

Current Issues in Accounting and Auditing: An Annual Update

AAU4/26/V1-A1

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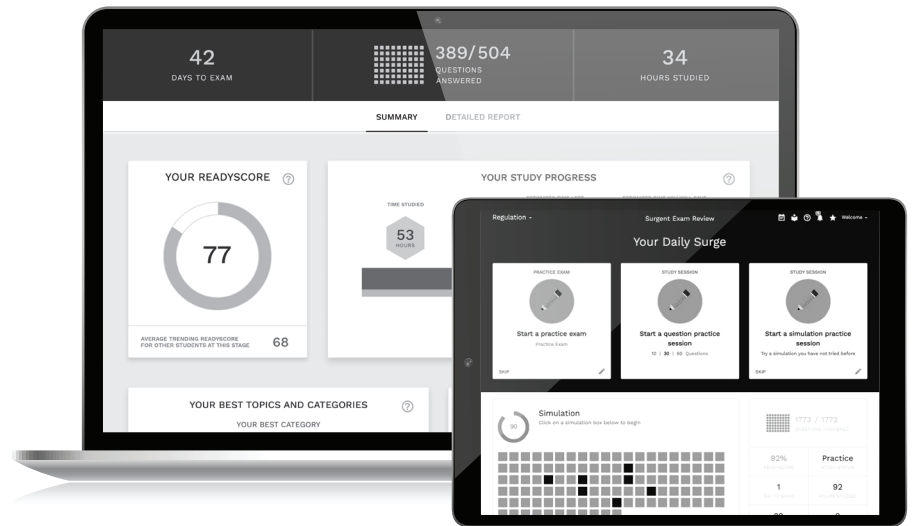
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Revised June 2026

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Supplement: ASU Nos. 2026-01 to 02

I. ASU No. 2026-02, Environmental Credits and Environmental Credit Obligations (Topic 818)

A. Executive summary

ASU 2026-02 is one of the most significant standards issued by the FASB in recent years because it creates an entirely new Topic (Topic 818) to address the accounting for environmental credits and environmental credit obligations, including carbon offsets. Prior to the Update, GAAP lacked authoritative guidance in this area, causing entities to account for environmental credits by analogy to inventory, intangible asset, and contingency guidance. The result was substantial diversity in practice.

The Update establishes a comprehensive recognition, measurement, presentation, and disclosure framework for environmental credits such as emissions allowances, renewable identification numbers (RINs), renewable energy certificates (RECs), and carbon offsets. It also creates a dedicated model for obligations arising from regulatory compliance programs.

B. Background and reason for issuance

Environmental markets have expanded dramatically over the last two decades. Entities increasingly participate in cap-and-trade systems, renewable fuel standards, renewable portfolio standards, and voluntary carbon reduction programs. Despite this growth, GAAP contained no dedicated accounting framework for these arrangements.

As a result, companies often analogized the accounting to inventory accounting, intangible asset accounting, or contingency guidance, producing inconsistent recognition and measurement outcomes. The Board's objective was not to measure greenhouse-gas emissions or evaluate environmental performance. Rather, its objective was to establish consistent financial reporting requirements for environmental credits and the obligations associated with regulatory compliance programs.

C. Main provisions

The Update introduces new definitions and accounting models for both environmental credits and environmental credit obligations.

An environmental credit is defined as "enforceable rights represented to prevent, control, reduce, or remove emissions or other pollution that are separately transferable in an exchange transaction." Examples include emissions allowances, renewable energy certificates, renewable identification numbers, and carbon offsets.

1. Environmental credits

Environmental credits are recognized as assets only when it is probable that they will be:

- a. Used to settle an environmental credit obligation;
- b. Transferred in an exchange transaction; or
- c. Used in a nonreciprocal transfer.

Credits acquired solely for voluntary sustainability initiatives, such as voluntary net-zero commitments, generally are expensed as incurred rather than recognized as assets.

The Update creates two categories:

- a. **Compliance environmental credits** – Credits expected to be used to satisfy regulatory obligations. These remain recorded at cost and are not subsequently remeasured.
- b. **Noncompliance environmental credits** – All other credits held for other purposes, such as trading. These are measured at cost less impairment and must be tested for impairment each reporting period. The credit is impaired if carrying value exceeds fair value. Impairment reversals are prohibited.

Entities may elect a fair value option for certain eligible classes of noncompliance credits, with changes recognized in earnings. Entities are required to present compliance environmental credit assets separately from environmental credit obligation liabilities on the balance sheet (e.g., no offsetting).

Disclosure requirements: The entity must disclose qualitative information about how it obtains and intends to use such credits. The entity must also disclose the current and noncurrent portions of the credits, total impairment expense, and total expenses for voluntary environmental credits. For annual reporting periods, if the use or intended use of environmental credits changes, the company must disclose:

- a. The nature of the change as of the date it occurs; and
- b. The impact on earnings.

2. Environmental credit obligation liabilities (ECOs)

The Update separately addresses obligations arising from regulatory compliance programs. An environmental credit obligation (ECO) is defined as “enforceable obligations resulting from regulatory compliance programs represented to prevent, control, reduce, or remove emissions or other pollution that may be settled with environmental credits.” An obligation is recognized when emissions or other qualifying events occur that create a compliance requirement. Voluntary environmental commitments do not create environmental credit obligations under Topic 818.

The entity must measure the ECO “using the carrying amount of the compliance environmental credits that the entity holds and expects to use to settle that obligation at the reporting date.” This is referred to as the funded portion of the ECO. If the entity lacks sufficient credits to satisfy the liability, the unfunded portion must be “measured at the fair value of the environmental credits necessary to settle the unfunded portion at the reporting date, with certain exceptions.” The ECO should be derecognized when an entity remits the necessary environmental credits to a regulator.

Disclosure requirements – For annual periods, the entity must disclose the following:

- a. The activities or events that result in environmental credit obligation liabilities under those programs, including the nature and timing of settlement provisions;
- b. The accounting policies used to account for the environmental credit obligations;
- c. How the unfunded portion of an environmental credit obligation liability is measured;
- d. Significant estimates and judgments used in applying the guidance;
- e. The current and noncurrent amounts of the funded and unfunded portions of environmental credit obligation liabilities (if not separately presented on a classified balance sheet);

- f. Total expense related to environmental credit obligation liabilities; and
- g. Total costs associated with environmental credit obligation liabilities that are capitalized in the carrying amount of another asset during the reporting period in accordance with another Topic.

D. Implications for practice

ASU 2026-02 will significantly affect utilities, energy companies, manufacturers, transportation companies, commodity traders, and other entities participating in environmental credit markets. The ASU establishes a clear distinction between regulatory compliance activities and voluntary environmental initiatives.

E. Impacted entities, effective date, and transition

The ASU applies to all entities. For public business entities, the Update is effective for annual periods beginning after December 15, 2027, including interim periods. For all other entities, the effective date is December 15, 2028. Early adoption is permitted as of the beginning of an annual reporting period. The standard is adopted using a retrospective approach through a cumulative-effect adjustment to opening retained earnings. Prior periods are not restated. At adoption, entities must reassess existing environmental credits and obligations under the new framework, including derecognizing certain voluntary environmental credits that no longer qualify for asset recognition and recognizing EC assets if it's probable the entity will use ECs to settle an ECO, transfer the credit in an exchange transaction, or use the credit in a nonreciprocal transfer. Exact measurement approaches are explained in more detail in the ASU.

II. ASU No. 2026-01, Equity (Topic 505): Initial Measurement of Paid-in-Kind Dividends on Equity-Classified Preferred Stock

A. Executive summary

The FASB issued ASU 2026-01 to establish authoritative guidance for the initial measurement of paid-in-kind (PIK) dividends on equity-classified preferred stock. Prior to this Update, U.S. GAAP addressed when PIK dividends should be recognized but did not provide explicit guidance regarding how they should be measured. As a result, issuers used varying approaches, including fair value measurement and measurement based on contractual dividend rates, creating diversity in practice and reducing comparability across financial statements.

The Update resolves this issue by requiring issuers to measure PIK dividends based on the dividend rate specified in the preferred stock agreement. While narrow in scope, the amendment affects reported preferred stock balances, income available to common shareholders, and earnings-per-share calculations. The Board concluded that the new guidance improves comparability while reducing cost and complexity.

B. Background and reason for issuance

The project originated with the Emerging Issues Task Force (EITF), which received stakeholder feedback regarding widespread diversity in practice for PIK dividends on equity-classified preferred stock. Some issuers measured dividends using the fair value of additional preferred shares issued, while others measured them using the contractual PIK dividend rate. Certain entities even applied different approaches depending on whether payment in kind was discretionary or mandatory.

Stakeholders emphasized that this inconsistency affected not only the carrying amount of preferred stock but also the amount of income available to common shareholders and related EPS calculations. The Board determined that authoritative guidance was necessary to improve comparability and provide investors with more consistent information about preferred shareholders' claims.

C. Main provisions

The core provision requires that PIK dividends on equity-classified preferred stock be initially measured using the PIK dividend rate specified in the preferred stock agreement. For example, if the agreement specifies that dividends equal a stated percentage multiplied by the liquidation value of the preferred stock, the dividend is measured using that formula.

The Update defines PIK dividends as dividends satisfied either by issuing additional preferred shares with terms identical to the original instrument or by increasing the value of the existing preferred stock, such as increasing the original's liquidation value.

Importantly, the guidance applies to preferred stock classified as equity, including certain preferred stock classified as temporary equity under SEC guidance. However, it does not apply to situations in which a fixed monetary dividend obligation is satisfied by issuing a variable number of shares with equivalent value, nor does it apply to deemed dividends arising from certain redemption transactions.

Unlike fair value approaches, it does not require recurring valuation exercises or subjective judgments regarding market pricing.

D. Illustrative example

Consider a preferred stock instrument with a liquidation value of \$10 million and a contractual PIK dividend rate of 8 percent. Under the new guidance, the issuer would recognize a PIK dividend of \$800,000 ($\$10\text{M} \times 8 \text{ percent}$) based on the contractual formula. If the dividend is paid through issuance of additional preferred shares or by increasing the liquidation preference of the existing instrument, the measurement remains tied to the contractual rate rather than the fair value of the additional shares issued.

E. Implications for practice

For most issuers, implementation should be straightforward because the required inputs already exist within preferred stock agreements. The Board specifically noted that entities generally will not need valuation specialists or complex fair value analyses.

F. Impacted entities, effective date, and transition

The amendments are effective for all entities that issue PIK dividends on equity-classified preferred stock for annual reporting periods beginning after December 15, 2026, including interim periods within those years. Early adoption is permitted.

Entities may choose either:

- a. **Prospective application**, applying the new guidance to PIK dividends recognized after adoption; or
- b. **Modified retrospective application**, applying the guidance to equity-classified preferred stock instruments that are outstanding as of the initial application date.

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FASB Accounting Standards Updates, Including the Activities of the PCC

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 2025 and 2024, that are effective in 2025 and beyond. It also covers ASUs issued prior with ongoing significance or application in 2026.

II. Key ASUs issued in 2024 and 2025

A. ASU No. 2025-11, *Interim Reporting (Topic 270)*

1. Executive summary and reason for issuance

ASU 2025-11 reorganizes Topic 270 to present a clearer, more coherent framework for interim disclosures. The Update clarifies what must be disclosed in condensed interim financial statements, consolidates scattered legacy guidance, and updates cross-references throughout the Codification. It does not add to or reduce existing disclosure requirements.

The central theme of the ASU is an explicit requirement to disclose events that occur after the end of the last annual reporting period that have a material impact on the entity. Topic 270 now directs preparers to consider applicable annual disclosure requirements as the baseline for explaining material interim events, rather than relying on minimal or generic quarterly descriptions.

The amendments do not create new categories of required information but instead streamline how interim disclosure requirements are presented. Conforming amendments across numerous Topics update the labeling of interim disclosure requirements and align them with the revised structure.

Public business entities apply the amendments beginning in 2027, with all other entities following in 2028. Early adoption is permitted, and transition may be prospective or retrospective to any or all periods presented.

2. Main provisions

Reorganized interim reporting framework

Topic 270 is restructured to articulate a clearer disclosure principle: interim financial statements must include the information necessary to avoid being misleading, taking into account users' access to the latest annual financial statements. The guidance now delineates (a) general interim disclosure principles, (b) minimum required disclosures, and (c) how interim requirements in other Topics interact with Topic 270.

Explicit requirement to disclose material post-year-end events

New paragraphs 270-10-50-68 through 50-70 require disclosure of material events occurring after the last annual reporting period that significantly affect the entity, such as major estimate changes, impairments, restructurings, financing changes, and business combinations. Preparers must look to annual disclosure requirements for the relevant Topic to determine the scope of interim disclosure for these events.

Clarification of when annual disclosures are needed in interim periods

Preparers must provide annual-type disclosures when necessary to explain a material interim event but need not repeat annual disclosures that have not changed. Continuing contingencies and uncertainties must be disclosed and repeated at each interim date until resolved or immaterial.

Conforming amendments across the Codification

More than 100 conforming amendments revise interim disclosure references in Topics including fair value, credit losses, financial instruments, segments, revenue, leases, and insurance. These amendments do not add new disclosures; they align terminology and cross-references with the reorganized Topic 270.

3. Effective date and transition

This ASU is effective for interim reporting periods within annual reporting periods beginning after December 15, 2027, for public business entities and for interim reporting periods within annual reporting periods beginning after December 15, 2028, for entities other than public business entities.

Early adoption is permitted.

B. ASU No. 2025-10, *Government Grants (Topic 832): Accounting for Government Grants Received by Business Entities*

1. Executive summary

In December 2025, the FASB issued ASU 2025-10 to establish, for the first time, authoritative U.S. GAAP on the accounting for government grants received by business entities. Historically, business entities relied on IAS 20, Topic 450, or portions of Subtopic 958-605 by analogy, resulting in persistent diversity in practice. Despite the introduction of disclosure-only requirements in Update 2021-10, stakeholders, including preparers, auditors, and investors, noted that recognition and measurement remained unaddressed areas of inconsistency.

The Update introduces a comprehensive recognition and measurement framework for government grants, distinguishing between grants related to assets and grants related to income, and specifying the timing and pattern of recognition. The amendments promote greater consistency while preserving optionality in several areas, reflecting the Board's conclusion that no single method had sufficient

stakeholder support to mandate universally (this approach led to three Board members to dissent from the final ruling).

2. Background and reason for issuance

Prior to this Update, U.S. GAAP lacked explicit guidance on government grants issued to business entities. During that time, entities developed various analogies, most prominently IAS 20, resulting in a patchwork of practices across industries. Stakeholder feedback emphasized that increased federal and state grant activity, including programs tied to pandemic relief and climate-related legislation, magnified the need for authoritative GAAP.

Investors sought more transparent and consistent reporting, particularly in light of the variation between cost-basis adjustments, deferred-income models, and cash-basis recognition that arose under different analogies. Preparers and auditors stressed the need for clarity regarding when grants should be recognized, especially when conditions span multiple periods, and how repayable or forgivable arrangements should be handled.

After deliberations and extensive outreach, the Board concluded that recognition, measurement, and presentation guidance should be codified within Topic 832, replacing reliance on nonauthoritative analogies.

3. Main provisions

ASU 2025-10 provides a unified GAAP model for recognition, measurement, and presentation of government grants. The amendments apply to business entities and exclude not-for-profit organizations and employee benefit plans. A government grant is defined as a transfer of a monetary or tangible nonmonetary asset from a governmental entity, outside of an exchange transaction.

Recognition threshold

A government grant received by the entity cannot be recognized until two criteria are met:

- a. It is probable that the entity will (1) comply with any attached grant conditions, and (2) the entity will receive the grant; and
- b. A business entity meets the recognition guidance for a grant related to an asset or a grant related to income.

This “probable” threshold replaces IAS 20’s “reasonable assurance,” which stakeholders applied inconsistently. Recognition cannot occur solely upon receipt of proceeds; recognition must coincide with both probability of meeting conditions and the incurrence of related costs.

Grants related to assets

For a government grant conditioned on the purchase, construction, or acquisition of an asset, an entity must choose one of two recognition approaches (Summary, pp. 6–7):

- a. **Deferred income approach** – The grant is recorded as deferred income on the balance sheet and amortized to earnings in a systematic and rational manner as the related asset costs are recognized (for example, through depreciation, impairment, or sale).
- b. **Cost accumulation approach** – The grant reduces the cost basis of the related asset. Under this approach, no separate subsequent recognition of grant income occurs; instead, the reduced cost basis yields lower depreciation or gains/losses over the asset’s life.

The ASU retains optionality because stakeholders and Board members could not agree on a single model (over the dissent of the three Board members), and many preparers already use both by analogy.

Grants related to income

Grants not directly tied to the acquisition of an asset are treated as income grants. These are recognized in earnings on a systematic and rational basis over the periods in which the entity incurs the expenditures the grant is intended to reimburse. Grants intended to compensate for prior expenditures or provide immediate financial support are recognized when the recognition threshold is met (Summary, p. 7).

Measurement of tangible nonmonetary grants

Entities receiving nonmonetary assets (such as land or equipment) may:

- a. Measure the asset at fair value under the deferred income approach if the grant is related to an asset; or
- b. Measure it at cost to the entity under the cost accumulation approach (Codification 832-10-30-1).

Repayment of grants

If a grant becomes repayable (e.g., when conditions are not met), the repayment is accounted for based on the nature of the underlying grant (832-10-35-1):

- a. **Income grants** – Repayments first reduce any unamortized deferred income; excess repayments are recognized immediately in earnings.
- b. **Asset grants** – Repayments either increase the asset's carrying amount (cost accumulation approach) or reduce the deferred income balance (deferred income approach), with any excess also recognized in earnings.

Presentation requirements

Grant proceeds may be presented in earnings either:

- a. As other income; or
- b. As a deduction from related expenses (Summary, p. 7).

Disclosure requirements

Entities must disclose (832-10-50-3 and 50-3A–C):

- a. The nature and form of the grant;
- b. Accounting policies applied (including which approach is used for asset grants) – “for example, for a grant related to an asset, whether the deferred income approach or the cost accumulation approach is applied, or for a grant related to income, whether the grant is presented separately under a general heading such as other income or deducted from the related expense”;
- c. Significant terms and conditions of the grant;
- d. Affected financial statement line items and amounts;
- e. For tangible nonmonetary grants, the fair value in the period recognized.

4. Illustrative examples

The ASU provides examples (Illustrations, pp. 19–25) that clarify application in practice:

Example 1: Grant related to an asset

A business receives a \$5 million grant to fund the purchase of a building, which is the only grant condition. Once the entity concludes it is probable that it will meet grant conditions and acquires the building, it may elect either:

- a. A deferred income approach, amortizing the grant over the building's 40-year useful life; or
- b. A cost accumulation approach, reducing the building's carrying amount cost basis and therefore reducing future depreciation.

Example 2: Grant related to income

A pharmaceutical entity receives a \$2 million cost-reimbursement grant for R&D activity. It recognizes the grant progressively over the two-year period in which qualifying expenditures occur, with no recognition before costs are incurred and no receivable until expenditures give rise to a claim.

5. Implications for practice

ASU 2025-10 introduces a long-awaited authoritative framework in GAAP, which should reduce diversity in application and enhance comparability across preparers. The Update preserves optionality – particularly around asset grants and income-statement presentation – responding to concerns about the varied economic objectives of public and private grant programs.

However, the optionality means entities must apply judgment in selecting policies and then apply them consistently for similar grants. Disclosure demands also increase, particularly for grants involving nonmonetary assets or complex, multi-period conditions.

The Board acknowledged dissents, which highlight concerns around conceptual consistency, specifically whether deferred income constitutes a liability under the conceptual framework and whether the cost accumulation approach obscures the economic value of tangible nonmonetary grants. Despite those concerns, the majority concluded that the benefits of codifying existing practice outweighed these conceptual tensions.

6. Effective date and transition

The amendments become effective as follows (Summary, pp. 8–9):

- a. **Public business entities** – Annual periods beginning after December 15, 2028, and interim reporting periods within those annual periods.
- b. **All other entities** – Annual periods beginning after December 15, 2029, and interim reporting periods within those annual periods.
- c. **Early adoption** is permitted in both interim and annual reporting periods.

Entities may choose among **three transition methods**:

- a. **Modified prospective** – Apply to grants entered into on or after the effective date and to incomplete grants – no restatement and no cumulative-effect adjustment.
- b. **Modified retrospective** – Restate only incomplete grants as of the earliest period presented, with a cumulative-effect adjustment to the opening balance of retained earnings.
- c. **Full retrospective** – Restate all periods presented with a cumulative-effect adjustment to the opening balance of retained earnings.

C. ASU No. 2025-09, *Derivatives and Hedging (Topic 815): Hedge Accounting Improvements*

1. Executive summary

ASU 2025-09 introduces targeted improvements to hedge accounting to enhance operability, address areas of diversity in practice, and respond to market developments following global reference rate reform. The Update is consistent with the original objective of ASU 2017-12 and focuses on five issues: similar risk assessment for cash flow hedges, hedging forecasted interest payments on choose-your-rate instruments, hedge accounting for nonfinancial forecasted transactions, net written options in hedge relationships, and foreign-currency-denominated debt instruments as hedging instrument and hedged item (dual hedge).

2. Background and reason for issuance

Following Update 2017-12, stakeholders continued to request clarification on several hedge accounting topics, including application of similar risk assessments, designation of hedged risks, and treatment of basis adjustments in dual hedges. In addition, the cessation of LIBOR created new complexities for hedging strategies involving interest rate swaps and optionality embedded in debt instruments. The Board responded with a targeted yet comprehensive refinement designed to align accounting more closely with contemporary risk management strategies.

3. Main provisions

Issue 1: Similar risk assessment for cash flow hedges

The Update fundamentally reshapes how entities determine whether a group of individual forecasted transactions may be designated together in a single cash flow hedge. Under prior guidance, forecasted transactions needed to have a *shared* risk exposure, a requirement interpreted narrowly in practice and one that often prevented entities from grouping transactions that were economically similar but not perfectly aligned in timing, volume, or rate sensitivity. ASU 2025-09 replaces the “shared risk exposure” standard with a more flexible “*similar* risk exposure” requirement.

Under the new standard, a group of forecasted transactions qualifies for hedge designation if the derivative hedging instrument is highly effective in offsetting the designated risk for each hedged risk in the group.

Issue 2: Hedging forecasted interest payments on choose-your-rate debt instruments

The Update introduces a new model designed specifically for choose-your-rate debt, which contains contractual provisions permitting the borrower to change both the interest rate index and the interest-rate tenor (for example, switching from SOFR one-month to SOFR three-month). Under the previous guidance, such contractual optionality risked triggering dedesignation because a change in index or tenor constituted a change in the hedged risk, even if the borrower’s intent and exposure were economically continuous.

ASU 2025-09 establishes a structured framework permitting entities to apply hedge accounting to forecasted or existing interest payments on choose-your-rate debt without dedesignating the hedging relationship when contractual terms change. The Update allows entities to use simplified probability assessments and streamlined hedge-effectiveness evaluations when the debt terms meet the criteria for choose-your-rate treatment. An entity may apply this model to existing, forecasted issuances of, and subsequent replacements of choose-your-rate debt.

Entities are prohibited from applying this guidance by analogy to other circumstances.

Issue 3: Cash flow hedges of nonfinancial forecasted transactions

This issue expands hedge accounting eligibility for forecasted purchases and sales of nonfinancial assets, particularly in industries such as energy, manufacturing, chemicals, and agriculture, where entities routinely face exposure to variable underlying inputs or referenced pricing components. Under the prior framework, entities could hedge only contractually specified components, meaning that if a contract did not explicitly name the price component being hedged, hedge accounting was prohibited, even when the component clearly drove the asset's economics.

ASU 2025-09 moves away from the contractual-specification requirement and instead permits designation of variable price components that are clearly and closely related to the nonfinancial asset being acquired or sold. This includes components embedded in spot-market transactions and forward-market transactions, as well as subcomponents of explicitly referenced pricing components in an agreement's pricing formula. To qualify for hedge designation, the variable price component of the forecasted purchase or sale of a nonfinancial asset is required to be clearly and closely related to the NFA being purchased or sold in the current normal purchases and normal sales exception.

The amendment further clarifies that entities may designate a variable price component in a contract that is accounted for as a derivative as the hedged risk if all other hedge criteria are satisfied.

The shift is significant. It acknowledges that contracts often reference only broad pricing mechanisms or indices, while economic exposure may stem from underlying elements within those mechanisms.

Issue 4: Net written options as hedging instruments

In response to the elimination of LIBOR, ASU 2025-09 eliminates the requirement to apply the net written option test to certain compound derivatives that include both a swap component and a written option designated as the hedging instrument in a cash flow hedge or fair value hedge of interest rate risk.

Issue 5: Foreign-currency-denominated debt instrument as hedging instrument and hedged item (dual hedge)

A dual hedge strategy is a hedge for which a foreign-currency-denominated debt instrument is both designated as the hedging instrument in a net investment hedge and designated as the hedged item in a fair value hedge of interest rate risk.

Under prior GAAP, this dual-designated strategy produced a recognition mismatch because the fair value hedge-related basis adjustment flowed through earnings, while the net investment hedge assessment measured effectiveness based on the instrument's full spot-rate exposure. This mismatch distorted hedge outcomes and complicated financial reporting.

ASU 2025-09 resolves this issue by requiring entities to exclude the debt instrument's fair value hedge basis adjustment from the net investment hedge effectiveness assessment. As a result, gains and losses from remeasuring the debt instrument's fair value hedge basis adjustment at spot exchange rates are recognized immediately in earnings, eliminating the asymmetry in prior guidance.

4. Implications for practice

The Update provides greater flexibility in achieving and maintaining hedge accounting, reduces the likelihood of dedesignation due to changes in contractual terms, and permits broader use of hedge accounting in nonfinancial transactions. Entities may find hedge programs easier to align with economic strategies, and financial reporting will more accurately represent risk management activities.

5. Effective date and transition

For public business entities, ASU 2025-09 is effective for annual reporting periods beginning after December 15, 2026, and interim periods within those annual reporting periods. For entities other than public business entities, the amendments are effective for annual reporting periods beginning after December 15, 2027, and interim periods within those annual reporting periods. Early adoption is permitted.

The Update is applied prospectively for all hedging relationships, and entities may modify hedge documentation for existing hedges without dedesignating the hedge, allowing for smooth transition and operational continuity. The entity may elect to adopt the ASU for hedging relationships that exist as of the date of adoption even if they originated prior to adoption.

D. ASU No. 2025-08, *Financial Instruments – Credit Losses (Topic 326): Purchased Loans*

1. Executive summary

ASU 2025-08 revises the accounting for acquired loans under Topic 326 by expanding the population of assets subject to the gross-up approach and reducing those subject to credit loss expense on day one. Historically, the distinction between purchased credit-deteriorated (PCD) and non-PCD loans created inconsistent and sometimes uneconomic results, particularly where non-PCD loans produced day-one credit loss expense despite expected credit losses already reflected in fair value. This Update introduces the concept of purchased seasoned loans (a new term) and significantly reduces reliance on subjective credit-quality assessments. It aligns acquisition accounting with the economic substance of purchased loan portfolios.

2. Background and reason for issuance

Following the issuance of ASU 2016-13, the Board monitored implementation through its post-implementation review (PIR) process. Stakeholders identified two key challenges: the operational difficulty of consistently distinguishing PCD from non-PCD loans and the uneconomic day-one loss recognition required for non-PCD assets. Investors described this treatment as “double counting” because expected credit losses were reflected both in the acquisition date fair value and in the newly recorded expense and related allowance. Preparers reported diversity in application, reducing comparability across financial institutions. ASU 2025-08 was issued to reduce this complexity and enhance the decision usefulness of information about acquired loans.

3. Main provisions

ASU 2025-08 introduces purchased *seasoned* loans by deeming all non-PCD loans acquired in a business combination as seasoned and by requiring other acquired loans to be evaluated using bright-line seasoning criteria. All non-PCD loans (excluding credit cards) that are acquired in a business combination are deemed seasoned. A loan is also seasoned if: (a) it is purchased more than 90 days

after origination, and (b) the acquirer was not involved in the origination of the loan. Purchased seasoned loans are accounted for under the gross-up approach, which adds the initial allowance for credit losses to the purchase price to determine the loan's amortized cost basis.

4. Implications for practice

The Update significantly reduces the number of acquired loans subject to day-one loss recognition and improves comparability by focusing on the nature and timing of acquisition rather than subjective evaluations of credit quality deterioration. It also improves alignment between fair value and allowance methodologies and reduces unnecessary volatility in acquisition-period results.

5. Effective date and transition

ASU 2025-08 is effective for annual reporting periods beginning after December 15, 2026, including interim periods within those annual reporting periods. Early adoption is permitted. The Update must be applied prospectively to loans acquired on or after the application date. Entities adopting in an interim period must apply the amendments either at the start of the interim period of adoption or the beginning of the annual period that includes that interim period.

E. ASU No. 2025-07, *Derivatives and Hedging (Topic 815) and Revenue from Contracts with Customers (Topic 606)*

1. Executive summary

In September 2025, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2025-07, *Derivatives and Hedging (Topic 815) and Revenue from Contracts with Customers (Topic 606): Derivatives Scope Refinements and Scope Clarification for Share-Based Noncash Consideration from a Customer in a Revenue Contract*. This dual-issue Update modernizes and clarifies the accounting treatment for two areas of concern: (1) the scope of derivative accounting for contracts linked to an entity's own operations or performance, and (2) the accounting for share-based noncash consideration received from customers in revenue contracts. The amendments are designed to reduce unnecessary complexity, enhance consistency across entities, and better align financial reporting with economic substance.

2. Background and reason for issuance

Stakeholders raised concerns that the definition of a derivative under Topic 815 had become too broad, leading to unintuitive results for contracts based on operational or entity-specific variables. For example, funding or licensing arrangements tied to regulatory milestones or internal financial performance measures were sometimes treated as derivatives subject to fair value accounting, even though such treatment did not reflect their underlying economics. The Board also observed diversity in accounting for share-based noncash consideration received from customers under Topic 606. Some entities applied derivative or investment accounting (Topics 815 and 321), while others deferred recognition until performance obligations were satisfied. This ASU addresses both issues to simplify application and enhance comparability across industries.

3. Main provisions

The Update introduces two key sets of amendments. First, it refines the scope of derivative accounting under Topic 815 by expanding the existing scope exception to exclude certain non-exchange-traded contracts with underlyings based on operations or activities specific to one of the parties to the contract. Second, it clarifies that share-based noncash consideration from a customer in a revenue contract should

be accounted for under Topic 606 until the entity's right to receive or retain the share-based instrument is unconditional.

Under the revised derivative guidance, contracts are excluded from Topic 815 if their settlement depends on operational or activity-based variables such as an entity's own earnings, sales volumes, or the occurrence of events like regulatory approval or a greenhouse gas reduction target. However, the exception does not apply to variables tied to market rates, prices, or indexes; the price or performance of a financial asset or liability; contracts involving the issuer's own equity (Subtopic 815-40); or call and put options on debt instruments. This principles-based refinement aims to improve alignment between financial reporting and the economic substance of such agreements.

For share-based noncash consideration, the ASU clarifies that an entity should apply Topic 606's noncash consideration guidance (paragraphs 606-10-32-21 through 32-24) when it receives shares, warrants, or other equity instruments from a customer as payment for goods or services. The entity should recognize revenue as it satisfies performance obligations, and the share-based instruments should not be recognized as derivative assets or equity securities until the right to receive them becomes unconditional. This clarification ensures consistent treatment of cash and noncash consideration and reduces diversity in practice.

4. Illustrative examples

The ASU provides several examples to illustrate the refined scope and clarified revenue guidance. In one research and development funding arrangement, an investor provides financing contingent upon the developer's successful achievement of regulatory approval and a profitability threshold. Because both variables are specific to the developer's operations, the contract is excluded from derivative accounting. Similarly, in a sustainability-linked bond, a subsidiary's interest rate increases if its parent fails to meet a group-level greenhouse gas reduction target. This event is considered specific to the consolidated entity's activities, qualifying for the scope exception.

Litigation funding arrangements also fall within the exception when payments depend on the outcome of a case handled by the funded entity or its law firm. In contrast, a commodities-based contract tied to a market price of gold does not qualify for the exception and remains subject to derivative accounting. Likewise, a variable payment arrangement based on stock price differentials is excluded from the exception because it involves a market-based underlying.

For revenue recognition, the ASU introduces an example in which an entity agrees to deliver products to a customer for cash plus a performance bonus in the form of share warrants if delivery milestones are met. The fair value of the warrants at contract inception is included in the transaction price and allocated to each unit sold. The warrants are recognized as consideration only once the entity's right to receive them is unconditional – after performance is complete.

5. Implications for practice

These amendments are expected to reduce both the cost and complexity of evaluating whether operationally linked contracts must be accounted for as derivatives. Entities engaged in research, pharmaceutical development, renewable energy financing, or ESG-linked lending arrangements will particularly benefit from the refined scope exception. The change also discourages structuring transactions to avoid derivative treatment by providing a clear, principles-based rule.

For revenue transactions, the clarification brings consistency to arrangements involving noncash consideration such as stock warrants, equity instruments, or tokens received from customers. Entities will no longer apply derivative or investment accounting to these awards before their rights to the consideration become unconditional. This promotes alignment with Topic 606's performance-based recognition model and enhances comparability across entities that receive both cash and share-based compensation for goods or services.

6. Effective date and transition

The amendments in ASU 2025-07 are effective for all entities for annual reporting periods beginning after December 15, 2026, including interim periods within those years. Early adoption is permitted. Entities may apply the guidance either prospectively to new contracts entered into on or after the adoption date or on a modified retrospective basis through a cumulative-effect adjustment to opening retained earnings. The Board also allows, on an instrument-by-instrument basis, an election to continue or revoke the fair value option for contracts affected by the new scope exception. Transition disclosures are required under Topic 250 to describe the nature and reason for the accounting change and its cumulative impact on equity.

F. ASU No. 2025-06, *Intangibles – Goodwill and Other – Internal-Use Software (Subtopic 350-40): Targeted Improvements to the Accounting for Internal-Use Software*

1. Executive summary

In September 2025, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2025-06, *Intangibles – Goodwill and Other – Internal-Use Software (Subtopic 350-40): Targeted Improvements to the Accounting for Internal-Use Software*. This Update modernizes the accounting for software development costs by removing outdated stage-based rules and replacing them with a principles-based capitalization model. The amendments affect all entities that develop or acquire internal-use software, including those that incur website development costs. They are effective for annual periods beginning after December 15, 2027, with early adoption permitted.

2. Background and reason for issuance

The FASB issued this Update in response to extensive stakeholder feedback that the existing guidance for accounting for internal-use software had become outdated. Previous requirements relied on a stage-based model (preliminary, application development, and post-implementation) that aligned with the traditional “waterfall” method of software development. However, most entities now use incremental and iterative approaches such as agile methodologies. As a result, the prior framework was difficult to apply and did not reflect the way software is currently developed. Stakeholders requested that the Board modernize the guidance to better capture evolving development practices and to increase consistency and operability across entities. The Board concluded that targeted improvements would enhance comparability without significantly changing the overall level of software capitalization for most companies.

3. Main provisions

ASU 2025-06 eliminates the prescriptive references to project stages and introduces a recognition threshold based on management authorization and the probability of completion. Under the new model, capitalization of software costs begins only when (1) management has authorized and committed to funding the computer software project, and (2) it is probable that the project will be completed and the

software used as intended. This threshold is referred to as the “probable-to-complete” recognition threshold.

The Update requires entities to evaluate whether “significant development uncertainty” exists before capitalization can begin.

Two factors indicate that such uncertainty exists:

- a. “The software being developed has technological innovations or novel, unique, or unproven functions or features, and the uncertainty related to those technological innovations, functions, or features, if identified, has not been resolved through coding and testing.”
- b. “The significant performance requirements of the software have not been identified, or the identified significant performance requirements continue to be substantially revised.”

If either factor is present, capitalization must be delayed until the uncertainty is resolved.

The amendments also revise disclosure requirements. All capitalized internal-use software costs must follow the Property, Plant, and Equipment disclosure model under Subtopic 360-10, rather than the intangible asset disclosure requirements under Subtopic 350-30. Furthermore, the Update supersedes Subtopic 350-50 on website development costs and incorporates relevant website-specific guidance into Subtopic 350-40.

4. Illustrative examples

The ASU includes practical illustrations that demonstrate the application of the new recognition threshold across different scenarios:

- a. In an enterprise resource planning (ERP) system implementation, a company entered into a contract with a third party to develop a hybrid solution that combined on-premises software and cloud features. Because the performance requirements were clear and the technology was established, the entity determined that no significant development uncertainty existed, and capitalization began upon contract execution.
- b. In the development of a new mobile application, management authorized funding early in the process but had not yet identified the application’s significant features. Capitalization was deferred until performance requirements were defined later in development.
- c. In the case of a software project involving novel technology, management authorized the project in 20X1, but uncertainty existed due to unproven functionality. That uncertainty was resolved only after coding and testing in 20X3. Accordingly, capitalization did not begin until 20X3, just before the project’s completion.
- d. For a nonprofit organization developing a website to display information about adoption services, capitalization began once the contract was executed and it was probable that the website would be completed. However, costs such as registering the site with search engines or inputting content were expensed as incurred, while initial graphics and the domain registration were evaluated for capitalization.

5. Implications for practice

For most entities, the amendments are not expected to result in significant changes to the amount of capitalized costs. However, for software developed for delivery through cloud computing arrangements, the new guidance may result in reduced capitalization and more frequent immediate expense recognition.

This will better align internal-use software accounting with external-use software accounting, leading to more consistent financial reporting outcomes. Preparers should also be aware of the judgment involved in assessing significant development uncertainty and documenting management's rationale for capitalization decisions.

6. Effective date and transition

ASU 2025-06 is effective for all entities for annual reporting periods beginning after December 15, 2027, including interim periods within those years. Early adoption is permitted. Entities may apply the amendments using one of three transition methods: (1) a prospective approach applying the guidance only to new costs incurred after adoption, (2) a modified approach in which in-process projects that no longer meet the capitalization criteria are derecognized through a cumulative-effect adjustment, or (3) a full retrospective approach with cumulative-effect adjustment to retained earnings. The flexibility in transition methods is intended to accommodate diverse preparer circumstances while minimizing undue implementation burden.

G. ASU No. 2025-05, *Financial Instruments – Credit Losses (Topic 326)*

1. Reason for issuance

FASB issued ASU 2025-05 to simplify the application of ASC 326 to current accounts receivable and current contract assets arising from transactions accounted for under ASC 606 (revenue). The PCC indicated that private entities were struggling with implementation costs and estimating credit losses under the standard despite the application of the standard not having a material impact on the entities. The PCC indicated that many private entities were recognizing credit losses as of the balance sheet date for amounts that were ultimately collected before the financial statements were made available.

This ASU aims to simplify the process for private entities that allows them to consider events after the balance sheet date and offer a practical expedient for all entities, reducing the complexity and costs of complying with ASC 326. It should provide useful and actionable information to financial statement users while simplifying the process and reducing the cost for nonpublic entities.

2. Entities affected

The practical expedient applies to all entities, public and private, while the policy election applies to entities other than public entities.

3. Main provisions

The amendments in the ASU provide (a) all entities with a practical expedient and (b) entities other than public business entities with an accounting policy election when estimating expected credit losses for current accounts receivable and current contract assets arising from transactions accounted for under Topic 606, as follows:

- a. **Practical expedient (available to all entities, public and private)** – In developing reasonable and supportable forecasts as part of estimating expected credit losses, all entities may elect a practical expedient that assumes that current conditions as of the balance sheet date do not change for the remaining life of the asset.
- b. **Accounting policy election (available to nonpublic entities only)** – An entity that elects the practical expedient is permitted to make an accounting policy election to consider collection activity after the balance sheet date when estimating expected credit losses (ASU 2025-05).

If adopting ASU 2025-05, an entity must apply expedient and/or election consistently across applicable balances. Customer-specific risks must still be considered. Disclosures must contain the election being made (policy election and/or practical expedient) and the date of the assessment being performed if such elections are made.

4. *Effective date and transition guidance*

The ASU is effective for annual periods beginning after December 15, 2025, including interim periods within. Early adoption is permitted for any financial statements not yet issued or made available for issuance. The practical expedient and/or policy election should be applied prospectively.

A preferability assessment is not required for nonpublic entities adopting the practical expedient or policy election after the effective date.

H. ASU No. 2025-04, *Share-Based Consideration Payable to a Customer*

1. *Reason for issuance*

FASB issued ASU 2025-04 to resolve diversity in practice and improve the clarity and operability of existing guidance related to share-based consideration (e.g., warrants, options, other equity instruments) granted to customers to incentivize them to purchase goods or services. Stakeholders identified uncertainty in distinguishing between service conditions and performance conditions and noted that existing policy elections for forfeiture accounting delayed revenue recognition in ways that reduced decision usefulness. Additionally, there was inconsistency in how the Topic 606 constraint on variable consideration (which is generally a reduction in revenue) was interpreted in conjunction with share-based consideration.

This ASU aims to ensure that revenue recognition reflects the economic substance of customer awards, especially when vesting is tied to purchase volume or value, and better aligns guidance for these awards with the principles of ASC 606 and ASC 718.

2. *Entities affected*

This Update applies to all entities, public and private, issuing share-based consideration to customers in the scope of Topic 606.

3. *Main provisions*

The ASU contains three main provisions within the update.

The ASU redefines the term “performance condition” in the Master Glossary to include vesting targets based on the volume or monetary amount of purchases as follows:

- a. “For share-based consideration payable to a customer that can result in a reduction of the transaction price in accordance with Topic 606, a condition affecting the vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award that relates to any of the following:
 - (i) Achieving a specified performance target that is defined solely by reference to the grantor’s own operations (or activities) or by reference to the grantee’s (the customer’s) performance related to the grantor’s own operations (or activities);
 - (ii) The grantee’s purchase (or potential purchase) of the grantor’s goods or services from either the grantor or the grantor’s customers; and/or

- (iii) A purchase (or potential purchase) of the grantor's goods or services from either the grantee or the grantee's customers.

The performance targets listed in this definition for employee and nonemployee awards (for example, a change in control) are also examples of performance conditions for share-based consideration payable to a customer."

For awards with service conditions, the ASU eliminates the forfeitures-as-they-occur election and instead requires entities to estimate forfeitures.

The amendment further clarifies that the ASC 606 constraint on variable consideration does not apply to share-based customer awards. The grantor is required to only apply Topic 718 to such scenarios.

As a result of the ASU, revenue recognition will no longer be delayed when an entity grants awards that are not expected to vest, allowing a better initial estimate of the transaction price under ASC 606.

4. Effective date and transition guidance

The ASU is effective for all entities for annual reporting periods (including interim reporting periods within annual reporting periods) beginning after December 15, 2026. Early adoption is permitted. Modified retrospective (default) or full retrospective adoption is permitted.

"When applying the amendments in this Update on a modified retrospective basis, a grantor should recognize a cumulative-effect adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) as of the beginning of the period of adoption and should not recast any financial statement information before the period of adoption. A grantor should apply the amendments as of the date of initial application to all share-based consideration payable to a customer.

When applying the amendments in this Update on a retrospective basis, a grantor should recast comparative periods and recognize a cumulative-effect adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) as of the beginning of the earliest period presented. Additionally, an entity that elects to apply the guidance retrospectively should use the actual outcome, if known, of a performance condition or service condition as of the beginning of the annual reporting period of adoption for all prior-period estimates. If actual outcomes are unknown as of the beginning of the annual reporting period of adoption, an entity should use its estimate of the probability of achieving a service condition or performance condition as of the beginning of the annual reporting period of adoption for all prior-period estimates."

I. ASU No. 2025-03, *Business Combinations (Topic 805) and Consolidation (Topic 810): Determining the Accounting Acquirer in the Acquisition of a Variable Interest Entity*

1. Reason for issuance

The FASB issued ASU 2025-03 to address inconsistencies in the determination of the accounting acquirer in transactions where a variable interest entity (VIE) is acquired. Under prior guidance, the primary beneficiary of a VIE was always considered the accounting acquirer, even when the transaction was effected by exchanging equity interests. Stakeholders raised concerns about lack of comparability

between VIE and non-VIE transactions, especially regarding reverse acquisitions and whether a business combination had occurred. The amendments aim to enhance consistency and comparability by allowing the same accounting acquirer assessment factors that are currently required for determining which entity is the accounting acquirer in other acquisition transactions.

2. Entities affected

This Update affects all entities involved in acquisition transactions effected primarily by exchanging equity interests when the legal acquiree is a VIE that meets the definition of a business.

3. Main provisions

The ASU modifies Topic 805 and Topic 810 to require entities to apply the same set of factors (outlined in ASC 805-10-55-12 through 55-15) to determine the accounting acquirer when:

- a. The legal acquiree is a VIE;
- b. The legal acquiree meets the definition of a business; and
- c. The transaction is effected primarily by exchanging equity interests.

Previously, the primary beneficiary was always the acquirer for VIEs; the ASU removes that automatic designation in the specific case of equity exchange transactions. The factors to consider include relative voting rights, governing body composition, senior management continuity, and size of the entities involved. The ASU does not change the accounting for reverse acquisitions or acquisitions where the legal acquiree is not a business.

4. Effective date and transition guidance

ASU 2025-03 is effective for all entities for annual reporting periods beginning after December 15, 2026, including interim periods within those annual periods. Early adoption is permitted at the beginning of any interim or annual reporting period where financial statements have not yet been issued or made available for issuance. The amendments must be applied prospectively to any qualifying acquisition transactions occurring after the initial application date.

J. ASU No. 2025-02, *Liabilities (Topic 405) – Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 122*

1. Main provision

This Update removed the guidance related to the safeguarding of crypto assets initially issued in SAB 121 that was subsequently repealed by SAB 122.

K. ASU No. 2025-01, *Income Statement – Reporting Comprehensive Income – Expense Disaggregation Disclosures (Subtopic 220-40): Clarifying the Effective Date*

1. Main provision

The amendment in this Update amends the effective date of Update 2024-03 to clarify that all public business entities are required to adopt the guidance in annual reporting periods beginning after December 15, 2026, and interim periods within annual reporting periods beginning after December 15, 2027. Early adoption of ASU 2024-03 is permitted. This ASU is discussed further in the ASU 2024-03 section.

L. ASU No. 2024-04, *Debt – Debt with Conversion and Other Options (Topic 470-20)*

1. Reason for issuance

ASU 2024-04 was issued to address and improve relevance and consistency in the application of the induced conversion guidance under Subtopic 470-20, with the largest focus being on determining if the conversion should be accounted for as an induced conversion or debt extinguishment. Current guidance was found to be inadequate, particularly after the introduction of cash convertible instruments and changes to accounting for convertible debt instruments with cash conversion features introduced in ASU 2020-06. Current guidance also does not address how the standards should be applied to the settlement of a convertible debt instrument that does not require new equity securities to be issued upon conversion. The Update seeks to clarify the guidance for determining whether a transaction involving the modification of a convertible debt instrument's terms (particularly a cash convertible instrument) at terms that are different from the original conversion terms should be accounted for as an induced conversion or a debt extinguishment.

2. Entities affected

This Update affects entities, public and private, that settle convertible debt instruments where the conversion privileges have been modified to induce conversion.

3. Main provisions

The main provisions of ASU 2024-04 significantly amend the guidance on induced conversions of convertible debt instruments. The changes include:

- a. **Clarification of inducement offers** – The ASU clarifies that, to account for a settlement of a convertible debt instrument as an induced conversion, the inducement offer must provide the holder with the consideration (in form and amount) that was issuable under the conversion privileges provided in the original terms of the instrument. This clarification addresses ambiguities about whether modifications to terms or the addition of new conversion incentives constitute an induced conversion or a debt extinguishment. The entity must assess this as of the date the conversion offer is accepted by the holder. If, when applying this criterion, the convertible debt instrument had been exchanged or modified (without being deemed substantially different) within the one-year period leading up to the offer acceptance date, an entity should compare the terms provided in the inducement offer with the terms that existed one year before the offer acceptance date.
- b. **Treatment of VWAP modifications** – The ASU specifies that incorporation, elimination, or changes to a volume-weighted average price (VWAP) formula or similar provision do not automatically lead to a debt extinguishment classification. Instead, an entity should assess whether the modified terms preserve the form and amount of the conversion consideration stipulated in the original terms as of the offer acceptance date.
- c. **Applicability to nonconvertible instruments** – The guidance extends to scenarios where a convertible debt instrument is not currently convertible but has a substantive conversion feature at issuance and at the time the inducement offer is accepted.

4. Effective date and transition guidance

ASU 2024-04 is effective for all entities for annual reporting periods beginning after December 15, 2025, and interim periods within those annual periods. Early adoption is permitted for all entities that have adopted ASU 2020-06.

Entities may apply the new guidance on a prospective or retrospective basis:

- a. **Prospective application** – Entities apply the amendments to settlements of convertible debt instruments occurring after the effective date of the guidance.
- b. **Retrospective application** – Entities can recast prior periods and recognize a cumulative-effect adjustment to equity at the later of the beginning of the earliest period presented or the date the entity adopted the amendments in ASU 2020-06.

M. ASU No. 2024-03, *Income Statement – Reporting Comprehensive Income – Expense Disaggregation Disclosures (Subtopic 220-40): Disaggregation of Income Statement Expenses*

1. Reason for issuance

ASU 2024-03 was issued in response to feedback from investors and other financial statement users who expressed the need for more detailed information about expenses to better understand an entity's performance, forecast future cash flows, and compare performance across entities. Specific feedback highlighted the importance of disaggregating costs of sales and selling, general, and administrative expenses (SG&A) to better understand an entity's cost structure.

2. Entities affected

The amendments in ASU 2024-03 apply to all public business entities.

3. Main provisions

The main provisions require public business entities to disclose more detailed information about their expenses in the notes to their financial statements. Specifically, entities must:

- a. Disclose the amounts of (1) purchases of inventory, (2) employee compensation, (3) depreciation, (4) intangible asset amortization, and (5) depreciation, depletion, and amortization recognized as part of oil-and gas-producing activities (DD&A) (or other amounts of depletion expense) included in each relevant expense caption. A relevant expense caption is an expense caption presented on the face of the income statement within continuing operations that contains any of the expense categories listed in (1)–(5);
- b. Include certain amounts that are already required to be disclosed under current generally accepted accounting principles (GAAP) in the same disclosure as the other disaggregation requirements;
- c. Disclose a qualitative description of the amounts remaining in relevant expense captions that are not separately disaggregated quantitatively; and
- d. Disclose the total amount of selling expenses and, in annual reporting periods, the entity's definition of selling expenses.

These disclosures are required for both interim and annual reporting periods and aim to enable investors to better understand the components of an entity's expenses, assess performance, and forecast future expenses.

4. Effective date and transition guidance

The FASB removed the initial effective date that was announced in ASU 2024-03. The effective date of ASU 2024-03 was amended shortly after issuance by ASU 2025-01 to correct for a situation where the guidance made it possible for a public business entity to apply the guidance to an interim reporting period prior to applying the guidance to an annual reporting period. Under ASU 2025-01, ASU 2024-03 is

effective for public business entities for annual reporting periods beginning after December 15, 2026, and interim reporting periods within annual reporting periods beginning after December 15, 2027.

Early adoption is permitted. Entities have the option to apply the amendments either retrospectively to all prior periods presented or prospectively to new or modified transactions after the effective date.

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

1. *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.

2. *Entities affected*

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

3. *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.

4. *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.

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

1. 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.

2. 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.

3. 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.

4. 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.

III. Key ASUs issued prior to 2024

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

1. 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.

2. Entities affected

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

3. 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.

4. Effective date

ASU No. 2023-09 was 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 were permitted.

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

1. 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.

2. Entities affected

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

3. 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 were 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.

4. 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.

IV. 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:

- a. Technical – Recognition and measurement projects (13);
- b. Research (7);
- c. EITF (3); and
- d. Post-implementation review (1).

A. Technical – Recognition and measurement projects – Narrow projects

There are 12 active recognition and measurement projects the FASB considers to be narrow projects. New projects added to the technical agenda include:

- a. Accounting for Commodities;
- b. Accounting for Transfer of Crypto Assets;
- c. Accounting for Environmental Credit Programs – Exploring how to improve the accounting for participants in programs that result in the creation of environmental credits;
- d. Classification of Certain Digital Assets as Cash Equivalents; and
- e. Definition of Common Control.

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

B. Emerging Issues Task Force (EITF)

The FASB is continuing its work on three EITF projects. Significant new EITF projects include the following:

- a. Application of the Topic 815 Normal Purchases and Normal Sales Scope Exception to Electricity Contracts;
- b. Consideration Payable to a Customer;
- c. Mortgage Servicing Rights – Recapture; and
- d. Post-Implementation Review (PIR) Projects.

The FASB currently only has one PIR project after completing the final stage of the PIR project for ASC 842, *Leases*, in 2025. The current ongoing PIR project is Credit Losses under ASC 326.

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.

V. 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 2025, through ASU No. 2025-05, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses for Accounts Receivable and Contract Assets*, to offer nonpublic business entities a practice expedient in applying ASC 326 to contract receivables.

A. Responsibilities

The PCC has two primary responsibilities:

- a. 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
- b. 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 chairperson, all of whom will be selected and appointed by the FAF Board of Trustees. The PCC chairperson is affiliated with the FASB and will have had substantial experience with and exposure to private companies during the course of their 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:

- a. Business combination project;
- b. Consolidation/variable interest entity (VIE) projects;
- c. Definition projects;
- d. Disclosure projects;
- e. Financial instruments projects;
- f. Emerging Issues Taskforce (EITF) projects;
- g. FASB's Agenda consultation; and
- h. Implementation issues related to 842.

VI. 2025 PCC Annual Report – Key highlights for private company accounting

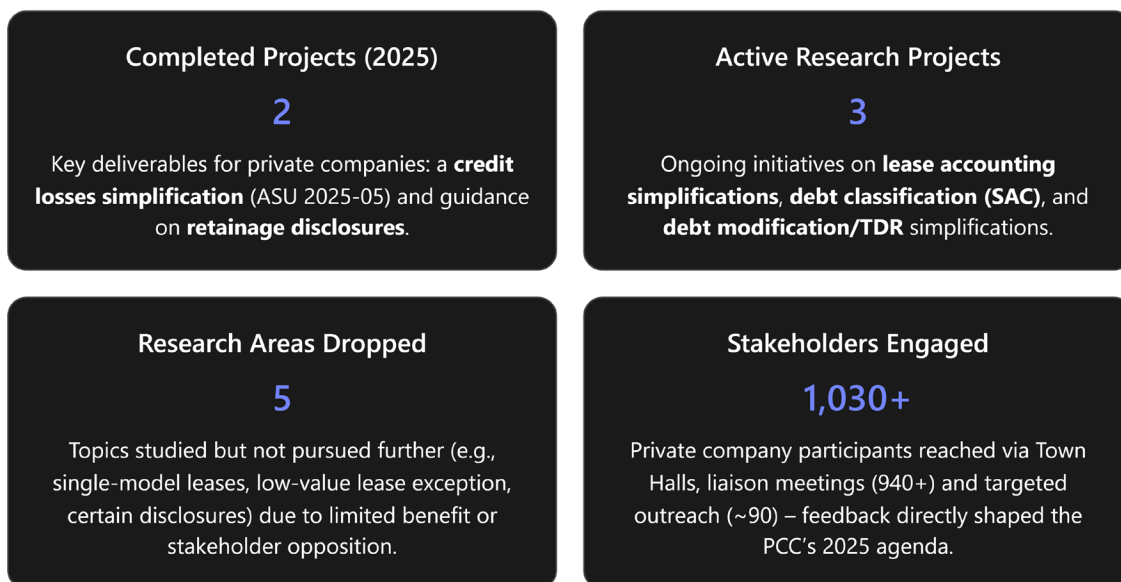
In 2025, the Private Company Council (PCC) advanced its mission of simplifying U.S. GAAP for private entities through targeted projects and stakeholder-driven priorities. The PCC completed two major initiatives while progressing three key research projects on leases and debt and concluding five other

research areas with no further action based on stakeholder input. Below is a summary of the most pertinent points for accounting professionals working with private companies that were pulled from the PCC's annual report released in March 2026:

- a. **Strategic focus** – The PCC's three strategic priorities are to engage private company stakeholders, pursue practical expedients and simplified alternatives in GAAP, and provide influential feedback to the FASB on issues affecting private companies. These guide all PCC activities and ensure that costly or complex requirements are reduced for private companies without compromising the usefulness of financial reporting.
- b. **2025 completed projects** – The PCC completed two projects in 2025. First, it worked with the FASB on a simplified approach to credit loss accounting for private companies' trade receivables and contract assets, culminating in ASU 2025-05 (issued July 2025), which was covered earlier in this chapter. This practical expedient streamlines the current expected credit loss (CECL) requirements for short-term receivables, reducing implementation effort while preserving the usefulness of information to financial statement users.
Second, the PCC published an FASB Staff Educational Paper on retainage in construction contracts (Topic 606) to clarify how contractors should present and disclose retainage (customer payment holdbacks) under revenue recognition guidance. This guidance addresses diversity in practice by illustrating optional, GAAP-permissible disclosures that enhance transparency of retainage amounts, benefiting users of private company financial statements.
- c. **Ongoing research projects** – The PCC significantly advanced three research initiatives in 2025, all aimed at practical simplifications for private companies:
 - (i) **Lease accounting simplifications** – Following the FASB final PIR report on leases, the PCC is exploring targeted simplifications to lease accounting (Topic 842) for private companies, as the FASB does not expect material changes to the standard for public companies, which will be discussed in Chapter 2. A PCC Leases Working Group (established in 2024) has been researching areas such as embedded leases, related-party lease disclosures, and lease modifications for potential relief or optional treatments. For example, stakeholders suggested an option to forgo recognizing embedded leases within service contracts under certain conditions to cut costs. The PCC is considering these ideas, balancing preparer concerns about complexity with user desires for transparency (e.g., users want clearer disclosures on common-control lease terms and significant lease modifications).
 - (ii) **Subjective acceleration clauses (SAC) and debt classification** – Developing a more cost-effective, "trigger-based" model for classifying debt that contains subjective acceleration clauses. Subjective acceleration clauses (lender provisions that can demand early debt repayment based on subjective judgments) are common in private company loans but rarely enforced. Currently, assessing these clauses under GAAP requires difficult probability judgments. The PCC's research is focused on a practical alternative: reclassifying debt only when a trigger event occurs (i.e., when the lender actually demands repayment). This approach would simplify reporting and reflect economic reality, coupled with enhanced disclosures around defaults and lender actions to preserve usefulness for credit analysts.

- (iii) **Debt modifications, extinguishments, and troubled debt restructurings (TDR)** – Examining ways to simplify the accounting for debt restructurings for private companies. Many stakeholders noted that current GAAP for debt modifications and TDRs is costly and complex to apply, and the distinctions it draws may not yield relevant information for private company financial statement users. In response, the PCC formed a joint working group (with members of the AICPA's Technical Issues Committee) to research potential simplified alternatives or practical expedients in this area. The goal is to identify solutions that better reflect private companies' economic reality without undue cost, addressing feedback that TDR accounting often lacks decision-usefulness for users.
- d. **Research areas concluded (no further action)** – After investigation and consultation, the PCC decided not to pursue five potential projects in 2025, as either the issues were not pervasive or stakeholder feedback indicated that existing guidance was adequate:
 - (i) **Optional single lease classification model** – The PCC considered allowing private companies to treat all leases under one model (instead of the complex dual finance vs. operating lease model). However, outreach found that the current dual classification provides decision-useful distinctions (rent vs. debt) for users, and changing it would disrupt financial analysis. Thus, no further action was taken on this idea.
 - (ii) **Weighted-average (W.A.) disclosures** – The PCC evaluated whether calculating certain weighted-average disclosures (e.g., lease term or discount rates) could be simplified for private firms. Stakeholder feedback indicated these disclosures are useful to investors and not overly burdensome for preparers, so no changes were recommended.
 - (iii) **Short-cycle manufacturing revenue** – The PCC studied challenges in applying revenue recognition (Topic 606) to short production-cycle manufacturing contracts. It concluded the issue is not widespread enough in private companies and other topics were higher priority, so this research was closed without changes.
 - (iv) **Low-value lease scope exception** – The PCC considered a special scope exception for low-dollar-value leases (similar to IFRS's practical expedient for low-value assets). After outreach, they found most private companies already use materiality thresholds to exclude trivial leases, and a formal rule could create unintended complexities. Therefore, they decided not to pursue a low-value lease exception (though some users would support it if optional and accompanied by disclosure of total expense for such leases).
 - (v) **Interest method for loan costs** – The PCC explored simplifying how private companies apply the effective interest method when determining amortization and interest rates on loans. Based on feedback, they concluded this area was less pressing, opting to focus on more significant debt issues (like the SAC and TDR topics above) and discontinued further research here.

To provide an overview at a glance, the table below summarizes the PCC's 2025 agenda outcomes, including completed projects (accomplishments), ongoing research projects, and areas where research was concluded without further action.



VII. PCC strategic priorities and role

The PCC was established to tailor U.S. GAAP to better fit private companies' needs, and its 2025 activities reflect three core strategic priorities:

- a. **Broad stakeholder engagement** – *“Maximize engagement with our constituencies to learn about the challenges faced by preparers and users of private company financial statements.”*
- b. **Practical simplification of standards** – *“Evaluate existing standards for alternatives that are most practical and efficient for private company preparers while sustaining effective reporting to users.”*
- c. **Advising the FASB** – *“Serve as a consistent and influential source of feedback to the FASB and stay current on the FASB's priorities and the effects of standard setting on private companies.”*

Together, these strategic priorities ensure the PCC remains focused on the most pressing issues for private company reporting and leverages its unique role to influence standards in favor of cost-effective, educational, and decision-useful outcomes.

VIII. 2025 projects – Accomplishments and ongoing work

The PCC's 2025 agenda was driven by issues raised from private company constituents, leading to tangible outcomes and ongoing projects aimed at simplifying accounting under U.S. GAAP. The table below provides a summary of PCC's 2025 accomplishments, active research projects, and concluded topics.

2025 PCC accomplishments (completed projects)	Active research projects (2025)	Research concluded (no further action)
Credit Losses – Trade Receivables and Contracts – Developed a <i>practical expedient</i> for measuring expected credit losses on short-term trade receivables and contract assets (Topic 326). Result: FASB issued ASU 2025-05 in July 2025, simplifying CECL application for private companies without sacrificing information quality.	Lease Accounting Simplifications – Investigating specific lease (Topic 842) simplifications (e.g., embedded leases in service agreements, related-party lease disclosure relief, easier lease modification accounting) via a PCC/FASB working group with the goal to reduce cost and complexity for private lessees while maintaining transparency for users.	Optional Single Lease Classification – Explored a single-model lease approach for private companies; decided against it after outreach showed the current dual model is useful for users (operating vs. finance lease distinction is important). No change pursued.
Retainage Disclosures – Construction Contracts – Addressed diversity in practice under revenue recognition (Topic 606) regarding retainage (withheld payments) for contractors. Result: FASB Staff Educational Paper (April 2025) was issued, clarifying GAAP presentation and disclosure of retainage, with examples of permissible voluntary disclosures to improve consistency and user understanding.	Subjective Acceleration Clauses (SAC) in Debt – Developing a trigger-based classification model for debt with SACs (common in private loans). Would reclassify debt to current only when a lender enforces an acceleration clause, replacing complex probability assessments. Aims to provide relief to preparers and still give lenders the information they need (with enhanced default disclosures).	Weighted-Average Disclosures – Reviewed requirements like average lease term and discount rate disclosures for private companies; concluded these disclosures are decision-useful and not unduly burdensome, so no changes were recommended.
<i>(Additional FASB-endorsed PCC input in 2025 led to final standards on government grants, share-based customer consideration, internal-use software, and other improvements, reflecting private company considerations).</i>	Debt Modifications and TDR Simplification – Analyzing costly “debt modification vs. extinguishment” accounting and troubled debt restructuring rules (Topics 470-20 and 310-40). A PCC working group (formed with AICPA TIC members) is identifying private-company simplifications or alternatives for these rules, responding to feedback that current TDR accounting is complex and not very useful for users.	Short-Cycle Manufacturing Revenue – Assessed challenges in applying revenue recognition to very short-term manufacturing contracts and determined the issue is not pervasive among private companies, and other issues take priority; no further action taken.
		Low-Value Lease Exception – Considered introducing an exemption for low-value leased assets and found most private companies already use materiality to ignore trivial leases, and a new rule could cause complexity (unless optional with disclosure). Decision: do not add – rely on existing materiality practice.

		Effective Interest Rate Method Simplification – Explored simplifying how private companies apply the interest method for loan costs and fees. Based on feedback, this issue was tabled to focus on more pressing debt topics, and no immediate changes were pursued.
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IX. Conclusion and future work

In summary, the 2025 PCC Annual Report highlights a year of significant progress in making U.S. GAAP more workable for private companies. Key takeaways include the introduction of new simplified accounting alternatives (especially the credit losses expedient), clarified guidance in troublesome areas (like construction contract retainage), and a strong pipeline of projects addressing leases and debt – all shaped by robust stakeholder involvement.

The PCC's ongoing commitment to listening to practitioners and users and to delivering practical expedients means that private-company accounting standards will continue to evolve. Educators should ensure they highlight these developments in curricula and training, as they represent both the current state and the future direction of private company financial reporting under U.S. GAAP.

Discussion question:

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

FASB Stage 3 PIR Report Findings – ASC 842, Leases

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FASB Stage 3 PIR Report Findings – ASC 842, Leases

Learning objectives

After completing this chapter, you should be familiar with:

- The FASB's lease accounting guidance in ASC Topic 842, *Leases*; and
- The results and findings of the FASB's Final (Stage 3) Post-Implementation Review (PIR) Report Topic 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:

- a. Public business entities:
 - (i) Effective since years beginning after December 15, 2018.
- b. Nonpublic business entities:
 - (i) 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: a. ASC 840 – Reasonably assured criteria. b. 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:

- a. Fixed payments, including in-substance fixed payments, less any lease incentives paid or payable to the lessee.
- b. 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.
- c. The exercise price of an option to purchase the underlying asset if the lessee is reasonably certain to exercise the option.
- d. Payments for penalties for terminating the lease if the lease term reflects the lessee exercising this option.
- e. Fees paid by the lessee to the owners of a special purpose entity for structuring the transactions.
- f. 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:

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

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

- a. 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.
- b. If the rate is not known by lessee, lessees can use the following:
 - (i) Incremental borrowing rate; or
 - (ii) 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:

- a. Payments represent substantially all of the asset fair value.
- b. The lease term is for a major portion of the asset's economic life.
- c. There is a bargain purchase option that the lessee is reasonably certain to exercise.
- d. 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:

- a. 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
- b. 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:

- a. The modification grants the lessee an additional right of use that was not in the original lease; and
- b. 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:

- a. Package of three:
 - (i) Reassessing classification;
 - (ii) Reassessing for embedded leases; and
 - (iii) Reassessing accounting for initial direct costs.
- b. 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:

- a. 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.
- b. 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:

- a. Lease classification;
- b. Accounting for initial direct costs;
- c. Accounting for nonlease components; and
- d. 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:

- a. Conveys the right to use a specific asset (the underlying asset); and
- b. 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:

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

Cumulative-Effect Adjustment at Transition



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:

- a. Incremental Borrowing Rate;
- b. Term and options to extend or terminate the lease;
- c. Economic life of the asset;
- d. Residual value guarantees; and
- e. 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.

- a. 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.
- b. 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:

- a. Remaining lease term;
- b. Leasehold improvements' remaining useful life; and
- c. 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:

- a. Prospectively to new leasehold improvements recognized on or after the date the above amendments are first applied.
- b. Prospectively as noted above, while also amortizing existing leasehold improvements over the remaining useful life determined at the date of application.
- c. 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, it's 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:

- a. Information about the nature of its leases (and subleases), including:
 - (i) A general description of those leases;
 - (ii) The basis, and terms and conditions on which variable lease payments are determined;
 - (iii) 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;
 - (iv) The existence, and terms and conditions of residual value guarantees provided by the lessee; and
 - (v) The restrictions or covenants imposed by leases.
- b. Information about leases that have not yet commenced but that create significant rights and obligations for the lessee.
- c. Information about significant assumptions and judgments made in applying the requirements of the leases standards, which may include the following:
 - (i) The determination of whether a contract contains a lease;
 - (ii) The allocation of the consideration in a contract between leases and nonlease components; and
 - (iii) The determination of the discount rate.
- d. The main terms and conditions of any sale and leaseback transactions.
- e. 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:

- a. Finance lease expense segregated between amortization of ROU assets and interest on lease liabilities.
- b. Operating lease expense.
- c. Short-term lease expense excluding expenses relating to leases with a lease term of one month or less.
- d. Variable lease expense.
- e. Sublease income.
- f. Cash paid for amounts included in the measurement of lease liabilities, segregated between operating and financing cash flows and between finance and operating leases.
- g. Supplemental noncash information on lease liabilities arising from obtaining ROU assets, segregated between finance and operating leases.
- h. Weighted-average remaining lease term disclosed separately for finance and operating leases.
- i. Weighted-average discount rate for finance and operating leases as of the reporting date.
- j. 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	<u>\$XXX</u>	<u>\$XXX</u>
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 leases	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,			
Operating lease cost		2017	2016
	\$	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,			
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		1,365	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:

	Total	Years Ending December 31,						Later Years
		2019	2020	2021	2022	2023		
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:

- a. 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.
- b. 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:
 - (i) The remaining minimum rental payments (as defined under ASC 840) plus
 - (ii) 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.
- c. 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.
- d. 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.

- e. 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:

- a. 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.
- b. 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.
- c. 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.
- d. 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).
- e. 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.
- f. 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:

- a. Use rate implicit in the lease, if known; or
- b. 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?

VII. Summary of the FASB PIR Report on Leases (Topic 842)

A. Introduction

The FASB's Post-Implementation Review (PIR) of ASC Topic 842, *Leases*, assessed whether the lease accounting standard achieved its objective of improving financial reporting transparency by bringing most leases onto the balance sheet and whether the benefits justify the costs. The review, conducted from 2016 (issuance of the standard) through November 2025 (PIR completion), involved extensive outreach to over 1,600 stakeholders and multiple public meetings. Overall, the FASB determined that Topic 842 successfully met its primary goal of recognizing lease assets and liabilities on lessees' balance sheets, enhancing visibility of lease obligations. However, stakeholder feedback was mixed. Investors and other users generally agree they now receive more decision-useful information about companies' leasing activities. However, the cost and complexity of implementation for **lessees** were significantly higher than initially expected by the FASB due to unanticipated system and process overhauls. **Lessors'** experience was smoother, with minimal implementation effort needed because lessor accounting changed only modestly from prior GAAP. The PIR identified key areas of implementation cost, major challenges, and benefits, especially from the perspectives of lessees, lessors, investors, and preparers. Below is a summary of these findings, along with a comparison of expected vs. actual outcomes for costs and benefits (see Table 1).

B. Significant implementation costs under Topic 842

1. Lessees – Higher than expected costs

Implementing the new lessee accounting requirements entailed substantial one-time and ongoing costs. Preparers report that initial adoption costs were *significantly higher* than the FASB anticipated, and continuing compliance remains costly. Key cost drivers for lessees included:

- a. **System upgrades and software** – Most companies discovered their existing IT systems couldn't handle the new standard's demands, especially the need to track operating leases on the balance sheet. This led to purchasing new lease accounting software or heavily modifying systems. Many entities also needed to develop processes for amortizing right-of-use assets for operating leases because the concept didn't exist under prior GAAP.
- b. **Comprehensive contract reviews** – Implementing Topic 842 required identifying all arrangements that contain a lease, including embedded leases, which were often difficult and costly to identify. Many lessees undertook painstaking reviews of contracts (real estate, equipment, service agreements, etc.) to find embedded leases and gather data on lease terms. This was far more labor-intensive than expected.
- c. **Data capture and entry** – Companies had to extract lease terms (payments, duration, renewal/termination options, etc.) from contracts and input them into new systems. Ensuring completeness and accuracy of lease data demanded significant time and effort from accounting teams and consultants.
- d. **Increased staffing and training** – Preparers often needed to hire additional staff or consultants specialized in lease accounting. Existing employees required training on Topic 842. Firms also incurred higher audit fees, as auditors spent more time reviewing lease implementations.
- e. **Ongoing compliance** – Even after adoption, lessees face higher ongoing costs for maintaining lease inventories, updating for modifications, and generating enhanced disclosures each period. These recurring costs (e.g., software maintenance and internal controls) have generally been higher than the Board's original expectations for post-implementation compliance.

2. Lessors – Minimal cost impact

In contrast, lessor accounting changes were minor, as the balance sheet recognition was largely unchanged from the prior lease model, so costs for lessors to implement and comply with Topic 842 have been low. Because Topic 842 largely retained the prior lease accounting model for lessors (with operating, direct financing, and sales-type leases similar to legacy GAAP), most lessors did not need major system changes. Key points:

- a. **Little systems overhaul needed** – Lessor systems and processes for lease accounting (e.g., recognize lease receivables, perform lease classification) remained largely unchanged, avoiding significant new costs.
- b. **Targeted improvements only** – The FASB issued a few narrow updates for lessors (for example, eliminating leveraged lease accounting and aligning revenue recognition timing). These tweaks were not cost-intensive, and the Board provided transition relief where needed.
- c. **Outcome** – Feedback indicates “most lessors incurred minimal costs” to initially adopt Topic 842 and to maintain compliance thereafter. Lessor stakeholders generally confirm that ongoing operations were not significantly disrupted by the new standard.

C. Biggest challenges in applying Topic 842 (lessee focus)

Experienced CPAs identified major practical challenges during and after implementing the leases standard, predominantly on the lessee side (since lessees' accounting underwent the greatest change). The seven most frequently cited challenge areas for lessees were related to determining the discount rate, recognition and measurement of the identified leases, and leases with related parties. Key challenges included:

- a. **Determining the discount rate** – Lessees must record lease liabilities at the present value of lease payments, which requires selecting an appropriate discount rate (incremental borrowing rate or the rate implicit in the lease). Private companies got relief by being allowed to use a risk-free rate, but for many lessees, especially public companies, estimating the correct discount rate for each lease was a complex and judgmental task that gained new scrutiny once lease liabilities were on the balance sheet.
- b. **Recognition and measurement** – Lessees struggled with the appropriate recognition of shipping costs, installation costs, ROU impairments, accounting for lease incentives, and the interaction of the requirements with business combination accounting under other standards. The FASB noted that these challenges were higher in the initial adoption period and have decreased over time.
- c. **Related parties** – Under ASC 842, related party leases are treated the same as all other lease arrangements. There is no separate guidance except for leases under common control arrangements (ASU 2023-01). The common control arrangements presented the biggest challenge for related party leases, which led to the issuance of the ASU.
- d. **Lease modifications and remeasurements** – The accounting for lease modifications (changes in lease scope or consideration) under Topic 842 can be complex. Depending on the nature of the change, a modification might be treated as a separate new lease or a remeasurement of the existing lease. Stakeholders reported difficulty applying the modification guidance, which often requires significant judgment and can affect multiple balances. This area was a notable change from legacy GAAP and required careful analysis.
- e. **Identifying all lease arrangements, with a focus on embedded leases** – Because Topic 842 requires bringing operating leases onto the balance sheet, companies had to scrutinize contracts enterprise-wide. Determining whether an arrangement “contains a lease” became a routine process. Lessees had to evaluate service agreements, supply contracts, and other agreements to find embedded leases (identified assets with control by the customer). This was more challenging than under prior rules, as previously many operating leases were just disclosed and not systematically tracked.
- f. **Sale-and-leaseback transactions, including built-to-suit arrangements** – Topic 842 implemented new rules for sale-leaseback (where an asset is sold and then leased back by the seller). These rules focus on establishing that a *true sale* has occurred under revenue recognition guidance. Preparers found the sale-leaseback guidance challenging, as it changed prior practice and required analyzing whether control of the asset transfers to the buyer/lessor. Determining if a sale took place (and when to recognize gain/loss) introduced complexity in these transactions. Under previous GAAP, “build-to-suit” leases had unique guidance. Topic 842 removed some of that and aligned more with the new control model, but accounting for unique or complex arrangements (like build-to-suit) still requires significant judgment. Lessees mentioned these areas as tough to navigate, although they are relatively niche.

- g. **Allocating between lease and nonlease components** – Contracts often bundle lease components (right to use an asset) with nonlease components (services or maintenance). Under Topic 842, lessees must separate lease components from service components to account for each appropriately (unless a practical expedient to combine is elected). Determining that split for each contract (and whether a contract even *contains* a lease) proved difficult and time-consuming for many companies.

Despite these challenges, it's important to note that many difficulties were mitigated over time through FASB staff guidance and companies' growing experience. The FASB's PIR found that no fundamental changes to the lessee model are deemed necessary now, as *stakeholders prefer not to overhaul the standard again* given the high cost already incurred to update systems and processes. However, private company constituents continue to seek practical expedients or simplifications to ease ongoing compliance burdens (e.g., simpler discount rate options), indicating some challenges persist for smaller entities.

Lessors' challenges under Topic 842 were comparatively fewer. The Board's intent was to keep lessor accounting "generally consistent with legacy GAAP," but some issues arose:

- a. **Recognition and measurement** – Despite minimal changes to lessor accounting, lessors still reported the most difficulties with recognition and measurement, particularly as it relates to sales taxes and other similar taxes collected as part of the lease transaction. The FASB responded by allowing lessors to make an election to skip the evaluation of such taxes altogether and not account for those taxes as lessor costs. Although similar to legacy GAAP, the Board clarified that costs paid by the lessee to third parties (i.e., insurance) should be excluded from the lessor's cost. However, costs excluded from consideration of a contract that the lessor pays and is reimbursed by the lessee should be recorded as variable payments/revenue.
- b. **Allocating between lease and nonlease components** – Aligning lessor accounting with the revenue recognition model (Topic 606) led to some initial confusion, for example, how to handle certain variable payments or classification criteria differences. Stakeholders noted outcomes weren't perfectly aligned with revenue guidance initially, prompting targeted amendments by FASB to restore desired outcomes (e.g., a 2018 update addressed an inconsistency in classifying leases with variable payments).
- c. **Interaction with Topic 606 and Topic 610** – A few lessor-specific technical areas (lease classification definitions, separating components when acting as a lessor, etc.) were mentioned, but overall lessors did not report significant ongoing challenges, and no major changes have been requested by lessor stakeholders.

In summary, lessees bore the brunt of implementation challenges, largely stemming from the effort to centralize all lease information and apply new judgment-intensive rules across their lease portfolios. The PIR process confirmed that while these were difficult and costly tasks, they were necessary to achieve the standard's greater transparency goals. Most stakeholders (including preparers) do not advocate reversing or fundamentally changing Topic 842 at this point since companies have already invested in overcoming these hurdles.

D. Key benefits observed from implementing Topic 842

Despite the costs and challenges, Topic 842 delivered significant benefits that were the very purpose of the new standard. The PIR found that the benefits are generally consistent with what the FASB and stakeholders expected when the standard was issued.

Below are the most important benefits noted by stakeholders:

- a. **Increased balance sheet transparency for investors** – The *primary benefit* of Topic 842 is that it (largely) ended the widespread off-balance sheet accounting for leases. Virtually all leases (other than short-term leases) now result in a right-of-use asset and lease liability on the balance sheet, whereas under legacy GAAP operating leases were invisible on the balance sheet. This gives investors and lenders a more faithful representation of a company's financial position regarding leased assets and obligations. Investors have better data to analyze leverage and obligations. For instance, they no longer must estimate lease liabilities from footnote disclosures, improving comparability across companies and industries.
- b. **Enhanced disclosures and visibility of lease commitments** – Stakeholders broadly agree that qualitative and quantitative disclosures about leasing improved under Topic 842. The standard introduced new disclosure requirements (e.g., weighted-average lease term, discount rate, maturity analysis of lease obligations, and information about lease variable payments and options). Investors commented that these disclosures are a notable improvement over the boilerplate or minimal disclosures under old rules, giving deeper insight into companies' leasing arrangements. For example, the PIR cites that *"almost all investors agree that the disclosures provided under Topic 842 are an improvement to those provided under legacy GAAP."*
- c. **Improved internal controls and lease management** – Many preparers (lessees) reported an unintended but positive consequence of implementing Topic 842 – it forced a thorough inventory of lease contracts and better cross-functional processes. By having to identify and quantify all leases, companies often discovered contract management weaknesses and subsequently strengthened internal controls around leasing and procurement. Organizations established new procedures to ensure completeness of lease recording and to monitor lease changes, which in many cases improved governance over contracts. In short, lessees gained better visibility into their lease portfolios and exposures, which is beneficial for management and auditors beyond just financial reporting compliance.
- d. **Greater comparability of financial statements** – Bringing leases on the balance sheet enhances comparability between companies that lease assets and those that borrow to buy assets. Under legacy GAAP, a company heavily using operating leases appeared less leveraged than a company owning assets with debt, even if the economic position was similar. Now, the playing field is more level, as lease liabilities are visible and can be compared or combined with debt obligations to assess true leverage. This benefit was a key objective stated by FASB (improving understanding of commitments regardless of financing method), and PIR feedback indicates this goal was achieved.
- e. **Alignment for lessors with revenue recognition** – Although lessor accounting didn't drastically change, one benefit of Topic 842 was better alignment of lessor guidance with the new revenue recognition standard (ASC 606). The PIR notes that Topic 842's lessor provisions were brought closer in line with the concepts of control and revenue recognition. For example, the definition of a lease and certain classification criteria were adjusted to mirror revenue principles. Stakeholders see this as a benefit because it reduces conceptual inconsistencies and is especially helpful when companies are both sellers and lessors (like manufacturers leasing their equipment).

- f. **Preservation of relevant information for lessors** – Investors generally remain satisfied with the information provided by lessors under Topic 842. Key metrics (lease income, residual values, etc.) are still reported in ways similar to before, meaning useful trend information was preserved, while incremental improvements (like additional disclosures on lessors' exposure to risks) were added. In essence, lessors kept the familiar reporting (no loss of decision-useful info) and gained some alignment benefits, which was in line with what the Board intended.

In summary, Topic 842's core benefit of increased visibility of lease obligations has been realized, and this addresses concerns about off-balance sheet financing that motivated the new standard. Investors, creditors, and other users now have a clearer and more comparable view of companies' leasing activities. Preparers acknowledge that despite the pain of adoption, their organizations now have improved processes and controls for managing leases. These benefits, according to the PIR, justify the new standard's costs in the eyes of many stakeholders, though some continue to debate the magnitude of those costs.

E. Expected vs. actual outcomes – Lessees vs. lessors

One focal point of the PIR was comparing the FASB's initial expectations (at issuance in 2016) about costs and benefits to the actual outcomes experienced. Table 1 below summarizes how lessees and lessors fared versus expectations in terms of implementation costs and realized benefits.

Table 1 – Expected vs. Actual Costs and Benefits of Implementing ASC 842 (Lessees vs. Lessors)

Aspect	Lessees – Expected (FASB's assumptions)	Lessees – Actual Outcome (PIR findings)	Lessors – Expected (FASB's assumptions)	Lessors – Actual Outcome (PIR findings)
Implementation Costs	<i>Moderate</i> incremental costs. Many companies anticipated using existing systems and processes from legacy GAAP; once initial setup was done, ongoing compliance costs would be only slightly higher than under old lease rules.	Significantly higher than expected. Widespread system limitations forced most lessees to purchase new software or overhaul processes. Substantial effort to identify all leases and inputs led to much greater one-time and ongoing costs than the Board envisioned. Many firms needed extra staff/consultants and continue to incur higher compliance costs annually.	<i>Minimal</i> changes needed. Because Topic 842 left most lessor accounting unchanged, the Board expected little cost impact for lessors. Preparers and the FASB assumed legacy systems and methods could handle the new standard with negligible effort or expense.	Minimal costs realized, as expected. Most lessors did not incur significant costs to implement or comply. Systems and processes were indeed adequate. The only investments were minor updates (for targeted amendments aligning with revenue recognition), which were not costly.

Key Challenges	(<i>Anticipated as low</i>) – FASB did not fully expect major operational challenges since lessee concepts (e.g., lease classification, lease term, etc.) were similar to old GAAP, and stakeholders downplayed implementation difficulty during development.	Numerous challenges emerged. Lessees faced unforeseen complexity in gathering complete lease data, applying new judgments (discount rates, options), and updating controls. The PIR found a “significant gap” between what preparers thought would be needed and the real-world complexity, especially in contract reviews, component separation, and lease modifications.	(<i>Anticipated as low</i>) – With no fundamental changes to the lessor model, the Board foresaw few challenges for lessors. Any issues would likely be minor clarifications, given alignment efforts with Topic 606 and removal of outdated concepts like leveraged leases.	Few challenges in practice. Lessor feedback confirmed no significant ongoing issues in applying 842. A few lessors requested fixes (e.g., for sales-type lease definitions, handling certain variable payments), which FASB addressed through small improvements, but overall, the lessor model was operational as intended.
Benefits of New Standard	Greater transparency and comparability from on-balance-sheet leases; improved lease disclosures; better insight into lease obligations for investors and creditors; closer alignment between lease accounting and the economics of transactions (fewer structuring opportunities). Also expected: stronger internal controls as companies formalize lease processes (acknowledged qualitatively in basis for conclusions).	Key benefits achieved. Investors report more useful information on lessee finances (lease liabilities now visible) and generally affirm that Topic 842’s disclosures and balance sheet recognition met their needs. Preparers and auditors note improved internal lease controls and awareness. Some investors had mixed views on the <i>magnitude</i> of benefits, but <i>almost all agree disclosures are better than before</i> . Overall, benefits realized match those intended, with no major benefits gap identified in PIR.	Preserve useful info from legacy GAAP while aligning with new revenue standard; give users additional details on lessors’ leasing risks; minimal disruption to lessor financial reporting.	Outcome met expectations. Investors are satisfied with lessor information under 842, indicating that the standard maintained decision-useful data for lessors. The intended alignment with revenue guidance was accomplished, and users received some incremental disclosures about lessors’ exposure to risk, without unexpected consequences. Benefits for the lessor side were essentially “as expected” in the PIR findings.

Table 1: Expected vs. Actual Outcomes – *This table compares what FASB and stakeholders expected at issuance vs. what actually occurred, for both lessees and lessors.* As shown, lessees experienced a large cost gap (actual costs far above expectations) but achieved the core intended benefits of transparency and comparability. Lessors' experience was much closer to expectations, with minimal costs and stable reporting, while also gaining the intended alignment benefits. The PIR concludes that for investors and users, the benefits (for both lessee and lessor information) are largely in line with what was promised, whereas for preparers (especially lessees), the cost burden was heavier than anticipated.

F. Conclusion and what's next

The post-implementation review of Topic 842 validates that the lease standard successfully addressed the core problem of off-balance sheet financing through lease accounting, providing more faithful representation of lease obligations and useful information to investors. Experienced CPAs should recognize that, despite initial hurdles, the standard has led to better financial reporting outcomes and improved internal practices around leases. The FASB has noted that no immediate standard-setting changes to Topic 842 are warranted as a result of the PIR, in part because the FASB has issued clarifying ASUs since initial implementation. Both lessees and lessors have largely adapted to the new rules.

However, the Board will continue to monitor feedback, particularly on reducing ongoing compliance costs for lessees (for instance, through the Private Company Council for smaller entities). Future standard-setting projects will also incorporate lessons learned from this PIR, such as the importance of thoroughly assessing system readiness and transition complexity during the development of major standards.

Overall, ASC 842's implementation was a costly journey for preparers, but it achieved meaningful improvements in financial reporting. Investors now have greater visibility into lease liabilities, and companies have better lease governance. As we move forward, incremental refinements may ease some burdens, but the fundamental shift to on-balance-sheet lease accounting is here to stay, fulfilling a long-standing objective to increase transparency in corporate financial statements.

The full report can be found on the FASB's website at the following link: <https://www.fasb.org/news-and-meetings/in-the-news/fasb-issues-post-implementation-review-report-for-its-leases-standard-423362>.

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Recent AICPA, PCAOB, and SEC Activity

Learning objectives

After completing this chapter, you should be able to:

- Understand recently issued AICPA and PCAOB standards and SEC rulemaking;
- Identify the AICPA's and PCAOB's priorities for 2025;
- Gain familiarity with the standards on the horizon; and
- Gain an understanding of recent PCAOB inspection results and areas of emphasis.

I. Overview

Over time, companies have become more and more global; some are headquartered in the United States (US) with foreign subsidiaries, others are headquartered overseas and have US subsidiaries. Technology played a major role in this global evolution and has advanced in ways that, even five years ago, we could not have imagined. The AICPA recognized these trends, and its Board of Directors formalized and approved an international strategy focusing on high priority areas such as convergence of the AICPA standards with International Standards of Auditing (ISA).

Many countries use international standards for both the audit and attestation engagements. Since they are becoming more widely accepted, practitioners in the U.S. are finding that they need to understand and use those standards in their multinational engagements. The Auditing Standards Board (ASB) has been working with the International Audit and Assurance Board (IAASB) on professional and regulatory matters for years and continues to work with them today. They also work with the International Federation of Accountants (IFAC). The IFAC and the AICPA are sensitive to the fact that most companies in the U.S. as well as overseas are private and have made significant effort to ensure that the needs of all sizes of companies are considered.

Realizing how important it is to align standards across countries, the ASB has successfully implemented its convergence strategy with the IAASB over the past several years while trying to minimize differences with the auditing standards issued by the Public Company Accounting Oversight Board (PCAOB). Complete convergence with International or PCAOB standards is unlikely because of the differences in companies that are served by those organizations. However, this initiative, along with the need to address emerging technologies, has led the ASB to issue several new standards over the last few years. More are in exposure draft form and in the pipeline.

Two of the largest and most impactful standards, SAS 142, *Audit Evidence*, and SAS 145, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, went into effect for December 2022 and 2023 year-ends, respectively. And while they had wide-ranging impacts on the evidence auditors gather, the documentation auditors create, and the risk assessment procedures they perform, these standards have now been in effect for multiple year-ends and are just the law of the land now.

SAS 149 is discussed here. As a reminder, SASs 143–145 were effective for December 2023 year-ends. SAS 147 was effective for audits of financial statements for periods beginning on or after June 30, 2023. SAS 148 effective dates are aligned with SAS 142 and SAS 145. Finally, SAS No. 149 is effective for December 2026 year-ends.

The AICPA continues to advance its initiative and, in the process, has identified these environmental drivers that form the focus for the future:

- a. Emerging technology and the extent of its use;
- b. Increasing complexity in business transactions and globalization;
- c. Complexity in financial reporting standards where more estimates and management judgments come into play;
- d. External reporting with users of financial statements asking for additional information about internal control, sustainability, cybersecurity, and governance; and
- e. Changing expectations of stakeholders.

II. Auditing standards update

A. New SASs effective for 2025, 2026, and beyond

In addition to those we have discussed above, the following is a summary of other updates that are effective beginning in 2025 or later:

- a. SAS 149 – *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors and Audits of Referred-to Auditors)*:
 - (i) Updates the requirements and guidance by providing a risk-based approach to planning and performing a group audit;
 - (ii) Defines the term “referred-to auditor” as an auditor who performs an audit of the financial statements of a component to which the group engagement partner determines to make reference in the auditor’s report on the group financial statements. Importantly, this auditor is not part of the engagement team. Previously, this auditor would have been referred to as a component auditor. Further, the definition of a “component auditor” has been revised to note that a component auditor is part of the engagement team; and
 - (iii) Provides guidance and requirements related to equity method investments.

1. SAS 146 – Quality Management for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards

SAS 146 is an amendment of AU-C 220 and is related to SSARS 26, which amends AR-C sections 60, 70, 80, and 90. It is effective for engagements conducted in accordance with GAAS for periods beginning on or after December 15, 2025. It clarifies that the engagement partner (EP) is ultimately responsible for the engagement even though that person may assign certain tasks to others within the engagement team.

The updates state that the EP needs to be sufficiently and appropriately involved throughout the engagement, as this is fundamental to providing the engagement leadership required to achieve high-quality engagements.

The following requirements of the EP were added to reinforce this point:

- a. **Fulfilling leadership responsibilities**, including taking actions to create an environment for the engagement that emphasizes the firm's culture and the expected behavior of engagement team members, and assigning procedures, tasks, or actions to other members of the engagement team;
- b. **Supporting engagement performance**, including taking responsibility for the nature, timing, and extent of the direction, supervision, and review of the work performed; and
- c. **Observing the "stand-back" requirement** to determine whether the engagement partner has taken overall responsibility for managing and achieving quality, including determining that the engagement partner's involvement has been sufficient and appropriate throughout the engagement and that the nature and circumstances of the engagement have been considered. Note that this is a new requirement.

The standard also includes these new requirements related to ethics:

- a. Understanding of the relevant ethical requirements and whether other members of the engagement team are aware of those requirements and the firm's related policies or procedures.
- b. Threats to compliance with relevant ethical requirements.
- c. Determining whether relevant ethical requirements, including those related to independence, have been fulfilled.

SAS 146 and SSARS 26 include clarifying guidance in many areas. One especially significant area is clarification on what the engagement partner needs to review, specifically significant matters and significant judgments as well as formal written communications to management and those charged with governance.

III. Attestation standards

A. Forthcoming standards updates

CPAs have traditionally added value by providing an opinion based on their examination of an assertion made by the party responsible for the subject matter to which the assertion relates.

B. Updates to the AICPA Code of Professional Conduct – Nonattest services and other matters

Since its recodification, which was effective in 2014, the AICPA Code of Professional Conduct (Code) had remained stable for several years. From 2014 to roughly 2018, the only new Code guidance issued by the AICPA's Professional Ethics Executive Committee (PEEC) dealt with the independence implications of certain hosting arrangements. However, the last few years have seen a litany of changes to the Code. While the expanded NOCLAR guidance was effective beginning in 2023, many threats to independence and changes to existing interpretation have been released since the NOCLAR guidance. As the NOCLAR guidance is now fully implemented, we have moved forward to address the more current guidance and interpretations.

The sections below will cover new PEEC guidance that will be effective in 2025 and 2026, as well as PEEC guidance that was effective in 2024:

- a. Revisions to Engagements Subject to the Statements on Standards for Attestation Engagements.
- b. ET section 1.275.005:
 - (i) Simultaneous Employment or Association With an Attest Client
- c. ET section 1.295.135:
 - (i) Executive or Employee Recruiting.
- d. ET sections 1.230.030 and 1.230.040:
 - (i) Determining Fees for an Attest Engagement; and
 - (ii) Fee Dependency.
- e. ET section 1.240.070:
 - (i) Section 529 Plans.

These updates address a cross-section of Code requirements. We'll explore each in greater detail now and discuss what's still on the PEEC's agenda.

C. Other new independence interpretations

1. New definition and technical wording changes for ET section 1.220.030

The PEEC finalized a new definition for “period covered by the attest report.” It is now defined as “the point in time or period of time to which the subject matter of the attest engagement relates. The period covered by the attest report can vary depending on the scope of the attest engagement.” The update also replaced much of the language focused on audit standards with “professional standards applicable to the attest engagement, such as AU-C...” It further replaced specific references to “audit” with “attest” throughout the Code section. Amendments in the section are effective as of June 15, 2026.

Here is an example of the application of the new definition of “period covered by the attest report.”

Examples of engagements performed in accordance with Statements on Auditing Standards or Statements on Standards for Accounting and Review Services	Examples of engagements performed in accordance with Statements on Standards for Attestation Engagements
a. The fiscal- or calendar-year period covered by an audit or review report on a complete set of <i>financial statements</i> , such as “as of and for the year ended December 31, 20X0.” b. The single day covered by an audit or review report on a balance sheet, such as “as of December 31, 20X0.”	a. The six-month period covered by an examination report on the controls at a service organization, such as “for the six-month period ending September 30, 20X0.” b. The fiscal- or calendar-year period covered by an examination or review report on greenhouse gas emissions information, such as “for the year ended December 31, 20X0.”

2. Simultaneous Employment or Association With an Attest Client (ET section 1.275.005)

The PEEC was concerned with threats to independence when simultaneous employment relationships or associations with attest clients exist. In recognition of this significant threat, the PEEC added a new definition to the Code: “**simultaneously employed or associated**” – “When a *partner* or professional employee of the *member’s firm* serves as a member of *those charged with governance* or as an employee of an *attest client* during the *period of the professional engagement*. This includes contractual or volunteer positions at the *attest client*.”

Independence would be at risk without a possible reduction in risk if the following situations exist: “The familiarity, management participation, advocacy, self-interest, or self-review *threats* to compliance with the ‘Independence Rule’ would **not** be at an *acceptable level* and could **not** be reduced to an *acceptable level* by the application of *safeguards*, and *independence* would be *impaired* when:

- a. A *covered member* is *simultaneously employed or associated* with the *attest client*; or
- b. A *partner* or professional employee who is not a *covered member* is *simultaneously employed or associated* in a *key position* with the *attest client*.”

The term “*key position*” replaces former “officer or director” language to be more principles-based.

Furthermore, “When a partner or professional employee intends to accept an offer to become simultaneously employed or associated with an attest client:

- a. The person should promptly report the offer to an appropriate person in the firm; and
- b. The appropriate person should apply the “Conceptual Framework for Independence” interpretation [1.210.010] to evaluate whether the familiarity, management participation, advocacy, self-interest, and self-review threats are at an acceptable level.”

The PEEC clarified that an inadvertent and isolated failure to apply the above will not impair independence if the impacted parties perform the required procedures upon discovery of the failure and continue to meet the rest of the standard in 1.275.

Here are factors to consider if the threat is at an acceptable level:

- a. The person’s position and role at the attest client – The more responsibility and visibility, the higher the threat;
- b. The person’s position and role at the firm – The more significant, the higher the threat;
- c. The level of assurance of the attest engagement – Audit clients likely present a higher threat than other assurance engagements;
- d. The nature and scope of the activity to be performed;
- e. The size and structure of the attest client – The smaller the client, the larger the threat;
- f. The length and status of the simultaneous employment/arrangement – The longer/full-time association is riskier than a short-term/temporary position; and
- g. The value of compensation paid to the member – If material to the member’s net worth, the threat is higher.

Examples of actions that may be safeguards to the observed threats are as follows:

- a. Designating an appropriate reviewer who has **not** provided services to the attest client to review the attest work performed; and
- b. Modifying the individual’s position or role at the attest client sufficiently so that threats to independence are reduced to an acceptable level.

However, communication with those charged with governance regarding threats is a safeguard but is not a sufficient safeguard independently. It must be applied with other safeguards like those listed above.

Specific provisions exist for those covered members operating as independent contractors. When an employee of an attest client is engaged as an independent contractor (IC) by the firm to perform professional services for the attest client, independence **would be impaired** if the same employee is **any** one of the following:

- a. A member of the attest engagement team for the same attest client;
- b. An individual in a position to influence the attest engagement for the same attest client;
- c. In a key position at the same attest client; or
- d. Serving in a role held by those charged with governance at the same attest client.

Exceptions to the updated rules exist. Threats will be at an acceptable level, and independence will not be impaired when:

- a. A partner or professional employee of the member's firm serves as an adjunct faculty member of an educational institution that is an attest client of the firm, and the partner or professional employee meets all the following safeguards:
 - (i) They are not in a key position or in a role held by those charged with governance at the educational institution;
 - (ii) They are not a member of the attest engagement team; and
 - (iii) They are not an individual in a position to influence the attest engagement.
- b. A member in a government audit organization performs an attest engagement with respect to the government entity, and the head of the government audit organization meets at least one of the following criteria:
 - (i) They are directly elected by voters of the government entity with respect to which attest engagements are performed;
 - (ii) They are appointed by a legislative body and are subject to removal by a legislative body; or
 - (iii) They are appointed by someone other than the legislative body, as long as the appointment is confirmed by the legislative body, and removal is subject to oversight or approval by the legislative body.

This Code update clearly identifies situations, employment relationships, and associations between an attest client and the accounting firm and provides practical safeguards, exceptions, and ways to mitigate such threats. You should be sure to discuss this updated standard with your team and ensure that the relationships between you, your firm, and your attest clients are at an acceptable level.

3. Executive or employee recruiting (ET section 1.295.135)

Effective January 1, 2026 (early implementation is allowed), after releasing an exposure draft concerning members in public practice performing recruiting services for a key position for an attest client, the PEEC finalized new interpretations to the Code related to recruiting services for attest clients. The recruiting guidance introduced new prohibitions for members performing recruiting services for attest clients.

Specifically, the following actions by a member would represent a threat to independence:

- a. Hiring or terminating the attest client's employees (*item prohibited under previous guidance*);
- b. Advising on the specific terms of employment, remuneration, or related benefits of a particular candidate for a key position;
- c. Searching for or seeking out candidates for key positions;
- d. Undertaking reference checks of prospective candidates for a key position;
- e. Recommending to the attest client only one candidate for consideration for a key position;
- f. Ranking candidates for a key position whether or not using the attest client's criteria;
- g. Negotiating with the candidate on behalf of the attest client; and
- h. Committing the attest client to employee compensation or benefit arrangements.

These prohibitions were in recognition that by performing recruiting services for an attest client self-review, familiarity, undue influence, and management participation threats to independence were all potentially present.

While there are new prohibitions, the new guidance also identifies activities where threats would likely be at an acceptable level, and independence would **not** be impaired:

- a. Recommending or advising on a position description or candidate specifications;
- b. Advising on the general terms of employment, remuneration, or related benefits of a particular position;
- c. Searching for or seeking out candidates for non-key positions using the attest client's criteria, such as required education, skills, or experience;
- d. Reviewing candidate resumes provided by the attest client to identify those who meet the attest client's criteria;
- e. Interviewing candidates and advising on a candidate's competence based on the attest client's criteria for any position; and
- f. Recommending to the attest client more than one candidate for any position for consideration based on the attest client's criteria, including providing analysis of how each candidate meets the attest client's criteria. If only one candidate for a non-key position meets the attest client's criteria, the member should apply the "Conceptual Framework for Independence" interpretation [1.210.010] to evaluate whether the threats are at an acceptable level.

4. Section 529 plans (ET section 1.240.070)

Effective May 31, 2025, the PEEC's revised interpretation for ET section 1.240.070, "Section 529 Plans," the *Code of Professional Conduct's* "Independence Rule," becomes effective for members in public practice. The independence interpretation focuses on Section 529 plans. Section 529 plans are tax-beneficial investment vehicles sponsored by institutions of higher education or states. **The plans can be either prepaid tuition plans or savings plans.** The owner of the account can designate themselves as the beneficiary and may change the beneficiary at any time to another individual or previous beneficiary.

Prepaid tuition plan

For prepaid tuition plans, the account owner of such a plan is considered to have a direct financial interest in the plan. If the plan is an attest client, **independence would be impaired** if a covered member is an account owner. However, the account owner **does not have** any financial interest in the underlying investments.

Savings plan

For savings plans, the rules are more nuanced. The account owner of a Section 529 savings plan is considered to have a direct financial interest in the savings plan. Similar to the prepaid tuition plan, if the plan is an attest client, independence would be impaired if a covered member is an account owner. Unlike the tuition plan, the account owner now **has an indirect financial interest** in the plan's underlying investments.

“The account owner has an indirect financial interest in the plan’s underlying investments because the account owner’s interest in the plan is evidenced by a unit of participation in the plan, which is a municipal fund security, and not shares of the underlying investments. The account owner does not have the ability to control or influence the underlying investments comprising the plan’s investment options. When the underlying investments in an account owner’s Section 529 savings plan do not include an attest client, there are no threats to independence. When an underlying investment in an account owner’s Section 529 savings plan is an attest client, threats to independence may exist if the account owner is a covered member with respect to the underlying investment.”

If the underlying investment in the attest client is material to the covered member, the self-interest threat would not be at an acceptable level, and independence would be impaired unless the covered member deployed one of the following safeguards:

- a. Reallocating plan holdings such that there is no material indirect financial interest in an attest client for which the member is a covered member.
- b. Transferring the account to another sponsor’s Section 529 savings plan that does not include a material indirect financial interest in an attest client for which the member is a covered member.
- c. Transferring the account to another account owner who is not subject to the “Independence Rule” [1.200.001].

“The safeguard should be applied as soon as practicable but no later than 30 days after the covered member has knowledge of the material indirect financial interest in the attest client and the right to transfer without a penalty or tax that is significant to the account. If the covered member will incur a penalty or tax that is significant to the account, the covered member may maintain the position in the plan until the safeguard can be applied without significant penalty or tax, provided that the covered member does not participate on the attest engagement team and is not an individual in a position to influence the attest engagement.”

5. Determining fees for attest engagements (ET section 1.230.030) and fee dependency (ET section 1.230.040) interpretations

Effective January 1, 2025 (early implementation was allowed), after releasing an exposure draft concerning fee dependency and determining fees for an attest engagement, the PEEC finalized new interpretations to the Code related to fees. In determining fees for an attest engagement, ET section 1.230.030 clarifies that fees for an attest engagement are not to be influenced by other services provided to the attest client. The fee should be determined on a standalone basis, not in conjunction with other fees for services provided to the client. The overarching goal of the interpretation is to ensure that other services provided to the client have no influence on the fee charged for the attest engagement.

The “Fee Dependency” interpretation (ET section 1.230.040) addresses the self-interest and undue influence risks that occur when a significant portion of a firm’s revenue is derived from a single attest client. If fee dependency remains for five years or more, the firm must put enhanced safeguards in place for the dependent engagement.

To help members identify fee-related independence threats, the PEEC enhanced the “Conceptual Framework for Independence” (ET section 1.210.010) with updated examples of threats. The “Client Affiliates” interpretation (ET section 1.224.010) has also been revised to clarify the affiliates subject to the fee-dependency requirements.

Discussion question:

Which of these new ethics interpretations do you feel will impact you the most?

IV. SEC and PCAOB updates

A. SEC update

1. Safeguarding crypto assets – SAB 121 and SAB 122

Staff Accounting Bulletin (SAB) 121, issued by the SEC staff in March 2022, outlines the staff's view that public companies – including banks and other financial institutions – that safeguard crypto assets for users must record a liability and a corresponding asset on their balance sheets. Specifically, the entity should recognize a liability to reflect the obligation to safeguard the crypto assets and an asset of equal amount to represent its right to receive reimbursement from the customer for safeguarding those crypto assets. This approach is based on the unique technological, legal, and regulatory risks associated with crypto asset custody, such as the heightened risk of loss due to theft, hacking, or loss of private keys.

The SEC staff also emphasized enhanced disclosure requirements. Entities must provide clear and comprehensive disclosures in their financial statements about the nature and amount of crypto assets held for customers, associated risks, and the accounting policies used. The intent of SAB 121 was to increase transparency for investors by ensuring they understand the risks and responsibilities assumed by custodians of crypto assets, even if the assets are not owned by the custodian. Notably, SAB 121 received considerable pushback at the time it was released.

In 2025, the SEC issued SAB 122, which repealed the interpretive guidance included in SAB 121, Section FF of Topic 5 in the SAB Series entitled "Accounting for Obligations to Safeguard Crypto-Assets an Entity Holds for its Platform Users." This was the guidance that required a custodian safeguarding crypto assets to record corresponding liabilities and assets for the crypto assets held by the custodian on behalf of a customer. That guidance is no longer SEC rule, effective as of January 30, 2025.

B. PCAOB update – New PCAOB guidance

1. Quality Control (QC) 1000

Effective December 15, 2026, the PCAOB is updating its guidance for PCAOB-registered firms. The guidance is similar to the International Standards on Quality Management and the AICPA's System of Quality Management Standards (SQMS). The new guidance creates a new risk-based system of quality management along with the existing mandated standards.

Firms must establish and actively maintain their quality control system, continuously monitor its effectiveness, and take corrective measures when policies or procedures fall short, thereby fostering an ongoing cycle of improvement. The firms must annually evaluate their QC system and report the results of their evaluation to the PCAOB in a new form (Form QC). The form must be certified by key firm personnel.

QC 1000 introduces an external (non-firm personnel) oversight function to firms' systems of quality control. Firms that annually audit more than 100 issuers must establish an external oversight function for

their QC system. This external oversight body must have one or more persons who can independently evaluate the QC system at the firm. It will operate similarly to a board of directors.

2. AS 1000 – General Responsibilities of the Auditor in Conducting an Audit

Effective for audits of financial statements for fiscal years beginning on or after December 15, 2024 (and one year later for registered firms with 100 or fewer issuer clients), the modernized standard consolidates and reorganizes existing standards into a single standard. It replaces AS 1001, AS 1005, AS 1010, and AS 1015. While it does not create new principles, it reaffirms some existing principles and expands definitions and guidelines for others. A key technical change in AS 1000 is that it reduces the maximum period for the auditor to assemble a complete and final set of audit documentation from 45 days to 14 days.

3. AS 2310 – The Auditor’s Use of Confirmation

Effective for audits of financial statements for fiscal years ending on or after June 15, 2025, the PCAOB has meaningfully updated its confirmation standard for the first time in decades. The standard adopted on an interim basis at its founding, AS 2310, “The Confirmation Process,” was originally written in 1992, and had not been updated since then to reflect the new technology and information environment firms are operating in today.

The updated standard moves to a principles-based approach to confirmations to allow for technological advancements and flexibility and removes reference to fax machines and traditional mail.

The standard also clarifies that negative confirmations alone are not sufficient audit evidence for accounts receivable. The auditors must perform other substantive audit procedures if negative confirmations are used. The new standard also reaffirms that the auditor is responsible for maintaining control over the confirmation process and must be the one to select the items to be confirmed, send the confirmation requests, and receive confirmation responses. In modernizing the standard, “the auditor or the confirming party can engage another party as an intermediary to facilitate direct electronic transmission of confirmation requests and responses between the auditor and the confirming party. When using an intermediary for this purpose, the auditor should evaluate the implications on the reliability of confirmation requests and responses.”

AS 2310 also establishes that the auditor should perform audit procedures for cash and cash equivalents held by third parties in addition to accounts receivable. When the auditor determines it is not feasible to obtain audit evidence, the auditor should obtain external audit evidence indirectly by performing other audit procedures.

4. AS 2301 – The Auditor’s Responses to the Risks of Material Misstatement and AS 1105 – Audit Evidence

In June 2024, in issuing PCAOB Release No. 2024-007, the PCAOB adopted significant amendments to Auditing Standards (AS) 1105 and AS 2301, which focused on modernizing audit requirements in light of technology-assisted analysis used by auditors. The changes clarify auditor responsibilities when using data analytics and other technology-based tools to obtain and evaluate audit evidence, ensuring auditors continue to obtain sufficient appropriate evidence in an era of increasing electronic data, AI, and analytic procedures. These amendments are principles-based (not prescribing specific tools) and adaptable to evolving technology, and they apply to all PCAOB audits for fiscal years beginning on or after December 15, 2025, following approval by the SEC in August of 2024.

Key amendments (summarized):

- a. **Clarified definition of a “test of details”** – Now defined in the standards as procedures on individual items in an account or disclosure, distinguishing them from analytical procedures. This can include dates, amounts, or terms. Auditors must apply appropriate procedures to each item selected for testing. This clarification (now located in AS 2301.48) addresses confusion over whether data-analytic procedures can constitute tests of details. It makes clear that analytics can be designed as tests of details if applied at the item level and aimed at a substantive objective.
- b. **Investigation of identified items (outliers)** – When using technology-assisted analysis to perform a test of details on a full population or specific items, auditors often identify outliers or unusual items. New AS 2301.49 requires auditors to investigate items identified through such procedures as part of their response to risk. The auditor must determine whether the identified items indicate a misstatement or a control deficiency, individually or in aggregate. This ensures apparent anomalies flagged by data analytics are appropriately followed up with additional audit work rather than ignored.
- c. **Selecting specific items vs. full population** – If an auditor tests specific items (nonstatistical selection) rather than an entire population or a statistically verified representative sample, new AS 2301.50 addresses the risk in the remaining, untested items. Auditors must evaluate whether untested items could contain a material misstatement and, if there’s a reasonable possibility, perform additional substantive procedures to cover that risk. This closes a gap in prior standards by explicitly requiring auditors to consider what hasn’t been tested when using targeted selection (often done with data analytic tools).
- d. **Using one procedure for multiple purposes** – Amendments to AS 1105.14 make it explicit that if an audit procedure is designed to achieve more than one objective (for example, a single data analytics procedure used both to identify risks and to obtain substantive evidence), the auditor must achieve each relevant objective of that procedure. In practice, this means auditors can’t double-count one analytical procedure for two purposes without meeting the full requirements of both. For instance, an automated transaction analysis might serve to pinpoint risk areas and test transactions. In doing so, the auditor should ensure it meets the standards for risk assessment and for substantive testing, or supplement it as needed.
- e. **Evaluating reliability of external information (electronic)** – A major update is the addition of AS 1105.10A, which codifies auditors’ responsibilities when using external information obtained by the company and provided to auditors in electronic form. Examples include bank statements, invoices, or confirmations that the company downloads or receives and then gives to the auditor. The auditor’s requirements involve:
 - (i) “Obtaining an understanding of (1) the source from which the company received the information; and (2) the company’s process by which such information was received, maintained, and, where applicable, processed, which includes understanding the nature of any modifications made to the information before it was provided to the auditor; and
 - (ii) Testing the information to determine whether it has been modified by the company and evaluating the effect of those modifications; or testing controls over receiving, maintaining, and processing the information (including, where applicable, information technology general controls and automated application controls).”

In short, if auditors are relying on externally sourced data (e.g., a PDF bank statement) furnished by management, they must now evaluate whether that data is authentic and reliable. This can be done by checking for any company-introduced modifications or by assessing the controls that ensure the data's integrity. This closes a gap. Previously, PCAOB standards did not explicitly address this scenario, even though it's common in practice to use company-provided external documents as evidence.

- f. **Emphasis on information technology (IT) controls** – The amendments reinforce the notion that effective IT controls at the company directly affect the reliability of information used as audit evidence. AS 1105.08 (which discusses reliability of evidence) and related provisions were amended to highlight that information from electronic sources is more reliable if the company's relevant IT general controls and application controls are effective. For example, if a company's report is generated from an IT system, the trustworthiness of that report improves if the underlying system access controls, change management, and data processing controls are sound. Auditors are reminded (and now explicitly required) to factor in IT control effectiveness when evaluating evidence quality and when deciding whether further procedures are needed to validate information. Additionally, AS 1105.10 was updated to explicitly mention testing IT controls as one way to verify the accuracy and completeness of information produced by the company (see clause (1) of .10), and AS 2501.12 (estimates standard) was conformed to reference IT controls in this context.
- g. **Relevance and disaggregation of information** – AS 1105.07 was revised to stress that the relevance of audit evidence depends on its relationship to the assertion *and* on the level of detail (disaggregation) of the information relative to the audit objective. In practice, this means auditors should ensure that when using aggregated data or broad analytical procedures, the data is broken down sufficiently to actually address the risk in question. For instance, analyzing an entire revenue balance might not be relevant to a specific fraud risk if not disaggregated by region or product line. The standard now emphasizes using an appropriate level of detail so that evidence gathered is relevant to the specific audit assertion. This concept ties into technology-assisted procedures because such tools enable analysis of large data sets. The auditor must choose the proper granularity for that analysis to be meaningful.
- h. **Modernizing terminology** – The amendments also update certain terms in AS 1105 to reflect modern audit practices:
 - (i) Using the term “information” instead of “documents or records” in describing audit procedures, acknowledging that information is often electronic and not always a traditional document;
 - (ii) Removing outdated phrasing like “recalculation manually or electronically.” Recalculation is now defined simply as checking mathematical accuracy, since it can be assumed it might be done with software; and
 - (iii) Replacing “internal” vs. “external” evidence wording with “produced by the company” versus other sources to more clearly distinguish company-generated information from third-party information.

These changes do not alter substantive requirements but ensure the standard's language aligns with current realities (e.g., an original "document" might be a digital file rather than paper). Consistency in terminology also helps avoid misinterpretation, for example, indicating that any procedure can be performed with electronic information (hence removing the implication that only certain ones might be electronic).

These amendments will become effective for audits of financial statements for fiscal years beginning on or after December 15, 2025.

For experienced auditors, the updated AS 1105 and AS 2301 reinforce fundamental audit principles in the context of modern tools and practices by focusing on a principles-based approach to auditing instead of specific applications and tools. The common theme is ensuring audit quality in the age of data analytics. Key takeaways are to thoroughly investigate anomalies identified by analytics, to be mindful that analytics don't bypass the need for item-level testing for significant risks, to carefully assess the reliability of any information not obtained directly, and to always tie the design of procedures (and the data used) back to the specific objectives and risks at hand. The standards' language is now closer to the reality of today's audit environment, providing clearer guidance on points that have caused diversity in practice. These amendments, as the PCAOB noted, are "*principles-based and adaptable to evolving technology*," meaning they set expectations without being tied to any one tool, which is a necessary approach given the rapid change in audit technology.

