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Real Estate

Accounting and Financial Reporting Update

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Financial Services Industry

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Foreword

November 24, 2014

To our clients and colleagues in the real estate sector:

We are pleased to announce our seventh annual accounting and financial reporting update. Some of the notable standard-setting developments that occurred during 2014 were (1) the issuance of new guidance on the recognition of revenue from contracts with customers and discontinued operations; (2) the continued work of the FASB on accounting for leases, consolidation, and financial instruments; and (3) the SEC's continued focus on rulemaking, particularly in connection with its efforts to complete mandated actions under the Dodd-Frank Act.

This publication is divided into three sections: (1) "Updates to Guidance," which highlights changes to accounting and reporting standards that real estate entities need to start preparing for now; (2) "On the Horizon," which discusses standard-setting topics that will affect real estate entities as they plan for the future; and (3) "Other Topics" that may be of interest to entities in the real estate sector.

The 2014 accounting and financial reporting updates for the banking and securities, insurance, and investment management sectors are available (or will be available soon) on US GAAP Plus, Deloitte's Web site for accounting and financial reporting news.

In addition, be sure to check out the eighth edition of our *SEC Comment Letters — Including Industry Insights*, which discusses our perspective on topics that the SEC staff has focused on in comment letters issued to registrants over the past year, including an analysis of comment letter trends in each financial services sector.

As always, we encourage you to contact your local Deloitte office for additional information and assistance.

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Introduction

The real estate market continued its modest recovery from 2013 into 2014. Through late 2014, the national home price index gained single-digit year-to-date returns compared with double-digit growth in 2013. Factors contributing to the continued increase in home prices include shrinking unemployment, low mortgage rates, and rising income for consumers. The commercial real estate market has also seen tapering price increases over the past year.

Economic Growth by Major Group

Commercial Real Estate

In 2009 and 2010, rental revenues in the commercial real estate industry declined dramatically because of weakened demand for commercial spaces. In 2014, revenues increased marginally, resulting in a five-year compound average revenue growth rate of about 2 percent. However, several factors could constrain long-term increases (e.g., increases in telecommuting, e-commerce).

Growth in REITs

REIT[1] fundraising has been increasing in recent years. REIT IPOs have been at their highest level (in terms of number and value of transactions) since 2005 and have involved both traditional and nontraditional real estate asset classes (e.g., single family rentals, data centers).

Property Management

As a result of the economic downturn, rental vacancy rates have decreased as more consumers have opted to rent a home rather than purchase one. However, this trend may change since the housing market is expected to expand over the next few years. Demand for office and factory space has also declined as firms have either reduced their workforces or closed operations. However, growth in this area was strong in 2014 and is forecasted to remain so.

Accounting Changes

During 2014, the FASB and IASB issued their final standard on revenue from contracts with customers, which supersedes most of the current revenue recognition guidance, including the guidance on real estate derecognition for most real estate disposals. The new standard is one of the most significant releases of guidance affecting the real estate industry since the issuance of FASB Statement 66 in October 1982. See the Revenue Recognition section for a discussion of key accounting issues and potential challenges related to real estate disposals.

The FASB also issued ASU 2014-08,[2] which amends the definition of a discontinued operation in ASC 205-20. The revised guidance will change how entities identify disposal transactions that are required to be accounted for as a discontinued operation under U.S. GAAP. The FASB issued the ASU to elevate the threshold for a disposal transaction to qualify as a discontinued operation (since too many disposal transactions were qualifying as discontinued operations under existing guidance). The ASU also requires entities to provide additional disclosures about disposal transactions that do not meet the discontinued operations criteria. See the Discontinued Operations Reporting section for a discussion of key accounting issues and potential challenges related to real estate.

For additional information about industry issues and trends, see Deloitte's 2014 Financial Services Industry Outlooks.

[1] For a list of abbreviations used in this publication, see Appendix B.
[2] For the full titles of standards, topics, and regulations used in this publication, see Appendix A.

Updates to Guidance

Revenue Recognition

Background

On May 28, 2014, the FASB and IASB issued their final standard on revenue from contracts with customers. The standard, issued by the FASB as ASU 2014-09, outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including the guidance on real estate derecognition for most transactions.

The ASU's model is based on a core principle under which an entity "shall recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services" and includes five steps to recognizing revenue:

1. Identify the contract(s) with a customer.
2. Identify the performance obligations in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations in the contract.
5. Recognize revenue when (or as) the entity satisfies a performance obligation.

Thinking It Through

The ASU will have a significant effect on the accounting for real estate sales. The ASU eliminates the bright-line guidance that entities currently apply under ASC 360-20 when evaluating when to derecognize real estate assets and how to measure the profit on the disposal. It will change the accounting for both real estate sales that are part of an entity's ordinary activities (i.e., real estate transactions with customers) and real estate sales that are not part of the entity's ordinary activities. While the ASU eliminates the guidance in ASC 360-20 on real estate sales, entities will still need to apply ASC 360-20 to sales of real estate that are part of sale-leaseback transactions, at least until the FASB has completed its project on leasing.

Key Accounting Issues

Some of the key accounting issues and potential challenges related to real estate disposals are discussed below.

Financing Arrangements (Existence of a Contract)

Under current guidance, when the seller of real estate also provides financing to the buyer, the seller must consider the buyer's initial and continuing investments in the property to determine whether they constitute a stake sufficient to ensure that the risk of loss will motivate the buyer to honor its obligation to the seller. If the specified investment requirements are not met, the seller accounts for the sale by using the installment method, the cost recovery method, or the deposit method.

Under the ASU, collectibility of the sales price affects the evaluation of whether a contract "exists." That is, the ASU requires an entity to determine whether a contract exists by assessing whether it is probable that the entity will collect the consideration to which it will be entitled (the collectibility threshold). However, the ASU does not include specific initial and continuing investment thresholds for performing this evaluation. If a seller determines that a contract does not exist, it would account for any amounts received as a deposit (even if such payments are nonrefundable). In addition, the seller would continually evaluate the amounts received to determine whether the arrangement subsequently qualifies as a valid contract under the ASU's criteria. Once it becomes probable that the seller will collect the consideration to which it will be entitled, the seller would evaluate the arrangement under the derecognition criteria in the ASU. If, instead, the contract is terminated, the seller would then recognize any nonrefundable deposits received as a gain.

Identifying Performance Obligations

Often, a seller remains involved with property that has been sold. Under current guidance, profit is generally deferred if a seller has continuing involvement with the sold property. Sometimes, instead of accounting for the transaction as a sale, the seller may be required to (1) apply the deposit method to the transaction or (2) account for the transaction as a financing, leasing, or profit-sharing arrangement. The current guidance focuses on whether the seller retains substantial risks or rewards of ownership as a result of its continuing involvement with the sold property.

In contrast, under the ASU, if the arrangement includes ongoing involvement with the property, the seller must evaluate each promised good or service under the contract to determine whether it represents a "separate performance obligation," constitutes a guarantee, or prevents the transfer of control.[1] If a promised good or service is considered a separate performance obligation, an allocated portion of the transaction price should be recognized as revenue when (or as) the entity transfers the related good or service to the customer.

Thinking It Through

Views are evolving on how real estate developers should account for contracts that may contain multiple performance obligations. For example, views differ on how a community developer that agrees to provide common areas (e.g., a community center, parks, or a golf course) as part of the development would evaluate whether the promise to provide these additional amenities represents separate performance obligations (to which a portion of the transaction price would be allocated and potentially deferred until the separate performance obligations were satisfied).

Determining the Transaction Price

A sales contract may allow the seller to participate in future profits related to the underlying real estate. Under current U.S. GAAP, the amount of revenue recognized is generally limited to the amount that is not contingent on a future event. Any additional revenue would be recorded only when the contingent revenue is realized. Under the ASU, some or all of the estimated variable consideration is included in the transaction price (and therefore eligible for recognition) to the extent that it is probable that the cumulative amount of the revenue recognized will not be subject to significant reversal (the "constraint").

Accordingly, an entity will need to estimate the portion of the contingent (or variable) consideration to include in the transaction price, which may be recognized up front. As a result, revenue may be recognized earlier under the ASU than under current requirements.

The ASU also requires entities to adjust the transaction price for the time value of money when the arrangement provides either the customer or the entity with a significant benefit of financing the transfer of real estate to the customer. In such instances, the entity will be required to adjust the promised amount of consideration to reflect what the cash selling price would have been if the customer had paid cash for the promised property at the time control was transferred to the customer. In calculating the amount of consideration attributable to the significant financing component, the entity should use an interest rate that reflects a hypothetical financing-only transaction between the entity and the customer. As a practical expedient, the ASU does not require entities to account for a significant financing component in a contract if, at contract inception, the expected time between substantially all of the payments and the transfer of the promised goods and services is one year or less.

Accordingly, if an entity enters into a contract that either requires an up-front deposit before the transaction date or gives the customer the right to defer payments for a significant period from the transaction date, it will need to determine whether the contract's payment terms (1) give the customer or the entity a significant benefit of financing the transfer of the real estate or (2) are intended for other purposes (e.g., to ensure full performance by the entity or the customer).

[1] Certain forms of continuing involvement would not constitute a separate performance obligation. For example, an option or obligation to repurchase a property is specifically addressed by the ASU and would preclude derecognition of the property. Further, a seller obligation that qualifies as a guarantee under ASC 460 would be outside the scope of the ASU.

Recognizing Revenue When (or as) Performance Obligations Are Satisfied

When evaluating whether the disposal of real estate qualifies for sale accounting under current U.S. GAAP, entities focus on whether the usual risks and rewards of ownership have been transferred to the buyer.

Under the ASU, a seller of real estate would evaluate whether a performance obligation is satisfied (and the related revenue recognized) when "control" of the underlying assets is transferred to the purchaser.[2] An entity must first determine whether control is transferred over time or at a point in time. If control is transferred over time, the related revenue is recognized over time as the good or service is transferred to the customer. If control is transferred at a point in time, revenue is recognized when the good or service is transferred to the customer.

Control of a good or service (and therefore satisfaction of the related performance obligation) is transferred over time when at least one of the following criteria is met:

- "The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs."
- "The entity's performance creates or enhances an asset . . . that the customer controls as the asset is created or enhanced."
- "The entity's performance does not create an asset with an alternative use to the entity . . . and the entity has an enforceable right to payment for performance completed to date."

Thinking It Through

Real estate sales in most jurisdictions (including the United States) will typically not meet the criteria to be recognized as revenue over time because it is uncommon for the seller to either (1) have an enforceable right to payment for its cost plus a reasonable margin if the contract were to be canceled at any point during the construction period or (2) be legally restricted from transferring the asset to another customer, even if the contract were canceled at any point during the construction period. The ASU contains an example[3] in which a real estate developer enters into a contract to sell a specified condominium unit in a multifamily residential complex once construction is complete. In one scenario in this example, the seller does recognize revenue over time; however, the example indicates that this conclusion is based on legal precedent in the particular jurisdiction where the contract is enforceable.

If a performance obligation does not meet any of the three criteria for recognition over time, the performance obligation is deemed satisfied at a point in time. Under the ASU, entities would consider the following indicators in evaluating the point in time at which control of real estate has been transferred to the buyer and when revenue should be recognized:

- "The entity has a present right to payment for the asset."
- "The customer has legal title to the asset."
- "The entity has transferred physical possession of the asset."
- "The customer has the significant risks and rewards of ownership of the asset."
- "The customer has accepted the asset."

[2] ASC 606-10-25-25 (added by the ASU) states that "[c]ontrol of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset" and "includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset."

[3] ASC 606-10-55-173 through 55-182.

While entities will be required to determine whether they can derecognize real estate by using a control-based model rather than the risks-and-rewards model under current U.S. GAAP, the FASB decided to include "significant risks and rewards" as a factor for entities to consider in evaluating the point in time at which control of a good or service is transferred to a customer. Accordingly, although a seller of real estate would evaluate legal title and physical possession to determine whether control has transferred, it should also consider its exposure to the risks and rewards of ownership of the property as part of its "control" analysis under the ASU.[4]

Effective Date and Transition

For public entities, the ASU is effective for annual reporting periods (including interim reporting periods within those periods) beginning after December 15, 2016. Early application is not permitted (however, early adoption is optional for entities reporting under IFRSs). Nonpublic entities can use the same effective date as public entities (regardless of whether interim periods are included) or postpone adoption for one year from the effective date for public entities.

Entities have the option of using either a full retrospective or a modified approach to adopt the ASU's guidance. Retrospective application would take into account the requirements in ASC 250 (with certain practical expedients). Under the modified approach, an entity recognizes "the cumulative effect of initially applying [the ASU] as an adjustment to the opening balance of retained earnings . . . of the annual reporting period that includes the date of initial application" (transactions in periods presented in the financial statements before that date are reported under guidance in effect before the change). Under the modified approach, the guidance in the ASU is only applied to existing contracts (those that are not completed) as of, and new contracts after, the date of initial application. The ASU is not applied to contracts that were completed before the effective date. Entities that elect the modified approach must disclose the impact of adopting the ASU, including the financial statement line items and respective amounts directly affected by the standard's application.

For additional information, see Deloitte's May 28, 2014, and July 2, 2014, *Heads Up* newsletters and Deloitte's September 22, 2014, *Real Estate Spotlight*.

Thinking It Through

Real estate entities will need to reassess their historical accounting for all real estate disposals to determine whether any changes are necessary. In addition to the issues discussed above, real estate entities will need to consider the ASU's guidance when accounting for (1) repurchase agreements (the seller may be required to account for the transaction as a lease, a financing, or a sale with a right of return) and (2) partial sales (entities that enter into partial sales will need to determine whether control of the real estate is transferred to the customer).

The ASU also requires significantly expanded disclosures about revenue recognition, including both quantitative and qualitative information about (1) the amount, timing, and uncertainty of revenue (and related cash flows) from contracts with customers; (2) the judgment, and changes in judgment, entities used in applying the revenue model; and (3) the assets recognized from costs to obtain or fulfill a contract with a customer. To comply with the ASU's new accounting and disclosure requirements, real estate entities may want to consider whether they need to modify their systems, processes, and controls to gather and review information that may not have previously been monitored.

[4] An entity would not consider parts of a contract that are accounted for under guidance outside the ASU (e.g., guarantees within the scope of ASC 460) when determining whether control of the remaining goods and services in the contract has been transferred to a customer.

Discontinued Operations Reporting

Background

On April 10, 2014, the FASB issued ASU 2014-08, which amends the definition of a discontinued operation in ASC 205-20 and requires entities to provide additional disclosures about disposal transactions that do not meet the discontinued-operations criteria. The revised guidance will change how entities identify and disclose information about disposal transactions under U.S. GAAP. The FASB issued the ASU to provide more decision-useful information to users and to elevate the threshold for a disposal transaction to qualify as a discontinued operation (since too many disposal transactions were qualifying as discontinued operations under existing guidance). Under the previous guidance in ASC 205-20-45-1, the results of operations of a component of an entity were classified as a discontinued operation if all of the following conditions were met:

- The component "has been disposed of or is classified as held for sale."
- "The operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity as a result of the disposal transaction."
- "The entity will not have any significant continuing involvement in the operations of the component after the disposal transaction."

The new guidance eliminates the second and third criteria above and instead requires discontinued-operations treatment for disposals of a component or group of components that represents a strategic shift that has or will have a major impact on an entity's operations or financial results. The ASU also expands the scope of ASC 205-20 to disposals of equity method investments and acquired businesses held for sale.

Further, the ASU (1) expands the disclosure requirements for transactions that meet the definition of a discontinued operation and (2) requires entities to disclose information about individually significant components that are disposed of or held for sale and do not qualify as discontinued operations.

The ASU also requires entities to reclassify assets and liabilities of a discontinued operation for all comparative periods presented in the statement of financial position. Before these amendments, ASC 205-20 neither required nor prohibited such presentation.

Regarding the statement of cash flows, an entity must disclose, in all periods presented, either (1) operating and investing cash flows or (2) depreciation and amortization, capital expenditures, and significant operating and investing noncash items related to the discontinued operation. This presentation requirement represents a significant change from previous guidance.

The new guidance is likely to have the greatest impact on entities that enter into routine disposal transactions, such as those in the real estate or retail industries.

Scope

Previously, investments in equity securities accounted for under the equity method were outside the scope of ASC 205-20. The ASU eliminates that scope exception. In addition, the ASU notes that a "business or nonprofit activity that, on acquisition, meets the criteria to be classified as held for sale is reported in discontinued operations." Further, the ASU removed the discontinued-operations scope exceptions in ASC 360-10-15-5 but retained the exception for oil and gas properties accounted for under the full-cost method.

Recognition Criteria

Under the revised guidance, the unit of account for evaluating disposals (other than an acquired business or nonprofit activity) continues to be a component of an entity or a group of components of an entity; the ASU retains the existing definition of a component of an entity.

Discontinued Operation

ASU 2014-08 defines a discontinued operation as a component or group of components of an entity that (1) has been disposed of by sale or other than by sale in accordance with ASC 360-10-45-15, or is classified as held for sale, and (2) "represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results." According to the ASU, a strategic shift that has (or will have) a major effect on an entity's operations and results includes the disposal of any of the following:

- A major geographical area.
- A major line of business.
- A major equity method investment.
- Other major parts of an entity.

The ASU does not define the terms "major," "line of business," or "geographical area." It does, however, provide examples illustrating the evaluation of whether a disposal qualifies as a discontinued operation. These examples illustrate the quantitative thresholds of various metrics (e.g., assets, revenue, net income) — ranging from 15 percent to 20 percent as of the disposal date and 30 percent to 40 percent in historical periods — in various scenarios in which there was a strategic shift in an entity's operations that has (or will have) a major effect on the entity's financial results.

Thinking It Through

Entities will need to use judgment in determining what constitutes "major." Some may interpret the illustrative guidance in ASC 205-20-55-83 through 55-101 as implying that breaching quantitative thresholds in the range of 15 percent to 20 percent indicates that a disposal is major. However, note that the FASB intentionally avoided creating a bright-line quantitative threshold because qualitative factors may also affect this assessment.

Entities may also find it challenging to define the terms "line of business" and "geographical area." For example, some entities may define a geographical area as a county, state, country, or continent, while others may base this definition on how management determines its regions. Further, there may be differences in how entities define a major line of business: some may weight quantitative considerations more heavily, while others may stress qualitative factors.

Example

A publicly traded REIT in the United States has a regional mall division, a shopping center division, and an other commercial property division. The REIT's regional mall division consists of shopping malls in cities across the United States. In October, the REIT decides to sell two shopping malls in Washington because of declining operations. The two malls in Washington comprise 2 percent of the REIT's total net income and 5 percent of its total assets. Because the sale of the malls in Washington does not represent a strategic shift in the REIT's operations and because the quantitative thresholds are not significant, the sale does not meet the criteria for presentation as a discontinued operation, although disclosures may be required (as discussed below).

Disclosures

The ASU introduces several new disclosure requirements for both (1) disposals that meet the criteria for a discontinued operation and (2) individually significant disposals that do not meet these criteria.

The following are some of the noteworthy new disclosure requirements:

- Major line items constituting the pretax profit or loss for all periods for which the discontinued operation's results of operations are reported in the income statement. Some examples of major line items are (1) revenue, (2) cost of sales, (3) depreciation and amortization, and (4) interest expense.
- For most discontinued operations, an entity must disclose either of the following in the statement of cash flows or the notes to the financial statements:
    - Operating and investing cash flows for the periods for which the discontinued operation's results of operations are reported in the income statement.
    - Depreciation and amortization, capital expenditures, and significant operating and investing noncash items for the periods for which the discontinued operation's results of operations are reported in the income statement.
- "For the initial period in which the disposal group is classified as held for sale and for all prior periods presented in the statement of financial position, a reconciliation of" (1) total assets and total liabilities of the discontinued operation that are classified as held for sale in the notes to the financial statements to (2) "[t]otal assets and total liabilities of the disposal group classified as held for sale that are presented separately on the face of the [balance sheet]."
- For disposal of an individually significant component that does not meet the definition of a discontinued operation, all entities must disclose pretax profit or loss reported in the income statement for the period in which the disposal group is sold or is classified as held for sale. In addition, public entities must also disclose pretax profit or loss for all prior periods presented in the income statement.

These disclosures are required for both interim and annual reporting periods.

Transition Guidance

The ASU is effective prospectively for all disposals (except disposals classified as held for sale before the adoption date) or components initially classified as held for sale in periods beginning on or after December 15, 2014, with early adoption permitted.

See Deloitte's April 22, 2014, *Heads Up* for further discussion of ASU 2014-08.

Going Concern

Background

In August 2014, the FASB issued ASU 2014-15, which provides guidance on determining when and how to disclose going-concern uncertainties in the financial statements. The new standard requires management to perform interim and annual assessments of an entity's ability to continue as a going concern within one year of the date the financial statements are issued.[5] An entity must provide certain disclosures if "conditions or events raise substantial doubt about [the] entity's ability to continue as a going concern."

Under U.S. GAAP, an entity's financial reports reflect its assumption that it will continue as a going concern until liquidation is imminent.[6] However, before liquidation is deemed imminent, an entity may have uncertainties about its ability to continue as a going concern. Because there are no specific requirements under current U.S. GAAP related to disclosing such uncertainties, auditors have used applicable auditing standards[7] to assess the nature, timing, and extent of an entity's disclosures. Consequently, there has been diversity in practice. The ASU is intended to alleviate that diversity.

[5] An entity that is neither an SEC filer nor a conduit bond obligor for debt securities that are traded in a public market would use the date the financial statements are available to be issued (in a manner consistent with the ASU's definition of "issued").

[6] In accordance with ASC 205-30, an entity must apply the liquidation basis of accounting once liquidation is deemed imminent.

[7] PCAOB AU Section 341.

The ASU extends the responsibility for performing the going-concern assessment to management and contains guidance on (1) how to perform a going-concern assessment and (2) when going-concern disclosures would be required under U.S. GAAP.

Key Provisions of the ASU

Disclosure Thresholds

An entity would be required to disclose information about its potential inability to continue as a going concern when there is "substantial doubt" about its ability to continue as a going concern, which the ASU defines as follows:

> Substantial doubt about an entity's ability to continue as a going concern exists when conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date that the financial statements are issued . . . . The term probable is used consistently with its use in Topic 450 on contingencies.

In applying this disclosure threshold, entities would be required to evaluate "relevant conditions and events that are known and reasonably knowable at the date that the financial statements are issued." Reasonably knowable conditions or events are those that an entity may not readily know of but can be identified without undue cost and effort.

Time Horizon

In each reporting period (including interim periods), an entity would be required to assess its ability to meet its obligations as they become due for one year after the date the financial statements are issued.

Disclosure Content

The disclosure requirements in the ASU closely align with those under current auditing literature. If an entity triggers the substantial-doubt threshold, its footnote disclosures must contain the following information, as applicable:

Substantial Doubt Is Raised but Is Alleviated by Management's Plans	Substantial Doubt Is Raised and Is Not Alleviated
• Principal conditions or events. • Management's evaluation. • Management's plans.	• Principal conditions or events. • Management's evaluation. • Management's plans. • Statement that there is "substantial doubt about the entity's ability to continue as a going concern."

The ASU explains that these disclosures may change over time as new information becomes available.

Effective Date

The guidance in the ASU is "effective for annual periods ending after December 15, 2016, and interim periods within annual periods beginning after December 15, 2016." Early application is permitted.

For additional information, see Deloitte's August 28, 2014, *Heads Up*.

Accounting for Investments in Qualified Affordable Housing Projects

Background

In January 2014, the FASB issued ASU 2014-01, which is based on the final consensus reached by the EITF on Issue 13-B. This ASU amends the criteria that must be met to qualify for an alternative method of accounting for low income housing tax credit (LIHTC) investments. It also replaces the previous alternative accounting method — the effective yield method — with the proportional amortization method. Lastly, it introduces new disclosures that all entities must provide about their LIHTC investments.

ASU 2014-01 is effective for public business entities for annual periods, and interim reporting periods within those annual periods, beginning after December 15, 2014. For entities that are not public business entities, the guidance is effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. Early adoption is permitted for all entities.

Scope

Before the issuance of ASU 2014-01, few entities were able to apply the effective yield method of accounting to their LIHTC investments because of the restrictive nature of the previous scope requirements. ASU 2014-01 amends the scope requirements so that more LIHTC investments will qualify for an alternative method of accounting. Specifically, ASU 2014-01 eliminates the requirement that the tax credits from the LIHTC investment must be "guaranteed by a creditworthy entity" and also allows entities to consider both the tax credits and other tax benefits (e.g., depreciation expense) when determining whether the projected yield of the investment is positive.

As a result of these and other changes to the scope requirements, more LIHTC investments are likely to qualify for the alternative method of accounting.

New Alternative Approach

As noted above, ASU 2014-01 replaces the effective yield method with the proportional amortization method. The new approach, however, retains the effective yield method's presentation method, under which an entity presents the amortization of the LIHTC investment as "a component of income tax expense (benefit)."

Under the proportional amortization method, an entity would amortize the initial carrying amount of the LIHTC investment "in proportion to the tax credits and other tax benefits allocated to the investor." Specifically, the amortization amount for each period would be equal to the product of (1) the initial carrying amount of the investment and (2) the "percentage of actual tax credits and other tax benefits allocated to the investor in the current period divided by the total estimated tax credits and other tax benefits expected to be received by the investor over the life of the investment."

The proportional amortization approach also requires entities to test their LIHTC investments for impairment "when events or changes in circumstances indicate that it is more likely than not that the carrying amount of the investment will not be realized." If the investment is impaired, an impairment loss would be recognized equal to the amount by which the carrying amount of the investment exceeds its fair value.

New Disclosures

ASU 2014-01 also introduces new disclosure requirements for all entities that hold LIHTC investments, irrespective of whether they have elected to apply the proportional amortization approach. The objective of these new disclosure requirements is to help financial statement users understand the "nature of [the entity's] investments in qualified affordable housing projects" and "the effect of the measurement of its investments in qualified affordable housing projects and the related tax credits on its financial position and results of operations."

Thinking It Through

ASU 2014-01 significantly changes both the scope requirements and measurement method for the alternative measurement approach for investments in LIHTC partnerships. As a result, to qualify for the generally preferred accounting method, investors in LIHTC partnerships may seek to modify the terms of the partnership agreements.

Definition of a Public Business Entity

In December 2013, the FASB issued ASU 2013-12, which defines the term "public business entity" (PBE). The definition establishes the scope of accounting alternatives developed by the Private Company Council (PCC).[8] Specifically, entities that do not qualify as PBEs are generally eligible for private-company accounting alternatives. In addition, the term PBE will be incorporated by the FASB into future standard setting. Under the recently issued revenue standard, for example, an entity would refer to the definition of a PBE to determine whether it qualifies for effective date and disclosure relief. Therefore, even if an entity has no plans to elect a private-company accounting alternative, it should consider whether it meets the definition of a PBE and therefore would qualify for such relief under future standards. An entity would apply the definition of a PBE in connection with its adoption of the first ASU that uses the term.

The ASU defines a PBE as a business entity that meets any one of the following criteria:

a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).

b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.

c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.

d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.

e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

Although these criteria are largely drawn from similar definitions under other standards (e.g., ASC 280 defines a "public entity"), some are new. For example, criterion (a) is not in certain definitions and criterion (e) is not in any. Further, an entity would meet criterion (a) if its financial statements are included in another entity's SEC filing (e.g., as a significant investee or an acquiree of an SEC registrant). As a result, there may be some cases in which an entity that would have been considered nonpublic under previous guidance will now qualify as a PBE. Conversely, because a subsidiary of a public entity is not by extension automatically a PBE under the ASU, there may be instances in which an entity that would have been considered public will not qualify as a PBE for stand-alone financial statement purposes.

[8] The PCC was established by the Financial Accounting Foundation in 2012 to improve the accounting standard-setting process for private companies.

Thinking It Through

An entity that determines it is not a PBE and can therefore elect the private-company accounting alternatives should remain cognizant of the following:

- *The mandates, if any, of its financial statement users* — The ASU's basis for conclusions acknowledges that "decisions about whether an entity may apply permitted differences within U.S. GAAP ultimately may be determined by regulators (for example, the SEC and financial institution regulators), lenders and other creditors, or other financial statement users that may not accept financial statements that reflect accounting or reporting alternatives for private companies." Therefore, entities should seek to understand the views of their regulators and other users about the acceptability of the accounting alternatives before making an election.

- *The absence of transition guidance* — The ASU does not provide guidance on situations in which an entity subsequently meets the definition of a PBE as a result of changed circumstances. Entities should assume that they would be required to eliminate any private-company accounting alternatives from their historical financial statements if they later meet the definition of a PBE (e.g., in connection with an IPO). Therefore, from a practical perspective, entities considering electing a private-company accounting alternative should consider the likelihood that they may later meet the definition of a PBE — and the potential effort associated with unwinding the accounting alternative — before making an election.

For more information on ASU 2013-12, see Deloitte's January 27, 2014, *Heads Up*.

Accounting Alternatives for Private Companies

During 2014, the PCC finalized alternative accounting guidance on the following (early adoption of each ASU is permitted):

- *Goodwill* — ASU 2014-02 allows private companies to use a simplified approach to account for goodwill after an acquisition. Under this alternative, an entity would (1) amortize goodwill on a straight-line basis, generally over 10 years; (2) test goodwill for impairment only when a triggering event occurs; and (3) make an accounting policy election to test for impairment at either the entity level or the reporting-unit level. In addition, the ASU eliminates "step 2" of the goodwill impairment test; as a result, entities would measure goodwill impairment as the excess of the entity's (or reporting unit's) carrying amount over its fair value. Entities would adopt the ASU prospectively and apply it to all existing goodwill (and any goodwill arising from future acquisitions). See Deloitte's January 27, 2014, *Heads Up* for more information.

- *Hedge accounting* — ASU 2014-03 gives private companies a simplified method of accounting for interest rate swaps used to hedge variable rate debt. An entity that elects to apply simplified hedge accounting to a qualifying hedging relationship continues to account for the interest rate swap and the variable-rate debt separately on the face of the balance sheet. However, it would be able to assume no ineffectiveness in the hedging relationship, thereby essentially achieving the same income statement effects as if it had issued fixed-rate debt. An entity that applies the simplified hedge accounting approach also may elect to measure the related swap at its settlement value rather than fair value. Financial institutions (including banks, savings and loan associations, savings banks, credit unions, finance companies, and insurance entities) are specifically ineligible to elect this accounting alternative. Entities would adopt the ASU under either a full retrospective or a modified retrospective method. See Deloitte's January 27, 2014, *Heads Up* for more information.

- *Consolidation* — ASU 2014-07 gives private-company lessees an exemption from having to apply the consolidation guidance on variable interest entities to a related-party lessor when the entity and the lessor are under common control. The entity must evaluate additional criteria about the relationship between the lessee and lessor before applying this exception. If it applies the ASU, the entity may no longer be required to consolidate a related-party lessor entity. The ASU would be adopted retrospectively. See the March 21, 2014, *Deloitte Accounting Journal* entry for more information.

- *Intangible assets* — The upcoming ASU on this alternative is expected to give private companies an exemption from having to recognize certain intangible assets in a business combination. Specifically, an entity would not be required to recognize intangible assets for noncompete agreements and certain customer-related intangible assets. Because the amounts associated with these items would be subsumed into goodwill, an entity that elects this accounting alternative would also be required to elect the goodwill accounting alternative, resulting in the amortization of goodwill. Entities would adopt the ASU prospectively and apply it to new business combinations occurring after its adoption. The FASB expects to issue the ASU by the end of this year.

Throughout 2014, the PCC has discussed aspects of financial reporting that are complex and costly for private companies. The accounting for stock-based compensation was a significant focus of these discussions. In a recent meeting, the PCC and FASB Board members agreed that the PCC would incorporate its views on this topic into the separate stock-based compensation project that the FASB is undertaking as part of its simplification initiative.

Thinking It Through

While entities in the industry may be particularly interested in the goodwill alternative, some may want to wait until the FASB completes its overall goodwill project before committing to the private-company alternative.

Pushdown Accounting

Background

On November 18, 2014, the FASB issued ASU 2014-17, which represents the final consensus reached by the EITF on Issue 12-F at its September 2014 meeting. The ASU provides guidance on determining when an acquired entity can establish a new accounting and reporting basis in its stand-alone financial statements (commonly referred to as "pushdown" accounting).

Also, in connection with the FASB's issuance of ASU 2014-17, the SEC rescinded SAB Topic 5.J, which contained the SEC staff's views on the application of pushdown accounting for SEC registrants. As a result of the SEC's actions, all entities — regardless of whether they are SEC registrants — will apply ASU 2014-17 for guidance on the use of pushdown accounting.

ASU 2014-17 reaffirms the EITF's consensus-for-exposure to provide an acquired entity[9] with the option of applying pushdown accounting in its stand-alone financial statements upon a change- in-control event. An acquired entity that elects pushdown accounting would apply the measurement principles in ASC 805 to push down the measurement basis of its acquirer to its stand-alone financial statements. In addition, the acquired entity would be required to provide disclosures that enable "users of [its] financial statements to evaluate the nature and effect of the pushdown accounting."[10] Under ASU 2014-17, when an acquired entity elects to apply pushdown accounting, it would be:

- Prohibited from recognizing acquisition-related debt incurred by the acquirer unless the acquired entity is required to do so in accordance with other applicable U.S. GAAP (e.g., because the acquired entity is legally obligated).
- Required to recognize the acquirer's goodwill.
- Prohibited from recognizing bargain purchase gains that resulted from the change-in-control transaction or event.

However, the acquired entity would treat the bargain purchase gain as an adjustment to equity (i.e., additional paid-in capital). ASU 2014-17 also clarifies that the subsidiary of an acquired entity would have the option of applying pushdown accounting to its stand-alone financial statements even if the acquired entity (i.e., the direct subsidiary of the acquirer) elected not to apply pushdown accounting.

[9] The scope of the final consensus will include both public and nonpublic acquired entities, whether a business or a nonprofit activity.
[10] Entities would achieve that disclosure objective by providing the relevant disclosures required by ASC 805.

ASU 2014-17 departs from the guidance in the proposed ASU in two notable ways:

- Rather than limiting the election of pushdown accounting to change-in-control events occurring after the effective date of the final consensus, the ASU permits entities to elect to apply pushdown accounting as a result of the most recent change-in-control event in periods after the event as long as it was preferable to do so. Entities would not be permitted to unwind a previous application of pushdown accounting (i.e., an acquired entity can change its election for the most recent change in control from not applying pushdown accounting to applying pushdown accounting, if preferable, but not vice versa).

- An entity is **not** required to disclose that a change-in-control event had occurred for which the entity had elected not to apply pushdown accounting.

Effective Date and Transition

ASU 2014-17 applies to all pushdown elections occurring after November 18, 2014. At transition, an acquired entity is permitted to elect to apply pushdown accounting arising as a result of change-in-control events occurring before the standard's effective date as long as (1) the change in-control event is the most recent change-in-control event for the acquired entity and (2) the election is preferable. Pushdown accounting applied in issued (or available-to-be issued) financial statements by an acquiree before the effective date of the guidance is irrevocable.

On the Horizon

Leases

Background

The FASB has been working with the IASB for almost a decade to address concerns related to the off-balance-sheet treatment of certain lease arrangements by lessees. The boards' proposed model would require lessees to adopt a right-of-use (ROU) asset approach that would bring substantially all leases, with the exception of short-term leases (i.e., those with a lease term of less than 12 months), on the balance sheet. Under this approach, a lessee would record an ROU asset representing its right to use the underlying asset during the lease term and a corresponding lease liability.

Thinking It Through

A lessee would include in the calculation of the ROU asset any initial direct costs related to a lease. A lessor would continue to account for initial direct costs in a manner consistent with the current requirements. However, the boards decided to amend the definition of initial direct costs. In May 2014, the boards tentatively decided that the definition of initial direct costs for both lessees and lessors should include only those costs that are incremental to the arrangement and that the entity would not have incurred if the lease had not been obtained. This definition would be consistent with the definition of incremental cost in the recently issued revenue recognition standard. Under this definition, costs such as commissions and payments made to existing tenants to obtain the lease would be considered initial direct costs. In contrast, costs such as allocated internal costs and costs to negotiate and arrange the lease agreement (e.g., professional fees such as those paid for legal and tax advice) would be excluded from this definition.

Lessee and Nonlease Components

Lessees and lessors would be required to separate lease components and nonlease components (e.g., any services provided) in an arrangement and allocate the total transaction price to the individual components. Lessors would perform the allocation in accordance with the guidance in the forthcoming revenue recognition standard, and lessees would do so on a relative stand-alone price basis (by using observable stand-alone prices or, if the prices are not observable, estimated stand-alone prices). However, the boards have noted that lessees would be permitted "to elect, as an accounting policy by class of underlying asset, to not separate lease components from nonlease components, and instead account for the entire contract . . . as a single lease component." For more information, see the May 23, 2014, *Deloitte Accounting Journal* entry.

Thinking It Through

The boards agreed that an activity should be considered a separate nonlease component when the activity transfers a separate good or service to the lessee. For example, maintenance services (including common area maintenance services) and utilities paid for by the lessor but consumed by the lessee would be separate nonlease components because the lessee would have been required to otherwise contract for these services separately. However, the boards have not addressed whether payments for property taxes would be considered a nonlease component.

Lessee Accounting

While the boards agree that a lessee should record an ROU asset and a corresponding lease liability when the lease commences, the FASB and the IASB support different approaches for the lessee's subsequent measurement of the ROU asset. The FASB decided on a dual-model approach under which a lessee would classify a lease by using criteria that are similar to the lease classification criteria currently in IAS 17. For leases that are considered Type A leases (many current capital leases are expected to qualify as Type A), the lessee would account for the lease in a manner similar to a financed purchase arrangement. That is, the lessee would separately recognize interest expense and amortization of the ROU asset, which typically would result in a greater total expense during the early years of the lease. For leases that are considered Type B leases (many current operating leases are expected to qualify as Type B), the lessee would recognize a straight-line total lease expense.

While the FASB tentatively decided on a dual-model approach, the IASB decided on a single-model approach under which lessees would account for all leases similar to a financed purchase arrangement.

Thinking It Through

Under the FASB's dual-model approach, a lease would be classified as Type A if any of the following criteria are met at the commencement of the lease:

- "The lease transfers ownership of the underlying asset to the lessee by the end of the lease term."
- It is reasonably certain that a lessee will "exercise an option to purchase the underlying asset."
- "The lessee otherwise has the ability to obtain substantially all of the remaining benefits of the underlying asset as a result of the lease."

These criteria are essentially the same as the existing lease classification criteria in IAS 17 but are not identical to the requirements in ASC 840. For example, under the proposed criteria, a lessee would be required to assess land and other elements separately unless the land element is clearly immaterial,[1] whereas under ASC 840 the land would only be evaluated separately if its fair value at lease inception was 25 percent or more of the fair value of the leased property. This change may result in more bifurcation of real estate leases into separate land and building elements that would be evaluated separately for lease classification purposes.

In addition, the FASB's tentative decision effectively eliminates the bright-line rules under the ASC 840 lease classification requirements — namely, whether the lease term is for 75 percent or more of the economic life of the asset or whether the present value of the lease payments (including any guaranteed residual value) is at least 90 percent of the fair value of the leased asset. The decision could also affect the lease classification.

Lessor Accounting

Earlier this year, the boards discussed constituent feedback on the ED and decided not to make significant changes to the existing lessor accounting model. Rather, they agreed to adopt an approach similar to the existing capital/finance lease and operating lease models in ASC 840 and IAS 17. However, the FASB decided to align the U.S. GAAP classification requirements with the criteria in IAS 17. In addition, the FASB decided that for leases that are similar to current sales-type leases, the lessor would only be permitted to recognize the profit on the transaction if the arrangement would have qualified as a sale under the new revenue recognition guidance (ASC 606).

Thinking It Through

The inability to recognize profit on a transaction if it would not have qualified as a sale under the new revenue recognition guidance will probably not have a significant impact on real estate lessors since they typically do not enter into sales-type leases. However, the effect of the proposed changes to conform the U.S. GAAP classification requirements to those under IFRSs may be similar to the effect discussed above for lessees. In addition, the proposed guidance would require real estate lessors to disclose more information.

[1] "Clearly immaterial" is not a defined term or threshold under U.S. GAAP. It is expected, however, that this threshold will be extremely low. We anticipate that, once adopted, an acceptable level for "clearly immaterial" will evolve based on industry practice and the profession.

Next Steps

The FASB and IASB are expected to complete their redeliberations during the first half of 2015 and, although they have not indicated a release date, are likely to issue final guidance during the second half of 2015. In addition, while the boards have not indicated when the final guidance would be effective, a date as early as January 1, 2018, is possible. See Deloitte's March 27, 2014, *Heads Up* for additional information about the boards' tentative decisions in connection with the proposed lessee and lessor accounting models.

Consolidation

Introduction

The FASB is currently finalizing its forthcoming ASU on consolidation. While the Board's deliberations have largely focused on the investment management industry, its decisions could have a significant impact on the consolidation conclusions for reporting entities in the real estate industry. Specifically, the amended guidance could affect a real estate entity's evaluation of whether (1) limited partnerships and similar entities should be consolidated, (2) variable interests held by the real estate entity's related parties or de facto agents affect its consolidation conclusion, and (3) fees it receives for decision-making services result in the consolidation of a variable interest entity (VIE).

Accordingly, real estate entities will need to reevaluate their previous consolidation conclusions in light of their involvement with current VIEs, limited partnerships not previously considered VIEs, and entities previously subject to the deferral in ASU 2010-10.

For additional information, see Deloitte's October 7, 2014, *Heads Up*.

Determining Whether Fees Paid to Decision Makers or Service Providers Are Variable Interests

One of the first steps in assessing whether a fund manager or property manager is required to consolidate a real estate fund or real estate operating entity is to determine whether the fund manager or property manager holds a variable interest in the entity. While the ASU will retain the current definition of a variable interest, it modifies the criteria for determining whether a decision-making arrangement is a variable interest.

Under current U.S. GAAP, six criteria must be met for an entity to conclude that its fee does not represent a variable interest. The ASU will eliminate the criteria focused on the subordination of the fees (ASC 810-10-55-37(b)) and the significance of the fees (ASC 810-10-55-37(e) and (f)). Under the ASU, the evaluation of whether fees are a variable interest would focus on whether (1) the fees "are commensurate with the level of effort" (ASC 810-10-55-37(a)), (2) the decision maker has any other direct or indirect interests (including indirect interests through its related parties) that absorb more than an insignificant amount of the VIE's variability (ASC 810-10-55-37(c)), and (3) the arrangement includes only customary terms (ASC 810-10-55-37(d)).

It is expected that with the elimination of three of the criteria in ASC 810-10-55-37, fewer fee arrangements would be considered variable interests.

Limited Partnerships (and Similar Entities)

Determining Whether a Limited Partnership Is a VIE

The ASU will amend the definition of a VIE only for limited partnerships and similar entities. Under the ASU, a limited partnership would be considered a VIE regardless of whether it has sufficient equity or meets the other requirements to qualify as a voting interest entity unless a single limited partner (LP) or a simple majority of all partners (including interests held by the general partner (GP) and its related parties) has substantive kick-out rights (including liquidation rights) or participating rights. As a result of the proposed amendments to the definition of a VIE for limited partnerships and similar

entities, partnerships that historically were not considered VIEs may need to be evaluated under the new VIE consolidation model. Although the consolidation conclusion may not change, an updated analysis on the basis of the revised guidance would be required. In addition, even if a reporting entity determines that it does not need to consolidate a VIE, it would have to provide the existing extensive disclosures for any VIEs in which it holds a variable interest.

Example

A limited partnership is formed to acquire a real estate property. The partnership has a GP that holds a nominal interest in the partnership; five unrelated LPs hold the remaining equity interests. Profits and losses of the partnership (after payment of the GP's fees, which represent a variable interest in the entity) are distributed in accordance with the partners' ownership interests. There are no other arrangements between the partnership and the GP/LPs.

The GP is the property manager and has full discretion to buy and sell properties, manage the properties, and obtain financing. In addition, the GP can be removed without cause by a simple majority of all of the LPs.

Under the Proposed Guidance

Although the GP has power over the activities that most significantly affect the limited partnership, a simple majority of all LPs can remove the GP. Accordingly, the equity holders as a group do not lack the criteria in ASC 810-10-15-14(b),and therefore, the partnership would not be considered a VIE provided that the conditions in ASC 810-10-15-14(a)[2] and ASC 810-10-15-14(c)[3] are not met. However, if kick-out rights did not exist, the limited partnership would be a VIE.

Consolidation of a Limited Partnership

Under current U.S. GAAP, a GP is required to perform an evaluation under ASC 810-20 to determine whether it controls a limited partnership that is not considered a VIE. This evaluation focuses on whether certain rights held by the unrelated LPs are substantive and overcome the presumption that the GP controls (and therefore is required to consolidate) the partnership. To overcome the presumption that the GP controls the partnership, the LPs (excluding interests held by the GP, by entities under common control of the GP, and by other entities acting on behalf of the GP) must have either (1) the substantive ability to dissolve (liquidate) the limited partnership or otherwise remove the GP without cause (as distinguished from with cause) or (2) substantive participating rights.

Like an entity's analysis under the current guidance in ASC 810-20, its analysis under the proposed guidance on determining whether the GP should consolidate a partnership that is not considered a VIE would focus on an evaluation of whether the kick-out, liquidation, or participating rights held by the other partners are considered substantive. Unlike current guidance, however, the FASB's tentative approach requires entities to assess interests held by the GP, by entities under common control of the GP, and by other entities acting on behalf of the GP. That is, the rights would be considered substantive if they can be exercised by a simple majority of all of the partners, including the GP.

Partnerships would be VIEs when a single partner or a simple majority (or a lower threshold) of all partners do not have a substantive kick-out right or participating rights. The evaluation of whether the GP should consolidate a limited partnership (or similar entity) that is considered a VIE is consistent with how all other VIEs would be analyzed (i.e., the GP's economic exposure to the VIE would be considered). Accordingly, the GP would generally not be required to consolidate a limited partnership if the partners do not have substantive kick-out or participating rights unless the GP (or an entity under common control of the GP) has an interest in the partnership that could potentially be significant.

[2] ASC 810-10-15-14(a) states that an entity is a VIE if the "total equity investment . . . at risk is not sufficient to permit the legal entity to finance its activities without additional subordinated financial support."

[3] ASC 810-10-15-14(c) states that an entity is a VIE if (1) "voting rights of some investors are not proportional to their obligation to absorb the expected losses [or] their rights to receive the expected residual returns" and (2) substantially all of the potential VIE's activities "either involve or are conducted on behalf of an investor that has disproportionately few voting rights."

Real Estate Funds That Are Not Limited Partnerships (or Similar Entities)

The ASU will eliminate the deferral of ASU 2010-10 for investment funds. Accordingly, while kick-out and participating rights may have been considered for entities that qualified for the deferral, for real estate funds that are not limited partnerships (or similar entities), kick-out and participating rights will not be considered in the determination of whether the equity-at-risk group controls the fund unless the rights are held by a single party (including its related parties and de facto agents). As a result, an entity other than a partnership that qualified for the deferral and was not a VIE because its board of directors, as a group, held simple majority kick-out or participating rights may become a VIE if the equity holders as a group are no longer considered to have "power" over the entity through their kick-out rights. Accordingly, more funds could become VIEs under the ASU (particularly if the fund manager has other potentially significant interests in the fund).

Under current guidance, a real estate fund manager's assessment of whether it is the primary beneficiary of a VIE (and therefore must consolidate the VIE) that qualifies for the deferral would focus on whether the fund manager absorbs the majority of the VIE's variability as determined through quantitative analysis. Under the ASU, the reporting entity would be required to consolidate a VIE if it has both (1) the power to direct the activities of the VIE that most significantly affect the entity's economic performance ("power") and (2) the obligation to absorb losses of, or the right to receive benefits from, the VIE that could potentially be significant to the VIE. Accordingly, a fund manager that has power over a VIE, but did not previously consolidate the VIE because it did not absorb a majority of the VIE's variability, may be required to consolidate the VIE if it holds an economic interest that could potentially be significant to the VIE (e.g., a 15 percent economic interest in the VIE).

Effective Date and Transition

Modified retrospective application (including a practicability exception) would be required, with an option for full retrospective application. For public business entities, the ASU's guidance would be effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2015. For entities other than public business entities, the ASU's guidance would be effective for annual periods beginning after December 15, 2016, and interim periods beginning after December 15, 2017. The ASU would allow early adoption for all entities but would require entities to apply its guidance as of the beginning of the annual period containing the adoption date.

Thinking It Through

More entities are likely to qualify as VIEs under the ASU than under current guidance, and real estate entities would be required to provide additional disclosures regardless of whether they consolidate the VIE. Specifically, any real estate venture or fund that is formed as a limited partnership would automatically be a VIE unless the partners hold simple majority kick-out or participating rights. However, as a result of the ASU's changes to the guidance on (1) how to evaluate partnerships for consolidation, (2) how a reporting entity's related parties' interests in the VIE affect the consolidation analysis, and (3) whether a decision maker's fees represent a variable interest, fewer VIEs are likely to be consolidated. Accordingly, real estate entities will need to reevaluate their previous consolidation conclusions.

Real estate fund managers and property managers should start considering the extent to which they may need to change their processes and controls to apply the revised guidance, including those related to obtaining additional information that may have to be provided under the disclosure requirements. Changing such processes and controls may be particularly challenging for entities that intend to early adopt the proposed guidance. In addition, companies should consider the effect of the revised guidance as they enter into new transactions.

Financial Instrument Impairment

Background

In late 2012, the FASB issued a proposed ASU to obtain feedback on its current expected credit loss (CECL) model. Under the CECL model, an entity would recognize as an allowance its estimate of the contractual cash flows not expected to be collected. The FASB believes that the CECL model will result in more timely recognition of credit losses and will reduce complexity of U.S. GAAP by decreasing the number of different credit impairment models for debt instruments.[4]

Under the existing impairment models (often referred to as incurred loss models), an impairment allowance is recognized only after a loss event (e.g., default) has occurred or its occurrence is probable. In assessing whether to recognize an impairment allowance, an entity may only consider current conditions and past events; it may not consider forward-looking information.

The CECL Model

Scope

The CECL model[5] would apply to most[6] debt instruments (other than those measured at fair value through net income (FVTNI)), lease receivables, reinsurance receivables that result from insurance transactions, financial guarantee contracts, and loan commitments. However, available-for-sale (AFS) debt securities would be excluded from the model's scope and would continue to be assessed for impairment under ASC 320.

Recognition of Expected Credit Losses

Unlike the incurred loss models in existing U.S. GAAP, the CECL model does not specify a threshold for the recognition of an impairment allowance. Rather, an entity would recognize an impairment allowance equal to the current estimate of expected credit losses (i.e., all contractual cash flows that the entity does not expect to collect) for financial assets as of the end of the reporting period. Credit impairment would be recognized as an allowance — or contra-asset — rather than as a direct write-down of the amortized cost basis of a financial asset. An entity would, however, write off the carrying amount of a financial asset when it is deemed uncollectible, which is consistent with existing U.S. GAAP.

Thinking It Through

Because the CECL model does not have a minimum threshold for recognition of impairment losses, entities will need to measure expected credit losses on assets that have a low risk of loss (e.g., investment grade held-to-maturity (HTM) debt securities). However, the FASB tentatively decided at its September 17, 2013, meeting that an "entity would not be required to recognize a loss on a financial asset in which the risk of nonpayment is greater than zero [but] the amount of loss would be zero." U.S. Treasury securities and certain highly rated debt securities may be assets the FASB contemplated when it tentatively decided to allow an entity to recognize zero credit losses on an asset, but the Board decided not to specify the exact types of assets. Nevertheless, the requirement to measure expected credit losses on financial assets whose risk of loss is low is likely to result in additional costs and complexity.

[4] Although impairment began as a joint FASB and IASB project, constituent feedback on the boards' "dual-measurement" approach led the FASB to develop its own impairment model. The IASB, however, continued to develop the dual-measurement approach and issued final impairment guidance based on it as part of its July 2014 amendments to IFRS 9. For more information about the IASB's impairment model, see Deloitte's August 8, 2014, *Heads Up*.

[5] This discussion of the CECL model reflects the FASB's redeliberations to date, including tentative decisions made at the October 29, 2014, Board meeting.

[6] The CECL model would not apply to the following debt instruments:

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

Measurement of Expected Credit Losses

An entity's estimate of expected credit losses represents all contractual cash flows it does not expect to collect over the contractual life of the financial asset. When determining the contractual life of a financial asset, the entity would consider expected prepayments but would not be allowed to consider expected extensions unless it "reasonably expects" that it will execute a troubled debt restructuring.

The entity would consider all available relevant information in making the estimate, including information about past events, current conditions, and reasonable and supportable forecasts and their implications for expected credit losses. The entity is not required to forecast conditions over the contractual life of the asset. Rather, for the period beyond the period that the entity can make reasonable and supportable forecasts, the entity would revert to an unadjusted historical credit loss experience.

The CECL model would not prescribe a unit of account (e.g., an individual asset or a group of financial assets) in the measurement of expected credit losses. However, an entity would be required to evaluate financial assets that are within the scope of the model on a collective (i.e., pool) basis when similar risk characteristics are shared. If a financial asset does not share similar risk characteristics with the entity's other financial assets, the entity would evaluate the financial asset individually. If the financial asset is individually evaluated for expected credit losses, the entity would not be allowed to ignore available external information such as credit ratings and other credit loss statistics.

The FASB tentatively decided to permit the use of practical expedients in measuring expected credit losses for two types of financial assets:

1. *Collateral-dependent financial assets* — In a manner consistent with existing U.S. GAAP, an entity would be allowed to measure its estimate of expected credit losses for collateral-dependent financial assets as the difference between the financial asset's amortized cost and the collateral's fair value.

2. *Financial assets for which the borrower must continually adjust the amount of securing collateral (e.g., certain repurchase agreements and securities lending arrangements)* — The estimate of expected credit losses would be measured consistently with other financial assets within the scope of the CECL model but would be limited to the difference between the amortized cost basis of the asset and the collateral's fair value (adjusted for selling costs, when applicable).

Thinking It Through

The FASB's tentative decisions would require an entity to collectively measure expected credit losses on financial assets that share similar risk characteristics (including HTM securities). While the concept of pooling and collective evaluation currently exists in U.S. GAAP for certain loans, the FASB has not specifically defined "similar risk characteristics." As a result, it remains to be seen whether the FASB expects an aggregation based on "similar risk characteristics" to be consistent with the existing practice of pooling purchased credit-impaired (PCI) assets on the basis of "common risk characteristics." Entities may need to make systems and process changes to capture loss data at more granular levels than they do now, depending on the expectations of market participants such as standard setters, regulators, and auditors.

Available-for-Sale Debt Securities

Under the proposed ASU, the CECL model would have applied to AFS debt securities. However, in August 2014, the FASB tentatively decided that AFS debt securities would not be included within the scope of the CECL model. Instead, the impairment of AFS debt securities would continue to be accounted for under ASC 320. However, the FASB tentatively decided to revise ASC 320 by:

- Requiring an entity to use an allowance approach (vs. permanently writing down the security's cost basis).

- Removing the requirement that an entity must consider the length of time fair value has been less than amortized cost when assessing whether a security is other-than-temporarily impaired.
- Removing the requirement that an entity must consider recoveries in fair value after the balance sheet date when assessing whether a credit loss exists.

Thinking It Through

The Board did not revise (1) step 1 of the existing other-than-temporary impairment model (i.e., an "investment is impaired if the fair value of the investment is less than its cost") and (2) the requirement under ASC 320 that entities recognize the impairment amount only related to credit in net income and the noncredit impairment amount in OCI. However, the FASB did tentatively decide that entities would use an allowance approach when recognizing credit losses (as opposed to a permanent write down of the AFS security's cost basis). As a result, in both of the following instances, an entity would reverse credit losses through current-period earnings on an AFS debt security:

1. If the fair value of the debt security exceeds its amortized cost in a period after a credit loss had been recognized through earnings (because fair value was less than amortized cost), the entity would reverse the *entire* credit loss previously recognized and recognize a corresponding adjustment to its allowance for credit losses.
2. If the fair value of the debt security does not exceed its amortized cost in a period after a credit loss had been recognized through earnings (because fair value was less than amortized cost) but the credit quality of the debt security improves in the current period, the entity would reverse the credit loss previously recognized only in an amount that would reflect the improved credit quality of the debt security.

The requirement to use an allowance approach for AFS debt securities may affect how a REIT communicates to its investors changes in cash flow expectations and their impact on the effective yield of the security. For example, under the proposed approach, the REIT would recognize any increase in cash flow expectations as a reversal of credit losses through earnings and a corresponding adjustment to its allowance. To the extent that the expected cash flows exceed the cash flows originally expected at acquisition of the asset, the REIT would recognize the excess as an income statement gain in the current period (as opposed to a prospective yield adjustment).

Purchased Credit-Impaired Assets

For PCI assets, as defined[7] in the proposed ASU, an entity would measure expected credit losses consistently with how it measures expected credit losses for originated and purchased non-credit-impaired assets. Upon acquiring a PCI asset, the entity would recognize as its allowance for expected credit losses the amount of *contractual* cash flows not expected to be collected. After initial recognition of the PCI asset and its related allowance, a reporting entity would continue to apply the CECL model to the asset. Consequently, any subsequent changes to its estimate of expected credit losses — whether unfavorable or favorable — would be recorded as impairment expense (or reduction of expense) during the period of change.

[7] The proposed ASU defines PCI assets as "[a]cquired individual assets (or acquired groups of financial assets with shared risk characteristics at the date of acquisition) that have experienced a significant deterioration in credit quality since origination."

Thinking It Through

Under the current accounting for PCI assets, an entity recognizes unfavorable changes in cash flows as an immediate credit impairment but treats favorable changes in cash flows that are in excess of the allowance as prospective yield adjustments. The CECL model's proposed approach to PCI assets eliminates this asymmetrical treatment in cash flow changes. In addition, under the CECL model, the discount embedded in the purchase price attributable to expected credit losses as of the date of acquisition must not be recognized as interest income, which is consistent with current practice.

An acquired asset is currently considered credit-impaired when it is probable that the investor would be unable to collect all contractual cash flows due to deterioration in the asset's credit quality since origination. Under the FASB's tentative approach, a PCI asset is an acquired asset that has experienced significant deterioration in credit quality since origination. Consequently, entities will most likely need to use more judgment than they do under current U.S. GAAP in determining whether an acquired asset has experienced significant credit deterioration.

Beneficial Interests Whose Credit Quality Is Not High or That Have Significant Prepayment Risk (Within the Scope of ASC 325-40)

The FASB tentatively decided at its June 11, 2014, meeting that an impairment allowance for "purchased or retained beneficial interests for which there is a significant difference between contractual and expected cash flows" should be measured in the same manner as PCI assets under the CECL model. Therefore, at initial recognition, a beneficial interest holder would present an impairment allowance equal to the estimate of expected credit losses (i.e., the estimate of *contractual* cash flows not expected to be collected). In addition, the FASB indicated that "changes in expected cash flows due to factors other than credit would be accreted into interest income over the life of the asset (that is, the difference between contractual and expected cash flows attributable to credit would never be included in interest income)."[8]

Thinking It Through

Under the CECL model, an entity would be required to determine the contractual cash flows of beneficial interests in securitized transactions. However, there may be certain structures in which the beneficial interests do not have contractual cash flows (e.g., when a beneficial interest holder receives only residual cash flows of a securitization structure). In these situations, an entity may need to use a proxy for the contractual cash flows of the beneficial interest (e.g., the gross contractual cash flows of the underlying debt instrument).

Disclosures

Many of the disclosures required under the proposal are similar to those already required under U.S. GAAP as a result of ASU 2010-20. Accordingly, entities would be required to disclose information related to:

- Credit quality.[9]
- Allowance for expected credit losses.
- Policy for determining write-offs.
- Past-due status.
- PCI assets.
- Collateralized financial assets.

[8] Quoted text is from a handout for the June 11, 2014, FASB meeting.

[9] Short-term trade receivables resulting from revenue transactions within the scope of ASC 605 are excluded from these disclosure requirements.

The Board plans to discuss at a future meeting rollforward disclosures of an entity's allowance and amortized cost balances and whether all of the tentative disclosure requirements should also apply to AFS debt securities.

Next Steps

At a future meeting, the Board plans to discuss additional matters related to disclosures, transition, and effective date.

Thinking It Through

Measuring expected credit losses will most likely be a significant challenge for real estate entities with lending activities. As a result of moving to an expected loss model, such entities could incur one-time and recurring costs when estimating expected credit losses, some of which may be related to system changes and data collection. While the costs associated with implementing the CECL model will vary by entity, nearly all entities will incur some costs when using forward-looking information to estimate expected credit losses over the contractual life of an asset.

Today, financial institutions use various methods to estimate credit losses. Some apply simple approaches that take into account average historical loss experience over a fixed time horizon. Others use more sophisticated "migration" analyses and forecast modeling techniques. Under the CECL model, for any approach that is based solely on historical loss experience, an entity would need to consider the effect of forward-looking information over the remaining contractual life of a financial asset. In addition, the FASB tentatively decided at its August 13, 2014, meeting that when an entity is "developing its estimate of expected credit losses . . . for periods beyond which the entity is able to make or obtain reasonable and supportable forecasts, [the] entity is allowed to revert to its [unadjusted] historical credit loss experience."

For instance, assume that an entity uses annualized loss rates to determine the amount of probable unconfirmed losses on its homogeneous pools of loans as of the reporting date. When moving to the CECL model, the entity may need to revise its allowance method by adjusting the fixed time horizon (i.e., annualized loss rates) to equal a period that represents the full contractual life of the instrument. Entities using a probability-of-default (PD) approach may need to revise their PD and loss-given-default (LGD) statistics to incorporate the notion of lifetime expected losses. Today, an entity's PD approach might be an estimate of the probability that default will occur over a fixed assessment horizon, which is less than the full contractual life of the instrument (often one year). Similarly, an entity would need to revise its LGD statistic to incorporate the notion of lifetime expected losses (i.e., the percentage of loss over the total exposure if default were to occur during the full contractual life of the instrument).

Classification and Measurement

Recent Redeliberations

The FASB is no longer pursuing a converged approach to the classification and measurement of financial instruments. Instead, the Board has decided to retain existing requirements related to (1) the classification and measurement categories for financial instruments other than equity investments, (2) the method for classifying financial instruments, (3) bifurcation of embedded derivatives in hybrid financial assets, and (4) accounting for equity method investments (including impairment of such investments). However, the Board has discussed targeted improvements to the requirements related to accounting for equity investments and presentation of certain fair value changes for fair value option liabilities.

Classification and Measurement of Equity Investments

Under the FASB's tentative approach, entities will be required to carry all investments in equity securities that do not qualify for the equity method or a practicability exception at FVTNI. For equity investments that do not have a readily determinable fair value, the FASB would permit entities to elect the practicability exception to fair value measurement under which the investment would be measured at cost less impairment plus or minus observable price changes. This exception would not be available to reporting entities that are investment companies or broker-dealers.

Impairment Assessment of Equity Investments That Are Measured by Using the Practicability Exception

In an effort to simplify the impairment model for equity securities for which an entity has elected the practicability exception, the FASB has tentatively decided to eliminate the requirement to assess whether an impairment of such an investment is other than temporary. In each reporting period, an entity would qualitatively consider certain indicators to determine whether the investment is impaired, including:

a. A significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee

b. A significant adverse change in the regulatory, economic, or technological environment of the investee

c. A significant adverse change in the general market condition of either the geographic area or the industry in which the investee operates

d. A bona fide offer to purchase, an offer by the investee to sell, or a completed auction process for the same or similar investment for an amount less than the cost of that investment

e. Factors that raise significant concerns about the investee's ability to continue as a going concern, such as negative cash flows from operations, working capital deficiencies, or noncompliance with statutory capital requirements or debt covenants.

An entity that determines that the equity security is impaired on the basis of an assessment of the above indicators would recognize an impairment loss equal to the difference between the security's fair value and carrying amount. In contrast, the existing guidance in ASC 320-10-35-30 requires entities to perform a two-step assessment under which an entity first determines whether an equity security is impaired and then evaluates whether any impairment is other than temporary.

Thinking It Through

Under existing U.S. GAAP, marketable equity securities other than equity-method investments (those for which the investor has significant influence over the investee) are classified as either held for trading (FVTNI) or available for sale (FVTOCI). For AFS equity securities, any amounts in accumulated OCI are recycled to net income upon sale or an other-than-temporary impairment. Investments in nonmarketable equity securities other than equity-method investments are measured at cost (less impairment) unless the fair value option has been elected. Because equity securities can no longer be accounted for as AFS securities or by using the cost method, REITs that hold such equity investments could see more volatility in earnings under the proposed guidance.

Presentation of Fair Value Changes Attributable to Instrument-Specific Credit Risk for Fair Value Option Liabilities

The FASB has tentatively decided to introduce a new requirement related to the presentation of fair value changes of financial liabilities for which the fair value option has been elected. Under this tentative decision, an entity would be required to separately recognize in OCI the portion of the total fair value change attributable to instrument-specific credit risk. For derivative liabilities, however, any changes in fair value attributable to instrument-specific credit risk would continue to be presented in net income.

Under the FASB's tentative approach, an entity would measure the portion of the change in fair value attributable to instrument-specific credit risk as the excess of total change in fair value over the change in fair value "resulting from a change in a base market risk, such as a risk-free interest rate . . . . Alternatively, an entity may use another method that it considers to more faithfully represent the portion of the total change in fair value resulting from a change in instrument-specific credit risk." In either case, the entity would be required to disclose the method it "used to determine the gains and losses attributable to instrument-specific credit risk and [to] apply the method consistently from period to period."[10]

See Appendix A in Deloitte's August 8, 2014, *Heads Up* for a comparison of classification and measurement models under current U.S. GAAP and the FASB's tentative approach.

[10] Quoted text is from a handout for the April 23, 2014, FASB meeting.

Next Steps

Additional matters that the Board plans to discuss at future meetings include disclosures (e.g., core deposits), transition, effective date, and cost/benefit considerations.

Hedging

At its meeting on November 5, 2014, the FASB voted to move its current research project on hedge accounting to its active agenda. In deliberating the project, the FASB will discuss the following issues:

- Hedge effectiveness requirements.
- Whether the shortcut and critical-terms-match methods should be eliminated.
- Voluntary dedesignations of hedging relationships.
- Recognition of ineffectiveness for cash flow underhedges.
- Hedging components of nonfinancial items.
- Benchmark interest rates.
- Simplification of hedge documentation requirements.
- Presentation and disclosure matters.

Formal deliberations in the hedging project will continue on a future date.

Thinking It Through

The FASB's hedging project may lead to welcome simplification of the existing guidance. For example, on the basis of constituent feedback received on the FASB's initial proposals, the criteria to qualify for applying hedge accounting are expected to be easier for entities to satisfy (e.g., from "highly effective" to a lower threshold). It is also expected that the guidance resulting from the project will simplify the actual application of hedge accounting for eligible entities by, for example, only requiring qualitative (rather than quantitative) ongoing assessments of hedge effectiveness.

Accounting for Goodwill by Public Business Entities and Not-for-Profit Entities

Overview

In November 2013, the FASB endorsed a decision by the PCC to allow nonpublic business enterprises to amortize goodwill and perform a simplified impairment test. The Board has received feedback indicating that many public business entities and not-for-profit entities have similar concerns about the cost and complexity of the annual goodwill impairment test. Thus, the Board added this project to its agenda for 2014 and has asked the staff to analyze the views below.

Current Status

The Board is considering the following alternatives for the accounting for goodwill by public business entities and not-for-profit entities:[11]

> View A — Goodwill would be amortized "over 10 years or less than 10 years if an entity demonstrates that another useful life is more appropriate." Goodwill would be tested for impairment "only when a triggering event occurs."
>
> *View B* — Goodwill would be amortized over its expected useful life, which would not exceed a specified number of years; the current impairment test would be retained.
>
> *View C* — An entity would write off goodwill directly at initial recognition or transition and would reflect the charge in net income or equity and provide additional disclosures for each acquisition. Under this alternative, there would be no subsequent goodwill accounting considerations.
>
> *View D* — An entity would not amortize goodwill but would perform a simplified impairment test. Such a model would most likely eliminate step 2 of the goodwill impairment test in ASC 350 and would potentially simplify the unit of account (i.e., raise it to a level above the reporting unit). In addition, "[a]n entity would make an accounting policy election to test goodwill for impairment at the entity level or at the reporting unit level. It would test goodwill for impairment only when a triggering event occurs."

Next Steps

At its November 5, 2014, meeting, the FASB discussed the results of the IASB's post-implementation review (PIR) of IFRS 3. The Board also discussed findings of a study on how the qualitative assessment has been used since the issuance of ASU 2011-09. On the basis of discussions during the meeting, the Board decided to add a project to its agenda on the accounting for identifiable intangible assets in a business combination for public business entities and not-for-profit entities. The purpose of this project will be to evaluate whether certain intangibles assets could be subsumed into goodwill.

Clarifying the Definition of a Business

Background

The FASB currently has a project on its agenda to clarify the definition of a business. According to the FASB's project update page, the objective of the project is to address "whether transactions involving in-substance nonfinancial assets (held directly or in a subsidiary) should be accounted for as acquisitions (or disposals) of nonfinancial assets or as acquisitions (or disposals) of businesses." The project will also include clarifying the guidance on partial sales of nonfinancial assets. The FASB has not yet made any technical decisions in connection with the project.

Thinking It Through

Accounting for real estate acquisitions as a business combination (rather than as an asset acquisition) affects whether (1) the real estate is initially measured at fair value or on an allocated cost basis, (2) acquisition related costs are capitalized or expensed, and (3) contingent consideration should be recorded as of the acquisition date. In addition, the differences between the asset-based or business-based derecognition requirements could affect when to derecognize real estate assets sold and how to measure any retained interests if a company sells a partial interest in an asset.

[11] Quoted text is from the FASB's tentative decisions at its March 26, 2014, meeting.

Other Topics

Disclosure Framework

Background

In July 2012, the FASB issued a discussion paper as part of its project to develop a framework to make financial statement disclosures "more effective, coordinated, and less redundant." The paper identifies aspects of the notes to the financial statements that need improvement and explores possible ways to improve them. See Deloitte's July 17, 2012, *Heads Up* for additional information. The FASB subsequently decided to distinguish between the "Board's decision process" and the "entity's decision process" for evaluating disclosure requirements.

FASB Decision Process

Overview

On March 4, 2014, the FASB released for public comment an ED of a proposed concepts statement that would add a new chapter to the Board's conceptual framework for financial reporting. The ED proposes a decision process to be used by the Board and its staff for determining what disclosures should be required in notes to financial statements. The FASB's objective in issuing the proposal is to improve the effectiveness of such disclosures by ensuring that reporting entities clearly communicate the information that is most important to users of financial statements. See Deloitte's March 6, 2014, *Heads Up* for additional information.

Summary of Comment-Letter Feedback

Comments on the FASB's ED were due by July 14, 2014. The FASB received over 50 comment letters from various respondents, including preparers, professional and trade organizations, and accounting firms. Respondents generally expressed support for the development of a conceptual framework for use in evaluating disclosure requirements that would apply to existing and future standards.

However, many respondents were concerned that the ED's "intentionally broad" proposed decision questions may result in excessive disclosure (which respondents had also noted in their comments on the discussion paper). Accordingly, many respondents suggested that the FASB use a filtering mechanism (e.g., based on cost and decision usefulness) to further narrow disclosure requirements.

Respondents also suggested that the FASB clarify the difference between relevance and materiality and align the definition of materiality in the FASB's concepts statement with that established by the Supreme Court.[1]

Further, many respondents encouraged the Board to work with regulatory bodies, such as the SEC, to develop requirements that result in disclosures that are more effective and less redundant in the overall financial reporting package.

Next Steps

The FASB will continue its redeliberations related to concerns raised in comment letters and will review feedback received as a result of its outreach activities, which included testing the entity's decision process against various Codification topics (see the Entity's Decision Process section). A final concepts statement is expected to be issued after the outreach process is complete.

[1] Paragraph QC11 in Chapter 3 of FASB Statement of Financial Accounting Concepts No. 8 states that "[i]nformation is material if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity." Further, PCAOB AS 11 explains that "[i]n interpreting the federal securities laws, the Supreme Court of the United States has held that a fact is material if there is 'a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.' As the Supreme Court has noted, determinations of materiality require 'delicate assessments of the inferences a "reasonable shareholder" would draw from a given set of facts and the significance of those inferences to him'" (footnotes omitted).

Entity's Decision Process

Topic-Specific Disclosure Reviews

The FASB staff is currently analyzing ways to "further promote [entities'] appropriate use of discretion" in determining proper financial statement disclosures. This process will take into account "section-specific modifications" to the following Codification topics:

ASC Topic	Status
820 (fair value measurement)	Testing in progress. Results discussed with Board.
330 (inventory)	Not started.
715 (defined benefit plans)	Testing in progress. Results discussed with Board.
740 (income taxes)	Not started.

A proposed ASU could be issued as a result of this process. No tentative decisions have been made on this matter to date.

Thinking It Through

The financial statements of real estate entities often contain lengthy fair value measurement disclosures. The FASB is currently using the ED's conceptual framework to test ASC 820 and expects that disclosures will ultimately be reduced as a result (i.e., by identifying disclosures that are beyond the scope of the conceptual framework).

During deliberations, the FASB discussed the Level 3 rollforward. The ED's decision question L7 contains information to be considered for disclosure, including "the causes of changes from the prior period (such as major inflows and outflows summarized by type or a detailed roll forward)," which may imply that a rollforward (or similar information) is required for each significant balance sheet line item.

In addition, the February 2014 post-implementation review report on FASB Statement 157 stated that "preparers and practitioners are concerned with the decision-usefulness of the Statement 157 disclosures. They cited concerns about disclosure overload, particularly as it relates to Level 3 disclosures, including the Level 3 rollforward."

At its September 2014 meeting, the Board discussed the following:

- Adding disclosures about:
  - Alternative measures.
  - Gains and losses.
- Modifying disclosures about:
  - The Level 3 rollforward. During deliberations, it was acknowledged that performing the rollforward every quarter was difficult for entities (see the Interim Reporting section).
  - Transfers between Level 1 and Level 2.
  - The policy for timing of transfers between levels.
  - Valuation process for Level 3 fair value measurements.
  - Sensitivity information.
  - Estimates of timing of future events.

No decisions were made, and the views of Board members were mixed. Board members also indicated that they would need to assess whether users would prefer (1) the application of materiality on a company basis or (2) uniform disclosures among all companies (including immaterial items).

Interim Reporting

The FASB deliberated modifications to the guidance on interim reporting. The Board tentatively decided that an update to an annual footnote disclosure is warranted as of an interim period if the update would alter the "total mix" of information available to investors. This is consistent with the guidance in SAB 99, which is based on a Supreme Court ruling.[2]

During future redeliberations on interim reporting, the Board will continue reviewing comment-letter feedback on the ED.

Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items

As part of its simplification initiative, the FASB issued a proposed ASU that would remove from U.S. GAAP the concept of extraordinary items and therefore eliminate the requirement for entities to separately present such items on the income statement and disclose them in the footnotes. Currently, extraordinary items (1) are unusual in nature and (2) occur infrequently. The proposed ASU retains the reporting and disclosure requirements for an event that demonstrates either of those characteristics. Accordingly, users of financial statements would continue to be informed about unusual or infrequent events after the concept of extraordinary items is eliminated.

The FASB believes that eliminating the concept would also improve the efficiency of the financial reporting process since it would relieve entities from having to identify extraordinary items and comply with associated presentation and disclosure requirements.

In October, 2014, the FASB voted to issue final guidance in an ASU. The Board tentatively decided to allow either prospective or retrospective application of the guidance. For all entities, the ASU will be effective for periods beginning after December 15, 2015. Early adoption is permitted when the guidance is applied from the beginning of the reporting period in the year of adoption.

Debt Issuance Costs

On October 14, 2014, the FASB issued a proposed ASU that would change the presentation of debt issuance costs in the financial statements. Under the proposal, an entity would be required to present such costs in the balance sheet as a direct deduction from the debt liability in a manner consistent with its accounting treatment of debt discounts. Amortization of the issuance costs would be reported as interest expense.

The proposed guidance would replace the guidance in ASC 835-30 that requires an entity to report debt issuance costs in the balance sheet as deferred charges (i.e., as an asset). It would also align U.S. GAAP on this topic with IFRSs, under which transaction costs that are directly attributable to the issuance of the liability are treated as an adjustment to the initial carrying amount of the financial liability.

Comments on the proposal are due by December 15, 2014. For more information about the proposed ASU, see Deloitte's October 14, 2014, *Heads Up*.

Liabilities and Equity — Short-Term Improvements

In November 2014, the FASB voted to move part of its current research project on liabilities and equity to its active agenda. Specifically, the FASB decided to add a project addressing (1) practice issues related to ASC 815-40 and (2) targeted improvements to the organization of the related Codification topics.

To date, no technical decisions have been made in the project.

[2] TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

COSO Framework

Background

Since the Committee of Sponsoring Organizations of the Treadway Commission issued an updated version of its *Internal Control — Integrated Framework* (the "2013 Framework") in May, 2013,[3] companies have been taking steps to implement it by December 15, 2014. While the internal control components[4] in the 2013 Framework are the same as those in the original framework issued in 1992, the updated framework requires companies to assess whether 17 principles underlying five components are present and functioning in determining whether their system of internal control is effective. Further, the 17 principles are supported by points of focus, which are important considerations in a company's evaluation of the design and operating effectiveness of controls to address the principles.

These changes will result in the need for entities to develop a different deficiency evaluation process. From an ICFR perspective, when one or more of the 2013 Framework's 17 principles are not present and functioning, a major deficiency exists, which equates to a material weakness under Section 404 of the Sarbanes-Oxley Act.[5]

See Deloitte's September 5, 2014, *Heads Up* for additional discussion of challenges and leading practices related to implementing the new framework, including observations and perspectives regarding its application for operational and regulatory compliance purposes.

SEC Rules

Background

The SEC continues to focus on rulemaking, particularly in connection with its efforts to complete mandated actions under the Dodd-Frank Act. Key SEC rulemaking activities and other developments that have occurred since the last edition of this publication are discussed below.

SEC Issues Proposed Rule Related to Treatment of Certain Communications Involving Security-Based Swaps

On September 8, 2014, the SEC issued a proposed rule under which "the publication or distribution of price quotes relating to security-based swaps that may be purchased only by persons who are eligible contract participants and are traded or processed on or through a facility that either is registered as a national securities exchange or as a security-based swap execution facility, or is exempt from registration as a security-based swap execution facility pursuant to a rule, regulation, or order of the Commission, would not be deemed to constitute an offer, an offer to sell, or a solicitation of an offer to buy or purchase such security-based swaps or any guarantees of such security-based swaps that are securities for purposes of Section 5 of the Securities Act."

Comments on the proposed rule were due by November 10, 2014.

[3] See Deloitte's June 10, 2013, *Heads Up* for an overview of the 2013 Framework.

[4] Control environment, risk assessment, control activities, information and communication, and monitoring activities.

[5] The 2013 Framework contains the following new guidance on a major deficiency in internal control:

> "When a major deficiency exists, the organization cannot conclude that it has met the requirements for an effective system of internal control. A major deficiency exists in the system of internal control when management determines that a component and one or more relevant principles are not present or functioning or that components are not operating together. A major deficiency in one component cannot be mitigated to an acceptable level by the presence and functioning of another component. Similarly, a major deficiency in a relevant principle cannot be mitigated to an acceptable level by the presence and functioning of other principles."

SEC Issues Final Rule on Asset-Backed Securities

On September 4, 2014, the SEC issued a final rule that is intended to enhance the disclosure requirements for ABSs. Specifically, the final rule requires "loan-level disclosure for certain assets, such as residential and commercial mortgages and automobile loans" and gives investors more time "to review and consider a securitization offering, revise[s] the eligibility criteria for using an expedited offering process known as 'shelf offerings,' and make[s] important revisions to reporting requirements."

The final rule will become effective on November 24, 2014.

For more information, see the September 3, 2014, *Deloitte Accounting Journal* entry and the press release on the SEC's Web site.

SEC Issues Final Rule on Nationally Recognized Statistical Rating Organizations

On August 27, 2014, the SEC issued a final rule that revises the requirements for NRSROs in response to a mandate of the Dodd-Frank Act. The amendments "address internal controls, conflicts of interest, disclosure of credit rating performance statistics, procedures to protect the integrity and transparency of rating methodologies, disclosures to promote the transparency of credit ratings, and standards for training, experience, and competence of credit analysts." The ultimate objective of these new requirements is "to enhance governance, protect against conflicts of interest, and increase transparency to improve the quality of credit ratings and increase credit rating agency accountability."

The final rule became effective on November 14, 2014.

For more information, see the September 3, 2014, *Deloitte Accounting Journal* entry and the press release on the SEC's Web site.

SEC Issues Final and Proposed Rules Related to Money Market Funds

On July 23, 2014, the SEC issued a final rule that amends the way money market funds (MMFs) are regulated. The rule eliminates the use of penny rounding for institutional nongovernment MMFs and establishes a current NAV — or floating NAV — like that used in other mutual funds. Government and retail MMFs may continue using amortized cost to value a fund´s investments instead of calculating the fund´s value by using a floating NAV (i.e., they may continue to use a stable NAV, which is typically $1).

The final rule notes that MMFs with floating NAVs will be permitted to "continue to use amortized cost to value debt securities with remaining maturities of 60 days or less if fund directors, in good faith, determine that the fair value of the debt securities is their amortized cost value, unless the particular circumstances warrant otherwise." The final rule also includes provisions related to redemption gates and liquidity fees.

The SEC has also issued a reproposed rule related to (1) MMF communications to investors and (2) the replacement of credit rating references in Rule 2a-7 and Form N-MFP with other factors a fund would use to assess liquidity and creditworthiness of investments to comply with Section 939A of the Dodd-Frank Act.

The final rule became effective on October 14, 2014. Comments on the proposed rule were also due by October 14, 2014.

For more information, see the July 24, 2014, *Deloitte Accounting Journal* entry and the press release on the SEC's Web site.

SEC Issues Final Rule on Cross-Border Security-Based Swaps

On June 26, 2014, the SEC issued a final rule that explains "when a cross-border transaction must be counted toward the requirement to register as a security-based swap dealer or major security-based swap participant." In addition, the rule addresses "the scope of the SEC's cross-border anti-fraud authority."

The final rule became effective September 8, 2014.

For more information, see the press release on the SEC's Web site.

SEC Proposes Rule for Covered Clearing Agencies

On March 12, 2014, the SEC issued a proposed rule that would amend the Exchange Act to establish additional regulations for "covered clearing agencies" (i.e., certain types of SEC-registered clearing agencies) that (1) the Financial Stability Oversight Council deems "systemically important" or (2) participate in "more complex transactions" (e.g., securities-based swaps). The new requirements would affect such agencies' financial risk management, operations, governance, and disclosures.

Comments on the proposed rule were due by May 27, 2014.

For more information, see the press release on the SEC's Web site.

SEC Extends Exemptions Related to Security-Based Swaps

On February 7, 2014, the SEC published amendments extending the expiration date for "interim final rules that provide exemptions under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Trust Indenture Act of 1939 for those security-based swaps that [1] prior to July 16, 2011 were security-based swap agreements and [2] are defined as 'securities' under the Securities Act and the Exchange Act as of July 16, 2011 due solely to the provisions of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act." The amendments affect the following interim final rules:

- Rule 240 of the Securities Act.
- Rules 12a-11 and 12h-1(i) of the Exchange Act.
- Rule 4d-12 of the Trust Indenture Act.

The new expiration date for the interim final rules is February 11, 2017.

SEC Issues Risk Alert on Investment Advisers' Use of Due Diligence

On January 28, 2014, the SEC's Office of Compliance Inspections and Examinations issued a risk alert summarizing its observations regarding the due-diligence procedures investment advisers follow when "recommending alternative investments to their clients." The SEC staff's observations fall into two main categories: (1) trends in investment advisers' due-diligence processes and (2) the extent to which the advisers have complied with applicable rules and regulations, including the Investment Advisers Act and the advisers' own codes of ethics that the Commission mandates for SEC-registered advisers.

For more information, see the press release on the SEC's Web site.

SEC Issues Interim Final Rule Related to Certain Collateralized Debt Obligations

On January 17, 2014, the SEC, in conjunction with the OCC, the Federal Reserve, the FDIC, and the CFTC, issued an interim final rule that "would permit banking entities to retain investments in certain pooled investment vehicles that invested their offering proceeds primarily in certain securities issued by community banking organizations of the type grandfathered under Section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act."

The interim final rule became effective on April 1, 2014.

For more information, see the press release on the SEC's Web site.

SEC Issues Final Rule and Interpretive Guidance Related to Rules for Registration of Municipal Advisers

On January 13, 2014, the SEC issued a final rule granting a temporary stay on the Commission's rules for registration of municipal advisers, which "require municipal advisors to register with the Commission if they provide advice to municipal entities or certain other persons on the issuance of municipal securities, or about certain investment strategies or municipal derivatives." The new date by which municipal advisers must comply with the rules is July 1, 2014. The temporary stay is effective as of January 13, 2014.

In addition, on January 10, 2014, the SEC issued a series of FAQs in response to questions the Commission has received from market participants about the municipal adviser registration rules. Topics covered in the FAQs include:

- Content that entities are permitted to provide to a municipal entity to avoid having to register as a municipal adviser.
- How to provide a request for proposals or request for qualifications that is consistent with the exemption to the definition of a municipal adviser.
- Requirements for the independent registered municipal adviser exemption.
- Exclusions related to underwriters and registered investment advisers.
- Whether a broker-dealer that served as underwriter for an issuance of municipal securities can continue to rely on the underwriter exemption after the issuance and the underwriting period.
- Whether advice provided by remarketing agents is within the scope of the underwriter exclusion.
- Opinions offered by public officials and citizens.
- Effective and compliance dates of the final rules.

For more information, see the January 10, 2014, and January 13, 2014, press releases on the SEC's Web site.

SEC Releases Examination Priorities for 2014

On January 9, 2014, the SEC's Office of Compliance Inspections and Examinations published a document highlighting the Commission's examination priorities for 2014. The objective of the document is to inform SEC registrants and investors about issues that the Commission is planning to focus on for the remainder of the year. These issues include fraud detection and prevention, corporate governance and conflicts of interest, new laws and regulations, and the Commission's programs for investment advisers and broker-dealers.

For more information, see the press release on the SEC's Web site.

SEC Implements Volcker Rule

On December 10, 2013, the SEC, OCC, FDIC, and Federal Reserve jointly issued a final rule to implement Section 619 of the Dodd-Frank Act (also known as the "Volcker Rule"). The final rule "contains certain prohibitions and restrictions on the ability of a banking entity and nonbank financial company supervised by the [Federal Reserve] to engage in proprietary trading and have certain interests in, or relationships with, a hedge fund or private equity fund."

For more information, see the press release on the SEC's Web site.

Appendixes

Appendix A — Glossary of Standards and Other Literature

The standards and literature below were cited or linked to in this publication.

FASB ASC References

For titles of *FASB Accounting Standards Codification* references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

FASB Accounting Standards Updates and Other FASB Literature

See the FASB's Web site for the titles of:

- Accounting Standards Updates.
- Proposed Accounting Standards Updates (exposure drafts and public comment documents).
- Pre-Codification literature (Statements, Staff Positions, EITF Issues, and Topics).
- Concepts Statements.

PCAOB Literature

PCAOB AU Section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*

PCAOB Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*

SEC Final Rules

33-9616, *Money Market Fund Reform; Amendments to Form PF*

33-9638, *Asset-Backed Securities Disclosure and Registration*

34-71288, *Registration of Municipal Advisors; Temporary Stay of Final Rule*

34-72472, *Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant Definitions to Cross-Border Security-Based Swap Activities"*

34-72936, *Nationally Recognized Statistical Rating Organizations*

SEC Interim Rules

33-9545, *Extension of Exemptions for Security-Based Swaps*

BHCA-2, *Treatment of Certain Collateralized Debt Obligations Backed Primarily by Trust Preferred Securities With Regard to Prohibitions and Restrictions on Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds*

SEC Proposed Rules

33-9643, *Treatment of Certain Communications Involving Security-Based Swaps That May Be Purchased Only by Eligible Contract Participants*

34-71699, *Standards for Covered Clearing Agencies*

IC-31184, *Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule*

SEC Staff Accounting Bulletins

SAB 99, codified as SAB Topic 1.M, "Materiality"

SAB Topic 5.J, "New Basis of Accounting Required in Certain Circumstances" (rescinded)

SAB Topic 13, "Revenue Recognition"

International Standards

See Deloitte's IAS Plus Web site for the titles of:

- International Financial Reporting Standards.
- International Accounting Standards.
- Exposure documents.

Appendix B — Abbreviations

Abbreviation	Description
AFS	available for sale
AICPA	American Institute of Certified Public Accountants
ASC	FASB Accounting Standards Codification
ASU	FASB Accounting Standards Update
CECL	current expected credit loss
CFTC	U.S. Commodity Futures Trading Commission
COSO	The Committee of Sponsoring Organizations of the Treadway Commission
ED	exposure draft
EITF	Emerging Issues Task Force
FAQs	frequently asked questions
FASB	Financial Accounting Standards Board
FDIC	Federal Deposit Insurance Corporation
FHLB	Federal Home Loan Bank
FVTNI	fair value through net income
FVTOCI	fair value through other comprehensive income
GAAP	generally accepted accounting principles
GP	general partner
HTM	held to maturity
IAS	International Accounting Standard
IASB	International Accounting Standards Board
ICFR	internal control over financial reporting

Abbreviation	Description
IFRS	International Financial Reporting Standard
IPO	initial public offering
LGD	loss given default
LIHTC	low income housing tax credit
LP	limited partner
MMF	money market fund
NAV	net asset value
NRSROs	nationally recognized statistical rating organizations
OCC	Office of the Comptroller of the Currency (U.S. Department of the Treasury)
OCI	other comprehensive income
PBE	public business entity
PCAOB	Public Company Accounting Oversight Board
PCC	Private Company Council
PCI	purchased credit-impaired
PD	probability of default
PIR	post-implementation review
REIT	real estate investment trust
ROU	right of use
SAB	SEC Staff Accounting Bulletin
SEC	Securities and Exchange Commission
VIE	variable interest entity

The following is a list of short references for the Acts mentioned in this publication:

Abbreviation	Act
Dodd-Frank Act	The Dodd-Frank Wall Street Reform and Consumer Protection Act
Exchange Act	Securities Exchange Act of 1934
Investment Advisers Act	Investment Advisers Act of 1940
Sarbanes-Oxley Act	The Sarbanes-Oxley Act of 2002
Securities Act	Securities Act of 1933
Trust Indenture Act	Trust Indenture Act of 1939

Appendix C — Other Resources

Deloitte Publications

Register to receive other Deloitte industry-related publications by going to www.deloitte.com/us/subscriptions, choosing the Industry Interests category, and checking the boxes next to your particular interests. Publications pertaining to your selected industry (or industries), along with any other Deloitte publications or webcast invitations you choose, will be sent to you by e-mail.

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Technical Library and US GAAP Plus

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In addition, be sure to visit US GAAP Plus, our free Web site that features accounting news, information, and publications with a U.S. GAAP focus. It contains articles on FASB activities and updates to the *FASB Accounting Standards Codification*™ as well as developments of other U.S. and international standard setters and regulators, such as the PCAOB, the AICPA, the SEC, the IASB, and the IFRS Interpretations Committee. Check it out today!

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