable election would result in the valuation of such assets at their fair value from the date of the election, other similar receivables for which the fair value election was not previously made would still be subject to ASC 326. To rectify this issue, the FASB issued ASU No. 2019-05.

The ASU provides entities with certain instruments within the scope of ASC 326-20 with the option to irrevocably elect the fair value option upon adoption of ASC 326. This option would be applied on an instrument-by-instrument basis for eligible investments and results in the entire portfolio of such receivables being accounted for using the fair value option. Entities would follow the guidance in ASC Subtopics 820-10 and 825-10 subsequently to this election. Further, the election does not apply to held-to-maturity debt securities.

For many nonbanks, the impact of adopting ASC 326 has been immaterial. The following is an example of transition disclosure made by a lessor when the impact of adoption was not material:

> On January 1, 2020, we adopted the new accounting guidance related to the allowance for credit losses on our trade receivables and sales-type leases. As a result of the adoption, we increased our allowance for credit losses and reduced retained earnings as of January 1, 2020. The impact of adoption of this standard was not material.

V. Presentation and disclosure matters

A. Presentation under ASC 326

The following table summarizes the presentation requirements under ASC 326:

	Financial assets measured at amortized cost	**AFS debt securities**	**Off-balance sheet credit exposure**
Balance sheet presentation	Amortized cost	Securities are presented at fair value, with amortized cost presented parenthetically	None – Disclosure only
Allowance for credit loss presentation	Presented separately as a contra-asset deducted from the asset's amortized cost	Presented parenthetically	Presented as a liability
Income statement presentation	Credit loss expense	Credit loss expense	Credit loss expense

B. Disclosure requirements of ASC 326

The overall objective of the disclosure guidance in ASC 326 is to enable financial statement users to understand:

- The credit risk inherent in the portfolio and how management monitors the credit quality of the portfolio;
- Management's estimate of expected credit losses; and
- Changes in the estimate of expected credit losses that have taken place during the period.

The ASU maintains the disclosures currently required under ASU No. 2010-10, *Receivables (Topic 310): Disclosures about the Credit Quality of Financial Receivables and the Allowance for Credit Losses*, updated for changes in methodology required under ASU No. 2016-13.

Many of the following disclosure requirements note that an entity should provide the information by either portfolio segment or by class of financial asset. Examples of portfolio segments would include type of debt instrument; industry sector of the borrower; and risk rate(s). An entity should base its principal determination of class of financial asset by disaggregating to the level that the entity uses when assessing and monitoring the risk and performance of the portfolio for various types of financing receivables. In this assessment, the entity should consider the risk characteristics of the financing receivables.

Classes of financial assets are generally a disaggregation of a portfolio segment. For determining the appropriate classes of financial assets that are related to a portfolio segment, the portfolio segment is the starting point.

Detailed disclosure guidance related to credit risk and the recognition of credit losses for instruments within the scope of ASC 326 include:

1. Credit-quality information.
2. Allowance for expected credit losses.
3. Past-due status.
4. Nonaccrual status.
5. Off-balance-sheet credit exposures.
6. Collateral-dependent financial assets.
7. Purchased financial assets with credit deterioration.

<u>Credit-quality information</u>
An entity should provide information that enables financial statement users to understand how management monitors the credit quality of its debt instruments and assess the quantitative and qualitative risks arising from the credit quality of its debt instruments. In this respect, an entity should provide quantitative and qualitative information by class of financial asset about the credit quality, including:

1. A description of the credit-quality indicator;
2. The amortized cost, by credit-quality indicator; and
3. For each credit-quality indicator, the date or range of dates in which the information was last updated for that credit-quality indicator.

An entity should provide this information by major security type and by class of financial asset.
If an entity discloses internal risk ratings, then the entity should provide qualitative information on how those internal risk ratings relate to the likelihood of loss.

The disclosure requirements above do not apply to short-term trade receivables that result from revenue transactions within the scope of ASC 605, *Revenue Recognition*, or ASC 606*, Revenue from Contracts with Customers*.

Allowance for expected credit losses

An entity should provide information that enables financial statement users to understand:

- Management's method for developing its allowance for expected credit losses;
- The information that management has used in developing its current estimate of expected credit losses; and
- The economic circumstances that caused changes to the allowance for expected credit losses, thereby affecting the related credit loss expense (or reversal) recognized during the period.

In this respect, an entity should disclose by portfolio segment a description of the entity's accounting policies and methodology used to estimate the allowance for expected credit losses, including:

1. A description of how expected loss estimates are developed;
2. A description and discussion of the factors that influenced management's current estimate of expected credit losses, including past events, current conditions, and reasonable and supportable forecasts about the future;
3. A discussion of risk characteristics relevant to each portfolio segment;
4. A discussion of the changes in the factors that influenced management's current estimate of expected credit losses and the reasons for those changes (for example, changes in loss severity, change in portfolio composition, change in volume of assets whether purchased or originated, and significant events or conditions that affect the current estimate but were not contemplated during the previous period);

The following disclosures should also be made, by portfolio segment:

- Identification of any changes to the entity's accounting policies or methodology from the prior period and the entity's rationale for the change, if applicable;
- A discussion of the reversion method applied for periods beyond the reasonable and supportable forecast period;
- Reasons for significant changes in the amount of write-offs, if applicable;
- The amount of any significant purchases of financial assets during each reporting period; and
- The amount of any significant sales of financial assets or reclassifications of loans held for sale during each reporting period.

Roll forward of the allowance account

Furthermore, to enable financial statement users to understand the activity in the allowance for expected credit losses for each period, by portfolio segment and major security type, an entity should separately provide the following quantitative disclosures for financial assets within the scope of this standard:

1. The beginning balance in the allowance for expected credit losses;
2. Current period provision for credit losses;
3. The initial allowance for credit losses recognized on PCD assets;
4. Write-offs charged against the allowance;
5. Recoveries of amounts previously written off; and
6. The ending balance in the allowance for expected credit losses.

Aging analysis

To enable financial statement users to understand the extent of financial assets that are past due, an entity should provide an aging analysis of the amortized cost for debt instruments that are past due as of the reporting date, disaggregated at the class of financial receivable and major security type. Furthermore, an entity should disclose when it considers a debt instrument to be past due.

Further, to enable financial statement users to understand the credit risk and interest income recognized on financial assets on nonaccrual status, an entity should disclose all of the following, disaggregated at the financing receivable and major security type level:

1. The amortized cost of debt instruments on nonaccrual status as of the beginning of the reporting period and the end of the reporting period;
2. The amount of interest income recognized during the period on nonaccrual debt instruments in accordance with paragraph 825-15-25-10;
3. The amortized cost of debt instruments that are 90 days or more past due, but not on nonaccrual status as of the reporting date; and
4. The amortized cost of debt instruments on nonaccrual status for which there are no related expected credit losses as of the reporting date because the debt instrument is a fully collateralized collateral-dependent financial asset.

Purchased financial assets with credit impairment

To the extent an entity purchased credit-impaired financial assets during the current reporting period, an entity should provide a reconciliation of the difference between the purchase price of the assets and the par value of the assets, including:

1. The purchase price;
2. Based on the acquirer’s assessment, the discount attributable to expected credit losses;
3. The discount (or premium) attributable to other factors; and
4. The par value.

Collateral-dependent financial assets

An entity should describe the type of collateral by class of financial asset, major security type, and the type of collateral, and should also describe qualitatively the extent to which collateral secures its financial assets.

An entity should explain qualitatively by class of financial asset and major security type, significant changes in the extent to which collateral secures those financial assets, whether because of general deterioration or some other reason.

Off-balance-sheet credit exposures

In addition to other required disclosures, an entity shall disclose a description of the accounting policies and methodology used to estimate its liability for off-balance-sheet credit exposures and related charges for those credit exposures. This disclosure should identify the factors that influenced management’s judgment and a discussion of risk elements relevant to particular categories of financial instruments.

Additional disclosures for financing receivables and net investments in leases

For only public business entities with net investment in leases and other financial receivables, the amortized cost basis within each credit quality indicator by year of origin should be disclosed. In presenting this disclosure, consider the following:

- For year of origin before the fifth annual period, the information can be presented in the aggregate.
- Lessor should use guidance in ASC 842-10-25-8 and 9 to determine if the modification is a current-period origin.

The purpose of disclosure is to show credit trends by year of origin of the credit indicator.

The following is an example disclosure by a lessor of its collectability considerations:

> When a business relationship with a customer is initiated, we evaluate collectability from the customer, and it is continuously monitored as services are provided. We have a credit rating system based on internally developed standards and ratings provided by third parties.
>
> Our credit rating system, along with monitoring for delinquent payments, allows us to make decisions as to whether collectability is probable at the on-set of the relationship and subsequently as we offer services. Factors considered during this process include historical payment trends, industry risks, liquidity of the customer, years in business, judgments, liens, and bankruptcies. Payment terms vary by contract type, although terms generally include a requirement of payment within 15 to 90 days.

ASU 2022-02 has brought in some new disclosure requirements that focus on modifications of receivables made to borrowers facing financial difficulties. The main goal here is to give users insight into the kinds of modifications that have been made, how big these modifications are, and how successful they have been in minimizing potential credit losses.

The updated guidance keeps (with some changes) the existing guidance on determining when a borrower is having financial difficulties as well as certain disclosures. For instance, it maintains the requirement for creditors to reveal the amount of any commitments to lend extra funds to borrowers in financial distress, for whom the creditor has modified the terms of the receivables via principal forgiveness, interest rate reduction, significant payment delay, or term extension during the current reporting period. Additionally, it keeps the guidance that certain financing receivables (like those measured at fair value with changes in fair value reported in current earnings) are not subject to these disclosures. These disclosure requirements apply whether a modification to a receivable from a debtor in financial difficulty results in a new loan or a modified loan.

For all income statement periods presented, reporting entities must disclose the following for modifications of receivables made to borrowers facing financial difficulty during the reporting period in the form of principal forgiveness, interest rate reduction, significant payment delay, or term extension:

- Qualitative and quantitative information, by class of financing receivable, including:
  - By type of modification, the total period-end amortized cost basis and the percentage relative to the total period-end amortized cost basis of receivables in the class of financing receivable.
  - The financial impact of the modification, providing information about the changes to the contractual terms due to the modification, including:
    - The incremental effect of principal forgiveness on the amortized cost basis; and/or
    - The reduction in the weighted-average interest rate (versus a range) for interest rate reductions.
  - The performance of the asset in the 12 months following the modification.
- Qualitative information, by portfolio segment, discussing how such modifications factored into the determination of the allowance for credit losses.

If a receivable is modified in more than one way (e.g., an interest rate reduction and principal forgiveness), this modification should be displayed in a separate category of modification type.

For all income statement periods presented, if there was a payment default during the period and the loan had been modified in the form of principal forgiveness, an interest rate reduction, a significant payment delay, or a term extension within the previous 12 months preceding the payment default when the borrower was experiencing financial difficulty, the reporting entity should also disclose the following:

- Qualitative and quantitative information, by class of financing receivable, about:
  - The types of contractual change that the modification provided; and
  - The amount of financing receivables that defaulted, including the period-end amortized cost basis for financing receivables that defaulted.
- Qualitative information, by portfolio segment, discussing how such defaults factored into the determination of the allowance for credit losses.

For an illustration of the disclosures mentioned above, refer to Example 3 within ASC 310-10-55-12A. These disclosures are required to be included in annual and interim periods in accordance with ASC 270-10-50-1.

ASU 2022-02 also included enhanced disclosures for public business entities. This update requires that an entity disclose current period gross write-offs by year of origination for financing receivables and net investments in leases within the scope of subtopic 326-20, *Financial Instruments – Credit Losses – Measured at Amortized Cost*.

VI. Application exercise

A. Exercise background

Part A

At December 31, 20X1, Bank A has a portfolio of personal loans with an amortized cost of $5,000,000 and with a term of 5 years. Historically, Bank A has seen a loss rate on its loan balance of .5 percent loss per year of the loan. Due to recent decreases in unemployment, Bank A expects this loss rate to decrease to .4 percent over the next two years. However, it is not able to develop a reasonable and supportable forecast for such losses past the next two years, as it feels that its expectations for the unemployment rate, which strongly correlates with loan defaults, are not supportable past a two-year period.

Bank A uses a loss-rate approach to determine its allowance for credit losses under ASU No. 2016-13.

Given this information, develop an estimate for Bank A's allowance for credit losses as of December 31, 20X1, under the guidance of ASU No. 2016-13.

Part B

Before calculating its necessary allowance for credit losses at December 31, 20X1, Bank A had an allowance for credit losses of $50,000. Propose the journal entry to record the amount that Bank A has determined to be required in its allowance for credit losses account as of December 31, 20X1.

B. Exercise solution

Part A

At December 31, 20X1, Bank A has a portfolio of personal loans with an amortized cost of $5,000,000 and with a term of 5 years, payable ratably each year. Historically, Bank A has seen a loss rate on its loan balance of .5 percent loss per year of the loan. Due to recent decreases in unemployment, Bank A expects this loss rate to decrease to .4 percent over the next two years. However, it is not able to develop a reasonable and supportable forecast for such losses past the next two years, as it feels that its expectations for the unemployment rate, which strongly correlates with loan defaults, are not supportable past a two-year period.

Bank A uses a loss-rate approach to determine its allowance for credit losses under ASU No. 2016-13.

Given this information, develop an estimate for Bank A's allowance for credit losses as of December 31, 20X1, under the guidance of ASU No. 2013-13.

Bank A's calculation of its estimated allowance for credit losses could look as follows:

	20X2	20X3	20X4	20x5	20X6
Loan Portfolio	$5,000,000	$4,000,000	$3,000,000	$2,000,000	$1,000,000
Expected credit loss %, per year	.4%	.4%	.5%	.5%	.5%
Expected credit loss, by year	$20,000	$16,000	$15,000	$10,000	$5,000
Total estimated credit losses					$66,000

Note that as Bank A's estimate of credit losses is only reasonable and supportable for the next two years, it should revert to its historical loss rate for the period of time in the term of the loan which is beyond this estimation period. In this case, this would be for years 3 through 5 of the loan term.

Part B

Given the above analysis, Bank A would record the following journal entry at December 31, 20X1 in order to properly state its allowance for credit losses:

Credit losses expense	$16,000	
Allowance for credit losses		$16,000

