SEC Financial Reporting Issues Meeting

Thursday, April 2nd
11am – 12:15pm
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

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Real Estate
Accounting and Financial Reporting Update

November 24, 2014

Financial Services Industry

Contents

Foreword iii

Acknowledgments iv

Introduction v

Updates to Guidance

- Revenue Recognition 2
- Discontinued Operations Reporting 6
- Going Concern 8
- Accounting for Investments in Qualified Affordable Housing Projects 10
- Definition of a Public Business Entity 11
- Accounting Alternatives for Private Companies 12
- Pushdown Accounting 13

On the Horizon

- Leases 16
- Consolidation 18
- Financial Instrument Impairment 21
- Classification and Measurement 25
- Hedging 27
- Accounting for Goodwill by Public Business Entities and Not-for-Profit Entities 27
- Clarifying the Definition of a Business 28

Other Topics

- Disclosure Framework 30
- Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items 32
- Debt Issuance Costs 32
- Liabilities and Equity — Short-Term Improvements 32
- COSO Framework 33
- SEC Rules 33

Appendixes

- Appendix A — Glossary of Standards and Other Literature 39
- Appendix B — Abbreviations 41
- Appendix C — Other Resources 42

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.

Dbriefs

We also offer *Dbriefs* webcasts, which feature discussions by Deloitte professionals and industry specialists on critical issues that affect your business. Aimed at an executive-level audience, *Dbriefs* are designed to be timely, relevant, interactive, convenient, and supportive of your continuing professional education objectives. For more information about *Dbriefs*, please visit www.deloitte.com/us/dbriefs.

Technical Library and US GAAP Plus

Deloitte makes available, on a subscription basis, access to its online library of accounting and financial disclosure literature. Called Technical Library: The Deloitte Accounting Research Tool, the library includes material from the FASB, the EITF, the AICPA, the PCAOB, the IASB, and the SEC, in addition to Deloitte's own accounting and SEC manuals and other interpretive accounting and SEC guidance.

Updated every business day, Technical Library has an intuitive design and navigation system that, together with its powerful search features, enable users to quickly locate information anytime, from any computer. Technical Library subscribers also receive *Technically Speaking*, the weekly publication that highlights recent additions to the library. For more information, including subscription details and an online demonstration, visit www.deloitte.com/us/techlibrary.

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!

Deloitte.

SEC Comment Letters — Including Industry Insights: A Recap of Recent Trends

Eighth Edition
November 20, 2014

To our clients, colleagues, and other friends:

We are frequently asked to provide our perspective on the topics the SEC staff focuses on in its comment letters to registrants. The eighth edition of *SEC Comment Letters — Including Industry Insights: A Recap of Recent Trends* offers such perspective. In addition to extracts of letters and links to relevant related resources, it contains analysis of staff comments to help registrants understand trends and improve their financial statements and disclosures.

Over the past year, the staff has continued to address virtually all topics discussed in our seventh edition, and it remains focused on the clarity of registrants' disclosures. Sections in the eighth edition have been updated to reflect newer comments on registrants' financial statements and other areas of their filings. In addition, the appendixes in the eighth edition offer further insights. For example, Appendix A gives a glimpse into the SEC staff's review and comment letter process. Appendix B discusses best practices for managing unresolved SEC comments, and Appendix C provides helpful tips on searching the SEC's EDGAR database for comment letters. In addition, Appendix D lists the titles (or links to titles) of the standards referred to in this publication, and Appendix E defines the abbreviations we used.

Our eighth edition captures developments on relevant financial reporting topics through the date of publication. The SEC and its staff will continue to provide registrants with information that is pertinent to their filings by means of rulemaking and written interpretive guidance as well as speeches delivered at various forums, of which the AICPA Conference is a prime example. Deloitte's US GAAP Plus Web site is a resource you can use to keep current on the SEC's latest activities related to financial reporting matters — including the SEC staff's participation at the next AICPA Conference, which is scheduled for December 8–10, 2014, and will be discussed in an upcoming issue of our *Heads Up* newsletter.

We hope you find our eighth edition of this publication — and other publications on US GAAP Plus — useful resources as you prepare your annual reports and plan for the upcoming year.

In keeping with recent SEC staff remarks about how registrants can make their disclosures more effective, we encourage you to consider materiality, relevance, and redundancy as you assess whether to provide additional disclosures or enhance existing ones.

As always, we encourage you to contact us for additional information and assistance, and we welcome your feedback.

Sincerely,

Bob

Bob Uhl
Accounting Standards and Communications

Christine

Christine Davine
SEC Services

Contents

Acknowledgments	v
Executive Summary	vi
Financial Statement Accounting and Disclosure Topics	**1**
Business Combinations	2
Consolidation	5
Contingencies	7
Debt	10
Discontinued Operations, Assets Held for Sale, and Restructuring Charges	13
Earnings per Share	15
Fair Value	17
Financial Instruments	19
Financial Statement Classification, Including Other Comprehensive Income	21
Foreign Currency	25
Impairments of Goodwill and Other Long-Lived Assets	27
Income Taxes	30
Leases	35
Materiality	36
Noncontrolling Interests	38
Other-Than-Temporary Impairment of Investments in Securities	39
Pensions and Other Postretirement Benefits	41
Revenue Recognition	44
SAB Topic 11.M (SAB 74) — Disclosures About the Impact of Recently Issued Accounting Pronouncements	48
Segment Reporting	49
Share-Based Payments	53
SEC Disclosure Topics	**56**
Management's Discussion and Analysis	57
SEC Reporting	62
Disclosures About Risk	70
Non-GAAP Financial Measures	72
Disclosure Controls and Procedures	75
Internal Control Over Financial Reporting	77
Executive Compensation and Other Proxy Disclosures	84
Emerging Growth Companies	88

Other SEC Reporting Matters 91
Certifications 91
Use of Experts and Consents 92
Material Contracts 93
Backlog Disclosures 94
Disclosures Regarding State Sponsors of Terrorism 95
Interactive Data — eXtensible Business Reporting Language (XBRL) 96

Disclosure Topics in Initial Public Offerings 98

Initial Public Offerings 99

Foreign Private Issuers 107

Foreign Private Issuers Using IFRSs 108

Industry-Specific Topics 112

Consumer and Industrial Products 113
Retail and Distribution 113
Transportation, Travel, Hospitality, and Leisure 114

Energy and Resources 116
Oil and Gas 116
Power and Utilities 120
Mining 123

Financial Services 124
Banking and Securities 124
Insurance 130
Investment Management 133
Real Estate 135

Health Sciences 140
Life Sciences 140
Health Plans 146

Technology, Media, and Telecommunications 148
Technology 148
Telecommunications 152

Appendixes 154

Appendix A: SEC Staff Review Process 155

Appendix B: Best Practices for Managing Unresolved SEC Comment Letters 156

Appendix C: Tips for Searching the SEC's Database for Comment Letters 158

Appendix D: Glossary of Standards and Other Literature 163

Appendix E: Abbreviations 168

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Executive Summary

In October 2014, a new chief accountant, James Schnurr, assumed leadership of the SEC's Office of the Chief Accountant (OCA). In early November, Mr. Schnurr gave a glimpse of his priorities and noted that the OCA would place heavy emphasis on monitoring the implementation of the FASB's and IASB's new converged revenue standard, which introduces a new contract-based model that is designed to replace all current revenue accounting literature. While the standard will not be effective until 2017, Mr. Schnurr noted that a significant number of implementation issues have been identified and that the OCA is considering what additional steps it may take. He also said that he would work with his staff to provide some clarity about whether and, if so, how, to incorporate IFRSs in the U.S. financial reporting system. So it is likely that we will hear more about these topics in the coming months.

Another priority, the aggressive pursuit of investor protections, has been the focus of the SEC's Division of Enforcement and Office of the Whistleblower. Recently, the SEC announced that in fiscal year 2014, the Division of Enforcement filed approximately 755 enforcement actions and levied penalties in excess of $4 billion — both record highs. Further, in September 2014, the Office of the Whistleblower announced that it expected to award a whistleblower approximately $30 million, the highest sum it has paid to date.

The Division of Corporation Finance (the "Division") has been equally busy undertaking its own priorities, devoting much of 2014 to fulfilling the SEC's mandated rulemaking activities under the Dodd-Frank and JOBS Acts. In December 2013, in a report provided under the JOBS Act, the Division's staff indicated that the SEC would commence a broad effort to modernize and streamline its rules and regulations (also called its "disclosure effectiveness project").[1] In addition, the Division's staff has remarked on how, in the absence of rule changes, registrants can improve their disclosure documents in the near term — most notably by focusing their disclosures on matters that are material and relevant to their operations, liquidity, and financial condition.[2]

Further, the Division continues to meet its responsibilities under the Sarbanes-Oxley Act to review registrants at least once every three years. MD&A is again the leading source of SEC staff comments, and the staff has encouraged registrants to "tell their story" in MD&A to allow investors to see the company "through the eyes of management." Comments often focus on enhancing the executive overview to provide an investor with a balanced summary of key drivers, challenges, and risks that affect the registrant's liquidity and results of operations. In results of operations, the staff has continued to focus on encouraging registrants to disclose known trends or uncertainties, quantify components of overall changes in financial statement line items, and enhance their analysis of the underlying factors that cause such changes.

In addition to MD&A, the SEC staff has commented on all sections of a registrant's filings, including the financial statements. Among the questions it frequently asks registrants are those related to:

- *Segment reporting* — This remains a perennial topic of SEC staff inquiry. Historically, the staff has asked registrants about the identification of the chief operating decision maker (CODM), the identification of operating segments, and the analysis supporting the aggregation of operating segments. While the prominence of these themes has continued over the past year, the SEC staff recently remarked that its views are evolving and that it will renew its focus on these topics. In particular, the staff (1) will continue to ask questions to obtain a better understanding of a registrant's management structure and whether that structure supports the person or group identified as the CODM and (2) is rethinking the importance placed on the information package provided to, and regularly reviewed by, the CODM (the "CODM package"). That is, it is likely that the staff will no longer regard the CODM package as the determinative factor supporting the identification of a registrant's operating segments but will treat the CODM package as one of many factors to be considered.

1 For additional information, see Deloitte's August 26, 2014, *Heads Up*.

2 The SEC staff has discussed this topic in various speeches over the past year. For more information about the staff's remarks, see Deloitte's October 16, 2014, March 20, 2014, and December 16, 2013, *Heads Up* newsletters.

- *Revenue recognition* — Comments continue to include those that address the completeness and consistency of disclosures about revenue recognition policies, accounting for multiple-element arrangements, and principal-versus-agent analysis (i.e., gross or net reporting).
- *Income taxes* — The SEC staff remains focused on (1) the valuation and sufficiency of deferred tax assets, (2) appropriate breakout (and descriptions of) adjustments in a registrant's rate reconciliation, and (3) disclosures about liquidity in MD&A when registrants assert that they have indefinitely reinvested foreign earnings.
- *Internal control over financial reporting (ICFR)* — The SEC staff has concentrated on a registrant's evaluation of the severity of deficiencies in ICFR when there are immaterial error corrections disclosed in the filing. The severity of a deficiency depends on whether there is a reasonable possibility that the deficiency could result in a material misstatement. Accordingly, the staff may question whether there is a material weakness in ICFR even though the actual magnitude of the error was not material in amount. In addition, the staff has asked registrants (1) how they assessed the effect of control deficiencies on other components of the COSO framework and (2) to disclose which COSO framework they used to evaluate their ICFR if they have not already made such disclosure.
- *Cash flow statement* — Like past SEC staff comments, recent ones have centered on the appropriate classification of items in the cash flow statement (i.e., the determination of whether particular items should be classified as operating, investing, or financing activities). The process and internal controls related to the preparation of this statement are likely to be topics of future comments given an increase in classification errors. At a recent conference, the SEC staff noted that the errors were generally not attributable to complex fact patterns and cautioned registrants to revisit their processes and related internal controls.

Industry-specific comments to registrants have also been substantial. For example, comments related to the oil and gas industry have focused on (1) understanding how registrants accounted for master limited partnerships, (2) the amount and classification of proved undeveloped reserves, and (3) separate disclosure of natural gas liquid reserves. Registrants in the technology and investment management industries have received comments on how they recognize revenue related to multiple-element arrangements and performance fees, respectively. The SEC staff has asked registrants in the banking industry about disclosures related to the credit quality of their assets, including the sufficiency of their loan loss allowances. Comments to registrants in the retail industry have centered on the need for separate disclosure and analysis of online sales in MD&A.

Financial Statement Accounting and Disclosure Topics

Business Combinations

Purchase Price Allocation

> **Example of an SEC Comment**
>
> Please expand the adjustment notes to disclose, in tabular form, how the purchase price was determined and allocated. . . . Please [also] expand the disclosure to show the allocation of the purchase price to the tangible and intangible assets acquired. Also, for each class of intangibles acquired disclose the related amortization period. Further, disclose the nature of the intangible assets acquired and the factors that make up the goodwill acquired in the [X] acquisition.

The SEC staff frequently asks registrants how they have assigned amounts to assets acquired and liabilities assumed in business combinations. In particular, the staff asks registrants that have recorded a significant amount of goodwill why they have not attributed value to identifiable intangible assets. The staff also compares disclosures provided in press releases, the business section, and MD&A to the purchase price allocation in the financial statements. For example, the SEC staff may ask why a registrant did not recognize a customer-related intangible asset if it discloses in MD&A that it acquired customers in a business combination. In addition, the SEC staff may ask detailed questions about (1) how a registrant determined that intangible assets would have a finite or indefinite useful life; (2) the useful life of identified intangible assets determined to have a finite useful life; and (3) material revisions to the initial accounting for a business combination, including what significant assumptions have changed that support a revision to the value of intangible assets.

Contingent Consideration

> **Example of an SEC Comment**
>
> We note that you agreed to pay an additional $[X] of contingent consideration for earn-out payments based upon performance and milestones. We further note that you determined the fair value of this contingent consideration to be $[Y]. Please revise your filing to clearly explain how you determined the $[Y] fair value for this contingent consideration. Disclose the significant assumptions and how the significant assumptions were determined.

The SEC staff often asks registrants to provide additional disclosures about the nature and terms of a contingent consideration arrangement and the conditions that must be met for the arrangement to become payable. Since ASC 805 requires entities to recognize contingent consideration at fair value as of the acquisition date, the staff may ask registrants to disclose how they determined the fair value of the contingent consideration. In addition, the staff may ask whether the change in the fair value of contingent consideration should be reflected as a retrospective adjustment to the amount of goodwill (i.e., if the adjustment is due to new information identified during the measurement period about facts or circumstances that existed as of the acquisition date) or in current earnings under ASC 805-10-25-13 through 25-19 and ASC 805-10-30-3. The staff may also ask for disclosure of the total amount of contingent consideration that could become payable under the terms of the arrangement.

Bargain Purchases

> **Example of an SEC Comment**
>
> We note your disclosure that you recognized a bargain purchase gain that represents the excess of the fair value of the property and equipment over the amount used to determine the original purchase consideration. Tell us what consideration you gave to discussing the reasons why the transaction resulted in a gain. Refer to ASC 805-30-50-1.f.2. In this regard, further explain to us how the purchase price was determined and why you believe the consideration was acceptable to the seller. Describe the methodology and assumptions used in the valuation of the property and equipment. In addition, please tell us how you considered the guidance in ASC 805-30-25-2 through 25-4.

When a registrant recognizes a gain related to a bargain purchase, the SEC staff will typically comment on how the registrant determined and reassessed the purchase price allocation. A gain from a bargain purchase occurs when the acquisition-date fair value of the identifiable assets acquired and liabilities assumed is greater than the sum of the acquisition-date fair value of (1) the consideration transferred, (2) the noncontrolling interest in the acquiree, and (3) any equity interests previously held by the acquirer. Before recognizing the gain, a registrant is required to perform a reassessment of the bargain purchase gain by verifying that all assets acquired and liabilities assumed were properly identified. The SEC staff has asked registrants to (1) explain their process, (2) provide the results of the reassessment, and (3) disclose that a reassessment was performed.

Disclosures

> **Example of an SEC Comment**
>
> Please revise [your filing] to include all of the disclosures required by ASC 805-10-50 as applicable. For example, it does not appear that you disclosed the revenue and earnings of the combined entity for the comparable prior period as though the acquisition date for all business combination that occurred during [the year indicated] had occurred as of the beginning of the comparable prior annual period (supplemental pro forma information.)

The SEC staff has commented when a registrant fails to provide pro forma disclosures under ASC 805-10-50 about the effects of an acquisition as of the beginning of a reporting period. ASC 805-10-50-2(h)(3) states that the disclosure requirements for comparative financial statements are as follows:

> [F]or a calendar year-end entity, disclosures would be provided for a business combination that occurs in 20X2, as if it occurred on January 1, 20X1. Such disclosures would not be revised if 20X2 is presented for comparative purposes with the 20X3 financial statements (even if 20X2 is the earliest period presented).

In accordance with ASC 805-10-50, registrants must also disclose the nature and amount of material, nonrecurring pro forma adjustments related to the business combinations that are recognized in the reported pro forma information.

If certain criteria are met (e.g., if a significant business combination has occurred or is probable), registrants may also be required to provide pro forma financial information that complies with Regulation S-X, Article 11, in a registration statement, proxy statement, or Form 8-K. For additional information, see the SEC Reporting section.

The SEC staff has also asked registrants:

- Whether an acquisition meets the definition of a business under ASC 805-10-20.
- To indicate which specific elements related to their use of the acquisition method of accounting are not yet complete and why they have not been finalized.
- To identify and disclose the income statement classification of acquisition-related costs they incurred (e.g., due diligence fees, legal fees).
- Whether individually immaterial acquisitions are collectively material, which would require them to disclose certain information.

Consolidation

ASC 810 provides guidance on entities that are subject to consolidation under either the voting interest entity model or the VIE model. Recent SEC comments have focused primarily on the consolidation conclusions reached under the VIE model, including those related to (1) the determination of whether an entity is a VIE, (2) the determination of whether the reporting entity is the primary beneficiary of a VIE, and (3) VIEs in foreign jurisdictions.

Determining Whether an Entity Is a VIE and Whether the Reporting Entity Is a VIE's Primary Beneficiary

Example of an SEC Comment

We note you consolidate the [partnership] and its subsidiaries. Please explain to us in detail your basis for consolidating these entities. If you are within the scope of the Variable Interest Subsections of ASC 810-10-15, please tell us in detail: (i) the basis for your conclusion that the [partnership], by design, is a variable interest entity based on the conditions in ASC 810-15-15-14; (ii) the basis for your conclusion that you have the power to direct the activities of the [partnership] that most significantly impact its economic performance and the obligation to absorb losses or the right to receive benefits that could potentially be significant to the [partnership] based on the provisions of ASC 810-10-25-38A through 25-38G; and (iii) your consideration of the disclosure requirements in ASC 810-10-50 related to variable interest entities.

To determine whether it is required to consolidate another entity, a reporting entity must evaluate whether the other entity is a VIE under ASC 810-10 and, if so, whether the reporting entity is the VIE's primary beneficiary. To be the primary beneficiary of a VIE and, therefore, the party that is required to consolidate it, the reporting entity must have (1) the power to direct the activities of the VIE that most significantly affect the VIE's economic performance 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.[1] The SEC staff continues to focus on consolidation conclusions under ASC 810-10 and often asks registrants to (1) explain their involvement with, and the structure of, VIEs; (2) provide detailed support for their conclusions about whether a structure is a VIE (including the consolidation model they ultimately used); and (3) discuss the basis for their determination of whether they are the primary beneficiary of a VIE.

VIEs in Foreign Jurisdictions

Examples of SEC Comments

- To provide balance and context, please disclose that the registrant is a holding company and clarify that your operational consolidated affiliated entity in the [People's Republic of China (PRC)] includes a variable interest entity holding the [Internet content provider (ICP)] license, material to your business operations and financial results. Disclose that it is through the contractual arrangements that you have effective control, which allows you to consolidate the financial results of the VIE in your financial statements. Disclose that, if your PRC VIE and its shareholders fail to perform their obligations under the contractual arrangements, you could be limited in your ability to enforce the contractual arrangements that give you effective control. Further, if you are unable to maintain effective control, you would not be able to continue to use the material ICP license to operate your business and that you are not eligible as a [foreign investment enterprise] to hold an ICP. Disclose the percentage of revenues in your consolidated financial statements that are derived from your use of the ICP held by the VIE.
- Please disclose all the terms of the various contractual agreements between [Entity A], the trustees, the [wholly foreign-owned enterprise], [Entity B] and [Entity C] such as duration, mutual consent provisions, validity and enforceability of the contracts and any revocability clause. Disclose how these terms convey to you through [Entity A] the power to control [Entity B] and [Entity C] and how the economics are flowing to you before the deconsolidation date. Include any provisions that might limit the ability to exercise power and or whether there are any restrictions on your contractual rights.

[1] Registrants should consider whether consolidating a VIE meets the significance thresholds for reporting under Item 2.01 of Form 8-K and Rule 3-05 of Regulation S-X.

The SEC staff also continues to focus on the consolidation conclusions for overseas VIE arrangements (particularly wholly foreign-owned entities used to invest in China). The SEC staff expects registrants to disclose the critical judgments they made about their involvement with overseas VIEs, such as the validity and enforceability of contracts with the parties involved and whether there are any restrictions on the registrants' contractual rights. Accordingly, the staff may ask registrants to disclose the terms of their significant contractual agreements (e.g., contract duration, mutual consent provisions, renewal rights, or revocability clauses) and how these terms enhance or limit the registrants' ability to exercise power over the foreign VIEs. Further, the staff has indicated that registrants should disclose details about such VIEs, such as their nature, purpose, size, and activities. The SEC staff has also pointed out that registrants' MD&A should (1) describe the economic effects of their involvement with a foreign VIE (e.g., whether material service fees under contractual arrangements are not being settled) and (2) allow investors to assess how registrants would be affected by their deconsolidation of foreign VIEs.[2] At the 2013 AICPA Conference, the SEC staff indicated that it would expect registrants to disclose risk factors related to these structures (e.g., the registrants may have only limited legal protection in China, or there may be restrictions on cash transfers from foreign VIEs).

These expectations overlap significantly with the disclosure requirements in ASC 810-10-50-2AA, under which reporting entities' audited financial statements must provide information about the following:

> a. The significant judgments and assumptions made by a reporting entity in determining whether it must do any of the following:
>
> 1. Consolidate a [VIE.]
> 2. Disclose information about its involvement in a VIE.
>
> b. The nature of restrictions on a consolidated VIE's assets and on the settlement of its liabilities reported by a reporting entity in its statement of financial position, including the carrying amounts of such assets and liabilities.
>
> c. The nature of, and changes in, the risks associated with a reporting entity's involvement with the VIE.
>
> d. How a reporting entity's involvement with the VIE affects the reporting entity's financial position, financial performance, and cash flows.

For additional information, see the Disclosures About Risk section.

Other Deloitte Resources

December 16, 2013, *Heads Up*, "Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments."

[2] Paragraph 2110.1 of the FRM clarifies that upon deconsolidation of a VIE, registrants should evaluate whether they need to file a Form 8-K for a significant disposition.

Contingencies

Because registrants' contingency disclosures have improved, the SEC staff has commented on this topic less frequently than in prior years. However, the staff continues to monitor registrants' contingency disclosures, and it comments when such disclosures do not comply with U.S. GAAP or SEC rules and regulations.

The staff has continued to comment on the following:

- Lack of specificity regarding the nature of the matter.
- Lack of quantification of amounts accrued, if any, and possible loss or range of loss (or disclosure about why such an estimate cannot be made).
- Lack of disclosure or insufficient detail about what triggered a significant current-period accrual for a contingency when no loss or a significantly lower amount was accrued in prior periods.
- Insufficient detail about judgments and assumptions underlying significant accruals.
- Insufficient detail about (and untimely reporting of) new developments related to loss contingencies and the effect of such developments on current and future periods.
- Inconsistency among disclosures in the footnotes, in other sections of the filing (e.g., risk factors and legal proceedings), and outside the filing (e.g., in press releases and earnings calls). In addition, if different registrants are parties to a claim, the SEC may also review the counterparty's filings and comment if the information is not consistent.
- Use of unclear language in disclosures (e.g., not using terms that are consistent with accounting literature, such as "probable" or "reasonably possible") and failure to consider the disclosure requirements in ASC 450, SAB Topic 5.Y, and Regulation S-K, Item 103.
- Lack of disclosure of an accounting policy related to accounting for legal costs (when material) and uncertainties in loss contingency recoveries, including (1) whether ranges of reasonably possible losses are disclosed gross or net of anticipated recoveries from third parties, (2) risks regarding the collectibility of anticipated recoveries, and (3) the accounting policy for uncertain recoveries.

Loss Contingencies

Example of an SEC Comment

For multiple matters you state that the impact of the final resolution on your results of operations in a particular reporting period is not known. It is not clear for these matters whether there is at least a reasonable possibility that a loss exceeding amounts already recognized may have been incurred. If so, please either disclose an estimate (or, if true, state that the estimate is immaterial in lieu of providing quantified amounts) of the additional loss or range of loss, or state that such an estimate cannot be made. Please refer to ASC 450-20-50.

If you conclude that you cannot estimate the reasonably possible additional loss or range of loss, please supplementally: (1) explain to us the procedures you undertake on a quarterly basis to attempt to develop a range of reasonably possible loss for disclosure and (2) for each material matter, what specific factors are causing the inability to estimate and when you expect those factors to be alleviated. We recognize that there are a number of uncertainties and potential outcomes associated with loss contingencies. Nonetheless, an effort should be made to develop estimates for purposes of disclosure, including determining which of the potential outcomes are reasonably possible and what the reasonably possible range of losses would be for those reasonably possible outcomes.

You may provide your disclosures on an aggregated basis. Please show us in your supplemental response what the revisions in future filings will look like.

Many comments from the SEC staff have focused on comparing current-year disclosures with those in prior-year filings. If a registrant's filing includes disclosures related to a potential contingency, or if the registrant discusses a potential contingency in its earnings calls, the SEC staff is likely to seek more information about the contingency and to inquire about whether the related disclosures are appropriate. The SEC staff encourages registrants to clearly disclose the "full story" regarding their loss contingencies because recognition of such contingencies requires a high degree of professional judgment. Further, the staff has noted that disclosures related to loss contingencies should be continually evaluated over time as facts and circumstances change.

The SEC staff often asks about estimates of potential losses. Questions commonly include whether additional reasonably possible losses have been incurred since the initial disclosure, why the accrual amount for the current year is different from that reported in previous filings, and whether there are any changes in facts and circumstances that may affect the accrual amount. In addition, the SEC staff often comments when a registrant omits disclosure of a loss or range of losses because its estimates lack "precision and confidence." If an estimate of the loss or range of losses cannot be made, the staff expects registrants to demonstrate that they at least attempted to estimate the loss or range of losses before concluding that an estimate could not be made. The staff has also indicated that in such cases, registrants should disclose the specific factors that limited their ability to reasonably estimate the loss and has asked about registrants' quarterly procedures related to such estimates. These factors should be specific to the loss contingency in question and could include representations that (1) claims do not specify an amount of damages, (2) there are a large number of plaintiffs, or (3) the case is in its early stages.

Further, the SEC staff may ask about (1) the basis of a registrant's accrual (e.g., factors supporting an accrual, such as trends in claims received and rejected), (2) the timing of a loss contingency's recognition, and (3) disclosure of a loss contingency. In addition, when a material settlement is disclosed during the period, the staff may review prior-period disclosures to determine whether such disclosures were appropriate (i.e., whether the registrant should have provided early-warning disclosures about the possibility of incurring or settling a loss in future periods to help users understand these risks and how they could potentially affect the financial statements). See the Management's Discussion and Analysis section for additional information about early-warning disclosures.

Litigation Contingencies

Example of an SEC Comment

Although your disclosures . . . indicate that you do not believe you have material potential liability in connection with litigation proceedings, you also disclose that they "could have a material adverse effect." Consistent with ASC 450-20-50-4(b), please disclose the aggregate estimated loss or range of reasonably possible losses in excess of amounts accrued or state that such an estimate cannot be made. If an estimate of reasonably possible additional losses can be made and that amount, both for each individual matter and in the aggregate, is not material to your consolidated financial position, results of operations or cash flows, we will not object to a statement to that effect.

The SEC staff often asks registrants to expand their disclosures about litigation contingencies. If a registrant discloses that the impact of pending or threatened litigation is not expected to be material to its financial statements, the staff is likely to request that the registrant disclose the estimated loss or range of reasonably possible losses in excess of amounts accrued in accordance with ASC 450-20-50-4(b) and SAB Topic 5.Y.[1]

[1] Specifically, the interpretive response to Question 2 of SAB Topic 5.Y indicates that "a statement that the contingency is not expected to be material does not satisfy the requirements of FASB ASC Topic 450 if there is at least a reasonable possibility that a loss exceeding amounts already recognized may have been incurred and the amount of that additional loss would be material to a decision to buy or sell the registrant's securities. In that case, the registrant must either (a) disclose the estimated additional loss, or range of loss, that is reasonably possible, or (b) state that such an estimate cannot be made."

In addition to complying with ASC 450, public entities must separately meet the requirements of Regulation S-K, Item 103, when disclosing litigation matters because while those requirements are similar to the requirements of ASC 450, they are not identical. Also, to address concerns related to a registrant's contention that providing too much information may be detrimental to efforts to litigate or settle matters, the SEC staff has indicated that registrants do not need to separately disclose each asserted claim; rather, they may aggregate asserted claims in a logical manner as long as the disclosure complies with ASC 450.

Debt

Restrictions

Example of an SEC Comment

We note you disclose that your Senior Notes and European Senior Notes include covenants that limit the Company's ability to cause its restricted subsidiaries to pay dividends or make other payments to the Company. Please tell us if the restricted net assets of the applicable restricted entities exceed 25% of consolidated net assets as of [the end of the most recently completed fiscal year]. If so please tell us how you have complied with the requirement to provide the disclosures required by Rule 4-08(e)(3)(i) and (ii) of Regulation S-X.

When the transfer of assets (cash or other funds) to the parent company/registrant from its subsidiary (or subsidiaries) or equity method investee is materially restricted, limited, or in need of a third party's approval, Regulation S-X, Rules 4-08(e), 5-04, and 12-04, may require:

- Footnote disclosure of the restriction or limitation (Rule 4-08(e)).
- Presentation of condensed parent-company financial data in a financial statement schedule (i.e., Schedule I).
- Both footnote and Schedule I disclosures.

Rule 4-08(e) disclosures are intended to inform investors of restrictions on a registrant's ability to pay dividends or transfer funds within a consolidated group. Such restrictions may result from a contractual agreement (e.g., a debt agreement) or a regulatory body. Without appropriate disclosures of such restrictions, an investor may presume that the registrant (at the parent or subsidiary level) may have more discretion to transfer funds or pay cash dividends than is actually the case.

If Rule 4-08(e) applies, registrants must disclose in the notes to the financial statements a description of "the most significant restrictions, other than as reported under [Rule 4-08(d)], on the payment of dividends by the registrant, indicating their sources, their pertinent provisions, and the amount of retained earnings or net income restricted or free of restrictions."

Disclosure is also required under Rule 4-08(e)(3) if the total restricted net assets of subsidiaries, plus the parent's equity in the undistributed earnings of 50 percent or less owned entities, exceed 25 percent of consolidated net assets. SAB Topic 6.K provides further guidance on determining the restricted net assets of subsidiaries. Disclosures required under Rule 4-08(e)(3) include:

- The "nature of any restrictions on the ability of consolidated subsidiaries and unconsolidated subsidiaries to transfer funds to the registrant in the form of cash dividends, loans or advances."
- Separate disclosure of "the amounts of such restricted net assets for unconsolidated subsidiaries and consolidated subsidiaries as of the end of the most recently completed fiscal year."

In addition, to give investors separate information about the parent company, registrants are required under Rule 5-04 to file Schedule I "when the restricted net assets [of the registrant's] consolidated subsidiaries exceed 25 percent of consolidated net assets as of the end of the most recently completed fiscal year."

The calculations under Rule 4-08(e) are different from those under Rule 5-04, which governs Schedule I, so registrants must perform both tests to determine what is required. If Schedule I is required, footnote disclosures under Rule 4-08(e) are also required. However, if Rule 4-08(e) disclosures are required, Schedule I may not be required. In addition, a registrant's filing of Schedule I does not necessarily mean that the registrant has satisfied the disclosure requirements of Rule 4-08(e), which are separate and distinct.

Refinancing

> **Example of an SEC Comment**
>
> We note you refinanced your credit facility [on two occasions]. Please tell us how you considered ASC 470-50, Modifications and Extinguishment, for these transactions and provide us with your analysis to determine if the transactions were a modification or extinguishment.

The SEC staff's comments on this topic have focused on registrants' (1) conclusions about whether debt refinancing transactions should be accounted for as debt extinguishments under ASC 470-50 and (2) disclosures about the significant components of the gains or losses recorded on a debt extinguishment and how registrants calculated the components.

Financial Covenant Disclosures

> **Example of an SEC Comment**
>
> Regarding your obtaining a limited waiver of the debt covenants subsequent to [the end of the fiscal quarter], pertaining to limitations on capital expenditures and the Debt Service Coverage (DSC) Ratio, please revise future filings to disclose the specific terms of the covenants, including the actual amounts for each period and the required amounts before and after any revisions or waivers. This will allow readers to understand how much cushion there is between the required and the actual ratios and amounts. Please show the specific computations used to arrive at the actual ratios with corresponding reconciliations to US GAAP amounts, if necessary. Your disclosure should also address the risks and potential consequences of not complying with your debt covenants.

It is important for a registrant to consider providing disclosures about covenant compliance in MD&A to illustrate its financial condition and liquidity. These disclosures may include a discussion of the terms of the most severe covenants and how a registrant has complied with those covenants. In addition, a registrant may present a table that compares its most material actual debt covenant ratios as of the latest balance sheet date with the minimum and maximum amounts permitted under debt agreements. Such transparent disclosures will enable investors to better understand the risk of future covenant noncompliance by the registrant.

For additional discussion on liquidity, see the Management's Discussion and Analysis section.

Classification as Debt or Equity

Under ASC 480, certain financial instruments that embody an obligation of the issuer should be accounted for as liabilities even if their legal form is that of equity or they involve obligations to repurchase or issue the entity's equity shares.

In addition, the guidance in ASC 480-10-S99-3A states that "ASR 268 requires preferred securities that are redeemable for cash or other assets to be classified outside of permanent equity if they are redeemable (1) at a fixed or determinable price on a fixed or determinable date, (2) at the option of the holder, or (3) upon the occurrence of an event that is not solely within the control of the issuer." ASC 480-10-S99-3A also notes the SEC staff's belief that ASR 268 can be applied analogously to other redeemable instruments.

For additional information on redeemable noncontrolling interests, see the Noncontrolling Interests section.

Consequently, the SEC staff frequently asks registrants with redeemable securities — including registrants undergoing IPO transactions — to support the basis for their classification of such securities as either debt or equity. (See the Initial Public Offerings section for additional considerations for entities undergoing IPO transactions.) In addition, the SEC staff frequently asks registrants about the accounting for conversion features in convertible instruments, including convertible preferred securities. See the Financial Instruments section for considerations regarding embedded conversion features.

Discontinued Operations, Assets Held for Sale, and Restructuring Charges

Discontinued Operations and Assets Held for Sale

Examples of SEC Comments

- Please tell us and disclose the gain or loss recorded upon the sale of your ownership interest in [Component A].
- We note your disclosure that business operations to be divested include the revenues and operating expenses from the recently acquired [Component A] and [Component B] business, both of which were acquired during the year ended September 30, 2013, and which [Company A] intends to divest. Tell us what consideration you gave to classifying these operations as held for sale and presenting as discontinued operations in your financial statements for the year end September 30, 2013, in accordance with ASC 360-10-45-9 and ASC 205-20-45. As part of your response, tell us how you considered the provisions of ASC 350-20-40-4 and 5 in determining the carrying value of any goodwill to be included in the disposal group.

The SEC staff continues to ask registrants whether the operations they have disposed of should be accounted for as discontinued operations. The staff may challenge whether the operations are a "component of an entity" under ASC 205-20. Specifically, it may ask whether the "operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity."

Whether components qualify as discontinued operations must be carefully considered, especially when the registrant has cash flows from, or continuing involvement with, the disposed-of operations.[1] In addition, the staff has asked registrants to discuss whether assets meet the held-for-sale criteria in ASC 360 and to explain how they considered the related required disclosures. The staff may inquire about items such as:

- The timeline of events leading to an asset sale.
- The factors used to determine whether to present assets held for sale separately on the balance sheet.
- Sales agreements and how they affected the determination of whether particular assets should be classified as held for sale.

The SEC staff may also question the appropriateness and timeliness of a registrant's impairment tests when assets or components (1) are disposed of, (2) are discontinued, or (3) appear misclassified on the basis of other information in the filing. For example, the staff may ask whether assets that the registrant was expected to sell or dispose of were tested for impairment in prior periods or subject to an impairment charge in the current period (i.e., classified as held for use and thus not recorded at net realizable value). See the Impairments of Goodwill and Other Long-Lived Assets and Management's Discussion and Analysis sections for further discussion of comments on long-lived-asset impairment testing and early-warning disclosures.

The SEC staff has also asked registrants about why they did not disclose the gain or loss on a sale after disposition.[2]

[1] Under ASC 205-20-45-1, when a component has been disposed of or is classified as held for sale, the results of the component's operations must be reported in discontinued operations if (1) 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" and (2) the "entity will not have any significant continuing involvement in the operations of the component after the disposal transaction."

[2] In accordance with ASC 205-20-45-3, gains or losses on disposal transactions "shall be disclosed either on the face of the income statement or in the notes to financial statements."

Restructuring Charges

Example of an SEC Comment

Please revise future filings to more fully disclose and discuss the specific nature of your restructuring activities and their impact and expected impact on future operations. In regard to your 2013 restructuring activities, please revise MD&A in future filings to address these activities and to disclose: the number and nature of the employees to be terminated; the actual number of employees terminated at the most recent balance sheet date; the nature of the other costs; the amount of any annual savings anticipated and when they are expected to be realized; and the amount of any savings actually achieved during the periods presented. Refer to SAB Topic [5.P]. Please show us your proposed revisions in your response.

The SEC staff has inquired about corporate reorganizations and restructurings and registrants' disclosures about such activities. Comments primarily stem from workforce reductions and facility closures. In accordance with ASC 420-10-50-1, registrants should disclose specific information in "notes to financial statements that include the period in which an exit or disposal activity is initiated and any subsequent period until the activity is completed." Such information would include a description of the exit or disposal activity, its expected completion date, where in the income statement the amounts are presented, and quantitative information about each major type of cost associated with the activity and about each reportable segment. In addition, under ASC 420-10-50-1(e), when "a liability for a cost associated with the activity is not recognized because fair value cannot be reasonably estimated," registrants should disclose "that fact and the reasons why." The SEC staff has also directed registrants to comply with the guidance in SAB Topic 5.P.4 on disclosures related to material restructuring activities.

Earnings per Share

Two-Class Method

> **Example of an SEC Comment**
>
> We note that you have both Class A and Class B Common Stock outstanding. Tell us what consideration you have given to the two-class method for computing basic and diluted earnings per share for each class of your common stock. We refer you to ASC 260-10-45-60B(d). To the extent that earnings per share would not differ under the two-class method, please revise your disclosures in future filings to indicate as such.

Under ASC 260-10-45-59A, the two-class method applies to the following securities:

> a. Securities that may participate in dividends with common stocks according to a predetermined formula (for example, two for one) with, at times, an upper limit on the extent of participation (for example, up to, but not beyond, a specified amount per share)
>
> b. A class of common stock with different dividend rates from those of another class of common stock but without prior or senior rights.

When a filing indicates that the registrant has two classes of common stock (or has other participating securities) that are treated as one class in the calculation of EPS, the SEC staff often asks whether the registrant considered the two-class method in computing EPS under ASC 260-10-45-59A through 45-70.

The SEC staff may ask a registrant to substantiate the method used to calculate EPS (e.g., the two-class method or the if-converted method). Further, the staff may request additional information or disclosures about each of the registrant's classes of common stock, preferred stock, and common-stock equivalents (such as convertible securities, warrants, or options).

Regarding the treatment of convertible instruments, the SEC staff expects that a registrant with two classes of common stock will present both basic and diluted EPS for each class regardless of conversion rights. See the Debt and Financial Instruments sections for more information about conversion features.

The SEC staff has focused on understanding the terms of registrants' arrangements regarding (1) classes and types of common (or preferred) stock, (2) such stock's dividend rates, and (3) the rights and privileges associated with each class (or type) of stock. When the registrant has preferred shares, the SEC staff may seek to determine whether the preferred stockholders have contractual rights to share in profits and losses of the registrant beyond the stated dividend rate. Similarly, the SEC staff may ask registrants about the dividend rights of restricted stock unit awards or other share-based payment awards and how they are considered with regard to the EPS calculation.

EPS Disclosures

> **Example of an SEC Comment**
>
> Please revise [your footnote] to disclose the number of stock options, restricted shares and other securities that could potentially dilute your basic earnings per share in the future that were not included in the computation of diluted earnings per share for the periods presented because to do so would have been antidilutive for the periods presented. If there were no such securities outstanding during the periods presented, please state this in [your footnote]. Refer to the guidance outlined in ASC [260-10-50].

The SEC staff may also comment on whether a registrant has met the requirements of ASC 260-10-50-1, under which an entity must disclose all of the following for each period in which an income statement is presented:

> a. A reconciliation of the numerators and the denominators of the basic and diluted per-share computations for income from continuing operations. . . .
>
> b. The effect that has been given to preferred dividends in arriving at income available to common stockholders in computing basic EPS.
>
> c. Securities . . . that could potentially dilute basic EPS in the future that were not included in the computation of diluted EPS because to do so would have been antidilutive for the period(s) presented.

In addition, the SEC staff may ask registrants to elaborate on their calculation of EPS by disclosing:

- How unvested shares, unvested share units, unvested restricted share units, and performance shares are treated in basic and diluted EPS.
- Whether unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (paid or unpaid) are treated as participating securities and factored into the calculation of EPS.
- The nature of incentive distribution rights.

Fair Value

The SEC staff continues to ask registrants about the sufficiency of disclosures for fair value measurements that rely on unobservable inputs and on the use of third-party pricing services.

Disclosures Related to Unobservable Inputs

Quantitative and Qualitative Information

> **Example of an SEC Comment**
>
> You disclose the range of significant unobservable inputs used in developing the fair value of your Level 3 positions. Given the wide range of the forward market price assumptions, please tell us your consideration of disclosing the weighted average of the forward market prices, similar to the illustration provided in ASC 820-10-55-103, and your basis for calculating the weighted average. Please also tell us what consideration was given to providing a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs. Please refer to ASC 820-10-50-2(bbb) and (g).

Although ASC 820 requires entities to disclose the significant unobservable inputs used in Level 3 fair value measurements, it contains no explicit guidance on the types of quantitative information an entity should disclose to meet such a requirement. However, the example in ASC 820-10-55-103 illustrates quantitative information an entity "might disclose" to meet the requirement under ASC 820-10-50-2(bbb). According to the example, such information includes the entity's valuation technique, its significant unobservable inputs, and the range and weighted average of those inputs.

Some may have interpreted from the example in ASC 820-10-55-103 that an entity is not required to disclose the weighted average of significant unobservable inputs used in a Level 3 fair value measurement. However, the SEC staff may inquire about weighted averages when registrants do not disclose them.[1] The SEC staff has suggested that a registrant could instead present qualitative information about the distribution of the range of values if a weighted average would not be meaningful. Ideally, such qualitative disclosures would address each significant input and describe the reason for the wide range, the drivers of dispersion (e.g., a particular position or instrument type), and data point concentrations within the range. For additional information about unobservable inputs used to determine fair value, see the Investment Management section.

Sensitivity of Level 3 Measurements

> **Example of an SEC Comment**
>
> [T]here is no information about the sensitivity of a fair value measurement of Level 3 assets to changes in unobservable inputs and any interrelationships between those unobservable inputs. See ASU 2011-04.

The SEC staff continues to comment when a registrant omits disclosures about the sensitivity of Level 3 measurements and may ask for disclosures about changes in significant unobservable inputs to be more granular and transparent. In addition, the staff has noted that it may be helpful for registrants to discuss the specific inputs that changed in the sensitivity analysis and the effect of changing those significant unobservable inputs.

[1] Such inquiries are consistent with SEC staff remarks at the 2012 AICPA Conference. For more information about the conference, see Deloitte's December 11, 2012, *Heads Up*.

Use of Third-Party Pricing Services

Example of an SEC Comment

We note you use third party pricing services and broker quotes to price your securities. Please tell us and revise MD&A disclosures in future filings to address the following areas:

- The number of quotes or prices you generally obtain per instrument, and if you obtain multiple prices, how you determine the ultimate value you use within your financial statements.
- Whether and if so, how and why, you adjusted prices or quotes you obtained from pricing services and brokers.
- The extent to which the brokers or pricing services are gathering observable market information as opposed to using unobservable inputs and/or proprietary models in making valuation judgments and determinations.
- Whether the broker quotes are binding or non-binding
- Describe any procedures you perform to validate the prices you obtain to ensure the fair value determination and its categorization within the fair value hierarchy is consistent with Topic 820 of the Accounting Standards Codification.

The SEC staff continues to ask registrants to describe the procedures they perform to validate fair value measurements obtained from third-party pricing services. The staff has also asked registrants to clarify when and how often they use adjusted rather than unadjusted quoted market prices and to disclose why prices obtained from pricing services and securities dealers were adjusted. If multiple quotes were obtained, the SEC staff may request information about how the registrant determined the ultimate value used in the financial statements.

Financial Instruments

Because of the complexity associated with determining whether certain financial instruments should be accounted for as derivatives, debt instruments, or equity, SEC staff comments related to financial instruments have focused on (1) accounting for embedded derivatives in hybrid instruments,[1] (2) classification of warrants, and (3) calculation of beneficial conversion features (BCFs).

Embedded Derivatives in Hybrid Financial Instruments

Examples of SEC Comments

- We note . . . that the company has performed analysis of [convertible preferred stock] and concluded that the embedded conversion feature does not need to be bifurcated and separately accounted for as a derivative as the conversion option is clearly and closely related to the economic characteristics of common equity and in turn, the host contract. . . . Please provide your analysis of the evaluation of the economic characteristics, risks and terms of the conversion option and the host contract to support your conclusion that the host contract is more akin to an equity host.
- Certain corporate bonds carry a make whole call provision and a par call provision. Please expand your disclosures to discuss the key terms of each of these provisions and any impact of these provisions on your accounting for the corporate bonds. Please also tell us what consideration you gave to the accounting impact of these provisions, including your consideration of ASC 815 in regards to the make whole call provision.

The SEC staff continues to focus on whether registrants have reached appropriate accounting conclusions regarding whether embedded features in hybrid instruments should be bifurcated from the host contract. ASC 815-15-25 provides guidance on whether an embedded feature (e.g., a purchased put option embedded in a company's preferred stock) should be separated from the host contract and accounted for as a stand-alone derivative instrument in accordance with ASC 815-10. If it is determined that an embedded feature is not clearly and closely related to the host contract, the embedded feature may need to be bifurcated from the host contract depending on whether certain other criteria are met and whether the embedded feature qualifies for any scope exceptions. For example, if the features in a hybrid instrument are predominantly debt-like, the entity would conclude that the host contract is more akin to debt; in such a case, an equity-like feature (e.g., a conversion option) would not be considered clearly and closely related to a debt host. Given the complexity involved in determining whether a host contract is debt-like or equity-like, registrants can expect the SEC staff to continue asking about the terms and features of convertible instruments to determine whether the registrant has (1) properly determined the nature of the host contract and (2) accounted for embedded features as stand-alone financial instruments when necessary.

Classification of Warrants

Example of an SEC Comment

Tell us why equity classification for the warrants [is] appropriate and reference the authoritative literature you rely upon to support your accounting.

If certain criteria are met, warrants issued in connection with debt and equity offerings are accounted for on a separate basis (i.e., as a freestanding financial instrument[2]). Under U.S. GAAP, an issuer of a stock purchase warrant is required to first determine whether the warrant should be classified as a liability under ASC 480. If the warrant is not classified as a liability under ASC 480, its classification as either debt or equity hinges on whether the instrument meets the definition of a derivative and qualifies for any scope exceptions under ASC 815-10-15. When a warrant is accounted for as a freestanding financial instrument,

[1] The ASC Master Glossary defines a hybrid instrument as a "contract that embodies both an embedded derivative and a host contract."

[2] The ASC Master Glossary defines a freestanding financial instrument as a financial instrument that either (1) "is entered into separately and apart from any of the entity's other financial instruments or equity transactions" or (2) "is entered into in conjunction with some other transaction and is legally detachable and separately exercisable."

the manner in which offering proceeds are allocated to the issued instrument and to the warrant depends on whether the warrant is classified as an equity instrument or as a liability instrument. Consequently, the SEC staff has asked registrants to explain the basis for their determination of how warrants should be classified, including the application of relevant accounting literature.

Calculation of BCFs

Examples of SEC Comments

- Please submit the analyses you performed in determining whether these classes of preferred shares contain [BCFs].
- Please tell us how you calculated the [BCF] you recorded in connection with the issuance of [convertible shares]. Further, please provide to us your accounting analysis which supports recognizing the BCF as a non-cash distribution that is recognized ratably from the issuance date through the conversion date in equity.

The SEC staff frequently comments on the recognition and calculation of BCFs. ASC 470-20 requires the issuer of a convertible security to measure the amount of any embedded BCF at the intrinsic value of the embedded conversion option, which is computed on the basis of the effective conversion price (i.e., the issuer computes the intrinsic value of the embedded conversion option by multiplying (1) the amount by which the fair value of the common stock or other securities into which the security is convertible exceeds the effective conversion price by (2) the number of shares into which the security is convertible). Accordingly, registrants can expect the SEC staff to ask how they calculated the value of a BCF that was recorded in connection with the issuance of a hybrid financial instrument. In addition, the SEC staff frequently asks registrants to provide the accounting analysis that supports the BCF calculation.

Financial Statement Classification, Including Other Comprehensive Income

The SEC staff frequently comments on registrants' classification of items in the financial statements, namely on whether their balance sheets, income statements, statements of cash flows, and statements of comprehensive income comply with the requirements of Regulation S-X and U.S. GAAP.

Balance Sheet Classification

Separate Presentation

> **Example of an SEC Comment**
>
> We note that over 10% of total current liabilities are aggregated into other accrued expenses for each period presented. Please revise future filings to separately state any current liabilities that exceed 5% of total current liabilities, as applicable. Refer to Rule 5-02.20 of Regulation S-X.

Under Regulation S-X, Rule 5-02, registrants should state separately on the face of the balance sheet or in a note to the financial statements (1) other current assets and other current liabilities in excess of 5 percent of total current assets and total current liabilities, respectively, and (2) other noncurrent assets and other noncurrent liabilities in excess of 5 percent of total assets and total liabilities, respectively. The SEC staff may ask a registrant to confirm whether the reported balances of other current assets and liabilities or other noncurrent assets and liabilities include any items in excess of 5 percent of total current assets and liabilities or total assets and liabilities, respectively. If the registrant confirms that any such items are included, the SEC staff will ask the registrant to state those items individually on the face of the balance sheet or in the notes.

Current Versus Noncurrent Classification

> **Example of an SEC Comment**
>
> [T]ell us how you considered the guidance in ASC 210-10-45-4 as it appears that this receivable balance has been outstanding longer than one year.

Many of the SEC staff's comments have addressed registrants' classification of current and noncurrent assets and liabilities, including debt. When presenting a classified balance sheet, registrants should consider the guidance in ASC 210-10-45 and other applicable accounting literature to determine whether an item should be classified as current or noncurrent. The SEC staff may ask a registrant to explain an item's classification and presentation or to reclassify an asset or liability appropriately.

Income Statement Classification

The SEC staff has commented on registrants' compliance with the technical requirements of Regulation S-X, Rule 5-03, which lists the captions and details that commercial and industrial registrants must present in their income statements. For example, the SEC staff has asked registrants to explain why they have excluded certain line items required by Rule 5-03 from the face of their income statements.

Because the guidance on classification of income and expense items lacks specificity, classification is often established through practice and the SEC comment process. The SEC staff has reminded registrants that when alternative classifications are permissible, they should disclose their policies and apply them consistently in accordance with ASC 235-10.

Separate Presentation

> **Example of an SEC Comment**
>
> We note from the disclosures that have been provided in Note 1 that the Company's revenues include revenues from both the provision of services and the sale of products. To the extent that your revenues from the sale of products [exceed] ten percent of your total revenues during the periods presented in your financial statements, please revise your consolidated statements of operations to provide separate disclosure of the revenues and related costs associated with revenues derived from sales of products and services. Refer to the guidance outlined in [Rule 5-03(b)(1)] of Regulation S-X.

The SEC staff frequently comments when registrants omit certain captions required by Rule 5-03 from the face of their income statements. It has asked registrants to explain their consideration of Rule 5-03 and to revise their income statement presentation accordingly. For example, the SEC staff has commented on the distinction between product and service revenue. If product or service revenue is greater than 10 percent of total revenue, the registrant must disclose such component as a separate line item on the face of the income statement. Costs and expenses related to these revenues should be presented in the same manner.

Cost of Sales

> **Example of an SEC Comment**
>
> In future filings, please revise your footnote disclosures to clarify, if true, that you allocate a portion of your depreciation and amortization to cost of goods sold. If you do not allocate a portion to cost of goods sold, please tell us how you considered the guidance in SAB Topic 11.B, including depreciation and amortization not being positioned in your statement of operations in a manner which results in reporting a figure for income before depreciation like gross margin. Please provide us your proposed disclosures.

The SEC staff often asks registrants to disclose the types of expenses that are included in or excluded from the cost-of-sales line item, in particular whether distribution costs are included in cost of sales. It may ask registrants to disclose the line item in which such costs are recorded as well as whether their gross margins are comparable to those of other registrants. The SEC staff has also commented on registrants' allocation of depreciation and amortization to cost of sales. SAB Topic 11.B states, in part:

> If cost of sales or operating expenses exclude charges for depreciation, depletion and amortization of property, plant and equipment, the description of the line item should read somewhat as follows: "Cost of goods sold (exclusive of items shown separately below)" or "Cost of goods sold (exclusive of depreciation shown separately below)." . . . [D]epreciation, depletion and amortization should not be positioned in the income statement in a manner which results in reporting a figure for income before depreciation.

Most of the SEC staff's comments on this matter have stemmed from registrants' lack of awareness or incorrect application of the guidance in SAB Topic 11.B, particularly their inappropriate reporting of an amount for gross profit before depreciation and amortization.

Operating Versus Nonoperating Income

> **Example of an SEC Comment**
>
> We note you recorded $[X] as a gain on the sale of certain [assets] that were included in the previous . . . business segment, and have reflected the gain as non-operating income. Please explain why the gain is not included in operating income.

The SEC staff has commented about items that registrants have included in, or excluded from, operating income. Under Rule 5-03, a subtotal line item for operating income is not required on the face of the income statement. However, if a registrant presents a subtotal for operating income, it should generally present the following items (which are sometimes incorrectly excluded) in operating income:

- Gains or losses on asset sales.
- Litigation settlements.
- Insurance proceeds.
- Restructuring charges.

The following items should generally be excluded from operating income (but are sometimes incorrectly included):

- Dividends.
- Interest on securities.
- Profits on securities (net gains or losses).
- Interest and amortization of debt discount and expense.
- Earnings from equity method investments (or unconsolidated affiliates).
- Noncontrolling interest in income of consolidated subsidiaries.

Cash Flow Statement Classification

Category Classification

> **Example of an SEC Comment**
>
> You classify dividends received by the parent company as cash inflows from investing activities. Please tell us why you classified these cash inflows to the parent company as investing cash flows as opposed to operating cash flows. Please refer to ASC 230-10-45-16 (b) for specific guidance on how to classify dividends received on a statement of cash flows.

Many of the SEC staff's comments are related to misclassification among the three cash flow categories: operating, investing, and financing. ASC 230 distinguishes between returns **of** investment, which should be classified as inflows from investing activities (see ASC 230-10-45-12(b)), and returns **on** investment, which should be classified as inflows from operating activities (see ASC 230-10-45-16(b)). In the absence of specific facts and circumstances to the contrary, dividends should be presumed to be returns **on** investment and classified as cash inflows from operating activities. Under ASC 230-10-45-16(b), cash inflows from operating activities include "[c]ash receipts from returns on loans, other debt instruments of other entities, and equity securities — interest and dividends."

At the September 2014 AICPA Banking Conference, the SEC staff noted that it has observed an increased number of classification errors in registrants' statements of cash flows. Further, such errors are generally not attributable to complex fact patterns. The SEC staff speculated that the errors may be occurring because registrants (1) are relying on manually used spreadsheets instead of automated processes to prepare their statements of cash flows and (2) are preparing their statements of cash flows late in the financial reporting process. Accordingly, the staff cautioned registrants to revisit their processes and internal controls associated with the preparation of their statements of cash flows. For information about SEC staff comments on how registrants' errors could affect their conclusions about DCP and ICFR, see the Disclosure Controls and Procedures and Internal Control Over Financial Reporting sections.

Net Versus Gross Presentation

> **Example of an SEC Comment**
>
> Please note that intercompany investing activities and intercompany long-term financing activities are required to be presented gross, not net. . . . See ASC 230-10-45.

The SEC staff may challenge whether it is appropriate to report the net amount of certain cash receipts and cash payments on the face of the statement of cash flows. ASC 230-10-45-7 through 45-9 state that although reporting gross cash receipts and cash payments provides more relevant information, in certain instances financial statement users may not need gross reporting to understand certain activities. The SEC staff may ask a registrant to revise the presentation or to explain (in accordance with ASC 230) why it is more appropriate to report certain cash flows on a net basis rather than on a gross basis.

Comprehensive Income

Entities are required to report components of comprehensive income in either (1) a continuous statement of comprehensive income or (2) two separate but consecutive statements.

Presentation of Tax Effects

> **Example of an SEC Comment**
>
> Please tell us your consideration of disclosing in the notes to the financial statements the gross changes, along with the related tax expense or benefit, of each classification of other comprehensive income. Refer to ASC 220-10-45-12 and 220-10-45-17.

The SEC staff has also commented on ASC 220-10-45-12, which requires entities to "present the amount of income tax expense or benefit allocated to each component of other comprehensive income, including reclassification adjustments." Entities must present such information each reporting period either on the face of the statement where the OCI is presented or in the footnotes.

Foreign Currency

Quantification of Foreign Currency Adjustments

> **Example of an SEC Comment**
>
> You indicate . . . that increases in the value of the U.S. dollar relative to other currencies may adversely affect your business, results of operations and financial condition. Please address the need to expand your segment discussions to address the impact that changes in the value of the U.S. dollar relative to other currencies had on segment sales and adjusted operating profit for each period presented.

The SEC staff's comments on quantitative disclosures related to foreign currency adjustments reflect its guidance[1] on the topic, under which registrants should:

- "[R]eview management's discussion and analysis and the notes to financial statements to ensure that disclosures are sufficient to inform investors of the nature and extent of the currency risks to which the registrant is exposed and to explain the effects of changes in exchange rates on its financial statements."
- Describe in their MD&A "any material effects of changes in currency exchange rates on reported revenues, costs, and business practices and plans."
- Identify "the currencies of the environments in which material business operations are conducted [when] exposures are material."
- "[Q]uantify the extent to which material trends in amounts are attributable to changes in the value of the reporting currency relative to the functional currency of the underlying operations [and analyze] any materially different trends in operations or liquidity that would be apparent if reported in the functional currency."

The foreign operations of many registrants may be subject to material risks and uncertainties that should be disclosed, including those related to the foreign jurisdiction's political environment, its business climate, currency, and taxation. The effects on a registrant's consolidated operations of an adverse event related to these risks may be disproportionate relative to the size of the registrant's foreign operations. Therefore, the registrant's segment information or MD&A may need to describe the trends, risks, and uncertainties related to its operations in individual countries or geographic areas and possibly supplement such disclosures with disaggregated financial information about those operations.

A registrant's assessment of whether it needs to provide disaggregated financial information about its foreign operations in its MD&A would need to take into account more than just the percentage of consolidated revenues, net income, or assets contributed by foreign operations. The registrant also should consider how the foreign operations might affect the consolidated entity's liquidity. For example, a foreign operation that holds significant liquid assets may have an exposure to exchange-rate fluctuations or restrictions that could affect the registrant's overall liquidity.

Disclosures About Venezuelan Operations

The SEC staff continues to focus on accounting and disclosure considerations related to the foreign currency exchange environment in Venezuela. Entities currently may be able to convert Venezuelan bolivar fuertes (BsF) to U.S. dollars at one of three legal exchange rates obtained via four exchange-rate mechanisms. Business operations in Venezuela may give rise to accounting questions about (1) which exchange rate is appropriate for remeasurement, (2) whether certain BsF-denominated monetary assets should be classified as noncurrent in a classified balance sheet, and (3) whether such operations should be deconsolidated or considered impaired. At the June 27, 2014, FASAC meeting, the SEC staff acknowledged that there is little guidance on which exchange rate an entity should use in a multiple-rate environment. The SEC staff advised registrants to disclose the exchange rates used and their thought processes in selecting the rate.

[1] Division of Corporation Finance: Frequently Requested Accounting and Financial Reporting Interpretations and Guidance, Section II.J.

Accordingly, registrants should consider providing disclosure in the notes to the financial statements as well as in the Description of Business, Risk Factors, and MD&A sections of their SEC filings. The SEC staff has informally indicated that additional disclosures related to a registrant's Venezuelan operations may be warranted if such operations are material. It has also provided certain disclosure recommendations, which can be found in Deloitte's Financial Reporting Alert 14-1.[2]

[2] Financial Reporting Alert 14-1, "Foreign Currency Exchange Accounting Implications of Recent Government Actions in Venezuela."

Impairments of Goodwill and Other Long-Lived Assets

Goodwill

Disclosures

Example of an SEC Comment

We note that during the second quarter of fiscal 2014, you forecasted a significant decline in revenue and operating revenue related to certain reporting units within your [X] reporting segment, which resulted in an interim evaluation of your goodwill for potential impairment. Tell us the percentage by which the fair value exceeded the carrying value for your [X] reporting segment at the time of your evaluation. Also, to the extent that you have determined the estimated fair value substantially exceeds the carrying value for your reporting units, please disclose this determination in future filings. Alternatively, if the estimated fair value for any of your reporting units is not substantially in excess of the carrying value and is potentially at risk of failing step one of your goodwill impairment analysis, please tell us and disclose the following in future filings:

- [T]he percentage by which the fair value of the reporting unit exceeded the carrying value as of the date of the most recent test;
- [D]iscuss the degree of uncertainty associated with the key assumptions; and
- [D]escribe the potential events and/or changes in circumstances that could reasonably be expected to negatively affect the key assumptions used in determining fair value.

Section 9510 of the FRM discusses the SEC staff's views on when goodwill impairment disclosures in the critical accounting estimates section of MD&A are appropriate and the extent of such disclosures. The SEC staff has commented on a registrant's compliance with the disclosure requirements in Regulation S-K, Rule 303(a)(3)(ii), to discuss a known uncertainty — specifically, to disclose the potential for a material impairment charge — in light of potential impairment triggers. The staff has noted that it may use these disclosures to assess whether a registrant's goodwill impairment analysis is reasonable or whether the registrant should have performed an interim goodwill impairment analysis.

While registrants often provide the appropriate disclosures before incurring an impairment charge, the SEC staff has noted instances in which registrants did not disclose the specific events and circumstances that led to the charge in the period of impairment. After performing an interim impairment test, a registrant should consider disclosing (1) that it performed the test, (2) the event that triggered the test, and (3) the test result, even if it passed the test. Further, registrants should avoid attributing the impairment charge to general factors such as "soft market conditions" or expected reductions in sales price or sales volume. Instead, the disclosures should discuss (1) why the changes occurred, (2) why the change in forecasts or results occurred in the particular period of the impairment charge, and (3) what known developments or other doubts could affect the reporting unit's fair value estimate.

Reporting Units

Example of an SEC Comment

We have reviewed your analysis of whether the components have similar economic characteristics to aggregate each of your reporting units. Please provide the following for [each of your] reporting units:

- [T]he level of variation between the products and services offered by each of the component businesses within each [of the] reporting units[;]
- [A]dditional information as to the manner in which you operate each component business and the nature of the resources and services shared amongst the component businesses related to operational management, equipment and intellectual resources[;]
- [C]ontrast the shared activities discussed in response to the bullet above with the types of activities that are not shared among the components of each reporting unit;
- [E]xplain which of the qualitative factors you weighted most heavily in your analysis to conclude that the components should be aggregated; and
- [T]he financial information regularly reviewed by segment management to assess performance.

The SEC staff continues to comment on asset grouping for goodwill impairment testing (e.g., the identification and composition of reporting units), especially when a registrant does not clearly disclose that it tests goodwill at the reporting-unit level or when changes appear to have been made to a registrant's reportable segments (e.g., as the result of a reorganization or acquisition). Given the interaction between the guidance on reporting units in ASC 350-20 and the guidance on operating segments in ASC 280, the staff may also ask questions to better understand (1) how the reporting units were identified; (2) how many reporting units were identified; (3) how the reporting units align with the registrant's segment reporting; (4) whether and, if so, how the registrant aggregated reporting units to perform goodwill impairment testing; and (5) how the fair value of the reporting units was determined.

Interim Impairment Tests

Example of an SEC Comment

You disclose that during the fourth quarter ended January 31, 2013, you concluded there were indicators of potential goodwill impairment. As a result, you updated your goodwill impairment as of January 31, 2013 and recorded a goodwill impairment charge of $[X]. Please tell us how circumstances changed in the fourth quarter from the second quarter when you performed you annual impairment testing and the third quarter, and the factors that existed in the fourth quarter to trigger the impairment charge in the fourth quarter that did not exist or were not reasonably foreseen in the second and third quarters. Also, tell us your assessment of the circumstances that existed in the third quarter and your conclusion at that time with respect to the prospect that impairment charges may be forthcoming. Additionally, tell us the three reporting units for which the carrying values including goodwill exceeded their fair values and how much the carrying value exceeded the fair value for each.

ASC 350-20 requires entities to test goodwill for impairment annually and also between annual tests if facts and circumstances indicate that goodwill may be impaired. The SEC staff has asked registrants about negative trends that could trigger the requirement to test for impairment between annual tests and often asks them to describe the events leading up to the recording of an impairment charge, including how circumstances changed from prior quarters and from when the registrant had performed its previous annual goodwill impairment test. The SEC staff may also request an explanation of how the impairment had not been reasonably foreseen during management's prior-period assessments. Specifically, the staff may question why management did not identify an impairment during a previous quarter.

Other Long-Lived Assets

In its comments on impairments of long-lived assets, the SEC staff may ask a registrant that is recording, or is at risk of recording, impairment charges to either disclose or inform the SEC staff about the following:

- The adequacy and frequency of the registrant's asset impairment tests, including the date of its most recent test.
- The factors or indicators (or both) used by management to evaluate whether the carrying value of other long-lived assets may not be recoverable.
- The methods and assumptions used in impairment tests, including how assumptions compare to recent operating performance, the amount of uncertainty associated with the assumptions, and the sensitivity of the estimate of fair value of the assets to changes in the assumptions.
- The timing of the impairment, especially if events that could result in an impairment had occurred in periods before the registrant recorded the impairment. In these circumstances, the SEC staff may ask registrants to justify why the impairment was not recorded in the previous period.
- The types of events that could result in impairments.
- In the critical accounting policies section of MD&A, the registrant's process for assessing impairments.
- The facts and circumstances that led to the impairments, along with a reminder that a registrant may be required to disclose in MD&A risks and uncertainties associated with the recoverability of assets in the periods before an impairment charge is recorded. For example, even if an impairment charge is not required, a reassessment of the useful life over which depreciation or amortization is being recognized may be appropriate.

Other Deloitte Resources

- March 20, 2014, *Heads Up*, "Highlights of the 'SEC Speaks in 2014' Conference."
- December 16, 2013, *Heads Up*, "Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments."

Income Taxes

The SEC staff's comments about income taxes continue to focus on (1) disclosure of potential tax and liquidity ramifications related to the repatriation of foreign earnings, (2) valuation allowances, (3) rate reconciliation disclosures, and (4) unrecognized tax benefits. More recently, the staff has asked registrants to support situations in which their valuation allowances were reduced or reversed.

The staff continues to ask registrants to provide early-warning disclosures to help users understand these items and how they potentially affect the financial statements. For additional information about early-warning disclosures, see the Management's Discussion and Analysis section.

Repatriation of Foreign Earnings and Liquidity Ramifications

Example of an SEC Comment

We note . . . you hold . . . undistributed earnings in non-U.S. subsidiaries that you plan to reinvest outside the U.S. indefinitely. [P]lease tell us the amount of cash and equivalents and liquid investments held by your foreign subsidiaries . . . and quantify the amount that would not be available for use in the U.S. without incurring U.S. taxes. . . . Further, as we note . . . that the majority of your net long-lived assets are in the U.S., please discuss for us the impact on your liquidity and capital positions if cash and cash equivalents as well as liquid investments held by your foreign subsidiaries were not available for use in the U.S. Similarly, discuss the impact of income tax liabilities you would incur if you were to repatriate the cash and cash equivalents as well as liquid investments held by your foreign subsidiaries to the U.S.

In accordance with ASC 740, when the earnings of a foreign subsidiary are indefinitely reinvested, registrants should disclose the nature and amount of the temporary difference for which no deferred tax liability (DTL) has been recognized as well as the changes in circumstances that could render the temporary difference taxable. In addition, registrants should disclose either (1) the amount of the unrecorded DTL related to that temporary difference or (2) a statement that determining that liability is not practicable.

Registrants may need to repatriate cash from foreign subsidiaries. ASC 740-30-25-19 states that "[i]f circumstances change and it becomes apparent that some or all of the undistributed earnings of a subsidiary will be remitted in the foreseeable future but income taxes have not been recognized by the parent entity, it shall accrue as an expense of the current period income taxes attributable to that remittance."

The SEC staff continues to (1) ask for additional information when registrants claim that it is not practicable to determine the amount of unrecognized DTL and (2) request that registrants expand disclosures in MD&A about their indefinitely reinvested foreign earnings. In addition, the staff has indicated that it evaluates such an assertion by taking into account registrants' potential liquidity needs and the availability of funds in U.S. and foreign jurisdictions.

Disclosures in an MD&A liquidity analysis should include the following:

- The amount of cash and short-term investments held by foreign subsidiaries that would not be available to fund domestic operations unless the funds were repatriated.
- A statement that the company would need to accrue and pay taxes if repatriated.
- If true, a statement that the company does not intend to repatriate those funds.

Valuation Allowances

Examples of SEC Comments

- Your disclosure indicates that it is generally difficult for positive evidence regarding projected future taxable income, exclusive of reversing taxable temporary differences, to outweigh objective negative evidence of recent financial reporting losses. Given your two years of recent losses, please tell us and revise future filings, including your next quarterly filing, to address the following:
    - [P]rovide a more robust discussion of the specific factors you considered in determining that no additional valuation allowance for deferred tax assets is necessary, including the reasons why you expect to return to profitability in FY 2014;
    - [D]isclose the amount of taxable income you are required to generate and the time period over which you are required to generate it to fully realize your deferred tax assets; and
    - [D]isclose the potential impact on your financial statements if you determine you will not return to profitability in FY 2014.
- We note your disclosure stating that after considering all available positive and negative evidence, you reversed $[X] of the remaining valuation allowance on your [Country A] and [Country B] deferred tax assets . . . , as you determined that it was more likely than not that these benefits would be realized.

  Given the impact of the reversal of the valuation allowance on your [net income], please provide draft disclosure to be included in future filings that expands discussion on the material positive and negative evidence you considered, along with how it was weighted, in determining that it is more likely than not that your deferred tax assets will be realized. Your response should provide a detailed analysis regarding how you determined [the] realization of the [Country B] deferred tax asset. Specifically address the positive and negative evidence considered for your [Country B] subsidiary . . . . Refer to the guidance in ASC 740-10-30-16 through 30-25.

ASC 740-10-30-5(e) requires entities to reduce deferred tax assets (DTAs) by "a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the [DTAs] will not be realized. The valuation allowance shall be sufficient to reduce the [DTA] to the amount that is more likely than not to be realized." ASC 740-10-30-16 through 30-23 provide additional guidance. In light of this guidance, the SEC staff has commented when registrants' filings indicate that no valuation allowance has been recorded, or when it seems that the valuation allowance recorded is insufficient. More recently, the staff has asked registrants about reversals of, or other changes in, their valuation allowances.

The staff has reminded registrants that in assessing the realizability of DTAs, they should consider cumulative losses in recent years to be significant negative evidence and that to avoid recognizing a valuation allowance, they would need to overcome such evidence with significant objective and verifiable positive evidence.

The SEC staff has indicated that factors for registrants to consider in making a determination about whether they should reverse a previously recognized valuation allowance would include:

- The magnitude and duration of past losses.
- The magnitude and duration of current profitability.
- Changes in the above two factors that drove losses in the past and those currently driving profitability.

Further, the staff has noted that registrants should bear in mind that the goal of the assessment is to determine whether sufficient positive evidence outweighs existing negative evidence. The staff has emphasized the importance of evidence that is objectively verifiable and has noted that such evidence carries more weight than evidence that is not. In addition, registrants should (1) assess the sustainability of profits in the current economic environment and (2) consider their track record of accurately forecasting future financial results. Doubts about the sustainability of profitability in a period of economic uncertainty may give rise to evidence that is less objectively verifiable. Likewise, a registrant's poor track record of accurately forecasting future results would also result in future profit projections that are less objectively verifiable. Thus, such evidence would carry less weight in a valuation allowance assessment.

The SEC staff has also pointed out that registrants' disclosures should include a discussion of the specific factors or reasons that led to a reversal of a valuation allowance to effectively answer the question "why now." Such disclosures would include a comprehensive analysis of all available positive and negative evidence and how the registrant weighed each piece of evidence in its assessment. In addition, the SEC staff has reminded registrants that the same disclosures would be expected when there is significant negative evidence and a registrant concludes that a valuation allowance is necessary.

For example, at the 2013 AICPA Conference, the SEC staff discouraged registrants from providing "boilerplate disclosures" and instead recommended that they discuss registrant-specific factors (e.g., limitations on their ability to use net operating losses and foreign tax credits). The SEC staff also stated that it has asked registrants to disclose the effect of each source of taxable income on their ability to realize a DTA, including the relative magnitude of each source of taxable income. In addition, the staff recommended that registrants consider disclosing the material negative evidence they evaluated since such disclosure could provide investors with information about uncertainties related to a registrant's ability to recover a DTA.

Rate Reconciliation

Example of an SEC Comment

We note your effective tax rate . . . compared to the prior year effective tax rate decreased [X]% due to changes in the geographical mix of income, among other reasons. If changes in the geographical mix of income were a significant driver of the decrease in your effective tax rate, please explain to us and disclose the facts and circumstances leading to the changes in the geographical mix of income and whether you expect these changes to continue. In this regard, an overview of how your effective tax rate may be impacted by a mix of earnings among your domestic and foreign operations would appear useful to an investor. We refer you to Item 303(a)(3)(i) of Regulation S-K and Section III.B of SEC Release No. 33-8350.

In accordance with ASC 740 and Regulation S-X, Rule 4-08(h)(2), registrants must disclose a reconciliation that uses percentages or dollar amounts of income tax expense or benefit attributable to continuing operations with the amount that would have resulted from applying domestic federal statutory tax rates (the regular rate, not the alternative minimum tax rate) to pretax income from continuing operations. Further, registrants should disclose the estimated amount and the nature of each significant reconciling item. ASC 740-10-50 does not define "significant." However, Rule 4-08(h) states that public entities should disclose (on an individual basis) all reconciling items that constitute 5 percent or more of the computed amount (i.e., income before tax multiplied by the applicable domestic federal statutory tax rate). Reconciling items may be aggregated in the disclosure if they are individually less than 5 percent of the computed amount.

At the 2013 AICPA Conference, the SEC staff noted the following issues related to registrants' tax rate reconciliation disclosures:

- Labels related to reconciling items were unclear, and disclosures about material reconciling items did not adequately describe the underlying nature of these items.
- For material reconciling items related to foreign tax jurisdictions, registrants did not disclose in MD&A (1) each material foreign jurisdiction and its tax rate and (2) how each jurisdiction affects the amount in the tax rate reconciliation.
- Registrants have inappropriately aggregated material reconciling items that are greater than 5 percent of the amount calculated by multiplying the pretax income by the statutory tax rate.
- Amounts reflected in the tax rate reconciliation were inconsistent with related amounts disclosed elsewhere in a registrant's filing.
- Corrections of errors were inappropriately reflected as changes in estimates.

Unrecognized Tax Benefits

Examples of SEC Comments

- You disclose . . . that the addition of unrecognized tax benefits . . . was primarily attributable to U.S. tax positions taken in the current year. Please explain in detail what these tax positions relate to by category and amount, including the facts and timing of the circumstances specific to these positions in the current year as compared to prior years. See FASB ASC 740-10-50.
- Reference is made to the discussion . . . regarding the [State A] audits of your tax returns and the related assessments. Please tell us your consideration of disclosing an estimate of the range of reasonably possible change in your unrecognized tax benefits or a statement that an estimate of the range cannot be made. Refer to ASC 740-10-50-15d.3. In addition, please tell us your consideration of expanding your critical accounting policy disclosure related to uncertain tax positions . . . to quantify the extent to which your estimate is sensitive to change.

Under ASC 740-10-25-6, entities cannot recognize a tax benefit related to a tax position unless it is "more likely than not" that tax authorities will sustain the tax position solely on technical merits. The tax benefit recognized is measured as the largest amount of the tax benefit that is more than 50 percent likely to be realized. The difference between a tax position taken or expected to be taken in a tax return and the benefit recognized and measured under ASC 740-10 is referred to as an "unrecognized tax benefit." Generally, if the unrecognized tax benefit would be settled by offsetting it with an available loss or tax credit carryforward, it should be netted against the related DTA for the carryforward. Otherwise, a liability is recognized for the amount of the unrecognized tax benefit. The SEC staff has commented when registrants omit disclosures required under ASC 740-10-50-15 and 50-15A about unrecognized tax benefits, which include a tabular reconciliation of such benefits.

In addition, the SEC staff may ask registrants about their conclusions regarding disclosures about reasonably possible changes in unrecognized tax benefits. Because the guidance on the acceptable level of aggregation of information for these disclosures is not prescriptive and permits judgment, the SEC staff evaluates a registrant's level of disclosure on a case-by-case basis.

Examples of what registrants should disclose under ASC 740-10-50-15(d) include the following:

- Information related to scheduled expiration of the tax position's statute of limitations. A registrant should disclose this information if (1) the statute of limitations is scheduled to expire within 12 months of the financial statement's date and (2) management believes it is reasonably possible that the statute's expiration will cause the total amounts of unrecognized tax benefits to significantly increase or decrease.
- Significant unrecognized tax benefits for tax positions that the registrant believes will be effectively settled within 12 months in accordance with ASC 740-10-25-9.

Other Deloitte Resources

December 16, 2013, *Heads Up*, "Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments."

Leases

Nonperformance Provisions

Example of an SEC Comment

Please address the following regarding the classification of your leases:

- Please tell us whether your leases contain default covenants related to nonperformance. If so, please confirm all the conditions set forth in ASC 840-10-25-14 exist. Otherwise, confirm that you included the maximum amount that the lessee could be required to pay under the default covenant in your minimum lease payments for purposes of applying ASC 840-10-25-1(d);
- Please tell us whether your leases contain material adverse change clauses. If so, please tell us how this is determined and what potential remedies are available to you as the lessor;
- Please tell us if your leases contain cross-default provisions. If so, please tell us what consideration you gave to the potential impact of these provisions on your lease classification; and
- Please tell us if your leases include subjective default provisions. If so, please tell us whether there is any cap on potential remedies that would impact your lease classification.

Refer to ASC 840-10-25-41 through 25-69.

In recent years, the SEC staff has heightened its focus on registrants' accounting for nonperformance covenants contained in lease agreements. Examples of such covenants include material adverse change clauses, cross-default provisions, subjective default clauses, and change-in-control provisions. Nonperformance covenants do not affect lease classification if they meet all the conditions in ASC 840-10-25-14. However, if any one of those conditions is not met (e.g., if default is subjectively determined), the maximum amount the lessee is required to pay under the nonperformance covenant must be included as a minimum lease payment regardless of the probability of the occurrence of a default. The SEC staff has asked registrants whether any of their lease contracts contain such provisions and, if so, to explain how they considered the provisions in determining whether the lease was a capital or operating lease.

While registrants have used different methods to establish the amount to include from default provisions in the measurement of the lease liability, the SEC staff has indicated that there are only two acceptable ways for registrants to consider potential payments that may result from default when measuring the lease liability: (1) by using the probability of default as part of the measurement of the lease liability (with an ongoing reassessment of probability each reporting period) or (2) by recognizing the maximum amount payable under the default provision regardless of the probability of default.

Sale and Leaseback Transactions Involving Fixed-Price Renewal Options

The accounting for sale and leaseback transactions that involve fixed-price renewal options can be problematic. In the past, the SEC staff has commented on how registrants considered fixed-price renewal options in evaluating whether a real estate transaction qualifies for sale and leaseback accounting. A fixed-price renewal option may cause real estate to be precluded from sale accounting (i.e., the real estate would remain on the seller's books and be treated as a financing arrangement). Renewal options that cover substantially all of the useful life of the real estate and enable the seller-lessee to participate in the appreciation of the underlying property (i.e., through favorable rent rates) are a prohibited form of continuing involvement.

Although comments have focused on fixed-price renewal options, the SEC staff may ask about any renewal terms that allow the seller-lessee to participate in increases in the value of the underlying real estate, including fixed base rents during the renewal period that a registrant calculates by adjusting the current base rents with an inflationary index. While these are not technically fixed-price renewals, they do have the potential to give the seller-lessee upside participation to the extent that market rates for rents exceed the rate of inflation.

Materiality

Example of an SEC Comment

Please tell us in greater detail the facts and circumstances regarding the corrections to prior year's income taxes and depreciation of properties. In your response, tell us how you complied with ASC 250-10-45-22 and SAB Topics 1M and 1N, and provide us with your materiality assessment. Please be detailed in your response.

Registrants perform materiality analyses to determine the impact of identified misstatements on their financial statements. SAB Topics 1.M (SAB 99) and 1.N (SAB 108) contain the SEC staff's guidance on assessing the materiality of misstatements identified as part of the audit process or during the preparation of financial statements.

SAB Topic 1.M indicates that a "matter is 'material' if there is a substantial likelihood that a reasonable person would consider it important." The definition of materiality is based on FASB Concepts Statement 2[1] and on legal precedent in interpretations of the federal securities laws. The SEC staff has noted that in Supreme Court cases, the Court has followed precedent regarding materiality; namely, that the materiality requirement is met when there is a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."

SAB Topic 1.M also indicates that registrants should consider (1) each misstatement individually and (2) the aggregate effect of all misstatements. SAB Topic 1.N provides guidance on how a registrant should consider the effects of prior-year misstatements when quantifying misstatements in current-year financial statements.

To understand registrants' materiality assessments and conclusions, the SEC staff frequently asks registrants about the nature of an error, the quantitative and qualitative factors that registrants considered, and an error's' impact on their conclusions about (1) the effectiveness of their ICFR and (2) other reporting requirements, such as the need to file a Form 8-K. Similarly, the staff challenges registrants' conclusions that errors are immaterial (e.g., whether the method of correcting the error is appropriate; whether restatement language is presented; and whether an Item 4.02 Form 8-K, indicating nonreliance on previously issued financial statements, was required).

Accordingly, registrants should first decide whether an individual error is material by considering the affected financial statement line item and the financial statements as a whole. Then, if the registrant concludes that an individual error has not caused the financial statements as a whole to be materially misstated, it should consider other errors, including offsetting errors, in determining whether the errors taken as a whole are materially misleading. In reaching this conclusion, the registrant should consider individual line items, subtotals, and totals in the financial statements. The SEC staff has cautioned registrants to avoid bright-line rules or litmus tests and "not to succumb" to rules of thumb or percentage thresholds when determining materiality, because no one factor can be viewed as determinative.[2]

SAB Topic 1.M specifies quantitative and qualitative factors a registrant should consider when assessing the materiality of known errors to its financial statements. The SEC staff has observed that registrants' materiality assessments are often presented in a "checklist" fashion in which only the factors in SAB Topic 1.M are considered. Instead, the staff believes that a registrant should describe how the factors were considered — that is, a registrant should provide a detailed, thoughtful analysis that takes into account the registrant's specific circumstances and is relevant to its investors and financial statement users.[3] In addition, the SEC staff has stressed that quantitative considerations in registrants' materiality assessments continue to be overemphasized while qualitative factors are often insufficiently evaluated.[4]

1 FASB Concepts Statement 2, which has been superseded by FASB Concepts Statement 8, defined materiality as the "magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."

2 The SEC commented on this topic at the 2011 AICPA Conference. See Deloitte's December 14, 2011, *Heads Up* for additional information.

3 In an October 2010 joint webcast with the CAQ, the SEC staff provided its views about registrants' materiality assessments.

4 The SEC staff discussed qualitative and quantitative factors at the 2012 AICPA Conference.

The SEC staff has also indicated that registrants should consider company-specific trends, performance metrics that may influence investment decisions, and the effects of unrelated circumstances on factors that are important to reasonable investors (such as the magnification of an error in the income statement simply because it occurs in a period in which net income is "abnormally small" relative to historical and expected trends).

In considering company-specific trends and performance metrics, a registrant should address in its materiality assessments what metrics it deemed important enough to include in press releases and earnings calls as well as what analysts cover in their reports. The SEC staff often considers analysts' reports and investor calls as it assesses the registrant's assertion of what is important to investors.

When considering whether net income is abnormally small, management should determine whether a decline in operating performance is an abnormal event or whether it represents a new normal. Management should also determine whether "unusual" or infrequent events or transactions, such as an asset sale or impairment that would affect trends, are reflected in the results. Documentation of such considerations should be included in management's analysis.

The SEC staff has also observed that certain registrants have argued that a quantitatively large error in the GAAP financial statements is immaterial when it has a quantitatively small impact on non-GAAP metrics. While the staff has indicated that it may be appropriate for a registrant to look at metrics other than those that are GAAP-based in determining whether the financial statements taken as a whole are materially misstated, the SEC staff will most likely focus on the GAAP metrics until a registrant can demonstrate why other metrics are more important to its investors. In addition, the SEC staff has acknowledged that while it is possible for quantitatively small errors to be material and for quantitatively large errors to be immaterial,[5] a quantitatively material GAAP error does not become immaterial simply because of the presentation of non-GAAP measures.[6] Further, there may be circumstances in which an error that is otherwise immaterial to the GAAP financial statements — when taken as a whole and depending on the focus that management, investors, and financial statement users have historically placed on non-GAAP information — is material in the context of non-GAAP information.[7]

In addition to inquiring about a registrant's materiality analysis under SAB Topics 1.M and 1.N, the SEC staff often asks questions about the errors themselves. Registrants should consider the impact that misstatements (including immaterial restatements) may have on their previous conclusions about ICFR and DCP. As a result of such misstatement, the SEC staff may question whether a material weakness existed at the time of the initial assessment. For additional considerations, see the Disclosure Controls and Procedures and Internal Control Over Financial Reporting sections.

After reaching a materiality conclusion, registrants should also consider whether they are required to file Form 8-K. Under Item 4.02(a) of Form 8-K, a registrant must file Form 8-K when it has concluded that previously issued financial statements, covering either an annual or interim period, should no longer be relied upon because of an error.

Other Deloitte Resources

December 11, 2012, *Heads Up*, "Highlights of the 2012 AICPA National Conference on Current SEC and PCAOB Developments."

5 At the 2007 and 2008 AICPA conferences, the SEC staff addressed these topics. For more information, see Deloitte's December 20, 2007, and December 18, 2008, *Heads Up* newsletters.

6 At the 2010 AICPA Conference, the staff expressed its views on this topic. See Deloitte's December 16, 2010, *Heads Up* on the conference.

7 In its October 2010 joint webcast with the CAQ, the SEC staff also discussed non-GAAP financial measures in the context of materiality.

Noncontrolling Interests

Examples of SEC Comments

- Please . . . explain the process by which you determine the allocation of net income (loss) to each of the predecessor, previous owners, and noncontrolling interest, and why the remainder of that allocation represents net income attributable to partners.
- We note that as part of your statement of changes in stockholders' equity, you have a column titled "Noncontrolling Interest." In light of the fact that you have both redeemable and non-redeemable noncontrolling interest, please revise this column to clearly identify this amount as non-redeemable noncontrolling interest. Also, please revise to present a column for redeemable noncontrolling interest which includes a roll-forward of this temporary equity amount but does not combine the total with permanent equity. See guidance in ASC 810-10-50-1A(c).

SEC staff comments related to noncontrolling interests (NCIs) continue to focus on the allocation of net income (loss) to the NCI and the parent. Consequently, the staff frequently asks registrants to provide it with detailed information about how the registrant determined the allocation, particularly when the allocation is disproportionate to the NCI holder's initial investment.

The SEC staff also continues to comment on registrants' accounting for redeemable NCIs since SEC rules still prohibit registrants from including redeemable equity in any caption titled "total equity." ASC 480-10-S99-3A(2) requires equity instruments to be classified outside of permanent equity if they are redeemable:

(1) at a fixed or determinable price on a fixed or determinable date,

(2) at the option of the holder, or

(3) upon the occurrence of an event that is not solely within the control of the issuer.

Thus, the SEC staff has indicated that "registrants with redeemable noncontrolling interests, redeemable preferred stock or other redeemable equity classified outside permanent equity should not include these items in any total or subtotal caption titled 'total equity.' " Further, changing "the caption in the statement of changes in shareholders' equity [from] 'total equity' to 'total' does not make the inclusion of redeemable equity acceptable."

For additional information about classification of redeemable securities, see the Debt and Financial Instruments sections.

Other-Than-Temporary Impairment of Investments in Securities

Registrants are required to evaluate investments in debt and equity securities for impairment in each reporting period. An investment in debt or equity securities is impaired when its fair value is less than its carrying value, but an impairment loss is not recognized in net income (or loss) unless the impairment is determined to be other-than-temporary.

A registrant must use significant judgment in determining whether an investment is other-than-temporarily impaired because no "bright lines" or "safe harbors" for this determination are established by either the SEC or U.S. GAAP. A registrant should therefore be prepared to support its conclusion that unrealized losses are temporary.

The improved performance of the equity markets over much of the past year has resulted in fewer SEC staff comments on OTTI of securities. However, market factors, such as increases in interest rates (which would cause debt securities to decrease in value), may lead the SEC staff to ask registrants how they determined whether their investments were other-than-temporarily impaired.

Investments in Debt and Equity Securities — Recoverability

Example of an SEC Comment

Considering the significant judgment required to determine if a security is other than temporarily impaired and the focus users of financial statements have placed on this area, we believe comprehensive and detailed disclosure is required . . . . [W]e note [from] your disclosure that: (1) the market for collateralized mortgage obligations was not active, (2) all of the securities are in mezzanine tranches and are currently rated less than investment grade . . . , and (3) you have determined that not all contractual cash flows will be received on collateralized debt obligations back[ed] by trust preferred securities. Yet we note that you have determined there was no other-than-temporary impairment in the periods presented. Please provide us your other-than-temporary-impairment analysis which clearly identifies the key factors you considered in your conclusion. Refer to ASC 320-10-35-33.

For debt securities, ASC 320-10-35 provides guidance on determining whether a credit loss has occurred. For example, ASC 320-10-35-33C specifies that a credit loss exists if the present value of cash flows that an entity expects to collect from the security is less than the security's amortized cost basis. Further, ASC 320-10-35-33F requires entities to consider a number of factors in estimating whether a credit loss exists, including (1) the "length of time and the extent to which the fair value has been less than the amortized cost basis" and (2) "[a]ny changes to the rating of the security by a rating agency." ASC 320-10-35 also includes guidance on assessing whether equity securities are impaired (see below for additional information). Consequently, the SEC staff frequently focuses on the duration and severity of losses when asking registrants about their conclusions related to whether securities with significant unrealized losses are other-than-temporarily impaired. As a result, the SEC staff has asked registrants to explain their basis for concluding that they have the intent and ability to hold debt and equity securities until recovery.

In addition, when credit losses on debt securities have not been recognized, the SEC staff may ask:

- Why unrealized losses of a longer duration are not indicative of credit losses.
- Whether the registrant continues to receive interest payments in a timely manner.
- How the registrant considered significant inputs, such as:
  - The performance indicators of the security's underlying collateral (if any), including default rates, delinquency rates, and percentage of nonperforming assets.
  - Loan-to-collateral-value ratios.
  - Current levels of subordination.

    - Geographic concentration.
    - Credit ratings.
- Whether the registrant's cash flow projections include expectations about a lack of receipt of future interest payments, principal payments, or both and, if so, the basis for this assumption.
- Whether a class of securities is considered investment-grade, including the amounts attributable to the securities that are considered below investment-grade.
- Whether there have been any changes to the rating of the security by a rating agency and, if so, when the changes occurred.
- Whether securities with unrealized losses are other-than-temporarily impaired when their credit spreads are significantly greater than credit spreads in the broader market.
- To what extent credit enhancement supports the registrant's judgment about unrealized losses.

For equity securities, registrants should consider the guidance in ASC 320-10-35 and SAB Topic 5.M to determine whether an impairment is other-than-temporary. Under SAB Topic 5.M, a registrant should consider the following factors, either individually or in combination with other factors, when evaluating an equity security for OTTI:

- Length of time and extent of impairment.
- Financial condition and near-term prospects of the issuer.
- Ability and intent to hold the security until recovery.

Registrants should avoid overreliance on bright lines. For example, depending on the facts and circumstances, a 75 percent decline in an equity security's fair value may be considered severe enough for an entity to recognize an OTTI even when the decline in fair value has been present for only three months.

OTTI Disclosures for Debt Securities

Because entities must use significant judgment to determine whether investments in securities are other-than-temporarily impaired, the SEC staff may ask registrants to provide qualitative and quantitative disclosures about the inputs and assumptions they used in discounted cash flow models to measure impairment losses and about the procedures they performed to determine whether a credit impairment exists. When bonds subsequently become other-than-temporarily impaired, the staff may ask the registrant to explain the facts and circumstances that led to the impairment and to disclose information about the potential for future impairment charges.

Timing of Recognition

The SEC staff may ask registrants to provide additional information about the facts and circumstances leading up to recognition of an OTTI, including their analysis supporting the recognition of the impairment in a given period rather than in an earlier period. In particular, the staff may ask what factors have changed since the last reporting period that triggered the recognition in the current period.

Pensions and Other Postretirement Benefits

The SEC staff continues to emphasize the disclosures related to how registrants account for pension and other postretirement benefit plans and how key assumptions and investment strategies affect their financial statements. Further, registrants may be asked how they concluded that assumptions used for their pension and other postretirement benefit accounting are reasonable relative to (1) current market trends and (2) assumptions used by other registrants with similar characteristics.

Critical Accounting Estimates

Examples of SEC Comments

- We see the significance and variability of your pension expense, in part related to your policy to fully [recognize] actuarial gains and losses in the fourth quarter of each year. However, we note that the disclosure in MD&A appears to mostly address the basic accounting policy. Please help us better understand your disclosure by responding to the following:
    - Tell us where you provide basic accounting policy disclosure in [your footnote] or elsewhere in your audited financial statements.
    - While we note that you make a general statement that reasonably likely changes in assumptions may have a material impact on future earnings, please tell us how your critical accounting policy disclosure considers the guidance from Section V of Release 33-8350. The cited guidance, in part, provides that: "Since critical accounting estimates and assumptions are based on matters that are highly uncertain, a company should analyze their specific sensitivity to change, based on other outcomes that are reasonably likely to occur and would have a material effect. Companies should provide quantitative as well as qualitative disclosure when quantitative information is reasonably available and will provide material information for investors."
- Please tell us how you determined the discount rates used in the measurement of plan obligations at the most recent balance sheet date and why you believe the discount rates are reasonable based on the expected dates and amounts of cash outflows associated with retiree pension benefits.

Because of factors such as the low-interest-rate environment, optionality in U.S. GAAP accounting methods, and significant assumptions used in benefit obligation valuation, the SEC staff has continued to ask registrants about assumptions related to their pension and other postretirement benefit plans. Often the staff asks a registrant how its disclosures in the critical accounting estimates section of MD&A align with its accounting policy disclosures in the notes to the financial statements. The staff also requests more quantitative and qualitative information about the nature of the registrant's assumptions. In particular, the staff has focused on the discount rate and the expected return on plan assets.

In addition, the SEC staff has indicated that it may be appropriate for a registrant to disclose the following:

- Whether a corridor[1] is used to amortize the actuarial gains and losses; and, if so, how the corridor is determined and the period for amortization of the actuarial gains and losses in excess of the corridor.
- A sensitivity analysis estimating the impact of a change in expected returns on income. This estimate should be based on a reasonable range of likely outcomes.
- Regarding the extent to which historical performance was used to develop the expected rate of return assumption, if use of the arithmetic mean to calculate the historical returns yields results that are materially different from the results yielded when the geometric mean is used to perform this calculation, it may be appropriate for the registrant to disclose both calculations.

[1] ASC 715-30-35-24 provides guidance on net periodic pension benefit cost and defines the corridor as "10 percent of the greater of the projected benefit obligation or the market-related value of plan assets." Similarly, ASC 715-60-35-29 provides guidance on net periodic postretirement benefit cost and defines the corridor as "10 percent of the greater of the accumulated postretirement benefit obligation or the market-related value of plan assets."

- The reasons why the expected return has changed or is expected to change in the future.
- The effect of plan asset contributions during the period on profit or loss, when this effect is significant. The SEC staff has indicated that additional plan asset contributions reduce net pension costs even if actual asset returns are negative because the amount included in profit or loss is determined through the use of expected and not actual returns. Consequently, such information can provide an understanding of unusual or nonrecurring items or other significant fluctuations so that investors can ascertain the likelihood that past performance is indicative of future performance.

Liquidity and Capital Resources

Example of an SEC Comment

We note that you significantly increased your pension contributions for fiscal year 2013 above the minimum funding requirement and that you anticipate doing the same for fiscal year 2014. In future filings, please explain the factors that contributed to this cash management decision along with the impact to your consolidated financial statements.

Registrants should sufficiently disclose how changes to their plan assets and obligations may affect their liquidity and capital resources. The SEC staff has encouraged registrants to explain the trends and uncertainties related to pension or other postretirement benefit obligations (e.g., a registrant's funding requirements may be affected by changes in the measurement of its plan obligations and assets). A registrant also may want to disclose in both qualitative and quantitative terms what its plan contributions have been in the past and the expected changes to those contributions.

Registrants may take steps to "de-risk" their pension plans by acquiring bonds for their plan asset portfolios whose expected maturities match the expected timing of the plan's obligations. The SEC staff has reminded registrants that they are required to disclose their plan investment strategy. MD&A should inform investors about any changes to that investment strategy, the reasons for those changes, and how a change in strategy affects the underlying plan assumptions and the registrant's ability to fund the plans. For example, a decision to invest more in fixed-income securities could be expected to lower the overall rate of return on plan assets.

When a pension plan is funded with a noncash transaction (e.g., an entity's own stock), it may be appropriate to disclose how management funded the pension plan, with a reference to the associated cash flow statement line items.

When commenting on other postretirement benefit plans, which are usually funded as the related benefit payments become due, the SEC staff has noted that the footnote disclosures should include the plan's expected future benefit payments for each of the next five years and in the aggregate for the five years thereafter. This information may indicate a registrant's expected liquidity requirements, which could then warrant discussion in the liquidity section of MD&A or in the contractual obligations table.

Fair Value of Plan Assets

The disclosures required by ASC 715 for fair value measurements for retirement plan assets are similar to the disclosures about fair value measurements required by ASC 820. These disclosures include employers' investment strategies, major categories of plan assets, concentrations of risk within plan assets, and valuation techniques used to measure the fair value of plan assets. The SEC staff may ask registrants about their compliance with such disclosure requirements. For more information, see the Fair Value section. A registrant also should disclose whether the fair value or calculated value[2] of plan assets is used to determine the expected return on plan assets and, if the calculated value is used, how this value is determined.

Immediate Recognition of Gains and Losses

The SEC staff has noted instances in which registrants have changed their method of accounting for the amortization of actuarial gains and losses in net periodic pension or other postretirement benefit cost. For example, some registrants have decided to move to an approach in which they immediately recognize all actuarial gains and losses or, alternatively, all actuarial gains and losses outside the "corridor," as a component of net periodic pension cost. In accordance with ASC 250, such registrants have retrospectively applied this change in accounting principles to their financial statements.

Once an entity adopts a policy of immediately recognizing gains and losses, changing to a less preferable method (i.e., a subsequent change to a method that results in slower amortization) would be difficult to support. When entities adopt a policy of immediately recognizing actuarial gains and losses as a component of net periodic pension cost, they often present non-GAAP financial measures that "remove the actual gain or loss from the performance measure and include an expected long-term rate of return."[3] The SEC staff will generally comment when (1) the disclosures are not clear and the pension-related adjustment (e.g., actuarial gains or losses) is not labeled; (2) an adjustment is labeled as a "noncash" pension expense, because the pension liability will ultimately be settled in cash; and (3) context about adjustments related to actuarial gains and losses is not provided.

Disclosures for Non-U.S. Plans

ASC 715-20-50-4 states that a "U.S. reporting entity may combine disclosures about pension plans or other postretirement benefit plans outside the United States with those for U.S. plans unless the benefit obligations of the plans outside the United States are significant relative to the total benefit obligation and those plans use significantly different assumptions." The SEC staff may ask registrants to explain the basis for combining pension and other postretirement benefit plan disclosures related to U.S. and non-U.S. plans. When there are significant differences in trends and assumptions between the U.S. and non-U.S. plans and the benefit obligation of the foreign plan is significant, the SEC staff has required registrants to provide disaggregated footnote disclosure for the U.S. and non-U.S. plans.

Other Deloitte Resources

- Financial Reporting Alert 13-3, "Financial Reporting Considerations Related to Pension and Other Postretirement Benefits."
- Financial Reporting Alert 11-2, "Pension Accounting Considerations Related to Changes in Amortization Policy for Gains and Losses and in Market-Related Value of Plan Assets."

[2] ASC 715-30-20 defines the market-related value of plan assets as follows: "A balance used to calculate the expected return on plan assets. The market-related value of plan assets is either fair value **or a calculated value** that recognizes changes in fair value in a systematic and rational manner over not more than five years. Different ways of calculating market-related value may be used for different classes of assets" (emphasis added).

[3] For more information, see the highlights of the June 2012 CAQ SEC Regulations Committee joint meeting with the SEC staff.

Revenue Recognition

Revenue Recognition Disclosures

Examples of SEC Comments

- We note your current revenue recognition disclosures. Confirm to us, if true, that you only recognize revenue if a sales transaction meets each of the criteria outlined at SAB Topic 13(A)(1). In that regard, in future filings please disclose whether there is persuasive evidence of an arrangement, the sales price is fixed or determinable, and management believes collectability is reasonably assured.
- We note that your business overview . . . separately discusses the nature of your regulated terminal operations, electricity transmission, regulated distribution, rail operations, port operations, toll road operations and energy transmission and distribution operations. Based on your consistent use of these categories to describe your business throughout your filing, it is unclear to us why disclosing revenues from each of those categories . . . would not be useful to investors. We note, for example, that your transport and energy platform consists of four separable lines of business in four different geographic regions: rail operations in Australia, port terminals in Europe, toll road operations in Chile, and natural gas transmission primarily in the U.S.

In addition to requesting general policy information, the SEC staff often asks registrants to clearly state whether a revenue recognition policy complies with SAB Topic 13, particularly the four criteria that generally must be met for revenue to be recognized. The staff may also ask how a criterion has been applied in the context of a particular transaction or group of transactions. For example, the SEC staff may inquire about whether collectibility is "reasonably assured" and whether the sales price the registrant is charging resellers for products is "fixed or determinable."

When reviewing the disclosures in a registrant's revenue policy footnote, the SEC staff often checks for completeness and consistency by comparing the disclosures with the revenue streams described in the business section, in MD&A, and on the registrant's Web site. At the 2013 AICPA Conference, the SEC staff indicated that registrants should consider expanding or clarifying their revenue recognition disclosures to include:

- The type, nature, and terms of significant revenue-generating transactions.
- The specific revenue recognition policy (including the manner in which revenue is recognized) for each type of revenue-generating transaction, including policies related to discounts, promotions, sales returns, post-shipment obligations, customer acceptance, warranties, credits, rebates, and price protection.
- The specific events or actions that trigger revenue recognition (i.e., avoid "boilerplate language").
- Relevant information about significant uncertainties related to revenue recognition (e.g., rights of return or variable consideration).
- A detailed breakdown of revenue by product/service line or business segment when the disclosure of revenue in the filing is less granular than the discussion of the registrant's results of operations in other publicly available information in or outside the filing.

The SEC staff may request more specific disclosures on the basis of the complexity or subjectivity of registrants' revenue recognition policies.

Sales Returns

> **Example of an SEC Comment**
>
> We note your statement that the sales return reserve represents the gross profit effect of sales returns. Please explain to us in more detail how you determine and record your sales return reserve. It is unclear to us if you are reducing sales for the gross profit of expected returns or if you are reducing sales and cost of sales to reflect estimated returns. Please refer to ASC 605-15-45-1.

The SEC staff continues to comment on registrants' failure to separately present or disclose information about their sales returns, particularly when other information in a registrant's filing or in other public communications suggests that sales returns may be material. In addition, the SEC staff will comment if it appears that a registrant has accounted for sales returns as a reduction in revenue on the basis of the gross profit of the related transactions instead of as a reduction in both sales and cost of sales as required by ASC 605-15.

Multiple-Element Arrangements

> **Examples of SEC Comments**
>
> - Tell us your consideration of disclosing whether the significant deliverables in your arrangements qualify as separate units of accounting, and the reasons that they do not qualify as separate units of accounting, if applicable. In addition, your disclosures should discuss the significant factors, inputs, assumptions and methods used to determine the selling price (whether vendor-specific objective evidence, third-party evidence, or estimated selling price) of the significant deliverables. We refer you to the guidance in ASC 605-25-50-2.
> - Explain how you concluded that the set-up services have no stand-alone value upon completion. Your policy states that revenue recognition begins upon delivery. Indicate whether the delivery is the result of the set-up services. It appears from your response that the set-up services require a significant amount of time and effort to complete. Indicate how the fee for these services compares to the entire contract value and whether this fee varies by contract or customer.

The SEC staff often asks registrants about the nature of, and accounting for, their multiple-element arrangements and whether they evaluated these arrangements under ASC 605-25. The staff typically asks for supplemental information, and sometimes requests additional disclosures, about multiple-element arrangements, including the following:

- A description of the registrant's rights and obligations under the arrangement.
- The registrant's method for determining whether certain deliverables in an arrangement qualify as separate units of accounting and the factors the registrant considered in making this assessment.
- The registrant's accounting policy for allocating and recognizing revenue for each deliverable.
- The registrant's support for its conclusion that a delivered item has stand-alone value.
- An analysis of how the transaction price was allocated to each deliverable, including how the selling price used for each unit of accounting was determined (i.e., VSOE, TPE, or estimated selling price).
- The period over which each unit of accounting is recognized.

The SEC staff has recently focused on registrants' accounting for set-up or installation services for products sold to customers, particularly when consideration for these services is paid at the inception of the arrangement or as the services are provided. The staff has asked registrants to explain whether such services have stand-alone value and how they determined the period over which the consideration for these services is recognized.

Principal-Agent Considerations

Example of an SEC Comment

Your revenue recognition policy continues to reiterate the overall revenue recognition requirements under U.S. GAAP. However, your disclosures should specifically address your policy for recognizing revenue in accordance with U.S. GAAP. For example, you should discuss how your current revenue recognition methodology complies with the Principal-Agent Considerations discussed in ASC Topic 605-45. In particular, tell us how you considered this literature in determining whether to report revenue gross as a principal or net as an agent.

The SEC staff often inquires into principal-agent considerations. ASC 605-45 discusses factors that an entity should consider in determining whether it acts as a principal (and records revenue at the gross amount billed to a customer) or as an agent (and records revenue at the net amount retained). The staff has asked registrants to explain how they determined gross or net reporting to be appropriate for certain revenue transactions under ASC 605-45. In addition, the SEC staff may request detailed information about the rights and obligations of the parties involved in a registrant's revenue transactions. The staff may ask registrants to provide expanded disclosures that describe the nature of these transactions and the factors they considered when determining whether revenue from such transactions should be recorded on a gross or a net basis. The focus of these disclosures is providing information that would enable an investor to understand whether title is transferred and who is the primary obligor. The SEC staff has stated that the analysis it applies to identify the primary obligor focuses on (1) identifying the product or service that is desired by the customer and (2) determining whether the registrant is responsible for providing that product or service.

Revenue Recognition for Long-Term Construction-Type and Production-Type Contracts

Examples of SEC Comments

- Please tell us . . . the percentage of revenue recognized using the percentage-of-completion method, using the completed-contract method, for [services], and for direct sales not provided in conjunction with the performance of construction contracts. . . . With respect to customer contracts, please revise future filings to disclose:
    - [T]he amount of contract losses recorded during each period presented and the current status of material loss contracts, as well as the current status of any contracts for which material losses are reasonably possible;
    - [T]he impact of material changes in contract estimates during each period presented; and
    - [T]he impact of contract penalties, claims, change orders and/or settlements during each period presented, if material.
- It appears $[X] of operating income in 2013 resulted from a change in estimates underlying your percentage-of-completion accounting on long-term contracts. [P]lease provide a discussion of the underlying reasons for the significant changes in estimates, including quantified information where available and useful for an investor's understanding of contract performance, the impact on operations, and the potential impact on future operations.

ASC 605-35 provides guidance on how and when to recognize revenue and costs for certain long-term construction-type and production-type contracts. The SEC staff frequently asks registrants to clarify their treatment of these contracts under ASC 605-35. For instance, the staff may ask a registrant to provide the following information:

- How the registrant developed its estimate of total contract costs and how those costs are directly related to contract performance.
- How the registrant treats precontract and early-stage contract costs, which should normally be expensed.
- A description of the nature, status, amounts, and types of change orders and claims that occurred during the periods presented and how the registrant accounted for them.
- Policy disclosures, including which contract accounting method was used (i.e., percentage-of-completion or completed-contract) and which method was used to measure progress toward completion (e.g., cost-to-cost, units of work).
- An analysis of a registrant's historical accuracy of making estimates and the likelihood of changes in those estimates in the future.
- The amount of contract losses recorded during each period presented.
- If there were changes in estimates during the period (e.g., the estimate of percentage complete or amount of profit recognized on claims), disclosures (under ASC 250-10-50-4) about the effect of the change in estimate in the financial statements.
- For transactions that recognize revenue under the completed-contract method, the specific criteria used to determine when a contract is substantially completed.

In addition, registrants that use the percentage-of-completion method should be aware that the SEC staff has asked some registrants that use that method to enhance their disclosures about the effect of changes in contract estimates. For example, the SEC staff may ask registrants to add disclosures in MD&A about gross aggregate favorable and gross aggregate unfavorable changes in contract estimates for each period presented.

Industry-Specific Considerations

See the Industry-Specific Topics section for industry-specific revenue considerations.

Other Deloitte Resources

- May 28, 2014, *Heads Up*, "Boards Issue Guidance on Revenue From Contracts With Customers."
- December 16, 2013, *Heads Up*, "Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments."

SAB Topic 11.M (SAB 74) — Disclosures About the Impact of Recently Issued Accounting Pronouncements

Example of an SEC Comment

We note from the disclosures provided in MD&A and in [a footnote] to the financial statements that you have not provided any disclosure as to how any recently issued accounting pronouncements may impact [your] financial statements in future periods. In future filings, please revise MD&A and the notes to the financial statements to discuss how any recently issued accounting standards or pronouncements may impact your financial statements. Refer to the guidance outlined in SAB Topic [11.M].

SAB Topic 11.M (SAB 74) indicates that a registrant should disclose the effects of recently issued ASUs and SABs that are not yet effective "unless the impact on [the registrant's] financial position and results of operations is not expected to be material" (footnote omitted). These disclosures are meant to help financial statement users assess the effect that new standards will have once adopted. SAB 74 disclosure is not required when a registrant will adopt a new accounting standard that will not affect the reported results (i.e., when only enhanced disclosures would be required by the new accounting standard).

According to SAB 74, a registrant should consider including the following disclosures in MD&A and the footnotes to the financial statements:

- A brief description of the new standard, the date that adoption is required and the date that the registrant plans to adopt, if earlier.
- A discussion of the methods of adoption allowed by the standard and the method expected to be utilized by the registrant, if determined.
- A discussion of the impact that adoption of the standard is expected to have on the financial statements of the registrant, unless not known or reasonably estimable. In that case, a statement to that effect may be made.
- Disclosure of the potential impact of other significant matters that the registrant believes might result from the adoption of the standard (such as technical violations of debt covenant agreements, planned or intended changes in business practices . . .).

The SEC staff does not expect the disclosures to include a "laundry list" of new standards that registrants state will have no material effect on their financial statements; only those ASUs that are expected to have a material impact should be described in the financial statements. However, the staff expects disclosures about the potential effects of a new standard to be increasingly clear and precise as the standard's effective date approaches.

Accordingly, the SEC staff has commented on the following items related to SAB 74 disclosures:

- Failure to provide the required disclosures.
- Inadequate discussion of the accounting changes and how they will be adopted (i.e., whether retrospectively or prospectively and what periods will be affected).
- Disclosures about prospective accounting standards that are exactly the same in both the notes to the financial statements and MD&A. For example, registrants may consider the effect of adoption on their operations, financial condition, or liquidity in future periods and provide related disclosures in their MD&A. Disclosures in the financial statements should focus on whether the historical financial information will change (e.g., as a result of the retrospective application of the standard).

Segment Reporting

Segment reporting remains a perennial topic of SEC staff comments. Like those issued in previous years, recent SEC staff comments have specifically addressed (1) the identification and aggregation of operating segments, (2) changes in reportable segments, (3) product and service revenue by segment, (4) the interaction of operating segments and goodwill impairment testing, and (5) disclosure of information about geographic areas.

Identification and Aggregation of Operating Segments

In asking registrants about the identification and aggregation of their operating segments, the SEC staff's comments have centered on (1) the identification of the chief operating decision maker (CODM), (2) how the company identifies operating segments and supports its process for identifying them, (3) the quantitative and qualitative factors used to support the aggregation of operating segments, and (4) how the registrant has considered whether previous decisions about the identification and aggregation of operating segments remain appropriate (i.e., how it has continued to assess such conclusions in light of changes in its management or operations).

Examples of SEC Comments

- We understand that you have identified your CEO as your CODM, although you acknowledge that he " . . . leads the Company with a supporting senior leadership team [(SLT)] that assists in providing input and driving the performance of the Company." You further clarify by stating that "the CEO utilizes inputs from the SLT to evaluate performance." Please describe the nature and form of this input. Additionally, explain the extent to which the input pertains to your [brands], and includes any combination of operating metrics, budgets or targets, related to sales, costs or market share.
- We note the discussion of your major markets . . . and the breakout of net sales by market application in Management's Discussion and Analysis . . . . Please tell us how you determined that you only have two [reportable] segments, [A] and [B], under FASB ASC 280-10-50. Your response should address the following:
  - Describe the contents of the information you provide to your chief operating decision maker.
  - Explain your disclosure that the segmentation reflects the go-to-market strategies for various products and markets.
- It appears to us that you aggregate four operating segments into your [X] reportable segment. Please demonstrate to us how you determined aggregation is appropriate and complies with ASC 280-10-50-11. We note we previously commented on this issue . . . . We also note since that time the number of your operating segments has increased . . . . Please ensure your assessment provides a specific and comprehensive discussion of the similar economic characteristics of each operating segment during each period presented.

Although ASC 280 has been effective for many years, segment reporting is still a frequent SEC comment letter topic. The staff often challenges registrants' conclusions about identification of operating segments, identification of the entity's CODM, and aggregation of operating segments into reportable segments. ASC 280 prescribes the "management approach" for the presentation of segments in a public entity's financial statements. The objective of the management approach is to allow users to (1) see through the eyes of management the entity's performance, (2) assess the entity's prospects for future cash flows, and (3) make more informed judgments about the entity as a whole. It is presumed that investors would prefer disaggregated information. Consequently, operating segments should not be aggregated unless providing more detailed information would not enhance an investor's understanding of the entity.

Determining an entity's operating segments is the first step in the assessment of what segment information needs to be reported in the entity's financial statements. An operating segment is a component of the business (1) that engages in business activities from which it may earn revenues and incur expenses, (2) whose operating results are regularly reviewed by the public entity's CODM, and (3) that has discrete financial information available. When challenging a registrant's conclusion about its operating segments, the SEC staff has historically placed a great deal of weight on the information regularly provided to, and reviewed by, the CODM (i.e., the CODM package). The SEC staff would frequently request copies of the CODM package to determine whether the information in the CODM package supports how operating segments are identified and aggregated.

However, technology advancements in registrants' financial reporting systems allow the CODM to easily access additional information that may not be reflected in the CODM package. These advancements have led the SEC staff to revisit its views on the importance of the CODM package in supporting a registrant's segment reporting. At the September 2014 AICPA Banking Conference, the SEC staff noted that while its views on how it should assess information in a registrant's CODM package are evolving, it may have overemphasized the importance of the CODM package. The staff indicated that rather than viewing the CODM package as the determinative factor in identifying operating segments, it would treat the CODM package as only one of many factors to be considered. Similarly, the staff noted that it would not view the CODM package as a safe harbor for registrants. In other words, the staff would not be supportive of an assertion that information in the CODM package would automatically nullify other information (i.e., information that might suggest different operating segments). Registrants should expect that the staff will review other publicly available information for consistency with the registrant's segment disclosures, such as the information in the forepart of Form 10-K (i.e., the business section and MD&A), the registrant's Web site, analysts' reports, and press releases.

As used in ASC 280, the term "chief operating decision maker" identifies a function, not an individual in the company who has the specific title. The CODM determines the allocation of resources and assesses the performance of the operating segments. While the CODM is usually an individual, sometimes the function is performed by a group.

At the AICPA Banking Conference, the SEC staff noted that it would place a renewed emphasis on the determination of a registrant's CODM. The staff remarked that although most registrants identify their CEO as the CODM, questions from the staff sometimes engender a change in the registrant's conclusion about its CODM's identity, which in turn affects the registrant's determination of operating segments. Accordingly, the staff indicated that it would also focus on understanding management's structure (e.g., through organization charts or other information) in supporting the person (or group) identified as the CODM.

In addition, ASC 280-10-50-11 allows entities to aggregate operating segments into reportable segments if the operating segments exhibit (1) similar economic characteristics (e.g., similar historical and expected future performance such as through similar long-term average gross margins) and (2) other similar characteristics, including:

a. The nature of the products and services

b. The nature of the production processes

c. The type or class of customer for their products and services

d. The methods used to distribute their products or provide their services

e. If applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities.

ASC 280-10 does not define the term "similar" or provide much guidance on the aggregation criteria, and the determination of whether two or more operating segments are similar depends on the individual facts and circumstances and is subject to a high degree of judgment. Further, many registrants have complex business models and organizational and reporting structures. Such complexities often make it difficult for registrants to determine the basis for economic similarity when aggregating operating segments. As a result, the SEC staff may ask a registrant to provide an analysis of how it determined that its aggregation of operating segments complies with ASC 280-10.

Consequently, registrants should continually monitor any changes in facts and circumstances that may affect the identification or aggregation of operating segments. Examples of changes that may prompt the SEC staff to seek additional information about registrants' reportable segments include changes in internal reporting after an acquisition and changes in the CODM. In addition, the staff may comment when the economic measures of a registrant's aggregated operating segments have not converged over time despite the registrant's previous assertion that it expected such measures to become more similar in the future.

For additional information, see Deloitte's Financial Reporting Alert 14-3, "Segment Reporting."

Changes in Reportable Segments

Example of an SEC Comment

We note your disclosure . . . that you began including your . . . services within your [A] segment on July 1, 2013. Please tell us whether you have restated prior segment financial information pursuant to ASC 280-10-50-34. Please quantify for us total assets of the transferred operations and the related impact they had on your statements of income, including revenues and net economic earnings, for all periods presented in your filing.

ASC 280-10-50-34 and 50-35 require public entities to recast information from prior periods for consistency with current reportable segments. If a registrant changes the structure of its business after year-end or quarter-end, the new segment structure should not be presented in financial statements until operating results managed on the basis of that structure are reported (typically in a periodic filing such as a Form 10-K or 10-Q). Paragraph 13310.1 of the FRM indicates that "[i]f annual financial statements are required in a registration or proxy statement that includes subsequent periods managed on the basis of the new organization structure, the annual audited financial statements should include a revised segment footnote that reflects the new reportable segments." A registrant can either include the revised financial statements in the registration or proxy statement or recast them in a Form 8-K, which can be incorporated by reference. See the SEC Reporting section for more information.

Product and Service Revenue by Segment

Example of an SEC Comment

Please explain to us how you considered ASC 280-10-50-40 in your determination that product line disclosures are not required. For example, we note from your business disclosures and your website that you appear to sell products across multiple product categories.

Registrants should remember to identify the "[t]ypes of products and services from which each reportable segment derives its revenues" and to report the total "revenues from external customers for each product and service or each group of similar products and services" in accordance with ASC 280-10-50-21 and ASC 280-10-50-40, respectively. The SEC staff has objected to overly broad views of what constitutes "similar" products and services.

Operating Segments and Goodwill Impairment

As discussed in the Impairments of Goodwill and Other Long-Lived Assets section, registrants should be aware that incorrect identification of operating segments can affect goodwill impairment testing. Goodwill is tested at the reporting-unit level in accordance with ASC 350-20, and reporting units are identified as either operating segments or one level below. If a registrant has not correctly identified its operating segments, it could be incorrectly testing goodwill for impairment (i.e., at the wrong level).

Information About Geographic Areas

The SEC staff has frequently asked registrants to include disclosures about geographic information in future filings in accordance with ASC 280-10-50-41 unless it is impracticable to do so.

Other Deloitte Resources

- December 16, 2013, *Heads Up*, "Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments."
- December 11, 2012, *Heads Up*, "Highlights of the 2012 AICPA National Conference on Current SEC and PCAOB Developments."

Share-Based Payments

Disclosures

Example of an SEC Comment

Please review the disclosure requirements for stock-based compensation found at ASC 718-10-50 and provide the following disclosures in future annual filings:

- [Please] revise future filings to include the total intrinsic value of options exercised during the year pursuant to ASC 718-10-50-2d2;
- Please disclose the weighted-average remaining contractual term of options currently exercisable pursuant to ASC 718-10-50-2e; and
- Please revise future filings to include the method used to estimate the fair value of all of your options, as well as, the significant assumptions used to determine fair value pursuant to ASC 718-10-50-2b & f.

Registrants should ensure that their disclosures address the following objectives outlined in ASC 718-10-50-1:

- The "nature and terms" of share-based payment arrangements.
- The "effect of [the related] compensation cost . . . on the income statement."
- The "method [for determining] the fair value of the equity instruments granted."
- The "cash flow effects [of] share-based payment arrangements."

Accordingly, the SEC staff's comments on share-based payment disclosures have focused on items such as:

- The nature of, and reason for, a modification in the share-based payment award's terms and how the registrant accounted for that modification.
- The terms and conditions of awards, including whether award holders are entitled to dividends or dividend equivalents.
- The number of options that are expected to vest and the assumptions used in developing those expectations.
- The registrant's valuation method, including significant assumptions used (e.g., volatility).

In its comments about disclosures, the SEC staff frequently refers to ASC 718-10-50-2, which describes the "minimum information needed to achieve the objectives in [ASC 718-10-50-1]."

In addition to commenting on the types of share-based payment transactions discussed above, the SEC staff often asks registrants about share-based payment information they are required to include in a proxy statement (e.g., those disclosures required by Regulation S-K, Item 402). See the Executive Compensation and Other Proxy Disclosures section for more information about staff comments on registrants' proxy statements.

Share-Based Payment Awards Issued by Privately Held Companies

Example of an SEC Comment

Please tell us about each significant factor contributing to the difference between the estimated IPO Price and the fair value of your shares since the September 2013 grant and any subsequent grants through the date of your response. In your response, please tell us about significant intervening events and reasons for changes in assumptions, as well as the weighting of expected outcomes and selection of valuation techniques employed.

Calculating share-based compensation for privately held companies can be complex and may require registrants to use significant judgment in determining the fair value of the equity instrument because there is typically no active market for the common stock of such companies. The SEC staff continues to comment on registrants' accounting and valuation assumptions for equity securities issued as compensation in periods before an IPO (commonly referred to as "cheap stock" considerations). The AICPA's accounting and valuation guide (known as the "Cheap Stock Guide") contains guidance on these accounting considerations.

A registrant preparing for an IPO should also refer to paragraph 7520.1 of the FRM, which outlines considerations for registrants when the "estimated fair value of the stock is substantially below the IPO price." In such situations, registrants should be able to reconcile the change in the estimated fair value of the underlying equity between the award grant date and the IPO by taking into account, among other things, intervening events and changes in assumptions that support the change in fair value.

While the SEC staff has historically asked registrants to expand the disclosures in their critical accounting estimates to provide additional information about the valuation methods and assumptions used for share-based compensation in an IPO, it recently updated its FRM to indicate that registrants should significantly reduce such disclosures. Specifically, the staff revised Section 9520 of the FRM to clarify what disclosures are expected in an IPO registration statement and thereby encourage registrants to provide less information about cheap stock. However, paragraph 9520.2 of the FRM notes that the staff may continue to "issue comments asking companies to explain the reasons for valuations that appear unusual (e.g., unusually steep increases in the fair value of the underlying shares leading up to the IPO)." Such requests are meant to ensure that a registrant's analysis and assessment support its accounting for share-based compensation and do not necessarily indicate that the registrant's disclosures need to be enhanced.

At the Practising Law Institute's "SEC Speaks in 2014" Conference, the SEC staff provided insights into how registrants would be expected to apply the guidance in paragraph 9520.1 of the FRM (and thereby reduce their share-based compensation disclosures):

- The staff does not expect much detail about the valuation method registrants used to determine the fair value of their pre-IPO shares. A registrant need **only** state that it used the income approach, the market approach, or a combination of both.

  Further, while registrants are expected to discuss the nature of the material assumptions they used, they would **not** be required to quantify such assumptions. For example, if a registrant used an income approach involving a discounted cash flow method, it would only need to provide a **statement** indicating that "a discounted cash flow method is used and [such method] involves cash flow projections that are discounted at an appropriate rate"; no additional details would be needed.

- Registrants would have to include a **statement** indicating that the estimates in their share-based compensation valuations are "highly complex and subjective." They would not need to provide additional details about the estimates.

- Registrants would also need to include a **statement** disclosing that such “valuations and estimates will no longer be necessary once the company goes public [because] once it goes public, it will rely on the market price to determine the market value of [its] common stock.”

For a discussion of SEC staff comments related to IPOs, see the Initial Public Offerings section.

Financial Statement Presentation

Under SAB Topic 14.F, share-based compensation expenses should be classified in the same manner as other cash compensation costs, and the presentation should not be driven by the form of consideration paid. Share-based compensation expense should be allocated to items such as cost of sales, R&D, and SG&A (as applicable) and should not be separately presented in a single share-based compensation line item. Further, SAB Topic 14.F states, “Disclosure of this information might be appropriate in a parenthetical note to the appropriate income statement line items, on the cash flow statement, in the footnotes to the financial statements, or within MD&A.”

Other Deloitte Resources

- April 28, 2014, *Heads Up*, “MD&A Disclosures About ‘Cheap Stock’ in IPO Transactions.”
- March 20, 2014, *Heads Up*, “Highlights of the ‘SEC Speaks in 2014’ Conference.”

SEC Disclosure Topics

Management's Discussion and Analysis

Regulation S-K, Item 303, provides guidance on the information a registrant should consider providing in its discussion of financial condition and results of operations in MD&A. The SEC staff continues to indicate that MD&A is the leading source of SEC staff comments and that well over half of all MD&A-related comments are about the results of operations section. Consequently, the SEC staff's comments have addressed most topics of MD&A1[1] but have continued to focus on greater transparency in registrants' disclosures about (1) material trends and uncertainties that affect results of operations, (2) liquidity and capital resources, (3) estimates in critical accounting policies, and (4) obligations subject to uncertainties.

The staff continues to stress that registrants should focus on providing disclosures that are material and relevant to their operations. In addition, the SEC staff continues to recommend [2] that registrants consider including an executive overview section in MD&A that contains a balanced discussion of the key drivers, challenges, and risks that affect results of operations and liquidity.

Results of Operations

The SEC staff frequently comments on how a registrant can improve its discussion and analysis of known trends, demands, commitments, events, and uncertainties and their impact on the results of operations. Such discussion and analysis is crucial to a financial statement user's understanding of the quality of, and potential variability in, a company's earnings and cash flows as well as the extent to which reported results indicate future performance. A determination of the appropriate disclosure generally should include (1) consideration of financial, operational, and other information; (2) identification of known trends and uncertainties; and (3) an assessment of whether these trends and uncertainties will have, or are reasonably likely to have, a material impact on the company's financial condition and operating performance.

Example of an SEC Comment

We note that you do not quantify the impact of the various factors that affected your revenues from period to period. For example, . . . you state that the sales . . . were negatively impacted by the exit of [certain product lines] and lower sales in your . . . product lines prior to being sold, but you do not quantify the impact. Similarly, you state . . . that gross profit . . . increased in 2013 primarily due to favorable raw material costs, but do not indicate either the change in raw material costs or the impact of this change. These are just examples. In future filings please quantify the effects of such factors and also discuss whether you believe these factors are the result of a trend, and, if so, whether you expect it to continue and how it may impact your financial condition and results of operations. See Item 303 of Regulation S-K and SEC Release No. 33-8350.

Under Item 303(a)(3), registrants are required to disclose in MD&A material known trends or uncertainties that may affect future performance (whether favorable or unfavorable). Registrants are commonly asked to (1) quantify components of overall changes in financial statement line items and (2) enhance their analysis of the underlying factors that cause such changes or the reasons for the components affecting the overall change — including an analysis of changes at the segment level because such an analysis is often meaningful in MD&A. The SEC staff has also suggested that in addition to discussing how volume and product mix affect a registrant's results of operations, the registrant should consider explaining other potential influences, such as pricing changes, acquisitions, new contracts, inflation, and foreign exchange rates.

The SEC staff also encourages registrants to:

- Use appropriate metrics to help them "tell their story" — including those that may be common to their industry (e.g., same-store sales, average subscribers). However, the SEC staff distinguishes such metrics from non-GAAP measures that are adjusted GAAP measures. See the Non-GAAP Financial Measures, Retail and Distribution, and Technology sections for additional information.

[1] See paragraphs 9110.1 and 9110.2 of the FRM for the SEC staff's interpretive views about the objectives of a registrant's MD&A.

[2] See the SEC's interpretive release for additional information.

- Present changes in a tabular format (e.g., a table that summarizes disaggregated cost of sales components by reportable segment).

The SEC staff has also asked registrants to separately discuss the impact of online sales on their results of operations. See the Retail and Distribution section for additional information.

Liquidity and Capital Resources

> **Example of an SEC Comment**
>
> In future filings, please provide a more informative analysis and discussion of changes in operating cash flows, including changes in working capital components, for each period presented. In doing so, please explain the underlying reasons for and implications of material changes between periods to provide investors with an understanding of trends and variability in cash flows. Please ensure your discussion and analysis is not merely a recitation of changes evident from the financial statements. Refer to Item 303(a) of Regulation S-K.

The SEC staff frequently requests more meaningful analysis in a registrant's MD&A of material cash requirements, historical sources and uses of cash, and material trends and uncertainties so that investors can understand the registrant's ability to generate cash and meet cash requirements. In addition, rather than repeating items that are reported in the statement of cash flows, registrants should (1) concentrate on disclosing the primary drivers of cash flows and the reasons for material changes in specific items underlying the major captions reported in their financial statements and (2) disclose significant developments in liquidity or capital resources that occur after the balance sheet date.

The SEC staff has noted that it is important for registrants to "accurately and comprehensively explain [their] liquidity story" and has advised registrants to consider including discussions of key liquidity indicators, such as leverage ratios and other metrics that management uses to track liquidity.[3] In addition, the SEC staff has indicated that MD&A disclosures should take into account how the following factors, among others, affect a registrant's liquidity:

- Any changes in leverage strategies.
- Any strains on liquidity caused by changes in availability of previously reliable funding.
- Sources and uses of funds.
- Intraperiod debt levels.
- Restrictions on cash flows between the registrant (i.e., the parent) and its subsidiaries.
- The impact of liquidity on debt covenants and ratios.

Registrants should also consider whether they need to provide enhanced disclosures about:

- Significant debt instruments, guarantees, and covenants. See the Debt section for more information about financial covenant disclosures in MD&A.
- Effects on liquidity of material cash balances that are held. For additional information, see the Income Taxes section.

[3] At the 2011 AICPA Conference, the SEC staff highlighted the need for registrants to include appropriate narratives regarding liquidity and capital resources.

Critical Accounting Policies

Example of an SEC Comment

Your discussion of goodwill . . . substantially duplicates the footnote disclosure. Please revise this section to provide an analysis of your goodwill accounting policies and the significant underlying estimates that supplements, but does not duplicate, the description of accounting policies in the notes to the financial statements and provides greater insight into the quality and variability of information regarding your impairment test of goodwill.

The critical accounting policies section of MD&A is intended to highlight only those financial statement items that require significant management estimates and judgment. Registrants should not simply copy their accounting policy disclosures from the footnotes to the financial statements. Instead, the SEC staff expects discussion and analysis of material uncertainties associated with the methods and assumptions underlying each critical accounting estimate.

To provide comprehensive and meaningful disclosures, management should consider disclosing the following items in the critical accounting policies section of MD&A:

- The method(s) used to determine critical accounting estimates.
- The accuracy of past estimates or assumptions.
- The extent to which the estimates or assumptions have changed.
- The drivers that affect variability.
- Which estimates or assumptions are reasonably likely to change in the future.

In addition, registrants should include an analysis of the sensitivity of estimates to change on the basis of outcomes that are reasonably likely to occur and that would have a material effect. The sensitivity analysis should be quantitative if it is reasonable for registrants to obtain such information.

The economy and volatility in the financial markets may also affect a registrant's defined benefit plans and related disclosures. For example, the SEC staff has indicated that registrants may need to expand disclosures in MD&A about key assumptions, pension asset investment strategies, changes to pension plan assets, and consideration of statutory minimum funding requirements. For additional information, see the Pensions and Other Postretirement Benefits section.

In addition to pension accounting, SEC staff comments to registrants have frequently focused on the management estimates used in the valuation of long-lived assets, income taxes (including DTAs and uncertain tax positions), and fair value estimates. See the Impairments of Goodwill and Other Long-Lived Assets, Income Taxes, and Fair Value sections for more information.

Tabular Disclosure of Contractual Obligations

Examples of SEC Comments

- Please expand footnote 1 [in your contractual obligations table] to disclose the components of "Other Liabilities" that were excluded from the Contractual Obligations table and the reasons why as stated in your response.
- We note . . . that you have long-term raw material and power supply contracts. Please tell us why you do not report these long-term contracts in your contractual obligations table under Item 303(a)(5) of Regulations S-K. In addition, tell us why amounts due under your revolving credit agreement are also excluded from the table. Please provide revised tabular disclosure of your contractual obligations to be included in future filings which includes these obligations or tell us how your current presentation complies with Item 303(a)(5) of Regulation S-K.

The SEC staff continues to comment on the contractual obligations table and the associated notes and disclosures. Such comments typically focus on (1) a registrant's omission of material obligations, such as interest payments on debt, pension obligations, and uncertain tax position liabilities, and (2) omission of disclosures about the terms of obligations, such as purchase obligations. See the Income Taxes section for more information about ASC 740-10 liabilities.

Some registrants have questioned how obligations subject to uncertainties about timing or amount should be presented in the table of contractual obligations. The SEC staff has noted that registrants should consider their circumstances and use judgment in determining whether to include such information in the table or the footnotes to the table.[4] The staff has also indicated that the footnotes should be used to clarify amounts in the table and to (1) explain the nature of the obligations, including whether they were included in, or excluded from, the table (and the reasons for inclusion or exclusion); (2) describe whether the obligations are subject to uncertainty; and (3) describe the uncertainty.[5]

Off-Balance-Sheet Arrangements

Example of an SEC Comment

Please revise to include a separately-captioned section within MD&A discussing your off-balance sheet arrangements as required by Item 303(a)(4) of Regulation S-K.

The SEC staff continues to focus on the requirement that registrants include a discussion of off-balance-sheet arrangements in a separately captioned section in MD&A[6] and has encouraged registrants to focus on the following themes in their disclosures about such arrangements:

- Any material difficulties that off-balance-sheet entities are experiencing (including asset write-downs or credit downgrades) and the effect on the registrant.
- Detailed disclosure of support the registrant has provided, or is obligated to provide, to off-balance-sheet entities (including obligations to provide liquidity).
- The potential effect on debt covenants, capital ratios, credit ratings, or dividends, should the registrant consolidate or incur losses associated with the entities.

[4] See the highlights of the September 2012 CAQ SEC Regulations Committee joint meeting with the SEC staff for discussion of a registrant's use of judgment related to disclosures in the table of contractual obligations.

[5] To the extent that the obligations cannot be quantified, the SEC staff expects registrants to disclose information that investors and users need to understand the nature and extent of the registrant's obligations. As indicated in paragraph 9240.7 of the FRM, registrants may include footnotes "to describe provisions that create, increase or accelerate obligations, or other pertinent data to the extent necessary for an understanding of the timing and amount of the registrant's specified contractual obligations."

[6] A reason for the staff's focus on off-balance-sheet arrangements is noted in paragraph 9230.2 of the FRM, which states that the disclosure requirements related to such arrangements "are intended to elicit disclosure about why the registrant engages in the off-balance sheet arrangement, the magnitude and importance of the arrangement and the circumstances that would cause the registrant to recognize material liabilities or losses related to the arrangement."

Early-Warning Disclosures

Item 303 requires disclosure of "any known trends or uncertainties that . . . the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations." Early-warning disclosures give investors insight into when charges may be incurred in the future; whether a charge is related to contingencies, restructuring activities, goodwill or other long-lived asset impairments, or the settlement of uncertain tax positions; when revenue growth or profit margins may not be sustainable because of underlying economic conditions; or when the registrant will be unable to comply with debt covenants. Such disclosures give investors insight into the underlying conditions and risks that the company faces before a material charge or decline in performance is reported.

Other Deloitte Resources

- December 16, 2013, *Heads Up*, "Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments."
- December 11, 2012, *Heads Up*, "Highlights of the 2012 AICPA National Conference on Current SEC and PCAOB Developments."
- December 14, 2011, *Heads Up*, "Highlights of the 2011 AICPA National Conference on Current SEC and PCAOB Developments."

SEC Reporting

SEC authoritative literature includes a number of requirements that govern the form and content of a registrant's financial statements and other information that must be included in filings with the SEC. The SEC staff often comments on these requirements, and they have been the subject of discussion at a variety of forums, including the annual AICPA Conference, various industry conferences, and joint meetings of the SEC staff and the CAQ SEC Regulations Committee.

At the 2013 AICPA Conference, the SEC staff noted that there may be situations in which registrants seek relief from complying with certain SEC reporting rules and regulations (see below for a discussion of many of those provisions). For example, a registrant may seek relief from complying with Regulation S-X, Rule 3-05, under which the registrant must provide financial statements of an acquired business if the required significance test yielded a result that the registrant believes is unusual or anomalous. With this in mind, the staff acknowledged that relief may be warranted in some cases and that registrants may seek to obtain a waiver from CF-OCA. The SEC staff provided best practices for registrants to consider when seeking reporting relief.

Private-Company Accounting Alternatives

As noted above and discussed further below, there are instances in which a registrant must provide the financial statements of other entities in its registration statements or periodic filings. Under ASU 2013-12, the definition of a public business entity (PBE) includes entities that are "required by the [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)." PBEs are not permitted to adopt private-company accounting alternatives. Accordingly, the effects of any previously elected private-company accounting alternatives would have to be eliminated from the historical financial statements of an entity whose financial statements are included in the SEC filing of a registrant.

Significant Business Acquisitions (Rule 3-05)

Examples of SEC Comments

- Please provide to us your significance calculations for [the acquisition of Company A] under the asset, investment and income tests as prescribed by Rule 3-05 of Regulation S-X and tell us your basis for not providing financial statements under Rule 3-05 for this acquisition.
- [C]onfirm that for each business acquired, or to be acquired, you have acquired substantially all of the target's key operating assets. Provide your analysis of why presenting full financial statements under Rule 3-05 of Regulation S-X is appropriate as you are not acquiring certain assets and assuming certain liabilities.

When a registrant consummates, or it is probable that it will consummate, a significant business acquisition, the SEC staff may require the registrant to file certain financial statements for the acquired or to be acquired business (acquiree) under Rule 3-05 in a Form 8-K, registration, or proxy statement. The following factors govern whether, and for what period, financial statements for the acquiree are required:

- Whether the acquired or to be acquired assets and liabilities meet the definition of a business for SEC reporting purposes.
- The significance of the acquired or to be acquired business. The significance is calculated on the basis of three tests: the investment (purchase price) test, the asset test, and the income test.
- Whether consummation of the business acquisition is probable or has occurred.

The SEC staff comments on the application of Rule 3-05 in connection with significant business acquisitions when registrants:

- Incorrectly determine that the acquired or to be acquired assets and liabilities do not meet the definition of a business for SEC reporting purposes. The definition of a business for SEC reporting purposes under Regulation S-X, Article 11, is not the same as the definition under ASC 805 for U.S. GAAP purposes.
- Did not perform the significance calculations correctly. Some of the most common mistakes are misapplications of the income test, such as excluding unusual gains or losses from the test.
- Did not realize that Rule 3-05 also applies, in a registration statement or certain proxy statements, to probable acquisitions whose significance is greater than 50 percent.
- Did not consider, in a registration statement or proxy statement, the cumulative significance of previously consummated individually insignificant acquisitions.

The staff may also question the financial statements provided by a registrant under Rule 3-05 when the registrant has acquired only selected parts of an entity. In such situations, it may be appropriate, on the basis of the facts and circumstances, for the registrant to include (1) full financial statements of the entity, (2) carve-out financial statements of the assets and operations acquired, or (3) abbreviated financial statements (i.e., Statement of Assets Acquired and Liabilities Assumed and Statement of Revenue and Direct Expenses). For additional information about how to determine what financial statements are appropriate when the registrant has acquired selected parts of an entity, see Section 2065 of the FRM.

Investments in Equity Method Investees (Rules 4-08(g) and 3-09)

Example of an SEC Comment

Please demonstrate to us that audited financial statements pursuant to Rule 3-09 of Regulation S-X were not required for any of your unconsolidated investees . . . . Provide all calculations and assumptions as applicable.

When a registrant has a significant equity method investment, Regulation S-X, Rules 4-08(g) and 3-09, may require the registrant to provide summarized financial information of the investee in the footnotes to the financial statements, separate financial statements of the investee, or both. To determine whether summarized information is required under Rule 4-08(g), a registrant must perform all three significance tests: the investment test, the asset test, and the income test.

Under Rule 3-09, significance is calculated for equity method investees on the basis of only two tests performed annually: the investment test and the income test. If an investee is significant, its separate financial statements must be filed in the registrant's Form 10-K. Thus, a registrant's compliance with Rule 3-09 is particularly important because its failure to file the financial statements of a significant investee may cause it to become a delinquent filer and lose Form S-3 eligibility.

Common errors that registrants make when performing the significance tests under Rules 4-08(g) and 3-09 include:

- Failure to document the tests each year. This is most common when an equity investee has been clearly insignificant in the past. In certain situations, such as a near-break-even year for the registrant or a large income or loss at the investee level, the current year's significance may change, making the equity investee significant for the first time.

- Failure to update the tests each year. Registrants should update and reassess the significance tests for all years presented in a Form 10-K after they report a retrospective change, such as a change in accounting principle or classification of a component as a discontinued operation. See paragraph 2410.8 of the FRM.

For additional SEC staff interpretations of Rules 4-08(g) and 3-09, see Section 2400 of the FRM.

Restrictions on Dividends (Rules 4-08(e), 5-04, and 12-04)

Registrants must consider the requirements of Regulation S-X, Rules 4-08(e), 5-04, and 12-04, when the transfer of assets (cash or other funds) to the parent company/registrant from its subsidiary (or subsidiaries) or equity method investee is materially restricted, limited, or in need of a third party's approval.

For additional discussion, see the Debt section.

Guarantors of Registered Securities (Rule 3-10)

Regulation S-X, Rule 3-10, requires a registrant to provide separate financial statements for each subsidiary issuer or guarantor of debt securities registered or being registered unless certain criteria are met. The information required under Rule 3-10 must be presented in registration and proxy statements and Forms 10-K and 10-Q. Therefore, a registrant should consider the requirements under Rule 3-10 if (1) the registrant registers debt and the debt is guaranteed by one or more of its subsidiaries or (2) one of the registrant's subsidiaries registers debt and the debt is guaranteed by the parent company or one or more of its other subsidiaries.

As noted above, Rule 3-10, contains certain exceptions under which a registrant may provide more limited financial information in lieu of full financial statements. If the registrant meets the exception criteria, it may be eligible to provide, in a footnote to the parent company's financial statements, either of the following types of modified financial information in lieu of separate financial statements:

- Condensed consolidating financial information.
- Narrative disclosures about each subsidiary issuer or guarantor.

All of the exceptions under Rule 3-10 require (1) the subsidiary issuer and guarantors to be "100 percent owned" by the registrant and (2) the guarantee to be "full and unconditional." The SEC staff sometimes comments on whether the registrant specifically meets these and other criteria necessary for the presentation of modified financial information.

For additional SEC staff interpretations of Rule 3-10, see Section 2500 of the FRM.

Definition of 100 Percent Owned

Example of an SEC Comment

Please revise your disclosure in future filings to clarify that all of the guarantor subsidiaries and the issuer are 100% owned by the parent as defined in [Rule] 3-10(h)(1) of Regulation S-X, if correct. In this regard, we note your reference to the guarantor subsidiaries as "wholly-owned", which has a different meaning than 100% owned. Please also refer to [Rule] 1-02(aa) of Regulation S-X for guidance.

Registrants must disclose that a subsidiary is 100 percent owned to meet one of the conditions for relief under Rule 3-10. The SEC staff has reminded registrants that under Regulation S-X, "100 percent owned" does not mean the same thing as "wholly owned" and that the terms are therefore not interchangeable. In addition, the staff has indicated that wholly owned under Regulation S-X, Rule 1-02, means that the parent owns substantially all of the outstanding voting stock of the subsidiary whereas 100 percent owned is defined as ownership of all outstanding shares of the subsidiary. For further clarification of the definition of 100 percent owned, see Rule 3-10(h)(1).

Full and Unconditional Guarantees and Release Provisions

> **Example of an SEC Comment**
>
> You disclosed that . . . all guarantees are full and unconditional, subject to certain customary release provisions set forth in the applicable Indenture. Please provide us with a specific and comprehensive discussion regarding how you considered these release provisions in determining that the guarantees are "full and unconditional" and in your reliance on Rule 3-10 of Regulation S-X.

A guarantee must be full and unconditional to allow the registrant to provide limited financial information in lieu of full financial statements under Rule 3-10. Paragraph 2510.4 of the FRM clarifies that an "arrangement that permits a guarantor to opt out of its obligation prior to or during the term of the debt is not a full and unconditional guarantee." However, a subsidiary whose guarantee is released automatically by one of the customary release provisions referred to in paragraph 2510.5 of the FRM may rely on the relief provided by Rule 3-10. Accordingly, registrants should disclose any qualifications of subsidiary guarantees and should not characterize a subsidiary guarantee as full and unconditional without disclosing the circumstances under which it can be released.

The FRM's guidance on customary release provisions applies only to subsidiary guarantees, not to parent guarantees. The SEC staff has clarified that to qualify for Rule 3-10 relief, a registrant must meet certain conditions specified in the rule, one of which is the filing of the parent company's financial statements for the periods indicated. Therefore, if the parent could be released from its guarantee, there would be no basis for relief under Rule 3-10. However, the staff has allowed limited exceptions to parent release provisions, such as situations in which the parent's guarantee is released when the debt is repaid. Registrants are encouraged to contact the staff regarding any parent release provisions in their debt indentures.

Condensed Consolidating Financial Information

> **Example of an SEC Comment**
>
> We note positive operating cash flows recorded for either the Parent or Guarantor in each period presented. It is unclear how the Parent was able to generate substantial positive operating cash flows . . . given the absence of any revenue transactions in the fiscal years presented and the lack of dividends from subsidiaries during [those fiscal years]. . . . Please advise and provide us a reconciliation of operating cash flows from net income using the indirect method for the Parent, Guarantor subsidiary and the Non-Guarantor subsidiaries for each period presented.

If a registrant presents condensed consolidating financial information, it should use a columnar format and include certain or all of the following as applicable: (1) the parent, (2) subsidiary issuer(s) of the security, (3) subsidiary guarantor(s), (4) nonguarantor subsidiaries, and (5) consolidating adjustments. Registrants should also provide sufficient detail about the assets, liabilities, operations, and cash flows for each of the parent, issuer, subsidiary guarantors, and nonguarantor subsidiaries, as appropriate.

The SEC staff often discusses form and content considerations related to the preparation of condensed consolidating financial information under Rule 3-10 and has highlighted that under this rule:

- The information should be presented in the same level of detail (i.e., the major financial statement captions) as interim financial statements prepared in accordance with Regulation S-X, Article 10.
- The information should be presented in accordance with U.S. GAAP[1] (e.g., intercompany receivables should be shown as an asset and not as a negative liability).

[1] One exception is that investments in subsidiaries should be presented under the equity method of accounting. See Rule 3-10(i)(5).

- The classifications in the condensed consolidated statement of cash flows should also comply with U.S. GAAP.
- A total for comprehensive income should be presented in either a single continuous statement or two separate but consecutive statements.[2]

The SEC staff may also comment when a registrant:

- Incorrectly assumes that certain exceptions in Rule 3-10 are met and therefore concludes that it does not have to provide separate financial statements, condensed consolidating financial information, or narrative disclosures.
- Incorrectly prepares the required condensed consolidating financial information by not presenting subsidiaries under the equity method of accounting, or not presenting information in sufficient detail to allow investors to determine the assets, results of operations, and cash flows of each of the consolidating groups.

The SEC staff has also commented when the parent (or guarantor) has recorded positive operating cash flows in a particular period in the absence of any revenue-generating activities during that time frame. Positive cash flow from operations often results when the parent (or guarantor) classifies dividends received from its subsidiaries as a "return on its investment." ASC 230 distinguishes between returns **on** investment, which should be classified as inflows from operating activities (see ASC 230-10-45-16(b)), and returns **of** investment, which should be classified as inflows from investing activities (see ASC 230-10-45-12(b)). The parent (or guarantor) should consider its particular facts and circumstances when determining whether the cash flows resulting from a dividend distribution represent a "return on" or a "return of" the related investment in the underlying subsidiary. The SEC staff may ask registrants to disclose (1) how they have accounted for such dividends and (2) the amount of dividends received from subsidiaries included in cash flows from operations.

Recently Acquired Subsidiary Issuers or Subsidiary Guarantors (Rule 3-10(g))

Under Rule 3-10(g), which applies to recently acquired subsidiary issuers or subsidiary guarantors, a registrant must provide separate financial statements of a significant subsidiary issuer or guarantor if the subsidiary's historical results have not been included in the parent's audited financial statements for at least nine months of the most recent fiscal year. The SEC staff noted that the significance test under Rule 3-10(g) is different from the tests under Rule 3-05 for businesses acquired or to be acquired (see Significant Business Acquisitions (Rule 3-05) above). To determine significance under Rule 3-10(g), a registrant should compare the net book value or purchase price (whichever is greater) of the subsidiary with the principal amount of the securities being registered. If the test result equals or exceeds 20 percent, the registrant must file separate financial statements of the acquired subsidiary that are audited in accordance with the standards of the PCAOB for the most recent fiscal year and unaudited interim financial statements for the appropriate interim period preceding the acquisition.

In computing significance under Rule 3-10(g), a registrant must aggregate the acquisitions of a group of related subsidiary issuers or guarantors before their acquisition. A registrant is also required to include financial statements in registration statements but not in periodic reports filed under the Exchange Act (e.g., Forms 10-K and 10-Q).

[2] Separately, the SEC staff has clarified that a registrant should present total comprehensive income in a manner consistent with the interim requirements for the registrant's primary financial statements. See paragraphs 2515.2 and 2810.1 of the FRM for additional information.

Issuers of Securities That Collateralize Registered Securities (Rule 3-16)

Example of an SEC Comment

Please advise whether the collateral includes the securities of any of the guarantors and, if so, whether such securities constitute a "substantial portion" of the collateral for the [notes] as defined in Rule 3-16 of Regulation S-X. In addition, . . . please advise how you intend to monitor any future obligation to provide financial statements pursuant to Rule 3-16.

Regulation S-X, Rule 3-16, requires a registrant to file full audited financial statements for each of the registrant's affiliates whose securities constitute a "substantial portion of the collateral" for any class of securities registered or being registered. This requirement may apply when the capital stock of some or all of the registrant's subsidiaries are pledged as collateral for a debt instrument. The registrant must provide these financial statements in its Forms 10-K and certain registration statements.

Registrants often look at the tests under Rules 3-10 and 3-16 as one test or related tests. However, they should be aware that these tests are performed separately and that the results must be assessed individually.

Rule 3-16 includes its own specific test (the "substantial portion of the collateral" test) and "bright-line" requirements. Unlike Rule 3-10, Rule 3-16 does not permit condensed consolidating financial information in lieu of full financial statements. Therefore, Rule 3-16 requires full audited financial statements of each affiliate whose securities constitute a substantial portion of the collateral of a security.

For additional SEC staff interpretations of Rule 3-16, see Section 2600 of the FRM.

Pro Forma Financial Information (Article 11)

Example of an SEC Comment

[T]ell us how you determined that these . . . expenses are (i) directly attributable to the transaction, (ii) not expected to have a continuing impact, and (iii) factually supportable. Refer to Rule 11-02(b)(6) of Regulation S-X.

Pro forma information is required under Regulation S-X, Article 11, when (1) it is material to an understanding of a significant consummated or probable transaction, such as a business combination; (2) a transaction is subject to a shareholder vote; or (3) other conditions outlined in Article 11 are met. Pro forma financial information under Article 11 may be required in a registration or proxy statement or a Form 8-K but is not required in a Form 10-K or 10-Q. Although Article 11 pro forma financial statements are not required in a registrant's Form 10-K or 10-Q, a registrant must separately evaluate the need for pro forma disclosures under ASC 805 (related to business combinations) in its financial statements included in a Form 10-K or 10-Q. See the Business Combinations section for more information about pro forma disclosures that are required under U.S. GAAP.

Registrants should generally present Article 11 pro forma financial statements in columnar form with separate columns for historical financial information, pro forma adjustments, and pro forma results. In limited circumstances, registrants may present narrative disclosures in lieu of pro forma financial statements. Further, Article 11 requires pro forma balance sheet adjustments to reflect events that are (1) factually supportable and (2) directly attributable to the transaction. In addition, pro forma income statement adjustments must have a "continuing impact" on the registrant's operations (i.e., they are not "onetime").[3] The SEC staff continues to comment on certain form and content matters, such as when a registrant fails to clearly explain each financial statement adjustment or does not clearly demonstrate how the above requirements are met.

[3] The SEC staff has expanded on its view of what would constitute continuing impact. See the highlights of the June 2012 CAQ SEC Regulations Committee joint meeting with the SEC staff for additional information.

When calculating pro forma adjustments, registrants should assume that the transaction occurred (1) as of the date of the most recent balance sheet for the pro forma balance sheet and (2) at the beginning of the fiscal year presented for the pro forma income statement. In the past, the SEC staff has clarified that this guidance applies only to calculating the amount of the pro forma adjustment and should not be used to determine whether an adjustment is appropriate. For example, in the preparation of a pro forma income statement, it would be inappropriate for a registrant to make a pro forma adjustment for a charge in the historical financial statements on the basis of an assertion that if the transaction had been consummated at the beginning of the year, the charge would not have been incurred.

For companies doing an IPO, the SEC staff has clarified that it would be rare for costs "that a company expects to incur as a public company" to be pro forma adjustments "since such costs are not directly attributable to the transactions for which pro forma information is presented." However, the staff has noted that depending on the facts and circumstances, a registrant may disclose the types and ranges of such costs in the notes to the pro forma financial information. See the Initial Public Offerings section for more information.

Section 3300 of the FRM summarizes special problems and issues that are often associated with pro forma financial information.

SEC Reporting Considerations for Material Changes That Require Retrospective Application

After the registrant has issued its annual financial statements, an event may occur that requires it to make a material retrospective change (e.g., the initial adoption of certain accounting pronouncements, a segment change, or the classification of a component as a discontinued operation). If the registrant files a new registration statement after it has filed interim financial statements that report the material retrospective change, it generally must file updated financial statements and other financial information (e.g., MD&A, selected financial data) to reflect the retrospective adjustments for periods before adoption of the change. These filings are typically made on Form 8-K. The SEC staff has allowed limited exceptions to this requirement for certain retrospective changes (see Section 13500 of the FRM for information regarding retrospective presentation of stock splits). In addition, there are different considerations for (1) currently effective registration statements (see Regulation S-K, Item 512(a)), (2) registration statements on Form S-8 (see the note to Section 13100 of the FRM), and (3) retrospective changes to provisional amounts recorded for business combinations (see Section 13600 of the FRM).

Topic 13 of the FRM provides additional information about the effects of retrospective changes on financial statements required in registration statements.

Audit Report Requirements

Examples of SEC Comments

- Please provide a dated audit report reflecting the city and state where issued as required by Rule 2-02(a) of Regulation S-X.
- We note that your auditor's report refers to "the auditing standards" of the PCAOB rather than to "the standards" of the PCAOB as is required by the PCAOB's Auditing Standard No. 1. Please explain why the report includes the qualifier "auditing"; and if the reason is a typographical error, please amend the filing to include a corrected audit report.

The SEC staff continues to comment when a registrant does not comply with Regulation S-X, Rule 2-02(a), and Regulation S-T, Rule 302. For example, the staff has commented when:

- A signature did not conform to Regulation S-X and S-T requirements.[4]
- A public accounting firm's city and state were omitted from the audit report.
- A registrant included a report from its auditor that does not appropriately identify all financial statements covered by the audit report.

The SEC staff will generally ask the registrant to amend its filing or provide a revised audit report if its Report of the Independent Registered Public Accounting Firm is not in compliance with the technical requirements of Regulation S-X, Rule 2-02(a), or Regulation S-T, Rule 302.

In addition, the CAQ issued Alert 2012-16 to remind auditors that "it **would not** be appropriate for the auditor's report for issuers or other entities that require compliance with PCAOB requirements to reference only the ***auditing* standards** of the PCAOB" since this qualifying language may imply that the auditor did not adhere to other standards of the PCAOB (e.g., its independence standards). The alert also encouraged registrants and auditors to review paragraph 4110.5 of the FRM for additional information regarding certain PCAOB requirements in various SEC filings.

Other Deloitte Resources

- December 16, 2013, *Heads Up*, "Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments."
- December 11, 2012, *Heads Up*, "Highlights of the 2012 AICPA National Conference on Current SEC and PCAOB Developments."

4 In February 2011, the CAQ issued Alert 2011-04 to remind auditors about (1) the requirement under Regulation S-X, Rule 2-02(a), for registrants to include signed audit reports in EDGAR filings and (2) the additional requirements related to typed "signatures" in electronic submissions.

Disclosures About Risk

The SEC staff continues to expect registrants to provide investors with tailored, comprehensive, and transparent risk disclosures.

Risk Factors

> **Example of an SEC Comment**
>
> Please ensure that your risk factors fully describe the material risks faced by you and explain specifically how such risks are related to your business.

In recent years, the SEC staff has emphasized that registrants should present tailored risk factors in their filings and avoid using boilerplate language. In an April 11, 2014, speech[1] highlighting the SEC staff's "disclosure effectiveness" initiative, a staff member indicated that "risk factors could be written better — less generic and more tailored — and they should explain how the risks would affect the company if they came to pass."

Accordingly, the SEC staff routinely asks registrants to replace boilerplate risk disclosures with a discussion of the risks that specifically affect the registrant and their possible impact on the registrant's business. This discussion may be supplemented with quantitative information to provide additional context about the risks. In addition, the staff often asks registrants whether they have (1) discussed all relevant risk factors and (2) provided sufficient MD&A discussion when a risk constitutes a material trend or uncertainty. The staff also reminds registrants that the title of each risk factor should adequately describe the related risk.

Cybersecurity

> **Example of an SEC Comment**
>
> We note your disclosure that an unauthorized party was able to gain access to your computer network "in a prior fiscal year." So that an investor is better able to understand the materiality of this cybersecurity incident, please revise your disclosure to identify when the cyber incident occurred and describe any material costs or consequences to you as a result of the incident. Please also further describe your cyber security insurance policy, including any material limits on coverage.

The SEC staff has noted the increasingly frequent occurrence of cyber incidents, which may cause registrants to incur significant remediation and other costs for (1) direct damages (both real and reputational), (2) the impact on their customers, and (3) increased protection from future cybersecurity attacks. It is important for registrants to consider the nature of any cyber incidents that occur and to provide the appropriate level of disclosure about such incidents in their filings.

At the "SEC Speaks in 2014" Conference, the SEC staff acknowledged that no SEC rules explicitly require registrants to disclose cybersecurity-related matters in their filings. However, registrants were reminded that the SEC's Division of Corporation Finance has issued CFDG Topic 2, which provides interpretive guidance on potential disclosures related to material cybersecurity matters. CFDG Topic 2 indicates that under existing SEC requirements, registrants may need to provide disclosures in various sections of an SEC filing, including risk factors, legal proceedings, MD&A, and the financial statements. For example, cybersecurity risks and cyber incidents may constitute material known trends and uncertainties that a registrant should consider disclosing in MD&A in accordance with Regulation S-K, Item 303(a)(3)(ii).

[1] Keith Higgins, director, Division of Corporation Finance, "Disclosure Effectiveness: Remarks Before the American Bar Association Business Law Section Spring Meeting," April 11, 2014.

In other remarks at the conference, the SEC staff clarified its expectations regarding the nature and extent of a registrant's cybersecurity disclosures. It noted that a registrant should avoid boilerplate cybersecurity disclosures and instead should include such information as (1) the aspects of the business that are subject to risks, (2) updates for new information, and (3) cost estimates, if possible and material. The staff reminded registrants that they should not state that there is a risk of a cybersecurity breach after the occurrence of an actual cyber-attack; rather, such registrants should disclose that they have experienced security breaches or cyber-attacks. However, the staff indicated that it would not expect disclosures to be so detailed that they constitute a "roadmap" that would further expose a registrant to cyber-attack. In addition, the staff acknowledged that limited disclosures may be justified in certain situations (e.g., when the registrant is working with law enforcement officials after a cybersecurity breach).

Accordingly, the SEC staff may monitor information outside a registrant's filings and ask why certain cyber incidents are not disclosed. Further, a registrant may be asked to confirm that it has disclosed the occurrence of material cyber incidents in its filings.

Issuers Based in China

At the 2013 AICPA Conference, the SEC staff discussed risk factor disclosures that issuers with substantial operations based in China should consider making (although the same considerations could apply to issuers with operations in other jurisdictions). See the Consolidation section for addition information.

Other Deloitte Resources

- October 16, 2014, *Heads Up*, "SEC Staff Suggests Ingredients for Effective Disclosures."
- August 26, 2014, *Heads Up*, "The Road to Effective Disclosures."
- April 8, 2014, *Heads Up*, "Highlights of the SEC's Cybersecurity Roundtable."
- March 20, 2014, *Heads Up*, "Highlights of the 'SEC Speaks in 2014' Conference."
- December 16, 2013, *Heads Up*, "Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments."

Non-GAAP Financial Measures

Example of an SEC Comment

Given your disclosure stating that you utilize your non-GAAP measure [to determine the amount of cash available for distribution to your limited partners,] please explain why you have not reconciled this non-GAAP liquidity measure to operating cash flow as the most directly comparable GAAP measure, rather than net income, to comply with Item 10(e)(1)(i)(B) of Regulation S-K.

SEC Rule 33-8176 defines a non-GAAP financial measure as a "numerical measure of a registrant's historical or future financial performance, financial position or cash flows" that includes amounts that are not part of the most directly comparable GAAP measure or excludes amounts that are part of the most directly comparable GAAP measure. Common non-GAAP financial measures include EBITDA or adjusted EBITDA, adjusted revenues, free cash flows, core earnings, funds from operations, and measures presented on a constant-currency basis.

The SEC staff has continued to comment on non-GAAP financial measures, primarily focusing on the extent of a registrant's disclosures and whether the disclosures demonstrate the purpose of the measures (i.e., how management uses them and their usefulness to investors). Regulation S-K, Item 10(e)(1)(i), states that for financial measures used in documents that are filed with the SEC, the following information should accompany a registrant's disclosure of non-GAAP financial measures:

> (A) A presentation, with equal or greater prominence, of the most directly comparable financial measure or measures calculated and presented in accordance with Generally Accepted Accounting Principles (GAAP);
>
> (B) A reconciliation (by schedule or other clearly understandable method), which shall be quantitative for historical non-GAAP [financial] measures presented, and quantitative, to the extent available without unreasonable efforts, for forward-looking information, of the differences between the non-GAAP financial measure disclosed or released with the most directly comparable financial measure or measures calculated and presented in accordance with GAAP . . . ;
>
> (C) A statement disclosing the reasons why the registrant's management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding the registrant's financial condition and results of operations; and
>
> (D) To the extent material, a statement disclosing the additional purposes, if any, for which the registrant's management uses the non-GAAP financial measure that are not [otherwise] disclosed.

The SEC staff has commented when a non-GAAP financial measure is not reconciled to the appropriate GAAP measure as determined on the basis of whether the purpose of the non-GAAP measure is to assess the registrant's performance or its liquidity. For example, the staff has indicated that the most directly comparable GAAP measure for reconciling EBITDA is typically net income (loss) for a performance measure and cash flows from operating activities for a liquidity measure.

The SEC staff focuses on consistency in communications with investors. It may ask a registrant about inconsistencies between (1) the measures identified as key metrics in information disclosed outside the registrant's SEC filings, such as on its Web site and in its press releases, earnings calls, and analyst presentations, and (2) the metrics in the registrant's SEC filings. The SEC staff has noted that it does not require registrants to use non-GAAP measures in their filings. However, the staff may comment if a registrant discusses non-GAAP financial measures in other communications to investors but such discussion is omitted from, or contradicts, the information in the registrant's filings. In addition, if a non-GAAP measure is the focal point in all of a registrant's outside communications but is not included in filed documents, the SEC staff may ask why.[1]

[1] The SEC staff discussed this topic at the 2010 AICPA Conference. See Deloitte's December 16, 2010, *Heads Up* for additional information.

At the 2013 AICPA Conference, the SEC staff noted that it continues to focus on disclosures of non-GAAP measures and particularly on whether registrants have (1) clearly labeled and described non-GAAP measures and adjustments (e.g., titles should not be confusingly similar to those of GAAP financial measures), (2) used appropriate conventional accounting terminology, and (3) provided context for their presentation.

The SEC staff has indicated that a registrant should not present non-GAAP measures if they are misleading — regardless of whether the registrant intends to use them in or outside a filing. Further, the staff has indicated that the following items should not be excluded from non-GAAP financial measures:

- Expenses that are necessary to run the business, such as traditional recurring cash operating expenses.
- The largest expenses that are necessary to generate the registrant's revenues.

The staff has also indicated that registrants should not eliminate recurring cash charges from a profit measure in a misleading way. When the staff believes that a registrant's presentation of a non-GAAP measure is misleading, it may take action in addition to issuing a comment, which could include bringing an enforcement action against the registrant.

See the Materiality and Real Estate sections for additional information about non-GAAP financial measures.

Nonrecurring, Infrequent, and Unusual Items

Example of an SEC Comment

We note your reconciliation of adjusted net earnings from continuing operations contains an adjustment for acquisition amortization . . . . Further, we note that you are providing this non-GAAP measure because it helps your investors understand the effect of nonrecurring items on your reported results. Explain to us why the acquisition adjustment item should not be considered a recurring item. In this regard, we note this adjustment was made for the past three fiscal years in your reconciliation. . . . Please revise your disclosure so that you do not indicate that these items are nonrecurring, infrequent or unusual. We refer you to Item 10(e)(1)(ii)(B) of Regulation S-K.

The SEC staff often comments when adjustments to non-GAAP measures are labeled as nonrecurring, infrequent, or unusual. Question 102.03 of the C&DIs related to non-GAAP financial measures clarifies the guidance in Regulation S-K, Item 10(e), which prohibits registrants from adjusting a non-GAAP financial performance measure "to eliminate or smooth items identified as non-recurring, infrequent or unusual, when the nature of the charge or gain is such that it is reasonably likely to recur within two years or there was a similar charge or gain within the prior two years." Specifically, Question 102.03 indicates that a charge or gain may be included as an adjustment as long as it is not inappropriately labeled or described as nonrecurring, infrequent, or unusual.

Undue Prominence of a Non-GAAP Financial Measure

Example of an SEC Comment

Your disclosures include a full non-GAAP income statement, which appears to be provided for the purposes of reconciling non-GAAP measures to the most directly comparable GAAP measures. We believe this may cause undue prominence to the non-GAAP information. Please confirm for us that you will revise your disclosures in future filings such that a full non-GAAP income statement is not included and your reconciliations are disclosed in a different format. We refer you to question 102.10 in the Division of Corporation Finance's Compliance and Disclosure Interpretations at http://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm.

The SEC staff will comment when a registrant presents its non-GAAP financial measures more prominently than its GAAP measures in terms of the order of presentation or the degree of emphasis. A registrant may receive a comment if its discussion of non-GAAP financial measures is significantly longer than its discussion of the corresponding GAAP financial measures, or if it uses a full non-GAAP income statement format instead of applying the guidance in Question 102.10 of the C&DIs related to non-GAAP financial measures. In recent comments, the SEC staff has indicated that as a substitute for presenting a full non-GAAP income statement, registrants may consider presenting only individual non-GAAP measures (e.g., line items) as long as each measure is used in a manner consistent with Item 10(e)(1)(i).

C&DIs Related to Non-GAAP Financial Measures

The SEC's C&DIs related to non-GAAP financial measures give registrants greater flexibility to disclose such metrics in filings with the Commission. The topics covered in the C&DIs include disclosure of non-GAAP financial measures in business combination transactions; interpretive issues related to the non-GAAP liquidity and performance measure prohibitions in Item 10(e) (including issues related to EBIT, EBITDA, and segment performance measures); and compliance issues related to the release of quarterly and annual financial information under Item 2.02 of Form 8-K.

In addition to the C&DIs, SEC resources on non-GAAP measures include Regulation S-K, Item 10(e); Regulation G; and Topic 8 of the FRM.

Other Deloitte Resources

December 16, 2013, *Heads Up*, "Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments."

Disclosure Controls and Procedures

In their quarterly discussions of disclosure controls and procedures (DCP),[1] registrants must use language that conforms to the requirements in Rule 13a-15(e) or Rule 15d-15(e) of the Exchange Act.[2] The SEC staff often comments when registrants do not use the proper definition of DCP or omit certain language in reaching conclusions about the effectiveness of their DCP. In these situations, the staff frequently requires registrants to confirm that their DCP are effective in the current year and to revise their disclosures in future filings.

Inappropriate Conclusion About DCP

Example of an SEC Comment

We note your statement that your disclosure controls and procedures are not effective for a company your size. Please revise to remove the qualifier "for a company our size." Refer to Item 307 of Regulation S-K, which requires a clear and unqualified statement as to whether your disclosure controls and procedures are effective or ineffective.

The SEC staff has noted that management must clearly state, without using any qualifying or alternative language, its conclusion about whether DCP are "effective" or "ineffective" as of the end of the respective quarter. Examples of unacceptable language include phrases such as "adequate," "effective except for," "effective except as disclosed below," or "reasonably effective."

In addition, the SEC staff has also commented when registrants refer to the level of assurance of the design of their DCP. Although registrants are not required to discuss such assurance, the staff has asked registrants that choose to do so to also state clearly whether the DCP are, in fact, effective at the "reasonable assurance" level.

In addition, when registrants have concluded that their DCP are ineffective, the staff has asked them to discuss how they intend to remedy the deficiencies identified.

Incomplete Definition of DCP

Example of an SEC Comment

We note that you disclose a partial definition of disclosure controls and procedures. When you include a definition of disclosure controls and procedures, the entire definition in Exchange Act Rules 13a-15(e) or 15d-15(e) is required. Alternatively, you can simply reference the Rule 13a-15(e) without including the definition. Please revise your disclosure in future annual and quarterly reports accordingly.

Registrants are not required to define DCP in their conclusion. However, if they choose to define the term, they must use the entire definition in Rule 13a-15(e) or Rule 15d-15(e).

Conclusion That DCP Were Effective If a Restatement Is Required, a Material Weakness Exists, or Reports Were Not Filed in a Timely Manner

Example of an SEC Comment

We note your disclosure of a material weakness related to the failure to maintain qualified accounting personnel. Your disclosure describes certain remediation efforts and states that you expect remediation to continue. Given Internal Controls over Financial Reporting ("ICFR") are an integral part of Disclosure Controls and Procedures ("DC&P"), please tell us how you came to the conclusion that your material weakness related to ICFR did not impact your conclusion on the effectiveness of your DC&P or amend to revise your conclusion on the effectiveness of your DC&P.

[1] Under Part I, Item 4 of Form 10-Q and Part II, Item 9A of Form 10-K.

[2] As required by Regulation S-K, Item 307.

Paragraph 4310.9 of the FRM states, "Because of the substantial overlap between ICFR and DCP, if management concludes that ICFR is ineffective, it must also consider the impact of the material weakness on its conclusions related to DCP." If a registrant concludes that its DCP are effective when a material weakness exists, the SEC staff often asks for information on the factors the registrant considered in reaching such a conclusion. In addition, when a registrant is required to file amended periodic reports containing restated financial statements, the SEC staff generally asks the registrant to reconsider its conclusions about the effectiveness of its DCP.

The SEC staff has also asked about management's conclusion that DCP were effective when a registrant did not file periodic reports in a timely manner. A registrant should design DCP to ensure that information it must disclose in its reports filed or submitted under the Exchange Act is recorded, processed, summarized, and reported within the periods specified in the SEC's rules. If the registrant does not report such information within these periods, the staff may request the registrant to supply additional information to support management's conclusion.

A Change in the Conclusion That DCP Were Effective If No Changes to ICFR Were Disclosed

Example of an SEC Comment

In light of the fact that your Form 10-K discloses that management determined that both disclosure controls and procedures and internal controls over financial reporting were not effective due to certain disclosed material weaknesses, please explain to us why you believe that it is appropriate to conclude that disclosure controls and procedures are effective for the quarterly periods subsequent to your most recent year-end. In this regard, we also note from your disclosure in your Form 10-Qs that there have been no changes in internal controls in the applicable quarterly periods. Please advise or revise to change your disclosure in your Form 10-Qs accordingly.

If a registrant concludes that its DCP were effective after a period in which the DCP had been deemed ineffective, the SEC staff may ask the registrant to explain the basis for its conclusion. The SEC staff is especially likely to do so if the registrant has disclosed in the same period that there have been no changes to its ICFR.

Internal Control Over Financial Reporting

In addition to disclosing material changes in ICFR on a quarterly basis,[1] a registrant must annually provide management's report on ICFR and, if applicable, the attestation report of the registrant's registered public accounting firm.[2] These reports are not required in registration statements or Form 11-K.[3] Newly public companies generally do not need to provide management's report on ICFR in the first Form 10-K that they file after their initial public registration statement is declared effective.[4] Further, the JOBS Act amended Section 404(b) of the Sarbanes-Oxley Act by exempting emerging growth companies (EGCs) from the requirement to obtain an attestation report on ICFR for as long as such entities retain their EGC status. See the Emerging Growth Companies section for considerations related to EGCs.

Entities should be mindful of the SEC's interpretive release regarding management's assessment of ICFR, particularly the guidance on the evaluation of control deficiencies. The OCA has stated that internal control reporting is a focus in its reviews and enforcement actions this year, and this focus is evidenced by two recent charges. In the first case, the SEC's Division of Enforcement brought an enforcement action against the CEO and CFO of a computer equipment company alleging internal control violations, including (1) the failure to disclose to their company's auditors significant deficiencies in internal control and (2) falsely representing in their signed certifications under Section 302 of the Sarbanes-Oxley Act that they disclosed all such deficiencies to the auditors. In the second case, an enforcement action was brought against a corporation for FCPA violations, including internal control violations of the Exchange Act, with the chief of the Division of Enforcement's FCPA Unit noting that "[w]hen a company makes the strategic decision to sell its products overseas, it must ensure that the right internal controls are in place and operating."

Evaluation of Severity of Control Deficiencies

Example of an SEC Comment

We note that you have concluded that no significant deficiencies or material weaknesses (arising from either your consolidation policies or revenue recognition policies or a combination of both) existed as of December 31, 2012 and December 31, 2013. Tell us whether you identified the existence of any control deficiencies as of either of those dates in relation to consolidation or revenue recognition that did not rise to the level of a significant deficiency or material weakness. If so, explain what they are and discuss how you assessed their severity. [Emphasis omitted]

When registrants identify numerous control deficiencies but do not report a material weakness, the SEC staff issues comments to understand how they evaluated the severity of the deficiencies in aggregate. The SEC staff has reiterated that the existence of a material weakness does not depend on the actual magnitude of the error in a restatement but instead depends on whether there is a reasonable possibility that a material misstatement could occur and not be detected or prevented by the registrant's ICFR.[5] In the interpretive release discussed above, the SEC stated that management needs to consider "whether each deficiency, individually or in combination, is a material weakness as of the end of the fiscal year . . . even though such deficiencies may be individually less severe than a material weakness"; in addition, the SEC noted an increased likelihood of misstatement when there are "[m]ultiple control deficiencies that affect the same financial statement amount or disclosure." At the 2013 AICPA Conference, Brian Croteau, deputy chief accountant in the OCA, stated that he remains convinced that "at least some of the PCAOB's inspection findings related to the audits of internal control over financial reporting are likely indicators of similar problems with management's evaluations of ICFR, and thus potentially [are] also indicative of risk for unidentified material weaknesses." He also questioned whether all material weaknesses are being properly identified and noted that only in rare instances does management identify a material weakness in the absence of a material misstatement. He attributed this to the following possibilities: (1) "the deficiencies are not being identified in the first instance" or (2) "the severity of deficiencies is not being evaluated appropriately."

1 Under Part I, Item 4, of Form 10-Q and Part II, Item 9A, of Form 10-K.

2 The requirement for an attestation report applies only to large accelerated and accelerated filers because nonaccelerated filers are exempt from this requirement under Section 404(b) of the Sarbanes-Oxley Act.

3 Form 11-K is used to file the annual reports for employee stock purchase, savings, and similar plans.

4 However, paragraph 4310.6 of the FRM states, "A company that historically reported under the Exchange Act as a voluntary filer or because of registered debt, and therefore filed annual reports up to and through the date of its [equity] IPO, in which it was required to comply with . . . Item 308(a) of Regulation S-K, is therefore required to provide management's report on ICFR in its first annual report following the IPO."

5 The SEC staff discussed this issue at the 2010 AICPA Conference. See Deloitte's December 16, 2010, *Heads Up* for more information.

Evaluation of Control Deficiencies Related to Immaterial Misstatements

Example of an SEC Comment

We note that during the second quarter of 2013, you identified an immaterial cumulative error . . . . We also note that you have corrected three separate financial statement item errors during the year ending December 31, 2013 which you have determined as immaterial to your previously reported amounts contained in your interim and annual reports. Please provide to us the following:

a) The amount(s) and a full description of the nature of the error . . . ;

b) [A]n explanation of factors considered by management in determining that the effect of the $[X] or [Y]% reduction to depreciation and depletion expense and [Z]% benefit to pre-tax loss in the second quarter was not material to results of operations for the second quarter of 2013 or to any of the prior periods affected by this error;

c) [Y]our criteria or policy for assessing an error as material. Please provide an explanation of the quantitative and qualitative factors considered by management in its conclusion that all three errors were not material to your financial statements for the year ended December 31, 2013 or any of the prior periods affected by these errors; and

d) [A]n explanation of how you considered the identification and correction of these errors in your evaluation of disclosure controls and procedures and internal controls over financial reporting as of the end of each related period, i.e., December 31, 2011, 2012, and 2013. In addition, tell us if the identification and correction of errors resulted in any changes to your internal controls that have materially affected, or [are] reasonably likely to affect materially, your internal control over financial reporting as of December 31, 2013.

At the 2014 AICPA Banking Conference, the SEC staff indicated that it will question how registrants have considered and evaluated the severity of deficiencies in ICFR related to immaterial misstatements that were corrected by immaterial restatements.[6] The staff reminded registrants that the severity of a deficiency does not depend on whether a misstatement actually has occurred; rather, it depends on whether there is a reasonable possibility that the deficiency could result in a misstatement, and the evaluation of the severity warrants consideration of risk factors including, but not limited to, the potential future consequences of the deficiency. Accordingly, it is possible that an immaterial restatement represents a material weakness in ICFR even though the actual magnitude of the error was not material. The SEC's interpretive release states:

> Management evaluates the severity of a deficiency in ICFR by considering whether there is a reasonable possibility that the company's ICFR will fail to prevent or detect a misstatement of a financial statement amount or disclosure; and the magnitude of the potential misstatement resulting from the deficiency or deficiencies. The severity of a deficiency in ICFR does not depend on whether a misstatement actually has occurred but rather on whether there is a reasonable possibility that the company's ICFR will fail to prevent or detect a misstatement on a timely basis.

Evaluation of Deficiencies Identified in the Other COSO Components

Example of an SEC Comment

In light of the multiple significant deficiencies involving multiple accounts and processes, please explain the extent to which you considered whether deficiencies existed in other components of the Committee of Sponsoring Organizations of the Treadway Commission Internal Control Framework (COSO), such as the control environment, information and communication, risk assessment, and monitoring. To the extent any deficiencies existed in these components, please tell us how you evaluated the severity of these deficiencies along with the existing significant deficiencies and other control deficiencies.

[6] An immaterial restatement is a restatement of previously issued financial statements for the correction of a misstatement that is either of the following:

- Not material to the prior period being changed but would be material to the current period if corrected in the current period.
- Not material to any periods being presented.

The SEC staff has questioned whether deficiencies in control activities may also be indicative of related deficiencies in the control environment, information and communication, risk assessment, and/or monitoring components of ICFR. Specifically, the SEC staff may ask a registrant to provide a detailed analysis on how it concluded that the controls related to each of the other four COSO components were effective.

Disclosure of Material Changes in ICFR

Example of an SEC Comment

Please disclose whether there has been any change in your internal control over financial reporting that occurred during the last fiscal quarter that has materially affected, or is reasonably likely to materially affect, your internal control over financial reporting. Refer to paragraph (c) of Item 308 of Regulation S-K.

The SEC staff has commented when a registrant has not explicitly and clearly asserted whether there has been a change in ICFR in the last fiscal quarter that had or could have a material effect on its ICFR, as required by Regulation S-K, Item 308(c). Registrants should state clearly whether there were changes in ICFR for the quarter and, if so, should disclose the nature of the changes. The staff has stressed that registrants should avoid "boilerplate" disclosure that there have been no material changes affecting ICFR in a period, particularly when identifiable events such as layoffs, changes in outsourcing arrangements, or changes in accounting policies exist.[7]

Consequently, the staff expects to see increased disclosures regarding changes in ICFR, specifically those related to remediation of material weaknesses. For example, the SEC staff has reminded registrants that it is important for management to monitor and consider disclosing a change in ICFR in the quarter in which management remediates a material weakness.[8]

At the 2013 AICPA Conference, the SEC staff stated that in reviewing registrant filings, it looks for indicators of potential ICFR deficiencies. Common indicators include disclosures about changes in ICFR and corrections of errors (discussed below). If indicators are observed, the staff routinely asks registrants about management's consideration of such indicators in relation to its conclusions about the effectiveness of ICFR (i.e., whether a deficiency in internal control represents a material weakness that should have been identified and disclosed). For the quarter in which any material changes in ICFR occur, registrants should provide disclosures about such material changes, including (1) the identification of any material weaknesses and (2) changes made to remediate material weaknesses.

Disclosures About the Impact and Remediation of Material Weaknesses

Example of an SEC Comment

Please address the following in relation to [the error you identified]:

- Provide further information to help us understand how you considered the identification and correction of the error in your evaluation of internal controls over financial reporting (ICFR) as of December 31, 2013 and whether control deficiencies existed due to the error. To the extent that you determined there were control deficiencies due to the error, describe the deficiencies and how you evaluated the severity of each identified.
- In addition, describe the evaluation performed on whether there was a reasonable possibility that your controls would have failed to prevent or detect a material misstatement associated with other related aspects of the consolidation process.
- Last, tell us if the identification and correction resulted in changes to your internal controls and if so, describe those changes and the timing.

[7] This issue was discussed by the staff of the SEC's Division of Corporation Finance in a speech at the Forums on Auditing in the Small Business Environment hosted by the PCAOB in December 2012.

[8] The SEC staff discussed remediation of material weaknesses and related disclosure considerations at the 2010 AICPA Conference. See footnote 5.

The SEC staff has indicated that management's disclosures about material weaknesses are expected to go beyond merely identifying the existence of one or more material weaknesses or providing a limited description. Rather, such disclosures should contain enough information to allow investors to understand the cause of a material weakness and determine the pervasiveness of its effect on ICFR.[9]

Similarly, the staff has called for more transparent disclosures about the pervasiveness of a material weakness's impact on the registrant's financial reporting and its ICFR. The staff has stressed that registrants need to avoid narrowly focusing their disclosures on a particular financial statement line item affected by a material weakness and that they should consider other financial statement line items that may also be affected.[10]

Registrants that have identified a material weakness have been asked to discuss (1) management's plans to remediate the weakness, (2) the estimated timing of management's remediation efforts, and (3) the related material costs.

In addition, in certain instances, the SEC staff has observed that questions about the validity and completeness of management's disclosures regarding material weaknesses have arisen as a result of management's discussion of its remediation plans. Sometimes the remediation plans are broader than the material weakness identified, potentially indicating that the actual material weakness is more pervasive than the material weakness disclosed or that there may be another material weakness that was not identified and disclosed. In providing disclosures about remediation plans, registrants should therefore consider the root cause of a material weakness and whether it highlights a more pervasive material weakness in their ICFR, or deficiencies in other controls.[11]

Further, the SEC staff has recently commented when registrants identified one or more material weaknesses in ICFR but either refrained from concluding on the effectiveness of ICFR or concluded that their ICFR is effective. In such instances, the staff has reminded registrants that Regulation S-K, Item 308(a)(3), prohibits a conclusion that ICFR is effective when one or more material weaknesses exist and has asked registrants to amend their filings to state that their ICFR is not effective as a result of the material weaknesses that were identified.

Conclusion That ICFR Remains Effective After a Restatement

Example of an SEC Comment

We note . . . that you continue to believe your internal controls over financial reporting and disclosure controls and procedures are effective despite this error in your financial statements. Given the significance of the error, we believe you should revise the conclusion in your fiscal 2013 10-K to state that your internal controls over financial reporting and disclosure controls and procedures were not effective. If you have since remediated the weaknesses in controls, you may disclose the remediations in your fiscal 2014 10-K.

Because a restatement is typically indicative of a material weakness in ICFR, the SEC staff may challenge registrants when they conclude that their ICFR (and DCP) are effective after restating their financial statements. As a result, registrants can expect questions from the staff about the effectiveness of their ICFR after a restatement has occurred. In addition, since most elements of ICFR are subsumed within the definition of DCP and it is therefore typically difficult for a registrant to conclude that its DCP are effective when its ICFR is ineffective, the SEC staff may ask registrants after a restatement has occurred to explain why they concluded that their DCP are effective. At the 2013 AICPA Conference, Mr. Croteau discussed a registrant's responsibility to maintain effective DCP and directed registrants' management to (1) review an SEC enforcement order that addresses a registrant's failure to maintain effective controls and (2) consider whether its own DCP and ICFR processes and procedures could be improved in light of the issues raised in that order. He also indicated that the adequacy of such controls and management's evaluations and conclusions about them are likely to be a focus of future Enforcement Division investigations.

9 For additional information, see Deloitte's December 18, 2008, *Heads Up* on the 2008 AICPA Conference. Also, see Deloitte's December 16, 2010, *Heads Up* on the 2010 AICPA Conference.

10 This issue was discussed at the December 2012 Forums on Auditing in the Small Business Environment. See footnote 7.

11 This issue was discussed at the 2008 AICPA Conference. See footnote 9.

Registrants should consider paragraphs 4310.16 and 4310.17 of the FRM regarding the restatement of financial statements:

> There is no requirement for a company to reevaluate the effectiveness of its internal controls and/or reissue a revised management's report on ICFR when a company restates its financial statements to correct errors . . . . However, a company may need to consider whether or not its original disclosures in management's report continue to be appropriate in light of these errors, and should modify or supplement its original disclosure to include any other material information that is necessary for such disclosures not to be misleading in light of the restatement. . . . If a company's management concludes that its original assessment of ICFR was incorrect, it should consider whether or not to revise its original report on ICFR.

Domestic Companies With a Majority of Operations Outside the United States

Example of an SEC Comment

We note that you conduct substantially all of your operations outside of the United States. In order to enhance our understanding of how you prepare your financial statements and assess your internal control over financial reporting, we ask that you provide us with information that will help us understand more about the background of the people who are primarily responsible for preparing and supervising the preparation of your financial statements and evaluating the effectiveness of your internal control over financial reporting and their knowledge of U.S. GAAP and SEC rules and regulations. Do not identify people by name, but for each person, please tell us:

- What role he or she takes in preparing your financial statements and evaluating the effectiveness of your internal control;
- What relevant education and ongoing training he or she has had relating to U.S. GAAP;
- The nature of his or her contractual or other relationship to you;
- Whether he or she holds and maintains any professional designations such as Certified Public Accountant (U.S.) or Certified Management Accountant; and
- About his or her professional experience, including experience in preparing and/or auditing financial statements prepared in accordance with U.S. GAAP and evaluating effectiveness of internal control over financial reporting.

The SEC staff is interested in understanding the credentials of the individuals preparing U.S. GAAP financial statements for domestic registrants with a substantial amount of their operations in foreign countries and has continued to focus on registrants' assertions that the internal controls of a foreign operation are effective. In evaluating assertions of U.S. GAAP expertise, the SEC staff attempts to ensure that management of the foreign operation has the appropriate knowledge and capability to prepare financial statements in accordance with U.S. GAAP, which may be demonstrated through:

- Education and ongoing training in U.S. GAAP.
- Professional qualifications such as a U.S. CPA license.
- Professional experience either as an auditor or a preparer of U.S. GAAP financial statements.

The SEC staff has mentioned that viewing the Internet and attending one-off conferences would not qualify as persuasive evidence of appropriate U.S. GAAP expertise. The staff has noted that its ultimate goal is to reduce material weaknesses by ensuring that registrants possess sufficient expertise and capabilities.[12] In addition, the staff has observed that it may ask registrants about their relationship with an outside consultant and about the consultant's qualifications if there is any doubt about the consultant's U.S. GAAP expertise.[13]

[12] This issue was discussed at the 2011 AICPA Conference. For additional information, see Deloitte's December 14, 2011, *Heads Up*.

[13] This issue was discussed at the December 2012 Forums on Auditing in the Small Business Environment. See footnote 7.

In addition, the SEC staff has reminded registrants that when a majority of their subsidiaries' operations are outside the United States, management should assess the U.S. GAAP competence and knowledge of those preparing U.S. financial information overseas for ICFR implications.[14]

Disclosure of the Framework Used to Evaluate ICFR

Example of an SEC Comment

Please revise future filings to clarify which version, 1992 or 2013, of the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control — Integrated Framework* you utilized when performing your assessment of internal control over financial reporting.

The COSO framework is one of the most widely applied frameworks used by registrants in evaluating the effectiveness of their ICFR. On May 14, 2013, COSO released an updated version of its *Internal Control — Integrated Framework* to reflect the significant changes in business and operational environments that have occurred since the original framework was introduced in 1992. Although the components of internal control under the framework remain unchanged, the update introduces 17 new principles that explicitly articulate and describe the components of internal control. At the 2013 AICPA Conference, the SEC staff stated that registrants must disclose the internal control framework they applied in assessing the effectiveness of their ICFR. Because the COSO framework was updated in 2013 and provides for a transition period before the original framework is superseded, registrants should disclose whether they applied the 2013 framework or the original framework.

The SEC staff often comments when registrants do not disclose the framework used to evaluate the effectiveness of ICFR. The staff has cited specific examples in which management did not identify the framework used, as well as instances in which management inappropriately referred to SEC guidance or COSO's small-company guidance as the framework used for the evaluation.[15] As a result, a registrant may be asked to advise the SEC staff of the framework used in the current year and to revise the disclosures in current and future filings. While COSO has indicated that it will consider the 1992 framework superseded by December 15, 2014, the SEC has not issued a formal statement concerning the transition and implementation of the revised framework for purposes of Section 404 of the Sarbanes-Oxley Act. However, the staff has stated that it will monitor the transition of issuers to the revised framework and evaluate the need for further actions by the SEC in the future. Registrants are encouraged to closely monitor this issue and any further statements by the SEC in planning any potential transition to the revised framework.[16]

The SEC staff has also noted that "the longer issuers continue to use the 1992 framework, the more likely they are to receive questions from the staff about whether the issuer's use of the 1992 framework satisfies the SEC's requirement to use a suitable, recognized framework."[17]

[14] This issue was discussed at the 2010 AICPA Conference. See footnote 5.

[15] The SEC staff discussed this issue in a speech at the 2008 AICPA Conference. See footnote 9.

[16] For additional information, see Deloitte's June 10, 2013, *Heads Up* on the revised COSO framework.

[17] For additional information, see the highlights of the September 2013 CAQ SEC Regulations Committee joint meeting with the SEC staff.

Disclosure of the Date of an ICFR Evaluation

Example of an SEC Comment

Please note that pursuant to Item 308(a)(3) of Regulation S-K, management's conclusion on its assessment of the effectiveness of internal control over financial reporting is required as of the end of the most recent fiscal year. [P]lease revise the disclosure to state, if true, that as of March 31, 2013, management concluded that your internal control over financing reporting was not effective. [Emphasis omitted]

Regulation S-K, Item 308(a)(3), requires registrants to assess and conclude on the effectiveness of their ICFR as of the end of their most recent fiscal year. In several instances, the SEC staff has issued comments to registrants when they have either failed to indicate a date for their ICFR evaluation or included a date other than the end of their most recent fiscal year in their filing. Registrants should ensure that the appropriate date of their ICFR evaluation is prominently displayed in any filing with the SEC.

Other Deloitte Resources

- September 5, 2014, *Heads Up*, "Challenges and Leading Practices Related to Implementing COSO's *Internal Control — Integrated Framework*."
- December 16, 2013, *Heads Up*, "Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments."

Executive Compensation and Other Proxy Disclosures

Proxy disclosure, particularly executive compensation, continues to be a topic of SEC staff focus. Many of the staff's comments are related to disclosures about (1) how performance is assessed, including the use of performance targets and benchmarking; (2) CD&A, including compensation table disclosures; and (3) related-party transactions.

Determining Compensation — Assessment of Performance

Performance Targets

Examples of SEC Comments

- Please revise this section to provide a more detailed explanation and analysis of specific factors that are considered in setting compensation for each of the named executive officers. For example, disclose the specific financial, operational and strategic objectives, in addition to personal achievement targets and/or goals established for each of the named executive officers. In that regard, we note you state . . . that the compensation committee reviews and approves corporate goals and objectives. Similarly, for each named executive officer, discuss the aspects of his individual performance, prior experience and level of responsibility that factored into the total compensation he received during the last year. See Item 402(b)(2) of Regulation S-K.
- Based on your disclosure, it is unclear how the compensation committee used the pre-established performance goals and evaluated individual performance to determine the actual amount that was paid to the NEOs in 2013. Please supplementally explain how each of the annual incentive bonuses for fiscal 2013 [was] determined for each named executive officer and include similar disclosure in future filings. Please also clearly state if the compensation committee established any individual performance goals for the NEOs.

The SEC staff frequently asks registrants that use performance targets to disclose them and provide information about their use.[1] Under Regulation S-K, Item 402(b), a registrant is required to discuss any compensation awarded to NEOs in its CD&A. The discussion should include the objectives of the compensation program, what the compensation program is designed to reward, the elements of the compensation, the registrant's reasons for paying each element, how each element is calculated (including any formula used), and how the program fits into the registrant's objectives. The SEC staff frequently comments on how certain performance factors affect compensation arrangements for NEOs as well as how nonequity incentive compensation granted to NEOs is calculated. Item 402(b) also requires discussion of whether and, if so, how the results of shareholder advisory votes on executive compensation may affect the registrant's decisions and policies related to executive compensation.

To help financial statement users understand the registrant's compensation policies and decisions, the SEC staff has asked registrants to:

- Quantify and disclose the performance target and explain the purpose of performance factors.
- Disclose actual performance results and detail the specific elements of individual performance and contributions that affected the compensation received.
- Discuss the correlation between achievement of performance targets and the compensation ultimately awarded.
- Indicate whether the compensation committee or others had discretion or additional qualitative input when determining the final amount of compensation awarded, and the factors that affected the determination.

[1] Registrants may exclude performance targets (and other confidential information) if disclosing such material would result in competitive harm. However, registrants must satisfy "confidential-treatment" criteria and demonstrate to the SEC staff, upon request, that they have done so. Even when omission of targets or other factors or criteria is appropriate, a registrant should disclose how difficult it will be for the executive, or how likely it will be for the registrant, to achieve the undisclosed target levels or other criteria.

Benchmarking

Example of an SEC Comment

It appears that total compensation levels for named executive officers were benchmarked at the [X] percentile of the benchmark compensation levels. However, your disclosure stating that "industry compensation survey data" represented [X]%, [Y]% and [Z]% of benchmark total compensation for certain officers is unclear. Please revise to clarify this statement.

A registrant may use benchmarks for total compensation or a material element of compensation (e.g., the registrant compared its executive compensation to that of a peer group in the same industry or used compensation surveys to determine compensation levels). When it does, the registrant must identify (1) the benchmark for each NEO and (2) the components of compensation used and the entities that constitute the benchmark group.[2]

If benchmarks are used, the SEC staff may request that registrants disclose:

- All elements of compensation that are subject to benchmarking.
- The impact of the benchmarking on compensation decisions.
- Additional details about how they used the comparison information, including whether they had discretion regarding when and how to use it as well as the nature and extent of such discretion.
- Where payments fell with respect to the benchmark for each NEO.
- The degree to which their compensation committees consider entities in the benchmark group to be comparable to the registrants themselves.

The staff has also asked for explanations when actual compensation fell outside the targeted range.

Compensation Discussion and Analysis

The SEC staff continues to focus on CD&A, particularly the summary compensation table, because it gives investors important information about a registrant's compensation polices and decisions.

Examples of SEC Comments

- [W]e note that your "NEOs are compensated through a combination of equity grants, carried interest and incentive fees . . . " and that Messrs. [X] and [Y] received incentive fees in fiscal 2013. Please explain why these compensation awards are not included in the compensation table.
- We note that you have disclosed in the "Bonus" column rather than the "Non-Equity Incentive Plan Compensation" column amounts earned pursuant to your annual bonus program . . . . Please advise regarding your basis for disclosing these amounts in the "Bonus" column. For guidance, refer to Question 119.02 of the Regulation S-K Compliance and Disclosure Interpretations.

The SEC staff often asks about inconsistencies between the amounts disclosed in the financial statements and the amounts disclosed in the summary compensation table. Regulation S-K, Item 402(c), requires that for each NEO, registrants include tabular disclosures specifying the NEO's name and principal position, the fiscal year covered, the base salary earned, the bonus earned, the stock/option awards, nonequity incentive plan compensation, the change in pension value and nonqualified deferred compensation earnings, all other compensation, and the total amount of compensation. Both the cash portion and the noncash portion of salary and bonus must be disclosed.

[2] See Regulation S-K, Item 402(b)(2)(xiv), for additional information.

Accordingly, the SEC staff often comments when registrants disclose amounts in incorrect columns of, or exclude types of compensation from, the table. For example, the SEC staff often asks why bonuses paid to NEOs (on the basis of achieved performance targets) are disclosed in the bonus column instead of in the nonequity incentive plan compensation column.

In addition, for stock awards included in CD&A, the SEC staff often asks for the aggregate grant-date fair value of the awards as computed in accordance with ASC 718 and for disclosure of all assumptions used in valuing share-based compensation, which the registrant can accomplish by including a reference to its footnotes to the financial statements or to the critical accounting policies section of its MD&A. Regulation S-K, Item 402(k)(2)(iii), also requires disclosure of the aggregate grant-date fair value and aggregate number of stock awards as of fiscal year-end for each director.

Related-Party Transactions

Regulation S-K, Item 404(a), requires disclosure of transactions that the registrant participated in, or will participate in, with related parties in which the "amount involved exceeds $120,000, and [the related party] had or will have a direct or indirect material interest." ASC 850 does not establish a quantitative threshold but requires disclosure in the financial statements when the information "would make a difference in decision making." In addition, Regulation S-X, Rule 4-08(k), requires registrants to disclose related-party transactions that affect the financial statements and, when material, to separately present amounts on the face of the balance sheet, income statement, or statement of cash flows. Types of related-party transactions that the SEC staff often comments about include sales and loans involving related parties.

As part of identifying related-party transactions, registrants should consider consulting with legal counsel and reviewing the instructions to Item 404(a) to better understand the definition of a "related person" and the types of transactions they need to disclose.

Policies and Procedures

> **Example of an SEC Comment**
>
> Please discuss your policies and procedures for the approval of related party transactions, as required by Item 404(b) of Regulation S-K, in future filings.

The SEC staff may request that the registrant provide a complete discussion of the policies and procedures related to the review, approval, or ratification of transactions with related persons, as required by Regulation S-K, Item 404(b). Registrants often disclose the existence, or a general summary, of such policies and procedures but exclude material features such as the types of transactions covered by the policies and procedures, the standards to be applied to the transactions, and the persons or group of persons responsible for applying the policies and procedures.

Transactions Involving Indebtedness

Example of an SEC Comment

For all transactions involving indebtedness, please revise to disclose the amount of principal paid during the periods for which disclosure is provided. Refer to Item 404(a)(5) of Regulation S-K.

The SEC staff also often asks registrants to improve their disclosures about related-party transactions involving indebtedness. Item 404(a) indicates that registrants should disclose the major terms of related-party indebtedness (e.g., the amounts involved, the largest principal amount outstanding during the period and as of the latest practicable date, the principal and interest payments during the period, the interest rate, and the interest-payable amount).

Other Deloitte Resources

- December 2013, Center for Corporate Governance, *Hot Topics: The 2014 Boardroom Agenda*.
- October 2013, Center for Corporate Governance, *Hot Topics: CEO Pay Ratio Disclosure: What Would It Take to Implement the SEC Proposal?*

Emerging Growth Companies

An emerging growth company (EGC) is a new type of issuer created by the JOBS Act to encourage public offerings by small and developing companies. The regulatory and reporting requirements for EGCs are less stringent than they are for other types of issuers and include the following:

- Only two years of audited financial statements are required in an IPO for common equity.
- The periods required for selected financial data in both registration statements and periodic filings do not extend to periods before the first year presented in the EGC's equity IPO.
- EGCs may elect to defer the adoption of new accounting standards until they become effective for private companies (i.e., nonissuers).
- EGCs are exempt from the requirement to obtain an attestation report on ICFR from their auditor.

In addition, an EGC may submit registration statements to the SEC for confidential reviews. Under the JOBS Act, an EGC would be required to make publicly available (at least 21 days before its "road show") any documents that were submitted to the SEC staff for confidential review. Accordingly, the SEC staff's comment letters to the EGC (and the EGC's responses) must be filed on EDGAR.

The staff in the SEC's Division of Corporation Finance has issued FAQs on numerous aspects of the JOBS Act, many of which are related to qualifying for EGC status and the filing requirements for EGCs. In addition, the SEC staff has incorporated EGC-related guidance in section 10000 of the FRM.

In its comment letters to EGCs, the SEC staff primarily has asked companies to disclose (1) that they qualify for EGC status, (2) how and when they may lose their EGC status, and (3) the elections they made under Title I of the JOBS Act.

EGC Status and Elections

Example of an SEC Comment

Since you appear to qualify as an "emerging growth company," as defined in the Jumpstart Our Business Startups Act, please:

- Disclose that you are an emerging growth company;
- Describe how and when a company may lose emerging growth company status;
- Briefly describe the various exemptions that are available to you, such as exemptions from Section 404(b) of the Sarbanes-Oxley Act of 2002 . . . ; and
- State your election under Section 107(b) of the JOBS Act:
  - If you have elected to opt out of the extended transition period for complying with new or revised accounting standards pursuant to Section 107(b), include a statement that the election is irrevocable; or
  - If you have elected to use the extended transition period for complying with new or revised accounting standards under Section 102(b)(1), provide a risk factor explaining that this election allows you to delay the adoption of [those standards until they] apply to private companies. Please state in your risk factor [and in your critical accounting policy disclosures] that, as a result of this election, your financial statements may not be comparable to companies that comply with public company effective dates.

Filing Status

A company can maintain EGC status for up to a maximum of five years after an equity IPO as long as certain conditions apply.[1] The SEC staff has asked EGC filers to disclose information about their filing status, including how and when the company may lose EGC status.

Extended Transition Period to Adopt New or Revised Accounting Standards

EGCs are allowed to adopt new or revised financial accounting standards on the basis of effective dates applicable to private companies (i.e., nonissuers) for ASUs issued after April 5, 2012 (i.e., the date of the enactment of the JOBS Act). Consequently, the SEC staff has asked EGC filers to indicate the basis on which they are adopting accounting standards. Further, the SEC has asked EGCs that elect to adopt accounting standards on the basis of adoption and transition dates that apply to private companies to disclose as a risk factor that their financial statements may not be comparable with those of registrants that elect (or are required) to adopt accounting standards on the basis of adoption and transition dates that apply to public companies. The SEC staff has also asked registrants to include similar disclosures in their critical accounting policy section of MD&A.

Section 404(b) Exemption

The JOBS Act amends Section 404(b) of the Sarbanes-Oxley Act by exempting EGCs from the requirement to obtain an attestation report on the company's ICFR from its registered public accounting firm. The staff has required registrants to disclose that they are exempt from obtaining an audit of their ICFR (for as long as they maintain EGC status).[2]

Other Considerations

Scope

Because a main objective of the JOBS Act is to promote smaller companies' access to capital markets, some of the JOBS Act's accommodations for EGCs resemble reporting requirements for smaller reporting companies (e.g., annual financial statement requirements in an IPO registration statement under Regulation S-X, Article 8). However, the rules are not the same, and the SEC staff has asked EGC filers to clarify descriptions of their filing status.

Reduced Financial and Proxy Reporting Requirements

Example of an SEC Comment

Briefly describe . . . exemptions [from the requirements related to obtaining shareholder approval of executive compensation under] Section 14A(a) and (b) of the Securities Exchange Act of 1934.

An EGC is required to present only two years of audited financial statements in its equity IPO registration statement. Further, the periods for which an EGC presents select financial data in its registration statements and periodic filings may be limited to the earliest year presented in its equity IPO registration statement. In addition, certain JOBS Act provisions for scaled disclosures may interact with other SEC rules (e.g., other entities' financial statements may be required under Regulation S-X, Rules 3-05 and 3-09). EGCs should therefore consider the SEC staff's FAQs on the JOBS Act to assess whether reduced reporting requirements apply in these situations. For additional information on Rules 3-05 and 3-09, see the SEC Reporting section.

1 For example, the EGC's total gross revenues do not exceed $1 billion during the five-year period; the EGC's market capitalization does not exceed $700 million (i.e., the EGC does not meet the definition of a large accelerated filer); and the EGC does not issue more than $1 billion in nonconvertible debt in a three-year period (which is not limited to calendar or fiscal years and is a rolling three-year period from the date of the EGC's last debt issuance).

2 EGCs are also exempt from any future PCAOB rules that may require (1) auditor rotation or (2) expansion of the auditor's report to include an auditor's discussion and analysis of the company under audit.

Under the JOBS Act, EGCs can comply with the SEC's proxy requirements regarding executive compensation by providing the same reduced disclosures that are required of smaller reporting companies. In addition, the JOBS Act exempts EGCs from certain proxy provisions of the Dodd-Frank Act.

Requests for Written Communications

Example of an SEC Comment

Please supplementally provide us with copies of all written communications, as defined in Rule 405 under the Securities Act, that you, or anyone authorized to do so on your behalf, present to potential investors in reliance on Section 5(d) of the Securities Act, whether or not they retain copies of the communications. Similarly, please supplementally provide us with any research reports about you that are published or distributed in reliance upon Section 2(a)(3) of the Securities Act added by Section 105(a) of the Jumpstart Our Business Startups Act by any broker or dealer that is participating or will participate in your offering.

The JOBS Act significantly changed the rules governing communication between EGCs and certain potential investors. Under the JOBS Act, an EGC, or any person authorized to act on behalf of an EGC, may engage in oral or written communications with potential investors that are qualified institutional buyers or institutional accredited investors to "test the waters" before the EGC files its registration statement. Consequently, the SEC staff has requested copies of such communications.

Other Deloitte Resources

April 15, 2014, *Heads Up*, "Two Years After the JOBS Act."

Other SEC Reporting Matters

Certifications

Example of an SEC Comment

We note that your officer certification is not in the exact form as set forth in Item 601(b)(31)(i) of Regulation S-K. Your certifications include inappropriate modifications, such as the following:

- [O]mitting reference to establishing and maintaining internal controls over financial reporting in paragraph 4 introductory language; and
- [O]mitting [subparagraph 4(b)] related to the design of internal controls over financial reporting;

Please file an amended Form 10-K [and similarly file an amended Form 10-Q] to provide officer certifications consistent with the language that is set forth exactly as provided for by Item 601(b)(31).

Registrants must provide quarterly and annual certifications in the form specified by Regulation S-K, Item 601(b)(31). When these certifications contain errors, registrants are often asked to file an amendment to an entire periodic filing in addition to submitting a corrected certification. Interpretation 246.14 of the C&DIs of Regulation S-K states:

> The following errors in a certification required by Item 601(b)(31) are examples of errors that will require the company to file a corrected certification that is accompanied by the entire periodic report: (1) the company identifies the wrong periodic report in paragraph 1 of the certification; (2) the certification omits a conformed signature above the signature line at the end of the certification; (3) the certification fails to include a date; and (4) the individuals who sign the certification are neither the company's principal executive officer nor the principal financial officer, or persons performing equivalent functions.

The SEC staff often comments when registrants' certifications, including punctuation marks and parenthetical phrases, do not appear exactly as specified in Regulation S-K, Item 601(b)(31). The staff routinely notes that inclusion of a registrant's certifying officer's title constitutes an inappropriate modification. In addition, the staff regularly comments on certifications that are dated incorrectly.

Registrants must include certifications when they are filing amendments to periodic reports. See Question 161.01 of the C&DIs of Exchange Act Rules for guidance on what paragraphs can be excluded in amendments to periodic reports.

Use of Experts and Consents

> **Examples of SEC Comments**
>
> - It appears that you attribute information to third parties in the registration statement. If any of these reports or publications were commissioned by you for use in connection with the registration statement, please file consents of such third parties pursuant to Rule 436 of the Securities Act as exhibits to your registration statement.
> - Please file an updated consent from your independent registered public accounting firm.

In their registration statements under the Securities Act and periodic reports under the Exchange Act (e.g., Forms 10-K and 10-Q), registrants sometimes refer to an "independent valuation firm" or other third party. The SEC staff has asked such registrants whether management or the board relied on a third-party expert and will sometimes infer reliance on a third-party expert even when the registrants do not refer to one. Examples of third-party experts that registrants commonly consider or rely on include the following:

- Valuation firms, about:
  - The valuation of a registrant's common and preferred stock in an IPO.
  - The fair value determination of goodwill and assets acquired and liabilities assumed in a business combination.
  - The determination of goodwill impairment.
  - The determination of asbestos liability.
- An independent actuary, about the estimation of workers' compensation liability.
- Petroleum engineers, about the evaluation of oil and gas reserves. See the Oil and Gas section.
- Pricing services or brokers that provide information used to determine the fair values of financial assets or liabilities. See the Fair Value section for additional considerations.

The SEC staff has stated that in registration statements or periodic reports, registrants generally are not required to refer to an independent valuation firm or other expert. If a registrant does not refer to the expert in its filing, the registrant is not required to name the expert or obtain the expert's consent; however, certain SEC requirements may compel the registrant to include or summarize an expert's report or opinion in its filing and could trigger a consent requirement. Registrants that refer to experts in their filings should consider the implications related to periodic reports and registration statements.

Periodic Reports (Securities Exchange Act)

Consents are not required for Form 10-K or 10-Q. However, the guidance below on registration statements should be applied if the registrant (1) refers to an independent valuation firm or other expert in periodic reports and attributes statements in the report to the expert and (2) incorporates that periodic report by reference into a registration statement.

Registration Statements (Securities Act)

Historically, if a registrant has referred to third-party experts in a registration statement, the SEC staff has asked the registrant to provide the experts' consents, including those from their independent registered public accounting firm. However, on the basis of informal discussions with the SEC staff and C&DIs issued by the staff, it appears that the key to assessing whether consent will be required is determining the degree to which management takes responsibility for statements related to work performed by a third-party expert that are included in or incorporated into the registration statement.

That is, if the registrant essentially "outsourced" the services to the third-party expert and management takes no responsibility for the ultimate statements or conclusion noted in the registration statement, management must obtain the consent of the third-party provider to be named an expert under the Securities Act. The SEC staff indicated that it would evaluate the totality of the disclosure provided when determining whether management is taking responsibility for the conclusion.[1]

Scope

The SEC staff has also commented on the use of "limiting" language in consents provided by third-party experts or in their reports. The staff has emphasized that an expert's consent should not contain any language that limits the use of the consent to the registrant or suggests that there is a limit on potential investor reliance.

Material Contracts

Example of an SEC Comment

We note that although you have filed as an exhibit your [X] Agreement with [Company Y], you have not filed your distribution agreement with that company. Please provide your analysis as to why filing of the distribution agreement is not required or file the agreement as an exhibit. Refer to Item 601(b)(10)(ii)(A) of Regulation S-K.

Regulation S-K, Item 601, requires registrants to file certain material contracts as exhibits if, during the reporting period, such contracts (1) become effective or (2) are executed, amended, or modified.

Recent comment letters have instructed registrants to do either of the following:

- File the material agreements in their entirety, including schedules and related exhibits, as exhibits to Form 10-K or 10-Q or separately on Form 8-K in accordance with Regulation S-K, Item 601.
- Explain why they have not filed the agreements.

The SEC staff also comments when registrants omit certain material agreements. Item 601(b)(10) requires a registrant to file:

- Every material contract that is "not made in the ordinary course of business."
- Any material contract "made in the ordinary course of business":
  - With certain parties, such as directors, officers, promoters, voting trustees, certain security holders, or underwriters, other than contracts involving only the purchase or sale of current assets at a price that equals a determinable market price.
  - On which the registrant's business substantially depends.
  - For the acquisition or disposition of any property, plant, or equipment for consideration exceeding 15 percent of the registrant's total consolidated fixed assets.
  - For a lease under which part of the property is held by the registrant.
- Generally, any management contract or compensatory plan, contract, or arrangement in which a director or NEO of the registrant participates (such contracts are considered material) and any other material management contract or any other compensatory plan, contract, or arrangement in which any other executive officer of the registrant participates.[2]

1 Registrants may look to Question 233.02 of the C&DIs of the Securities Act Rules that were issued by the SEC staff in November 2008 but should be aware that other consent-related C&DIs of the Securities Act Rules may apply to their specific circumstances and that they should therefore review such C&DIs periodically.

2 For examples of management contracts or compensatory plans, contracts, or arrangements that are exempt from this filing requirement, see Item 601(b)(10)(iii)(C).

- Any other material compensatory plan, contract, or arrangement "adopted without the approval of security holders pursuant to which equity may be awarded" in which any employee of the registrant (i.e., regardless of whether the employee is an executive officer) participates.

The SEC staff has also issued a number of C&DIs related to Regulation S-K, Item 601, to address the various circumstances in which a registrant may be required to file agreements as exhibits. Registrants are encouraged to consult these and, in particular, the C&DIs in Sections 146 and 246.

Backlog Disclosures

Examples of SEC Comments

- Please revise future filings to provide the following additional disclosures regarding your backlog:
  - Discuss how backlog is calculated, including what it includes and excludes;
  - Discuss any changes in the methodology used to determine backlog during each period, if material and applicable;
  - To allow better insight into changes in backlog from period to period, provide a roll-forward of backlog. The roll-forward should include beginning and ending balances, new contracts, cancellations, amounts recognized in revenue, and any other major categories relevant to your business.
- We note your disclosure of unbilled deferred revenue backlog for existing subscription agreements. Please tell us how you considered disclosing the amount of backlog not reasonably expected to be filled within the current fiscal year consistent with the requirements in Item 101(C)(1)(viii) of Regulation S-K.

Regulation S-K, Item 101(c)(1)(viii), requires disclosure of the "dollar amount of backlog orders believed to be firm, as of a recent date and as of a comparable date in the preceding fiscal year, together with an indication of the portion thereof not reasonably expected to be filled within the current fiscal year, and seasonal or other material aspects of the backlog." Because backlog information is a non-GAAP financial measure, the SEC staff has requested expanded disclosures about it, including (1) the methods used (or changes in methods used) to determine backlog and (2) changes in backlog resulting from new contracts, canceled contracts, and contracts recognized in revenue. In addition, the SEC staff has reminded registrants to disclose in accordance with Item 101(c)(1)(viii) the backlog not reasonably expected to be filled within the current fiscal year.

Disclosures Regarding State Sponsors of Terrorism

Examples of SEC Comments

- Cuba, Sudan and Syria are designated by the Department of State as state sponsors of terrorism and are subject to U.S. economic sanctions and export controls. Please describe to us the nature and extent of your past, current, and anticipated contacts with Cuba, Sudan and Syria, whether through subsidiaries, affiliates, partners, customers, joint ventures or other direct or indirect arrangements. Your response should describe any services, products, information or technology you have provided to Cuba, Sudan or Syria, directly or indirectly, and any agreements, commercial arrangements, or other contacts you have had with the governments of those countries or entities controlled by their governments.
- Please discuss the materiality of any contacts with Cuba, Sudan and Syria described in response to the foregoing comment, and whether those contacts constitute a material investment risk for your security holders. You should address materiality in quantitative terms, including the approximate dollar amounts of any associated revenues, assets, and liabilities for the last three fiscal years and the subsequent interim period. Also, address materiality in terms of qualitative factors that a reasonable investor would deem important in making an investment decision, including the potential impact of corporate activities upon a company's reputation and share value. Various state and municipal governments, universities, and other investors have proposed or adopted divestment or similar initiatives regarding investment in companies that do business with U.S.-designated state sponsors of terrorism. Your materiality analysis should address the potential impact of the investor sentiment evidenced by such actions directed toward companies that have operations associated with Cuba, Sudan and Syria.

The U.S. Department of State has designated four countries as state sponsors of terrorism — Cuba, Iran, Sudan, and Syria. These countries are subject to U.S. economic sanctions and export controls. Registrants that do business in these countries are required to disclose material operations conducted in them and any agreements, commercial arrangements, or other contracts with the countries' respective governments or with entities controlled by such governments.[1] The SEC staff regularly comments on this subject and believes that such disclosures are important to investors in making investment decisions. The staff has asked registrants to disclose the nature and extent of these contracts (past, present, and probable) — as well as to provide a detailed analysis of the materiality of contacts with these countries — on the basis of both quantitative and qualitative factors. See the Materiality section for additional information about materiality considerations. In addition to providing quantitative disclosures of revenues, assets, and liabilities associated with these countries, registrants are encouraged to disclose any related qualitative factors that may have a significant impact on their activities.[2]

[1] In 2007, the SEC issued a concept release that requested input on certain matters related to sponsors of state terrorism. The concept release indicates that the "federal securities laws do not impose a specific disclosure requirement that addresses business activities in or with a country based upon its designation as a State Sponsor of Terrorism." However, as with other requirements to disclose material information, the "federal securities laws do require disclosure of business activities in or with a State Sponsor of Terrorism if this constitutes material information that is necessary to make a company's statements, in the light of the circumstances under which they are made, not misleading." [Footnote omitted]

[2] Further, the Iran Threat Reduction and Syria Human Rights Act of 2012 requires registrants to include certain disclosures related to sanctionable activities in all quarterly and annual reports. For implementation guidance, see Questions 147.01 through 147.07 of the C&DIs of Exchange Act Sections.

Interactive Data — eXtensible Business Reporting Language (XBRL)

SEC Staff's Review and Observations

Examples of SEC Comments

- The staff notes that you have not submitted electronically and posted on your corporate Web site every Interactive Data File required to be submitted and posted during the preceding 12 months. Please file this information pursuant to Rule 405 of Regulation S-T.
- The XBRL Document and Entity Identification Information rendered as part of your filing appears to contain a number of data element errors, including but not limited to, your classification as a non-accelerated filer. Please revise to comply with the requirements of Section 405 of Regulation S-T and the EDGAR Filer Manual.

The SEC staff continues to monitor registrants' interactive data file (i.e., XBRL) submissions for completeness and compliance with the provisions of Regulation S-T, Rule 405. The staff often asks whether the registrant has (1) submitted its interactive data files as an exhibit to Form 10-K and Form 10-Q in accordance with Regulation S-K, Item 601(b)(101), (2) checked the appropriate box on the cover page of its Form 10-K or 10-Q to indicate that all required interactive data files have been submitted, and (3) posted its interactive data files on its Web site. When a registrant has omitted a required interactive data file exhibit, the staff may ask why and request an amended filing that includes the missing information.

The SEC staff also considers the quality of interactive data filings and has commented broadly on the problems encountered in that regard. For example, the staff has indicated that it continues to see basic errors in interactive data submissions and has directed registrants to its observations on the SEC's Web site for additional details. Specifically, the staff has reminded registrants to (1) use negative values properly, (2) ensure the completeness of tagging, and (3) use custom tags only when appropriate.

In its July 2014 report *Staff Observations of Custom Tag Rates*, the SEC staff noted that although it has seen a steady decline in custom tag use by larger filers, it has not observed a similar decline in usage by smaller filers.[1] Further analysis revealed that this trend may be partially attributable to smaller filers' use of certain third-party providers. The staff expressed its intention to continue monitoring registrants' use of custom tags and indicated that it may issue further guidance or take additional action in the future.

Requirement to Include Calculation Relationships

Sections 6.14 and 6.15 of the EDGAR Filer Manual provide guidance on complying with the requirement to include calculation relationships in an interactive data file. In addition, the SEC staff's "Dear CFO" letter,[2] which was posted to the SEC's Web site in July 2014 and has been sent to a number of public companies, reminds registrants that the XBRL rules require them to "include calculation relationships for certain contributing line item elements for [the] financial statements and related footnotes." The letter advises registrants to "take the necessary steps to ensure that [they] are including all required calculation relationships" in their XBRL files.

Interactive Data Requirements in Other Filings

Example of an SEC Comment

We note that you have not included XBRL tagged financials as exhibits to your registration statement. Rather, you make reference to the XBRL information in your annual report on Form 10-K for the fiscal year ended December 31, 2013. Please include electronically tagged Interactive Data Files with your next amendment.

[1] The staff used the term "smaller filers" to refer to U.S. GAAP filers that are not large accelerated filers.

[2] *Sample Letter Sent to Public Companies Regarding XBRL Requirement to Include Calculation Relationships.*

Under Regulation S-T and Regulation S-K, Item 601(b)(101)(i), registrants must submit an interactive data file as an exhibit to a registration statement if the statement contains (1) financial statements and (2) a price or price range. For purposes of Item 601(b)(101)(i), the disclosure of the "offering price" of a shelf offering, an at-the-market offering, an exchange offer, or a secondary offering in a filed registration statement is construed as a price or price range.

In addition, Item 601(b)(101)(i) highlights that an interactive data file would be required for a Form 8-K filing "when the Form 8-K contains audited annual financial statements that are a revised version of financial statements that previously were filed with the [SEC] that have been revised pursuant to applicable accounting standards to reflect the effects of certain subsequent events, including a discontinued operation, a change in reportable segments or a change in accounting principle."

Other Deloitte Resources

- July 8, 2014, *Deloitte Accounting Journal*, "SEC Issues Communications to XBRL Filers."
- December 16, 2013, *Heads Up*, "Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments."
- September 19, 2013, *Heads Up*, "XBRL — Past, Present, and Future."

Disclosure Topics in Initial Public Offerings

Initial Public Offerings

An IPO is most commonly thought of as the initial sale of equity securities to the public by a private company that registers its securities on Form S-1. However, there are other situations in which a company can register debt or equity securities with the SEC for the first time, such as by exchanging debt securities previously issued in a private transaction for registered debt securities (typically on a Form S-4), registering currently outstanding equity securities, or distributing shares in a spin-off transaction by a public company (typically on a Form 10). All such transactions are referred to as IPOs in this discussion. As a result of the JOBS Act, which was signed into law on April 5, 2012, certain companies that meet the requirements for emerging growth company (EGC) status are eligible to raise capital and register as new issuers by complying with less stringent regulatory and reporting requirements than those required for a typical IPO. See the Emerging Growth Companies section for additional information on such requirements.

Because an IPO typically represents a company's first filing with the SEC, the SEC staff nearly always reviews the related registration statement. The staff's review is typically comprehensive, covering reporting, accounting, and legal issues. In addition, comments about reporting topics often include:

- Significant business acquisitions (Regulation S-X, Rule 3-05).
- Investments in equity method investees (Regulation S-X, Rule 3-09).
- Guarantors of registered securities (Regulation S-X, Rule 3-10).
- Issuers of securities that collateralize registered securities (Regulation S-X, Rule 3-16).
- Pro forma financial statements (Regulation S-X, Article 11).

For more information on these topics, see the SEC Reporting section. Other SEC staff comments on IPOs have addressed accounting and disclosure topics such as (1) complex equity instruments; (2) share-based compensation, including equity securities issued as compensation in periods before an IPO (commonly referred to as "cheap stock" considerations); and (3) revenue recognition. For more information, see the Debt, Financial Instruments, Revenue Recognition, and Share-Based Payments sections. The SEC staff also comments on certain issues that are more specific to IPO registration statements. Such issues are discussed in this section.

Registrant Financial Statements

A company undergoing an IPO is required to present its financial statements, footnotes, and schedules for certain annual and interim periods in its registration statement. Regulation S-X, Rules 3-01 through 3-04, describe the general financial statement requirements for the registrant and its predecessors. Registrants must determine which financial statements to include in their initial registration statement on the basis of their individual facts and circumstances and must continue to update the financial statements throughout the registration process. The SEC staff often comments when registrants do not include the required financial statements in the registration statement.

Recently Organized Registrant

Example of an SEC Comment

Tell us why you have not included an audited balance sheet for the registrant as of a point within 135 days of filing your registration statement as would ordinarily be required under Rule 3-01 of Regulation S-X.

Sometimes the legal entity registering securities in an IPO is a newly formed company that will succeed to the operations of an existing business before the effective date of the initial registration statement. In such cases, the entity may need to include the balance sheet of the recently organized registrant in addition to the financial statements of the existing business. See Section 1160 of the FRM for additional guidance on newly formed entities. In addition, Regulation S-X, Rule 3-01, provides guidance on a registrant's balance sheet requirements.

Age of Financial Statements

Example of an SEC Comment

Please consider the financial statement updating requirements set forth in Rule 3-12 of Regulation S-X.

A registrant's financial statements must meet the "age of financial statements" requirements as of every filing date as well as when the registration statement is declared effective. The age of financial statements generally refers to the specific annual and interim periods for which financial statements are required in a filing. Regulation S-X, Rule 3-12, provides guidance on such periods and on when the financial statements become stale (i.e., should be updated).

Predecessor Financial Statements

Examples of SEC Comments

- We note from your website [your relationship with Company A]. Please describe your relationship with [Company A] and provide us with your analysis addressing whether [Company A] represents a predecessor for which financial statement information should be provided.
- Please tell us what factors you considered, and why you concluded, [Company A] represents your predecessor. In your response, please tell us how you are actually succeeding to substantially all of the business of [Company A], and what impact control of [Company A] has upon your ability to succeed to the business. We may have further comment.

Section 1170 of the FRM addresses the requirements for predecessor financial information. It states that the designation "predecessor" is required when "a registrant succeeds to substantially all of the business (or a separately identifiable line of business) of another entity (or group of entities) and the registrant's own operations before the succession appear insignificant relative to the operations assumed or acquired." Because a predecessor's historical financial information is considered important to an investing decision, when a predecessor is identified, the registration statement must also present the predecessor's financial information and reflect such information as if it were the registrant's. That is, financial statements for both the registrant and its predecessor should be presented as of and for all periods that are required by Regulation S-X.

Carve-Out Financial Statements

Examples of SEC Comments

- Please note that the historical income statements of a registrant should reflect all of its costs of doing business. We note your disclosure [that the parent company] is responsible for the payment of your operating expenses, legal and accounting expenses related to the merger. Please tell us how you account for uncompensated services rendered by [the parent company]. Refer to SAB Topic 1.B.1.
- We note from your disclosures . . . that the predecessor financial statements represent the combination of carve out financial statements for the [assets] that [Company A] intends to transfer to [Company B] prior to the offering. Please explain to us in more detail how you determined these combined carve out financial statements were the most appropriate financial statements to present as the predecessor.

"Carve-out financial statements" is a generic term used to describe separate financial statements that are derived from the financial statements of a larger parent company. A carve-out occurs when a parent company segregates a portion of its operations and prepares a distinct set of financial statements in preparation for a sale, spin-off,[1] or IPO of the "carve-out entity." Examples of a carve-out entity may include (1) all or part of a subsidiary of a parent company or (2) a line of business that was previously part of a larger parent company.

In many cases, the parent may not have historically accounted for the carve-out entity separately, and the registrant (i.e., the carve-out entity) may have relied on the parent for certain functions. SAB Topic 1.B indicates that the registrant's historical income statements should present all of the costs of doing business, including expenses incurred by the parent on behalf of the registrant. Examples of such costs include salary, rent, depreciation, advertising, accounting and legal services, and other SG&A. Registrants must use a reasonable method to allocate the common expenses from the parent to the registrant if specific identification is not practicable. The method for such allocation must also be disclosed in the notes to the financial statements, with an explanation of why management believes such method is reasonable. To the extent that the registrant and the parent have shared functions (e.g., treasury or cash management), these shared functions need to be evaluated so that the appropriate amount of expense and related assets and liabilities to be allocated to the carve-out entity can be determined.

When financial statements of a carve-out entity are used in an IPO, it is critical that the carve-out financial statements identify the appropriate assets and operations of the registrant. A registrant's determination of the composition of the carve-out financial statements depends on the its specific facts and circumstances and may require significant judgment because the process of identifying appropriate assets and operations of the registrant in an IPO transaction is complicated. As stated in the highlights of the September 23, 2014, CAQ SEC Regulations Committee joint meeting with the SEC staff, the staff (1) acknowledged that "identifying the predecessor entity in many transactions requires careful analysis of all relevant facts and circumstances," (2) "noted that current guidance in the FRM, GAAP and various SABs did not contemplate the level of complexity encountered in recent transactions," and (3) "encourages companies to pre-clear these transactions."

[1] A spin-off is a type of divestiture in which an independent company is created through the sale or distribution of new shares of a portion of a parent's operations.

Spin-off transactions can be highly complex and involve numerous legal and accounting decisions that registrants must consider, including the accounting for the transaction (i.e., forward spin or reverse spin) in accordance with ASC 505-60. Registrants should also consider other aspects of carve-out financial statement reporting, including (1) the allocation of items such as pension and postretirement benefit plans, income taxes, impairment of goodwill and other intangible assets, and debt and contingencies and (2) the application of pushdown accounting and treatment of intercompany transactions. In addition, carve-out entities in an IPO will need to consider their ongoing compliance with Rules 3-05 and 3-09 for acquisitions and equity method investments, respectively, whose level of significance may differ from that of the parent's acquisitions and equity method investments. Further, the SEC staff may ask about segment reporting and EPS in these complex transactions.

For additional considerations related to carve-out transactions, see Deloitte's June 2013 publication *A Roadmap to Accounting and Financial Reporting for Carve-Out Transactions*.

Public-Entity Disclosures and Transition Provisions

A nonpublic entity's previously issued financial statements may not be sufficient for an IPO. Nonpublic entities will need to revise their financial statements to include the public entity disclosures required under U.S. GAAP and Regulation S-X.[2] In addition, such entities will need to obtain an auditor's report on their financial statements that (1) is issued by a PCAOB-registered accounting firm and (2) refers to the PCAOB's Standards.[3]

U.S. GAAP

Certain provisions of U.S. GAAP differ for public and nonpublic entities. A registrant's financial statements in an IPO must adhere to accounting principles and disclosures required for public entities for all periods presented.[4] The term "public entity" generally refers to an entity that files its financial statements with the SEC. However, there are different definitions of public entity under U.S. GAAP. Examples of accounting principles and disclosures that apply to public entities include EPS (under ASC 260-10-15-2 and 15-3); segment reporting (under ASC 280-10-15-3 and ASC 280-10-20); and pensions and other postretirement benefits, such as defined benefit plans (under ASC 715-20-20). See the Earnings per Share, Pensions and Other Postretirement Benefits, and Segment Reporting sections for additional reporting considerations related to these topics.

In addition, the transition provisions related to the adoption of a new accounting pronouncement may differ depending on how a public entity is defined in ASC topics. Some guidance is effective for public entities before it is effective for nonpublic entities. Since registrants must follow public-entity guidance for all periods presented in the IPO financial statements, a nonpublic entity may be required to retrospectively change its adoption date to that required for a public entity.[5]

Further, a company that is preparing to go public — or that may consider going public in the future — should be cautious about electing the alternatives developed by the PCC. Because such a company would be considered a PBE, it would not be permitted to adopt PCC accounting alternatives. Accordingly, any previously elected PCC alternatives would need to be eliminated from the company's historical financial statements before such statements can be included in its IPO registration statement. See the SEC Reporting section for additional information about PBEs.

2 EGCs are allowed to adopt new or revised financial accounting standards on the basis of effective dates applicable to private companies (i.e., nonissuers) "if such standards apply to companies that are not issuers." See the Emerging Growth Companies section for additional information.

3 See paragraph 4110.5 of the FRM for additional information.

4 See footnote 2.

5 See footnote 2.

SEC Rules and Regulations

Examples of SEC Comments

- As required by Rule 4-08(k) of Regulation S-X, please identify and state the amounts of your related party transactions on the face of the consolidated balance sheets, income statements, and/or statements of cash flows.
- You disclose that you are in the process of redeeming $[X] of your redeemable [preference shares]. Please clarify whether you are redeeming these shares for common stock or for cash. Please also tell us whether you were required to redeem these shares or if you had the sole option to redeem the preferred shares. Tell us how you considered Rules [5-02.27 and 5-02.28] of Regulation S-X in determining the classification of your redeemable preferred stock as of [period end].
- We note that "under certain circumstances, including a change in control . . ." the company is obligated to purchase common stock from shareholders at fair market value. Please tell us why these shares should not be presented outside of permanent equity pursuant to the guidance in [ASC 480-10-S99-3A]. Your response should be detailed and specific and should consider circumstances and examples such as those described in [ASC 480-10-S99-3A.7–9].

In an IPO, the registrant's financial statements should comply with the applicable requirements of Regulation S-X, and SABs, for each period presented in the financial statements. Because such requirements and guidance are new to the registrant, the SEC staff frequently requests additional disclosures. Regulation S-X prescribes the types, form, and content of the financial information that registrants must file. Many of these requirements expand on the disclosures directly required by U.S. GAAP. SABs provide guidance on 14 broad topics, including business combinations, revenue recognition, and share-based payment arrangements. Requirements addressed by Regulation S-X and SABs that often affect nonpublic-entity financial statements during the IPO process include:

- Balance sheet and income statement presentation requirements (Regulation S-X, Rules 5-02 and 5-03) and age of financial statement requirements (Regulation S-X, Rule 3-12).
- Summarized financial information of subsidiaries not consolidated and 50 percent or less owned persons (Regulation S-X, Rule 4-08(g)).
- Income tax expense (Regulation S-X, Rule 4-08(h)).
- Related-party disclosures (Regulation S-X, Rule 4-08(k)).
- Audited financial statement schedules (Regulation S-X, Articles 5 and 12).
- Preferred stock subject to mandatory redemption requirements or whose redemption is outside the issuer's control (Regulation S-X, Rule 5-02.27; ASR 268; ASC 480-10-S99-3A).
- Pushdown accounting to reflect a change in basis because of an acquisition (ASU 2014-17).[6]

For additional reporting considerations related to these topics, see Financial Statement Classification, Including Other Comprehensive Income; Income Taxes; and SEC Reporting.

[6] In November 2014, the FASB issued ASU 2014-17, which gives an acquired entity the option of applying pushdown accounting in its stand-alone financial statements upon the occurrence of a change-in-control event. The guidance is effective immediately. Also, in connection with the FASB's issuance of ASU 2014-17, the SEC has rescinded SAB Topic 5.J, which historically has conveyed the SEC staff's views on the application of pushdown accounting for SEC registrants. See the November 18, 2014, *Deloitte Accounting Journal* entry for additional information.

Distributions to Owners

Examples of SEC Comments

- [W]e note that prior to the closing of this offering [the Company] intends to make additional cash distributions of approximately $[X] to the [owners of the Company] to enable them to meet their estimated income tax obligations for the period . . . . We also note that the board . . . has authorized an $[X] distribution to its members in the third quarter . . . . In this regard, we assume that you will reflect the distribution accrual (but not giving effect to the offering proceeds) in the pro forma balance sheet [alongside] the historical balance sheet in the filing.
- We . . . assume that the pro forma per share data will give effect to the number of shares whose proceeds would be necessary to pay the dividend (but only the amount that exceeds current year's earnings). The number of shares to be added to the denominator for purposes of pro forma per share data should not exceed the total number of shares to be issued in the offering. Also note that a dividend declared in the latest year would be deemed to be in contemplation of the offering with the intention of repayment out of offering proceeds to the extent that the dividend exceeded earnings during the previous twelve months.

It is common for registrants to plan dividends or distributions to owners as of, or immediately before, the closing of an IPO. The SEC staff often comments on the need for pro forma information related to such distributions.

SAB Topic 1.B.3 and paragraph 3420.1 of the FRM express the SEC staff's view that a significant planned distribution that is not reflected in the latest historical balance sheet should be presented in a pro forma balance sheet regardless of whether it has been declared or will be paid from the proceeds of the offering. The pro forma balance sheet should be presented alongside the most recent historical balance sheet in the filing and should reflect the accrued distribution (but not give effect to the offering proceeds).

In addition, SAB Topic 1.B.3 indicates that if a distribution will be paid to owners from the proceeds of the offering rather than from the earnings in the current year, the registrant should present pro forma EPS data for the latest year and interim period in addition to historical EPS. Paragraph 3420.2 of the FRM provides additional guidance on the calculation of such pro forma per share data.

Changes in Capitalization

Entities often have other capitalization changes that occur before, or concurrently with, the effective date or closing of an IPO. Some changes, such as a stock split, are reflected retrospectively in all periods presented in the financial statements. Other changes, which may include (but are not limited to) the redemption or automatic conversion of preferred stock into common stock or the conversion of debt to equity, are only recorded prospectively and may not be reflected in the financial statements presented in an IPO filing. Registrants should present such changes in capitalization as part of the pro forma information. The SEC staff often focuses on the presentation of such pro forma information.

Pro Forma Balance Sheet

Example of an SEC Comment

Please revise to present a pro forma balance sheet giving effect to the redemption of the [preferred stock], excluding effects of the offering proceeds, alongside of the most recent historical balance sheet. Please also include disclosure in the notes to financial statements that describes the pro forma presentation.

The SEC staff asks registrants to present pro forma information when changes in capitalization will occur after the date of the latest balance sheet. Paragraph 3430.2 of the FRM indicates that when such changes will result in a material reduction in permanent equity or are the result of a redemption of a material amount of securities in conjunction with the offering, a filing should include a pro forma balance sheet (presented alongside the historical balance sheet) that takes into account the change in capitalization but not the effects of the offering proceeds.

Pro Forma EPS

Example of an SEC Comment

We note that your convertible preferred stock will convert to [X] shares of common stock upon the closing of this offering. Revise to present unaudited pro forma basic and diluted EPS for the latest year giving effect to the conversion.

Paragraph 3430.3 of the FRM indicates that when a conversion of outstanding securities occurs after the latest balance sheet date and will result in a material reduction in EPS exclusive of the effects of the offering, registrants should present pro forma EPS (but should exclude the effects of the offering). Such pro forma EPS should be presented for the latest fiscal year and interim period.

Draft Audit Reports

Example of an SEC Comment

We note that your reverse stock split will be effective immediately prior to completion of the offering. This reverse split should be retrospectively reflected in the financial statements, selected financial data and elsewhere throughout the filing. If the transaction prevents the auditor from expressing an opinion on the financial statements at the time of filing, we will not object to the filing of a "draft report" in the form that it will be expressed at effectiveness. In this case, the draft report should be accompanied by a signed preface of the auditor stating that it expects to be in a position to issue the report in the form presented at effectiveness. No registration statement can be declared effective until the preface is removed and the accountant's report finalized.

In accordance with Regulation S-X, Rule 2-02, and various interpretive guidance (e.g., Section 4710 of the FRM), the auditor's report should be dated and signed by the auditor and should not contain restrictive language (e.g., "draft"). The SEC staff will generally not commence its review of a registrant's filing if the registrant has filed a registration statement that does not meet these requirements. However, if a transaction (e.g., a stock split) is expected to occur immediately before the registration statement is declared effective, the registrant may wish to give effect to the transaction before it occurs. When such an anticipated transaction has been included in the historical financial statements so as to prevent the auditor from expressing an opinion regarding the financial statements at the time of filing (because the filing took place before the transaction occurred and before the registration statement was declared effective), the SEC staff has accepted the filing of a "draft report" in the form in which it will be expressed at effectiveness. Such a report would include a preface indicating that the report will not be final until the transaction is completed. The SEC staff will remind registrants to remove the preface from a registration statement that was filed before being declared effective because no registration statement can be declared effective until the preface is removed and the accountant's report is finalized.

Dilution Disclosure

Examples of SEC Comments

- You have not disclosed a net tangible book value per share before the planned offering that is consistent with historical amounts shown in your consolidated balance sheet at December 31, 2013. Please explain to us your basis for concluding that this presentation of dilution per share to new investors conforms to guidance in Item 506 of Regulation S-K.
- Please explain to us why you are excluding from your calculation of dilution the impact of the [X] million shares to be issued upon fulfillment of the [restricted stock unit] liquidity event condition.

Under Regulation S-K, Item 506, certain disclosures (including net tangible book value per share before and after a distribution) are required when "common equity securities are being registered and there is substantial disparity between the public offering price and the effective cash cost to officers, directors, promoters and affiliated persons of common equity acquired by them."

Section 8300 of the FRM acknowledges that there is no authoritative definition of "tangible book value" but notes that the metric "is used generally as a conservative measure of net worth, approximating liquidation value." The interpretive guidance (1) indicates what tangible assets should exclude and (2) cites examples of when the SEC staff has allowed dual calculation of tangible book value. Accordingly, the staff may question a registrant's calculation of dilution and its related disclosures, particularly if net tangible book value reported in the dilution section of the registration statement appears to be inconsistent with the historical financial statements.

Other Deloitte Resources

December 24, 2013, *Deloitte Accounting Journal*, "FASB Defines a Public Business Entity."

Foreign Private Issuers

Foreign Private Issuers Using IFRSs

Currently, about 500 foreign private issuers (FPIs) reporting under IFRSs are registered with the SEC. The SEC staff's comments to FPIs have addressed a number of financial accounting and disclosure topics. Many of the comments are generally consistent with those issued to domestic filers and raise topics that are discussed in other sections of this publication (albeit financial statement topics refer to the IFRS "equivalent" of U.S. GAAP).

In addition to nearly all of the topics that have been identified as comment trends applicable to domestic filers, SEC staff comments to FPIs ask about (1) the presentation of financial statements; (2) accounting for expenditures related to the exploration for, and evaluation of, mineral resources (i.e., under IFRS 6); (3) references to the use of IFRSs as issued by the IASB; and (4) going-concern language in PCAOB audit reports. These topics are discussed below.

Presentation of Financial Statements

Examples of SEC Comments

- Since you present costs and expenses by function, please provide additional information about the expenses by nature in accordance with paragraph 104 of IAS 1.
- Please consider revising future filings to present additional line items on the face of the statement of income for total operating income and total operating expense. Refer to paragraph 85 of IAS 1.
- Please address what consideration was given to Basis for Conclusions paragraph 56 of IAS 1 in determining that . . . it was appropriate to exclude the costs included in other expenses, net line item from your determination of operating income.

The SEC staff's comments have often focused on missing disclosures about the nature of expenses when issuers used a functional presentation of expenses in the statement of profit or loss and OCI. The staff has also commented on the exclusion of certain expenses from amounts presented as results of operating activities. In addition, the staff has asked issuers to present additional line items in the statement of profit or loss and OCI when such presentation is relevant to an understanding of the issuer's financial performance.

Under IAS 1, an entity can present expenses either by nature or by function. According to IAS 1.104, an entity that presents expenses by function must provide additional disclosures about the "nature of expenses, including depreciation and amortisation expense and employee benefits expense." As explained in IAS 1.105, this is "because information on the nature of expenses is useful in predicting future cash flows." The use of the term "including" in IAS 1 implies that additional disclosures about the nature of expenses may not be limited to depreciation, amortization, and employee benefit expenses. Rather entities should disclose other expenses by nature if such information may be useful in predicting future cash flows. An entity that uses a functional format should ensure that all additional disclosures are included in the footnotes and should consider including them in a single footnote for greater transparency. IAS 1.IG6 illustrates income statements that are presented by nature and by function.

IAS 1.82 and IAS 1.82A each list line items that an entity should include, at a minimum, in its statement of profit or loss and OCI. Disclosure of the results of operating activities as a separate line item in the statement of profit or loss and OCI is not required; however, an entity that decides to present the results of operating activities (i.e., operating income) or a similar line item should refer to IAS 1.BC56, which notes, in part, that "it would be misleading and would impair the comparability of financial statements if items of an operating nature were excluded from the results of operating activities, even if that had been industry practice."

Further, IAS 1.85 requires an entity to present additional line items, headings, and subtotals on the face of the statement of comprehensive income "when such presentation is relevant to an understanding of the entity's financial performance." When including such line items and subtotals, an entity should consider providing transparent disclosures that clearly convey the relevance of the items to financial statement users. In such cases, an entity may amend the description of the line items and reorder them to explain the particular element of financial performance.

Exploration for, and Evaluation of, Mineral Resources

Examples of SEC Comments

- We note . . . that you rely on IFRS 6 guidance in capitalizing exploration expenditures. We also note . . . that capitalized exploration costs are classified as mine development assets and you are relying on the guidance in IAS 16. To help us better understand your accounting policy for capitalizing exploration expenditures, please address the following items:
  - Tell us why you consider it appropriate to classify the capitalized exploration costs as mine development assets under IFRS 6 paragraphs 10 and 25.
  - Tell us how you reclassify the capitalized exploration costs when the technical feasibility and commercial viability of extracting a mineral resource are demonstrable under the guidance in IFRS 6 paragraph 17 if the related capitalized exploration costs have been recorded as mine development assets.
  - Tell us the amount of exploration costs capitalized by mine at [Mine A and Mine B].
- You indicate that you do not use free cash flow as a liquidity measure. In light of this, please further explain in your disclosures the reasons why you believe the presentation of this non-GAAP measure provides useful information to investors. Refer to Item 10(e)(1)(i)(C) of Regulation S-K.

The SEC staff has often requested more information about the issuer's accounting policy related to the types of expenditures that the issuer recognizes as exploration and evaluation assets, including whether such policy complies with IFRS 6. In addition, the SEC staff's recent comments to issuers in the mining industry have focused on non-GAAP financial measures, particularly on whether (1) those measures have been clearly labeled and described as non-GAAP measures and (2) the issuer's disclosures demonstrate the purpose of the measures and their usefulness to investors. See the Non-GAAP Financial Measures and Mining sections for further discussion.

IFRS 6 requires an entity to develop an accounting policy that specifies the types of expenditures it recognizes as exploration and evaluation assets and to apply that policy consistently — particularly because IFRS 6 does not require entities to capitalize exploration and evaluation expenditures. In addition, when specified conditions are met, IFRS 6 permits entities to continue applying the accounting policies they used to account for exploration and evaluation expenditures before adopting IFRS 6.

Under IFRS 6, an entity's assessment of which expenditures would qualify as exploration and evaluation assets is determined on the basis of how closely the expenditures are associated with finding specific mineral resources. IFRS 6 provides a nonexhaustive list of expenditures that an entity might consider including in the initial measurement of its exploration and evaluation assets. Such expenditures include those related to:

- Acquisition of rights to explore minerals.
- Topographical, geological, geochemical, and geophysical studies.
- Exploratory drilling.

- Trenching.
- Sampling.
- Activities related to evaluating the technical feasibility and commercial viability of extracting a mineral resource.

However, in accordance with IFRS 6, entities should not recognize expenditures related to the development of mineral resources as exploration and evaluation assets; instead, entities are required to apply the *Conceptual Framework for Financial Reporting* and IAS 38 to determine an appropriate accounting policy for such amounts. Further, although the term "development" is not defined, IFRS 6.5(b) indicates that the development phase begins "after the technical feasibility and commercial viability of extracting a mineral resource are demonstrable."

References to the Use of IFRSs as Issued by the IASB

> **Example of an SEC Comment**
>
> Please amend your filing to include an audit opinion that refers to and opines on International Financial Reporting Standards as issued by the International Accounting Standards Board or include a reconciliation to US GAAP. Refer to Item 17(c) of Form 20-F.

The SEC staff has requested that issuers amend their Form 20-F when they have not asserted, and the audit report has not stated, that the financial statements were prepared in accordance with "IFRSs as issued by the IASB."

As stated in paragraph 6310.2 of the FRM and similarly indicated in Item 17 of Form 20-F, the issuer's "accounting policy footnote must state compliance with [IFRSs] as issued by the IASB and the auditor's report must opine on compliance with [IFRSs] as issued by the IASB." An issuer that does not prepare its financial statements in accordance with IFRSs as issued by the IASB is required to reconcile its financial statements to U.S. GAAP. The SEC staff has reiterated that FPIs need to provide a statement of compliance with "IFRSs as issued by the IASB" to be eligible to omit the U.S. GAAP reconciliation.

Going-Concern Language in PCAOB Audit Reports

> **Example of an SEC Comment**
>
> As noted in the Audit Report and consistent with Instruction 2 to Item 8.A.2 of Form 20-F, the audit was conducted in accordance with the standards of the Public Company Accounting Oversight Board in the United States (PCAOB). As such, the audit opinion should comply with the PCAOB standard regarding going concern uncertainties. As previously requested, amend your filing to include a report that uses the term "substantial doubt." Refer to AU 341.12. Also refer to the related discussion at the International Practices Task Force meeting on November 22, 2011.

The SEC staff continues to request that issuers amend their going concern language in their PCAOB audit reports to include unconditional statement of "substantial doubt."

Paragraph 4230.1(c) of the FRM emphasizes the importance of the phrase "substantial doubt" by stating that "[g]oing concern opinions that do not use the words 'substantial doubt' when referencing a going concern matter do not comply with PCAOB standards/U.S. GAAS."

Further, AU Section 341.12 states that the "auditor's conclusion about the entity's ability to continue as a going concern should be expressed through the use of the phrase '**substantial doubt** about its (the entity's) ability to continue as a going concern' [or similar wording that includes the terms substantial doubt *and* going concern]" (emphasis added). In addition, Footnote 5 to AU 341.13 states that "the auditor should not use conditional language in expressing a conclusion concerning the existence of substantial doubt about the entity's ability to continue as a going concern. [One example] of inappropriate wording in the explanatory paragraph would be, 'If the Company continues to suffer recurring losses from operations and continues to have a net capital deficiency, there **may** be substantial doubt about its ability to continue as a going concern' " (emphasis added).

Industry-Specific Topics

Consumer and Industrial Products

Retail and Distribution

The SEC staff's comments to registrants in the retail and distribution industry have focused on topics such as the results of operations section in MD&A (including disclosures about metrics and online sales) and the revenue-recognition implications of customer loyalty programs.

In addition, registrants in this industry typically have multiple distribution channels (e.g., stores, catalogs, the Internet), customer segments, geographic locations, and store concepts and brands. Consequently, the SEC staff frequently asks registrants about the identification and aggregation of their operating segments, particularly when they disclose only one reportable segment. See the Segment Reporting section for additional information.

MD&A — Results of Operations

Examples of SEC Comments

- [Y]ou indicate that comparable store metrics are calculated on an annual basis, including relocations, using all stores open at least one year. In future filings, please provide the following:
  - Please revise your disclosures to clarify how your comparable store metrics take into account stores closed during the period; and
  - Please also disclose the percentage of your net sales that are online sales and state whether these online sales are included or excluded from comparable store metrics. If online sales are included in comparable store metrics, please address the extent to which online sales impacted the increase or decrease in comparable store sales from period to period in your MD&A.
- Fiscal years that contain 53 weeks should generally include a quantified analysis of the impact of the extra week on the comparability of your results.
- Since it appears that your online business has a significant impact on your results, please provide a quantified discussion of your online business as part of providing investors with a view of the company through the eyes of management.

The SEC staff frequently asks registrants to improve their MD&A (e.g., by including operational and statistical measures) to help investors see registrants' performance through the eyes of management. Many retailers consider same-store sales a key operating metric; accordingly, same-store sales are often discussed in MD&A to help explain fluctuations in results of operations. Because there can be variability in the way same-store sales are calculated, the SEC staff often asks registrants to enhance their disclosures about such metrics and elaborate on any factors that could affect year-to-year comparability. For example, a registrant that has a 53-week fiscal year should quantify how inclusion of the extra week in its analysis affects comparability with previous years' results. Recently, the staff has also asked registrants to clarify whether online sales are included in the calculation of same-store sales and, if so, to quantify their effect.

At the 2013 AICPA Conference, the SEC staff observed that registrants sometimes do not provide enough information about how online sales affect their strategies and financial results. It noted that registrants need to assess the materiality of Internet sales and provide MD&A disclosures about these sales if warranted. Specifically, it indicated that when a registrant's online sales are significant, the staff may ask the registrant to separately discuss (1) the impact of such sales on the results of operations, including changes in overall gross margin, and (2) any trends affecting online sales.

Many registrants in the retail and distribution industry separately use non-GAAP financial measures (e.g., EBITDA) to communicate results. Consequently, the SEC staff may challenge their related disclosures. See the Non-GAAP Financial Measures section for additional information.

For other considerations, including SEC staff views on the use of appropriate metrics that help registrants "tell their story," see the Management's Discussion and Analysis section.

Revenue Recognition — Customer Loyalty Programs

Examples of SEC Comments

- Please explain to us and expand your disclosure to clarify how you account for the points at the time of award and when the points are redeemed. Also please disclose whether the points expire or have a specific term.
- [T]ell us how the cash-back feature of [your cobranded credit cards is] recognized, measured and classified in your financial statements.

The SEC staff may ask registrants to clarify the key terms and related accounting for customer loyalty programs and cobranded credit card arrangements. In such cases, the staff often seeks to understand the registrant's income statement classification analysis under ASC 605-50 and its consideration of other factors for recognizing and measuring such incentives.

Transportation, Travel, Hospitality, and Leisure

The SEC staff's comments to registrants in the TTHL industry have focused on capital expenditure disclosures, long-lived asset impairments, and VIEs.

Capital Expenditures

Examples of SEC Comments

- Please expand your disclosure to include additional analysis of your capital expenditures by breaking down total capital expenditures between new development (as applicable), routine capital expenditures and other capital expenditures by year. The total of these expenditures should reconcile to the cash flow statement. In addition, please expand your narrative discussion of fluctuations from year to year to discuss any known trends or expectations for the future.
- Please revise your disclosure related to capital expenditures in future filings to discuss significant variances or trends in your expenditures, and in your response to us, please tell us the reason for the decrease in enhancements to existing properties from $[X] during 2011 to $[Y] during 2012 to $[Z] during 2013.

The SEC staff often asks TTHL registrants to clarify their capital expenditure activities by disclosing in MD&A information such as:

- The reasons for overall fluctuations in capital expenditures from year to year.
- Capital expenditures on a disaggregated basis (e.g., new development, renovations) in tabular form for each year presented to facilitate investor analysis of trends and enhance comparability. If it is not readily apparent, the SEC staff also may ask registrants whether (and how) total capital expenditures presented in MD&A reconcile to total capital expenditures in the cash flow statement.
- To the extent material, the methods used to allocate and capitalize soft costs (e.g., payroll) and a discussion of fluctuations in soft costs for the periods presented. Similarly, the SEC staff may ask TTHL registrants to clarify in the notes to the financial statements (1) the types and amounts of soft costs capitalized for each period presented and (2) the registrants' accounting policies regarding the capitalization of soft costs. Determining the types and amounts of soft costs to be capitalized frequently requires judgment, and such determinations may vary depending on whether the associated asset is considered inventory, a long-lived asset, or a leased asset.

Long-Lived Assets

> **Example of an SEC Comment**
>
> We [note that you] believe the market value of each of the vessels equals or exceeds its carrying value. In order to provide investors with additional information as to trends that could potentially impact your future results of operations, please revise future filings to include a comparative analysis of how the carrying values of your vessels compare to the fair market value of such vessels as of each balance sheet date presented in your financial statements. Also, please consider revising this table to include the date of acquisition, purchase price and carrying value at the balance sheet date for each of your vessels.

The SEC staff has encouraged shipping company registrants to provide tabular disclosures in the critical accounting policies section of MD&A that include information about assets at the individual-vessel level, especially if asset values are depressed. Consequently, the staff may ask such registrants to discuss more thoroughly the factors and conditions that would lead them to record an impairment loss.

In addition, the SEC staff has asked such registrants to disclose, on a comparative basis, the aggregate amount by which their vessels' carrying value exceeds the vessels' aggregate basic charter-free market value (or valuation for covenant compliance purposes). This disclosure is intended to highlight the potential for impairment, the trend in vessel values, and how that trend could affect future results of operations.

Further, the SEC staff may ask for more robust disclosures about the sensitivity of assumptions used in the test for impairment, particularly those used in the selection of historical average charter rates. Accordingly, registrants are encouraged to consider disclosing the margins by which estimated future undiscounted cash flows would exceed each vessel's carrying value if management were to use various historical trailing averages (e.g., those based on one-year, three-year, and five-year periods).

VIE Arrangements

> **Example of an SEC Comment**
>
> You have disclosed that your subsidiary has been granted the exclusive right to manage, operate and control [Entity A]. Please elaborate upon the notion of control and provide your analysis under ASC 810-10, including the specific rights held by you and [other] parties. Tell us how you have determined that you should consolidate this entity.

TTHL registrants may enter into arrangements that create variable interests (e.g., interests related to real estate investments, property management ventures, or investments in utilities that supply energy to property developments) that must be assessed in a consolidation analysis. The SEC staff often inquires about (1) the specific terms of such arrangements, (2) the initial determination and evaluation of the primary beneficiary under ASC 810-10, and (3) changes in circumstances (e.g., development plans) that could affect the primary-beneficiary status. The staff has asked registrants to discuss how they evaluated changes in circumstances to determine whether consolidation was warranted and may request revised and expanded disclosures that more thoroughly explain the nature of the arrangements and the registrant's evaluation of any changes in circumstances.

For more information, see the Consolidation section.

> **Other Deloitte Resources**
>
> December 16, 2013, *Heads Up*, "Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments."

Energy and Resources

Oil and Gas

The SEC staff's comments to registrants in the oil and gas industry continue to focus on (1) master limited partnerships (MLPs); (2) oil and gas reserves; (3) disclosures about drilling activities, wells and acreage data, and delivery commitments; and (4) non-GAAP financial measures.

MLP Considerations

Distributable Cash Flow and Maintenance Capital Expenditures

Examples of SEC Comments

- [You state] that Distributable Cash Flow provides investors with an approximation of Available Cash, as defined in your partnership agreement, prior to the establishment of any cash reserves. Please provide us with a comparison of the calculations of Available Cash and Distributable Cash Flow (e.g., tell us how capital expenditures are determined in calculating Available Cash). With your response, please tell us about the extent to which Distributable Cash Flow is considered by management and the board of directors in determining actual cash distributions. . . . As part of your response, explain how you evaluate, and how you believe investors should consider any excess or shortfall of Distributable Cash Flow over actual cash distributions for any given period.
- We note that a significant component of your distributable cash flow calculation is maintenance capital expenditures, which reduce the cash flow available for distribution to your unitholders. Since we understand that the definition of this term may vary within the industry, please tell us your definition of maintenance capital expenditures. Specifically, please clarify what you are maintaining: a specific level of net assets, throughput, capacity, profitability, etc. Since we understand that the definition of this term may vary, please also tell us how you considered clarifying this matter to your investors.

The partnership agreements of MLPs typically define distributable cash flow and often call for a distinction between capital expenditures associated with maintenance and those associated with growth. In turn, MLPs frequently disclose distributable cash flow and capital expenditure amounts. Consequently, because distributable cash flow is not determined on the basis of SEC rules or U.S. GAAP, SEC staff comments to industry registrants may focus on:

- Providing greater clarity about how distributable cash flow is calculated.
- How maintenance capital expenditures is defined and how it affects distributable cash flow.
- Describing the relationship between the calculated amount of distributable cash flow and actual distributions.
- Understanding liquidity ramifications related to requirements to distribute cash.
- Compliance with S-K Item 10(e) related to non-GAAP financial measures, including (1) how distributable cash flow is used by management and (2) the registrant's reconciliation of the non-GAAP measure to the appropriate GAAP measure (e.g., why distributable cash flow as a cash measure is reconciled to a profit measure, such as net income, instead of to operating cash flows).

EPU Considerations

MLPs are common structures used in the energy and real estate industries. Frequently, MLPs have differing classes of ownership units, such as general partner (GP) units, limited partner (LP) units, and incentive distribution rights, that participate in earnings on the basis of the contractual rights stipulated in the partnership agreement; therefore, in such cases, MLPs must apply the two-class method in ASC 260 to determine earnings per unit (EPU). MLPs also commonly engage in dropdown transactions, in which the GP of the MLP transfers assets to the MLP in exchange for a greater partnership interest in the MLP or cash (or both).

ASC 260 does not address how the MLP's presentation of historical EPU would be affected by a dropdown transaction that (1) occurs after the MLP's initial formation and (2) is accounted for as a reorganization of entities under common control. As a result, two common approaches have developed, as noted in a memorandum prepared for the EITF's deliberations on this issue at its September 2014 meeting:

- Restate historical EPU "by allocating the net income (loss) of the transferred business prior to the date of the dropdown transaction to the GP, LPs, and [other participating interest] holders."
- Allocate "the net income (loss) of the transferred business prior to the date of the dropdown transaction entirely to the GP." The memorandum indicates that "[u]nder this alternative, there is no retrospective adjustment to previously reported EPU."

Consequently, the SEC staff has asked registrants about the basis for their EPU calculations in dropdown transactions. To address the diversity in practice, the FASB issued a proposed ASU in October 2014 under which an MLP would perform the allocation by using the second approach described above. As a result, there would be no adjustment to historical EPU reported for LP units.

Oil and Gas Reserves

PUD Reserves

Example of an SEC Comment

You disclose that a significant percentage of your net undeveloped acreage will expire over the next three years. Please tell us the extent to which you have assigned any proved undeveloped reserves . . . to locations which are currently scheduled to be drilled after lease expiration. If your undeveloped reserves include any such locations, [tell] us the steps you will take regarding an extension of your legal right to these leases; otherwise, please remove these undeveloped reserves as proved reserves in your next filing.

Under Regulation S-X, Rule 4-10(a)(22), a registrant should be reasonably certain when estimating proved reserves that the reserves can be recovered in future years under existing economic conditions. In accordance with Rule 4-10(a)(31)(ii), "[u]ndrilled locations can be classified as having undeveloped reserves only if a development plan has been adopted indicating that they are scheduled to be drilled within five years, unless the specific circumstances, justify a longer time."

The SEC staff may ask registrants to justify recorded proved undeveloped (PUD) reserves that will remain undeveloped for more than five years because a registrant's decision not to develop PUD reserves for such a long period may indicate uncertainty regarding development and ultimate recoverability. In accordance with Regulation S-K, Item 1203(d), a registrant may be asked to explain why the reserves have not been or will not be developed, why it believes that the reserves are still appropriate, and how it plans to develop the reserves within five years given the registrant's historical conversion rate. The SEC staff may also ask registrants to support engineering assumptions, such as terminal decline rates, used in proved reserve estimates, as well as assumptions used in future cash flow analyses (e.g., estimated future well costs).

Separate Disclosure of NGL Reserves

> **Example of an SEC Comment**
>
> We note you disclose proved reserves of crude oil, condensate and natural gas liquids (NGLs) as a single aggregated quantity in the tables . . . . The staff considers NGLs to be a separate product type under Item 1202(a)(4) of Regulation S-K; therefore, NGL reserves, if material, should be presented as separate quantities for disclosure under Item 1202(a)(2) of Regulation S-K. Please revise your disclosures to separately present, on a disaggregated basis, your NGL reserve quantities.

Although NGLs are not separately identified as a product type in Regulation S-K, Item 1202(a), they are discussed in ASC 932-235-50-4. Accordingly, the SEC staff may ask registrants to disclose NGLs separately if they aggregate significant NGLs with other product types in their disclosures of proved reserves.

Significant Changes in Reserves and Standardized Measures

> **Examples of SEC Comments**
>
> - Please revise your disclosure of changes in proved reserve quantities to include an explanation of significant changes that occurred during the periods presented. Refer to FASB ASC 932-235-50-5.
> - Please expand your disclosure of the changes in net quantities of proved reserves to include appropriate explanations of significant changes relating to extensions and discoveries, other additions and revisions of previous estimates, for each of the reporting periods shown, to comply with FASB ASC Topic 932-235-50-5.

The SEC staff has commented on registrants' disclosures about (1) changes in proved reserves and standardized measures and (2) their compliance with ASC 932-235-50. Accordingly, the SEC staff may ask registrants to describe the technical factors (e.g., the activities, findings, and circumstances) that led to significant changes in proved reserves; to address negatively revised estimates attributable to performance separately from those attributable to price reductions; to explain significant changes in extensions and discoveries; and to disclose prices used in the calculation of standardized measures. Further, the SEC staff may (1) ask industry registrants whether abandoned assets have been included in the standardized measure and, if so, to provide information about them and (2) refer registrants to guidance in a sample letter provided by the Division of Corporation Finance.

Reserve Reports

> **Example of an SEC Comment**
>
> Please file a third party report that complies with the requirements of Item 1202(a)(8) of Regulation S-K: (i) The purpose for which the report was prepared and for whom it was prepared; (ii) The date on which the report was completed; (iv) The data and procedures used, including the percentage of the registrant's total reserves reviewed in connection with the preparation of the report, and; (x) The signature of the third party. Include the third party's responsible person's technical qualifications as required by Item 1202(a)(7) of Regulation S-K.

Under Regulation S-K, Item 1202(a)(8), a registrant must file a third-party report as an exhibit to its periodic report or registration statement when it "represents that a third party prepared, or conducted a reserves audit of, the registrant's reserves estimates, or any estimated valuation thereof, or conducted a process review." Accordingly, certain disclosures are required under Item 1202(a)(8). The SEC staff issues comments when these required disclosures are omitted. Often, the staff's comments are related to the requirement in Regulation S-K, Item 1202(a)(8)(iv), to disclose the "assumptions, data, methods, and procedures used, including the percentage of the registrant's total reserves reviewed in connection with the preparation of the report, and a statement that such assumptions, data, methods, and procedures are appropriate for the purpose served by the report."

Drilling Activities, Wells, Acreage, and Delivery Commitments

Examples of SEC Comments

- Please revise or otherwise expand your disclosure to present the total gross and net productive wells expressed separately for oil and gas as of a reasonable current date or as of the end of the current fiscal year pursuant to the disclosure requirements under Item 1208(a) of Regulation S-K.
- Please expand the disclosure of your present activities, such as the number of wells in the process of being drilled, completed or shut in awaiting infrastructure, to provide this information as of March 31, 2014. Please refer to the disclosure requirements in Item 1206 of Regulation S-K.

The SEC staff has continued to focus on registrants' disclosures about production information, drilling activities, wells and acreage data, and delivery commitments under Regulation S-K, Items 1204, 1205, 1206, 1207, and 1208. Additional disclosures that may be requested include (but are not limited to) the following:

- Production by geographic area and for each country and field that contains 15 percent or more of the registrant's total proved reserves.
- Drilling activities for each of the last three years by geographic area.
- Steps to be taken to meet significant delivery commitments.
- The number of wells that the registrant operates, including the total gross and net productive wells, expressed separately for oil and gas by geographic area.
- Information related to undeveloped acreage regarding minimum remaining terms of leases and concessions for material acreage concentrations, including significant undeveloped acreage that will be expiring over the next three years.

Non-GAAP Financial Measures

Registrants in the oil and gas industry commonly use derivative instruments to hedge their exposure to commodity price risk. However, registrants may elect not to apply hedge accounting for such derivative transactions. Accordingly, any mark-to-market adjustments are recorded in registrants' earnings (i.e., unrealized gains and losses are recorded in profit and loss in registrants' income statements). In addition, some registrants may present non-GAAP financial measures, such as adjusted EBITDA, as well as adjustments (in the required reconciliation to the most directly comparable GAAP measure) for the effects of such derivative transactions (e.g., excluding net unrealized gains/losses), which the SEC has indicated may not be in accordance with U.S. GAAP. As a result, the SEC staff has asked registrants to present two separate reconciling items within the non-GAAP reconciliation for (1) total net gains or losses in accordance with U.S. GAAP (i.e., total net realized and unrealized gains/losses) and (2) net cash receipts or payments for derivatives settled during the period (i.e., net realized gains/losses). See the Non-GAAP Financial Measures section for more information related to non-GAAP measures.

Power and Utilities

The SEC staff's comments to registrants in the power and utilities industry have continued to focus on (1) accounting for the impact of rate making; (2) regulatory disallowance of property, plant, and equipment; (3) identification of possible phase-in plans; and (4) parent and subsidiary dividend restrictions.

In addition, the staff continues to question whether registrants in the power and utilities industry have complied with requirements under ASC 450 to disclose their range of loss in connection with litigation and other contingencies and with segment reporting requirements under ASC 280. See the Contingencies and Segment Reporting sections for more information.

Because many utilities have both regulated and nonregulated businesses, the SEC staff has asked industry registrants to discuss their analysis for determining whether to separately disclose revenues and costs of revenues related to their nonregulated businesses. For additional information see the Financial Statement Classification, Including Other Comprehensive Income section.

Master limited partnerships (MLPs) are common structures used in the energy industry. See the Oil and Gas section for additional considerations related to MLPs.

Accounting for the Impact of Rate Making

Example of an of SEC Comment

You disclose that $[X] of regulatory assets [was] not earning a rate of return as of September 30, 2013. You subsequently disclose that a portion of the regulatory asset related to pensions and other postemployment benefits relating to the unfunded differences between the projected benefit obligation and plan assets also does not earn a rate of return, but do not disclose an amount. Please revise to disclose the total amount of regulatory assets for which you do not earn a rate of return. Refer to ASC 980-340-50-1.

The SEC staff continues to ask rate-regulated utilities to disclose (1) how their current regulated rates are designed to recover their specific costs of providing service; (2) the nature of all of their material regulatory assets and liabilities; (3) the anticipated recovery period of their regulatory assets, or the anticipated refund period of their regulatory liabilities; (4) whether a particular regulatory asset is earning a rate of return; and (5) their accounting policies for revenues subject to refund. In addition, the SEC staff may request supplemental explanations or separate detailed analysis and evidence that support the registrant's recognition of regulatory assets.

Regulatory Disallowance of Property, Plant, and Equipment

Example of an of SEC Comment

It is our understanding that you continued to recognize [certain] capital costs related to your recently completed administrative and operations buildings as of June 30, 2013. If our understanding is correct, please tell us the specific facts and circumstances you considered in continuing to recognize said capital costs after the draft decision was issued, and your consideration of ASC 980-360-35-12. Please also tell us what events you believe would trigger derecognition of said capital assets.

Recently, various public utility registrants have received comments from the SEC staff about how they applied ASC 980-360-35, which provides guidance on an entity's subsequent measurement and recognition of property, plant, and equipment. Registrants have been asked to explain considerations related to their derecognition of property, plant, and equipment in light of recent regulatory orders by state public utility commissions that limit a public utility entity's cost recovery. Also, given the increasing costs of capital projects and cost caps imposed by regulatory authorities at the time of approving large new capital projects, the SEC staff has requested disclosure regarding the estimated costs of capital projects and detail of the costs that could change during construction. SAB Topic 10.E states that "disallowed costs for recently completed plants [should] be charged to expense when the disallowance becomes probable and can be reasonably estimated."

Registrants can refer to the example in ASC 980-360-55-18 for assistance in applying the guidance on accounting for the disallowance of plant cost resulting from a cost cap.

Identification of Possible Phase-In Plans

Example of an of SEC Comment

Please supplementally explain the history of the regulatory asset relating to depreciation including why a portion of depreciation for financial reporting purposes was deferred. Tell us over what period it arose and the identity of the plant(s) to which it relates . . . including whether any plant(s) were recently completed. Tell us when you started amortizing this regulatory asset.

Since many regulators wish to keep rates down in a current rate proceeding, a regulator may decide to defer costs associated with a major new plant addition. A deferral of any costs associated with a major new plant addition could be a phase-in plan. In accordance with ASC 980-340-25-2, cost deferrals are not permitted for phase-in plans. To qualify as a phase-in plan, a method for recognizing allowable costs must meet three criteria outlined in ASC 980-360-20. Rate-making methods that can result in a phase-in plan include those under which:

- Rates for a new facility are levelized.
- Rates are based on the levelized lease payments under a capital lease (or power purchase agreement that meets the definition of a lease).
- A percentage of an overall rate increase that has been approved is deferred and included in rates in later years.
- The depreciation expense of a major new plant is deferred and included in rates in later years.

If a major newly completed plant is being included in rates for the first time and the regulator provides for a deferral of any costs associated with the new plant for inclusion in future rates rather than as part of cost of service in the current proceeding, those costs may not qualify as a regulatory asset under U.S. GAAP unless an exception applies, regardless of the probability that the incurred costs will be recovered in future rates.

Dividend Restrictions

The financial flexibility of registrants in the power and utilities industry and the nature of their relationships with affiliated parties, including the parent company, may be constrained by regulation. Subsidiaries often enter into financing agreements that may restrict (1) the transfer of assets in the form of advances, loans, or dividends to the parent company or another affiliated party or (2) other types of transactions with affiliates. The inability of a subsidiary to transfer assets to the parent company could, in turn, restrict the parent company's ability to pay a dividend to its shareholders. In addition, holders of significant noncontrolling interests in a subsidiary may influence the subsidiary's operations.

Various public utility registrants have received comments from the SEC staff about their compliance with Regulation S-X, Rules 4-08(e) and 5-04. The staff has questioned whether such registrants adequately considered the Federal Power Act as well as Federal Energy Regulatory Commission rules, state rules and regulations, and other regulations that restrict transfers of assets. In addition, the staff has asked public utility registrants whether, in the absence of regulatory restrictions, they have considered other limitations (e.g., debt agreement covenants), which could restrict the transfer of assets from a subsidiary to the parent company through dividends, loans, advances, or returns of capital.

As a result of the staff's comments, several power and utilities registrants have been required, or have agreed, to prospectively (1) expand their notes to the financial statements about potential dividend restrictions in accordance with Rule 4-08(e) and (2) include a Schedule I in their annual Form 10-K in accordance with Rule 5-04. A registrant must determine whether it needs to comply with Rule 4-08(e) independently of Rule 5-04 because compliance with one set of disclosure requirements does not satisfy the requirements of the other.

For additional considerations about dividend restrictions, see the Debt section.

Mining

Example of an SEC Comment

We note you present the non-GAAP measures of total cash costs per ounce of gold produced for fiscal years ended 2011 through 2013 on a mine-by-mine basis, computed after deducting by-product metal revenues. We understand your desire to convey the notion that sales of by-products offset part of your costs. However, to supplement your existing disclosure, please provide draft disclosure of the following information to be included in future filings:

- A measure presenting cash costs per ounce of gold produced before adjusting for by-product metal revenues;
- Transparent line item captions, i.e., cash costs per ounce of gold produced before by-product metal revenue and cash costs per ounce of gold produced net of by-product metal revenues;
- Description of the reasons why certain metals are considered by-products if the amount of by-product credits is material.

Recent SEC staff comments to registrants in the mining industry have focused on the registrants' use of non-GAAP financial measures. One such measure, which is often used in this industry, is total cash cost per ounce for the principal mineral the company produces. In their disclosures about the production of that mineral, registrants may identify by-products that generate revenue. The SEC staff has noted that registrants sometimes calculate the non-GAAP measure by netting the revenue earned from the by-products with the production cost of the principal mineral. This may result in a non-GAAP measure that is low compared with the gross production cost, or even negative, which could be confusing to investors.

At the 2013 AICPA Conference, the SEC staff emphasized that at a minimum, it expects full disclosure of what the non-GAAP measure represents and clear labeling of the measure to highlight that the cash costs per ounce have been reduced by the by-product revenues. To provide additional transparency, registrants may use a "with or without" measure that adjusts for the by-product revenues. The SEC staff also indicated that it may challenge the appropriateness of using the measure when by-product revenues materially affect the cost measure. The staff further emphasized that in cases involving multiple by-products, registrants should present any related revenues separately when material and reconcile such amounts to the total by-product revenue included in the non-GAAP measure.

In addition, recent SEC staff comments have asked registrants in the mining industry to (1) revise the titles of their non-GAAP measures throughout their filings to clarify that the measures are net of by-product credits, (2) disclose why management believes that presenting a cost measure net of revenue is useful to investors, and (3) explain why management considers other metals to be by-products when sales of such metals are significant.

See the Non-GAAP Financial Measures section for more information about non-GAAP measures.

Other Deloitte Resources

December 16, 2013, *Heads Up*, "Highlights of the 2013 AICPA Conference on Current SEC and PCAOB Developments."

Financial Services

Banking and Securities

The SEC staff's comments to registrants in the banking industry continue to focus on the estimation of allowances for loan losses, loan modifications, and TDRs. In addition, the SEC staff periodically asks registrants in the securities industry to provide more information about PCI and other acquired loans as well as quantitative and qualitative disclosures about market risk and VaR.

Allowance for Loan Losses

Qualitative and Quantitative Factors Used in Evaluating the Allowance for Loan Losses

Examples of SEC Comments

- [D]escribe in detail the qualitative or quantitative factors you track and consider in your allowance methodology and specifically discuss how those factors are able to track and incorporate the current loss trends in order to ensure your allowance is appropriately capturing all incurred losses.
- Please revise future periodic filings to provide a more robust and detailed discussion of how you determine this allowance for loan loss. Your disclosure should discuss, as appropriate, but not be limited to:
    a. how you group loans with similar characteristics (e.g. geography, past-due status, internal risk ratings, etc.);
    b. how forecasted probable losses are determined (e.g. historical loss rates adjusted for environmental factors, migration analysis, etc.);
    c. the key qualitative factors you considered and the impact on forecasted probable losses;
    d. the time frames over which you evaluate loss experience; and
    e. the interplay between the forecasted probable losses and the loss confirmation period.
- [You disclose] that you decreased the portion of your allowance for loan and lease losses (ALLL) related to qualitative and environmental factors to reflect improving credit quality trends and stabilizing economic conditions in some of your markets. Please revise your disclosure in future filings to address the following:
    - Clarify whether the reduction in the ALLL in each portfolio segment was driven solely by the portion related to qualitative and environmental factors . . . . In this regard, please also clarify whether more recent periods are more heavily weighted when determining historical loss rates.
    - Enhance your disclosure within MD&A to discuss the drivers of such reductions in each component of your ALLL in a more granular level of detail. . . . Please also ensure that your disclosure addresses both positive and negative credit quality trends and how they were impacted [by] the level of your ALLL.

Estimating the allowance for losses is an inherently subjective process that requires registrants to consider both quantitative and qualitative factors related to the loan loss reserve as well as the tendency of the reserve to change. Registrants have been asked to expand their disclosures about how they determine each element of the allowance for loan losses, including how they derive general and unallocated components.

Specifically, the SEC staff may ask registrants to disclose:

- How they group loans with similar characteristics to evaluate loan collectibility (such as loan type, past-due status, sector, and risk).
- How they determine loss rates (e.g., on the basis of historical loss rates that are adjusted for environmental factors or migration analysis), and what factors they consider when establishing appropriate time frames for the evaluation of loss experience.

- Qualitative factors (e.g., industry, geographical, economic, and political) that have affected loss rates or other loss measurements.
- How they consider housing price depreciation and homeowners' loss of equity in collateral when determining the allowance for loan losses related to residential mortgages and other loans collectively evaluated for impairment.
- The basis for assumptions used about housing price depreciation.
- How increases and decreases in expected cash flows on covered loans affect FDIC indemnification assets and allowance for loan losses, and how these changes are recognized in the income statement.
- How they consider write-downs recognized on real estate inventory transactions in determining the appropriate level of allowance for loan losses (both individually assessed and collectively assessed) for other loans with similar collateral.
- Where in the income statement they charge negative differences between carrying amounts of a loan and the fair value less costs to sell.
- Why certain types of loans have lower nonaccrual and charge-off statistics than others.

In addition, in light of improved economic conditions that have enabled banking institutions to reduce their allowances for loan losses, the SEC staff has asked registrants in the banking industry to provide expanded disclosures in MD&A about the factors that led to reductions in those allowances.

Further, SEC staff comments to registrants in the banking industry commonly cite the guidance in ASC 310-10-S99-4 and Chapter 9 of the AICPA's Audit and Accounting Guide for depository and lending institutions. The SEC staff's interpretive guidance in ASC 310-10-S99-4 states that when registrants change their method for determining the allowance for loan losses, the staff would normally expect them to maintain "documentation that describes and supports the changes." Accordingly, the SEC staff in such cases continues to request the following disclosures:

- The nature of, and reason for, the modification.
- The specific change(s) made.
- Why the change is necessary.
- Why the change is expected to result in a more appropriate allowance.
- The impact of the change on the level of the allowance for loan losses.

Credit Quality

Example of an SEC Comment

Please tell us and revise future filings to fully explain how you analyze how changes in the credit quality of your loan portfolio are considered when you determine the amount of your provision for loan loss recorded during the period and the amount of the allowance for loan losses at period end. For example, provide an analysis of each component of your allowance for loan losses (general, specific, unallocated, etc.) detailing how you determined that each component was directionally consistent with the underlying credit quality of the applicable loan portfolio.

To better understand the credit quality of a banking industry registrant's loan portfolio, the SEC staff has requested additional information (and enhanced discussions) about (1) changes in credit quality indicators, such as loan-to-value ratios and FICO scores, and (2) the impact of seasonality on the allowance for loan losses. In addition, if the credit quality of a registrant's loans changes significantly, the SEC staff expects the registrant to discuss (1) the components of the registrant's allowance for loan losses for each period and (2) how the effects of the change in credit quality are reflected in the financial statements. Registrants should also disclose other relevant information that clearly explains the reasons for the change in credit quality during the period (e.g., significant charge-offs recorded as a direct result of a regulatory examination) and how they measured the components of their allowance for loan losses.

The SEC staff may also comment if it appears that disclosures about credit quality in the notes to the financial statements are inconsistent with those in other parts of the registrant's filing or in other publicly available information (e.g., a press release or earnings call).

Collateral Appraisals

Example of an SEC Comment

Discuss how frequently you obtain appraisals for the underlying collateral for both loan origination and loan impairment analysis and the type of appraisal obtained (e.g., in-person full appraisals, drive-by appraisals or automated valuation models . . .). If the type of appraisal differs by loan product or value, discuss those differences.

To understand how registrants determine their allowance for loan losses, the SEC staff often asks them to disclose how frequently they obtain updated appraisals for impaired collateral-dependent loans and to describe the types of adjustments that are made to appraised values.

Disclosures About Credit Quality Under ASC 310-10

Example of an SEC Comment

Please revise future filings to disclose both the balance of your allowance for loan losses and your recorded investment in financing receivables by impairment method (e.g. collectively evaluated, individually evaluated, acquired with deteriorated credit quality) for each loan portfolio segment. Refer to ASC 310-10-50-11B(g) and (h) and the example disclosure in ASC 310-10-55-7 for guidance.

ASC 310-10 requires entities to enhance and disaggregate their disclosures about the credit quality of their financing receivables and their allowance for credit losses. The FASB's objective in requiring enhanced disclosures is to give financial statement users a better understanding of (1) the nature of an entity's credit risk associated with its financing receivables, (2) how the entity assessed that risk in estimating its allowance for credit losses, and (3) changes in the allowance and why they were made.

Specifically, ASC 310-10 requires disclosure of the following information about credit exposure and reserving methodology on the basis of disaggregated portfolio segments and classes of financing receivables:

1. Credit quality indicators of financing receivables at the end of the reporting period by class of financing receivables
2. The aging of past due financing receivables at the end of the reporting period by class of financing receivables
3. The nature and extent of troubled debt restructurings that occurred during the period by class of financing receivables and their effect on the allowance for credit losses

4. The nature and extent of financing receivables modified as troubled debt restructurings within the previous 12 months that defaulted during the reporting period by class of financing receivables and their effect on the allowance for credit losses

5. Significant purchases and sales of financing receivables during the reporting period disaggregated by portfolio segment.

PCI and Other Acquired Loans

Examples of SEC Comments

- Please revise, in future filings, to provide a loan summary table that addresses the loans by category that are self-originated and that have been acquired (both PCI and non-PCI loans) for each period presented.
- Please revise, in future filings, to also provide a rollforward of the activity in the allowance for loan losses for non-PCI loans for each of the periods presented. This will provide the reader with an enhanced understanding of the performance of the non-PCI loans given the continued significant growth of these types of loans.

The SEC staff has asked registrants whose loan portfolios have grown significantly as a result of acquired rather than self-originated loans to provide more granular disclosures about loan balances and corresponding loan loss allowances for (1) self-originated loans and (2) acquired loans (both PCI and non-PCI).

Loan Modifications and TDRs

Examples of SEC Comments

- We note your disclosure that you have created a number of loan modification programs to help borrowers stay in their homes and operate their businesses. You also state that in some of these cases, the restructure or loan modification fits the definition of a [TDR] as defined by current accounting guidance. Please tell us and revise future filings to provide a brief summary of your various loan modification programs, disclose the amount of loans modified that are not considered TDR's, disaggregated by loan portfolio segment, and explain how you determined the modifications did not meet the definition of a TDR pursuant to ASC 310-40-15-5.
- We note that corporate renegotiated loans and consumer renegotiated loans . . . declined year over year despite the increase in consumer U.S. mortgage loans . . . . Please tell us how much of the decline in renegotiated loans is due to loan sales, payments, charge-offs, removal from renegotiated/TDR loan status, or other factors, and confirm that you will revise your disclosure in future filings to separately address material trends in your renegotiated loans including any material offsetting amounts.

The SEC staff continues to request enhanced disclosures about loan restructurings. The staff has also inquired about whether such restructurings should be accounted for as TDRs and therefore should be included in the registrant's risk element disclosures required by SEC Industry Guide 3.

The SEC staff has suggested that registrants consider disclosing the following:

- How modifications affect the timing of the recording of the allowance for loan losses.
- A description of the key features of the registrant's loan modification programs, including whether the programs are government- or company-sponsored and whether they are short- or long-term.

- Quantification of the types of concessions made (e.g., rate reductions, payment extensions, forgiveness of principal, forbearance) and discussion of success with the different types of concessions.
- The accounting policy for restructured loans, including how and when a restructured loan is determined to be nonaccrual or accrual (i.e., noninterest accruing or interest accruing); the factors the registrant considered in determining whether the loan should accrue interest; the anticipated period and number of borrower payments for a restructured loan to return to accrual status; and whether any loan loss allowance has been recorded or any portion of the loan has been charged off.
- Confirmation of whether loan restructurings should be classified as TDRs under ASC 310-40 and, if so, separate disclosure of the loans in the nonperforming assets table under SEC Industry Guide 3, Item III(C)(1).
- TDRs by loan type, classified separately as accrual or nonaccrual.

In addition, if there are material changes in TDRs, the SEC staff may ask about such changes and request additional disclosures, including a rollforward detailing loan sales, payments, charge-offs, and loans that have been removed from TDR status.

Further, when a material amount of a registrant's loan modifications is not accounted for as TDRs, the SEC staff often requests disclosures that explain the following:

- Triggers and factors the registrant considered to identify loans to modify and to support its conclusion that modifications are not TDRs.
- Key features of the modification programs, including a description of the significant terms modified and the typical length of each modified term.
- Success rates of the modification programs.
- The amount of the loans modified in each period presented.
- Whether the modified loans are included in the company's impairment analysis of the general reserve (ASC 450-20) or individual reserve (ASC 310-10) and, if included in the general reserve analysis, whether a materially different amount would have resulted if the loans had been included in the individual reserve analysis.

In evaluating whether a loan modification represents a TDR, a registrant must use judgment to determine whether (1) the debtor (i.e., the borrower) is experiencing financial difficulty and (2) the lender has granted a concession to the borrower.

ASC 310-40 outlines considerations for determining whether a borrower is experiencing financial difficulties (e.g., debtor default, debtor bankruptcy, and concerns about the borrower's ability to continue as a going concern). Further, it clarifies that a borrower not currently in default could be experiencing financial difficulties if default is probable in the foreseeable future.

Quantitative and Qualitative Disclosures About Market Risk and VaR

Example of an SEC Comment

We note that you use a [VaR] methodology to measure the market risk inherent in your trading activities. Please revise your future filings to provide the following additional disclosures:

- [S]pecify the confidence level and time horizon used in your VaR model;
- [D]isclose your average, high and low VaR by type of risk (e.g., interest rate, equity, energy, foreign exchange, etc.) for each period presented; and
- [Q]uantify the number of times that actual trading losses exceeded VaR during the periods presented. Refer to Regulation S-K Item 305.

The SEC has periodically asked registrants in the banking and securities industries to provide more information on quantitative and qualitative disclosures about market risk and VaR. In addition, the SEC staff may ask broker-dealer registrants to:

- Quantify the amount of the investment positions excluded from the VaR measure.
- Explain whether the VaR measure includes the market risk associated with securities sold but not yet purchased.
- Include comparative disclosures for the prior year, along with a discussion describing the reasons for material quantitative changes in market risk.

Insurance

In many of its comments to registrants in the insurance industry, the SEC staff has continued to focus on (1) transactions with captive subsidiaries; (2) reinsurance receivables; (3) assumptions used in establishing reserves and loss adjustment expense; (4) deferred acquisition costs; and (5) various other considerations, including those related to statutory disclosures, disclosures about dividend restrictions, and investments and financial instruments.

In addition to the insurance-related matters (discussed below), the SEC staff's comments to registrants in the insurance industry have focused on goodwill and income taxes. See the Impairments of Goodwill and Other Long-Lived Assets and Income Taxes sections for more information.

Captive Subsidiaries

Example of an SEC Comment

Please provide us the following information regarding your use of [Company A], your special purpose financial captive insurance company:

- The nature and the business purpose of transactions with [Company A] and, if applicable, other captives. Explain how you reinsure with [Company A] including whether, and if so, to what extent, [Company A] assumes reinsurance from third parties to whom you ceded policies.
- The amount of [Company A's] obligations and the nature and amount of assets and guarantees that secure the captives' obligations, apart from the line of credit with [Company B] . . . . Tell us the nature and amount of the [the holding company's) assets, guarantees, letters of credit or promises securing [Company A's] obligations.
- The effects in your GAAP consolidated financial statements of transacting with [Company A] directly and, if applicable, indirectly through third parties.
- Your consideration of disclosing the risks of employing your captives strategy.
- Any uncertainties associated with the continued use of this strategy and the expected effects on your financial position and results of operations if you discontinue this strategy.

Many insurance entities have captive subsidiaries, which insure specific risks for the parent entity and its affiliates. These captive subsidiaries allow entities to manage their own risks and also provide many advantages, including capital management benefits. The SEC staff has continued to request expanded disclosures about transactions between registrants in the insurance industry and their captive subsidiaries, such as the nature, purpose, and number of those transactions. Further, it has requested enhanced disclosures about the impact of captive subsidiaries on registrants' financial statements and about the risks and uncertainties associated with those subsidiaries.

Reinsurance Receivables

Example of an SEC Comment

Given the magnitude of your reinsurance recoverable assets in relation to your equity, please provide us proposed revised disclosure to be included in future periodic reports that specifically indicates how you manage your associated credit risk. In your disclosure, at a minimum, please include the following concepts provided in your response to [a previous comment]:

The criteria you use to qualify new reinsurers;

- How you monitor the financial strength ratings of existing reinsurers; and
- The amount of collateral you hold against these recoverable assets and how you have accounted for this collateral, including where it is classified on your balance sheet.

In addition to information about investments and financial instruments, the SEC staff has asked registrants about their disclosures related to the credit quality of financing receivables and allowances for credit losses associated with insurance-specific balances, such as reinsurance receivables (also known as "reinsurance recoverables"). The staff has also asked registrants to disclose how they manage credit risk related to those receivables.

Reserves and Loss Adjustment Expense

Examples of SEC Comments

- We refer to your disclosure . . . noting the updates to your loss development triangles based on the higher than expected reported losses, changes in loss development factors and other actuarial assumptions. Please tell us for each significant line of business and assumption the nature and extent of a) new events that occurred or b) additional experience/information obtained in the second quarter that led to the change in estimates of prior year unfavorable development of $[X] which resulted in an additional reserve of $[Y] recorded in the second quarter of 2013 and $[Z] recorded in the third quarter of 2013. Ensure your explanation clarifies the timing of the change in estimate such as why recognition occurred in the period that it did and why recognition in earlier periods was not required.
- Please identify and describe those key assumptions included in your underlying actuarial methodologies that materially affect the estimate of the reserve for loss and loss adjustment expenses. From your disclosures in the risk factors section it appears that the number of claims expected to be paid (frequency) and the average cost per claim (severity) are considered to be the key assumptions that materially affect your losses and loss adjustment reserve. When applicable, for each of your key assumptions quantify and explain what caused them to change from the assumptions used in the immediately preceding period.

The SEC staff continues to ask registrants to explain the key methods and assumptions used in deriving their loss adjustment expense and related reserves and to provide current disclosures that comply with the requirements of SEC Industry Guide 6. In addition, the staff has asked registrants to discuss the drivers of the estimate's change, including assumptions that have changed and assumptions that are reasonably likely to change, in the critical accounting policy section of their MD&A. Further, the SEC staff may comment on reserve disclosures related to catastrophes. See the Management's Discussion and Analysis section for more information about comments related to critical accounting policies.

Deferred Acquisition Costs

Examples of SEC Comments

- Please provide us revised disclosure to be included in future periodic reports that addresses the following requirements of ASC 944-30-50-1:
  - Please revise your policy disclosure to clarify that the nature of acquisition costs capitalized relates only to the costs associated with successful efforts;
  - Disclose the amount of acquisition cost amortized for the period; and
  - Clarify whether the policy acquisition expenses line-item on your statements of operations and comprehensive income includes expenses that are not capitalized and amortized.
- Please confirm that the ceding commission income you reflect as revenue in your statements of income includes reimbursement for the recovery of acquisition costs on the ceded premiums. If so, please tell us why you did not reflect that portion of your ceding commissions as a reduction of your deferred acquisition costs as required by ASC 944-30-35-64 and tell us for each period provided in your filing the portion of your ceding commission income that relates to the recovery of acquisition costs.

The SEC staff has asked registrants in the insurance industry to (1) provide disclosures about the composition of their deferred acquisition costs (and enhance their related accounting policy disclosures) and (2) discuss omitted disclosures when it appears that such disclosures may be material. Further, the staff has asked such registrants about the presentation in the statement of comprehensive income of ceding commission income that is essentially a recovery of acquisition costs.

Other Considerations

Statutory Disclosures and Disclosures About Dividend Restrictions

SEC staff comments to registrants in the insurance industry continue to focus on compliance with existing disclosure requirements about statutory capital, surplus, and dividend restrictions under ASC 944-505-50 and Regulation S-X, Rule 4-08(e). When registrants have used in their annual audited financial statements labels such as "Unaudited," "Approximate," or "Preliminary" to describe their statutory capital and surplus, the staff will remind them that these disclosures are required to be audited. Further, the staff has asked registrants to enhance disclosures on minimum capital and surplus requirements for both domestic and foreign subsidiaries.

In addition, the SEC staff has asked registrants in the insurance industry about their compliance with Regulation S-X, Rules 4-08(e) and 7-05(c),[1] when there appear to be restrictions on the payment of dividends. The staff has asked registrants to add information about the considerations underlying their determination of why they did not need to disclose information required under Regulation S-X, Rules 4-08(e) and 7-05(c). Also, the staff has reminded registrants that in applying Rule 4-08(e), they must consider foreign insurance operations and nonregulated subsidiaries in addition to U.S. domestic subsidiaries. See the Debt section for additional information.

Investments and Financial Instruments

Given the significance of investment portfolios to most registrants in the insurance industry, the SEC staff may ask such registrants about their investments and financial instruments and whether related disclosures portray their financial position accurately. Accordingly, the staff may concentrate on conclusions reached by management about the credit quality of investments and may ask registrants to summarize the procedures they performed (and other support they obtained) to make such determinations.

The SEC staff may also question registrants' disclosures about key drivers that affected their net derivative results. When there has been significant volatility in results for multiple periods, registrants may be asked to enhance their disclosures about the drivers of net derivative gains and losses.

Further, depending on the interest rate environment, the SEC staff may comment on effective interest rates and ask registrants to expand their disclosures about the expected effects of the interest rate environment and the impact of those effects on future financial information (e.g., financial position, results of operations, and cash flows).

See the Fair Value, Financial Instruments, and Other-Than-Temporary Impairment of Investments in Securities sections for more information.

[1] Rule 7-05(c) requires registrants in the insurance industry to file Schedule II if the rule's conditions are met. These conditions are identical to those under Regulation S-X, Rule 5-04, that govern whether a commercial company must file Schedule I. See the Debt section for information about Rule 5-04.

Investment Management

The SEC staff's recent comments to registrants in the investment management industry have continued to focus on topics such as fair value measurement, revenue recognition, risk oversight, and consolidation. The staff has also commented on executive compensation, quantitative and qualitative disclosures about market risk, and share-based payments. For more information on these topics, see the Disclosures About Risk, Executive Compensation and Other Proxy Disclosures, and Share-Based Payments sections.

In addition, in a June 2014 speech, Norm Champ, director of the SEC's Division of Investment Management (the "Division"), highlighted the examination priorities of the SEC's 2014 National Exam Program for investment advisers and investment companies, which include issues such as conflicts of interest and fund marketing and performance. Mr. Champ noted that under this program, the SEC staff "will continue to examine a significant percentage of the advisers who have been registered with the [SEC] for more than three years, but have not yet been examined by the National Exam Program." Another focus of the Division has been to continue the practice of issuing IM Guidance Updates[1] that summarize the Division's views regarding various disclosures and other regulatory and compliance matters.

Fair Value Measurements

Example of an SEC Comment

We note your disclosure that the valuations for corporate private equity and real estate investments may be derived by reference to observable valuation measures adjusted by management for differences between the investment and the referenced comparables, and in some instances by reference to option pricing models or other similar methods. Please revise your disclosure to discuss the type of adjustments and the factors and information you consider when determining the appropriate adjustment to make to the observable valuation measures of your corporate private equity and real estate investments. Also explain the situations when the fair value determination would be made by reference to option pricing models or other similar methods.

The SEC staff continues to focus on fair value measurement and related disclosures in comments to registrants in the investment management industry. In particular, the SEC staff will frequently ask registrants to disclose additional qualitative information about their processes for determining fair value. Specifically, it will ask a registrant for additional information about (and, potentially, additional disclosures related to) Level 3 inputs, adjustments to quoted market prices, and investments for which the registrant's net asset value per share does not represent fair value. Further, the SEC staff has asked registrants to disclose additional information about the procedures they use to validate values obtained from external sources (e.g., broker quotes). In addition, the SEC staff has often asked registrants to expand quantitative disclosures, such as a weighted average or range of inputs in the tabular disclosure of Level 3 unobservable inputs. For more information, see the Fair Value section.

[1] See, for example, the Division of Investment Management's Guidance Update Nos. 2014-07, "Private Funds and the Application of the Custody Rule to Special Purpose Vehicles and Escrows," and 2014-08, "Guidance Regarding Mutual Fund Enhanced Disclosure."

Revenue Recognition

Examples of SEC Comments

- We note your disclosure that investment management fees are recognized as earned over the period in which services are rendered and are generally determined based on a percentage of [assets under management (AUM)]. We also note your disclosures . . . regarding your sales and distribution fees including those paid by Rule [12b-1] plans where you pay substantially all of the fees to the financial advisers and other intermediaries. Please expand your revenue recognition policy in future filings to address the following:
    - Disclose how frequently these fees are calculated and paid, and identify the basis for the AUM in the calculation. For example, tell us whether the fee is based on a percentage of average daily or monthly AUM. In your response clarify any differences between investment management fees earned under contractual arrangements with your [sponsored investment products] versus the sub-advised products.
    - Tell us whether any portion of your investment management fee on sub-advised products is paid to another party, and if so, explain whether the fees are reported on a gross or net basis.
- Tell us the typical contractual terms of your consolidated funds with incentive income arrangements. For example, clarify whether there are typically hurdle rates or lock-up periods, and describe the typical type of waterfalls for the incentive income distributions for these funds.
- We note you present your assets under management (AUM) by investment objective and the average mix of AUM for the last three fiscal years . . . . We also note your discussion . . . for fluctuations in operating revenues and expenses that are driven by the mix or average of certain investment objective AUM. In an effort to provide more transparent disclosures regarding trends in revenue and expenses, please disclose your average AUM by investment objective.

The SEC staff guidance in EITF D-96 (codified in ASC 605-20-S99) provides two alternatives for recognizing performance-based management fees and requires disclosure of the accounting policy used with regard to these arrangements. Disclosure should also include (1) whether the company has recorded any revenue that is at risk as a result of future performance contingencies, (2) the nature of contracts giving rise to the contingencies, and, if material, (3) the amount of such revenues recorded. The SEC staff has asked registrants to discuss their revenue recognition policy disclosures and has also inquired about their contract terms, including (1) whether carried interest and incentive fees are based on a fixed percentage and (2) whether there are any hurdle rates or lock-up periods. In addition, registrants have been asked whether they report transaction and/or placement fees on a gross or net basis and to explain how they made that reporting determination. Further, registrants have been requested to provide more transparent disclosures about trends in revenue and expenses by disclosing average AUM by investment objective, which could include a sensitivity analysis that demonstrates the impact that changes in the fair value of managed assets could have on results of operations (e.g., revenues and net income).

Risk Oversight

Example of an SEC Comment

You disclose that each segment runs its own risk management process. Please describe your policies and procedures related to the reporting of risks from each segment to your Board of Directors, your Manager, your Managing Partners and other entities/individuals with risk management responsibilities.

An Exchange Act registrant is required to disclose its board's risk management policies and procedures under Regulation S-K, Item 407(h). The SEC staff may ask a registrant in the investment management industry to elaborate on its board's risk management oversight of investment vehicles and to disclose additional information about the risk management responsibilities of board committees (such as the audit and compliance committees).

Consolidation

Because VIEs are common in the investment management industry, the SEC staff continues to comment on management's conclusions regarding the consolidation or deconsolidation of VIEs and asks registrants to clarify why certain vehicles have been consolidated and others have not. The SEC staff frequently questions (1) the consolidation model applied to specific investments, (2) the qualitative and quantitative assessments used to determine the primary beneficiary, and (3) the related disclosures. For more information, see the Consolidation section.

Real Estate

The SEC staff's comments to registrants in the real estate industry have focused on topics such as whether real estate acquisitions represent acquisitions of businesses, assets, or real estate operations; leasing activities; capitalization of real estate development, construction, and leasing costs; non-GAAP financial measures; liquidity considerations associated with distributions; consolidation; and impairments.

In addition, the SEC staff typically expects registrants that qualify as a REIT to file Schedule III,[1] which requires them to present supplemental information about real estate investments and accumulated depreciation. Registrants that recently converted to a REIT but did not file Schedule III may receive comments from the SEC staff.

Master limited partnerships (MLPs) are common structures used in the real estate industry. See the Oil and Gas section for additional considerations related to MLPs.

Real Estate Acquisitions

Examples of SEC Comments

- Please provide us with an analysis of the acquisitions you have made in the past three years, and whether or not those acquisitions were treated as asset acquisitions or business combinations. For each of these transactions, tell us whether properties were purchased vacant, partially leased, fully leased or whether you entered into a lease in conjunction with the purchase, and what impact this had on your accounting. For the transactions accounted [for] as asset acquisitions, please tell us if you allocate any value to in-place leases, and tell us the amount of transaction costs you have capitalized.
- We note that your [acquisition] was significant and you filed [Regulation S-X, Rule] 3-14 financial statements . . . . Please tell us the extent of [your acquisition's operations that are] other than leasing real estate (i.e. property management or development) and how this factored into your determination that [Rule] 3-14 financial statements are more appropriate than [Regulation S-X, Rule] 3-05 financial statements.

[1] The schedule is required for certain real estate companies in accordance with Regulation S-X, Rule 12-28.

Regulation S-X, Rule 3-05, requires a registrant to provide full financial statements for significant acquired or to be acquired businesses. However, Regulation S-X, Rule 3-14, permits a registrant to file only abbreviated income statements (and pro forma financial information) for significant acquired or to be acquired real estate operations. Because the requirements of Rules 3-05 and 3-14 are different, it is important for a registrant to determine whether it acquired a real estate operation (see the SEC Reporting section for additional information about Rule 3-05). As a result, the SEC staff may ask a registrant to provide an analysis supporting its conclusion that its acquisitions are real estate operations under Rule 3-14.

In addition, the SEC staff has asked registrants with material acquisitions to elaborate on their process for determining whether the acquired assets, including acquired real estate (e.g., single-family homes) that is subject to a lease, qualify as a business or an asset acquisition under U.S. GAAP. To help entities make this determination, ASC 805-10-25-1 links to the Master Glossary's definition of a business. ASC 805-10-55-4 through 55-9 also contain guidance on what constitutes a business. This determination is important because the accounting for an asset acquisition differs from the accounting for a business combination. In acquisitions accounted for as business combinations, all transaction costs must be expensed as incurred. In asset acquisitions, however, transaction costs are capitalized as part of the purchase price. The SEC staff has asked registrants to enhance their disclosures to discuss the accounting policies they apply to property acquisitions, including policies for allocating value to identified intangible assets and for recognizing acquisition-related costs.

Leasing Activities

Triple Net Leases

> **Example of an SEC Comment**
>
> It appears that [Entity X] is a significant lessee of properties under a long-term triple-net lease. Please tell us how you determined it was not necessary to provide audited financial statements of [Entity X].

In a triple net lease, a lessee is typically required to pay costs that are normally associated with ownership, such as property taxes, insurance, utilities, and maintenance costs. In accordance with Section 2340 of the FRM, an investor may be interested in (or may need) the lessee's financial statements or other financial information when (1) a registrant leases (under triple net leases) one or more properties to a single lessee or tenant and (2) "such properties represent a 'significant' portion of the registrant's assets." That is, such lease arrangements with a single lessee or tenant may represent a significant concentration of risk that an investor would need to evaluate.

Further, Section 2340 notes that a registrant should provide full audited financial statements of the lessee (or guarantor) — for the periods required by Regulation S-X, Rules 3-01 and 3-02 — when the asset concentration exceeds 20 percent of the registrant's assets as of its most recent balance sheet. Accordingly, when an industry registrant enters into a triple net lease transaction, the SEC staff may ask it to provide additional information about whether a triple net lease is significant, particularly when it appears to the staff that such a lease may be significant but the registrant has not included the lessee's or tenant's financial statements.

Disclosures About Rental Performance

Examples of SEC Comments

- We note your disclosure regarding your weighted average net rental rates. In future Exchange Act periodic reports, please provide an explanation of whether these amounts are net of leasing costs, including free rent. In addition, please include a comparison of both rents on new leases to rents on expiring leases and rents on renewals and expansions to rents on expiring leases.
- Please provide additional information regarding the fluctuations in your rental income amounts. Specifically, please expand your disclosures to quantify the amount increased as a result of increased rental rates on renewed leases, including the average percentage increase and the amount of the increase associated with new leases signed during the period.

Over the past few years, as rental rates in many markets have fluctuated, the SEC staff has commented about registrants' disclosures in MD&A of lease rollover trends, including changes in rental rates on lease renewals and new leases in the reporting period. For space expected to be re-leased over the next 12 months, the staff has commented on the difference between existing rents and current market rents to better understand registrants' current and future performance trends.

The SEC staff has also requested information about activity related to new leases and lease renewals during the reporting period, including:

- Square feet leased.
- Average rents.
- Per-square-foot costs associated with leasing (e.g., leasing commissions, tenant allowances, and tenant improvements).

See the Leases section for additional staff comments on leasing transactions.

Capitalization of Real Estate Development, Construction, and Leasing Costs

Examples of SEC Comments

- We note your disclosure related to upcoming capital expenditures for the coming months. In future filings please include additional analysis of your capital expenditures that have occurred by breaking down total capital expenditures between new development, redevelopment/renovations and other capital expenditures by year. The total of these expenditures should reconcile to the cash flow statement. In addition please provide a narrative discussion for fluctuations from year to year and expectations for the future.
- [P]lease include the amount of soft costs (i.e., payroll costs, interest expense, etc.) capitalized for each year that are included in the table of capital expenditures below the table.

The SEC staff frequently asks registrants to enhance their disclosures about the capitalization of real estate development, construction, and leasing costs (including their accounting for these costs). For example, the SEC staff has asked registrants to clarify their accounting policy for capitalizing or deferring costs in accordance with ASC 835-20, ASC 840-20-25-16, and ASC 970-10. It has also requested quantitative disclosures of certain expenses that are being capitalized, such as soft costs (e.g., interest and payroll).

In addition, the SEC staff has asked registrants to expand their disclosures about capital expenditures (either on the face of the statement of cash flows or in MD&A) to highlight expenditures related to acquisitions, new development, redevelopment, and improvements to existing properties.

Non-GAAP Financial Measures

> **Examples of SEC Comments**
>
> - We note your use of funds from operations (FFO) and net operating income (NOI) in your press release. Please explain to us whether you consider these metrics to be key performance indicators. To the extent that you do consider FFO and NOI to be key performance indicators, tell us why you have not included a discussion of these metrics in your MD&A.
> - We note your disclosure of operating statistics for your same store property portfolio . . . . In future Exchange Act periodic reports, please expand your analysis in the MD&A section to address any material period to period changes in same-store performance, including the relative impact of occupancy and rental rate changes, or advise.

The SEC staff has commented on inconsistencies between (1) the key performance measures identified in press releases, earnings calls, and analyst presentations and (2) the non-GAAP financial measures disclosed in registrants' SEC filings. Although the filings of most REITs include FFO as defined by NAREIT, REIT communications to shareholders and analysts may use other performance measures, such as modified FFO, adjusted FFO, core FFO, EBITDA, NOI, or core earnings.[2] In circumstances in which these key performance measures are provided in other communications to investors, the SEC staff may ask registrants why these non-GAAP financial measures were not disclosed in their periodic reports (e.g., Forms 10-K and 10-Q).

The SEC staff has also focused on non-GAAP performance metrics used in MD&A. The staff has requested clarification of how registrants define NOI to determine whether any additional property operating costs should be included. The SEC staff will often question whether the MD&A disclosure of period-to-period changes in rental revenue and expenses clarifies the impacts of same-store and non-same-store results and the impacts of changes in rental rates and occupancy. To improve transparency, disclosures of "same-store NOI" should be accompanied by an explanation of how the same-store pool is determined and should highlight any changes in the pool from the prior reporting period.

Recently, the staff has also requested further information and disclosure about backlog for those real estate companies involved in engineering and construction, such as home builders.

See the Backlog Disclosures, Management's Discussion and Analysis, and Non-GAAP Financial Measures sections for additional information.

Liquidity and Capital Resources — Distributions

> **Examples of SEC Comments**
>
> - In your tabular disclosure, please show the percentage of your distributions that were covered/funded by your cash flow from operations for each period presented.
> - Please disclose your cumulative earnings or FFO since inception as compared to your cumulative distributions.

The SEC staff frequently requests disclosures that investors can use to evaluate the registrant's ability to maintain or increase its historical distribution yield. When GAAP cash flow from operations is insufficient to cover the total distributions paid during a particular period, the SEC staff may inquire about the cash resources used to cover the shortfall, such as offering proceeds. Registrants should adequately disclose the risks associated with paying distributions in excess of GAAP cash flow from operations. In addition, the SEC staff may request disclosures that compare earnings (or FFO) with paid distributions, including

[2] See Questions 102.01 through 102.03 of the C&DIs on non-GAAP financial measures for additional information about FFO and NAREIT.

amounts reinvested through a distribution reinvestment plan. The staff sometimes asks registrants to disclose these items on a cumulative basis so that financial statement users can better understand the relationship between earnings (or FFO) and distributions.

See the Management's Discussion and Analysis section for further discussion about liquidity and capital resources.

Consolidation

> **Example of an SEC Comment**
>
> We note that you have a [70-plus percent] interest in [a] joint venture and that you have determined that the joint venture is a variable interest entity. It appears that you have determined that you are not the primary beneficiary because you do not have the power to direct the activities that most significantly impact the VIE's economic performance. Please tell us which activities most significantly impact the VIE's economic performance and tell us what happens if a vote on a significant matter is deadlocked. In addition please tell us if either party is required to consent to any significant activity of the entity or [whether there are] any contractual clauses that determine how to break a deadlock. For reference see ASC 810-10-25.

The SEC staff continues to focus on registrants' involvement with VIEs and joint ventures and has inquired about consolidation assessments.

The staff also routinely asks for additional information and disclosures about non-VIE joint ventures, particularly when a registrant that has a majority ownership interest uses the equity method of accounting or when the qualitative disclosures about such arrangements are not robust. Disclosures about these arrangements should include a discussion of the governance provisions that led the registrant to conclude that it does not exercise control over the joint venture.

See the Consolidation section for further discussion.

Impairments

> **Example of an SEC Comment**
>
> We note that due to changes in cash flow estimates and hold periods, you have recognized [an] impairment charge on real estate held for investment. Please tell us and revise future periodic filings to include a description of the impaired real estate and the facts and circumstances leading to the impairment . . . . To the extent these facts and circumstances are different for each real estate holding, please discuss separately. Reference is made to paragraph 360-10-50-2 of the Financial Accounting Standards Codification. In addition, your MD&A disclosure should also be expanded to discuss these changes, potential variability from period to period, and to the extent any of these changes are attributable to an area of concentration risk.

The SEC staff has frequently asked registrants in the real estate industry to enhance their disclosures about (1) the timing of impairments, (2) the need for MD&A disclosures that warn of potential future impairments, (3) the inputs used in asset recoverability tests, and (4) the valuation techniques used to develop nonrecurring measurements of fair value. Comments on impairment issued to such registrants are consistent with those discussed in the Fair Value and Impairments of Goodwill and Other Long-Lived Assets sections.

Health Sciences

Life Sciences

The SEC staff's comments to registrants in the life sciences industry have focused on topics such as revenue recognition, MD&A disclosures, business combinations, contingencies, and segment disclosures.

Revenue Recognition

Collaborative Arrangements

Examples of SEC Comments

- [P]lease identify for us each significant accounting element in the arrangement, the character of each element (revenue vs. expense reimbursement), the units of accounting (i.e., which elements are separate vs. combined), and the accounting basis for the units of accounting (e.g., ASC 605-25).
- In order to help us understand more fully how your collaborative arrangements impact your financial statements for each period presented, please provide us a table showing amounts by year and by line item included in your statements of operations attributable to transactions arising from collaborative arrangements between you and the other participants and to third-parties. Please provide separate tables for this information for each of your significant collaborative arrangements and in the aggregate for all of your collaborative arrangements (i.e. the significant arrangements and all other arrangements).

Collaborative arrangements are common for biotech and pharmaceutical companies. ASC 808-10 provides guidance on the income statement presentation, classification, and disclosures related to collaborative arrangements but "does not address recognition or measurement matters related to collaborative arrangements, for example, determining the appropriate units of accounting, the appropriate recognition requirements for a given unit of accounting, or when the recognition criteria are met." As a result, the SEC staff often asks registrants in the industry about the nature of, and accounting for, their collaborative arrangements and has continued to probe them to better understand the basis for such accounting under U.S. GAAP. Inquiries to registrants have focused on:

- The overall effect of collaborative arrangements on the financial statements. For example, the SEC staff has asked that registrants prepare a tabular summary to provide the staff with a composite disclosure of the financial statement impact of all collaborative arrangements. For all periods presented, the staff may request a separate table for each significant collaborative arrangement and a table for all collaborative arrangements in the aggregate; in such tables, the staff may also ask that the registrant separately present amounts attributable to transactions with other participants and third parties that are presented net in a financial statement line item.
- The factors leading to the registrant's conclusion that a collaborative arrangement is (or is not) within the scope of ASC 808. For example, if an arrangement involving the manufacture of a drug to be sold to third parties began after the drug was FDA-approved for sale, the SEC staff may seek to understand the basis for the registrant's conclusion that it entered into a collaborative arrangement (since the parties' agreement did not include initial research activities).
- The registrant's conclusion about whether certain transactions with the collaboration partner represent true vendor-customer activities. Collaborative arrangements within the scope of ASC 808 are based on the premise that each party to the agreement assumes a proportionate share of risks and, therefore, a vendor-customer relationship does not exist. Even if the registrant concludes that it is a party to a collaborative agreement, however, there may be circumstances in which certain elements of the agreement represent activities that are similar to those in a vendor-customer relationship. Accordingly, the SEC staff seeks to understand the registrant's process for identifying, and allocating consideration to, such activities.

- The registrant's determination and disclosure of (1) the separation, allocation, recognition, and classification principles that were used to account for payments between collaboration partners and (2) the factors that led the registrant to conclude that it is the principal (or agent) in transactions with third parties.

The SEC staff also has requested enhanced disclosures about registrants' collaborative agreements. Staff requests for such disclosures have focused on clearly describing the material terms of a collaborative arrangement, such as (1) each party's rights and obligations under the arrangement, (2) potential payments, (3) the existence of royalty provisions, and (4) duration and termination provisions.

Further, the staff may also ask registrants to file a material collaborative arrangement as an exhibit to their filing in accordance with Regulation S-K, Item 601(b)(10). For more discussion, see the Material Contracts section.

Milestones

Examples of SEC Comments

- Regarding your development, license and supply agreement with [Entity A], please disclose the amount of the upfront payment received and how you accounted for the agreement. In addition disclose each substantive milestone and the related contingent consideration. Refer to ASC 605-28-50-2b.
- Please expand your disclosure . . . to disclose the factors that management considered in determining whether the milestone or milestones are substantive as required by ASC 605-28-50-2d. This comment also applies to your disclosure of new agreements in the interim financial statements.

The SEC staff often comments on disclosures about milestone recognition under ASC 605-28. When such disclosures apply, the staff will review filings to determine whether they contain the following disclosures outlined in ASC 605-28-50-2:

a. A description of the overall arrangement

b. A description of each milestone and related contingent consideration

c. A determination of whether each milestone is considered substantive

d. The factors that the entity considered in determining whether the milestone or milestones are substantive

e. The amount of consideration recognized during the period for the milestone or milestones.

Registrants in the industry will often make adjustments for milestones when determining non-GAAP income. For a discussion of adjustments made by registrants when determining their non-GAAP measures, see the Non-GAAP Financial Measures section.

Multiple-Element Arrangements

Examples of SEC Comments

- Please confirm that all of the disclosures required by ASC 605-25-50-2 have been made. For example, please assure that the performance-, cancellation-, termination-, and refund-type provisions of your [revenue] agreement have been disclosed. Clarify the reasons why your significant deliverables under the agreement do not qualify as separate units of accounting.
- Please revise your disclosure to state the reason why the license does not qualify for a separate unit of accounting. Refer to ASC 605-25-50-2f. Additionally, please clarify whether the initial supply of the compound of the license product represents a separate unit of accounting.

The SEC staff often asks registrants in the life sciences industry to expand or clarify their disclosures about multiple-element arrangements. Registrants could improve their required disclosures about the nature and terms of such arrangements by (1) separating the description of the obligations and rights from the discussion of how they were accounted for, (2) ensuring that such description is complete (i.e., that all material terms are disclosed), and (3) precisely describing the rights conveyed by the license. In addition, the staff has reminded registrants that they should explicitly identify each deliverable in the arrangement and explain why it represents (or does not represent) a separate unit of accounting. The staff has also suggested that registrants could improve their disclosures about the relative selling price method of allocating arrangement consideration by (1) quantifying the total arrangement consideration to be allocated, (2) identifying the amount of consideration allocated to each unit of accounting, and (3) explaining how the estimated selling price for each unit was determined (including the significant assumptions used). For more information about multiple-element arrangements and other revenue-related considerations, see the Revenue Recognition section.

Branded Pharmaceutical Drug Annual Fee

In July 2014, the IRS issued final regulations that indicate that an entity's obligation to pay its portion of the branded pharmaceutical drug (BPD) annual fee (under the Patient Protection and Affordable Care Act and the Health Care and Education Affordability Reconciliation Act of 2010) in any given calendar year is not triggered by the first qualifying sale in that calendar year but instead by the qualifying sales in the previous year. This accounting treatment differs from that previously prescribed in ASC 720-50 and will apply to financial reporting periods that include the July 28, 2014, effective date of the final IRS regulations. Accordingly, registrants should consider disclosing information about (1) the change in recognition of the BPD fee resulting from the final IRS regulations, (2) the impact of the catch-up adjustment recorded in the period, and (3) how the BPD fee will be accounted for prospectively. For additional information see Deloitte's October 13, 2014, Financial Reporting Alert 14-2.

MD&A Disclosures

R&D Expenses

Example of an SEC Comment

You state that you have made, and expect to continue to make, substantial investments in research and development to expand your product portfolio and grow your business. . . . Please provide us with the following information and revise your disclosures as appropriate:

- For your key research and development projects, please tell us the following:
  - The nature, objective, and current status of the project;
  - The costs incurred during each period presented and to date;
  - The nature of efforts and steps necessary to complete the project;
  - The risks and uncertainties associated with completing development;
  - The extent and nature of additional resources that need to be obtained if current liquidity is not expected to be sufficient to complete the project; and
  - Whether a future milestone such as completion of a development phase, date of filing [a new drug application (NDA)] with a regulatory agency, or approval from a regulatory agency can be reliably determined.
- For the remainder of projects not considered individually significant, tell us the composition of the total R&D expense for each period presented. This can take a variety of forms but is mainly driven by how many projects are managed and how they are reported within the organization. We believe disclosure of R&D by your divisional structure would be informative. Also distinguishing between discovery, preclinical and clinical development categories and further by late stage such as phase III development categories along with providing the number of projects in each category helps provide information necessary to understand the pipeline and trends by division. To the extent that management has information available by therapeutic class, we believe that further enhances the understanding of R&D expense and trends.
- If based on a known event, trend, demand, commitment or uncertainty, future R&D expense or the mix of R&D expense is reasonably likely to differ from current trends, please tell us the reasons for and the amount of the expected change.
- For projects that you disclose are in the late stage of development such as phase III, unless management believes that the expected effect on results of operations or financial position from the project when completed will be insignificant, please tell us the following about each project, even if the R&D expenses incurred on the project [have] not been material, in order to provide insight into expected effects on future operations, financial position or liquidity. Please include:
  - A description of the nature and its indication;
  - The phase the project is in at the end of the reporting period and the month and year it entered that phase;
  - Significant patents associated with the project and their expiration dates as well as other information about the exclusivity period related to the project;

Example of an SEC Comment (continued)

- o Significant developments of the project during the period such as significant milestones, filing for regulatory approval, approval and other responses from regulatory agencies; suspension or termination and their reasons;
- o Future expected milestones such as completion of a development phase, date of filing an NDA with a regulatory agency, or approval from a regulatory agency if it can be reliably determined. If the extent and timing of these future events cannot be reliably determined, please tell us the facts and circumstances that prevent their determination.

The SEC staff has asked registrants in the life sciences industry to expand their disclosures about internal R&D expenses and estimated future expenses beyond those required under ASC 730-10. In addition to disclosing the types of activities and elements included in R&D expenses and the amount of R&D expenses incurred during each reporting period, registrants may be asked to revise their MD&A and business sections to include information about each major R&D project. If registrants do not maintain information about R&D costs by project or program, they may be asked to explain why.

Registrants must carefully consider whether their R&D projects are significant enough to warrant disclosure and whether the timing of the costs associated with the projects can be reasonably estimated. Registrants involved in late-stage clinical trials should consider expanding their disclosures about such projects to reflect the uncertainty of ultimate regulatory approval and commercial success.

The SEC staff may also ask a registrant to include, in its contractual obligations table in MD&A, commitments to make payments for R&D contractual relationships. See the Management's Discussion and Analysis section for more information about the contractual obligations table.

Patents

Examples of SEC Comments

- [Please] include proposed disclosure about the type of protection offered by the patent covering [Formulation A] that expires in 2016. Please additionally disclose what effects such expiration could have on sales of [Product X], and what specific steps you plan to take to mitigate this loss of patent protection in your Management's Discussion and Analysis section. You should also provide proposed disclosure to this effect to be included [in] your risk factors section.
- Please expand your disclosure to provide the type of patent coverage (e.g., method of use, composition of matter) and the expiration date (or, if a patent application, the date filed).

The SEC staff has also regularly commented on life sciences registrants' disclosure of patents, particularly on patent exclusivity of their products and the impact of such exclusivity on revenues and overall operations. Patent expiration and challenges can affect not only a registrant's current-period earnings but also its future operations and liquidity, particularly if the patents are for core products. Registrants should consider Regulation S-K, Items 101 and 503(c), respectively, for guidance on (1) disclosing patent information in the business section of their periodic filings and (2) discussing patent expiration and challenges as possible risk factors in their annual reports. In addition, the SEC staff has requested information on the subject matter and jurisdiction of a registrant's patents.

Liquidity

> **Example of an SEC Comment**
>
> [P]lease disclose the amount of cash and investments that are currently held by your foreign subsidiaries that are considered permanently reinvested and its expected effect on your liquidity and capital resources. Refer to Item 303(a)(1) of Regulation S-K and Section IV of SEC Release 33-8350.

Life sciences companies typically have manufacturing and distribution sites, as well as holding company subsidiaries, domiciled in countries with favorable tax rates. If a life sciences registrant discloses that it will reinvest undistributed earnings of its foreign subsidiaries indefinitely, the SEC staff is likely to examine the registrant's liquidity disclosure to determine whether its cash holdings are sufficient to meet its long- and short-term liquidity needs. Therefore, the disclosures in the liquidity section of the MD&A about how the registrant plans to meet its funding obligations should be clear and robust. See the Income Taxes section for additional information.

Business Combinations

> **Example of an SEC Comment**
>
> As [Product X] was an approved product when you licensed it, please provide us with an analysis supporting your conclusion that the license of [Product X] was an asset acquisition and not a business combination. Please refer to [ASC] 805-10-55-4 to 9.

Since business combinations in the life sciences industry are typically complex and individually unique, the SEC staff frequently comments on registrants' disclosures about them. For example, the staff has asked registrants about their evaluation of whether a certain transaction constitutes a business combination under ASC 805. In addition, the staff has asked registrants how they determined the useful life of their intangible assets. Because the intangible assets acquired are typically the patent rights to a product or potential product, most life sciences companies begin their analysis by considering the patent life of the underlying product. However, useful life could be affected by other factors, such as the risk of competition from branded or generic products before the registrant's patent expires or a high barrier to market entry even after the registrant's patent expires. Therefore, the staff has asked registrants to provide additional analysis that explains the basis for their conclusions about their intangible assets' useful life. For additional accounting and reporting considerations related to acquisitions, see the Business Combinations section.

Contingencies

> **Examples of SEC Comments**
>
> - Please further clarify your policy in which you record "at least the minimum estimated liability related to those claims where a range of loss has been established," given the requirements of paragraph 450-20-30-1 of the FASB Accounting Standards Codification.
> - We note the accruals for product liability contingencies involve a large number of small individual claims of a similar type. Please tell us your consideration of providing a roll forward within MD&A of the outstanding claims including the number of claims pending at each balance sheet date, the number of claims filed each period presented, the number of claims dismissed, settled, or otherwise resolved for each period, and/or including the average settlement amount per claim as discussed in Question 3 to SAB Topic [5.Y].

The SEC staff often comments on life sciences registrants' disclosures about legal contingencies. Pharmaceutical and medical device companies alike must often defend against various claims related to their products, including potentially both product liability and patent infringement claims. In addition, further legal exposure may arise from an entity's potential noncompliance with applicable government regulations (e.g., FDA and FCPA). The SEC staff commonly asks registrants in the industry to explain (1) how their accounting and reporting for a loss contingency complies with the recognition, measurement, and disclosure requirements in ASC 450 and (2) their consideration of the disclosure requirements in SAB Topic 5.Y. Also, the SEC staff often asks such registrants to quantify, in the risk factors section, the amount of product liability coverage they maintain. For additional accounting and disclosure considerations related to contingencies, see the Contingencies section.

Segment Disclosures

Example of an SEC Comment

We note your disclosure with respect to Medicare. Please tell us how you considered FASB ASC 280-10-50-42 which states that you should consider a group of entities under common control as a single customer (for example, the federal government). This comment also applies to your interim information.

Many life sciences companies have a diverse portfolio of products that are sold throughout the world. The SEC staff may question how a registrant's segment disclosures comply with the requirements in ASC 280 regarding disclosures that are disaggregated by products and services, geography, or major customer. The staff, for example, routinely reminds registrants of the requirement to disclose revenue information pertaining to groups of similar products and services, and it objects to an overly broad definition of "similar." For additional discussion of segment disclosure requirements, see the Segment Reporting section.

Health Plans

The SEC staff's recent comments to health plan registrants have focused mainly on (1) the provision for adverse deviation and (2) statutory disclosures. Like other registrants, health plan registrants have also continued to receive comments related to contingencies, goodwill impairment, and revenue recognition. For more information on these topics, see the Contingencies, Impairments of Goodwill and Other Long-Lived Assets, and Revenue Recognition sections.

In addition, because health plan registrants are primarily engaged in offering health care insurance products, SEC staff comments to registrants in the insurance industry may also apply to health plans. For more information, see the Insurance section.

Provision for Adverse Deviation

Example of an SEC Comment

You state . . . that for the three and six months ended June 30, 2013, there were no material reserve developments related to prior years. You state in [your Form 8-K] that you had a favorable development of $[X] for the six months ended June 30, 2013. Please provide proposed disclosure to be included in your next [Form] 10-Q to clarify the reserve development relating to prior years and the reasons for the development. You state in [your Form 8-K] that the majority of the adjustments to reserves relate to variables and uncertainties associated with actuarial assumptions. Please clarify in the proposed disclosure what assumptions changed, why the assumptions changed and how it affected your reserve.

For most health plans, the provision for adverse deviation represents a significant estimate involving assumptions that are often highly subjective and that are, or could be, material to the plan's financial condition or operating performance. Accordingly, the SEC staff expects registrants to disclose information that would allow users to clearly understand (1) what the provision for adverse deviation represents, (2) how this reserve is established, and (3) the amount of the provision and changes in the provision for each period presented. The staff also asks registrants how the provision complies with the requirements of ASC 944-40-25.

Statutory Disclosures

> **Example of an SEC Comment**
>
> Although you disclose that your regulated subsidiaries currently exceed the minimum capital requirements, please provide us proposed disclosure to be included in future filings that states the amount of statutory capital and surplus necessary to satisfy regulatory requirements if significant in relation to actual statutory capital and surplus, as required under ASC 944-505-50-1b. If not significant, please clarify in the disclosure.

Specifically, the SEC staff has commented when registrants' disclosures required by Regulation S-X, Rule 4-08(e), and ASC 944-505 (e.g., disclosures about statutory requirements related to minimum capital standards and certain restricted accounts or assets that may limit payment of dividends) are incomplete or missing. In addition, the SEC staff reminds registrants that such ASC 944-905 disclosures should not be labeled unaudited. For more information, see the Debt and Insurance sections.

Technology, Media, and Telecommunications

Technology

In 2014, SEC registrants in the technology industry have seen an increase in SEC staff comments. This increase is partly attributable to the continued strength of the markets, which have prompted more IPOs, but it has also resulted from the complexity of, and significant judgments necessary to apply, the accounting guidance on topics such as revenue recognition. As it did in the prior year, the SEC staff continues to focus on software and nonsoftware multiple-element arrangements. More recently, it has also focused on registrants' considerations related to gross versus net revenue reporting, accounting for nonrefundable up-front fees, and disclosures about key metrics in MD&A. See the Revenue Recognition section for more information about SEC staff comments on revenue-related topics.

In addition, SEC staff comments to registrants in the technology industry, like those received by registrants in other industries, have concentrated on disclosures about contingencies, income taxes, segment determination, and share-based compensation. See the Contingencies, Income Taxes, Segment Reporting, and Share-Based Payments sections for additional information about such comments.

Revenue Recognition — Multiple-Element Arrangements

Multiple-Element Arrangement Accounting Policies and Disclosures

Examples of SEC Comments

- We note that for multiple element arrangements that include non-software elements, you allocate revenue to all deliverables based on their relative selling prices. Please tell us how you determine the selling price of the deliverables in your multiple deliverable arrangements including the significant factors, inputs, assumptions and methods used to determine the selling price. Please also tell us what consideration was given to disclosing this information. Refer to ASC 605-25-30-2 and ASC 605-25-50-2(e).
- Please tell us what consideration was given to the application of the provisions of ASC 985-605-15-3 to determine whether your software element is essential to the functionality of your hardware. In this regard, please explain whether the hardware has substantive functionality without the software such that a customer could reasonably be expected to purchase the hardware without the software.

Under ASC 605-25, consideration in a multiple-element arrangement must be allocated to the deliverables on the basis of their relative selling price. To determine the selling price of each deliverable, entities apply a hierarchy that requires them to use VSOE if available, TPE if VSOE is not available, or their best estimate of the selling price if neither VSOE nor TPE is available. The SEC staff focuses on how technology registrants allocate consideration to elements in such arrangements and may request additional information about the factors, inputs, and assumptions used to determine the selling price of each element.

In addition, given the prevalence of multiple-element arrangements in the industry, when the SEC staff reviews the filings of technology registrants, it may comment on the manner in which revenue is measured and recognized in such arrangements as well as on the related disclosures. Historically, registrants have been asked to clarify the descriptions of the elements or deliverables in an arrangement, how they determined that components have stand-alone value, and the timing of each element's delivery or performance.

For multiple element arrangements that include tangible products containing software, the staff may ask registrants to clarify the accounting guidance they applied and how they determined whether the software components and nonsoftware components of the tangible product function together to deliver the tangible product's essential functionality (and are therefore outside the scope of the guidance in ASC 985-605). Accordingly, registrants should carefully consider all facts when determining the appropriate accounting guidance to apply to arrangements that involve tangible products containing software and should clearly and adequately disclose the guidance they applied to such arrangements.

Disclosures About VSOE

> **Example of an SEC Comment**
>
> We note that, for multiple element arrangements that contain software products and related services, you allocate the total arrangement consideration to all deliverables based on VSOE of fair value. Please describe for us, in detail, your methodology for establishing VSOE for each of the elements in your multiple element arrangements. For example, if VSOE of your subscription services is based on stated renewal rates please provide the range of renewal rates and tell us what percentage of your customers actually renew at such rates. Alternatively, if VSOE is based on stand-alone sales, then provide the volume and range of stand-alone sales used to establish VSOE. Also, please tell us what consideration was given to disclosing the significant factors, inputs, and assumptions used to determine VSOE. Refer to ASC 605-25-50-2(e).

Establishing VSOE of fair value can significantly affect how revenue is recognized under ASC 985-605. To recognize revenue for a delivered element (e.g., a software license) in a software arrangement, a vendor must first establish VSOE for any undelivered elements (e.g., PCS or professional services). If the vendor cannot establish VSOE of fair value for undelivered elements, it generally must defer all revenue in the arrangement until VSOE is established, the undelivered elements are delivered, or the last remaining deliverable is PCS.

The SEC staff continues to focus on this topic and frequently asks registrants that have multiple-element arrangements within the scope of ASC 985-605 — many of which are undergoing IPOs — to expand their disclosures about how they determined VSOE. The additional information may include:

- The percentage of customers that renew at contractually stated rates for PCS and how the rates are substantive when contractually stated renewal rates are used to establish VSOE.
- An explanation of how the registrant determined VSOE if it does not use stated renewal rates or a bell-curve analysis of stand-alone sales to establish VSOE.
- A description of the process used to evaluate the various factors that affect VSOE.
- A quantitative description of the volume and range of stand-alone sales used to establish VSOE and how the registrant accounts for contracts whose sales volume falls outside that range.
- A description of how VSOE is determined when different levels of renewable rates exist.
- An explanation of why the registrant believes that it cannot determine VSOE for its undelivered elements if it accounts for software arrangement elements ratably because they are not separated.
- An explanation of why the registrant could not determine VSOE in prior years and, in cases in which VSOE is first established or is reestablished, what changes arose in the current year.

Revenue Recognition — Gross Versus Net Reporting

Under ASC 605-45, an entity should report revenue on a gross basis when it is acting as the principal of the transaction and on a net basis when acting as an agent to the transaction; applying this guidance often requires careful consideration and judgment. Although ASC 605-45 references eight indicators of gross reporting, the SEC staff has placed a higher emphasis on (1) which party is the primary obligor to the transaction and (2) which party has general inventory risk.

Determining the principal in an online transaction is challenging for technology companies, particularly those engaging in transactions related to software as a service (SaaS), online gaming, or online advertising, since there is no tangible product (and, in some instances, transactions are executed almost instantaneously). Because these types of arrangements have become more prevalent, they are topics of increased SEC staff focus.

SaaS and Online Gaming

Examples of SEC Comments

- You indicate that in certain instances, your partners are considered the primary obligors for providing subscription services and at other times you are considered the primary obligor. Please tell us how the criteria of ASC 605-45 regarding principal-agent considerations [were] considered in your analysis.
- [Y]ou indicate that for all your types of games, you are able to release game updates and special editions through [your network]. In addition, we note . . . that your cloud-based server and network infrastructure enable you to deliver games and that you routinely deliver massive amounts of content to millions of users across your platform. In light of these disclosures, please clarify your statement that developers are responsible for providing the game product desired by the game players used in your evaluation of principal agent considerations.

SaaS and online gaming companies often use operator or reseller partners to target new markets. Questions arise about which party is the primary obligor (i.e., the party responsible for providing the product or service desired by the customer). The SEC staff has challenged the conclusions of various SaaS and online gaming companies (and their resellers) about the appropriateness of gross or net reporting for their transactions and has asked such registrants to provide additional analysis with an emphasis on the factors outlined in ASC 605-45-45. The staff may also request additional disclosures about the nature of these transactions and the role of each of the parties.

Online Advertising

Like other forms of advertising, online advertising often involves at least three parties:

- An owner/operator of the online content (a "publisher") that provides the online space or search engine results in which advertising content may be placed.
- A party (an "advertiser") that desires to place the advertising content.
- A third-party service provider (e.g., an advertising agency).

In addition, there are many companies that offer various technologies and solutions to help advertisers and publishers in what is commonly referred to as the "ad tech" industry. These include "ad networks" or "demand-side platforms,"[1] "ad exchanges,"[2] and "supply-side platforms."[3]

A registrant that has entered into an online advertising arrangement needs to evaluate the terms of the arrangement and the responsibilities of each of the parties to the agreement to determine whether it should report revenues on a gross or net basis. As a result, the SEC staff may review the contractual terms and marketing materials related to the transaction to determine the nature of the deliverable and the party ultimately responsible for fulfillment. For example, it may be challenging for an ad exchange to conclude that it is the primary obligor (and therefore the principal) if it cannot demonstrate that it is responsible for displaying the advertising content but instead appears to be acting as an agent by matching advertisers with the publishers. On the other hand — to understand whether, for example, a demand-side platform is the principal — the SEC staff often seeks to understand contractual terms (among other factors) to determine whether there are sufficient economic and fulfillment risks analogous to inventory risk. Accordingly, the SEC staff may review the contractual agreements with advertisers to understand whether the demand-side platform provided a firm commitment to deliver a certain amount of advertising space at fixed pricing by means of contractual insertion orders (a common contractual form used in the online advertising industry).

1 Ad networks or demand-side platforms are companies that interact closely with an advertiser to develop the strategy and scope of an advertising campaign and use their technologies to take control of executing such a campaign.

2 Ad exchanges are companies that provide an auction process (generally in a real-time bidding (RTB) environment) and partner with various parties representing advertisers and publishers that participate in the RTB auction.

3 Supply-side platforms are companies that interact closely with a publisher to develop an optimal strategy for making advertising space available to bring about the greatest monetary return on such advertising space.

Because of the complexity and judgments associated with determining whether to record revenues on a gross or net basis, technology registrants should (1) thoroughly document the basis for their conclusions and (2) consider whether additional disclosures would be appropriate for investors.

Revenue Recognition — Accounting for Nonrefundable Up-Front Fees

> **Example of an SEC Comment**
>
> We note that revenue from non-refundable upfront fees is deferred and recognized over the term of the related arrangement or the estimated customer life. Please tell us whether the non-refundable upfront fees have standalone values and are considered separate units of account. Refer to ASC 605-25-25-5(a). Also, please tell us how you determine whether the fees are recognized over the arrangement term versus over the estimated customer life.

SAB Topic 13.A.3(f) provides guidance on the accounting for nonrefundable up-front fees. In the technology industry, up-front fees often exist in hosting or SaaS arrangements. These fees, which are typically charged together with a subscription fee for the hosting or SaaS services, cover items such as training, connection services, data migration, and other implementation services. Entities entering into such arrangements are generally required to determine whether the activities associated with the up-front fees and those related to the ongoing hosting or SaaS services are separate units of accounting in a multiple-element arrangement under ASC 605-25. To make this determination, entities must assess whether the activities associated with the up-front fees have stand-alone value and can therefore be regarded as a separate unit of accounting. In assessing stand-alone value, entities need to consider whether such activities are sold separately by any vendor or whether the customer can resell any products or services received.

When the activities associated with an up-front fee and the hosting or SaaS services are treated as a single unit of accounting under ASC 605-25, registrants apply the guidance in SAB Topic 13.A.3(f) to determine an appropriate accounting policy for recognizing revenue related to the up-front fees. Under that guidance, "[u]nless the up-front fee is in exchange for products delivered or services performed that represent the culmination of a separate earnings process," revenue is typically deferred and recognized over the period in which the up-front fees are earned, which may extend beyond the initial contract term.

Footnote 39 of SAB Topic 13.A.3(f) states that the "revenue recognition period should extend beyond the initial contractual period if the relationship with the customer is expected to extend beyond the initial term and the customer continues to benefit from the payment of the up-front fee." The SEC staff has asked registrants about their accounting policies for recognizing revenue in these circumstances. Specifically, it has focused on the period during which registrants recognize revenue for up-front fees, particularly when revenue is recognized either immediately or over the initial contract period despite indications that the relationship with the customer may extend beyond that period.

Disclosures About Key Metrics in MD&A

> **Examples of SEC Comments**
>
> - We note that in your earnings calls you discuss the weighted average duration of new contracts signed in the quarter. Please tell us what consideration was given to disclosing this metric in MD&A. Also, tell us whether the weighted average duration of new contracts signed is a key performance indicator for your business. Refer to Section III.B.1 of SEC Release 33-8350.
> - We note your response [that] the number of your end customers is [not] a key metric used by management to evaluate your business. Please explain why you believe the number of your end customers is not a key metric in spite of the prominence you provide such figures [in] your prospectus.

Technology registrants often use metrics to convey information to their investors. Because there are various types of registrants in the industry (i.e., offering a broad range of products and services), there is diversity in metrics discussed in registrants' earnings calls, registration statements, and periodic filings. Examples of metrics common to registrants in the technology industry include (1) number of "likes," (2) revenue per user, (3) daily or monthly active users, and (4) weighted average duration of contracts. The SEC staff has questioned registrants when certain metrics are not explained in MD&A, changes are not appropriately quantified, and it is unclear whether metrics represent key performance indicators. Accordingly, the staff may ask registrants to provide a detailed quantitative and qualitative discussion and analysis of the impact of changes in their key metrics disclosed in MD&A, in a manner consistent with Sections III.B.1 and III.B.2 in SEC Release No. 33-8350 and Regulation S-K, Item 303(a)(3)(iii). In addition, registrants that have not already done so are asked to provide disclosures in MD&A to discuss why the metrics were chosen, how they are used, and any inherent limitations in the metrics selected.

Because of the vast volume of the metrics used, the SEC staff has been concerned that (1) metrics may not be presented with appropriate context and (2) the link between registrants' key metrics and their income and future profitably may not be clear. Registrants should review their metrics to ensure that the metrics portray a balanced discussion and remain relevant. If that is not the case, registrants should consider removing metrics (or replacing them with new ones).

Telecommunications

The SEC staff's comments to registrants in the telecommunications industry have focused on topics such as revenue recognition and long-lived asset impairment.

Revenue Recognition

Examples of SEC Comments

- While your disclosure addresses the basic revenue recognition criteria related to product sales, it is not clear when delivery typically occurs and when the related revenues are typically recognized. . . . Please tell us what consideration was given to disclosing the general timing of delivery or performance of service and the general timing of revenue recognition for product sales. Please refer to ASC 605-25-50-2.
- Tell us and explain why [Product A shipments] were not recognized as revenues. It is unclear from the Critical Accounting and Estimates section of the MD&A what revenue recognition criteria were not met. In addition, tell us in detail the nature of your sell-through to end users and how you are accounting for such sales.

The SEC staff often asks telecommunications registrants to expand or clarify their disclosures about revenue recognition. Customer arrangements in the industry often involve multiple deliverables. Accordingly, the disclosure requirements under ASC 605-25 are intended to help financial statement users understand the nature of each deliverable, how it is valued, and how revenue is recognized.

In addition, the SEC staff may ask registrants for details about their compliance with the four criteria for revenue recognition contained in SAB Topic 13. The staff has indicated that registrants must carefully monitor these criteria when selling products to resellers and distributors and, in particular, should evaluate whether the substance of an arrangement is such that the price is not fixed or determinable until the product is sold to the end customer. When revenue is deferred because a criterion was not satisfied, registrants should specify which criterion was not met and disclose how and when the transaction will be recognized.

As the industry continues to evolve, telecommunications registrants must consider the revenue recognition implications of new business practices and ensure transparent disclosure. Wireless operators, for example, are increasingly offering subscribers more flexible handset-purchase options, such as installment plans and exchange rights. Such offerings can have significant revenue recognition implications. New offerings also may trigger a requirement for telecommunications registrants to provide financial statement disclosures not previously considered significant. These could include disclosures about financing receivables for which registrants may not have historical information to appropriately predict an allowance for credit losses, credit quality indicators, and potential guarantee liabilities that arise from the various handset-purchase options. New business practices are likely to draw SEC staff scrutiny if the registrants' relevant revenue recognition policies and considerations are not clearly disclosed.

In addition, given the complexity of accounting for contracts that contain multiple deliverables, the staff may also request a registrant's analysis of whether it is a principal or an agent in a transaction.

For information on multiple-element arrangements and other revenue-related considerations, see the Revenue Recognition section.

Long-Lived Asset Impairment

> **Example of an SEC Comment**
>
> We note that you have made significant success-based capital investments, which include building out fiber to new wireless towers and replacing copper facilities with fiber facilities to wireless towers that you already serve. Tell us how you evaluated the remaining economic life of copper facilities that you already serve and the impact on depreciation expense in subsequent periods.

The SEC staff continues to question registrants in the telecommunications industry about the recoverability of their long-lived assets, including physical network assets and spectrum licenses. For example, the staff inquires about the reasonableness of the useful-life estimates used by registrants to determine whether their long-lived assets are potentially impaired. Such assets may be subject to a greater risk of impairment as a result of the rapid rate of technological innovation. In addition, the staff has asked registrants to disclose the carrying values of significant types of assets and the methods used to estimate the assets' useful life. For additional information, see the Impairments of Goodwill and Other Long-Lived Assets section.

Appendixes

Appendix A: SEC Staff Review Process

The SEC's Division of Corporation Finance (the "Division") selectively reviews filings made under the Securities Act and the Exchange Act. In January 2009, the SEC staff issued an overview that explains its filing review and comment letter process.[1] The overview aims to increase transparency in the review process and expresses the staff's willingness to discuss issues with registrants. For example, the overview indicates that the "[staff] views the comment process as a dialogue with a company about its disclosure" and that a "company should not hesitate to request that the staff reconsider a comment it has issued or reconsider a staff member's view of the company's response to a comment at any point in the filing review process."

The overview is divided into two main sections:

- *The filing review process* — This section explains that the Division comprises 12 offices staffed by experts in specialized industries, accounting, and disclosures. The section includes background on the different types of review (required and selective) and covers the comment process, indicating that "[m]uch of the [staff's] review [process] involves reviewing the disclosure from a potential investor's perspective and asking questions that an investor might ask when reading the document." The section also addresses how to respond to staff comments and close a filing review.
- *The reconsideration process* — This section emphasizes that "staff members, at all levels, are available to discuss disclosure and financial statement presentation matters with a company and its legal, accounting, and other advisors." In addressing a registrant's potential request for the SEC staff to reconsider a staff member's comment or view on a registrant's response, the staff emphasizes that registrants do not have to "follow a formal protocol." However, the staff explains where registrants should start and the steps involved in the normal course of the reconsideration process. The staff also specifies contact information for each office for both accounting and financial disclosure matters and legal and textual disclosure matters.

Registrants may involve the SEC's Office of the Chief Accountant (OCA) during any stage of the review process. Unlike the Division's role, which is to address matters related to the age, form, and content of registrants' financial statements that are required to be filed, the OCA's role is to address questions concerning a registrant's application of GAAP. Guidance on consulting with the OCA is available on the SEC's Web site.

A registrant that receives an SEC comment letter should generally respond within the time frame indicated in the letter. See Appendix B for more information about responding to SEC comment letters. The registrant should continue to respond to any requests for more information until it receives a letter from the Division stating that the Division has no further comments. A registrant that does not receive a completion letter within a reasonable amount of time after submitting a response letter should call its SEC staff reviewer (named in the letter) to ask about the status of the review. If the review is complete, the registrant should request a completion letter.

To increase the transparency of the Division's review process, comment letters are made public, via the SEC's Web site, no more than 20 days after the review is completed. See Appendix C for tips on searching the SEC's comment letter database.

[1] An overview of the legal, regulatory, and capital markets offices is also available on the SEC's Web site.

Appendix B: Best Practices for Managing Unresolved SEC Comment Letters

The best practices below are intended to help registrants resolve any staff comment letters in a timely manner. Unresolved comments may affect a registrant's ability to issue financial statements and an auditor's ability to issue the current-year audit report. In addition, when responding to staff comment letters, registrants should be mindful of their responses because all responses to staff comment letters are made publicly available and become part of a registrant's "total mix of information" and disclosure records (i.e., investors may read such responses similarly to how they interpret a registrant's other filings and publicly available information).[1] A registrant should therefore do the following:

- Consider the impact the comment letter may have on its ability to issue the financial statements.
- Consult with its SEC legal counsel about the impact the comment letter may have on the certifications contained in its Form 10-K.
- Consult with its auditors to discuss the impact the comment letter may have on their ability to issue the current-year audit report.
- Review the comment letter immediately and respond to the SEC staff reviewer (named in the letter) within the time indicated in the comment letter (usually 10 business days). If possible, the registrant should not request an extension, since this may delay resolution of the comment letter. However, in certain circumstances, the registrant should consider requesting an extension to provide a more thorough and complete response that addresses all of the staff's comments.
- If the registrant does not fully understand any specific comment, the registrant should contact its SEC staff reviewer quickly for clarification so that it can provide an appropriate response.
- Include in the response a discussion of supporting authoritative accounting literature and references to the specific paragraph(s) from the standard(s).
- Because some comments may request disclosure in future filings, the registrant should consider including such disclosure in the response letter to potentially eliminate additional requests from its SEC staff reviewer.
- If an immaterial disclosure is requested, the registrant should consider explaining why the disclosure is immaterial instead of including the immaterial disclosure in future filings.
- Maintain contact with its SEC staff reviewer and make the reviewer aware of the registrant's required timing (on the basis of its current-year filing deadlines).
- If the registrant has not received a follow-up letter or been contacted within two weeks of filing the initial response letter, the registrant should contact its SEC staff reviewer to determine the status of the comments. The registrant should promptly address any follow-up questions.
- If the registrant is uncertain about whether its review has been completed without further comments, it should ask the SEC staff reviewer about the status of the review. If the review is complete, the registrant should ask the reviewer for a completion letter.

Oral Comments

In certain circumstances, the SEC staff may provide oral comments to a registrant instead of a written comment letter. The registrant should ask the SEC staff reviewer how he or she would like to receive the registrant's response to the oral comments. If the reviewer requests a response via EDGAR, a registrant should respond with a written letter. If the reviewer requests an oral response or identifies no preference, a registrant should still, although it is not required to do so, consider responding to the staff's comments with a letter to formally document the registrant's understanding of the staff's comments and the discussions held as well as the registrant's response.

[1] The SEC staff discussed this topic at the 2012 AICPA Conference. Refer to Deloitte's December 11, 2012, *Heads Up* for more information.

Disclosure Requirements

Under the Securities Offering Reform, large accelerated filers, accelerated filers, and well-known seasoned issuers must disclose in their Forms 10-K the substance of any material unresolved SEC staff comments that were issued 180 or more days before the end of the current fiscal year.

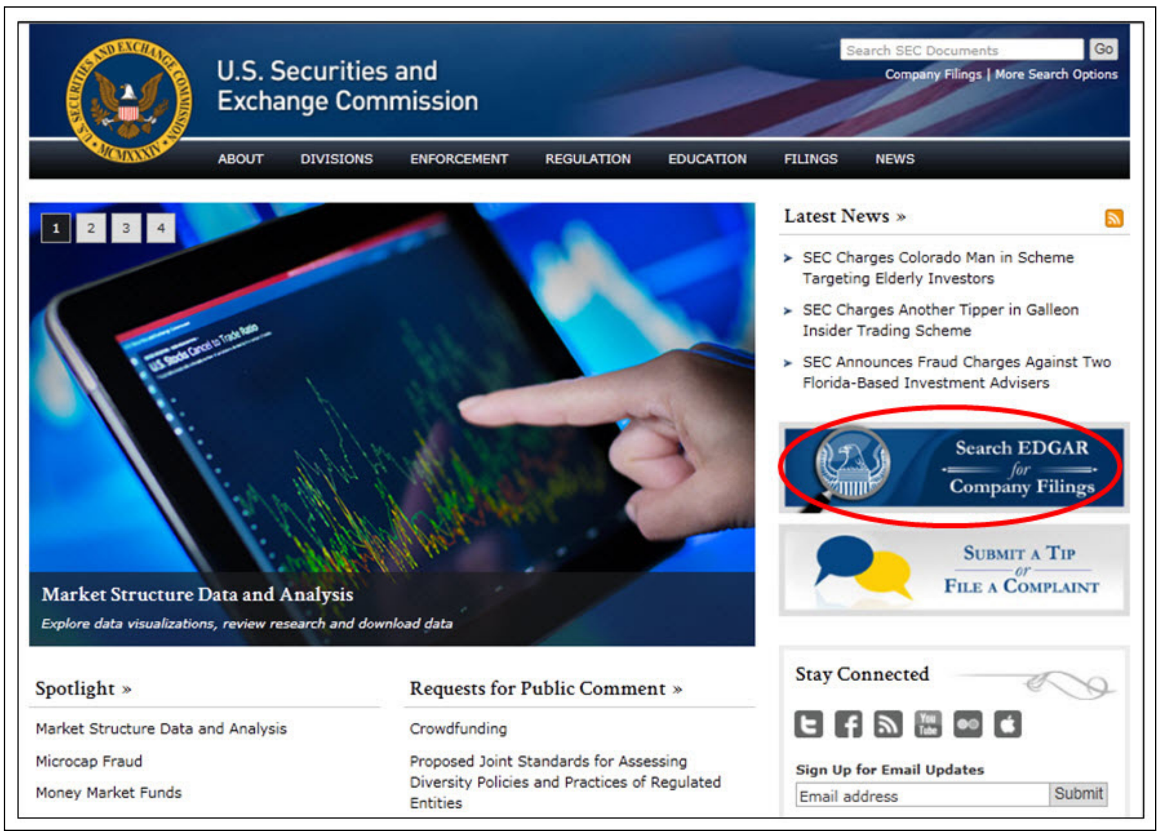
Appendix C: Tips for Searching the SEC's Database for Comment Letters

The SEC adds comment letters (and responses from registrants) to its EDGAR database no earlier than 20 days after its review of a filing is complete. Registrants can refer to such comments as part of their financial statement review process and to improve their own accounting and overall disclosure.

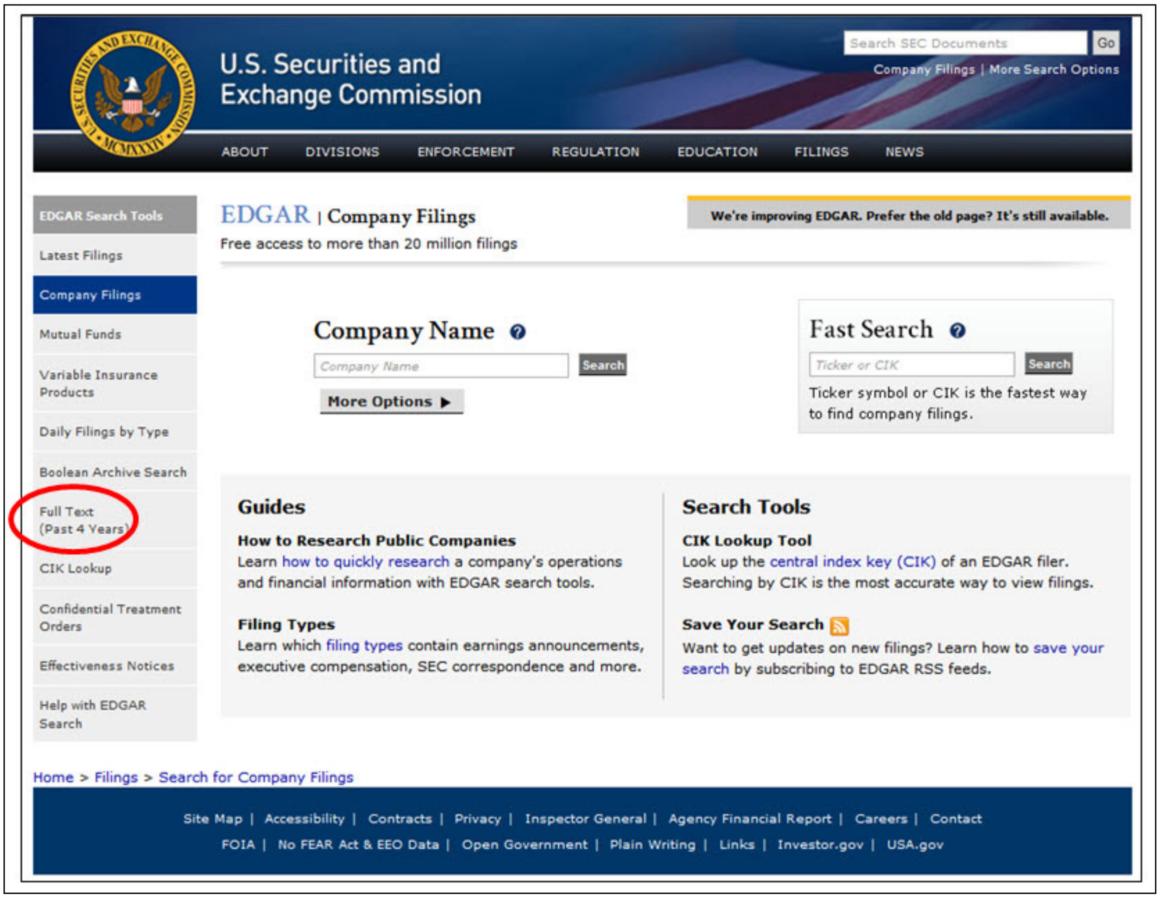
Although the SEC has recently updated the EDGAR search engine to simplify searches of corporate filings, users may still wish to use the "full-text" search feature to find the text of specific comment letters posted within the last four years and to generally narrow their search results. The process of performing a full-text search is discussed below.

Full-Text Searching

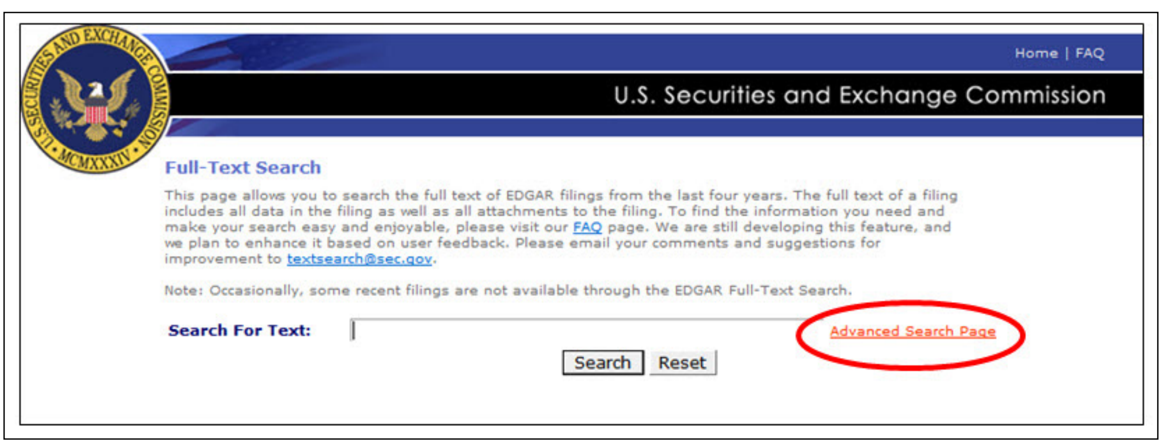
To perform a full-text search, first go to the SEC's home page (www.sec.gov) and click the "Search EDGAR for Company Filings" image:



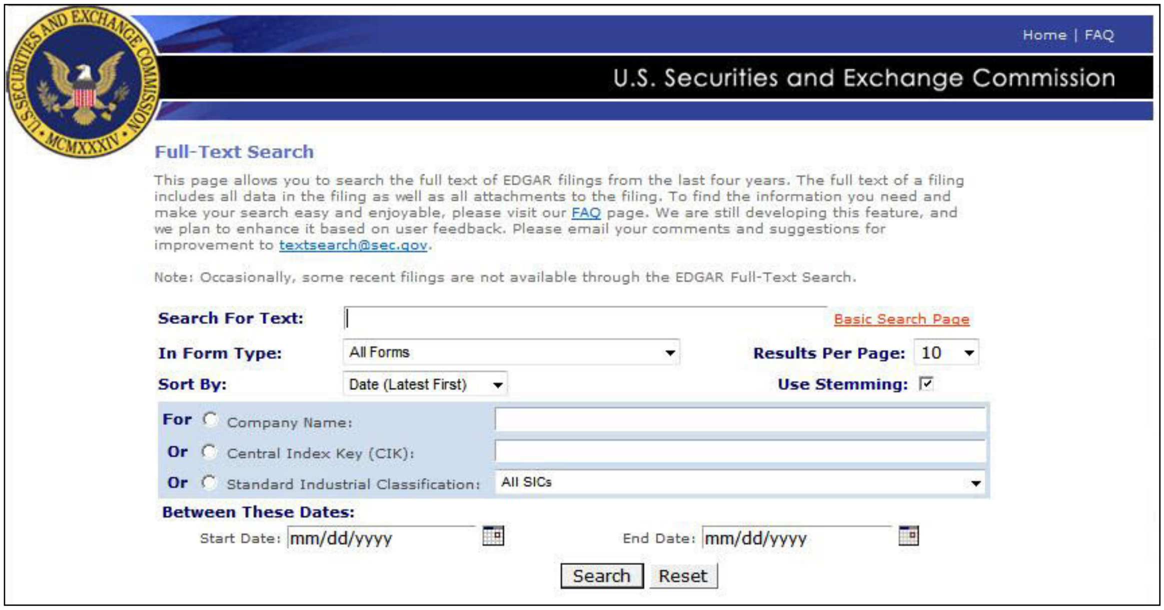
Then, click the "Full Text" link in the left sidebar on the "EDGAR | Company Filings" page:



On the "Full-Text Search" page, select "Advanced Search Page":



This brings up the following form:


Home | FAQ

U.S. Securities and Exchange Commission

Full-Text Search

This page allows you to search the full text of EDGAR filings from the last four years. The full text of a filing includes all data in the filing as well as all attachments to the filing. To find the information you need and make your search easy and enjoyable, please visit our FAQ page. We are still developing this feature, and we plan to enhance it based on user feedback. Please email your comments and suggestions for improvement to textsearch@sec.gov.

Note: Occasionally, some recent filings are not available through the EDGAR Full-Text Search.

Search For Text: Basic Search Page

In Form Type: All Forms **Results Per Page:** 10

Sort By: Date (Latest First) **Use Stemming:**

For Company Name:

Or Central Index Key (CIK):

Or Standard Industrial Classification: All SICs

Between These Dates:

Start Date: mm/dd/yyyy End Date: mm/dd/yyyy

Search Reset

In the form, limit the search results to SEC comment letters by using the drop-down menu next to **"In Form Type"** and choosing "UPLOAD" (or select "CORRESP" to include registrant responses as well).

Then, enter search terms in the **"Search for Text"** field. The documents found will contain at least one of the words entered as well as variations of the key word(s). To search for specific phrases, enclose the phrase in quotation marks (e.g., "management's discussion and analysis"). Results will include documents that contain the quoted phrase as well as conceptually related phrases, such as "managerial discussion & analysis."

Enhancing Search Results

Searches can be further refined by using Boolean operators such as AND, OR, and NOT (capitalization of these terms is required). For an operator to work effectively, a key word or phrase generally must be included before and after it (e.g., investments AND temporary). Searches in which operators are used will produce results as follows:

- *AND* — Documents will contain **all** terms connected (but not necessarily in the same sentence or paragraph) by the AND operator. The terms can appear in any order in the document.
- *OR* — Documents will contain **any** terms connected by the OR operator.
- *NOT* — Documents will contain one term but **not** another term.

Using wildcards or the "nearness" feature can also enhance search results:

- *Wildcards* — While certain variations of key words are automatically included in search results, using an asterisk (*) can ensure that all variations are included. For example, the wildcard "impair*" can be used to find documents that contain the words impair, impaired, impairing, impairment, or impairs.

- *Nearness* — Key words or phrases within a certain distance of each other can be searched by stipulating a range. The range is determined by using the term “NEARn,” with “n” representing the maximum number of words in the range (e.g., “impairment NEAR5 test” would find documents with impairment and test within five words of each other).

Advanced search features can frequently be combined. For example, quotations used to find a specified phrase can be combined with Boolean operators (e.g., investments AND “temporary decline”).

Note that numbers are ignored in searches. Thus, a search for “Final Rule 108” will only locate documents that contain the terms “Final” and “Rule.” Searches can, however, be sorted by other criteria, such as dates, as discussed below.

Sorting by Dates and Other Specific Criteria

On the full-text search form, selections can also be made to limit results to a specified:

- Company name.
- Central index key (CIK).[1]
- Standard industrial classification (SIC) code.[2]
- Date range.

Note that clicking the SIC code in the list of search results will display a list of additional companies that have the same SIC code:

Example

Controlling and Displaying Search Results

The **Results Per Page** drop-down list can be used to limit the number of search results that display. To open a comment letter, click on the underlined title of the form to the right of the date. The comment letters will include any attachments or exhibits.

Example of the Benefits of Using Full-Text Search Features

Assume that a user is interested in SEC comments issued over the past two years that are related to results of operations in the hotel industry. By searching for the words “results” and “operations” with “All Forms” selected and no dates specified, the user would obtain over 8,000 results, many of which are not relevant.

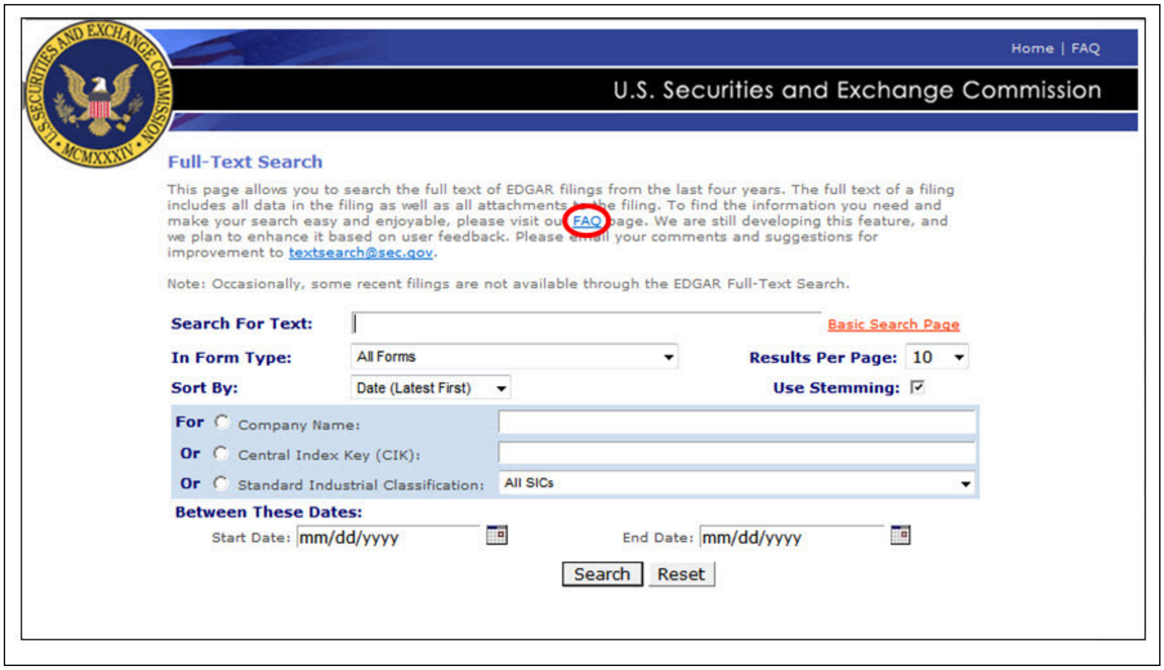
However, if the user narrowed his or her search by (1) selecting the form type UPLOAD, (2) entering the search term “results of operations” in quotation marks, (3) entering the industry code for the hotel/motel industry (SIC 7011), and (4) providing a date range spanning the last two years, the number of results will be more relevant and manageable.

[1] According to the SEC’s Web site, “a CIK is the unique number that the SEC’s computer system assigns to individuals and corporations who file disclosure documents with the SEC. All new electronic and paper filers, foreign and domestic, receive a CIK number.”

[2] A SIC code is an industry designation. Note that some of the SIC code descriptions are similar, so narrowing results by SIC code may not include certain issuers that are in a similar industry yet have a different assigned SIC code.

Additional Information

For more information about full-text searching, click the FAQ link on in the search form:



Appendix D: Glossary of Standards and Other Literature

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

AICPA Audit and Accounting Guide

Depository and Lending Institutions

Valuation of Privately Held Company Equity Securities Issued as Compensation ["Cheap Stock Guide"]

AICPA Accounting and Valuation Guide

Valuation of Privately-Held-Company Equity Securities Issued as Compensation

CAQ Alerts

Alert No. 2012-16, "Reference to the Standards of the PCAOB in Auditors' Reports"

Alert No. 2011-04, "SEC Staff Reminds Auditors of Requirement to Sign EDGAR Audit Reports"

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 — Other Literature

See the FASB's Web site for titles of:

- Accounting Standards Updates.
- Pre-Codification literature (Statements, Staff Positions, EITF Issues, and Topics).
- Concepts Statements.

PCAOB Auditing Standards

See the Standards page on the PCAOB's Web site for titles of its auditing standards.

SEC ASR

Accounting Series Release No. 268, "Presentation in Financial Statements of 'Redeemable Preferred Stocks'" (Rule 5-02.28 of SEC Regulation S-X)

SEC C&DI Topics

Exchange Act Rules

Exchange Act Sections

Non-GAAP Financial Measures

Regulation S-K

Securities Act Rules

SEC Division of Corporation Finance Disclosure Guidance

Topic 2, "Cybersecurity"

SEC Concept Release

33-8860, *Mechanisms to Access Disclosures Relating to Business Activities in or With Countries Designated as State Sponsors of Terrorism*

SEC Division of Corporation Finance FRM

Topic 1, "Registrant's Financial Statements"

Topic 2, "Other Financial Statements Required"

Topic 3, "Pro Forma Financial Information"

Topic 4, "Independent Accountants' Involvement"

Topic 6, "Foreign Private Issuers & Foreign Businesses"

Topic 7, "Related Party Matters"

Topic 8, "Non-GAAP Measures of Financial Performance, Liquidity, and Net Worth"

Topic 9, "Management's Discussion and Analysis of Financial Position and Results of Operations (MD&A)"

Topic 10, "Emerging Growth Companies"

Topic 13, "Effects of Subsequent Events on Financial Statements Required in Filings"

SEC Final Rule

33-8176, *Conditions for Use of Non-GAAP Financial Measures*

SEC Industry Guides

Guide 3, "Statistical Disclosure by Bank Holding Companies"

Guide 6, "Disclosures Concerning Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Insurance Underwriters"

SEC Interpretive Release

33-8350, *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations*

33-8810, *Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934*

SEC Regulation G

SEC Regulation S-K

Item 10, "General"

Item 101, "Description of Business"

Item 103, "Legal Proceedings"

Item 303, "Management's Discussion and Analysis of Financial Condition and Results of Operations"

Item 305, "Quantitative and Qualitative Disclosures About Market Risk"

Item 307, "Disclosure Controls and Procedures"

Item 308, "Internal Control Over Financial Reporting"

Item 402, "Executive Compensation"

Item 404, "Transactions With Related Persons, Promoters and Certain Control Persons"

Item 407, "Corporate Governance"

Item 503, "Prospectus Summary, Risk Factors, and Ratio of Earnings to Fixed Charges"

Item 506, "Dilution"

Item 512, "Undertakings"

Item 601, "Exhibits"

Item 1202, "Disclosure of Reserves"

Item 1203, "Proved Undeveloped Reserves"

Item 1204, "Oil and Gas Production, Production Prices and Production Costs"

Item 1205, "Drilling and Other Exploratory and Development Activities"

Item 1206, "Present Activities"

Item 1207, "Delivery Commitments"

Item 1208, "Oil and Gas Properties, Wells, Operations, and Acreage"

SEC Regulation S-T

Rule 302, "Signatures"

Rule 405, "Interactive Data File Submissions and Postings"

SEC Regulation S-X

Rule 1-02, "Definitions of Terms Used in Regulation S-X"

Rule 2-02, "Accountants' Reports and Attestation Reports"

Rule 3-01, "Consolidated Balance Sheets"

Rule 3-02, "Consolidated Statements of Income and Changes in Financial Position"

Rule 3-03, "Instructions to Income Statement Requirements"

Rule 3-04, "Changes in Stockholders' Equity and Noncontrolling Interests"

Rule 3-05, "Financial Statements of Businesses Acquired or to Be Acquired"

Rule 3-09, "Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons"

Rule 3-10, "Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered"

Rule 3-12, "Age of Financial Statements at Effective Date of Registration Statement or at Mailing Date of Proxy Statement"

Rule 3-14, "Special Instructions for Real Estate Operations to Be Acquired"

Rule 3-16, "Financial Statements of Affiliates Whose Securities Collateralize an Issue Registered or Being Registered"

Rule 4-08, "General Notes to Financial Statements"

Rule 4-10, "Financial Accounting and Reporting for Oil and Gas Producing Activities Pursuant to the Federal Securities Laws and the Energy Policy and Conservation Act of 1975"

Article 5, “Commercial and Industrial Companies”

Rule 5-02, “Balance Sheets”

Rule 5-03, “Income Statements”

Rule 5-04, “What Schedules Are to Be Filed”

Rule 7-05, “What Schedules Are to Be Filed”

Article 8, “Financial Statements of Smaller Reporting Companies”

Article 10, “Interim Financial Statements”

Article 11, “Pro Forma Financial Information”

Rule 11-02, “Preparation Requirements”

Article 12, “Form and Content of Schedules”

Rule 12-04, “Condensed Financial Information of Registrant”

Rule 12-28, “Real Estate and Accumulated Depreciation”

SEC SAB Topics

SAB Topic 1.B, “Allocation of Expenses and Related Disclosure in Financial Statements of Subsidiaries, Divisions or Lesser Business Components of Another Entity”

SAB Topic 1.M, “Materiality” (SAB 99)

SAB Topic 1.N, “Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements” (SAB 108)

SAB Topic 5.J, “New Basis of Accounting Required in Certain Circumstances”

SAB Topic 5.M, “Other Than Temporary Impairment of Certain Investments in Equity Securities”

SAB Topic 5.P, “Restructuring Charges”

SAB Topic 5.Y, “Accounting and Disclosures Relating to Loss Contingencies”

SAB Topic 6.K, “Accounting Series Release 302 — Separate Financial Statements Required by Regulation S-X”

SAB Topic 10.E, “Classification of Charges for Abandonments and Disallowances”

SAB Topic 11.B, “Depreciation and Depletion Excluded From Cost of Sales”

SAB Topic 11.M, “Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period” (SAB 74)

SAB Topic 13, “Revenue Recognition” (SAB 101 and SAB 104)

SAB Topic 13.A, “Selected Revenue Recognition Issues”

SAB Topic 14.F, “Classification of Compensation Expense Associated With Share-Based Payment Arrangements”

Securities Act of 1933 Rules

Rule 405, "Definitions of Terms"

Rule 436, "Consents Required in Special Cases"

Securities Exchange Act of 1934 Rules

Rule 13a-15, "Issuer's Disclosure Controls and Procedures Related to Preparation of Required Reports"

Rule 15d-15, "Controls and Procedures"

Appendix E: Abbreviations

Abbreviation	Description
AICPA	American Institute of Certified Public Accountants
AICPA Banking Conference	AICPA National Conference on Banks and Savings Institutions
AICPA Conference	The annual AICPA Conference on Current SEC and PCAOB Developments
ALLL	allowance for loan and lease losses
ASC	FASB Accounting Standards Codification
ASR	SEC Accounting Series Release
ASU	FASB Accounting Standards Update
AU	PCAOB Interim Auditing Standard
AUM	asset under management
BCF	beneficial conversion feature
BPD	branded pharmaceutical drug
CAQ	Center for Audit Quality
C&DI	SEC Compliance and Disclosure Interpretation
CD&A	Compensation Discussion and Analysis
CEO	chief executive officer
CF-OCA	SEC's Division of Corporation Finance, Office of the Chief Accountant
CFDG	Corporation Finance Disclosure Guidance
CFO	chief financial officer
CIK	central index key
CODM	chief operating decision maker
COSO	Committee of Sponsoring Organizations of the Treadway Commission
CPA	certified public accountant
DCP	disclosure controls and procedures
DTA	deferred tax asset
DTL	deferred tax liability

Abbreviation	Description
EBIT	earnings before interest and taxes
EBITDA	earnings before interest, taxes, depreciation, and amortization
EDGAR	SEC's Electronic Data Gathering, Analysis, and Retrieval system
EGC	emerging growth company
EITF	Emerging Issues Task Force
EPS	earnings per share
EPU	earnings per unit
FASAC	Financial Accounting Standards Advisory Council
FASB	Financial Accounting Standards Board
FAQs	frequently asked questions
FCPA	Foreign Corrupt Practices Act
FDA	Food and Drug Administration
FDIC	Federal Deposit Insurance Corporation
FFO	funds from operations
FICO	Fair Issac Corporation
FPI	foreign private issuer
FRM	SEC Financial Reporting Manual
GAAP	generally accepted accounting principles
GAAS	generally accepted auditing standards
GP	general partner
IASB	International Accounting Standards Board
ICFR	internal control over financial reporting
ICP	Internet content provider
IFRS	International Financial Reporting Standard
IPO	initial public offering
IRS	Internal Revenue Service

Abbreviation	Description
LP	limited partner
MD&A	Management's Discussion and Analysis
MLP	master limited partnership
NAREIT	National Association of Real Estate Investment Trusts
NCI	noncontrolling interest
NDA	new drug application
NEO	named executive officer
NGL	natural gas liquid
NOI	net operating income
OCA	SEC's Office of the Chief Accountant
OCI	other comprehensive income
OTTI	other-than-temporary impairment
PBE	public business entity
PCAOB	Public Company Accounting Oversight Board
PCC	Private Company Council
PCI	purchased credit-impaired
PCS	postcontract customer support
PUD	proved undeveloped
R&D	research and development
REIT	real estate investment trust
SaaS	software as a service
SAB	SEC Staff Accounting Bulletin
SEC	Securities and Exchange Commission
SG&A	selling, general, and administrative expense
SIC	standard industrial classification
TDR	troubled debt restructuring

Abbreviation	Description
TTHL	transportation, travel, hospitality, and leisure
TPE	third-party evidence
VaR	value at risk
VIE	variable interest entity
VSOE	vendor-specific objective evidence
XBRL	eXtensible Business Reporting Language

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

Abbreviation	Act
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
Exchange Act	Securities Exchange Act of 1934
JOBS Act	Jumpstart Our Business Startups Act
Sarbanes-Oxley Act	Sarbanes-Oxley Act of 2002
Securities Act	Securities Act of 1933

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

July 14, 2014

Ms. Susan Cosper
Technical Director
File Reference No. 2014-200
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116
director@fasb.org

Delivered Electronically

Re: File Reference No. 2014-200, Exposure Draft: *Conceptual Framework for Financial Reporting, Chapter 8: Notes to Financial Statements*

Dear Ms. Cosper:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) in response to the Financial Accounting Standards Board's (FASB or the Board) *Exposure Draft: Conceptual Framework for Financial Reporting, Chapter 8: Notes to Financial Statements* (the Exposure Draft).

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other real estate businesses throughout the world that own, operate and finance commercial and residential real estate. NAREIT's members play an important role in providing diversification, dividends, liquidity and transparency to investors through their businesses that operate in all facets of the real estate economy.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT U.S. Real Estate Index, which covers both Equity REITs and Mortgage REITs. This Index contained 209 companies representing an equity market capitalization of $783 billion at April 30, 2014. Of

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these companies, 168 were equity REITs representing 91.2% of total U.S. listed REIT equity market capitalization (amounting to $714 billion)[1]. The remainder, as of April 30, 2014, was 41 publicly traded mortgage REITs with a combined equity market capitalization of $69 billion.

EXECUTIVE SUMMARY

NAREIT supports the Board's objective to improve the effectiveness of disclosures in the notes to the financial statements by clearly and concisely communicating the information that is most relevant to users of financial statements. NAREIT further welcomes the potential benefit of reducing superfluous, duplicative and/or irrelevant disclosures as a consequence of a sharper focus on what users of financial statements value most in evaluating the prospects of future cash flows of public companies. However, we do not believe that the disclosure framework included in the Exposure Draft would achieve the project's objective. Rather than improving disclosure effectiveness and eliminating redundancy, we believe that the proposed framework could expand possible disclosure requirements significantly because it does not provide clear direction. Thus, we do not believe that the framework would prove operational for Board members as they develop disclosure requirements in future standards setting. NAREIT offers a number of recommendations that we believe would assist the Board in developing an effective and efficient disclosure framework.

NAREIT RECOMMENDATIONS

Following are NAREIT recommendations that should assist the Board in developing an effective framework that would promote consistent decisions and the proper use of discretion by the Board:

- **Re-evaluate and reconcile the purpose of the Exposure Draft with the root cause that triggered the project**

- **Ensure that disclosures address each of the financial statements, not just the balance sheet**

- **Focus disclosure requirements on the elements of the financial statements, rather than financial statement line items only**

- **Coordinate efforts to address the problem of "disclosure overload" with the IASB**

- **Address materiality as a key element to the Exposure Draft**

- **Develop a financial reporting model that delineates which disclosures belong in the notes to the financial statements as opposed to MD&A**

[1] http://www.reit.com/sites/default/files/reitwatch/RW1405.pdf at page 21.

- **Ensure that interim disclosures are not a mere repeat of the annual disclosures unless there is a material change**

- **Further engage and collaborate with all interested constituents, including regulators (*i.e.*, the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB)), preparers, analysts, and auditors, in field testing of the revised Exposure Draft**

Re-evaluate and reconcile the purpose of the Exposure Draft with the root cause that triggered the project

NAREIT concurs with the Exposure Draft's explanation that "The primary purpose of notes to financial statements is to supplement or further explain the information on the face of financial statements by providing financial information relevant to existing and potential investors, lenders, and other creditors for making decisions about providing resources to the entity."[2] Further, NAREIT understands that the "objective and primary focus of this project is to improve the effectiveness of disclosures in notes to financial statements by clearly communicating the information that is most important to users of each entity's financial statements."[3] However, NAREIT fears that the Board is not meeting the project's objective based on the contents of the Exposure Draft. Rather than adding specificity about the type of information that the Board would require in the notes, the Conceptual Framework "would identify, by design, a broad range of possibilities for the Board to consider when deciding on the disclosures related to a particular topic that is required under U.S. GAAP."[4] The Board would rely on individual standard-setting projects to then narrow the disclosure requirements.

Based on this approach, NAREIT has significant concern that the Exposure Draft provides Board members with a framework that would expand disclosure requirements, rather than narrowing the focus of disclosure to be both useful and relevant to users of financial statements. Such an unfettered approach would exacerbate future standard setting in continually starting from a wide-ranging view of potential disclosures where the sky is the limit, rather than focusing on the type of information that users of financial statements actually need. In our view, an underlying principle to the Conceptual Framework should be the consideration of decision-usefulness of information to users of financial statements at a reasonable cost before considering the infinite realm of potential disclosure. Without a holistic view of and a sound foundation for the purpose

[2] http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175828468314&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=424282&blobheadervalue1=filename%3DProposed_Concepts_Statement_CF_for_Financial_Reporting%25E2%2580%2594Chapter8-Notes_to_Financial_Statements.pdf&blobcol=urldata&blobtable=MungoBlobs at page 5, par. S2.
[3] http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=1176156344894
[4] http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175828468314&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=424282&blobheadervalue1=filename%3DProposed_Concepts_Statement_CF_for_Financial_Reporting%25E2%2580%2594Chapter8-Notes_to_Financial_Statements.pdf&blobcol=urldata&blobtable=MungoBlobs at page 3, par. P13.

of notes to the financial statements, the Board might perpetuate the piece-meal approach that has resulted in voluminous disclosure historically.

Ensure that disclosures address each of the financial statements, not just the balance sheet

In NAREIT's view, the Exposure Draft is driven by balance sheet disclosure. NAREIT observes that the Board should consider expanding the disclosure framework to include the income statement and the statement of cash flows. Based on feedback that we have received from users of financial statements, the information included in the income statement and statement of cash flows is critical for their financial analysis in developing valuations for our member companies. These valuations are the basis for buy or sell recommendations that impact capital allocation decision and ultimately have a direct impact on share price.

Focus disclosure requirements on the elements of the financial statements, rather than financial statement line items only

NAREIT recommends that the FASB refocus the Exposure Draft to view disclosure as an extension of the economics of transactions, rather than specific line items in the financial statements. NAREIT observes that the FASB has historically developed standards with transactions in mind (*e.g.*, leases and revenue recognition that are relevant to the real estate industry), rather than a focus on financial statement line items alone. A transaction and economics-based view of disclosure will place non-accountants on a level playing field to understand the implications on risk, volatility and the future prospects of a company resulting from elements of the financial statements.

Coordinate efforts to address the problem of "disclosure overload" with the IASB

NAREIT understands that the idea of enhancing and synthesizing disclosure requirements is not just a U.S. phenomenon. For example, the International Accounting Standards Board (IASB) recently commenced its own Disclosure Initiative that is intended to explore how disclosures in International Financial Reporting Standards can be improved. In a speech titled "Breaking the Boilerplate," Chairman Hans Hoogervorst stated that "For many companies, the size of their annual report is ballooning. The amount of useful information contained within those disclosures has not necessarily been increasing at the same rate. The risk is that annual reports become simply compliance documents, rather than instruments of communication."[5]

Especially in light of recent remarks made by Securities and Exchange Commission Chairman Mary Jo White[6] in reference to the future possibility of IFRS reporting in the U.S., NAREIT believes it would be prudent for the FASB to coordinate its efforts toward developing a disclosure framework in conjunction with the IASB's efforts on its Principles of Disclosure. These efforts would potentially reduce disclosure requirement gaps between U.S. GAAP and

[5] http://www.ifrs.org/Alerts/Conference/Documents/2013/HH-Amsterdam-June-2013.pdf
[6] http://www.iasplus.com/en/news/2014/05/sec-speech

IFRS in future standard setting, which could be especially useful to issuers who need to file both in the United States and in IFRS jurisdictions.

Address Materiality as a key element to the Exposure Draft

The FASB might also benefit from collaboration with the IASB on the materiality phase of the IASB's Disclosure Initiative. While the FASB has not considered materiality in the Exposure Draft, the IASB is currently researching how materiality is utilized in preparing financial statements. In NAREIT's view, the FASB should evaluate how the consideration of a materiality principal would enhance future disclosure requirements. We recognize that developing materiality thresholds for disclosure is somewhat abstract and challenging from a qualitative perspective. However, absent a consideration of materiality in the Exposure Draft, preparers will be faced with proving why disclosure is not material to auditors and the Public Company Accounting Oversight Board (PCAOB). In our view, preparers may not believe that reducing disclosure for materiality sake is worth the time, effort, and level of second-guessing to be endured. As a result, preparers may simply default to the "check-list" safe-harbor approach to disclosure that has developed in the U.S. over time.

Develop a financial reporting model that delineates which disclosures belong in the notes to the financial statements as opposed to Management's Discussion and Analysis (MD&A)

NAREIT is concerned that new disclosures that are *prospective* in nature and akin to financial analysis would be required to be included in the notes to the financial statements. Today, information typically included within the financial statements is primarily *historical*, while *forward-looking* information is generally included in MD&A. Beyond NAREIT's concern that blending financial analysis with historical information embedded in the notes to financial statements would cause confusion to financial statement users, NAREIT questions whether audit firms would be able to render unqualified audit reports on financial statements that include this information.

NAREIT suggests that the Board develop a model that delineates which disclosures belong in the notes to the financial statements as opposed to MD&A. One possible way of accomplishing this would be to develop a principle that historical information is included within the financial statements, while forward looking information is generally included in MD&A. In so doing, NAREIT suggests that the FASB work with the SEC in studying existing disclosure requirements in the notes to financial statements and in MD&A and **seek to eliminate redundancies**.

In order to effectuate a financial reporting model that clearly requires historical information in the financial statements and forward-looking information in MD&A, NAREIT suggests that the Board move the following paragraph from the Basis for Conclusions (*i.e.*, paragraph BC16) to the forefront of the "Future-Oriented Information" section of the final conceptual framework:

> [A]lthough disclosures may be oriented toward the future, the information in those disclosures is appropriate if it is either dictated by a current known condition or

> embedded within a current measurement used within the financial statements. Furthermore, expectations and assumptions about the future that were not within a current measurement would not be appropriate for requirement in notes.[7]

Ensure that interim disclosures are not a mere repeat of the annual disclosures unless there is a material change

NAREIT has observed a growing trend in accounting pronouncements that requires companies to prepare the same types of disclosures at both interim and annual reporting dates. NAREIT questions whether detailed information can continue to be disclosed at interim periods given shorter quarterly SEC financial reporting deadlines (*i.e.*, 40 days for both large accelerated filers and accelerated filers, and 45 days for non-accelerated filers[8]) when compared with annual SEC financial reporting deadlines (*i.e.*, 60 days for large accelerated filers, 75 days for accelerated filers, and 90 days for non-accelerated filers).[9] In NAREIT's view, each interim period is an integral part as opposed to a discrete part of the annual reporting period. Therefore, NAREIT suggests that the Board consider the approach that the SEC utilizes for material changes in financial condition and quantitative and qualitative disclosures of market risks. The SEC requires these disclosures in annual reports. To the extent that there has been a material change since the date of the most recent annual report, the SEC requires disclosures in quarterly filings as well. By taking this approach, the SEC has effectively incorporated both relevant and meaningful disclosure for interim reporting periods, while eliminating duplicative disclosure. NAREIT believes that the FASB could achieve its objective by taking a similar approach.

Further engage and collaborate with all interested constituents, including regulators (*i.e.*, the SEC and the PCAOB), preparers, analysts, and auditors, in field testing of the revised Exposure Draft

In order to increase the likelihood of the success of the project, NAREIT believes that it would be prudent for the Board to further engage and collaborate with all interested constituents in the process of field testing the revised Exposure Draft by preparing and evaluating "real life" examples of financial statements. Without obtaining the perspectives of all interested parties at the forefront, the Board runs the risk of having preparers default to a check list of disclosure requirements so as to reduce the possibility of being second-guessed by auditors and regulators. While NAREIT understands that many preparers and auditors take comfort in knowing that they complied with the "letter of the law" by following rules and ensuring compliance with the said rules through the use of check-lists, the success of this project hinges on a fundamental change in mindset amongst *all* constituents. By obtaining consensus at the commencement of the project,

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[7] http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175828468314&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=424282&blobheadervalue1=filename%3DProposed_Concepts_Statement_CF_for_Financial_Reporting%25E2%2580%2594Chapter8-Notes_to_Financial_Statements.pdf&blobcol=urldata&blobtable=MungoBlobs at page 39.
[8] http://www.sec.gov/answers/form10q.htm
[9] http://www.sec.gov/answers/form10k.htm

there would be significantly less probability that current extensive disclosures are simply carried forward into the future. NAREIT would welcome the opportunity to participate in field testing and in coordinating a broad spectrum of constituents from the preparer, auditor, and financial statement user community focused on the real estate sector.

* * * *

We thank the FASB for the opportunity to comment on the Exposure Draft. If you would like to discuss our views in greater detail, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at gyungmann@nareit.com or 1-202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 1-202-739-9442.

Respectfully submitted,

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NAREIT

Christopher T. Drula
Vice President, Financial Standards
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NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

December 11, 2013

Ms. Phoebe W. Brown
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Delivered Electronically

Re: PCAOB Rulemaking Docket Matter No. 034

Dear Board Members:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) in response to the solicitation for public comment by the Public Company Accounting Oversight Board (PCAOB or Board) with respect to its *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements (PCAOB Release No. 2013-005, August 13, 2013, PCAOB Rulemaking Docket Matter No. 034)* (the Proposal).

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service those businesses.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT All REITs Index, which covers both Equity REITs and Mortgage REITs. This Index contained 193 companies representing an equity market capitalization of $659.6 billion[1] at September 30, 2013. Of these companies, 154 were Equity REITs representing 90.7% of total U.S. listed REIT equity market capitalization (amounting to $598.5 billion). The remainder, as of September 30, 2013, was 39 publicly traded Mortgage REITs with a combined equity market capitalization of $61.1 billion.

This letter has been developed by a task force of NAREIT members, including members of NAREIT's Best Financial Practices Council. Members of the task force include financial executives of both Equity and Mortgage REITs, representatives of major accounting firms, institutional investors and industry analysts.

NAREIT appreciates the PCAOB's efforts toward improving audit quality since its inception in 2002. NAREIT acknowledges the PCAOB's substantive consideration of the feedback it received on its *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards, Notice of Roundtable, (PCAOB Release No. 2011-003, June 21, 2011, PCAOB Rulemaking Docket Matter No. 34*[2]*)* (the Concept Release) that discussed alternatives for changing the auditor's reporting model. In particular, NAREIT supports the PCAOB's decisions to retain the current pass/fail model of auditor reporting and to reject the requirement for an auditor's discussion and analysis. However, NAREIT does not support a requirement for the auditor to report on "critical audit matters" (as that term is defined in the Proposal). In our view, such a requirement would not meet the PCAOB's objective of providing users of financial statements with additional meaningful information. As discussed further below, it is our view that the PCAOB's proposal for auditor reporting of critical audit matters would largely result in generic disclosures that are duplicative of information that is provided by management while simultaneously increasing audit cost.

NAREIT Comments on Critical Audit Matters

We understand that the PCAOB is trying to add value to the audit report and enhance its decision usefulness by requiring that the auditor identify and discuss critical audit matters as a part of the annual audit report. However, we believe that a requirement to disclose critical audit matters in the audit report would potentially:

- Confuse and mislead users with a piecemeal discussion of audit procedures that readers of the financial statements have no context or basis to understand;

- Introduce situations when the auditor is disclosing sensitive information that is not otherwise required to be disclosed by the issuer;

- Duplicate information already disclosed by the issuer;

[1] http://returns.reit.com/reitwatch/rw1310.pdf at page 21
[2] http://pcaobus.org/Rules/Rulemaking/Docket034/Concept_Release.pdf

- Increase audit fees for, among other things, the senior level time the auditor would incur describing the critical audit matters for purposes of drafting the proposed disclosure and incremental time discussing those matters and the related disclosure with management and the audit committee; and,

- Exacerbate existing time pressures to meet financial reporting deadlines.

Each of these concerns is further discussed below.

Confuse and mislead users with a piecemeal discussion of audit procedures that readers of the financial statements have no context or basis to understand

In reporting critical audit matters, auditors would likely feel compelled to describe the audit procedures they performed, consistent with the examples in the proposal. NAREIT questions whether the substantial majority of financial statement users are likely to understand a discussion of audit procedures. When the auditor discusses its audit process with the audit committee, the auditor has the opportunity to answer questions and provide additional information to the audit committee members, thus limiting the risk of confusion or misunderstanding about the nature and extent of audit procedures performed. Further, when the audit committee and auditor are discussing the audit work in discrete areas, they are doing so in the context of the audit taken as a whole. In this context, there is no potential for confusion about whether the auditor is, in some way, effectively providing a piecemeal opinion on an individual line item within the financial statements.

NAREIT believes that users would likely be confused by the discussion of audit procedures in an audit report not only because they lack an understanding of the audit process as a whole but because they lack the context for the discussion of discrete audit procedures on an individual financial statement line item. We are therefore concerned that the Proposal would widen the existing expectation gap regarding the nature and extent of audit work required by the PCAOB's auditing standards.

Introduce situations when the auditor is disclosing sensitive information that is not otherwise required to be disclosed by the issuer;

One of the examples in the Proposal (Hypothetical Auditing Scenario #3) illustrates a fact pattern in which the auditor discloses a "control deficiency less severe than a material weakness noted in the Company's internal control system."[3] This information is part of the auditor's required communication to the issuer's audit committee, under current PCAOB standards, but there is nothing in securities law that requires public reporting of either significant deficiencies in internal controls or audit adjustments.

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[3] http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf at page A5-77

The Proposal acknowledges a fact pattern whereby control deficiencies that are not material weaknesses would be disclosed by the auditor. For example, Appendix V of the Proposal states:

> Because a deficiency or deficiencies in the company's internal control over financial reporting could have a significant effect on the conduct of the audit and on the level of difficulty in gathering audit evidence or forming an opinion on the financial statements, an internal control deficiency might be an indicator of a critical audit matter.[4]

This would mean that the auditor would be disclosing sensitive information that is not otherwise required to be reported by the issuer. Furthermore, unlike the existing audit requirement to discuss such matters with the audit committee, the information is being presented to users of financial statements with limited context and no opportunity for the clarifying discussion that occurs during most audit committee meetings.

We strongly believe that an audit firm should not report sensitive information that is not required to be disclosed under existing securities laws and/or generally accepted accounting principles. We believe that existing U.S. securities laws and existing U.S. GAAP are sufficient to provide users with the appropriate amount of information to make investment decisions. Further, the expansion of existing disclosure requirements is the purview and responsibility of the SEC and the FASB. Accordingly, if the PCAOB were to go forward with this Proposal, we believe the auditor should be prohibited from disclosing any information that is not otherwise required to be disclosed by the issuer.

Duplicate information already disclosed by the issuer

We believe that the most difficult, subjective and complex audit matters encountered by the auditor are highly likely to be the critical accounting policies and estimates that the issuer is already disclosing in its Management Discussion and Analysis (MD&A). Given that the sections of MD&A that cover critical accounting policies and estimates provide the reader with management's assessment of the most judgmental aspects of the financial statements, NAREIT questions why the Board would require auditors to duplicate this information. If the PCAOB believes that this existing information is not sufficiently robust or transparent, NAREIT recommends that SEC or the Financial Accounting Standards Board (FASB) evaluate this aspect of financial reporting and provide additional guidance through the comment letter process. Another possibility would be to request that the FASB evaluate these disclosures as part of its Disclosure Framework Project.

Increase audit fees for, among other things, the senior level time the auditor will incur describing the critical audit matters for purposes of drafting the proposed disclosure and incremental time discussing those matters and the related disclosure with management and the audit committee

[4] http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf at page A5-32

NAREIT acknowledges that the current audit standards require the auditor to identify and communicate significant audit matters to the audit committee. However, NAREIT believes that requiring the auditor to report critical audit matters in the audit opinion would lead to increased audit fees. At a minimum, each and every audit engagement team would incur additional senior level time in order to determine the critical audit matters (CAMs) for purposes of drafting the proposed disclosure and discussing both the CAMs and the related disclosure with management and the audit committee.

Further, given the significant degree of subjectivity involved in determining which significant audit matters are “the most critical” and the inevitable second guessing of that determination by audit committees, management, PCAOB inspection teams, SEC staff and litigators, NAREIT anticipates that audit partners would need to consult others in the firm regarding both the selection of CAMs as well as the report language. The added time and related increased risk incurred by the audit firm would directly translate into an unnecessary and avoidable increase in annual audit fees. Further, we believe that there is a risk of inconsistent disclosure of CAMs both within and among the audit firms. We sense that the added disclosure in the audit report would open both audit firms and issuers to increased litigation risk, the cost of which will be passed on to issuers (and thus investors) in the form of increased audit fees.

Exacerbate existing time pressures to meet reporting deadlines

Given the nature of the audit process, auditors are unlikely to be able to conclude definitively on “the most” significant, judgmental or complex audit matters until substantially all the audit work has been completed. That necessarily places the decisions and discussions surrounding CAMs into the very final stages of the audit and just prior to the release of the audited financial statements on Form 10-K. If the Board moves forward with this Proposal, NAREIT foresees the addition of a very time consuming step into the late stages of what is already a tight deadline for many issuers.

In light of time pressures, liability concerns and fee issues, audit firms may feel compelled to develop standardized audit report language for common critical audit matters. Thus, stepping back and looking at the sum total of our concerns, we believe there is a significant risk that the PCAOB’s proposal will result in boilerplate, duplicative disclosures that add to the cost of the audit without adding to the information available to users of financial statements.

NAREIT Comments on Auditor Tenure

NAREIT understands that there is some interest amongst financial statement users about auditor tenure. We observe that for many issuers, the tenure of an audit firm can be determined by a review of the issuer’s public filings. However, NAREIT does not support the Proposal that auditors report on their tenure because that information, placed in the audit report, infers a direct relationship between auditor tenure and the quality of the audit or the content of the audit report that does not exist. NAREIT is unaware of evidence indicating that auditor tenure has a direct correlation to audit quality.

Perhaps more importantly, NAREIT considers auditor tenure to be a corporate governance matter under the direct purview of the issuer's audit committee only. A statement regarding auditor tenure placed in the audit report would provide no information about how the audit committee assesses the quality of the audit work and determines that a change in auditor is appropriate. It also would provide no information regarding the most recent tendering of the audit. Some users might incorrectly infer that longer auditor tenure indicates that the audit has not been retendered when, in fact, the audit committee's decision to retain the incumbent audit firm was made after an extensive retendering process.

Therefore, NAREIT recommends that information regarding auditor tenure continue to be excluded from the audit report. If users of financial statements believe this information would provide significant value, the SEC should consider adding relevant disclosure requirements to proxy statements that are filed coincident with audit committee reports or in connection with company shareholder ratification of auditor appointments.[5]

NAREIT Comments on Other Information

We do not understand the purpose of expanding the audit report to explicitly address information that is not audited and that is often outside the expertise of an auditor. More importantly, NAREIT believes the proposed language that would be included in the audit report regarding other information would mislead users into believing that the auditor has an authoritative basis to conclude on the sufficiency, accuracy or completeness of the other, unaudited information. This, in turn, would cause auditors to do additional work and invest additional resources into the reading of the unaudited information beyond what may be required by the standard because they would be perceived as being more closely associated with that information. Inevitably, this exercise would increase the cost of the audit as well as the cost of preparing the unaudited information. The result would be more cost to shareholders without additional assurance to those same shareholders.

In NAREIT's view, there is no need to change the existing audit standard related to other information contained in a report that includes audited financial statements. We are unaware of any evidence indicating that auditors are either not meeting their existing (albeit very limited) responsibilities for other information or that users are misinformed about which elements of an SEC filing are audited and which are not. In fact, in its Proposal, the PCAOB notes that "investors generally were not supportive of auditor assurance on other information outside the financial statements."[6] To the extent that the audit committee or external third parties (*e.g.*, underwriters, institutional investors, or analysts) believe it is appropriate to obtain additional assurance on other information included in SEC filings, the PCAOB's existing standards provide auditors with the tools to meet those requests. Accordingly, nothing more is needed.

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[5] In its Proposal, the PCAOB notes that the UK-listed companies are "required to provide information about auditor tenure in a separate section of the annual report" (page A5-16.) The approach used by the UK is consistent with our view that information about auditor tenure, while potentially of interest to investors, is a matter of corporate governance.

[6] http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf at page 25

The PCAOB states that

> The required procedures under the proposed other information standard would focus the auditor's attention on the identification of material inconsistencies between other information and the company's audited financial statements and on the identification of material misstatements of fact, based on relevant evidence obtained and conclusions reached during the audit.[7]

NAREIT views these requirements as largely consistent with the existing audit standard which states that the auditor "should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation appearing in the financial statements."[8] However, the proposed changes to the standard, and the related proposed language in the audit report, suggest that the auditor's responsibility should extend beyond what has been historically required. Specifically, under the Proposal the auditor would be required to state that, "in addition to auditing the financial statements and the Company's internal controls over financial reporting," the auditor would also be required to "evaluate" the other information in the filing, an evaluation that was "based on relevant audit evidence obtained and conclusions reached during the audit." What level of assurance is provided by an "evaluation?" Absent clarification by the PCAOB, users of financial statements could mistakenly perceive the audit firm's work and the level of assurance provided surrounding other information as something substantial, with no meaningful understanding as to the distinction between an "evaluation" and an "audit." This perception gap could have severe ramifications on the investment community as well as the audit profession. Instead of adding more clarity to the audit report and narrowing the expectation gap, we view this Proposal as significantly obfuscating the nature and scope of an audit and dramatically widening the expectation gap.

In NAREIT's view, this aspect of the Proposal is fraught with many issues involving each financial statement users' perspectives, and would likely lead auditors by default to performing a far more significant amount of unnecessary work on other information than under current standards due to the lack of clarity regarding the nature and scope of the auditor's responsibility. This would cause increases in audit fees when there is absolutely no demand or requirement for any type of assurance on this information and could lead to less useful information being provided to investors.

Summary

NAREIT does not believe that the changes recommended by the Proposal with respect to the audit report, disclosure of auditor tenure, and the auditor's responsibility for other information are warranted. These requirements would add costs without improving the quality of the audit. Furthermore, these proposals would be likely to confuse and in some cases even mislead users of

[7] http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf at page 7
[8] See AU 550.04

financial statements. Therefore, NAREIT recommends that the PCAOB suspend its efforts on the Proposal, and instead focus its time and resources on improving aspects of the audit procedures that would enhance audit quality so as to provide investors with more confidence that the audited financial statements are, indeed, free of material misstatement.

In the event that the PCAOB decides to move forward with the Proposal, NAREIT recommends that the Board consider conducting robust field testing. In our view, field testing should involve not only the preparer and auditor community, but also representatives from the investment community in order to fully assess both the costs and the benefits of the Proposal. This would provide the Board with evidential matter in evaluating whether the Proposal is operational, whether additional guidance is needed, whether the implementation costs outweigh the perceived benefits, and if the Proposal's objectives could actually be achieved.

* * *

We thank the PCAOB for the opportunity to comment on the Proposal. If you would like to discuss our views in greater detail, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at gyungmann@nareit.com or 1-202-739-9432, or Christopher T. Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 1-202-739-9442.

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NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

October 31, 2014

Ms. Phoebe W. Brown
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Washington, D.C. 20006-2803
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Delivered Electronically

Re: Staff Consultation Paper, *Auditing Estimates and Fair Value Measurements*

Dear Board Members:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) in response to the solicitation for public comment by the Public Company Accounting Oversight Board (PCAOB or Board) with respect to the Staff Consultation Paper, *Auditing Estimates and Fair Value Measurements, August 19, 2014* (the Staff Paper).

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service those businesses.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT All REITs Index, which covers both Equity REITs and Mortgage REITs. This Index contained 209 companies representing an equity market capitalization of $789 billion[1] at September 30, 2014. Of these companies, 169 were Equity REITs representing

[1] http://www.reit.com/sites/default/files/reitwatch/RW1410.pdf at page 21

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91.8% of total U.S. listed REIT equity market capitalization (amounting to $724.5 billion). The remainder was 40 publicly traded Mortgage REITs with a combined equity market capitalization of $64.5 billion.

This letter has been developed by a task force of NAREIT members, including members of NAREIT's Best Financial Practices Council. Members of the task force include financial executives of both Equity and Mortgage REITs, representatives of major accounting firms, institutional investors and industry analysts.

NAREIT appreciates the PCAOB's efforts toward improving audit quality since its inception in 2002. However, NAREIT has significant concerns with the Staff Paper as drafted.

Why is a change to the existing audit framework for auditing estimates warranted?

NAREIT is not persuaded that a change to the audit framework for auditing estimates is necessary. In NAREIT's view, a single standard for auditing estimates and fair value measurements is an unworkable solution given the multiple iterations of accounting estimates in U.S. Generally Accepted Accounting Principles (GAAP). Additionally, NAREIT's member companies observe that external auditors currently perform a significant amount of audit work surrounding estimates pursuant to existing audit standards. For example, multiple member companies have indicated that the audit fees for auditing fair value estimates of real estate and auditing purchase price allocations in business acquisitions *exceed* the fees paid to the third party valuation companies that develop the estimates. In NAREIT's view, the suggestions in the Staff Paper would not pass a cost benefit test. The suggestions in the Staff Paper would only expand the work that auditors perform today, with no increase in the reliability or credibility of the audited financial statements. Further, as discussed below, there is no evidence that the existing auditing standards related to auditing estimates fail to detect significant errors in financial statements. In short, NAREIT sees no basis to conclude that increased audit work (and thus audit fees) would provide any measurable benefit.

What is the underlying problem that the Staff Paper is trying to solve?

NAREIT does not believe that the Staff Paper articulates a pervasive problem that would be solved by a change in auditing standards. The Staff Paper seems to be justifying a significant increase in audit work (and cost) based on the number of deficiencies found in the inspections process. While NAREIT acknowledges that PCAOB inspection reports have identified shortcomings in the audit work surrounding estimates, we observe that these criticisms could be caused by a number of factors:

- Auditors are not following the current standards;

- Auditors are performing the required procedures but are not adequately documenting the work that they perform;

- Auditors lack sufficient knowledge with respect to quantitatively sophisticated methods of developing estimates used by their clients or third party specialists and therefore are not capable of designing appropriate audit procedures to test the estimates; or,

- The expectations of the PCAOB inspection teams do not reflect the inherent uncertainties and imprecision that underlies estimates, including estimates of fair value measurements.

NAREIT is not aware of any significant audit failures (with "audit failures" defined as restatements of financial statements) driven by erroneous estimates in recent history that would necessitate standard setting by the PCAOB. NAREIT questions whether the PCAOB's inspection findings in the areas of estimates, including estimates of fair value measurements, are more likely driven by auditor shortcomings relative to existing standards rather than problems with the auditing standards themselves.

As illustrated by FASB Member Larry Smith and former FASB Chairman Robert Herz[2] at the October 2, 2014 PCAOB Standing Advisory Group Meeting, estimates are prevalent throughout financial statements prepared under U.S. GAAP. Further, accounting estimates extend above and beyond fair value measurements and the GAAP hierarchy for fair value measurements that was introduced by FAS 157 *Fair Value Measurements*. Examples of accounting estimates within the real estate industry include: depreciation and amortization, asset impairment, reserves for tenant receivables, accrued expenses, deferred revenues, commitments and contingencies, contingent rental revenue, unrealized gains and losses on derivatives, foreign currency translation adjustments, changes in value for available-for-sale securities, etc. Developing estimates and fair value measurements is not new to the accounting profession. NAREIT fails to see where audits have failed to assess the reasonableness of the financial statements in accordance with U.S. GAAP.

Why should external third parties be considered an extension of management?

NAREIT strongly objects to the portions of the Staff Paper that suggest expanding the scope of audit work in the evaluation of processes and controls when management uses a third party specialist or pricing services. NAREIT continues to believe that the auditor's testing of the accuracy of information provided to the third party is appropriate. Additionally, NAREIT considers the evaluation of information provided by third parties to be sufficient in accordance with current audit literature. However, we disagree with requiring the auditor to "test the information provided by the specialist as if it were produced by the company"[3] or to "evaluate the audit evidence obtained [from the third-party source] as if it were produced by the company.[4]" The idea that either management (in its assessment of the adequacy of the company's internal controls over financial reporting) or the external auditor (in its evaluation of management's assessment) could evaluate third parties' processes and controls is simply not operational. NAREIT notes that existing audit guidance in AU 342.04 *Auditing Accounting*

[2] http://pcaobus.org/News/Events/Documents/10022014_SAG/Herz_slides.pdf
[3] Staff Paper, page 38, Management's Use of a Specialist
[4] Staff Paper, page 44, Use of Third Parties

Estimates acknowledges that "[a]s estimates are based on subjective as well as objective factors, it may be difficult for management to establish controls over them.[5]" Finally, third party specialists and pricing services are separate entities from the companies that engage them. To assume otherwise is not factual.

By suggesting that the auditor treat third party specialists as part of the entity that they are auditing, the Staff Paper seems to be requiring management to understand and evaluate the operating effectiveness and sufficiency of controls at third party vendors. There are two clear business reasons why companies engage third parties to assist in the development of estimates: (i) the company does not have the requisite expertise or time to perform the work in-house; or (ii) the company's management believes that the use of third parties enhances the objectivity and reliability of its estimates. Requiring management and the auditor to evaluate the third parties' processes and controls as if they were part of the company itself would exacerbate the company's resource constraints in the first scenario and potentially discourage the company's efforts in the second scenario. As indicated earlier, in NAREIT's view, the costs of implementing such audit requirements would far outweigh any incidental benefits.

Isn't an accounting estimate, by its very nature, merely one possibility in a range of reasonable outcomes?

While NAREIT understands the importance of auditing estimates, we have to wonder whether the Staff Paper is attempting to reach a level of precision via the audit process that contradicts the inherent nature of the subject being audited.

Estimates, including fair value measurements, are used extensively in the preparation of real estate entities' financial statements. Preparers, auditors and, most importantly, investors and other users of this financial information understand the imprecision that results from the use of estimates. In the context of financial reporting, management's responsibility is to use its judgment regarding available information in making accounting estimates. AU 342.03 notes that "[m]anagement's judgment is normally based on its knowledge and experience about past and current events and its assumptions about conditions it expects to exist and courses of action it expects to take." The auditor's responsibility is *not* to conclude whether the estimate is right or wrong, but to assess whether management's accounting estimate is *reasonable.* Auditing Standard No. 14 *Evaluating Audit Results* states: "If an accounting estimate is determined in conformity with the relevant requirements of the application financial reporting framework and the amount of the estimate is reasonable, a difference between an estimated amount best supported by the audit evidence and the recorded amount of the accounting estimate ordinarily would not be considered to be a misstatement.[6]"

[5] http://pcaobus.org/standards/auditing/pages/au342.aspx
[6] http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_14.aspx

NAREIT's recommendation: Focus on targeted improvements to identified problems

In the event that the PCAOB decides to move forward with some change to existing auditing standards, NAREIT recommends that the PCAOB use a targeted approach instead of wholesale changes to the audit framework for estimates. For example, if there are shortcomings in the use of the work of specialists, the PCAOB might consider focusing on auditing the work of specialists to further evaluate the expertise and/or objectivity of the specialist or auditing the inputs provided by the company to the specialist. Alternatively, if the shortcomings stem from inadequate documentation or insufficient subject matter knowledge, the PCAOB could consider steps that would target those issues.

As a starting point, NAREIT recommends that the PCAOB address how proposed changes to auditing literature would impact the auditor's consideration of materiality. NAREIT observes that the Staff Paper is silent on the assessment of materiality. The intersection of where estimates and materiality meet would appear to be a fundamental starting point for the PCAOB's focus in making targeted improvements to audit literature.

Summary

NAREIT appreciates the PCAOB's staff efforts in their endeavor to further audit quality. However, NAREIT does not believe that the PCAOB has identified the root cause that would necessitate further amendments to auditing standards. While the PCAOB cites fair value as a common area of "significant audit deficiencies[7]", NAREIT fails to see where these deficiencies have translated into restatements of previously reported financial results. Thus, NAREIT questions whether the Staff Paper simply represents rule-making for the sake of rule-making, without a clearly articulated underlying problem. As indicated above, in the event that the PCAOB concludes that further standard setting is required, NAREIT recommends that the Board make targeted improvements to specific sections of audit guidance as opposed to wide-ranging changes to the entire audit framework.

* * *

We thank the PCAOB for the opportunity to comment on the Staff Paper. If you would like to discuss our views in greater detail, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at gyungmann@nareit.com or 1-202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 1-202-739-9442.

[7] Staff Paper, page 3, Introduction

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FASB Simplification Initiative

Goals and Facts:

1) To make narrow-scope simplifications and improvements to accounting standards through a series of short-term projects.
2) Intended to improve or maintain the usefulness of the information reported to investors while reducing costs and complexity in financial reporting.
3) Initiative is a natural offshoot of the FASB Disclosure Effectiveness project.
4) Projects impact all financial statement users, not just private companies.

Completed Projects Impacting REITs:

1) Extraordinary Items – Eliminates from GAAP the concept of extraordinary items, which was rarely used in practice yet still sometimes required significant time spent on the assessment (for instance following the events of 9/11). Effective 1/1/16 for calendar year-end companies with early adoption permitted as long as it is applied in the first quarter of the adoption year.

Note: The FASB website and more specifically the section called "Simplifying Accounting Standards" has been used as a source for this presentation.

FASB Simplification Initiative (continued)

Current Projects Impacting REITs:

1) Presentation of Debt Issuance Costs – Would require that debt issuance costs be presented in the balance sheet as a direct deduction from the carrying amount of the corresponding debt liability, consistent with debt discounts (contra liability as opposed to an asset). Final standard expected in Q2 2015.
2) Share Based Payments:
   a) Accounting for Forfeitures – For share-based payments with only service conditions, companies could elect to account for forfeitures as they occur or continue to estimate forfeitures upfront and true-up the estimates over time as is currently required.
   b) Minimum Statutory Withholding Requirements – The amount of shares withheld/repurchased to satisfy the minimum statutory income tax withholding obligation could be up to the maximum marginal tax rate in a given jurisdiction without triggering liability/fair value classification for the entire stock award.

   Final standard is expected in 2015.
3) Clarifying Certain Existing Principles on Statement of Cash flows – The FASB is looking to reduce diversity in practice through the clarification of certain existing principles for classifying cash flows. Examples of issues noted include the following:
   - Insurance proceeds, including from company-owned captives
   - Debt prepayment or extinguishment costs
   - Classification of changes in restricted cash
   - Classification of dividends from equity method investees
   - Classification of cash flows from securitizations

   No timetable for this project was listed on the FASB's website.

FASB Simplification Initiative (continued)

Current Projects Impacting REITs (continued):

4) Accounting for Income Taxes – Intra-Entity Asset Transfers – Would eliminate the exception for recognition of income taxes on intercompany transactions. Instead, recognition of the current and deferred income tax consequences of an intra-entity asset transfer would be required when the transfer occurs as opposed to waiting until the assets have been sold to a third party. Final standard is expected in Q2 2015.

The FASB Simplification Initiative contains various other projects that could have an impact on selected REITs with defined benefit pension plans and classified balance sheets and/or for those REITs that are considered private companies. More information can be obtained on the FASB website in the section called "Simplifying Accounting Standards".

pwc

No. US2015-03
February 26, 2015

What's inside:

Background 1
Key provisions 2
Scope 3
Variable interest determination 4
Determining whether an entity is a variable interest entity 9
Variable interest entity model 16
Voting interest entity model 22
Disclosures 23
Effective date and transition 23

New consolidation standard

The new FASB guidance allows early adoption now

At a glance

On February 18, 2015, the FASB issued a final standard that amends the current consolidation guidance. The amendments affect both the variable interest entity (VIE) and voting interest entity (VOE) consolidation models. The changes are extensive and apply to all companies. The need to assess an entity under a different consolidation model may change previous consolidation conclusions.

The standard is effective for public reporting entities in fiscal periods beginning after December 15, 2015, and fiscal periods beginning after December 15, 2016 for non-public business entities. Early adoption is permitted.

Background

.1 On February 18, 2015, the FASB issued Accounting Standard Update 2015-02, *Consolidation – Amendments to the Consolidation Analysis* (the "ASU"). Once effective, the ASU will apply to the consolidation assessment of all entities.

PwC observation:

The changes introduced by the ASU are not limited to any particular industry. All reporting entities that hold a variable interest in other legal entities will need to re-evaluate their consolidation conclusions and potentially revise their disclosures. This process may be time consuming, particularly for reporting entities with large numbers of VIEs and for those that need to apply an entirely new consolidation model to the assessment (for example, many limited partnerships and reporting entities that hold variable interests in investment companies previously subject to an indefinite deferral of certain provisions of the consolidation guidance). Changes may be required to systems, processes, and controls to analyze and continuously monitor applicable relationships for presentation and disclosure purposes.

.2 The ASU concludes the FASB's project to rescind the indefinite deferral of the VIE guidance in ASU 2009-17[1] (FAS 167[2]) for reporting entities with variable interests in legal

[1] ASU 2009-17, *Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*
[2] FAS 167, *Amendments to FASB Interpretation No. 46(R),* codified in ASC 810, *Consolidation*

entities that have the attributes of an investment company that meet certain criteria (ASU 2010-10[3]). The ASU also makes changes to the VOE consolidation model.

. 3 Prior to the issuance of ASU 2009-17, the consolidation guidance for VIEs (FIN 46(R)[4]) required a reporting entity to consolidate a VIE if it was exposed to a majority of the VIE's expected losses, expected residual returns, or both through its variable interests. ASU 2009-17 shifted the consolidation analysis from a risks and rewards-based approach to a model that defines control as a combination of having (i) the power to direct the most significant activities that impact an entity's economic performance, and (ii) potentially significant economic exposure. As an unintended outcome, ASU 2009-17 would have required many asset managers to consolidate the investment funds they manage, which most practitioners (preparers and users alike) believed would not provide useful financial information. As a result, the FASB issued ASU 2010-10, which required entities meeting the deferral criteria to continue to apply the risk and rewards approach.

. 4 The FASB undertook a project to consider changes to the consolidation model for the express purpose of rescinding the deferral and eliminating the risk and rewards approach. Their initial proposal was issued in late 2011. Under that proposal, a decision-maker with a variable interest in an entity would perform a separate analysis to determine whether it was using its decision-making authority in the capacity of a principal or an agent. A principal would consolidate the entity while an agent generally would not.

. 5 Numerous changes were made to the 2011 proposal in response to comment letter feedback received from constituents. Most notably, the FASB abandoned the requirement for a separate principal versus agent analysis, opting instead to embed the concepts underlying that analysis throughout the VIE model. The FASB also abandoned its proposal to align the definition of participating rights between the VIE and VOE models.

Key provisions

. 6 The ASU does not change the general order in which the consolidation models are applied. A reporting entity that holds an economic interest in, or is otherwise involved with, another legal entity (has a "variable interest") should first determine if the VIE model applies, and if so, whether it holds a controlling financial interest under that model. If the entity being evaluated for consolidation is not a VIE, then the VOE model should be applied to determine whether the entity should be consolidated by the reporting entity. Since consolidation is only assessed for legal entities, the determination of whether there is a legal entity is important. It is often clear when the entity is incorporated, but unincorporated structures can also be legal entities and judgment may be required to make that determination. The ASU contains a new example that highlights the judgmental nature of this legal entity determination (see paragraphs .48 –.51 for further information).

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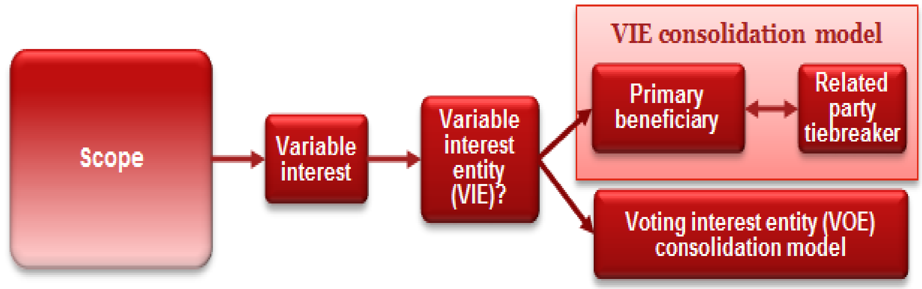
[3] ASU 2010-10, *Consolidation (Topic 810), Amendments for Certain Investment Funds*
[4] FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*

Scope



Money market funds

.7 The ASU does not remove or amend any of the existing scope exceptions. It does, however, provide a new scope exception pertaining to certain money market funds. The consolidation guidance will no longer apply to money market funds registered with the SEC pursuant to Rule 2a-7 of the *Investment Company Act of 1940* (registered money market funds) and "similar" unregistered money market funds. This scope exception is responsive to concerns of financial statement users and preparers that the consolidation of money market funds by the asset manager does not result in decision-useful financial information.

.8 The scope exception applies to all reporting entities that hold interests in registered and similar unregistered money market funds, including investors, sponsors, asset managers, and any other interest holders. None of the interest holders will need to assess these funds for consolidation under any consolidation model (VIE or VOE). Reporting entities will be required to provide new disclosures about financial support (see paragraph .74 for further details).

PwC observation:

Once it has been determined that the scope exception applies, it will not be necessary to establish whether the investment advisor to the fund has a decision making fee that is a variable interest, since the VIE disclosure requirements would not apply. However, reporting entities involved with funds subject to this exception are required to provide certain disclosures irrespective of whether they have explicit variable interests. These disclosures are a subset of those required for reporting entities that have a variable interest in a VIE and are therefore considerably less onerous.

.9 During redeliberations, the Board acknowledged the challenge of amending the VIE model to create an outcome where a sponsor would not consolidate a registered money market fund. Specifically, financial support provided by the sponsor to prevent the fund from "breaking the buck" through, for example, the waiver of management fees and purchases of securities at prices in excess of fair value created unique challenges that could not be solved by amending the model. The Board ultimately determined that the most effective way of addressing stakeholder concerns without creating unintended consequences for other entities was to provide a scope exception.

.10 Unregistered money market funds that operate in a manner similar to registered money market funds are also subject to the scope exception. Determining whether an unregistered money market fund is similar to a registered money market fund will require judgment. Registered money market funds are required to invest in securities issued by entities with minimal credit risk with a short duration (considering individual securities and the average maturity of the portfolio). In addition, they are subject to constraints related to credit risk and diversification.

.11 The unregistered money market fund's purpose and design, as well as the risks it was designed to create and pass along to its interest holders, should be considered in assessing whether the fund operates in a manner similar to a registered money market fund. Specifically, the fund's portfolio quality, maturity, and diversification should be considered when making this determination. The structure and intended outcome of the fund may also be relevant factors to consider.

Exhibit 1: Points of focus when assessing whether an unregistered fund is similar to a registered money market fund

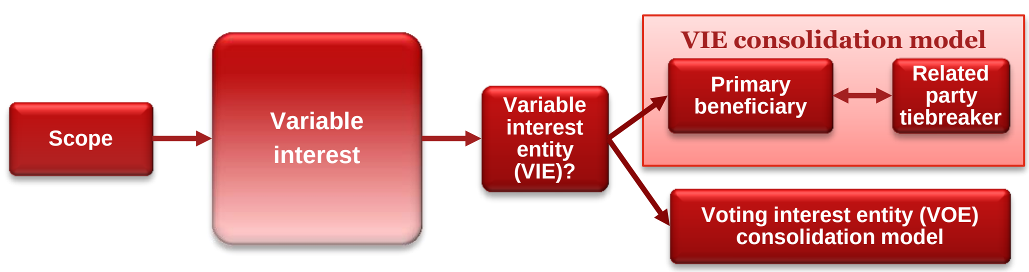
Characteristic	Description
Portfolio quality	Does the fund invest in high-quality, short-term securities with credit risk similar to those held by registered money market funds?
Portfolio maturity and diversification	Are the fund's objectives regarding (1) credit quality of its eligible investments, (2) the diversification of the portfolio, (3) maximum maturity of eligible investments, and (4) average maturity of the portfolio, consistent with the objectives of a registered money market fund?

PwC observation:

Unregistered money market funds that operate in a manner similar to registered money market funds are currently subject to the indefinite deferral. These unregistered money market funds may or may not be eligible for the scope exception. Sponsors of unregistered money market funds will need to evaluate and document their assessment of whether each of their unregistered funds is in fact similar to a registered money market fund based on the guidance contained in the ASU.

Variable interest determination

.12 The ASU also does not change the general approach for applying the VIE model. A reporting entity would first determine whether it holds a variable interest in the legal entity being evaluated for consolidation. If the reporting entity holds a variable interest, it must determine (a) whether the entity is a VIE, and (b) if the entity is a VIE, whether the reporting entity is the VIE's primary beneficiary. The reporting entity would perform the analysis of whether the entity is a VIE when it initially becomes involved with the entity and subsequently if one of the defined reconsideration events occurs. In contrast, the analysis of who is the primary beneficiary of the entity is an ongoing assessment.



.13 The ASU does not alter the definition of a variable interest. A variable interest continues to be defined as an economic arrangement that gives a reporting entity the right to the economic risks and/or rewards of another entity. Sometimes it may be obvious that the reporting entity has a variable interest, such as when it holds a debt or equity interest in an entity. In other cases, the nature of the interest (e.g., contracts) may require judgment to determine if a variable interest exists. Only those interests that absorb changes in the fair value of an entity's net assets are considered variable interests.

.14 When a legal entity's shareholders or governing body outsources all or certain decision-making over the entity's activities through a contractual arrangement, the decision maker or service provider must assess its fee arrangement to determine whether it qualifies as a variable interest. Currently, a decision maker fee arrangement is not a variable interest if all six criteria in ASC 810-10-55-37 are met. This determination requires judgment and should consider all relevant facts and circumstances.

.15 The ASU removes three of the six criteria that must be considered when determining whether a decision maker fee arrangement is a variable interest. If all three of the retained criteria, presented in Exhibit 2a, are met, the fee arrangement will not be a variable interest.

Exhibit 2a: Retained criteria to determine whether a fee paid to a decision maker or service provider is a variable interest (ASC 810-10-55-37)

Ref.	Criterion
A	The fees are compensation for services provided and are commensurate with the level of effort required to provide those services
C	The decision maker or service provider does not hold other interests in the VIE that individually, or in the aggregate, would absorb more than an insignificant amount of the VIE's expected losses or receive more than an insignificant amount of the VIE's expected residual returns
D	The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length

.16 The three criteria removed by the ASU are listed below.

Exhibit 2b: Removed criteria to determine whether a fee paid to a decision maker or service provider is a variable interest (ASC 810-10-55-37)

Ref.	Criterion
B	Substantially all of the fees are at or above the same level of seniority as other operating liabilities of the VIE that arise in the normal course of the VIE's activities, such as trade payables
E	The total amount of anticipated fees are insignificant relative to the total amount of the VIE's anticipated economic performance
F	The anticipated fees are expected to absorb an insignificant amount of the variability associated with the VIE's anticipated economic performance

PwC observation:

It is expected that fewer fee arrangements will be considered variable interests under the ASU since the three criteria that have been removed have historically caused many decision maker fee arrangements to be variable interests. In particular, fee arrangements with a performance-based element that is *more than insignificant* (i.e., the fee's relative size and/or variability are *significant* to the entity) and/or where all or part of the fee is subordinated to other interests (i.e., paid after the entity's normal operating liabilities are settled) may no longer be variable interests under the ASU. If a reporting entity's decision maker fee arrangement no longer qualifies as a variable interest, and that reporting entity holds no other variable interests in the entity, it will not be required to further evaluate that entity for consolidation under the VIE model, or consider the applicability of the VIE disclosures. If a reporting entity's fee arrangement is not a variable interest, but it has other insignificant variable interest(s) in the entity, the reporting entity would still need to determine whether the entity is a VIE for disclosure purposes. Refer to PwC *Financial Statement Presentation Guide*, Chapter 18, for the disclosure requirements for reporting entities that have a variable interest in an unconsolidated VIE.

.17 As depicted in the Exhibit 2a above, the new analysis will continue to include the requirement that the decision maker fee arrangement is arms-length and contains customary terms and conditions ("at market" – see D in Exhibit 2a above) and represents compensation that is considered fair value for the services provided ("commensurate" – see A in Exhibit 2a above) to not be a variable interest. The ASU notes that the magnitude of the fee does not on its own mean that the fee arrangement is not at market or commensurate.

.18 To determine whether the fee arrangement is at market and commensurate, a reporting entity should consider external fee arrangements involving other third party decision makers for the same or similar services. However, the lack of any comparable arrangements does not necessarily mean that the fee arrangement is not at market or commensurate. For example, there may not be a comparable arrangement when the arrangement being assessed involves a new product or strategy, or a new service offering.

PwC observation:

The existence of comparable fee arrangements does not necessarily mean the fee arrangement is at market and commensurate. A fee arrangement that enables the decision maker to obtain substantially all of the residual returns of an entity is common in certain structures and likely would not be at market and commensurate. Examples of such arrangements include physician practice management entities, certain television/radio broadcasting structures, as well as entities in jurisdictions that restrict foreign equity ownership. The ASU includes a new example to illustrate this point.

.19 Other fee arrangements that expose the reporting entity to principal risk of loss are excluded from the at market and commensurate evaluation and would be considered variable interests. For example, fees for guarantees of an entity's outstanding debt or liquidity arrangements, for obligations to fund the entity's operating losses, or those relating to derivatives that absorb variability would still be considered variable interests. The FASB considered asset management fee arrangements to be different from other fee arrangements as the asset manager's downside exposure is limited to the risk that the fees collected will be less than expected (i.e., an opportunity cost). In contrast, a reporting entity is exposed to principal risk of loss when it could lose its existing investment or be required to fund losses of the entity or other investors.

.20 The ASU retains the criterion requiring consideration of the level of other economic interests held by the decision maker ("other economic interests" – see C in Exhibit 2a above). Holding other variable interest(s) in the entity that result in the decision maker absorbing more than an insignificant amount of variability would cause the decision maker fee arrangement to be a variable interest. In addition, certain related party interests will need to be considered in this assessment (see paragraph .23 below for further details). The assessment of whether the decision maker's collective other interests expose it to more than insignificant variability will continue to be both qualitative and quantitative, and require the exercise of judgment.

.21 If the decision maker does not hold other economic interests, directly or indirectly through its related parties, which absorb more than an *insignificant* amount of the entity's expected variability, and the fee arrangement is at market and commensurate, then the fee arrangement will not represent a variable interest.

PwC observation:

The reduction in the criteria reflects the FASB's belief that a decision maker with an at market and commensurate fee can still act in an agency capacity, notwithstanding the relative size or variability of its fee or the fact that its fee has subordination or residual-like characteristics.

By removing the three criteria that often caused a decision maker fee arrangement to be a variable interest (see Exhibit 2b), the ASU increases the focus on the determination of whether the fee is at market and commensurate. Historically, it was often clear that one of the other criteria was not met and, therefore, the arrangement was a variable interest.

Related party interests – the new "indirect" interest concept

.22 Today, for the purposes of assessing the "other economic interests" criterion, a decision maker includes all economic interests held by its related parties. Depending on whether the reporting entity is subject to the deferral, the interests of employees or employee benefit plans may be excluded. Including interests of employees and employee benefit plans, together with any other interests, often gives rise to these interests being more than insignificant.

.23 The ASU limits the extent to which related party interests are included in the other economic interest criterion to the decision maker's effective interest holding. A decision maker would need to have a direct economic interest in its related party, which in turn, has to have an economic interest in the entity being evaluated for consolidation. The decision maker would then include its effective share of that indirect economic interest as if it was held directly in the entity when applying this criterion. However, if the reporting entity and the related party are under common control, then the commonly controlled related party's entire economic interest should be attributed to the decision maker. In some cases, this may cause the decision maker's fee arrangement to be a variable interest.

PwC observation:

We believe the term “indirect interest” is intended to mean indirect *variable* interest. To have an indirect interest, a decision maker should have a direct variable interest in a related party that, in turn, has a direct and/or indirect variable interest in the entity being evaluated for consolidation. For example, a reporting entity with a fee arrangement with a related party that is not a variable interest would not need to consider any interests held through that fee arrangement as an indirect interest (assuming it holds no other variable interests in the related party). Our rationale is based on the notion that it would be counterintuitive for a fee arrangement with a related party that is not a variable interest to carry greater weight in the analysis than if that fee arrangement existed directly with the entity being evaluated for consolidation.

.24 To illustrate the concept, consider a decision maker that owns a 30% equity interest in a related party that in turn, holds a 60% equity investment in an entity. Further assume that the decision maker’s fee arrangement is at market and commensurate, and that the decision maker and its related party are not under common control. The decision maker would treat its effective 18% indirect equity interest in the entity (i.e., its 30% interest in the investee multiplied by the investee’s 60% interest in the entity) as if it were a direct variable interest when assessing the significance of other economic interests held by the decision maker. However, if the decision maker and the related party were under common control, then the decision maker would include the related party’s entire 60% interest in the analysis.

PwC observation:

Although this requirement may appear straightforward, this analysis will become more complex when the economic interests held deviate from “plain vanilla” common equity held by the decision maker in the related party, and/or by the related party in the entity being evaluated for consolidation. For example, the decision maker may hold a convertible preferred equity investment in the related party that in turn holds a debt investment in the entity being evaluated for consolidation.

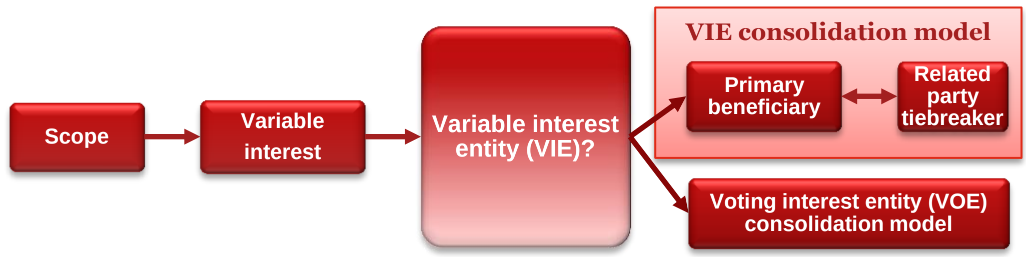
Companies will need to implement systems, processes, and controls to identify changes in the reporting entity’s indirect interests in VIEs. Changes to indirect interest percentages may be frequent for entities that have ongoing changes in investors and investment amounts. For example, a related party investor’s interest in a fund may change constantly as new investments are made or as interests are redeemed by third parties.

.25 A decision maker’s employees or employee benefit plans may hold variable interests in the entity being evaluated for consolidation. However, those interests would only be included in the indirect interest assessment if they are being used to circumvent the VIE guidance.

PwC observation:

When evaluating whether a decision maker has an indirect interest through its employees and employee benefit plans, the guidance does not specifically state that the portion of any interest financed by the decision maker should be considered as an indirect interest. This differs from the guidance prescribed in the primary beneficiary analysis which specifically indicates that a decision maker should include the effective portion of any employee interests that it has financed as an indirect interest (see paragraph .60). Although not explicit, we would generally expect the guidance in the primary beneficiary analysis to also apply when assessing whether a decision maker fee is a variable interest. Note that in its basis for conclusions to the ASU, the FASB does not draw a distinction between these two analyses.

Determining whether an entity is a variable interest entity



.26 The ASU retains the five main characteristics of a VIE described in ASC 810-10-15-14. As is the case today, if a reporting entity holds a variable interest in an entity that fails to qualify for one of the VIE scope exceptions described in ASC 810-10-15, then the reporting entity should determine whether that entity is a VIE.

.27 The ASU introduces a separate and different analysis specific to limited partnerships and similar entities (e.g., a limited liability company governed by a managing member as opposed to a board of directors). In addition, the ASU changes the manner in which a reporting entity that is not a limited partnership assesses whether the equity holders at risk lack decision making rights under ASC 810-10-15-14(b)(1).

Separate requirement for limited partnerships and similar entities

.28 The ASU introduces a new requirement to be applied only to limited partnerships and similar entities. This requirement was added based on the unique purpose and design of a limited partnership as compared to a corporation. Entities that are determined to be "similar" to limited partnerships would also be subject to this new requirement. For example, as noted above, some limited liability companies may be more like limited partnerships than corporations.

PwC observation:

Consistent with today's practice, judgment should be applied to determine if an entity should be evaluated as a corporation or as a limited partnership subject to the new requirement. Some limited partnerships are currently evaluated as corporations on the basis that they have a governance structure more akin to a corporation, such as when the general partner interest is vested in a board of directors elected by the investors.

Under the ASU, the determination of whether entities such as limited liability companies are similar to, or the functional equivalent of, limited partnerships will continue to focus on the entity's governance structure. In practice, limited liability companies that have a managing member and separate partner capital accounts are typically evaluated as limited partnerships.

.29 The ASU requires limited partners of a limited partnership, or the members of a limited liability company that is similar to a limited partnership, to have, at minimum, kick-out or participating rights to demonstrate that the partnership is a voting entity. Any of these rights, if present, are considered analogous to voting rights held by corporate shareholders that provide those shareholders with power over the entity being evaluated for consolidation. A limited partnership may be a VIE under one of the other characteristics even if these rights are present.

.30 The definition of kick out rights is amended by the ASU to include both removal and liquidation rights. Liquidation rights are now broadly defined as the ability to dissolve the entity.

.31 The kick-out rights must be substantive to demonstrate the partnership (or similar entity) is not a VIE. Kick-out rights will only be considered substantive if they are exercisable by a simple majority vote of the entity's limited partners (exclusive of the general partner, parties under common control with the general partner, and other parties acting on behalf of the general partner) or a lower threshold (i.e., as low as a single limited partner). The substance of kick-out rights granted to an entity's limited partners may be called into question when there are economic or operational barriers such as:

- Conditions that make it unlikely that the rights will be exercised
- The kick-out rights are subject to financial penalties or operational barriers to exercise
- There is an inadequate number of qualified replacements, or the level of compensation paid to the decision maker is inadequate to attract a qualified replacement
- No explicit mechanism exists, by matter of contract or law, that would allow the holder to exercise the rights or obtain the information necessary to exercise the rights

PwC observation:

Many limited partnerships require the general partner to make a substantive investment of more than 1% of total partnership capital. Under today's guidance, when a general partner contributes substantive equity, that general partner is grouped with the other investors to determine whether the equity investors as a group have decision making over the most significant activities. As a result, in these situations the limited partnership is typically a voting interest entity (assuming no other characteristics of a VIE are met), and would be evaluated for consolidation under ASC 810-20 (formerly, EITF 04-5). In contrast, the ASU disregards the level of equity provided by the general partner and instead focuses on the voting rights of the limited partners.

We expect this change to cause more partnerships to be considered VIEs, as limited partners often do not hold kick-out or participating rights.

.32 Substantive participating rights held by one or more of the limited partners would also demonstrate that the partnership is a voting entity. For this purpose, the ASU defines participating rights as rights to block or participate in significant financial and operating decisions that are made in the ordinary course of business, consistent with the definition in the VOE model. Additional guidance already exists for assessing whether these rights are substantive.

.33 Redemption rights held by the limited partners are not considered equivalent to kick-out or participation rights under the ASU. The ability of an individual investor to require a limited partnership to redeem its interest is not considered by the ASU to provide the holder with the ability to remove the decision maker or liquidate the partnership. During redeliberations, the FASB acknowledged that a scenario could exist where the exercise of a redemption right could lead to liquidation (e.g., when an entity has a single investor that holds a redemption right) although that scenario was believed to be rare.

.34 If a limited partnership is determined to be a variable interest entity and the general partner meets both the "power" and "economics" tests (see paragraph .52), then a single party kick-out or participating right over all of the entity's most significant activities would be needed for the general partner to avoid consolidation. That is, the right must be unilaterally exercisable and not exercisable solely by a simple majority of limited partners.

Assessing if equity holders at risk lack decision making rights for entities that are not limited partnerships or similar entities

.35 The ASU changes the evaluation of whether the equity holders at risk lack decision making rights when decision making is outsourced. In particular, the changes apply if there is a single decision maker that is subject to a contractual fee arrangement separate from (not embedded in) a substantive equity investment in the entity, and that arrangement conveys power to the decision maker to direct the activities that most significantly impact the economic performance of the entity.

.36 The change in how outsourced activities are to be assessed resulted from the FASB's consideration of whether a registered mutual fund that outsources decision making to a third party manager should be considered a VIE in the absence of single party kick-out or participating rights. The rights of shareholders and boards of mutual funds registered in accordance with the *Investment Company Act of 1940* ("the 1940 Act") convinced the Board that these entities should generally be considered voting interest entities. The Board determined that rights exercisable by a registered mutual fund's shareholders, either directly or through the entity's independent board of directors, are not substantively different from rights held by shareholders of a public company (which would generally not be a VIE).

.37 The new guidance shifts the focus to a fund's shareholder rights and, if substantive, considers these rights to effectively constrain the manager's level of discretion and decision-making authority. Thus, the new guidance concludes that the shareholders, rather than the manager, have the power to direct the fund's most significant activities if these rights are substantive.

.38 Although this concept was discussed in the context of a registered mutual fund, it applies to all entities that outsource decision making power. Entities would apply this approach only if they are not subject to the separate requirement for limited partnerships and similar entities.

.39 The new approach can be summarized in the following three steps.

Step 1 – Determine if the decision-maker's fee arrangement is a variable interest

.40 If the decision maker fee arrangement is not a variable interest, then the equity investors as a group would not lack the power to direct the activities of the entity that most significantly impact its economic performance. The nature of that arrangement would suggest the decision maker is acting as an agent and is therefore presumed to lack power over the entity's most significant activities. As a result, the entity would not be a VIE under this characteristic and steps two and three would not apply. See paragraphs .15–.25 for a discussion of how to determine if a fee arrangement is a variable interest.

PwC observation:

As fewer fee arrangements will be variable interests under the ASU, certain entities may no longer be VIEs, since the equity investors would not lack decision making power.

Step 2 – Assess the rights of shareholders

.41 The need to assess the rights of shareholders is a new step required by the ASU if the decision maker's fee arrangement is a variable interest. Under current guidance applicable to companies not subject to the deferral, the equity investment at risk is not considered to have decision making rights over the outsourced activities unless there is a single party that is able to unilaterally exercise a substantive kick out or participating right.

.42 The ASU requires that the reporting entity first consider the rights of the equity investment at risk before determining whether substantive single party kick out or participating rights exist. If the shareholders have substantive rights, then the entity would not be a VIE and step three would not apply.

.43 The ASU contains an example to illustrate some of the rights that may suggest the equity investment at risk has decision making power. The example is written in the context of a series mutual fund, and points to various shareholder rights as being present, including the ability to remove and replace the board members and the decision maker, and to vote on the decision maker's compensation. However, the basis for conclusions to the ASU notes that this concept is intended to be applied broadly to all entities.

PwC observation:

The FASB introduced this concept to differentiate between typical voting corporations (where the shareholders have rights over the most significant activities of an entity) and entities where shareholders have limited or no rights.

The example does not point to any particular right as being determinative since it will depend on the specific facts and circumstances. It will generally be the *aggregate* rights that provide the shareholders with the ability to exercise power over the entity. However, the inability of shareholders or the entity's board of directors to remove and replace the decision maker and approve its compensation will likely be determinative that the equity holders lack decision making under this step.

The rights listed in the example are not intended to be all-inclusive. As such, other rights may exist that should be considered when determining whether the equity holders lack the power to direct the activities of the entity that most significantly impact its economic performance.

.44 The existence of these shareholder rights alone does not indicate that an entity's shareholders have power. The reporting entity would also need to consider if these rights are substantive when determining if the entity's shareholders have power.

.45 The following example illustrates the application of this concept in a non-fund scenario.

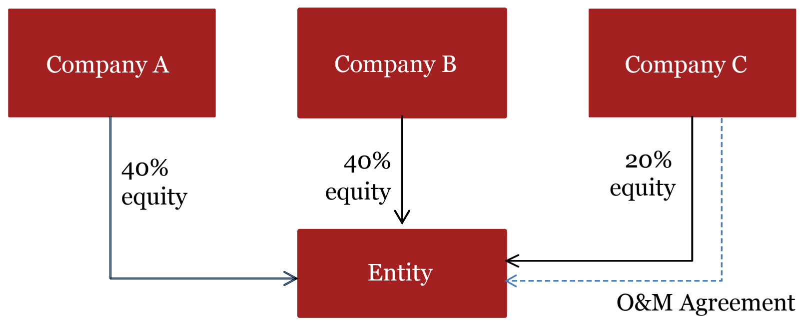
Example: Assessing shareholder rights

Three unrelated companies established an entity to invest in shipping vessels. Company A and B each provide 40 percent of the financing in exchange for equity interests and Company C provides the other 20 percent of equity financing. The entity operates subject to the supervision and authority of its board of directors. Each party has the ability to appoint members to the entity's board and shares in the entity's profits and losses in proportion to their respective ownership interests. The purpose, objective, and strategy of the entity is established at inception and agreed upon by the shareholders pursuant to the entity's formation agreements. The three companies identified and jointly agreed to the specified shipping vessels in which the entity would invest at formation.

A number of decisions require simple majority board approval. These include:

- The removal and replacement of the Operating and Maintenance (O&M) manager, without cause
- Changes in the O&M manager's compensation
- The acquisition of new ships
- The sale of existing ships
- A merger and/or reorganization of the entity
- The liquidation or dissolution of the entity
- Amendments to the entity's charter and by-laws
- Increasing the entity's authorized number of common shares
- Approval of the entity's periodic operating and capital budgets

Company C performs all of the daily operating and maintenance activities over the shipping vessels under an O&M agreement. The decisions relating to the operation and maintenance of the vessels are determined to be the activities that would most significantly impact the entity's economic performance. Company C receives a fixed annual fee for services provided to the entity that is at market and commensurate. However, the fee arrangement is determined to be a variable interest because Company C has another significant variable interest in the entity (equity financing).



Do the equity holders as a group lack decision making rights (is the entity a VIE)?

Analysis – current guidance

The entity would be a VIE as the equity holders would be deemed to lack decision making power to direct the entity's most significant activities. This is because the O&M agreement (the decision maker fee arrangement) is a variable interest, is not embedded in the equity of Company C, and no single equity holder is able to remove Company C as the O&M manager.

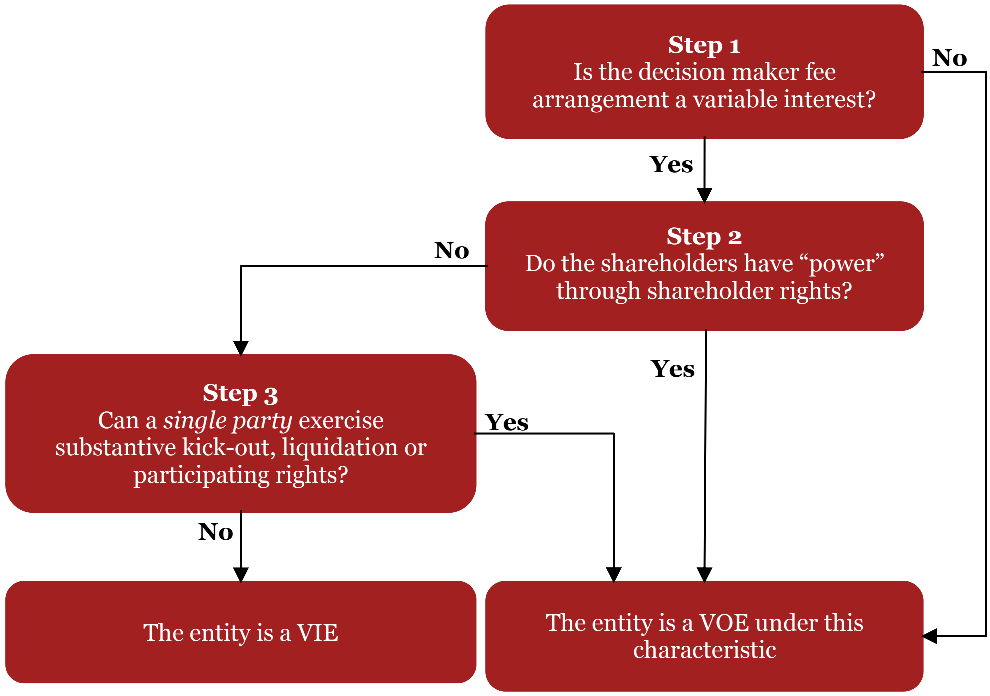
Analysis – amended guidance contained in the ASU

Under the ASU, the entity would not be a VIE despite the decision making fee arrangement being a variable interest. The board is actively involved in making decisions about the activities that most significantly impact the entity's economic performance. Among other rights, the board is able to remove the O&M manager without cause and approve its compensation. As the board is elected by the shareholders and is acting on their behalf, the shareholders in effect have power to direct the activities that most significantly impact the economic performance of the entity.

Step 3 – Determine if there is a unilateral kick out or participating right

.46 Finally, if the decision maker's fee arrangement is a variable interest under the first step, and the shareholders do not have certain rights as discussed in the second step (or such rights are not substantive), the reporting entity would need to determine if there is a single party that can exert substantive kick out or participating rights. Only if there is a single party with these rights would the entity not be a VIE under this characteristic. This step is consistent with current guidance applicable to companies not subject to the deferral.

.47 The decision tree for this characteristic applicable to entities that are not limited partnerships or similar entities can be illustrated as follows:



Series fund structures

.48 Series fund structures, which are common in the asset management industry, are structured with one umbrella legal entity that is typically a trust or corporation. Each series fund is represented by a separate share class of the trust/corporation and the proceeds from the issuance of the share class are invested in assets according to the strategy of the series fund. The trust/corporation is governed by a single board of directors that is responsible for overseeing the operations of each series fund. Many series funds are mutual funds registered in accordance with the 1940 Act.

.49 A question could be raised as to whether each individual series fund should be evaluated for consolidation as a separate legal entity, or instead, if the trust or corporation should first be evaluated. If the trust or corporation should be evaluated first, the determination of whether each series fund is a silo, subject to consolidation, would be required only if the trust/corporation is a VIE. The ASU includes an example that clarifies that each series fund that is a mutual fund subject to the 1940 Act should be treated as a separate legal entity. The rights of the entity's equity holders (series funds' shareholders), as opposed to the decision maker, are then considered to determine if the equity holders have the power to direct the entity's most significant activities (see the step discussed in paragraphs .41 – .45 for further information).

.50 The question of whether series funds are legal entities and VIEs is not new and there are differing views in practice today. However, because these series fund structures were subject to the indefinite deferral, the threshold for consolidation is generally the same (a majority) irrespective of whether they are viewed as VOEs or VIEs. By rescinding the deferral, these structures will potentially be subject to the "power" and "economics" consolidation model (see paragraph .52) for the first time. This model has a lower economic threshold for consolidation (potentially significant) and, therefore, this question becomes more important.

.51 The series fund example in the ASU includes specific factors that make 1940 Act series funds legal entities for purposes of the consolidation analysis. However, during Board redeliberations, the FASB staff noted that these factors are often not present in international series structures, and as a result, a different conclusion may be reached.

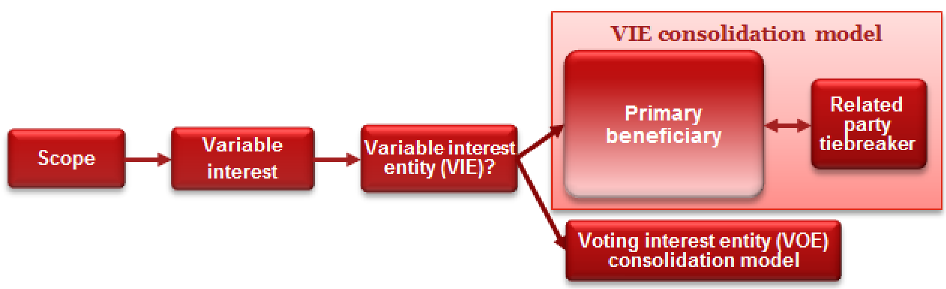
Exhibit 3: Factors noted as indicating that series mutual funds are legal entities
The fund has its own investment objectives and policies
The fund has its own custodial agreement
The fund has its own shareholders separate from other series funds
The fund has its own unique tax identification number
The fund files separate tax returns with the Internal Revenue Service
Separate audited financial statements are prepared for the fund
The fund is considered a separate investment company for investor protections in virtually all circumstances

PwC observation:

Asset managers expressed concern that by removing the deferral, the ASU would cause them to consolidate many series funds for a longer period than they do today after establishing a new fund and providing the initial seed capital. This is because the threshold for consolidating VIEs subject to the deferral (majority) will be lower upon adoption of the ASU (reduced to potentially significant). By concluding that each mutual series fund is a separate legal entity and focusing on each series' shareholder rights, the FASB expects that these funds will be considered VOEs. However, funds that continue to be VIEs on adoption of the ASU will be consolidated by asset managers for a longer period than today.

Variable interest entity model

Primary beneficiary determination



.52 A reporting entity with a variable interest in a VIE consolidates that VIE if it has both the power to direct activities that most significantly impact the economic performance of the entity ("power") and the right to receive potentially significant benefits or the obligation to absorb potentially significant losses ("economics").

.53 The ASU changes how the "economics" test is performed in two ways. First, the ASU reduces the circumstances when decision maker fees are included in the economics test. Second, the ASU changes the extent to which related party interests are considered in the test and also when related party relationships are considered in the VIE model.

Considering decision maker fee arrangements in the economics test

.54 The analysis to determine whether a reporting entity meets the economics test is not solely quantitative, but is also qualitative and should consider the VIE's purpose and design. Consequently, there is no bright line in today's guidance to indicate when a reporting entity's variable interests are potentially significant. In some cases, this analysis can be complex and highly judgmental.

PwC observation:

Upon adoption of the ASU, reporting entities will apply the "power" and "economics" VIE control model to entities that previously were subject to the deferral. Determining whether the economic interests are "potentially significant" is an area of significant judgment that is not probability-based; it considers all possible scenarios. During its redeliberations, the Board considered, but chose not to provide a new bright line that would indicate when economic interests are potentially significant.

.55 The ASU provides some relief to reporting entities applying the economics test. Under current GAAP, decision maker fees with a performance-based element would likely cause a decision maker with stated power to consolidate a VIE because the fee inuring to the decision maker could be potentially significant to the VIE. The ASU requires a decision maker to disregard the economics it absorbs through the fee arrangement when evaluating the economics test, provided the arrangement is at market and commensurate (see paragraph .15 for the definition of at market and commensurate).

PwC observation:

Under the ASU, the assessment of at market and commensurate is considered for the fee as a whole. Many fee arrangements include a fixed and a performance fee element. If the total fee is not at market and commensurate, then the entire fee should be included in the economics test. It would not be appropriate to only include that portion of the fee determined to be off-market or not commensurate.

.56 Although a decision maker's exposure to a VIE's economics through a fee arrangement will be disregarded if the arrangement is at market and commensurate, other variable interests held by the decision maker should be considered when applying the economics test. In addition, as discussed in paragraph .19, fees that expose a decision maker to a principal risk of loss would not be subject to the at market and commensurate assessment and would also be included in the economics test.

PwC observation:

The relief for at market and commensurate fees will not be helpful in the economics test if a decision maker's fee arrangement is considered a variable interest because this conclusion will likely stem from the fact that the decision maker holds other variable interest that are more than insignificant. The existence of a more than insignificant variable interest would generally be considered "potentially significant" under the economics test.

Certain funds that continue to be VIEs may now need to be consolidated by their asset manager due to the existence of other economic interests held by the manager. Entities subject to the deferral would have been consolidated by a party under the VIE model that either (1) absorbs a majority of the entity's expected losses or residual returns, or (2) was deemed the "most closely associated" under the related party tiebreaker test. Because the economic threshold (potentially significant) is lower in the "power" and "economics" VIE model, some funds that are determined to be VIEs may need to be consolidated despite the ability to exclude the asset manager's fee from the economics test.

.57 The ASU does not distinguish between the form of a decision maker's compensation (e.g., cash compensation or equity). A decision maker may receive an equity allocation based on performance of the entity, typically referred to as a "carried interest." Carried interests are commonly used in the alternative asset management industry, including for hedge funds and private equity funds.

PwC observation:

A question arises about whether a carried interest should be included in the economics test. Oftentimes that interest is subject to future reversal if performance of the entity declines. Until such time as that interest is no longer subject to reversal (i.e., the fee is crystallized), we believe that it should be excluded from the economics test. However, once the interest is no longer subject to reversal, it would be included in the economics test on the basis that it is no different from a direct equity investment made by the decision maker. The carried interest does not crystallize at the same times for all asset managers. Assuming it is determined to have power, an asset manager that continually reinvests its crystallized fee in a fund would need to consolidate that fund at the point when its cumulative interests meet the economics test threshold (i.e., becomes potentially significant).

Considering related party interests in the economics test – the new "indirect" interest concept

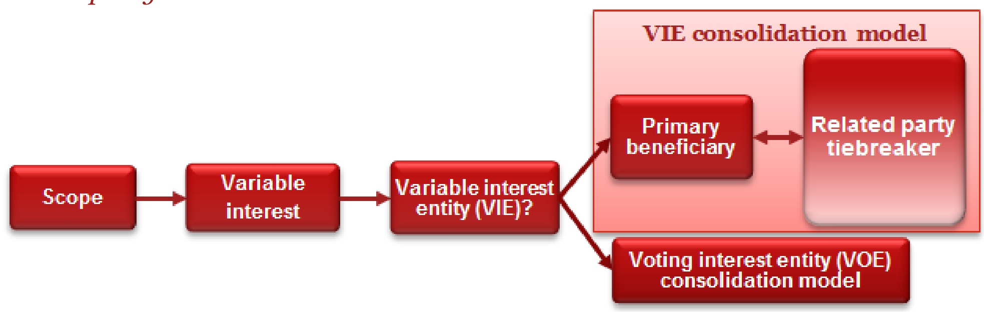
.58 Under current guidance, a reporting entity first performs the power and economics tests on a standalone basis. Only if the reporting entity does not meet both tests on a standalone basis does the reporting entity consider related parties in the analysis. At that time, the entire variable interest held by the reporting entity and its related parties are considered in determining if the related party group collectively meets the power and economics tests.

.59 The ASU changes the order in which related party interests are considered, and also the extent to which they are considered in many instances when the power test is met by a single party. The ASU brings forward the consideration of related party interests when analyzing whether the reporting entity with power meets the economics test on a stand-alone basis. Note, however, that the manner in which related parties are considered remains unchanged when the power test is not met by a single party (i.e., if power is shared).

.60 Under the ASU, the reporting entity that meets the power test will includes its indirect interests in the VIE together with its own direct interests when determining whether it meets the economics test on a standalone basis. An indirect interest exists when the reporting entity has a direct economic interest in a related party that in turn holds an economic interest in the VIE. Consistent with the analysis for whether a decision maker fee arrangement is a variable interest, the indirect interest represents the reporting entity's effective economic interest in the entity through its direct investment in the related party (see paragraph .24 for an example of how to calculate the indirect interest). Consistent with that analysis, when the indirect interest is held by an affiliate under common control, the full economic interest of the affiliate should be included. In addition, if the decision maker financed any portion of an employee's interest, it would need to determine and include its effective economic interest in the entity through that financing.

.61 Related parties to be considered in this context include those defined in ASC 850, *Related Party Disclosures*, as well as parties deemed to be "de facto agents" under the VIE guidance (ASC 810-10-25-43).

Related party tie-breaker



.62 Under current guidance, if a reporting entity does not meet both the power and economics tests on a standalone basis, it would need to consider whether, together with its related parties, the group collectively meets both tests. If the related party group has both characteristics of a primary beneficiary, the "related party tiebreaker" test is performed to identify the variable interest holder within that related party group that is "most closely associated" with the entity. The party most closely associated with the VIE would be the one to consolidate it.

.63 As discussed in paragraph .60, the ASU introduces the indirect interest concept that effectively accelerates the consideration of related party interests by incorporating them into the reporting entity's assessment of whether it is the primary beneficiary on a standalone basis in situations where the power test is met by a single party. However, consistent with current practice, all variable interests must be considered when assessing whether the related party group has the characteristics of a primary beneficiary.

.64 The ASU limits application of the related party tiebreaker test to the following two circumstances:

(1) If no single party in the related party group has unilateral power (i.e., power is shared), then the related party tiebreaker should be applied to identify the related party that consolidates the entity.

(2) If a single party in the related party group has unilateral power, and the related party group is under common control, then the related party tiebreaker should be applied to identify the related party within the common control group that consolidates the entity.

PwC observation:

The FASB retained the notion that a VIE should be consolidated at an intermediate level (i.e., sister company level) in common control situations by requiring application of the related party tiebreaker. This is due to the discretionary or arbitrary manner in which an ultimate parent could shift interests within a related party group to avoid consolidation at the lower level. Under the voting model, consolidation is generally not required at an intermediate level if that reporting entity lacks a controlling financial interest in the investee on a standalone basis.

.65 The FASB made the changes discussed in paragraph .64 to reduce the application of the related party tiebreaker in response to constituent feedback that the tiebreaker test is applied in too many fact patterns and sometimes requires consolidation that results in less decision-useful financial reporting. In addition, requiring the application of the tiebreaker test after a reporting entity had already considered indirect interests held through related parties would in effect subject the reporting entity to two related party tests.

PwC observation:

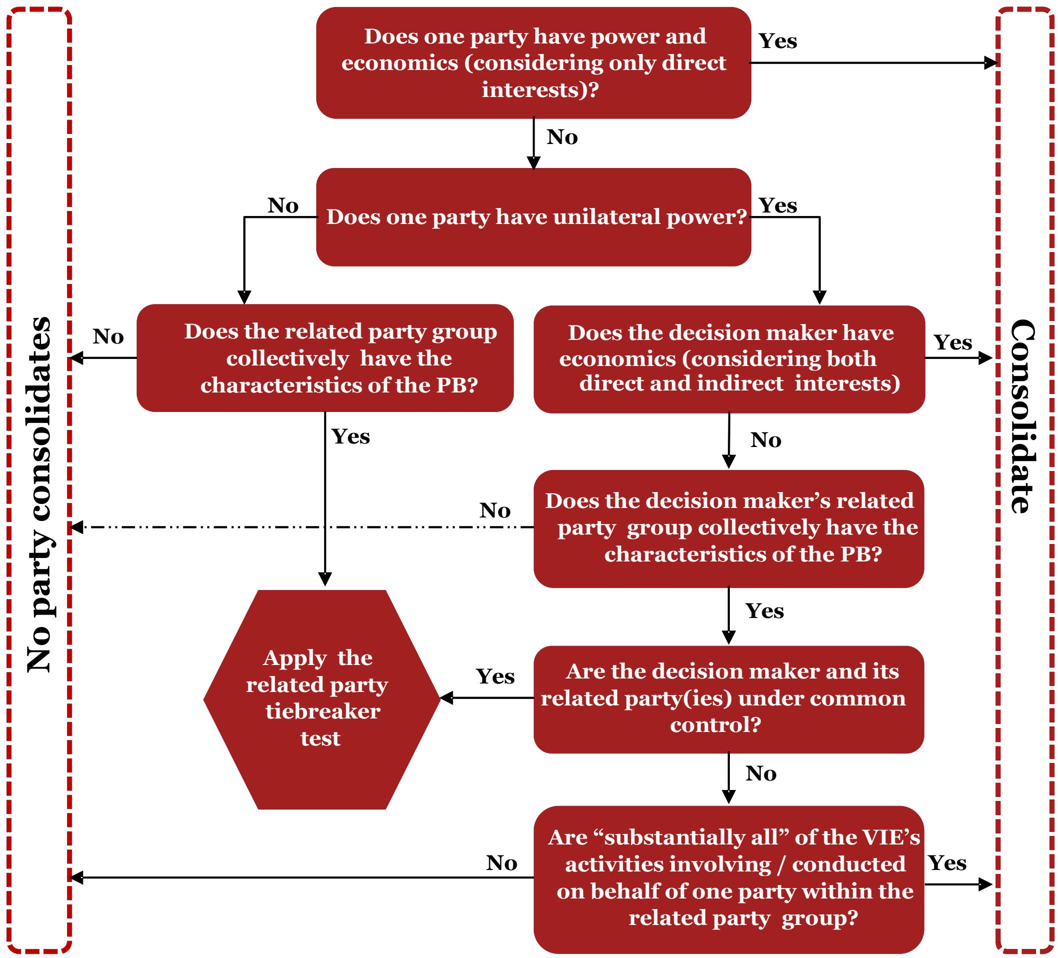
Some may question when, if ever, the related party tiebreaker would apply in common control situations where a single party has power. The ASU requires a decision maker with unilateral power to consider its indirect interests held through related parties when applying the economics test. A decision maker must have a direct variable interest in a related party that has a variable interest in the VIE for that relationship to represent an indirect interest. Therefore, a decision maker would not consider a commonly controlled related party's variable interest(s) in the VIE absent a direct variable interest in the related party when determining if the decision maker is the VIE's standalone primary beneficiary.

If the decision maker does not individually meet both characteristics of a primary beneficiary, the related party group must be evaluated to assess whether it meets the economics test. In that circumstance, all variable interests held by the related party group must be considered. If the related party group meets the primary beneficiary test, the related party tie breaker would be required to determine which party within the commonly controlled related party group must consolidate the VIE. The related party tiebreaker analysis requires judgment and a consideration of various factors, and therefore it is possible to conclude that the affiliate, and not the decision maker, would consolidate.

.66 If a single party within a related party group has unilateral power and the related party group is not under common control, the related party tiebreaker would not apply. However, the ASU requires that if "substantially all" of the VIE's activities involve or are conducted on behalf of any party within the related party group, then that party is required to consolidate the VIE. This requirement is intended to prevent abuse (i.e., "vote parking" arrangements) where the decision maker's level of economics is not consistent with its stated power. This assessment (which is intended to be consistent with the assessment of whether an entity is a VIE because the equity investment at risk has non-substantive voting) is qualitative and should consider all relevant facts and circumstances.

.67 The ASU specifically exempts investors in low income housing tax credit (LIHTC) partnerships from having to assess whether they benefit from "substantially all" of the entity's activities. The FASB was concerned that investors would be required to consolidate these partnerships despite not meeting the power test when they hold substantially all of the limited partner interests. This outcome would undermine the recent ASU[5] enabling investors in qualified affordable housing projects to apply the proportionate amortization method (see Dataline 2014-02, *Accounting for investments in qualified affordable housing projects,* for further information).

.68 The analysis to be applied for related parties can be illustrated as follows:

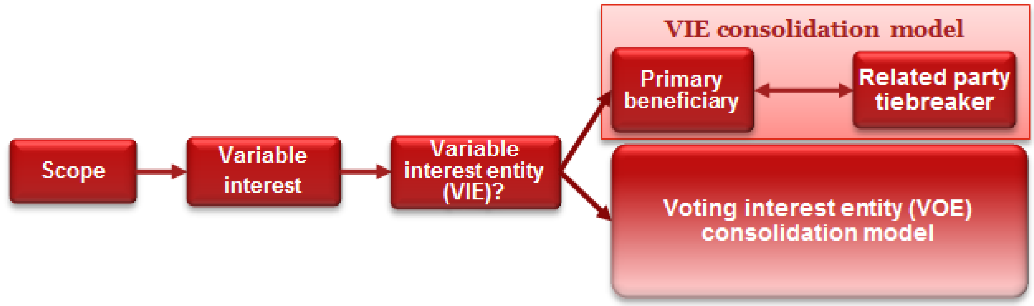


PwC observation:

Situations where the related party tiebreaker has been applied under current guidance should be evaluated carefully when there is a single party that meets the power test. It is possible that the new circumstances in which the tiebreaker is applied and the introduction of the new indirect interest concept could lead to different consolidation outcomes in certain fact patterns.

[5] ASU 2014-01, *Investments – Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects*

Voting interest model



Creation of a single voting interest model for all entities

.69 The ASU creates a single model for all voting interest entities regardless of the entity's legal form of governance structure. This single VOE model will focus on relative voting rights and consider other rights that enable a noncontrolling equity investor to participate in an entity's ordinary course operating and/or financial decisions. Such voting rights may be in the form of kick-out or participating rights. In the absence of such rights, a majority investor would be expected to control an entity unilaterally and consolidate the entity under the voting model.

.70 In creating a single model, the ASU removes the voting model specific to limited partnerships and similar entities (ASC 810-20, formerly EITF 04-5). That guidance is effectively incorporated into the VIE determination in assessing whether the equity investment at risk has decision making rights (see paragraphs .28 – .33). In addition, the rebuttable presumption that a general partner unilaterally controls a limited partnership under the VOE model has been eliminated.

.71 The ASU also clarifies that a single investor's ability to exercise a kick-out right (for example, a limited partner that holds the majority of the kick out rights) may convey unilateral control to the holder in the voting model, assuming another limited partner does not hold a substantive participating right. Accordingly, the investor with the kick-out right may be required to consolidate the entity under the revised voting model. This represents a change in current practice as the holder of a single party kick-out right typically accounts for its interest in a partnership that is a VOE using the equity method of accounting, as opposed to consolidation.

PwC observation:

The changes will, in effect, mean that a general partner will not consolidate a limited partnership under the VOE model due to the existence of substantive kick out or participating rights.

In addition, unlike a single party kick out right, the ability to unilaterally exercise a participating right would not give a limited partner control, absent any other rights. Participating rights do not convey power, but only prevent the party with power from exercising that power (i.e., they provide the holder with the ability to veto decisions made in the ordinary course of business as oppose to directing such decisions).

Proportionate consolidation

.72 Only investors in unincorporated entities that are in the extractive industry (for example, oil and gas exploration and production) and the construction industry may apply proportionate consolidation instead of the equity method of accounting.

Proportionate consolidation requires the investor to reflect its pro rata share of assets, liabilities, revenues, and expenses of the investee on a gross basis. Although the separate consolidation model for limited partnerships and similar entities that are VOEs is being removed by the ASU, the previous exception in that model is being retained. Accordingly, a general partner may continue to apply the proportionate consolidation method rather than consolidating the entity and reflecting a noncontrolling interest.

Disclosures

.73 The ASU does not amend the existing disclosure requirements for VIEs or VOEs. During redeliberations, some Board members acknowledged the concerns of some stakeholders that the current disclosures pertaining to VIEs may at times be excessive and not helpful to financial statement users. However, the reconsideration of the current disclosures for VIEs was outside the scope of this project.

.74 The ASU does, however, require new disclosures for reporting entities that have explicit arrangements to provide financial support to money market funds. In addition, reporting entities would have to provide disclosures if they have provided any financial support during any of the income statement periods included in the financial statements. The following represent examples of sources of support noted in the ASU that would require disclosure in a reporting entity's footnotes:

- Capital contributions to the money market fund
- Standby letters of credit
- Guarantees of principal and interest
- Agreements to purchased troubled securities at amortized cost
- Waiver of fees, including management fees

PwC observation:

The sponsor of a money market fund may waive a portion of its management fee solely to enhance the fund's performance relative to its peer group. We believe the disclosure requirements for sponsors of money market funds apply when the sponsor has provided any form of support, including those described above, regardless of its purpose or intent. These disclosures should not be limited to situations where support provided by the sponsor was necessary to prevent the fund from "breaking the buck." Other requirements under the money market rules and investment company guidance may already result in similar disclosures.

Effective date and transition

.75 The ASU will be effective for public business entities for annual periods (and interim periods within those annual periods) beginning after December 15, 2015. Nonpublic business entities will need to apply the standard for annual periods beginning after December 15, 2016, and for interim periods beginning after December 15, 2017. Early adoption is permitted.

.76 Reporting entities will be able to early adopt the changes in any interim reporting period and are required to apply the changes on a modified retrospective or on a full retrospective basis. If a reporting entity adopts the ASU during an interim period on a modified retrospective basis, it would be required to reflect any adjustments as of the beginning of the annual period of adoption. If a reporting entity adopts the ASU on a full retrospective basis, it would be required to reflect any adjustments as of the beginning of the earliest comparative period presented.

PwC observation:

Companies seeking to early adopt the ASU should not underestimate the work needed to update their analyses, and the related changes that may be needed to systems and controls. In addition, associated internal controls may need to be evaluated and tested.

.77 The transition guidance is intended to be broadly consistent with those contained in ASU 2009-17, summarized as follows:

- For entities that will be consolidated for the first time due to the application of the ASU, assets and liabilities should be recognized as of the date of adoption based on what the carrying amounts would have been had this guidance always been applied. If it is not practical to determine the carrying amounts of individual assets and liabilities of the entity, then the fair value as of the date of adoption can be used. In addition, reporting entities can elect the fair value option on an entity by entity basis provided that the fair value option is applied to all eligible assets and liabilities of that entity.

- For entities that will be deconsolidated upon adoption of the ASU, the carrying amount of any retained interests should be determined based on what they would have been had this guidance always been applied. If it is not practical to determine the carrying amount of the retained interest in the entity, then the fair value of the retained interest as of the date of adoption can be used.

- Any difference between the net amount of the assets and liabilities of the entities that are added to, or subtracted from, the reporting entity's balance sheet and the previously held or retained interest, should be recognized as a cumulative-effect adjustment to retained earnings.

PwC observation:

As reporting entities enter into new transactions prior to adoption of the ASU, they should consider the consolidation conclusions under the new guidance.

Questions?

PwC clients who have questions about this *In depth* should contact their engagement partner. Engagement teams who have questions should contact the Financial Instruments team in the National Professional Services Group (1-973-236-7803).

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In depth

A look at current financial reporting issues

pwc

Revenue from contracts with customers

The standard is final – A comprehensive look at the new revenue model

US2014-01 (supplement)
September 8, 2014

What's inside:

Overview 1
Scope 2
Overview of the revenue model 3
Sales of real estate 3
Real estate asset management 8
Other considerations 11
Disclosures 12
Transition 13
Appendix A 14
Appendix B 21

Real estate industry supplement

At a glance

On May 28, the FASB and IASB issued their long-awaited converged standard on revenue recognition. Almost all entities will be affected to some extent by the significant increase in required disclosures. But the changes extend beyond disclosures, and the effect on entities will vary depending on industry and current accounting practices.

In depth US2014-01 is a comprehensive analysis of the new revenue standard. This supplement highlights some of the areas that could create the most significant challenges for U.S. GAAP reporters in the real estate industry as they transition to the new standard.

Overview

The new revenue standard will supersede existing revenue recognition guidance; however, certain types of contracts will be scoped out of the revenue standard. Most significantly for real estate, leasing transactions are not within the scope of the new standard. Accounting for leasing transactions is being addressed by a separate standard-setting project that is currently underway.

The new revenue standard is effective for public entities that are U.S. GAAP reporters for the first interim period within annual reporting periods beginning after December 15, 2016 (nonpublic companies have an additional year to adopt). The standard prohibits early adoption for public entities that are U.S. GAAP reporters, but does allow nonpublic companies to adopt the standard using the public company effective date.

This publication focuses on how the standard will affect certain revenue arrangements for real estate companies applying U.S. GAAP. The examples and related discussions are intended to provide areas of focus to assist entities in evaluating the implications of the new standard. The views expressed in this publication are preliminary and may change as interpretations of the guidance evolve.

This publication will predominantly address sales of real estate, real estate asset management considerations, and property management arrangements. Appendix A to this publication provides examples of common real estate transactions and the implications of the new revenue standard as compared to existing U.S. GAAP. Appendix B to this publication provides a detailed example illustrating the practical application of the new revenue standard for a "vertically integrated" homebuilder.

Scope

The new revenue standard will apply to sales of real estate assets to customers, such as sales by homebuilders, merchant builders, land developers, condominium sellers, and timeshare sellers. Sales of real estate that constitute a business, when those sales are made to customers, will also be in the scope of the new standard. The new standard will also apply to property management fees, construction or development fees, leasing commissions, and other types of fees commonly present in real estate arrangements.

Sales of property, plant, and equipment, operating property, and investment property are generally not considered "revenue from contracts with customers" or an output of an entity's ordinary activities. For the transfer of nonfinancial assets that are not an output of an entity's ordinary activities (e.g., sale of real estate to a non-customer), the FASB amended ASC 360-20, *Real Estate Sales,* and requires companies to apply other standards, as described below.

If the real estate is being sold to a non-customer and constitutes a business, the guidance in ASC 810, *Consolidation*, applies. For sales of nonfinancial assets to non-customers, the FASB created ASC 610-20, *Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets*, which requires entities to apply the guidance from the new revenue standard on the following topics: (a) existence of a contract – to determine when the seller has a contract that creates enforceable rights and obligations; (b) control – to determine when to derecognize the asset; and (c) measurement – to determine the amount of gain or loss to recognize when the asset is derecognized (including any constraints on the transaction price when the consideration is variable).

If derecognition treatment is appropriate (e.g., the seller has transferred control of a business under ASC 810-10 or the seller transferred control of an asset under ASC 610-20), these transactions generally result in a non-operating gain or loss rather than revenue.

Homebuilders, land developers, merchant builders, condominium sellers, and timeshare sellers are expected to be the most affected by the new standard. For these entities, when a performance obligation is satisfied subsequent to a sale to a customer, timing of both revenue and costs may differ from current accounting. Examples include amenities (such as pools, clubhouses, and golf courses), infrastructure, and offsite elements completed after delivery of a portion of the property to customers.

The standard may also affect entities in other industries that enter into real estate transactions. Examples include sales of manufacturing facilities, sales of real estate (e.g., other real estate owned or "OREO"), sales by banks, sales of plants in the power and utility industry, and store carve-outs and divestitures in the retail and consumer industry. The type of real estate sales these transactions represent (e.g., sale of a business or an asset to a customer or non-customer) will dictate which accounting guidance is applicable.

PwC observation:

The new standard could significantly change the timing of revenue recognition for many arrangements. As a result, the standard may require management to perform a comprehensive review of existing contracts, business models, company practices, and accounting policies.

The standard also has broad implications for an entity's processes and controls. Management may need to change existing IT systems and internal controls to capture different information than needed in the past. The impact could extend to other functions such as treasury, tax, and human resources. For example, changes in the timing or amount of revenue recognized may affect long-term compensation arrangements, debt covenants, and key financial ratios.

Changes to financial reporting without changes to tax requirements may necessitate complex tracking of book/tax differences for tax return and deferred tax provision purposes.

Overview of the revenue model

The boards believe a single, comprehensive revenue recognition model for all contracts with customers will lead to greater consistency in the recognition and presentation of revenue and will improve comparability within industries, across industries, and across capital markets.

The standard contains principles that an entity will apply to determine the amount and timing of revenue recognition. The core principle is that an entity recognizes revenue as it transfers goods or services to customers at an amount that the entity expects to be entitled to in exchange for those goods or services.

The five-step approach to revenue recognition

Step 1: Identify the contract(s) with the customer
In many situations, identifying a contract with a customer is one of the easier aspects of the model to apply. However, for sales of real estate, this step may be critical as the appropriate derecognition model will depend primarily on whether there is a sale of an asset or a business to a customer or a non-customer.

Step 2: Identify the performance obligations in the contract
A performance obligation is a promise (whether explicit or implicit) in a contract with a customer to transfer a distinct good or service (or bundle of goods or services) to the customer. A good or service is distinct if (a) the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer and (b) the good or service is distinct in the context of the contract.

Step 3: Determine the transaction price
The transaction price is the amount of consideration that an entity expects to be entitled to in exchange for transferring goods or services, excluding amounts collected on behalf of third parties. Variable consideration, significant financing components, noncash consideration, and consideration payable to a customer can all affect the transaction price.

Step 4: Allocate the transaction price to the performance obligations
The standard generally requires an entity to allocate the transaction price to the separate performance obligations based on their relative standalone selling prices. Standalone selling price is generally the observable price of a good or service sold separately by the entity; however, there could be a number of instances where the standalone selling price is not observable and must be estimated. Entities may utilize a residual approach to estimate the standalone selling price of a good or service, but only if the selling price is highly variable or uncertain. This will often require real estate entities to make estimates of the standalone selling prices for services they do not sell on a standalone basis, which could require judgment.

Step 5: Recognize revenue when (or as) a performance obligation is satisfied
An entity will recognize revenue when (or as) it satisfies a performance obligation by transferring control of a promised good or service to a customer. Performance obligations can either be satisfied at a point in time or satisfied over time.

Sales of real estate

The new revenue standard will apply to transfers of a nonfinancial asset to a customer (either a business or an asset). Transfers of a nonfinancial asset (that does not constitute a business) that is not an output of an entity's ordinary activities is within the scope of ASC 610-20, which incorporates aspects of the guidance in the new revenue standard. This decision was made in response to concerns raised regarding sales of real estate, but it could have broader implications. Derecognition or timing of income recognition might differ depending on the guidance applied.

The nature of sales of real estate will need to be evaluated to determine if they are sales of assets or businesses, and whether those sales are to customers or non-customers. Significant judgment will be required to determine if the sale of real estate constitutes an asset or a business. Under U.S. GAAP, substantially all sales of rental real estate (with leases in place) may be considered sales of businesses to non-customers.

The appropriate revenue recognition model to apply depends on which sales scenario exists, as illustrated in the table below.

Scenario	Revenue recognition model
Scenario 1: Sales of real estate to customers Sales of real estate (businesses and assets) to customers in the ordinary course of business (e.g., timeshares, condominiums, homebuilding, etc.)	Apply the new revenue standard to the entire transaction.
Scenario 2: Sales of real estate (asset sales) to non-customers Sales of real estate outside of the ordinary course of business (non-customers) that does not constitute a business (e.g., sale of vacant building or empty land lot)	Apply ASC 610-20, which requires entities to apply certain aspects of the new revenue standard to determine: 1. if an enforceable contract exists, 2. if control of the asset has transferred to the buyer, and 3. the amount of gain or loss to recognize when the asset is derecognized, considering any constraint on income due to variable consideration.
Scenario 3: Sales of real estate (businesses) to non-customers Sales of real estate that constitute a business	Refer to the derecognition model in the consolidation guidance (ASC 810), which has been modified to no longer scope out sales of real estate. This guidance also refers to ASC 610-20, which incorporates aspects of the new revenue standard, as described above for "Scenario 2."
Scenario 4: Partial sale of real estate Sales of real estate (businesses and assets) to a joint venture to be accounted for as an equity method investment (e.g., seller retains interest but does not control the joint venture)	The appropriate accounting model to apply to the partial sale will depend on whether the transaction is a partial sale of a business or asset. The derecognition model in the consolidation guidance (ASC 810) or the partial sale model in the nonmonetary transaction guidance (ASC 845) may need to be considered. Determining the appropriate gain recognition and accounting treatment of the retained interest will depend on which model is applied.

Note: Refer to Appendix A for discussion of the accounting considerations relevant to certain real estate sales scenarios outlined in the table above.

The current real estate sales guidance in U.S. GAAP was largely written in the 1970s to address perceived financial reporting abuses in the real estate sector. It is viewed by many in the industry as a rigid, rules-based approach; therefore, some may welcome the changes resulting from the new revenue standard. The current guidance has two primary objectives: (a) the appropriateness of derecognition, which is assessed by evaluating whether a sale has been consummated for accounting purposes (this is not necessarily based solely on whether a legal sale has occurred); and (b) measurement of profit.

Under current U.S. GAAP guidance, sales of real estate are assessed to determine whether "risk and rewards" have transferred, including consideration of any continuing involvement by the seller. These rules are complex, and often a sale is not recognized or a large amount of profit is deferred based on the maximum exposure to loss (rather than the expected exposure). Many view the maximum exposure to loss concepts in the existing guidance to be inconsistent with revenue models applied in other industries.

Today, if a sale of real estate meets the criteria for sale accounting, the transaction is evaluated for "full accrual" profit recognition (which allows for full profit recognition upon sale). Typically, the most significant factor impacting profit recognition is whether there is sufficient initial and continuing investment. A sale may be recorded under the deposit method (no sale recognized), installment method, cost recovery method, or reduced profit method if the investment is not sufficient. Over time, a transaction may migrate (usually with incremental investment from the buyer, such as principal payments on seller financing) from one method to another and ultimately, to the full accrual method. Further, certain types of continuing involvement may require reduction in the amount of profit recognized (under the appropriate method) until the continued involvement is eliminated or expires on a maximum-exposure-to-loss basis (potentially deferring all the profit if the exposure is not capped).

Sales of real estate may be recognized earlier under the new standard as it eliminates these prescriptive requirements. Collectibility, contract enforceability, and transfer of control will be the key factors in determining whether to recognize revenue under the new standard.

While most forms of continuing involvement today may not prevent derecognition under the new standard, these factors can call into question whether control of the asset has transferred. Certain terms in a transaction (such as significant seller financing) may also call into question whether an entity has a contract with a customer that is in the scope of the standard. Common terms that could prevent derecognition of a real estate asset include repurchase rights or obligations. Appendix A to this publication provides examples of common forms of continuing involvement and their implications under current guidance and the new standard.

PwC observation:

In recent years, the Emerging Issues Task Force (EITF) has addressed perceived conflicts between the real estate sale guidance (ASC 360) and consolidation guidance (ASC 810). Specifically, these decisions addressed partial sales of real estate and the potential deconsolidation of in-substance real estate entities when a default on nonrecourse debt exists. In each of these instances, the EITF concluded that the real estate sale guidance should prevail.

In the new revenue recognition standard, the board reversed these historical positions of the EITF to conclude that sales of real estate to non-customers that meet the definition of a business, should be subject to the derecognition rules in ASC 810 (formerly FAS 160), which will likely result in transactions achieving derecognition earlier than under the existing guidance.

Sales of real estate to customers

The scope of the new standard specifically includes sales of real estate, whether a business or an asset, to customers. This may include sales by homebuilders, land developers, merchant builders, condominium sellers, and timeshare sellers.

Under the new standard, a performance obligation can be explicit or arise in other ways. Legal or statutory requirements can create performance obligations even though such obligations are not explicit in the contract. Customary business practices, such as an entity's practice of providing customer support, might also create performance obligations.

The new standard will significantly affect the accounting for sales of real estate in situations where certain performance obligations are satisfied after the legal sale of the assets. Such performance obligations could be explicitly defined in the contract (e.g., an "amenity" such as a pool or clubhouse) or implicitly required by the builder in order to get zoning for the subdivision and sale (e.g., roads, infrastructure, schools, firehouse, street lights, etc.).

Homebuilders, land developers, and merchant builders construct assets (that they own during construction) for sale to customers upon completion of construction. Therefore, these arrangements are fundamentally different than those in the construction industry where the entity is constructing an asset on behalf of the owner and the entity does not own or control the asset during construction.

Management will need to assess whether these transactions meet the criteria for performance obligations satisfied over time. The new standard states that an entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognizes revenue over time, if one of the following criteria is met: (a) the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs; (b) the entity's performance creates or enhances an asset (e.g., work in process) that the customer controls; or (c) 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. If none of these criteria are met, an entity satisfies the performance obligation at a point in time.

It will be important for all entities to assess and make a determination as to which pattern of revenue recognition (point in time versus over time) is applicable.

Sales by homebuilders

Under current guidance, there is frequently only one sale recognition point for real estate transactions even in cases where some costs will be incurred at a later date (e.g., amenities). Current real estate guidance requires a "cost accrual" model relating to these sales transactions under ASC 970-340-25-9 and 25-10 (formerly FAS 67). For example, a homebuilder may sell an individual home before completing roads, amenities, or offsite costs (e.g., schools, firehouses, stop lights) for which it is committed pursuant to the contract with the customer. Today, upon each sale, the homebuilder accrues a liability for the unit's pro-rata portion of future costs and includes this amount in the cost of sale at the time the sale is recorded, even though these costs have not yet been incurred. In some jurisdictions, amenity work may be performed and paid for under a separate contract with a government authority rather than with the customer, in which case this issue might not apply.

However, under the new revenue standard, there may be multiple performance obligations that could result in different timing of revenue recognition for portions of the transaction price for the same unit. Refer to Appendix B of this publication for a detailed example of the impact of the new standard on a sale by a homebuilder.

PwC observation:

The nature of an entity's operations may significantly affect how revenue is recognized. The issue discussed above is relevant for "vertically integrated" homebuilders that are also responsible for land development. A homebuilder that buys finished lots and is solely responsible for the delivery of the home may reach different accounting conclusions.

Sales of timeshares and condominiums

Today, certain types of real estate sales (such as sales of timeshares or condominiums) have specialized accounting and may qualify for "percentage of completion" revenue recognition. This specific literature will be eliminated by the new standard, and these sales might not meet the criteria for revenue recognition over time under the new standard.

For example, the new standard includes an illustration (ASC 606-10-55-173 through 55-182) of a real estate developer that enters into a contract to sell a specified condominium unit once construction is complete, and receives a deposit from the customer at contract inception. The asset (unit) does not have an alternative use to the entity because the contract precludes the entity from transferring the specified unit to another customer. The determination of the appropriate revenue recognition is therefore dependent on whether the developer has an enforceable right to payment for its performance to date throughout the contract, which may differ based on jurisdiction. If it is determined that the right to payment is legally enforceable, the developer will recognize revenue over time. If not, the developer will recognize revenue at the point in time at which control of the unit is transferred to the customer.

The new revenue standard could also result in delayed revenue recognition for sales of condominiums and timeshares due to the potential for having multiple performance obligations that are satisfied over time.

Contract costs

Incremental costs of obtaining a contract are costs the entity would not have incurred if the contract had not been obtained (e.g., sales commissions). Under the new standard, an entity is required to recognize an asset for the incremental costs to obtain a contract that management expects to recover. As a practical expedient, an entity is permitted to recognize the incremental cost of obtaining a contract as an expense when incurred if the amortization period would be one year or less.

An entity recognizes an asset for costs to fulfill a contract when specific criteria are met. Management will first need to evaluate whether the costs incurred to fulfill a contract are in the scope of other standards (e.g., inventory, fixed assets, or intangibles). Costs that are in the scope of other standards should be either expensed or capitalized as required by those standards. If fulfillment costs are not in the scope of another standard, an entity recognizes an asset only if the following criteria are met: (a) the costs relate directly to a contract, (b) the costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future, and (c) the costs are expected to be recovered.

An asset recognized for the costs to obtain or fulfill a contract will be amortized on a systematic basis as control of the goods or services to which the assets relate is transferred to the customer. An entity recognizes an impairment loss to the extent that the carrying amounts of an asset recognized exceed (a) the amount of consideration the entity expects to receive for the goods or services less (b) the remaining costs that relate directly to providing those goods or services.

Currently homebuilders record sales commissions and other direct contract acquisition costs at the time of closing (that is, at the same time as the related revenue recognition). However, under the new model, this may become more complex. A portion of the contract acquisition costs may need to be allocated to the various performance obligations (if more than one) and recognized when the related revenue on those performance obligations is recognized.

Warranties

Under the new standard, an entity will account for a warranty (e.g., a home warranty) as a separate performance obligation if the customer has the option to purchase the warranty separately. An entity accounts for a warranty as a cost accrual if it is not sold separately. However, if a warranty provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, that service is a separate performance obligation.

An entity that promises both a quality assurance and service-based warranty, but cannot reasonably separate the obligations and account for them separately, will account for both warranties together as a separate performance obligation recognized over the warranty period.

The guidance in the new standard on warranties is generally consistent with current guidance under U.S. GAAP. However, it could be challenging in some instances to separate a single warranty that provides both a standard warranty (e.g., for defects in construction) and a service element (e.g., an extended warranty or a maintenance arrangement). Also, determining the estimated standalone selling price for warranty-related services when such services are not sold separately requires judgment and could be challenging.

Service element warranties are less common in the real estate industry, but may exist and need to be evaluated. For example, in timeshare transactions, other contractual arrangements (such as annual assessment fees) could include a service element.

Sales of real estate to non-customers

Certain sales of real estate that are "not an output of an entity's ordinary activities" (e.g., sales to non-customers) will be subject to aspects of the guidance in the new standard as outlined in the table above. This may include: (a) certain sales of real estate by a real estate company primarily engaged in leasing such property or (b) the sale of property, plant, and equipment by a manufacturer or retailer (including "non-traditional" real estate or integral equipment considered to be real estate). Such transactions may also be constructively completed through the sale of equity in an entity that is "in substance" the sale of real estate.

Because ASC 360-20 provides guidance for recognizing profit on *all* real estate sales, regardless of whether real estate is an output of an entity's ordinary activities, the FASB considered the implications of retaining the guidance in ASC 360-20 for contracts that are not within the scope of the new revenue standard. The FASB noted that retaining the existing real estate guidance for real estate sales could result in an entity recognizing the profit or loss on a real estate sale differently depending on whether the transaction is a contract with a customer. However, there is economically little difference between the sale of real estate that is an output of an entity's ordinary activities (e.g., sales to customers) and the sale of real estate that is not (e.g., sales to non-customers). Consequently, the FASB concluded that the difference in accounting should relate only to the presentation of the profit or loss in the income statement. ASC 360-20 was therefore superseded, except for certain guidance related to sale-leaseback transactions.

As noted in the table above, an entity that sells a business to a non-customer will now refer to the derecognition model in the consolidation guidance (ASC 810), which focuses on the consolidation and changes in ownership interest (including disposals) of a subsidiary (a legal entity). This guidance has been modified to remove the scope exception that previously existed for sales of in-substance real estate and refers to the guidance in ASC 610-20to determine: (a) the amount of consideration to be included in the calculation of the gain or loss on sale, and (b) when a sale of real estate (business) should be derecognized. Sales of real estate assets (that do not constitute a business) to non-customers will also follow the guidance in ASC 610-20.

Under ASC 610-20, to measure the appropriate gain or loss on sale, an entity will apply certain elements of the new revenue standard to determine the transaction price, including all of the following: (a) estimating variable consideration; (b) constraining estimates of variable consideration; (c) the existence of a significant financing component; (d) noncash consideration; and (e) consideration payable to a customer.

To determine when to derecognize the real estate, a seller will apply certain elements of the new revenue standard, including identifying the contract and assessing when an entity satisfies a performance obligation by transferring control of an asset. The guidance outlines certain indicators that control has transferred, which include, but are not limited to, the following:

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

Assessing the indicators that control has transferred could require judgment, such as determining whether the buyer has the significant risks and rewards of ownership of the asset. Various forms of continuing involvement may indicate that the significant risks and rewards of ownership have not been transferred to the buyer and still remain with the seller.

Appendix A includes examples that further discuss the accounting considerations for sales of real estate to non-customers.

Partial sales of real estate

Sales or a contribution of real estate to a newly formed joint venture in which the seller retains an ownership interest are common transactions in the real estate industry and are considered "partial sales." These transactions are outside of the scope of the new revenue standard. For joint ventures accounted for under the equity method of accounting (e.g., the seller retains an ownership interest but does not control the joint venture), an entity will need to evaluate the transaction to determine the appropriate accounting model to apply to the partial sale, which will depend on whether the transaction represents a partial sale of a business or an asset.

For a partial sale that constitutes a business, the derecognition model in the consolidation guidance (ASC 810) will need to be evaluated to determine whether control of the business has been lost. Within the consolidation guidance, sales or transfers of nonfinancial assets (including partial sales of real estate that constitute businesses to non-customers) require an entity to evaluate the guidance in ASC 610-20 to determine: (a) the amount of consideration to be included in the calculation of the gain or loss on sale and (b) when a sale of real estate (business) should be derecognized. Refer to additional discussion in the section titled "Sales of real estate to non-customers" above.

For a partial sale that constitutes an asset, the guidance for nonmonetary transactions in ASC 845, *Nonmonetary Transactions*, will need to be evaluated to determine if full or partial gain recognition is appropriate.

Determination of the appropriate gain recognition and accounting treatment of the retained interest will depend on which model is applied.

Real estate asset management

Revenue recognition in the real estate asset management industry can be complex as there are many variations of investment structures aimed at achieving returns or investment income for investors. Asset managers will recognize revenue they expect to be entitled to, subject to a constraint. The constraint will limit the amount of consideration that may be recognized to the amount for which it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is resolved. As a result, there could be changes in how revenue is recognized in the real estate asset management industry.

The impact of the new standard will vary depending on an entity's existing accounting policies. Areas most affected could include recognition of upfront fees (which may now be deferred in some cases), upfront costs, and performance-based fees. Some of the key issues companies will need to address include identifying who the "customer" is, and how to identify the distinct performance obligations.

Customer considerations

The new standard requires an entity to identify the contract with the customer. As part of this step, an entity must determine which party is its customer. This important step has ramifications throughout the revenue model and might significantly affect how the standard is applied. Asset managers will need to apply judgment in some situations to determine whether the customer is the investor or the fund itself. This issue may evolve as industry constituents begin applying the guidance to typical investment structures.

While not determinative, certain factors may point to the fund or investor being the customer. Management will need to weigh the different factors, and reach a conclusion based on the overall facts and circumstances.

A factor that points to the fund being the customer is a fund's ability to enter into contracts with third parties for additional services such as fund accounting or transfer agent activities. Also, in certain fund structures, there may be numerous investors that the manager does not deal with directly. For example, in many registered investment companies, some investors purchase shares through a third-party distributor that holds the shares in "omnibus account" along with other investors. An omnibus account is often used by third-party distributors to simplify the subscription and redemption process into a fund. There may be situations where the asset manager does not have visibility into the underlying investors that make up the omnibus account.

In other situations, factors may point to the investor as the customer. If the investor is heavily involved in negotiating specific fees, or interacts directly with the manager, this could indicate that the investor is the customer. Also, if there are very few investors in a fund, this could indicate that the investors have the potential to play a more direct role in the arrangement. As noted above, these factors are not determinative, and management will have to consider all facts and circumstances.

Determining which entity is the customer is important when it comes to identifying the performance obligation(s), timing of revenue recognition, and capitalizing contract costs. The FASB acknowledged these alternate perspectives during its public deliberations, but ultimately did not formally take a position given the wide variety of arrangements in the asset management industry. In our view, the conclusion should be based on the facts and circumstances of each arrangement and should not be viewed as an "accounting policy" election.

Performance obligations

Another key assessment that affects the timing of revenue recognition is whether there is more than one performance obligation in a contract. There are often several different fees the asset manager is entitled to, such as management fees and performance fees. The new standard will require a manager to consider whether the services being performed should be viewed as a single performance obligation, or whether some of these services are "distinct" and should therefore be treated as separate performance obligations.

Even though these services and related fees are often included in different contracts, they may represent a single performance obligation. The new standard requires an entity to combine contracts that are entered into at or near the same time and account for them as a single contract if they are: (a) negotiated as a package, (b) the amount of consideration to be paid in one contract depends on the price or performance of the other contract, <u>or</u> (c) the services in the contracts represent a single performance obligation. Since these contracts are typically entered into at the same time in the asset management industry, the contracts would be combined and accounted for as a single contract if, for example, the services performed under the contract represent a single performance obligation.

The new standard requires an entity to assess the services promised in a contract with a customer and identify as performance obligations those services that are distinct. A service is distinct if: (a) the customer can benefit from the service either on its own or together with other resources that are readily available to the customer and (b) the service is distinct in the context of the contract. If a service is not distinct, the entity must combine the services until such a point that a bundle of services are viewed as distinct. In some cases, this will result in all services being combined into a single performance obligation.

In general, identifying the separate performance obligations will be heavily dependent on which entity is deemed the customer. For example, if the fund is the customer, a distribution service may be a distinct service that the fund could obtain from another party, and accordingly, a separate performance obligation. On the other hand, if the investor is the customer, the service of distributing the funds to that customer may not be distinct as it is just a necessary prerequisite to allow the asset manager to provide the asset management services to that customer. This is an area of significant judgment and it is possible that views will evolve in advance of the standard becoming effective.

Variable consideration

The transaction price is the consideration the real estate asset manager expects to be entitled to in exchange for satisfying its performance obligations. Management must determine the amount of the transaction price at contract inception and update any estimates of variable consideration at each reporting date. One of the primary performance obligations in the asset management industry is the delivery of asset management services. This performance obligation is satisfied over time, as asset management services are delivered.

If the amount the entity expects to be entitled to is variable, the variable consideration included in the transaction price is constrained to the amount for which it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is resolved. In making this assessment, an entity should consider both the likelihood and the magnitude of the revenue reversal. Factors that could increase the likelihood or the magnitude of a revenue reversal include, but are not limited to: (a) the amount of consideration is highly susceptible to factors outside the entity's influence (e.g., market volatility), (b) the uncertainty about the amount of consideration is not expected to be resolved for a long period of time, and (c) the contract has a large number and broad range of possible consideration amounts.

Management fees for real estate funds are usually based on net assets under management, while performance fees are usually based on profits generated from the underlying investments held by funds subject to certain thresholds (e.g., internal rate of return). As such, management fees and performance fees are variable consideration that is subject to the constraint. Also, an entity will need to consider whether there is some minimum amount of variable consideration that needs to be recorded even if the full amount of variable consideration cannot be recorded.

PwC observation:

The boards included the constraint in response to feedback that revenue could be recognized prematurely for variable consideration. We expect that some entities will recognize revenue earlier under the new guidance because they will be able to recognize amounts before all contingencies are resolved.

Management fees

A fixed percentage asset-based management fee is variable consideration that is subject to the constraint in the revenue standard. For management fees, an asset manager will update its estimate of the variable consideration each reporting period. Because the management fee is calculated based on net assets under management, any uncertainty related to the variable consideration will generally be resolved as of the end of each reporting period. The asset manager will allocate the transaction price associated with the management fees to the services provided during the period because the fee relates specifically to those services. In many circumstances, analysis of the pattern of transfer of asset management services will result in recognition of management fees in a manner that is consistent with current practice under U.S. GAAP.

Performance fees

The new standard may impact the timing of recognition of performance fees, as these fees are variable consideration and subject to the constraint. Accordingly, performance fees that have a broad range of possible outcomes and are highly susceptible to market volatility will often not be included in the transaction price until the uncertainty is resolved or almost resolved. Management will need to determine if there is a portion of the variable consideration (that is, some minimum amount) that should be included in the transaction price, even if the entire estimate of variable consideration is not included due to the constraint. Management will reassess its estimate of the transaction price each reporting period, including any estimated minimum amount of variable consideration.

Real estate asset managers of funds with a finite life (e.g., ten years) often receive performance fees (or carried interest) that are subject to clawback on a cumulative basis based on the performance of the fund over its life. Thus, it is possible the manager will have to return the cash distribution if the fund underperforms in the future. Periodic cash receipt from a fund as a result of its current performance will not necessarily indicate that the entity is able to recognize the amount as revenue.

Accordingly, for funds with a finite life, the entity will need to determine the appropriate time when the performance fees (or a portion thereof) overcome the constraint on variable consideration and can be included in the transaction price. This may be before the end of the fund's life. Later in the fund's life cycle, it may be probable that a significant reversal in the amount of cumulative revenue recognized will not occur for some portion of the fee given the fund's cumulative performance in relation to remaining assets. For example, a fund that holds a limited number of remaining investments could sustain total losses on those investments and still exceed the performance fee hurdle; therefore, revenue should be recognized for the portion of the performance fee that is not constrained.

PwC observation:

Application of the new guidance may result in significant changes for entities that record performance fees under Method 2 (otherwise known as the "hypothetical liquidation method") today, where performance fees are recognized as revenue at the amount that would be due under the contract at any point in time as if the contract was terminated at that date. As a result, there is a possibility that fees earned by exceeding performance targets early in the measurement period could be reversed due to missing performance targets later in the measurement period under today's guidance.

The new guidance requires a higher degree of certainty before recording performance fees than the approach under Method 2. As discussed above, management must conclude that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur prior to recognizing revenue.

Other considerations

Property management contracts

Entities in the real estate industry frequently enter into property management and incentive performance fee revenue arrangements with related parties or third parties. For fixed fee arrangements, revenue will likely be recognized ratably over time as this is likely the best reflection of progress given an equal amount of effort provided over time. However, the fees for these arrangements are not typically fixed.

More frequently, property management fees are based on a fixed percentage of revenue or net operating income of the property each month. Generally, these contracts do not provide for any clawback of prior fees if property performance deteriorates. These contracts are often subject to termination with 30 days advance notice or upon sale of the underlying property. In addition, incentive-based contracts provide for participation by the property manager expressed as a percentage of the change in the value of the property at a point in time or upon sale or refinancing.

Arrangements to provide property management services over a period of time will likely be viewed under the new standard as a single performance obligation. Today, such fees are recognized at the end of each operating period, typically each month. If the management arrangement is considered a series of monthly performance obligations, then there will not be many differences in the accounting applied today and under the new revenue standard.

Incentive fees based on the fair market value of the property upon sale or refinancing of the property (or upon termination of the contract) represent variable consideration. Such amount can only be recognized to the extent that the performance obligation is satisfied and the amount of variable consideration is not constrained. Generally, this will occur only when the measurement period has ended and it is probable that a clawback of the incentive will not occur as a result of subsequent declines in performance or value.

Tenant construction management

Many real estate entities perform construction management services on behalf of their tenants (e.g., oversight and management of construction of tenant improvements). These arrangements are similar to other construction management contracts except on a smaller scale.

Under existing guidance, fees a landlord earns a fee for performing construction management services for the build out of tenant improvements are typically recorded over the construction period. Under the new standard, entities will need to evaluate the criteria to determine if the arrangement qualifies for recognition over time (i.e., over the construction period).

The arrangement may qualify for recognition over time if construction of tenant improvements has "no alternative use" to the entity and the entity is entitled to payment for performance to date, even if the tenant terminates the contract. If it does not qualify, fees for tenant construction performed prior to lease commencement may need to be deferred and recognized when the performance obligation is satisfied, which may be upon commencement of the lease. This is because control of the tenant improvements may not transfer until the tenant obtains control of the leased asset (i.e., lease commencement).

Leasing commission revenue

Many real estate entities provide leasing services on behalf of third parties or related parties (e.g., equity method ventures with other parties). In general, the associated fees are earned at the inception of the lease and upon renewal of the lease. The fees are typically a fixed percentage of contractual future revenues to be received by the property owner from the tenant. Renewal periods are contingent upon the exercise of a renewal by the tenant.

For example, a real estate entity may be a broker in a third-party leasing arrangement where the tenant will be paying an aggregate of $10 million and $6 million in rent for an initial period of ten years and a subsequent option period of five years, respectively. Under the terms of the broker contract, the broker receives a commission of $600,000 (6% of $10 million) upon the tenant taking possession of the leased space for the initial period and, potentially, an additional $360,000 (6% of $6 million) upon the beginning of the renewal period in the event the tenant exercises the renewal.

From the perspective of the real estate entity providing these broker services, there is likely a single performance obligation that is satisfied when the tenant takes possession of the space, at which point the broker has no remaining services to provide. However, the portion of the transaction price associated with the potential renewal period is variable consideration, since the renewal is uncertain at the inception of the lease. An estimate of variable consideration is included in the transaction price and recognized as revenue only if the entity concludes it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the tenant decides whether or not to renew its lease.

For real estate leasing commissions, the exercise of a particular tenant renewal may be affected by a multitude of factors including the terms of the contract, tenant operations (both general and property-specific), and general market conditions. Accordingly, it may be difficult to assert that historical experience is predictive of the outcome of a particular lease (that is, whether the tenant will renew the lease). Entities will need to consider a number of factors in determining whether leasing commissions earned for extension periods should be included in the transaction price, or whether such amounts are constrained. For example, there may be certain indicators that the renewal is likely to be exercised at some point prior to the renewal, such as extensive tenant improvements by the tenant during the lease period or the property representing a flagship location.

Disclosures

The revenue standard includes a number of disclosure requirements intended to enable users of financial statements to understand the amount, timing, and judgments related to revenue recognition and the corresponding cash flows arising from contracts with customers.

The more significant disclosure requirements include:

- The disaggregation of revenue into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors

- An explanation of the significant changes in the contract asset and the contract liability balances during the reporting period

- An analysis of the entity's remaining performance obligations, including the aggregate amount of the transaction price allocated to performance obligations that are unsatisfied (or partially unsatisfied), the nature of the goods and services to be provided, the timing of satisfaction, and significant payment terms

- Significant judgments and changes in judgments that affect the determination of the amount and timing of revenue from contracts with customers

- Disclosure of the closing balances of capitalized costs incurred to obtain and fulfill a contract and the amount of amortization recognized during the period

PwC observation:

While there is some relief provided to nonpublic reporting entities from the above disclosure requirements, the extensive disclosure requirements for public reporting entities may be particularly onerous and complex.

Transition

An entity can apply the new revenue standard retrospectively, including using one of more of the following practical expedients:

- For completed contracts, an entity is not required to restate contracts that begin and end within the same annual reporting period.

- For completed contracts that have variable consideration, an entity may use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in prior periods.

- For all reporting periods presented before the date of initial application, an entity is not required to disclose the amount of the transaction price allocated to the remaining performance obligations and an explanation of when it expects to recognize that amount as revenue.

An entity should apply any expedients it elects to use consistently to all contracts within all reporting periods presented. In addition, an entity is required to disclose the expedients it has used and a qualitative assessment of the estimated effect of applying the expedients, to the extent possible.

An entity can alternatively choose to recognize the cumulative effect of initially applying the new standard to existing contracts as an adjustment to the opening balance of retained earnings in the annual reporting period that includes the date of initial application, with some additional disclosures.

Entities that elect the simplified transition method are required to disclose, for reporting periods that include the date of initial application:

- The amount by which each financial statement line item is affected in the current reporting period by the application of the new standard as compared with the guidance in effect before the change

- An explanation of the reasons for significant changes identified between the reported results under the new standard and the guidance in effect before the change

Entities that elect this method must also disclose this fact in their financial statements.

Appendix A – Common real estate sales transactions

This Appendix provides examples of common real estate sales transactions and the consideration of certain forms of continuing involvement. The examples discuss the guidance under the new standard as well as other guidance that will be applicable to certain types of real estate sales scenarios.

Example 1: Sale recognition (absent any forms of continuing involvement)

Seller and Buyer enter into a purchase and sale agreement for an existing office property on September 30, 20X1. Closing occurs with consideration and title transferring from Seller to Buyer on December 15, 20X1.

Existing U.S. GAAP

The sale is recognized at the time of the closing, once title has transferred and all consideration has been exchanged, as this is typically the date the sale has been "consummated" in accordance with ASC 360-20-40-7.

Sales of real estate (assets and businesses) to customers (new revenue standard)

Under the new revenue standard, when and how revenue is recognized is driven by the terms of the contract with the customer. Typically, an approved contract where both parties demonstrate commitment to fulfill their respective obligations will meet the criteria for sale recognition at the time control transfers to Buyer. The guidance outlines certain indicators of the transfer of control, such as transfer of legal title and Buyer taking on the significant risk and rewards of ownership of the asset.

Sales of real estate (assets and businesses) to non-customers (guidance in ASC 610-20)

Sales of nonfinancial assets to non-customers will apply aspects of the new revenue standard to determine proper sales treatment. Timing of when to derecognize the property will be a key focus and will require judgment based on the facts and circumstances of the transaction. To determine when to derecognize the real estate, Seller will apply guidance in the new revenue standard on the existence of a contract and when an entity satisfies a performance obligation by transferring control of an asset. The guidance outlines certain indicators of the transfer of control, such as transfer of legal title and Buyer taking on the significant risk and rewards of ownership of the asset (these factors are outlined in the "Sales to real estate to non-customers" section within this publication).

PwC interpretive response:

In this example, if there are no forms of continuing involvement that preclude Seller from transferring control to Buyer, it is likely that the sale will be recognized under the new standard when consideration is paid to Seller and title transfers to Buyer on December 15, 20X1.

Example 2: Seller is required to develop the property in the future

Seller sells a parcel of land to Buyer. In connection with the sale, Seller also agrees to develop a single tenant industrial warehouse to be used by Buyer in its business.

Existing U.S. GAAP

Under ASC 360-20-40- 61 through 40-63, profit allocable to (a) the performance after the sale of the land and (b) the sale of land should be recognized when the sale meets the criteria of ASC 360-20-40-5 if the future costs of development can be reasonably estimated at the time of sale. If such costs cannot be reasonably estimated, no profit should be recognized at the time of the sale. The profit is allocated to the sale of the land and the subsequent development or construction on the basis of estimated costs of each activity with the same profit margin attributed to each activity.

Sales of real estate (assets and businesses) to customers (new revenue standard)

Seller will need to determine if the bundle of goods and services represents one performance obligation or two separate performance obligations. Goods and services will be accounted for as separate performance obligations if both of the following criteria are met:

- The promised good or service is capable of being distinct because the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer.

- The promised good or service is distinct within the context of the contract because the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

In this example, it is expected that the sale of the parcel of land and development of the warehouse will be considered distinct as the customer can benefit from each on its own and they are separately identifiable; therefore, the contract includes two performance obligations. Seller will allocate the transaction price to the two performance obligations based on their standalone selling prices and recognize revenue as each performance obligation is satisfied.

Sales of real estate (assets and businesses) to non-customers (guidance in ASC 610-20)

Sales of nonfinancial assets to non-customers will apply aspects of the new revenue standard to determine proper sales treatment. Timing of when to derecognize of the property will be a key focus and will require judgment based on the facts and circumstances of the transaction. To determine when to derecognize the real estate, Seller will apply guidance in the new revenue standard on the existence of a contract and when an entity satisfies a performance obligation by transferring control of an asset. The guidance outlines certain indicators of the transfer of control, such as transfer of legal title and Buyer taking on the significant risk and rewards of ownership of the asset (these factors are outlined in the "Sales to real estate to non-customers" section within this publication).

PwC interpretive response:

In this example, Seller will likely conclude that the sale of land and the development of the property represent two separate performance obligations, as discussed. While current U.S. GAAP requires a constant profit margin to be recorded on both elements (that is, the sale of land and the development of the property), the new guidance could result in different profit margins on each performance obligation.

Example 3: Seller-provided financing

Scenario #1

Buyer purchases a multi-tenant property from Seller with nonrecourse financing provided by Seller to Buyer representing 98% of the purchase price. The loan includes interest-only payments over the five-year term with a balloon payment in year five.

Existing U.S. GAAP

No sale is recorded. Because the amount of cash paid by Buyer is only 2%, the transaction may be more appropriately viewed as an option to purchase the property. If the amount of cash paid was more significant, but not sufficient to qualify for the full accrual method under ASC 360-20-55-1, the transaction might qualify for sale (i.e., derecognition), but Seller would need to apply either the cost recovery or installment methods (depending on the facts).

Sales of real estate (assets and businesses) to customers (new revenue standard)

The new standard requires a seller to determine whether the buyer is committed to perform its obligations under a contract. In this example, Seller may determine that Buyer has not made a sufficient down payment to qualify for revenue recognition because Buyer could decide to default on its obligation and surrender the real estate to Seller. However, Seller will need to consider all facts and circumstances, not just the extent of the down payment.

If Seller concludes Buyer is not committed to perform its obligations, Seller will continue to re-evaluate this conclusion each reporting period. Unless this criterion is met, revenue will not be recognized until either: (a) Seller has no remaining obligations to transfer goods or services to Buyer, and all, or substantially all, of the consideration promised by Buyer has been received by Seller and is nonrefundable, or (b) the contract has been terminated and amounts received are nonrefundable.

Sales of real estate (assets and businesses) to non-customers (guidance in ASC 610-20)

Sales of nonfinancial assets to non-customers will apply aspects of the new revenue standard to determine proper sales treatment. Timing of when to derecognize the property will be a key focus and will require judgment based on the facts and circumstances of the transaction. To determine when to derecognize the real estate, Seller will apply guidance in the new revenue standard on the existence of a contract and when an entity satisfies a performance obligation by transferring control of an asset. The guidance outlines certain indicators of the transfer of control, such as transfer of legal title and Buyer taking on the significant risk and rewards of ownership of the asset (these factors are outlined in the "Sales to real estate to non-customers" section within this publication).

PwC interpretive response:

This first scenario will likely result in a similar outcome to today's accounting with no sale recognized. However, the treatment of the cash received (the down payment) could differ from today's accounting due to the embedded economic put feature inherent in nonrecourse financing (refer to example on "buyer put options" below for more details).

Scenario #2

Assume the same facts as above, except Seller provides Buyer with a loan representing 90% of the purchase price. The loan terms include principal and interest payments over the five-year term with a balloon payment for any remaining outstanding principal at the end of the term.

Existing U.S. GAAP

Seller will recognize a sale; however, the sale will likely not qualify for the full accrual method because the down payment would not meet the minimum initial investment threshold described in ASC 360- 20-55-1 and 55-2 for this property type. Seller will likely apply either the installment method or cost recovery method.

Sales of real estate (assets and businesses) to customers (new revenue standard)

Seller will be able to recognize the sale if it determines that Buyer is committed to perform its obligations under the contract. If not, Seller will re-evaluate this conclusion each reporting period and record the sale when it determines that Buyer is committed to perform under the contract.

Sales of real estate (assets and businesses) to non-customers (guidance in ASC 610-20)

Sales of nonfinancial assets to non-customers will apply aspects of the new revenue standard to determine proper sales treatment. Timing of when to derecognize the property will be a key focus and will require judgment based on the facts and circumstances of the transaction. To determine when to derecognize the real estate, Seller will apply guidance in the new revenue standard on the existence of a contract and when an entity satisfies a performance obligation by transferring control of an asset. The guidance outlines certain indicators of the transfer of control, such as transfer of legal title and Buyer taking on the significant risk and rewards of ownership of the asset (these factors are outlined in the "Sales to real estate to non-customers" section within this publication).

PwC interpretive response:

Under the new guidance, Seller will need to determine if Buyer is committed to perform its obligations under the contract. That determination will drive when revenue is recorded. This represents a difference from current accounting where some or all of the gain would be deferred under either the installment method or cost recovery method.

Example 4: Option or obligation to repurchase the property

Seller "call" option

Seller sells a property to Buyer. The sales agreement provides Seller with an unconditional option to repurchase the property at some point in the future.

Existing U.S. GAAP

Under ASC 360-20-40-38, if the buyer provides an option to the seller to repurchase the property, the transaction should be accounted for as a financing, a lease, or a profit-sharing arrangement (depending on the facts and circumstances) rather than a sale.

Sales of real estate (assets and businesses) to customers (new revenue standard)

The accounting depends on the amount of the repurchase price relative to the original sales price, as follows:

- If the repurchase price is less than original sales price, Seller will account for the transaction under the leasing guidance in ASC 840.
- If the repurchase price is greater than or equal to the original sales price, Seller will account for the transaction as a financing. Seller will not derecognize the property and will record a financial liability for the consideration received from Buyer.

If the agreement creates an unconditional obligation, rather than an option, for the seller to repurchase the asset in the future, the resulting accounting will be the same as above under the new standard.

Sales of real estate (assets and businesses) to non-customers (guidance in ASC 610-20)

Sales of nonfinancial assets to non-customers will apply aspects of the new revenue standard to determine proper sales treatment. Timing of when to derecognize the property will be a key focus and will require judgment based on the facts and circumstances of the transaction. To determine when to derecognize the real estate, Seller will apply guidance in the new revenue standard on the existence of a contract and when an entity satisfies a performance obligation by transferring control of an asset. The guidance outlines certain indicators of the transfer of control, such as transfer of legal title and Buyer taking on the significant risk and rewards of ownership of the asset (these factors are outlined in the "Sales to real estate to non-customers" section within this publication).

The existence of an option for Seller to repurchase the property in the future will likely prevent Buyer from obtaining control of the property, therefore preventing Seller from recognizing the sale.

PwC interpretive response:

It is likely that control has not passed to Buyer in this situation, so the sale is not recognized.

Buyer "put" option

Seller sells a property to Buyer. The sales agreement provides Buyer with the ability to put the property back to Seller at any time within three years of the transaction date.

Existing U.S. GAAP

Under ASC 360-20- 40-38, if the seller may have an obligation to repurchase the property, the transaction should be accounted for as a financing, a lease, or a profit-sharing arrangement (depending on the facts and circumstances) rather than a sale.

Sales of real estate (assets and businesses) to customers (new revenue standard)

Seller will evaluate at contract inception (without a requirement to reassess) whether Buyer has a significant economic incentive to exercise the put:

- If yes, the sale is not recorded and Seller will account for the transaction as a financing or a lease following the guidance in ASC 840.
- If no, the sale is recorded and Seller will recognize an asset and a liability for any expected returns.

In evaluating whether a significant economic incentive exists, the following factors should be considered:

- Relationship of repurchase price to the sales price and expected market value of the property at potential repurchase date
- Length of time until the put option expires

Sales of real estate (assets and businesses) to non-customers (guidance in ASC 610-20)

Sales of nonfinancial assets to non-customers will apply aspects of the new revenue standard to determine proper sales treatment. Timing of when to derecognize the property will be a key focus and will require judgment based on the facts and circumstances of the transaction. To determine when to derecognize the real estate, Seller will apply guidance in the new revenue standard on the existence of a contract and when an entity satisfies a performance obligation by transferring control of an asset. The guidance outlines certain indicators of the transfer of control, such as transfer of legal title and Buyer taking on the significant risk and rewards of ownership of the asset (these factors are outlined in the "Sales to real estate to non-customers" section within this publication).

The existence of an option for Buyer to require Seller to repurchase the property in the future may not prevent Seller from transferring control of the property if it is determined that Buyer does not have a significant economic incentive to exercise the put option. This will be based on the facts and circumstances of the transaction.

PwC interpretive response:

Determining whether a buyer has a significant economic incentive to exercise a put option will require significant judgment as it will be based on the facts and circumstances of the transaction. This could result in different entities arriving at different conclusions for the same (or similar) transactions.

If a conclusion is reached that the buyer does not have a significant economic incentive to exercise the put option, the concept of recording an asset and liability for any expected returns may present a challenge as sales of real estate are unique in nature.

Example 5: Guarantees (seller provides a return of or return on the buyer's investment)

Seller sells a multi-tenant retail property to Buyer. Because some of the leases are expected to expire within the next 6 to 18 months, Seller guarantees Buyer that the cash flows of the property will be sufficient to meet all of the operating needs of the property for the first four years after the sale.

Existing U.S. GAAP

Under ASC 360-20-40- 41, if the seller guarantees return of the buyer's investment or guarantees a return on the investment for an **extended** period, the transaction should be accounted for as a financing, a lease, or a profit-sharing arrangement (depending on the facts and circumstances) rather than a sale.

If the guarantee of a return is for a **limited** period, the deposit method should be used until operations of the property cover all operating expenses, debt service, and contractual payments.

Sales of real estate (assets and businesses) to customers (new revenue standard)

The existence of an obligation to support operations would not preclude the sale transaction and derecognition of the property. Seller will separately account for the guarantee under ASC 460, *Guarantees*, and allocate a portion of the sales proceeds received to the guarantee. The amount allocated to the guarantee will be the fair value of the guarantee and the remaining consideration will be allocated to the sale of the property.

Sales of real estate (assets and businesses) to non-customers (guidance in ASC 610-20)

Sales of nonfinancial assets to non-customers will apply aspects of the new revenue standard to determine proper sales treatment. Timing of when to derecognize the property will be a key focus and will require judgment based on the facts and circumstances of the transaction. To determine when to derecognize the real estate, Seller will apply guidance in the new revenue standard on the existence of a contract and when an entity satisfies a performance obligation by transferring control of an asset. The guidance outlines certain indicators of the transfer of control, such as transfer of legal title and Buyer taking on the significant risk and rewards of ownership of the asset (these factors are outlined in the "Sales to real estate to non-customers" section within this publication).

PwC interpretive response:

Under current U.S. GAAP, this form of continuing involvement precludes sale recognition for accounting purposes. That is, the real estate remains on the seller's balance sheet. Compared to today, the new standard will result in a dramatically different outcome where the sale is recognized (assuming control has transferred) and the measurement of the gain/loss on sale will be impacted by the fair value of the guarantee.

Example 6: Seller's participation in future profit (without risk of loss)

Seller sells a property to Buyer for $10 million. As part of the agreement, Buyer agrees to share 15% of any excess proceeds it receives above $10 million from a subsequent sale to another buyer at some point in the future.

Existing U.S. GAAP

Under ASC 360-20-40-64, the contingent future profits should be recognized when they are realized. All of the costs of the sale are recognized at the time of sale (i.e., no costs are deferred to periods when the contingent profits are recognized).

Sales of real estate (assets and businesses) to customers (new revenue standard)

The future profit participation is variable consideration, which could impact the transaction price. Seller will estimate the transaction price using either: (a) the "expected value" (sum of probability-weighted amounts) or (b) the "most likely amount" (single most likely outcome) approach. Seller will update its estimate at each reporting period end until the contingency is settled.

Seller is limited to recording income for the amount for which it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is resolved, and will need to consider whether there are any minimum amounts that should be recorded.

Sales of real estate (assets and businesses) to non-customers (guidance in ASC 610-20)

Sales of nonfinancial assets to non-customers will apply aspects of the new revenue standard to determine proper sales treatment. Timing of when to derecognize the property will be a key focus and will require judgment based on the facts and circumstances of the transaction. To determine when to derecognize the real estate, Seller will apply guidance in the new revenue standard on the existence of a contract and when an entity satisfies a performance obligation by transferring control of an asset. The guidance outlines certain indicators of the transfer of control, such as transfer of legal title and Buyer taking on the significant risk and rewards of ownership of the asset (these factors are outlined in the "Sales to real estate to non-customers" section within this publication).

PwC interpretive response:

If Seller concludes that some minimum amount of the variable consideration is not constrained, the new standard will result in earlier recognition of income than current U.S. GAAP. The assessment of variable consideration will introduce significant judgment and requires updating the estimate each period.

Also, in assessing the variable consideration and whether a significant reversal would occur, Seller needs to consider the amount of cumulative revenue recognized. Since it will have recognized $10 million at the time of sale, the evaluation of the variable amount needs to consider the potential for 15% of the upside as compared to the $10 million already recorded. For example, if the entity believes the future sale will be at least $11 million, then the variable consideration that is being assessed is only $150,000, which may not be considered "significant" compared to $10 million.

Appendix B – Application of the new standard for a “vertically integrated” homebuilder

Background

A homebuilder has a 200-unit project (homogeneous units) and sells the individual homes over a four-year period. The homes are sold with a promise (based on the sales contracts or zoning agreements) to complete certain amenities (e.g., a school, roads, or a pool/clubhouse) by the middle of Year 3. In this example, there is no seller-provided financing or other forms of continuing involvement.

The revenue and cost assumptions are as follows (in 000’s except unit numbers):

		Total	Per unit
Total units		200	
Sales price		$20,000	$100

		Total	Per unit	Cost ratio	
Land/homebuilding construction cost		$15,000	$75	88.2%	
Costs for non-home construction elements		$2,000	$10	11.8%	
		$17,000	**$85**	**100%**	

	Year 1	Year 2	Year 3	Year 4	Total
Home sales (units)	40	75	65	20	200
Contractual revenue:	$4,000	$7,500	$6,500	$2,000	$20,000
Costs					
Land/home construction	$3,000	$5,625	$4,875	$1,500	$15,000
Total costs for non-home construction elements	-	-	2,000	-	2,000
Total costs	$3,000	$5,625	$6,875	$1,500	$17,000

Application of the new standard

Step 1: Identify the contract(s) with the customer
The contracts with the individual homebuyers are the relevant contracts

Step 2: Identify the performance obligations in the contract
In addition to the delivery of the constructed home, there are potentially several performance obligations in this example that may be satisfied at different times. For purposes of simplifying this example, we have assumed that all of the non-home construction elements are completed and delivered simultaneously and therefore can be treated as a single performance obligation separate from the home delivery performance obligation. For this purpose, the standard home warranty is predominantly a "quality assurance" element in many jurisdictions and not treated as separate performance obligations.

Step 3: Determine the transaction price
The transaction price is the sale price for the individual home sales. In this example, there are no other elements that impact the transaction price, such as variable consideration, time value of money (all cash paid at closing), noncash consideration, or consideration paid to a customer.

Step 4: Allocate the transaction price to the performance obligations
The transaction price should be allocated between the identified performance obligations based on their relative standalone selling prices. Possible approaches to estimating standalone selling price include (but are not limited to) expected costs plus a reasonable margin or assessment of market prices for similar goods or services. Generally, the non-home construction elements would not have separate market prices and in this case, possibly neither do the home construction elements since each project is different. For purposes of this example, we allocated based on the relative costs between home and non-home construction performance obligations and assuming a consistent margin between the two. In reality, there is likely a different margin earned on the non-home construction elements, which could result in further complexities.

Step 5: Recognize revenue when (or as) a performance obligation is satisfied
Upon each home settlement (that is, the transfer of control to the buyer), the performance obligation relating to the home delivery is settled. Until the non-home construction performance obligations are completed, none of the related per unit revenue should be recognized. At completion of the non-home construction elements, the portion of the revenue related to units settled to date will be recognized. Thereafter, the non-home construction elements will be recognized upon each home settlement (as control of the non-home construction elements does not transfer prior to home settlement).

Application of the current accounting model

(in 000's except unit numbers)

	Year 1	Year 2	Year 3	Year 4	Total
Home sales (units)	40	75	65	20	200
Contractual revenue at closing	$4,000	$7,500	$6,500	$2,000	$20,000
Costs					
Land/home construction	$3,000	$5,625	$4,875	$1,500	$15,000
Allocated non-home construction costs	400	750	650	200	2,000
Total costs	**$3,400**	**$6,375**	**$5,525**	**$1,700**	**$17,000**
Gross margin	***$600***	***$1,125***	***$975***	***$300***	***$3,000***

Application of the new standard

(in 000's except unit numbers)

Allocation of transaction price per unit to performance obligations using cost ratio	Revenue	Costs	
Home construction	$ 88.235	$ 75.000	88.2%
Non-home construction elements	11.765	10.000	11.8%
Total	$100.000	$ 85.000	100%

	Year 1	Year 2	Year 3	Year 4	Total
Home sales (units)	40	75	65	20	200
Performance obligation revenue:					
Home construction at delivery	$3,529	$6,618	$5,735	$1,765	17,647
Non-home construction:					
At delivery of non-home elements for closings to date			1,735		1,735
Subsequent to non-home elements at settlement			383	235	618
Total non-home construction			**2,118**	**235**	**2,353**
Total revenue	***$3,529***	***$6,618***	***$7,853***	***$2,000***	***20,000***
Costs:					
Home construction at delivery	$3,000	$5,625	$4,875	$1,500	$15,000
Non-home construction:					
At delivery of non-home elements for closings to date			$1,475		1,475
Subsequent to non-home elements at settlement			$325*	$200*	525
Total non-home construction			**1,800**	**200**	**2,000**
Total costs	***$3,000***	***$5,625***	***$6,675***	***$1,700***	***$17,000***
Gross margin	***$529***	***$993***	***$1,178***	***$300***	***$3,000***
Difference (new standard vs current accounting model)					$(0)
Revenue	$(471)	$(882)	$1,353	-	$(0)
Costs	(400)	(750)	1,150	-	$(0)
Gross margin	$(71)	$(132)	$203		

*Costs to fulfill the non-home elements performance obligation would likely be capitalized and amortized as control of the non-home elements transfer to the customers.

PwC observation:

Most projects will be substantially more complex than the example provided and may have significant subsequent changes in assumptions/estimates over the life of the project. Further, tracking of income tax temporary differences, already complex for many entities, may become substantially more challenging as a result of the new standard.

About PwC's Real Estate practice

PwC has a global team of multidisciplinary professionals providing real estate services. Our industry specialists span our core assurance, tax, and advisory capabilities. This team of dedicated professionals advises members of the private and public sector, owners, users, and investors in real estate throughout the capital stack. Our commitment to industry is demonstrated by the corporate owners/users, developers, hospitality organizations, investors, and REITs we serve, as well as our active participation in leading real estate organizations, and the quality of research and reporting we provide to executives, investors, owners, and ratings agencies, among others.

PwC helps organizations and individuals create the value they're looking for. We're a network of firms in 157 countries with more than 184,000 people who are committed to delivering quality in assurance, tax, and advisory services.

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In the loop
December 2014

Pushdown accounting: make the right choice for your company

What you need to know

- New guidance allows acquired companies to elect whether to apply fair value pushdown accounting in their separate financials, on a transaction-by-transaction basis.
- Previous SEC guidance has been eliminated, which required or precluded pushdown accounting depending on the buyer's ownership percentage.
- In deciding whether to apply pushdown accounting, consider the needs of financial statement users and the practical implications to the buyer and acquired company.
- The new option is available immediately for all open financial reporting periods.

Pushdown accounting is now optional–which approach is best for your company and investors?

Typical impact of pushdown accounting on an acquired company's financial statements[1]:

Assets	↑	Impact of goodwill and "step up" in value of PP&E, intangibles, and inventory	Revenue	NEUTRAL	Future revenues could decrease if the fair value of acquired deferred revenue is less than book value
Liabilities	NEUTRAL	Liabilities could increase if contingencies are recorded at fair value	Expenses	↑	Impact of increased amortization and depreciation expense
Equity	↑	Reflects value paid by buyer; typically exceeds book value	Net income	↓	Impact of increased expenses
Operating cash flows	NEUTRAL	Impact of pushdown is typically noncash	EBITDA	NEUTRAL	EBITDA could decrease if "step up" of inventory results in increased costs of goods sold

[1]Illustration purposes only; impact could vary depending on the transaction.

"Pushdown" accounting refers to establishing a new basis for reporting assets and liabilities in an acquired company's separate financial statements based on a "push down" of the buyer's basis. This typically results in "stepping up" the basis of assets and liabilities to fair value and recording goodwill in the acquired company's financial statements. Under the new guidance, pushdown accounting is optional for any transaction in which another party obtains control of the reporting company. Now that there is choice, management will need to weigh various factors to decide whether to apply pushdown accounting, including both practical considerations and the needs of investors and creditors.

pwc

An election to apply pushdown accounting is irrevocable – weigh the factors before making a decision

What matters to investors and creditors?

It is important to consider the needs of the users of the acquired company's financial statements–and those needs may vary. Some users may prefer the "stepped-up basis" that results from pushdown accounting. For example, retaining the historical basis can result in the acquired company reporting negative equity if the transaction involves taking on new debt to finance the purchase of treasury stock (a leveraged recapitalization). Management should also keep in mind any regulatory or contractual requirements that focus on balance sheet measures.

Other users may prefer an acquired company retain its historical basis to avoid distorting income statement trends as a result of increased amortization and depreciation expense. Users that focus on cash flow and EBITDA measures, however, may be indifferent to the impact of pushdown accounting as these measures are often not significantly affected.

Other considerations before electing pushdown accounting

From a practical standpoint, buyers that report consolidated results may favor pushdown accounting at the subsidiary level to avoid separately tracking assets, such as goodwill and fixed assets, at two different values (historical basis and "stepped-up basis"). Conversely, the acquired company may prefer to carry over its historical basis due to the increased complexities of pushdown accounting. Companies may also decide to retain the historical basis when that is the basis used for tax reporting purposes (that is, in transactions where there is no tax "step up").

You can change your mind later…but only in one direction

If an acquired company does not elect to apply pushdown accounting upon a change-in-control event, it can do so in a subsequent period as a change in accounting policy. However, once pushdown accounting is elected for a specific transaction, that election is irrevocable. Management should therefore weigh the needs of investors and the practical implications prior to making an election.

In the loop

Executive-level insight into today's top financial reporting and regulatory issues

How PwC can help

To have a deeper discussion of how the pushdown accounting guidance might affect your company, please contact:

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Coming soon

In depth: Pushdown accounting becomes optional
More details and insights on the new guidance, including when the pushdown election is available and how pushdown accounting is applied

For more accounting and financial reporting developments, visit www.cfodirect.com www.pwc.com

Stay informed
2014 SEC comment letter trends
Financial Services

Current developments in SEC reporting

November 2014

To Our Clients and Friends:

The Securities and Exchange Commission ("SEC") continues to emphasize the primary role and responsibility assumed by management and audit committees in providing meaningful and transparent information to investors. The uncertainties in the current economic and regulatory environment make the preparation of high-quality reports increasingly important and challenging.

To help you prepare for your annual reporting, PwC's Financial Services Industry Group has developed the enclosed publication titled Stay informed Financial Services 2014 SEC comment letter trends. In this latest edition of our annual publication we have analyzed SEC staff comment letters issued to registrants across different sectors within the financial services industry, including: banking and capital markets, insurance, asset management, and real estate. We have highlighted the top areas where registrants received the majority of comments and have also provided relevant examples of recent comment letters along with the applicable accounting or reporting guidance.

Understanding the SEC staff's recent areas of focus is an important aspect to consider as part of the year-end reporting process. The SEC staff continues to emphasize the importance of providing information to investors that is reliable, meaningful and transparent, particularly in areas that involve significant judgment. Continuing key themes emphasized by the SEC staff through recent comment letter trends impact both financial and non-financial statement disclosures, with management's discussion & analysis once again being the most frequent area of comment.

We hope that a better understanding of these trends, along with specific examples of comments, will provide you with helpful insights and will aid in your producing high-quality annual reports for investors and other stakeholders. Please don't hesitate to contact your PwC engagement team or me to discuss the information in this publication or to address any questions you may have.

Best regards,

Bob

Robert Sands
U.S. Financial Services Assurance Leader

Contents

SEC developments **2**

Overview **4**

Methodology 5

Management's discussion and analysis and Risk factors **7**

Results of operations 7

Liquidity and capital resources 9

Risk factors 10

Fair value measurement **11**

Business combinations **13**

Loss contingencies **14**

Impairments **15**

Executive compensation **17**

Internal Control **18**

Sector highlights **21**

Banking and capital markets 21

Insurance 22

Asset management 23

Real estate 25

About PwC's Financial Services Industry Group **28**

SEC Developments

2014 was a busy year at the SEC. Although there were only a few changes in senior personnel (compared to 2013 when several high profile staff positions were filled and three Commissioners, including a new Chair, were appointed), one notable change was the appointment of Jim Schnurr as the SEC's Chief Accountant. Schnurr joined the SEC staff in October and will play a major role in shaping the SEC's agenda at a time when accounting, auditing and financial reporting are key areas of focus. This focus reflects a common understanding that transparent, accurate and reliable financial reporting forms the foundation of trust which allows our capital markets to function properly and provides the transparency and confidence investors need when making decisions.

Following through on initiatives started in 2013, 2014 has seen a high level of activity in the SEC's enforcement program, with renewed attention on financial fraud, issuer disclosure and gatekeepers. The Enforcement Division's Financial Reporting and Audit Task Force—a small group of experienced attorneys and accountants charged with developing state-of-the art tools to better identify financial fraud and incubating cases to be handled by other groups—is one example of how the SEC has increased its focus. The Task Force monitors high-risk areas, analyzes industry performance trends, reviews restatements, revisions, and class action filings as well as academic research. It is also working on the SEC's Accounting Quality Model—sometimes referred to as Robocop—which is being developed to use data analytics to assess the degree to which a company's financial reporting appears noticeably different from its peers. The Task Force was very busy during 2014 with even more activity expected in 2015.

The SEC staff has continued to focus on internal control over financial reporting, with more attention on how companies evaluate deficiencies relating to immaterial financial statement errors. The SEC staff signaled its intention to increase its focus in this area in late 2013, and this has led to more frequent comments and questions in 2014, with more likely to come in 2015.

Recognizing that full and fair disclosure is a central goal of the U.S. securities laws and is critical to the fulfillment of the SEC's core mission, during 2014 the SEC launched a "Disclosure Effectiveness" initiative. Through this initiative, the SEC is looking for ways to update and modernize its disclosure system and to eliminate duplicative or overlapping requirements, while continuing to provide material information. Trying "to put better disclosure into the hands of investors," the SEC staff is taking a fresh look at the question: what information do investors need to make informed decisions? In addition to looking at the specific disclosures companies provide, the SEC staff is also looking closely at how disclosures are provided, particularly in light of advances in technology and changes in how information is consumed. For instance, the SEC staff might explore a “company file” approach through which investors would access company-specific information on the SEC's website through tabs such as “Business information,” “Financial information,” “Governance information” and “Executive compensation,” instead of searching for that same information by combing through a reverse chronological list of filings. The SEC staff has been clear that reducing disclosure is not the objective of this important project (indeed, they have said that updating the requirements may well result in additional disclosures), but they have indicated that they believe the initiative can reduce costs and burdens on companies.

Even before any rule changes are adopted (or proposed), companies already have the ability to improve the quality and relevance of their disclosures by reducing redundancy, removing out-of-date, unnecessary information, and refining disclosures to focus on those issues which are truly applicable and material. The SEC staff has been encouraging companies to experiment with the presentation of the information in their filings with the objective of improving the transparency, quality and relevance of their disclosures.

John A. May
SEC Services Leader

Overview

Overview

To help registrants gain insight into the SEC staff's current areas of interest, PwC analyzed comment letters issued to domestic registrants within the financial services industry. From this analysis, we identified "hot topic" areas, including industry-specific considerations and some other notable trends in comments received across the financial services industry that we believe are relevant and may be of increasing focus in the near term.

The hot topics identified among comments issued to registrants in the financial services industry are somewhat consistent with those in other industries, with management's discussion and analysis disclosures regarding results of operations, liquidity, and capital resources being the most prevalent. Financial services shares a continued focus on loss contingencies and impairments with other industries as well. Other comments specifically impacting the financial services industry relate to valuation and business combinations, among other areas. As in prior years, executive compensation continues to garner a significant number of comments, generally with a focus on the determination, drivers and transparency of executive compensation. In addition, regulatory reporting, primarily as it relates to the insurance sector, was a significant trend, including comments regarding statutory accounting matters.

Our analysis considered the breakdown of the financial services industry into four sectors: banking and capital markets, insurance, asset management, and real estate. All four of the sectors, when analyzed individually, presented substantially similar trends. Significant matters specific to a particular sector are summarized in our "Sector highlights" section.

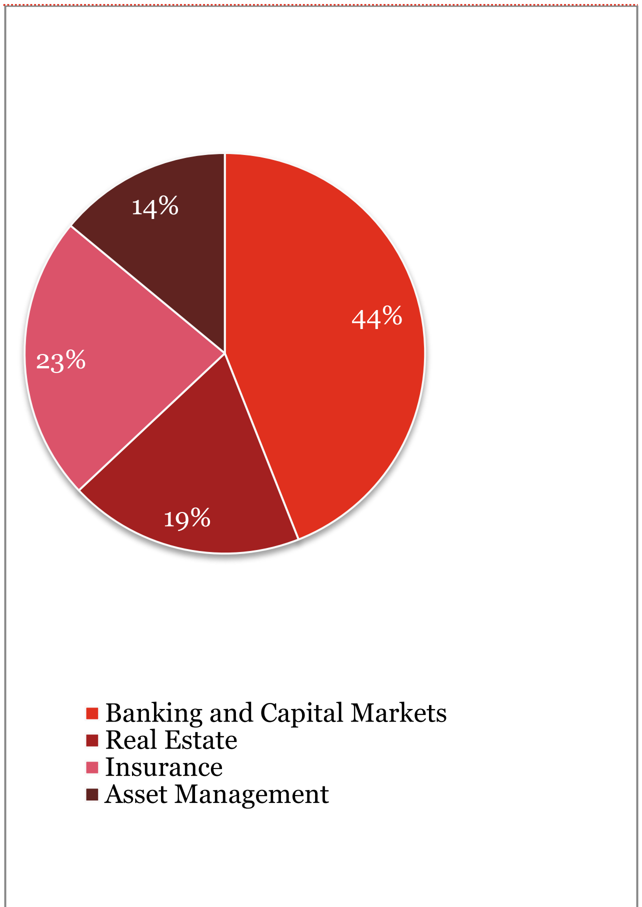
Rank	"Hot topic" financial services reporting areas	%
1	Management's discussion and analysis	28
2	Fair value measurements	11
3	Business combinations	7
4	Regulatory reporting*	4
5	Impairments	3
6	Executive compensation	3
7	Loss contingencies	2
8	Other**	42
Total		100

*See statutory disclosures in the Insurance sector highlights for further detail
**Primarily items covered in sector highlights

Overview

The chart below shows the percentage of total comments by sector included in our analysis of comment letter trends.

Breakdown by sector



Methodology

The analysis of SEC staff comment letter trends was based on comments issued and released by the SEC between November 1, 2013 and October 31, 2014 related to Forms 10-K and 10-Q. For consistency of evaluation, the analysis was based solely on the Standard Industrial Classification (SIC) codes indicated on the SEC EDGAR website for each respective financial services sector, as follows:

- Banking and Capital Markets – 6021, 6022, 6029, 6035, 6036, 6099, 6111, 6141, 6153, 6159, 6162, 6163, 6172, 6189, 6199, 6200, 6211
- Insurance – 6311, 6321, 6324, 6331, 6351, 6361, 6399, 6411
- Asset Management – 6282, 6221, 6799, and Business Development Companies
- Real Estate – 6500, 6510, 6512, 6513, 6519, 6531, 6532, 6552, 6798

Financial Services Comment Letter Trends

Management's discussion and analysis and Risk factors

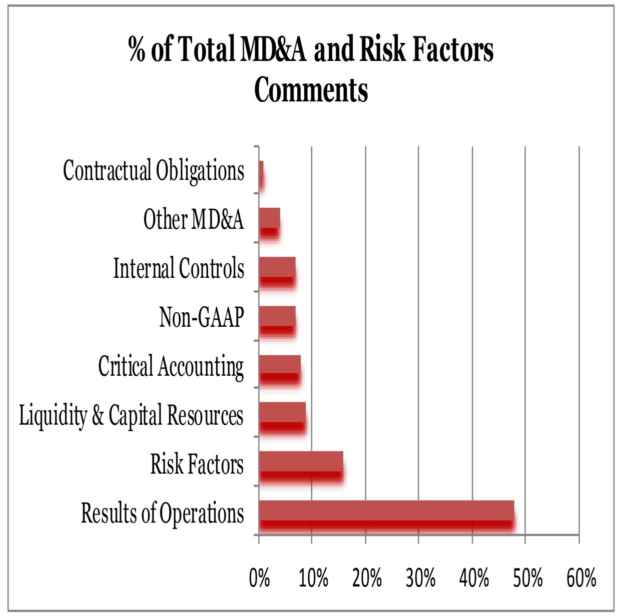
Management's discussion and analysis (MD&A) of financial condition and results of operations is a critical component of registrants' communications with investors and continues to be the top area for comment by the SEC staff in 2014. The key objectives of MD&A are to provide a narrative explanation of the financial statements that enables investors to see the company through the eyes of management, to offer context to the financial statements, and to provide information that allows investors to assess the likelihood that past performance is indicative of future performance. We have found that the majority of SEC staff comments in this area are not aimed at meeting specific technical requirements, but rather at enhancing the quality of disclosures to meet these objectives.

The requirements themselves are set forth in Item 303 of Regulation S-K, which identifies five categories of disclosure in MD&A: liquidity, capital resources, results of operations, off-balance-sheet arrangements, and contractual obligations. Item 503 of Regulation S-K provides the requirements for risk factors. Additional guidance is also contained in Financial Reporting Release (FRR) 36 and FRR 72.

More recently, following the release of its December 2013 Report on Review of Disclosure Requirements in Regulation S-K mandated by the JOBS Act, the SEC has indicated that the Division of Corporation Finance will pursue a project to develop recommendations focused on improving and streamlining disclosure requirements. This project may reduce the costs and burdens on companies and eliminate duplicative disclosures in MD&A, but may also identify opportunities to increase the transparency of information, which may lead to new requirements.

In the meantime, the comment letter process has reinforced the well-established MD&A objectives that disclosures should be: 1) transparent in providing relevant information, 2) tailored to the company's facts and circumstances, 3) consistent with the financial statements and other public communications, and 4) comprehensive in addressing the many business risks that exist in today's economic environment.

The table below summarizes the percentage of comments received by registrants by topical area of MD&A and risk factors. Results of operations and liquidity and capital resources are the areas of MD&A that have received the most attention in SEC staff comment letters. We provide relevant examples of comments issued in each of these areas.



Results of operations

SEC staff comments have reminded registrants that the results of operations section should provide readers with a clear understanding of the significant components of revenues and expenses and events that have resulted in or are likely to cause a material impact on revenues or income from operations.

The SEC staff has frequently issued comments specifying that MD&A should not simply repeat information provided elsewhere in the filing; rather, it should explain the underlying drivers behind changes in the financial position, results of operations and cash flows of registrants. Increasingly, registrants are being challenged to quantify the impacts that such factors have had, especially when an account has been impacted by multiple factors. General observations on the population of SEC staff comments include the following:

- Disclosing known trends - The SEC staff has asked registrants to disclose known trends affecting the business, in particular, disclosure of events that have occurred and how those events were a positive or negative indicator of future performance. Examples include changes in market conditions, entering a new market or changes in asset classes, or an acquisition that is expected to impact operating results. In addition, they encourage the discussion of key operating metrics used by management, coupled with an analysis of the relationship between such metrics and GAAP results

- Drivers behind fluctuations - Many comments relate to improving registrants' disclosures of significant fluctuations between periods. The SEC staff has asked for more detailed descriptions related to the specific factors driving such fluctuations and for registrants to quantify each factor separately, even when they net to an insignificant change overall
- Consistency of information - The SEC staff has been known to review public information for consistency with the information included in a registrant's periodic filings. When management discusses events or trends on earnings calls, social media channels, investor presentations or the company's website, the SEC staff may question why such events are not also addressed in MD&A

Sample comments:

1. We note that your MD&A section is overly brief and does not present all of the information required under Item 303 of Regulation S-K. In future filings, you should provide more analysis of the disclosure you are currently providing. For example, discuss the reasons for the increases or decreases in operating expenses and address the material changes in line items under the "Expenses" section, including general and administrative, and professional fees. Rather than simply repeat information that is contained in the financial statements, you should provide an analysis and narrative disclosure throughout your MD&A section so that investors understand the company's business model and future plans in the context of the financial information provided in this section.
2. You state that the low interest rate environment has impacted earnings and that in addition to continuing spread compression in your interest sensitive product line, there is also potential for interest rate related impacts to amortization and the level of reserves, which could be material. Please provide us proposed disclosure to be included in your future periodic reports (in MD&A) that discloses the expected effects of this known trend or uncertainty on your future financial position, results of operations and cash flows.
3. Please revise your discussion of results of operations to provide your investors with more insight on the causes of increases or decreases in the components of net income. Please include the following:
   - When you identify more than one reason for an increase or decrease in the components of net income, to the extent possible, please quantify the effect of each different reason.
   - When you identify intermediate causes of changes in revenues please provide your readers with insight into the underlying drivers of those changes.
4. We note your disclosure of underwriting and distribution revenues and expenses segregated by distribution channel. In an effort to provide greater transparency into your various revenue sources, please revise your disclosure in future filings to quantify the significant components of your underwriting and distribution revenues (e.g., 12b-1 fees, front-end load sales, fees from asset allocation products, insurance premiums, etc.). Consider providing these disclosures in a tabular format.
5. We note on your website that you issued an overview of the Mortgage Data Program that includes an implementation timeline of the requirements in such program. We were unable to locate disclosures in your Form 10-K and first quarter Form 10-Q on the program and its related requirements. Please tell us and revise future filings to disclose a detailed summary of the program along with the requirements and implementation dates and how it impacts your business. Please ensure your discussion includes detailed information on the program and whether it will impact any of your internal models (i.e., internal price index).

Liquidity and capital resources

A key objective of the liquidity and capital resources discussion is to provide a clear picture of the registrant's ability to generate cash and to meet existing known or reasonably likely future cash requirements. The SEC staff expects the liquidity and capital resource discussion to address material cash requirements, sources and uses of cash, and material trends and uncertainties related to a registrant's ability to use its capital resources to satisfy its obligations. General observations on the population of SEC staff comments include the following:

- Disclosure of events impacting liquidity - The SEC staff has asked registrants to discuss known trends, events, or uncertainties that are reasonably likely to impact future liquidity. Such events could include entry into material commitments, loss of customers or contracts, or plans for significant capital expenditures
- Debt agreements and related covenants - Comments from the SEC staff have requested expanded disclosure of the material terms of debt agreements, including an indication of compliance with financial covenants. In situations where there has been or is projected to be a violation with regard to covenant compliance, registrants should provide a detailed description of the covenants, the target and actual covenant measures for the most recent reporting period, and an indication of the sensitivity of those measurements, if applicable. Other items potentially impacting the availability of credit should also be made clear, including limitations on the ability to draw on existing lines of credit, or other borrowing limitations
- Stranded cash - For companies with foreign operations, the SEC staff has focused on the registrant's ability to repatriate cash to the United States in order to meet significant upcoming obligations, such as debt repayments or mandatory pension contributions. Comments have focused on the relationship between liquidity needs and the income tax assertion about management's intent to permanently reinvest foreign earnings. The SEC staff has also asked companies to quantify the amount of cash held overseas and the amount of incremental deferred tax, if any, that would be recorded if cash were to be repatriated. This is also a common topic in SEC staff comments related to income taxes
- Cash flow analysis - One of the common criticisms in the liquidity analysis is when registrants simply repeat information readily found on the face of the statement of cash flows. Instead, registrants should disclose the underlying factors driving changes in operating assets and liabilities and the related cash flows

Sample comments:

1. In future filings please provide a more informative analysis and discussion of changes in operating cash flows for each period presented. In doing so, please explain the underlying reasons for and implications of material changes between periods to provide investors with an understanding of trends and variability in cash flows. Please ensure your discussion and analysis is not merely a recitation of changes evident from the financial statements. Refer to Item 303(a) of Regulation S-K.
2. Please provide us proposed revised disclosure to be included in future periodic reports that quantifies the parent company's short-term and long-term obligations over the next few years and any plans to deploy excess capital, and that quantifies the sources of liquidity to meet these obligations and plans.
3. Please identify and discuss any known trends, demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in your liquidity increasing or decreasing in any material way. In this regard, we note your disclosure that your long-term indebtedness has steadily increased and has more than doubled in five years. Please refer to Item 303(a)(1) of Regulation S-K.
4. We note you have international operations in multiple foreign countries and local taxes and currency controls may impact your ability or willingness to repatriate funds to the United States. Please clarify the amount of cash and cash equivalents held by foreign subsidiaries. To the extent material, please revise future filings to disclose this amount and also provide a statement indicating whether it is your intention to repatriate these funds and that you would need to accrue and pay taxes if repatriated.

Risk factors

Registrants are required by Item 503(c) of Regulation S-K to provide a description of significant risk factors within Item 1A of the Form 10-K. The discussion should include an explanation of the risks that specifically affect the registrant (a summary of generic risks that would apply to all entities is not sufficient). Registrants are also required to address market risks, including credit and interest risks, in Item 7A of the Form 10-K.

In recent months, cybersecurity has become a top concern for many companies, regulators and law enforcement agencies given the impact it has had on companies and other capital market participants. Cyber-attacks aimed at the capital markets can have a devastating effect not only on a company but also on the economy and individual consumers. The SEC staff has continued to focus on cybersecurity-related issues and in 2011 issued guidance to assist public companies with their disclosures of cybersecurity risks and cyber incidents. The guidance reminds companies to disclose the risk of cyber incidents if it is among the most significant factors that make an investment in the company speculative or risky. Registrants should evaluate their cybersecurity risks and take into account all available relevant information, including prior cyber incidents and the severity and frequency of those incidents in determining whether a risk factor is required.

Sample comments:

1. We note that you disclose that you may be vulnerable to breaches, hacker attacks, unauthorized access and misuse, computer viruses and other cybersecurity risks and events. Please tell us whether you have experienced any breaches, hacker attacks, unauthorized access and misuse, computer viruses and other cybersecurity risks and events in the past and, if so, whether disclosure of that fact would provide the proper context for your risk factor disclosures.
2. We note the Company increased its mortgage banking activities during the year and intends to continue to increase its activities in this area going forward. Please tell us and revise future filings to disclose the specific risks involved with this shift in business focus, including the Company's exposure in the event it is unable to sell the mortgages into the secondary market.
3. Please expand the risk factor to explain that adverse market conditions vary with respect to different products and the overall product mix. For example, you noted in your recent earnings call that several of your products generally perform better in down markets and you have experienced net outflows in periods of strong market conditions.

Fair value measurement

The SEC staff has continued to focus on compliance with the financial statement disclosure requirements included in ASC 820, *Fair Value Measurement*, emphasizing both the quantitative and qualitative requirements set forth in the standard. Qualitative comments have placed an emphasis on how the registrant implements its processes and controls to support fair value measurements, while the quantitative comments have focused on significant unobservable inputs for level 3 measurements and how they were used to determine fair value.

Management's process to understand the assumptions used by third-party pricing sources has been a point of focus by the SEC staff. Comments have been focused on ensuring management maintained responsibility for the estimates provided by the pricing service and used in the company's financial statements. Ultimately, management's ownership and understanding will result in more meaningful and reliable information disclosed in the financial statements.

The SEC staff comments have continued to focus on the following disclosures:

- The weighted average of the significant unobservable inputs to supplement any wide ranges and the basis for determining the weighted average
- The amount for each valuation technique used within a class of assets or liabilities when multiple valuation techniques were used
- The factors considered when determining the appropriate weighting to be applied to each valuation technique when multiple valuation techniques are used to determine fair value
- The procedures and controls in place to support the completeness and accuracy of the prices received from third party vendors
- The basis for any adjustments made to the valuations received from third-party vendors

As it relates to the categorization of assets and liabilities within the fair value hierarchy, the SEC staff has requested additional information from registrants supporting their determination of a particular asset or liability's classification. Questions raised by the SEC staff surrounding leveling have been asked about both assets and liabilities measured using valuations provided by third-party vendors and those valuations measured internally. The SEC staff has challenged companies' classification of certain level 2 assets and liabilities whose valuations may include significant level 3 inputs.

Sample comments:

1. We note your disclosure of the range of significant unobservable inputs used in the fair value measurement of level 3 assets and liabilities as well as qualitative information on the sensitivity of the fair value measurements to changes in the significant unobservable inputs. Given the wide range of assumptions for several of the categories, please revise your future filings to also provide a weighted average of the significant unobservable inputs reported, similar to the illustration provided in ASC 820-10-55-103, and state your basis for calculating the weighted average (e.g., weighted average by notional, principal, etc.).
2. Please break out (based on the valuation technique actually used) the dollar figures in the column entitled "Fair Value at December 31, 20XX" among the various valuation techniques set forth in the column entitled "Valuation Technique".
3. We note that you use valuations provided by third-party pricing services as the basis for your fair value measurements for several different types of financial instruments. Please revise your future filings to disclose the procedures you perform to validate the valuations received from such third-party pricing services.
4. We note that the fair values of certain level 3 investment are determined using broker quotes for the subject security and/or similar securities. We also note your disclosures related to the valuation process for fair value measurements categorized within level 3. Please enhance your disclosure in future filings to address the following:
    - Discuss the average number of broker quotes received and whether such quotes are binding or non-binding.
    - Describe the process you undertake to validate the broker quotes received.

Fair value measurement

- Confirm the broker(s) quotes you receive provide you with sufficient detail such that you are able to assess whether the pricing methodology complies with ASC 820.
- Discuss how frequently you adjust the pricing of any particular security you receive from the broker(s).

5. You disclose that in your fair value measurement for collateral dependent loans you discount third-party appraisals based on the historical sales proceeds compared to appraised values. This discount appears to meet the definition of a level 3 input. This input also appears to be significant to the entire measurement and therefore, the entire measurement should be categorized within level 3 of the fair value hierarchy. Refer to ASC 820-10-35- 38A. Please revise your disclosure accordingly or tell us why you do not believe the discount is a level 3 input. Additionally, please disclose the information required by ASC 820-10-50-2.bbb and c.

6. We note that you have classified impaired loans as level 2 in the fair value hierarchy, and have disclosed that the fair value is determined based on quoted prices for similar assets, adjusted for the attributes of the loan, or based on the fair value of the collateral, which is typically estimated based on the quoted market prices if available, appraisals or other internal valuation techniques. Please tell us in more detail how you determined that the techniques used for these impaired loans qualified as level 2 in the fair value hierarchy. For example, describe the types of impaired loans and the market information used in the analysis to support a level 2 classification.

7. It appears from your fair value hierarchy disclosures that the majority of your credit derivatives are level 2. Please address the following regarding your credit derivatives in your synthetic credit portfolio: Tell us the level in which you have classified these instruments in the fair value hierarchy as well as your basis for including the item in that particular level. Tell us if there were any adjustments made for liquidity or any other adjustments made to the fair value of these positions. If so, tell us how you consider whether the adjustment is significant to the overall fair value measurement for purposes of classification in the fair value hierarchy.

Business combinations

Acquisition-related accounting and disclosure requirements can be complex, and can vary based on the nature of the transaction and the nature of the assets acquired and liabilities assumed. As companies continue to seek growth opportunities through acquisitions, the SEC staff continues to comment on various acquisition accounting and disclosure items.

ASC 805, *Business Combinations,* requires extensive disclosures to enable users to evaluate the nature and financial effects of a business combination. Companies should carefully consider all of the disclosure guidance in preparing financial statements, both in the period of the acquisition and in subsequent periods.

For companies in the financial services industry, SEC staff comments have focused on both the accounting and disclosure requirements of ASC 805, including:

- Questions about how fair value was determined and the key assumptions used
- The reasons for significant adjustments to the initial determination of fair values and the reasons why such information was not available at an earlier date
- How goodwill was allocated to reporting units and the interplay with the company's operating segments disclosures

Sample comments:

1. Please provide us proposed revised disclosure to be included in future periodic reports that indicates your accounting policy for business combinations. In your disclosure, please specifically indicate: that you apply the acquisition method; how you record assets acquired and liabilities assumed; how you record contingent consideration; how you determine the value of goodwill; and, how you treat acquisition costs.
2. We noted that the Company recorded a measurement period adjustment during the fourth quarter, based on the receipt of new appraisals, to reflect a change in the estimate of the acquisition date fair value of the loans acquired earlier in the year. Please confirm, if true, that the new information obtained in the fourth quarter was directly related to facts and circumstances that existed as of the acquisition date.
3. Please tell us how you calculated the purchase consideration associated with the contingently issuable shares of the common stock. Please also clarify and disclose in future filings how you intend to account for any changes in the fair value of this consideration prior to resolution of the contingency, as well as the revenue targets that must be achieved to trigger the annual issuances of stock. We refer to ASC 805-30-35-1.

Loss contingencies

The SEC staff continues to focus on ensuring that registrants comply with the guidance of ASC 450, *Contingencies*. Some registrants are resistant to providing the required disclosures for fear that they may divulge information that could adversely affect the outcome of litigation. To that end, the SEC staff has indicated that they will accept disclosure of estimated exposure on an aggregated basis, rather than requiring separate disclosure for each individual matter.

GAAP requires companies to record an accrual for a loss contingency when it is probable that a loss has been incurred and the amount of the loss can be reasonably estimated. Even if the criteria for accrual have not been met, disclosure may still be required if the loss is reasonably possible. For loss contingencies that meet the criteria for disclosure, registrants should disclose the nature of the contingency and an estimate of the possible loss or range of loss (or a statement that such estimate cannot be made).

To keep investors apprised of material developments associated with the nature, timing and amount of a loss contingency, such details should generally not be disclosed for the first time in the period in which they are recorded. The SEC staff has frequently evaluated the disclosures in periods prior to the period in which a loss is recorded and commented on the lack of adequate early-warning or foreshadowing disclosures. Such comments often request additional information to understand the triggering event for recording the loss and whether such losses should have been recorded in an earlier period. The SEC staff expects that loss contingency disclosures will be updated regularly, both qualitatively and quantitatively, for developments in the related matters and as more information becomes available.

Sample comments:

1. In future filings, for any contingencies where there is at least a reasonable possibility that a loss or an additional loss may have been incurred, please provide an estimate of the possible loss or range of loss or a statement that such an estimate cannot be made.
2. Although you do not expect the outcome of outstanding legal proceedings to have a material adverse impact on your financial position, the outcome of any such matters could be material to your results of operations or cash flows in a given period. Despite your assertion that it is not presently possible to determine your ultimate exposure to these matters, please tell us if you are able to estimate a loss or a range of losses that are at least reasonably possible, and revise your future filings to provide this disclosure as required by ASC 450-20-50-3 and 50-4.
3. Please tell us and revise future filings, to address whether there is an exposure to loss in excess of the amount accrued and what the reasonably possible loss or additional loss may be.

Impairments

The SEC staff continues to issue comments on registrants' considerations of disclosures surrounding critical accounting estimates related to goodwill, indefinite-lived intangible assets and long-lived asset impairments.

Goodwill and indefinite-lived intangible assets

SEC staff comments during the 2014 comment letter cycle reflected themes similar to 2013. Comments have requested additional details about a company's assessment of qualitative factors used to determine whether it is more likely than not that the fair value of the entity (or the reporting unit) is less than its carrying amount (referred to as step zero). Additionally, details surrounding a company's quantitative impairment tests and the related assumptions used have also been requested. For reporting units whose fair values are not substantially in excess of their carrying amounts ("at risk" reporting units), the SEC staff has asked registrants to disclose:

- The percentage by which the fair value of the reporting unit exceeded its carrying value as of the date of the most recent quantitative analysis
- The amount of goodwill allocated to the reporting unit
- A description of the methods and key assumptions used in the impairment assessment and how they were determined
- A discussion of the degree of uncertainty associated with key assumptions
- A description of potential events and circumstances that could have a negative effect on the reporting unit's fair value

These types of requests are consistent with guidance outlined in the Division of Corporation Finance Financial Reporting Manual Section 9510.3.

The SEC staff has also continued to challenge whether impairment charges were recognized in the appropriate period. In some instances, the SEC staff has requested that registrants provide the current period and historical impairment analyses, accompanied by a comparison of key assumptions underlying each analysis with supporting evidence for changes in those assumptions. Some registrants also received comments from the SEC staff when no impairment charge was recorded during the annual assessment, but other publicly available data indicated the presence of a negative trend that could impact the impairment assessment.

Long-lived assets

The SEC staff comments related to long-lived assets were consistent with the themes presented for goodwill and other indefinite-lived intangible assets. Specifically, the SEC staff scrutinized the timing of when impairment charges were recorded and the sufficiency of disclosures of valuation methodologies. The SEC staff has also requested that registrants provide additional information about the level of uncertainty and sensitivity of key assumptions related to "at risk" assets or asset groups. In some instances, the SEC staff requested details of the impairment analysis and challenged registrants' conclusions relative to how registrants considered economic challenges, operating losses at a specific segment, the impairment of similar assets as a potential trigger event, or how they defined the lowest level of identifiable cash flows used to identify the asset group.

Sample comments:

1. We note your on-going losses in the insurance segment. We also note that the goodwill allocated to this segment is not impaired because you state that the estimated fair value of the insurance reporting unit exceeded its carrying value and that, therefore, step two of the impairment analysis was not performed. Please provide us the following information regarding your analyses for each period presented in your Form 10-K and include any available updated information through the fiscal quarter ended June 30, 20XX:
   - Provide us your complete impairment analysis for each of the periods mentioned above.
   - Provide us a complete narrative of your analyses, including all material assumptions and any change in those assumptions between periods.
   - Provide us pricing information of your common stock and market capitalization for each of the periods mentioned above.

Impairments

- Discuss how this information and any other external indicators were considered in your analyses.

2. We note that you elected to perform a qualitative assessment in your evaluation of goodwill impairment and concluded that performance of the two-step test was not required. Please provide us with additional insight into the positive and negative qualitative factors that you considered in concluding that this qualitative analysis was sufficient for each of your reporting units with specific attention to your Insurance reporting unit given the continued net losses generated by the business in recent periods. Please also tell us the date that you last performed Step 1 of the goodwill impairment test for your Wealth Management reporting unit and its fair value as a percentage of carrying value as of that date.

3. We note that based on a review of past filings a significant amount of your indefinite-lived intangible assets relate to management contracts that were obtained in the acquisition. Please tell us and consider revising your disclosure in future filings to address whether the merger-related outflows impact your assessment of whether the values of the management contract intangible assets are impaired and whether the indefinite-life classification is still appropriate. In your response, specifically address whether, and if so, how you determined that there is a high likelihood of continued renewal based on historical experience for these acquired management contracts, which we noted is a key factor in the assignment of indefinite lives to such contracts per your disclosure on page xx.

4. You stated in the 10-K for the year ended December 31, 20XX that your reporting unit indicated the carrying value exceeded fair value by 2% in step 1 of your goodwill analysis. In step 2 the implied fair value was greater than the carrying value by $X million. Please tell us why you believed your assumptions in your goodwill analysis were reasonable. For example, tell us the basis for assuming the 40% control premium disclosed.

5. Please tell us each reporting unit for your goodwill impairment test and the respective goodwill balance at December 31, 20XX. For any reporting unit in which the estimated fair value is not substantially in excess of the carrying amount and therefore is at risk of failing step one of the impairment test, please provide proposed revised disclosure to be included in future filings to include the following:
   - Percentage by which fair value exceeded carrying value as of the date of the most recent test;
   - Amount of goodwill allocated to the reporting unit;
   - Description of how the key assumptions in the impairment analysis were determined;
   - Discussion of the degree of uncertainty associated with the key assumptions. The discussion regarding uncertainty should provide specifics to the extent possible (e.g., the valuation model assumes recovery from a business downturn within a defined period of time); and
   - Description of potential events and/or changes in circumstances that could reasonably be expected to negatively affect the key assumptions.

Executive compensation

The SEC staff continues to focus on registrants' executive compensation disclosures in an effort to establish more direct and transparent disclosures to shareholders. Item 402 of Regulation S-K contains extensive disclosure requirements related to executive compensation. The applicability of these disclosures varies based on each registrant's particular facts and circumstances. SEC staff comments in this area focused on enhancing the disclosures of specific aspects of an employee's performance and/or the criteria used to evaluate and determine compensation awards. Where benchmark or market data, including competitor information, is used in the evaluation the data, its use should be specifically disclosed.

Sample comments:

1. In future filings, please describe in greater detail how you determine the cash bonus and long-term incentive awards granted to your named executive officers on an individual basis. While we note the subjective nature of your compensation decisions, your future disclosure should provide enough information for an investor to understand why you awarded specific amounts to each named executive officer, as well as the reasons why award amounts may have differed significantly among named executive officers.
2. We note your disclosure illustrated that the total compensation targets "generally fall near the median compensation for peers..." Please clarify how you establish and approve the total compensation targets for your named executive officers.
3. We note that individual compensation levels are determined on a discretionary basis. Please expand your disclosure to describe the factors the Compensation Committee considered awarding the revenue productivity, the subsidiary management bonus and the cash bonus. Expand the discussion of the company based goals and individual performance goals to explain which bonuses these goals were designed to affect. Additionally, discuss the level of achievement of these goals and how these achievements impacted the bonuses awarded.

Pay Ratio Disclosure

The SEC has proposed a new rule, as required under the Dodd-Frank Act, that would require public companies to disclose the median annual total compensation of all employees, excluding the chief executive officer; the annual total compensation of the CEO; and the ratio of the two figures. The proposed rule does not require a specific methodology for determining the median employee, but rather allows for flexibility. The selection of a methodology would be based on a company's circumstances, including the size and structure of the company and the way it compensates employees.

The comment period closed in December 2013 and the SEC is currently moving toward a final rule. Although there is no definitive timetable as to when the final rule will be issued, recent comments by the SEC staff indicate that the final rule may yet be issued in 2014. Under the proposed rule, a company would be required to provide the new pay ratio disclosures for its first fiscal year commencing on or after the effective date of the final rule, which if released in 2014, would mean calendar-year registrants would need to calculate the pay ratio based on 2015 compensation.

Internal Control

We have heard various members of the SEC staff signal that internal control over financial reporting (ICFR) is an area of increasing interest. At the 2013 AICPA National Conference on Current SEC and PCAOB Developments Conference, several presenters noted that as part of the comment letter process, the SEC staff is looking for potential indicators of material weaknesses, such as corrections of an error or disclosures regarding material changes in internal controls. Presenters also commented that the SEC staff may be interested in a registrant's conclusions regarding ICFR in instances where they do not agree with a registrant's conclusion on an accounting matter. This focus on ICFR has continued to be mentioned in the months since the conference, and we expect it to be discussed again at the 2014 conference. We have begun to see an increasing volume of comments in this area, with the SEC staff challenging registrant's conclusions regarding the existence and severity of internal control deficiencies. Registrants should continue to carefully evaluate the ICFR and disclosure controls and procedures (DC&P) implications in responses to the SEC staff and the sufficiency of their disclosures, assessments and certifications.

While the SEC staff is likely to question why a restatement did not result in the reporting of a material weakness, we have also seen comments about the existence of material weaknesses when errors are corrected by means of revision of comparative financial statements.

Companies sometimes assess control deficiencies with a priority focus on the Control Activities component of COSO. It is important to evaluate the implications of control deficiencies on all COSO components. The SEC staff has asked for additional information about the company's consideration of specific components within the COSO framework.

The SEC staff has also questioned registrants when there is no explicit conclusion about the effectiveness of DC&P or when management has concluded that ICFR is ineffective but DC&P is effective. Under Rule 13a-15(b) of the Exchange Act, the registrant's management must evaluate the effectiveness of DC&P as of the end of each fiscal quarter. This evaluation includes assessing the controls and other procedures designed to ensure that information required to be disclosed by the registrant in its filings is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Although separately assessed, it is important to remember that there is substantial overlap between the processes considered DC&P and those considered part of IFCR. Nearly all of ICFR falls within the scope of DC&P, whereas there are aspects of DC&P that extend beyond what is considered part of ICFR. As such, it is rare that a material weakness in ICFR would not also result in DC&P being considered ineffective.

Item 308 of Regulation S-K requires registrants to disclose any change in the company's ICFR that has materially affected, or is reasonably likely to materially affect, the registrant's ICFR each quarter. Changes requiring disclosure include changes in internal control made in the process of remediating previously identified material weaknesses, as a result of the integration of significant acquisitions, or due to the implementation of new information technology systems. The SEC staff often looks to information contained in companies' current reports, on their websites, and in other sources to identify potential changes in ICFR. SEC staff comments in this area have focused on the timeliness and completeness of the disclosures in periodic filings.

If a registrant has identified one or more material weaknesses in its internal control over financial reporting, the SEC staff may ask that the registrant include a risk factor (in accordance with Item 503(c) of Regulation S-K) to explain the potential adverse effects resulting from these circumstances and how it could impact the company's financial reporting, results of operations and market value.

Sample comments:

1. It appears that your control structure failed, in either design or execution, to prevent an error from being detected before resulting in a material restatement. It remains unclear whether there were no controls in place that would have prevented such an error, or if the controls in place failed. Please clarify. Further, because the control failure resulted in a material restatement, it is unclear why you believe the related weakness is not material. Please explain.
2. We continue to question your evaluation of the deficiencies in ICFR and your determination that it was not reasonably possible that a material misstatement of your financial statements would not be prevented or detected on a timely basis as a result of certain control deficiencies.

Internal control

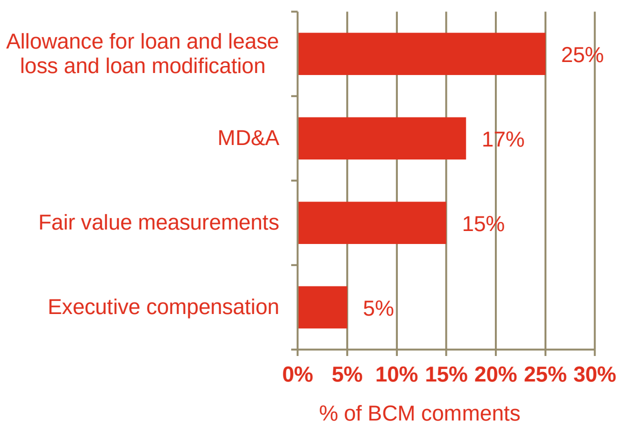
3. Tell us why the severity is limited to the specific, individual process-level errors you describe in your response and how you determined that the reasonably possible potential error for each is limited to the various errors identified. For example, how was it determined that the significant deficiency is limited to only being manifested through an immaterial error in a specific type of revenue transaction.
4. Please describe in greater detail how you considered the numerous deficiencies in evaluating the monitoring and risk assessment components of COSO. Specifically, we continue to question whether one or more deficiencies exist in the risk assessment or monitoring component and whether one or more such unidentified deficiencies represent a material weakness.
5. In light of the ineffectiveness of your internal controls over financial reporting, it is unclear to us how you determined that your disclosure controls and procedures were effective. Please explain.
6. Exchange Act Rule 13a-15(b) or 15d-15(b) requires that management evaluate, with the participation of the principal executive and principal financial officers, the effectiveness of disclosure controls and procedure as of the end of each fiscal quarter. Please revise to disclose that your principal executive and financial officer participated in the evaluation. Item 308(a) of Regulation S-K.
7. We see you assessed your disclosure controls and procedures as of December 31, 20X1 as "not effective" due to the material weakness that resulted in the restatement of your financial statements. Subsequently, you conclude that as of March 31, 20X2, disclosures controls and procedures are effective and state that there have been no changes in internal control over financial reporting in the fiscal quarter ended March 31, 20X2. Please tell us how disclosure controls and procedures are now effective without any changes in internal control over financial reporting. Please also reconcile the statement that there were no changes in internal control over financial reporting in the quarter ended March 31, 20X2 with the disclosure of the remediation efforts to address the material weakness subsequent to year-end in your Form 10-K.
8. In light of the disclosure regarding disclosure controls and procedures in your quarterly reports, please revise this section to provide a risk factor to alert investors to your ineffective controls and procedures. The risk factor should disclose all material risks resulting from these circumstances. In this regard, consider addressing the risk to the Company if it is unable to adequately correct any material weaknesses in its internal controls and procedures. Alternatively, if you have determined that a risk factor is unnecessary, tell us the basis for your conclusion.

Sector highlights

Sector highlights

Banking and capital markets

Most frequent banking and capital market comment letter topics



Allowance for loan and lease losses and loan modifications

The SEC staff continues to focus on the transparency and completeness of disclosures over the allowance for loan and lease losses and modifications. This is an area where significant judgment is required to develop the accounting estimate and continues to be a focus point for investors, regulators and other stakeholders. Comments continue to be focused on changes financial institutions have made to their models and the assumptions used to calculate their allowance. The SEC staff expects disclosures around these changes to be clear and transparent and has requested that registrants quantify the impact of the change.

As the economy continues to stabilize, the focus has shifted slightly to the release of reserves. The SEC staff believes that the investor needs to be able to understand the drivers of changes in the allowance for loan and lease losses ("ALLL") and how they are consistent with the changes to the credit and asset quality indicators. To this end, the SEC staff continues to ask for more robust information, with a focus on the MD&A disclosures regarding economic trends and how they reconcile to the decision to release or increase reserves. Comment letters have also requested additional information about the financial institution's policy of allocating the ALLL to the various pools of assets that are not assessed on an individual basis.

Expressing similar concerns, loan modifications, including troubled debt restructurings ("TDRs"), remains an area of focus for the SEC staff. The staff continues to look for enhanced qualitative and quantitative disclosure around modifications being made and how income accruals are impacted. They have also expressed concern in public statements that they continue to observe a lack of clarity in how banks define payment default and that practices are varied with regard to look back disclosures. In addition, the lack of disclosure around the removal of a TDR designation has been an area of increased comment.

Sample comments:

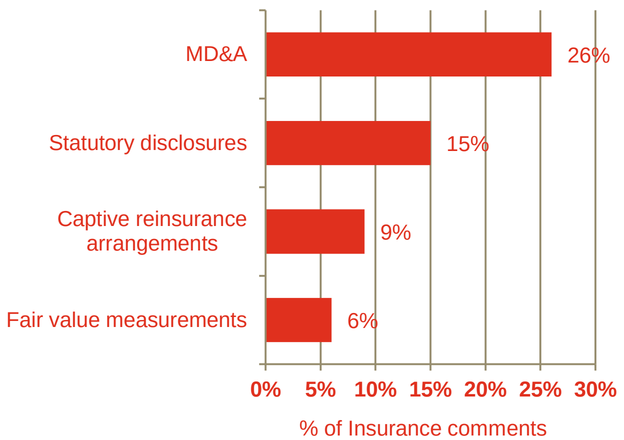
1. Despite the small and decreasing amounts of loan and lease charge-offs and the noticeable improvement in asset quality you have continuously recognized provisions for loan and lease losses over this five year period. Please tell us and revise future filings to provide a more detailed discussion of the changes in your credit quality since your methodology for determining the allowance for loan and lease losses does not appear to capture the apparent improvement in credit quality in your loan portfolio.
2. Please revise the table of non-accruing loans presented in future filings to clearly set forth accruing and non-accruing troubled debt restructurings.
3. Provide a rollforward of the activity in the allowance for loan losses for non-purchase credit impaired loans for each of the periods presented. This will provide the reader with an enhanced understanding of the performance of the non-purchase credit loans given the continued significant growth of these types of loans.
4. You had significant levels of loans classified as delinquent 90 days or more which were accruing/accreting. Please provide us with your analysis that supports the continuing accrual of income on loans that are past due more than 90 days. Please also tell us the fair value of the collateral and the amount of the accretable yield for the non-covered loans that are past due more

than 90 days for which you are continuing to accrue income.

5. Please tell us and revise your future filings to disclose the dollar value and delinquency thresholds for your commercial portfolios (including impaired commercial real estate, construction and land, and large commercial and industrial loans) that are reviewed for impairment on an individual basis.
6. We note that loans individually evaluated for impairment principally include troubled debt restructurings (TDRs). Please address the following for loans that are past due 180 days and individually evaluated for impairment: Tell us whether you believe measuring the incurred losses for loans past due 180 days based on an individual assessment of the most likely outcome, as opposed to a pool basis, is consistent with the guidance in ASC paragraph 310-10-35-21.

Insurance

Most frequent insurance comment letter topics



Statutory disclosures

The SEC staff continues to focus on registrants' statutory and regulatory disclosures as required by ASC 944, *Financial Services-Insurance*, in an effort to establish more direct and transparent disclosures to shareholders. The SEC staff has been consistent with regard to their comments on these disclosures across all types of insurance products. Comments have included requests for information about regulatory requirements of statutory entities and increased disclosure about restrictions on the payment of dividends. The SEC staff also continues to remind registrants that statutory disclosures should not be labelled unaudited.

Sample comments:

1. Disclose the amount of statutory capital and surplus necessary to satisfy regulatory requirements, if significant in relation to actual statutory capital and surplus, as required under ASC 944-505-50-1b. If not significant, please clarify in the disclosure.
2. Disclose the amount of retained earnings or net income that is restricted or free of restrictions for payment of dividends to your stockholders as required by Rule 4-08(e)(1) of Regulation S-X.
3. Regarding your disclosure that statutory amounts for the latest period are unaudited, please represent to us that you will remove this designation in future filings as this information is required by ASC 944-505-50-1a. To the extent you intended to express that the audits of your statutory financial statements were not yet complete at the time you issued your financial statements, we do not believe that the timing of regulatory filings is relevant to disclosures required by GAAP.

Captive Reinsurance Arrangements

Many registrants in the life insurance industry utilize captive reinsurance arrangements to help ease capital strain that can arise under statutory regulations. While the captive reinsurance arrangements are predominately intercompany in nature, the SEC staff has focused on the impact a change in the use of these arrangements may have on the overall business operations of the registrant. Specifically, the SEC staff has asked registrants to disclose the following in MD&A:

- The nature and business purpose of transactions with captives
- Uncertainties associated with the use of captive reinsurance arrangements and the reasonably likely effects on an entity's financial position and results of operations if they discontinued the use of these arrangements
- The extent of reinsurance assumed from third parties
- The amount of assets and other guarantees that secure the captives' obligations

Sample comments:

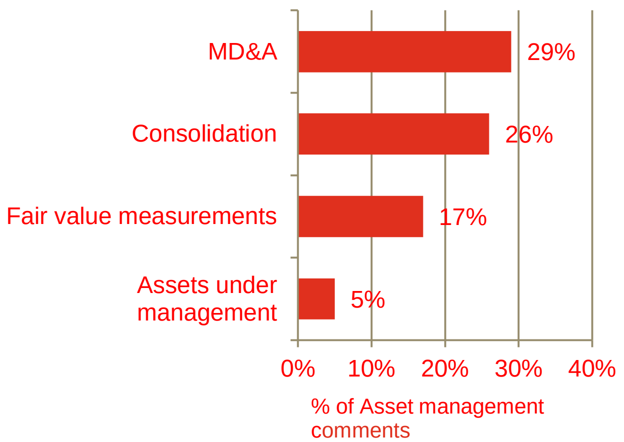
1. Please tell us the nature and business purpose of transaction with captives. Please explain whether and if so, how you reinsure with these captives

including whether, and if so, to what extent, captives assume reinsurance from third parties to whom you ceded policies.

2. Please tell us the amount of captives obligations and the nature and amount of assets, guarantees, letters of credit of promises that secure the captives' obligations.
3. Please tell us the effects in your GAAP consolidated financial statements of transacting with captives directly and, if applicable, indirectly through third parties.

Asset management

Most frequent asset management comment letter topics



Variable Interest Entities (VIE)

Under ASC 810, *Consolidation*, a reporting entity must consolidate any entity in which it has a controlling financial interest. ASC 810 defines a variable interest as investments or other interests that will absorb portions of a VIE's expected losses or receive portions of the entity's expected residual returns. The identification of a variable interest represents one of the more challenging aspects of the VIE model. A VIE is consolidated by the primary beneficiary, which is the party that has the power to direct the entity's most significant economic activities and the obligation to absorb losses or the right to receive benefits that could potentially be significant to the entity. This party could be an equity investor, some other capital provider, or a party with contractual arrangements. Within the asset management sector, VIE's generally include investment companies advised by asset managers and securitization vehicles involving commercial debt obligations and commercial loan obligations.

The VIE model requires that both the primary beneficiary of a VIE and a reporting entity with a variable interest in a VIE disclose key information on their involvement with a variable interest entity. This is in addition to the disclosure requirement that may be required by other accounting topics. Accordingly it is important that companies develop, monitor and maintain systems, processes and internal controls to ensure compliance with these requirements in a timely and complete manner. ASC 810 provides extensive disclosure requirements to enable users to evaluate the nature and financial effects of VIE's.

The SEC staff comments have requested that registrants enhance their disclosures of their accounting policy and the determination of which entities are consolidated and which ones are not. In addition, the SEC staff has requested additional information about registrant's primary beneficiary assessment, focusing on the significant judgments and assumptions, the qualitative factors considered, and the quantitative analysis used, if any, to determine whether the rights to receive benefits could potentially be significant. The SEC staff has also focused on the existence of any control deficiencies relating to a company's consolidation policy and how management determined the severity of the deficiency.

Sample comments:

1. We note your disclosure that many of your funds are considered variable interest entities (VIEs). Given your involvement with a number of entities and the fact that only certain of them are consolidated, please revise your future filings to provide a more specific understanding of the types of entities with which you are involved, why certain entities are considered VIEs vs. voting interest entities, and the key considerations in determining whether such entities should be consolidated. In this regard, we note your accounting policy disclosure discusses your consolidation policy in somewhat general terms but does not provide the reader with a sense of the specific types of entities with which you are involved and how your consolidation determination may vary by entity based on the consolidation model applied.
2. We note your disclosure that for certain asset management funds, you evaluate the rights of the limited partners to determine whether to consolidate the fund in accordance with ASC 810-20-25. Please revise your future filings to disclose, if correct, that first you determine whether these funds are VIEs in accordance with

ASC 810-10-15-14 and you perform the quantitative assessment to determine whether you are the primary beneficiary. For those funds that you determined do not meet the definition of a VIE, disclose that these funds are considered voting interest entities for which you evaluate the rights of the limited partners to determine whether to consolidate the fund.

3. Please provide us with a comprehensive analysis supporting your determination that you are not required to consolidate your CLOs. In this regard, we note that although you have concluded that you have the power (as collateral manager) to direct the activities of the CLO that most significantly impact the entity's economic performance, you do not believe that you have the obligation to absorb losses or the right to receive benefits that would potentially be significant to the VIE. Your disclosure indicates that you performed a quantitative analysis and determined that under various scenarios your fees would not be significant to the CLOs, but it is not clear whether you determined if they could potentially be significant. Furthermore, it is not clear how you considered any seed investments in these CLOs in your analysis.

4. We note that during the third quarter, you deconsolidated a fund and began recognizing your investment in this investment vehicle under the equity method, as your ownership interest declined below 50%. Please provide us with your analysis as to how you determined that you lost control over this investment vehicle and deconsolidation was appropriate, including specific references to the FASB Codification that supports your accounting.

5. We note that you have concluded that no significant deficiencies or material weaknesses (arising from your consolidation policy) existed as of December 31, 20X2 and December 31, 20X1. Tell us whether you identified the existence of any control deficiencies as of either of those dates in relation to consolidation that did not rise to the level of a significant deficiency or material weakness. If so, explain what they are and discuss how you assessed their severity.

As the FASB's consolidation project nears completion, significant changes have been proposed to the principal versus agent model exposed in 2011, making the potential impacts more broad than initially anticipated. The FASB's initial goal was to provide relief to asset managers from consolidating funds they manage; however, the FASB has made decisions that will impact several aspects of the current consolidation guidance and impact all companies. The tentative decisions reached will impact, among other items (1) how to evaluate control for voting entities; (2) when an entity is a variable interest entity (VIE); (3) how to evaluate economics when determining who consolidates a VIE; and (4) when to apply the related party tiebreaker. As a result of the current decisions, both the VIE model and voting model for consolidation are expected to change. The standard is in its final review stages and is expected to be issued in 2015.

Assets under management

The majority of revenues generated by asset management advisors are based on assets under management ("AUM"). Any fluctuations in AUM will generally have a direct impact on revenues and profitability. The AUM disclosures included as part of the results of operations section of MD&A have been a focus of the SEC staff comments for several years. The SEC staff continues to request enhanced disclosures and transparency surrounding the drivers of changes in AUM and how changes to AUM and asset classes impact the registrant's results of operations. They also frequently ask for additional disaggregation of AUM by various distribution channels or investment strategies and how each class of assets under management impacts the results of operations.

Sample comments:

1. We note you present your assets under management (AUM) by channel, asset class, and client domicile and the average mix of active and passive AUM for the last three fiscal years in the tables provided. We also note your discussion states that investment management fees for products offered in the retail distribution channel are generally calculated as a percentage of the daily average asset balances, and for products offered in the institutional and private wealth management distribution channel, fees also vary in relation to the level of client assets managed. Finally, we note that retail products offered outside of the U.S. do not generate a separate distribution fee, as the quoted management fee rate is inclusive of these products. In an effort to provide more transparent disclosures regarding trends in investment management fees, please revise the tables referred to above to include your average AUM by channel, asset class and client domicile.

Sector highlights

2. Please revise your summary of changes in AUM table in your future filings to disaggregate your market and foreign exchange appreciation (depreciation) amounts. In this regard, we also think it would be more useful to provide disaggregated net flows (i.e., inflows and outflows shown separately) in the table, rather than provide this information in narrative format. Provide us with your proposed disclosures.

3. Please provide a reasonably detailed discussion of your roll forward of fee-earning AUM to help readers understand the impact that such performance/activity had on your results of operations and cash flows. Your discussion should include a comprehensive analysis of each of the significant components in your roll forward for each period presented on a consolidated basis as well as by segment, including market appreciation/(depreciation). Please ensure your discussion addresses material contributions or capital commitments, distributions, redemptions and market appreciation/(depreciation), including the identification and quantification of the material underlying sources that drove those activities.

Business Development Companies (BDCs)

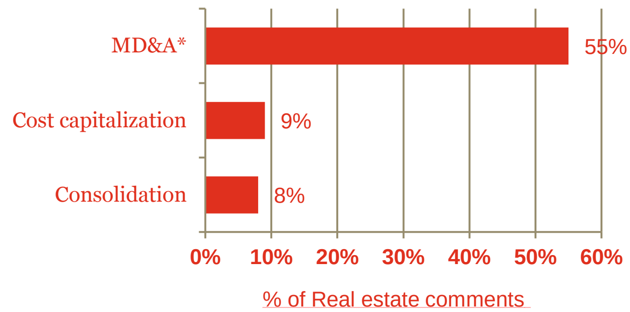
Specific to BDCs, the SEC's Division of Investment Management has issued guidance clarifying the applicability of the rules for presenting separate financial statements and summarized financial information of unconsolidated majority-owned subsidiaries and subsidiaries not consolidated. This guidance has had a significant impact on companies and in some cases, has required BDCs to include the separate audited financial statements of the investee in the Form 10-K or increase disclosures about such investees in the financial statements. The requirement for separate financial statements and/or summarized data with respect to investees is contingent on the significance tests described in Regulation S-X, which determine the financial reporting requirements.

Sample comment:

1. Has the company performed an analysis as to whether the financial statement and disclosure requirements of Rules 3-09 or 4-08(g) of Regulation S-X should be applied? The Staff believes that Rules 3-09 and 4-08(g) of Regulation S-X apply to BDCs and registered investment companies (RICs). Rule 3-09 of Regulation S-X is applicable for a majority owned subsidiary (greater than 50% ownership) which is not consolidated by the Registrant. Rule 4-08(g) of Regulation S-X is applicable for subsidiaries (generally, 25% or more ownership) not consolidated.

Real estate

Most frequent real estate comment letter comments



* Includes "Leasing activities" and "Same property comparison"

Leasing activities

The majority of comments related to MD&A for real estate companies continued to be focused on results of operations and leasing activities. Specifically, the SEC staff has requested enhanced discussion of trends in leasing activities for real estate investment trusts (REITs), including disclosure of average occupancy, average rental rates, comparison of rates of expiring leases vs. current market rents, and costs incurred to obtain new leases.

Sample comment:

1. In future periodic filings please expand your disclosure of your leasing activities for the most recent period, including a discussion of the volume of new or renewed leases, average rents or yields on new and renewed leases, the relationship between new rents and old rents on released space and, where applicable, average tenant improvement costs, leasing commissions and tenant concessions. To the extent you have material lease expirations in the next year, please include trend disclosure regarding the relationship of rents on expiring leases to market rents.

Sector highlights

Cost capitalization

Recent comment letters trends show that cost capitalization continues to be an area of focus. The SEC staff has recently asked for disclosure of total soft costs (e.g., interest expense, real estate taxes, payroll, and other general and administrative expenses) capitalized during each period presented. Additionally, the SEC staff has requested further breakout of soft costs capitalized by development, redevelopment, and other capitalized expenditures within MD&A, along with a narrative discussion of fluctuations from year to year. Further, the SEC staff has also requested that registrants disclose in MD&A the anticipated completion date, budgeted costs and costs incurred to date for significant development projects.

The SEC staff has also requested that registrants define when the capitalization period for development begins and ends in their accounting policy footnote and present cash flows used to acquire real estate separate from development costs within the statement of cash flows.

Sample comments:

1. We note that you capitalize soft costs such as interest, payroll and other G&A expenses. In future filings please disclose the amount of these soft costs capitalized that breaks down total capital expenditures between new development, redevelopment and other capital expenditures. Please provide a narrative discussion for fluctuations from year to year.
2. Please tell us, and disclose as part of your significant accounting policies and critical accounting policies in future filings, the capitalization period relating to the other costs associated with your capital projects, including when the capitalization period begins and ends and how that is determined.
3. In future Exchange Act periodic reports, to the extent you engage in development projects or the redevelopment of your properties, and to the extent such development or redevelopment is material, please provide disclosure regarding your anticipated completion date, costs incurred to date, and budgeted costs.

Same property comparison

The SEC staff continues to provide comments on the registrants' explanation of their results of operations, with a focus on same property performance. The SEC staff's comments in this area have focused on providing greater transparency into which properties are included in a registrants' same property portfolio. Specifically, the staff has requested clear disclosure of when development and redevelopment properties are transferred into and out of the same property portfolio and whether acquisitions/dispositions are included. Additionally, the SEC staff has requested enhanced disclosure of the period over period operating performance of the same property portfolio, including the impact of occupancy changes and rental rate changes.

The SEC staff's comments have also focused on registrants providing enhanced disclosure around same property net operating income (NOI). Specifically, the SEC staff has requested that registrants disclose whether management considers same property NOI a key performance measure, define which properties are included in the same property portfolio, and include a clear definition of how same property NOI is computed and a reconciliation to the most directly comparable GAAP measure.

Sample comments:

1. Please tell us if management evaluates the period to period changes in your same store/property performance. If so, please discuss such evaluation and clearly define the same store pool in future Exchange Act reports, as applicable. In addition, within your discussion of the same store performance, please also include disclosure regarding the relative impact of occupancy and base rent and/or management fee changes.
2. In future Exchange Act periodic reports, in order to illustrate for investors your internal earnings growth, please disclose period to period same store net operating income. Additionally, please disclose how you determine the properties that fall within the "same store" pool, including also a discussion of any properties that were excluded from the pool that were owned in all periods compared, and how you determined which revenues and expenses to include in determining NOI. For example, please explain if you include items such as tenant improvement and leasing commissions, ground rent, lease termination fees and marketing costs.

Sector highlights

Consolidation

Consolidation continues to be an area of focus for the SEC staff. Specifically, the SEC staff has focused on investments in which the registrant owns a greater than 50% interest, but accounts for such investment under the equity method of accounting. Registrants should ensure they clearly disclose the provisions of such governing agreement that led the registrant to determine that consolidation was not necessary. For further details on other consolidation issues regarding VIEs, see the VIE section included in the Asset Management sector discussion.

Sample comment:

1. We note that you have a 75% ownership interest in joint venture A. Please provide us with your analysis of how you determined to not consolidate this joint venture. Please cite the applicable guidance in your response.

About PwC's Financial Services Industry

About PwC's Financial Services Industry Group

PwC serves multinational financial institutions across banking and capital markets, insurance, asset management, hedge funds, private equity, payments, and financial technology. As a result, PwC has the extensive experience needed to advise on the portfolio of business issues that affect the industry, and we apply that knowledge to our clients' individual circumstances. We help address business issues from client impact to product design, and from go-to-market strategy to human capital, across all dimensions of the organization.

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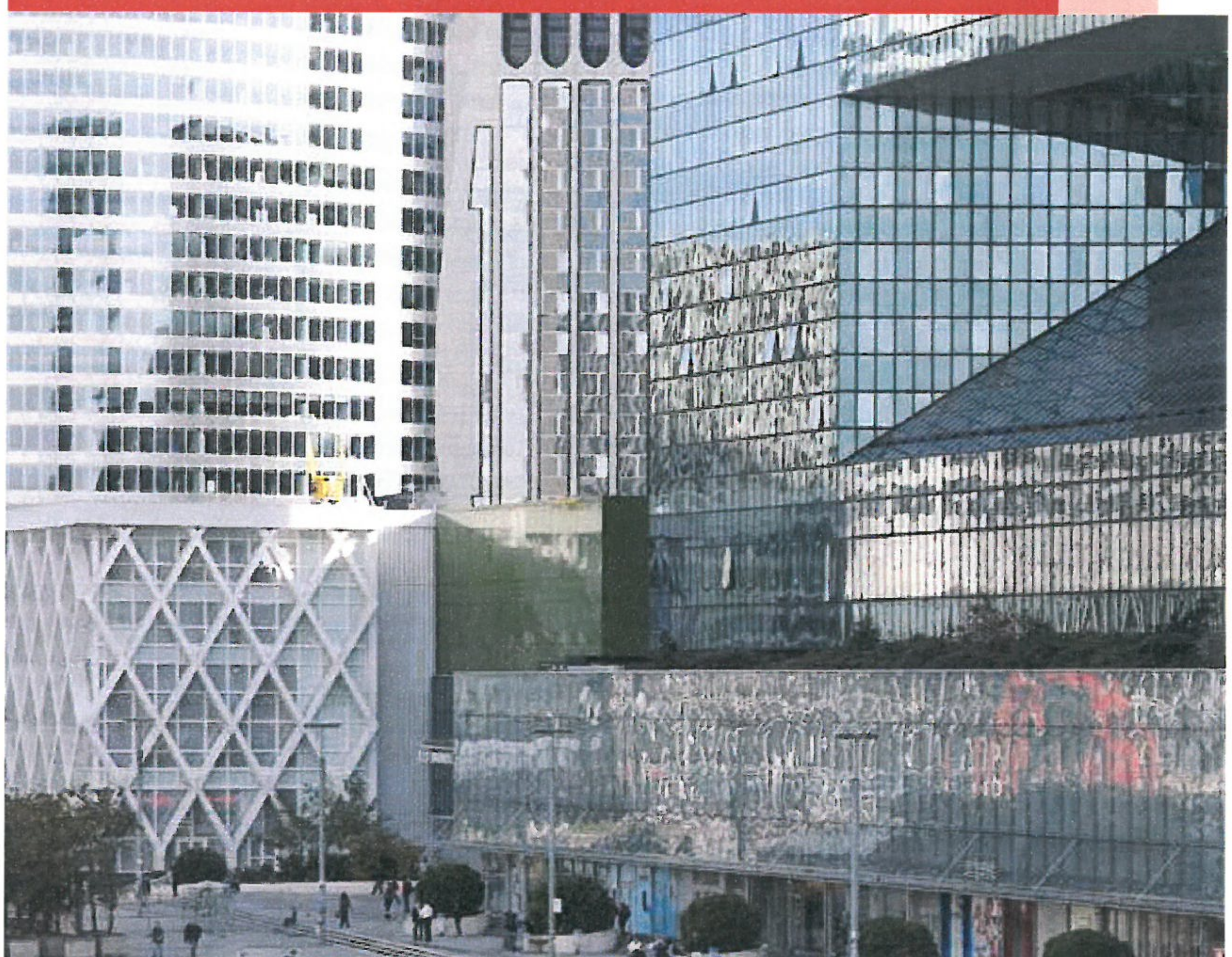

pwc

Dear Clients and Friends,

On behalf of PwC's Real Estate Practice, it is our pleasure to offer another edition of US Real Estate Insights. This publication provides perspectives on the latest market and economic trends, regulatory activities and legislative changes affecting the real estate industry, as well as informed views of the most current developments in operations, business strategy, taxation, compliance and financing.

Consistent with our global vision statement – to build trust and work toward solutions to the world's biggest problems – we continue to bring you thought leadership that is relevant to your industry, while also speaking to your topical needs related to accounting and financial trends and updates.

In this edition of US Real Estate Insights we are especially pleased to provide insightful articles in two areas of increased focus within the real estate investing community – the global search for investment opportunities and the impact of technology and generational preferences on the way commercial real estate is utilized. Following the financial crisis, many investors grew accustomed to identifying distressed investments as opportunities to enhance returns. In "Identifying real property investment opportunities in Spain," David Criado and Matthew Rosenberg discuss how, following a severe economic downturn, a combination of structural reforms and a change in the trends of economic indicators has attracted investors to the risk reward profile of distressed investment opportunities within this Eurozone country. Additionally, in "Where do we grow from here? The impact of millennials on urban real estate," with input from Richard Barkham, CBRE's Global Chief Economist, and Winston Fisher, Partner at Fisher Brothers, Willem VanDooijeweert discusses how landlords and corporations may adjust the way they design their commercial real estate spaces and real estate strategies. These changes are influenced by the generational preferences of Millennials as they become a larger percentage of the workforce.

We also encourage you to read our flagship thought leadership piece, ***Emerging Trends in Real Estate 2015***. As confidence returns to real estate, the industry faces a number of fundamental shifts that will shape its future. To help real estate managers and the investment community better plan, we have looked into the likely changes in the real estate landscape over the coming years and identified the key trends which, we believe, will have profound implications for real estate investment and development.

We hope you will find US Real Estate Insights to be informative and helpful to you in your business.

As always, we encourage you to share your thoughts, opinions and suggestions. For more information or to be added to our distribution list, please feel free to contact the authors of this edition's articles or your local PwC representative.

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Table of contents

Where do we grow from here?
The impact of millennials on urban real estate 1

Identifying real property investment opportunities in Spain 7

Emerging Trends in Real Estate 2015:
Sustaining momentum but taking nothing for granted 11

The resurgence of the mortgage REIT 15

Searching for higher-yielding CRE investments 18

SEC comment letter trends for real estate companies 21

Real estate state and local taxation: Industry update 23

PwC Real Estate Contacts 28

Where do we grow from here? The impact of millennials on urban real estate

by Willem VanDooijeweert

A couple of years ago, I walked into the dining room to bring my son dinner, and as I approached the table, I heard the familiar voice of his friend Marcus shouting; "Hi, Mr. V." Ironically, Marcus was present yet nowhere to be found. My son had strategically placed a tablet across the table and was video-chatting with his friend while they both prepared to scarf down a late meal after soccer practice. The idea of a virtual dinner was mind-boggling to me, but also a lesson in efficiency. They discussed everything from school to soccer, polished off homework, shared files and used their smart phones to organize a soccer-video game party where a group of friends would convene later to play online simultaneously.

Two hours later, everything was done!

Earlier generations, such as my own Generation X, were not instantly connected and a great deal of time was lost travelling back and forth to places like malls, libraries, record stores and each other's houses. Weather often cancelled our plans, and information was so far from our fingertips that school reports took weeks, versus hours to complete. Our idea of sharing was a party telephone line using multiple homes accessible from one rotary phone in the kitchen. If we wanted to take a "selfie," the process would span a month including three trips to the store to buy a roll of film, drop it off for development, then pick up prints, which we would review and pay for expensive duplicates to be snail-mailed to select friends or families. Nothing was instant, except the vitamin-fortified breakfast drink, and the idea of getting everything done in an evening was not fathomable.

To keep up with the changing workforce and rapidly-changing technology, many organizations are beginning to scrutinize where and how things get done through a physical and virtual network of connections to understand the evolution of people and place. When signing a fifteen year lease, organizations are constructing an environment not only to meet the needs of the current workforce but also to be suitable for today's teenagers who will start entering the workforce five years from now. Imagine designing office space catering to a new generation of multi-tasking, hyper-connected employees who rarely use E-mail and will likely:

- Share everything from workspace to automobiles;
- Buy groceries without going to the supermarket;
- Hang out without leaving their residences;
- Train behind computers without going to a classroom; and
- Have face-to-face meetings without shaking hands in person.

To real estate professionals educated under the mantra of "location, location, location," the idea of building infrastructure for employees accustomed to visiting places that do not physically exist presents a paradox challenging companies to rethink the definition of place.

The ability of people to connect with colleagues worldwide from almost anywhere has some real estate experts predicting an Arm'chair'meggedon with employees isolated in their residences collaborating on work products without ever going to the office. The corresponding outward migration of staff from the office to remote locations coupled with companies building more efficient infrastructure will then result in a decreased demand for real estate.

As the workforce demographics change, tenants' demand for traditional office space will change; however, landlords need not panic and liquidate their brick and mortar assets for space in the clouds. Building owners clinging to the old school *Field of Dreams* philosophy of "if you build it they will come," could likely suffer declining returns on their investments. Assets positioned to take advantage of the changing demographics and megatrends, however, may be better positioned to reap the benefits of companies who demand a new type of space. Just as today's teenagers do not go to a record store to buy music, they will not aspire to visit an obsolete office building or building full of offices. The big question for an evolving economy of workers who believe work is a thing and not a place "Where will they go?"

Today's millennials (born between 1980 and 2000) are intelligent, global-minded, environmentally-sensitive, highly-social multitaskers, who have hundreds and sometimes thousands of online friends and followers. These network-minded individuals will work most efficiently in buildings and spaces designed to foster connections and knowledge transfer. As organizations embrace mobility, staff will visit the office for specific needs, challenging end users to consider not only designing multipurpose space encouraging employee engagement, but also with finding locations to which people will want to come.

Modern corporate real estate professionals charged with the mission of finding homes for employees who demand more from their infrastructure can no longer determine space requirements based on simple metrics such as square foot per person. Instead, they use sophisticated occupancy tracking tools to provide data for analytical tools used to determine space utilization rates and who is coming into the office. To maximize employee engagement and reduce turnover, firms may rethink the traditional approach of hiring architects to develop designs based on agreed upon company standards or "space mix." Rather, real estate departments, human resources and information technology functions in tangent with the businesses that they serve may partner with architectural firms to develop intricate programs to determine the ideal "place mix." CBRE Group, a leading global real estate advisory firm, in its article *3 Workspace Trends to Watch for in 2013 (and Beyond)* anticipates that companies will need to consider adding a "Chief of Work Officer" into the C-suite coordinating those three departments with an eye of attracting and retaining top talent.

"Place mix" consists of the places an employee occupies while working across two major dimensions:

1. **Virtual place**: the virtual places employees visit using their technological devices to complete activities such as work, communication, socialization, networking, training and research
2. **Physical place**: the physical spaces employees inhabit such as client sites, home offices, coffee shops, airplanes/airports, green spaces, hotels, or company owned real estate

Creating the ideal "Place Mix" requires examining multiple data sources and working with the business lines to develop employee behavioral profiles, which provide the foundation for programming, design and site selection. These behavioral profiles continue to support the ongoing trend of urbanization, offering savvy landlords the opportunity to provide an experience meeting the needs of the future workforce. To understand why, it may be easier to journey into the heads of the new millennials and consider how the city center experience and creative office space designs will satisfy their needs across the following key attributes:

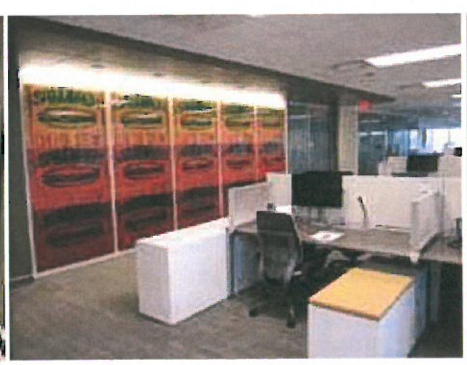
1. Experience craving
2. Hyperconnectivity
3. Global minded

Though millennials represent an increasing share of the future workforce, and thus the focus of this article, it is important to note that many major cities have rebounded even after the dot.com crash. Well before the millennials first entered the workforce, corporations were already moving globally, pushing the envelope on technologies and building the network infrastructure, which supported the growth of the online commerce and communication. It is not uncommon to see long-tenured professionals using laptops, mobile devices and tablets, leveraging a host of applications and software tools designed to help them be more efficient and productive. The gap between millennials and Generation X is not as wide as people think.

Readers are also cautioned that the attributes ascribed to millennials herein, come from a perspective of professionals with experience in financial services, technology sector, post-education and media industries. These industries have experienced dramatic change in how they work ranging from content delivery to leveraging global outsourced solutions. The attributes outlined above, however, are reflective of a generation of young people who are and will be entering all forms of industry, and helping to change the landscape of how goods and services will be delivered in the future. Any industry from manufacturing to healthcare can benefit from understanding how their emerging work force acts and thinks.

Experience craving

Millennials place a high priority on workplace culture and desire a work environment that emphasizes teamwork and a sense of community.[1] Accordingly, the building, the office space and its amenities should synergistically blend into the community to provide a unique experience that gives employees a reason to come into the office and more importantly, enjoy the work. For instance, in PwC's Philadelphia office, full scale wall-graphics and artwork were carefully selected by the architects and the local office design committee to provide a distinctive "Philadelphia" feel and sense of connection to the city and its rich heritage. Designed and built to national standards, the environment provides a mix of collaborative, free address and focus spaces allowing the employees to leverage the different types of settings needed to complete work.




1 PwC's NextGen: A global generational study 2013 Summary and compendium of findings, p 8.

Since millennials are accustomed to sharing, various seat types are reserved through web-based and mobile applications allowing for easy access where and when required. To further enhance the experience, each space is designed to "work harder," or serve multiple purposes. For example, offices are designed as team rooms and are equipped with wireless display monitors, which automatically connect to laptops and mobile devices. The combination of flexible furniture and technology enables staff to utilize the rooms as focus areas, video rooms, overflow seating for seasonal or peak periods, interview rooms, and conference rooms. By providing a flexible environment where a host of activities can be completed in various settings using multiple devices over state-of-the-art wireless platform, the office space attempts to deliver energetic space that maximizes the work experience of the employees.

However, even versatile space brimming with "cool" factor is not enough to draw young professionals. The office location, commuter access, building quality and amenities need to augment the space to create a dynamic environment that millennials crave. Landlords will continually need to rethink the strategies for their buildings and market the overall unique experience of each one to tenants. When asking Winston Fisher (a partner primarily responsible for finance, acquisitions and new development at the Fisher Brothers) about how his role as a landlord has changed over the past few years, he replied, ***"We are no longer just a rent collector. We are now a full service provider from the infrastructure of our buildings to the services we provide our tenants. Each building requires a different mindset."***

Urban landlords can offer space to businesses that enhances the experience of their employees at three levels. Within the building, tenants can leverage special use spaces such as sundry shops, cafeterias, conference rooms, lobby space and retail. At street level, tenants can access a vast array of amenities such as mass transit stops, retail, and restaurants offering everything from fine cuisine to late-night delivery during busy periods. At the city level, employees enjoy access to arts, housing, theater, green spaces, museums and everything urban life has to offer. Echoing the importance of these three levels coming together to create an urban center experience, Fisher claims, "Everything is designed around collaboration. We're green, we're efficient ... from a tenant, landlord and city perspective."

Hyperconnectivity

During one of my son's freshman soccer games, the team's left back made a spectacular tackle that prevented the opposition from scoring a goal. When the cheering subsided and the ball was still in play, his mother yelled that he was awesome, and he calmly responded, "Thanks, now can I have my phone back?"

Most anyone with a teenager at home can tell you, taking a phone away is a travesty of epic proportions. Today's youth are continually connected and their mobile devices, which ping more than the roof of a car in a hail storm, serve as arteries into the heart of their social networks. Similarly, where employees work must foster connectivity in order to engage employees and reduce turnover.

The term "office building" symbolizes a compartmentalized view of space; rather than the more holistic depiction of "network buildings." Since employees are no longer tied to desktop computers linked to local networks and can complete focus work almost anywhere, office space should be designed to foster distinctive connections. Collaborative offices offer multiple spaces allowing for both formal and informal interaction. In addition to conference rooms for formal meetings, the environment must offer spaces where millennials can spontaneously connect to socialize, learn and ideate. Free address spaces such as internet cafes and teaming areas, supplemented by video technology, wall talkers and other devices designed to facilitate interactions are critical for companies whose services depend on creativity of its employees and knowledge transfer.

To increase collaboration, CBRE transitioned its Downtown Los Angeles high-rise office into the new global corporate headquarters, which is the winner of this year's CoreNet *Global Innovator's Award*—a fluid, technologically-advanced, inclusive workplace, and the first office in the world to be WELL Pilot Certified.

Realizing that CBRE's existing space was 51% underutilized, the company was primed to change the game. Addressing the goal of increasing productivity and collaboration, CBRE re-envisioned a completely new and innovative workplace concept for its new global headquarters. Through several months of exploration, research, benchmarking tours, and focus groups, the emerging design objective was to create an innovative, 100% free-address environment connecting two floors in an urban high rise. The result was 48,000 square feet of office space with no assigned offices or work stations, and sixteen different types of spaces to accommodate both individual and collaborative work, as well as informal spaces that encourage interaction between departments. A year after moving in, an employee survey showed that 92 percent of employees report a positive effect on their health and well-being and 83 percent say they feel more productive.

Connectivity does not end at the office. To recruit and retain the best talent, companies should consider locations that develop connections beyond the office walls like cities, which rarely sleep and provide a highly diverse environment to network. Cities with robust infrastructure where people can easily move by foot, bicycle or mass transit systems provide a physical network mirroring the internet, allowing young professionals to move about quickly and connect at locations from favorite happy hour spots to athletic clubs. Universities and other continuing education providers are readily accessible, making urban locations ideal for millennials, who are able to pursue their professional designations and various degrees while building their careers. Further, the high concentrations of industries such as entertainment, banking and financial services in cities such as New York help the millennials meet industry peers, build client relationships, join professional organizations and advance their careers.

Global minded

One of the advantages the millennials have enjoyed through hyperconnectivity is a lifetime of access to global information sources. Growing up with the internet of everything, millennials do not have an outside-looking-in perspective, rather with a computer or portable device they can at any time link to and become a strand on the world wide web. This strand does not simply provide a one way link to a virtual network, but to a lively community of billions of people who share common interests or shared experience. In many cases, such as the gaming community or image/video sharing sites, language is not a barrier allowing people to connect in new ways where the experience becomes the shared mode of communication. Further, at the end of every strand is a unique individual, who not only has access to this content, but the ability to upload and download different types of audio and visual information. Anyone who has ever sent a Snap Chat or viewed an online video can understand that paradigm shift is happening where businesses are controlling less and less of the content on line and the people are empowered to drive change. The media and retail industry has felt this shift hard, and those that have weathered the storm have figured out a way to balance both the physical and virtual connection to provide the best possible experience for their consumers.

Charles Darwin is known for advocating that maximum diversity supports maximum life. The rise of the Internet will likely support growth in urban centers by providing culturally diverse hubs teeming with life where people can physically connect. Richard Barkham, CBRE's Global Chief Economist, notes this parallel and sees, "The world economy is in a period where both physical and virtual infrastructure meet to minimize cost and maximize creativity. Understanding those trends will be crucial for businesses to construct solutions for their people." As the web draws in users, commerce, finance, entertainment, education and tourism have attracted people to major cities for thousands of years and there is no reason to believe that growth will slow down any time soon. Historically, large multinational corporations have a presence in all the major markets and are constantly looking for top notch talent to help expand their businesses. As more millennials work for global firms, they will be exposed to new cuisines, cultures, languages, arts and customs, augmenting their internet networks with personal connections and building social skills. These intangible skills are necessary as their work experience grows and they travel abroad to share best practices and develop integrated global business platforms.

When asked what attracts people to work in a city environment like New York, Fisher responded, "New York has a concentration of different cultures, which breeds collaboration. Different cultures plus collaboration lead to cutting edge innovation, which is what New York is all about. I like to call it 'cross pollination.' People need to gather and collaborate. This is what breeds success." The millennials have grown up on a foundation of sharing and trust, allowing businesses to operate without storefronts, share distribution channels and reach customers in non-trade restricted countries all over the world. As the markets expand and channels widen, the urban centers will continue to see demand from itinerant workers coming in and out of the cities to make connections and expand their businesses.

So where do we grow from here?

As we adapt to a mobile, high-tech workforce, employees will want a mix of infrastructure allowing them to optimize their "place mix." Corporations will likely cut their "physical place" or traditional real estate as much as fifty percent and focus on building office space, which creates an environment of shared spaces serving various purposes allowing employees to work in multiple settings and complete different activities. In turn for shedding physical space, employees will need technologies such as laptops and mobile devices affording them more access, learning, and collaboration in virtual space. Office space should be designed to match space utilization and the behavioral profiles of businesses rather than against outdated benchmarks like square foot per person or staff to workspace ratios. Finally, these offices should foster connections, knowledge transfer, socialization and diversity to create an experience where people will benefit from coming into work.

Though demands for physical space may diminish, the decline will likely be hardest felt in outdated buildings with limited amenities or differentiators providing unique experiences for tenants. As companies reduce their physical footprint, some may opt to pay more for higher quality or repositioned office buildings that create a unique experience the millennials crave. New developments may also benefit as companies move from lower quality buildings with outdated infrastructure to green buildings with more efficient floorplates. In addition to the traditional urban model, many cities are expanding their infrastructure and amenities by revitalizing areas where the arts, parks, retail and residential growth may help offer the lively experience that young professionals crave. As a result, landlords understanding these trends and positioning their buildings to capitalize changing workforce demands may be better positioned to reap the benefits; whereas, those that fail to do so may find it increasingly difficult to attract tenants at premium rates.

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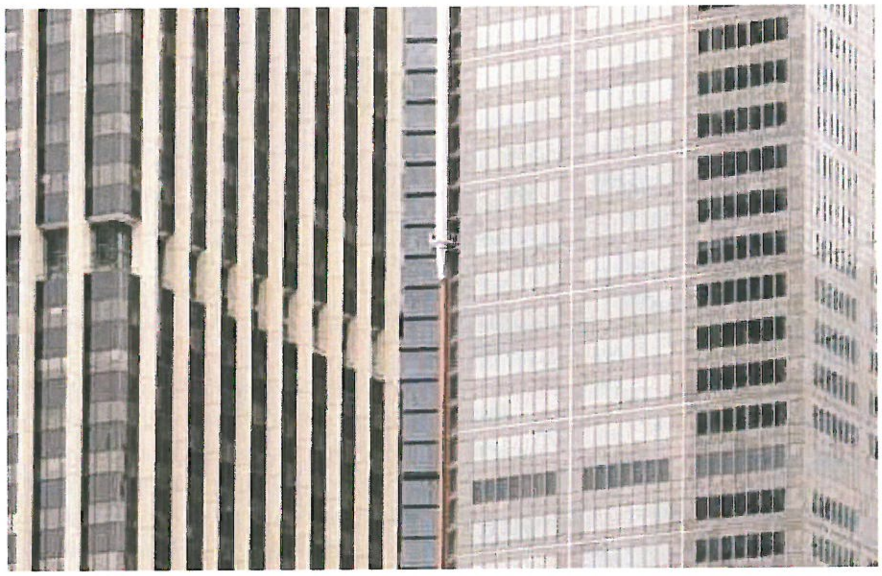
Identifying real property investment opportunities in Spain

by David Criado and Matthew Rosenberg



As value in core domestic markets has become harder to identify, the need and desire of investors to look beyond their home markets to search for investment opportunities has grown. This change in the investing landscape appears to have led many in the real estate investment community to re-evaluate their international investment profile. Of particular focus are those regions which are believed to be nearing the bottom or coming out of their financial crisis. This is because, in many cases, financial crisis' experienced by different economic environments across the globe have led to depressed asset prices. In this regard, since the pace of economic and real estate recoveries has been uneven, some investors are drawn to the potential risk adjusted returns that are presented in certain of these international markets. Many institutional investors have been drawn to Spain, where a real estate bubble has been deflating since 2008.

Background

During the period from 1996 to 2007, the Spanish real estate market endured a significant increase in the price of real estate. According to Global Property Guide, national average home prices increased by 197% in nominal terms, one of Europe's highest home price increases during that period.[1] The growth in home prices has been credited to numerous factors including high demand and the availability of credit.

Increased domestic demand can be credited to high Spanish homeownership rates and changes in the international environment after the introduction of the Euro. According to an International Monetary Fund (IMF) whitepaper, domestic policies, dating back to the 1960s and 1970s, stimulated demand for real estate, such as favorable fiscal treatment of homeownership through tax legislation as well as legal uncertainties and difficulties that owners encountered to evict problem tenants. This is evidenced through a homeownership rate of approximately 80% in Spain.[2] As a result, one could say that homeownership is part of

1 "Spain's Housing Market is Recovering." *Global Property Guide*. N.p., 20 July 2014. Web. 8 Sept 2014.

2 "Technical Note on Housing Prices, Household Debt, and Financial Stability." *Spain: Financial Sector Assessment Program—Technical Note— Housing Prices, Household Debt, and Financial Stability* (2006): n. pag. www.imf.org. International Monetary Fund, May 2006. Web. 8 Sept. 2014.

the Spanish psyche. Moreover, during this period, demand for real estate was driven by the creation of approximately five million jobs during the ten year span, record levels of immigration, and foreign real estate investment since the introduction of the Euro, which resulted in easier cross-country flow of capital.[3]

Further, the availability and cost of credit made homeownership a more attainable goal for many Spaniards. During the period leading up to the bubble, credit institutions were providing mortgages with higher historical loan-to-value (LTV) ratios, at lower interest rates, and for longer terms than had previously been encountered. Typical residential mortgage loans on primary residences were issued at LTVs of 80-100% and at Euribor + 40-85bps, while Euribor rates floated between 200 and 300 bps from 2003 to 2006. Moreover, lending terms extended for as long as 40 years.[1,3] This made investing in homeownership more attainable and attractive for Spaniards. However, the vast majority of these mortgages were at variable rates[2], which meant that a slight change in the Euribor could have a dramatic effect on a borrower's ability to continue to pay debt service.

Inevitably, the financial crisis in the US spread to Europe and Spain's housing market began to crash, along with its economy. From 2008 through 2013, the real estate market suffered price declines of over 35%.[1] Financial institutions suffered terrible losses, the availability of credit froze, real estate construction stopped, unemployment soared above 25%, and GDP fell dramatically. After years without seeing improvements in the economy, in 2011, the government and regulators began to take remedial actions.

Market reforms

The Spanish market adjustments were agreed on between the European Stability Mechanism (ESM), Kingdom of Spain, The Bank of Spain, and Fondo De Reestructuracion Ordenada Bancaria (FROB) and monitored by the European Union, the European Central Bank (ECB) and the International Monetary Fund. Unlike the bailouts of Greece and Ireland, Spain itself was granted a credit facility to recapitalize Spain's banking sector in order to reactivate the financial system and economy. In exchange for the credit facility, the Financial Assistance Facility Agreement required that the financial institutions develop credible restructuring plans that improve the sector's viability, improve burden sharing, and limit distortions of competition in a manner that promotes financial stability, including reducing the amount of participating entities and regional banks' exposure to non-performing and under-performing real estate related assets. The ESM provided a credit facility of up to $100 billion Euros to FROB, which acted as guarantor of the facility and was responsible for dispensing the funds to the respective institutions. Those actions, together with social benefit cuts, public employee salary reductions, tax increases, and social austerity policies, began to bring confidence back to the public.

In August 2012, the Spanish Government established SAREB, or commonly known as the "bad bank," which is beneficially owned by the State, private institutional investors and Spanish banks. SAREB began acquiring bad assets from banks, including non-performing loan portfolios and properties, at a discount, in exchange for bonds secured by the Government of Spain. For example, according to a report released by SAREB in May 2014, SAREB's original portfolio of distressed real estate assets was worth approximately 51 billion Euros, which demonstrated the size and significance of the assets acquired by SAREB.[4] SAREB's strategy is to hold the assets and dispose of them to the public in an organized manner, operating similar to asset management firms. One of the goals of SAREB was to improve the availability of credit in the system by removing these bad assets from banks' balance sheets and stabilizing prices by controlling the supply of real estate assets entering the market.

Further, in 2012, the Spanish government approved structural changes to the Spanish Real Estate

3 Embassy Madrid. *Spain's Booming Housing Market And The Uncertain Future*. Rep. Embassy Madrid, 18 Mar. 2005. Web. 8 Sept. 2014.

4 SAREB, The Key To Cleaning Up Spanish Banks' Balance Sheet. "SAREB." *Press Kit May 2014* (2014): n. pag. *www.sareb.es*. SAREB, May 2014. Web. 9 Sept. 2014.

Investment Trust, (SOCIMI – the Spanish REIT regime). These changes made the investment vehicle more attractive, mainly by reducing the taxation rate from 19% to 0%. This Spanish REIT structure brought a competitive investment vehicle with similar characteristics to REIT structures along Europe and the US and provided a way to increase the amount of capital flowing to the real estate sector. Since the changes, more than 20 Spanish REITs have registered with Spanish tax authorities.

These reforms led to an improving economic environment, as discussed further below.

Current environment

The outlook for the Spanish economy is the best it has been since 2008. Analysts expect that GDP will be positive during 2014. The Wall Street Journal notes that during Q3 2014 the unemployment rate fell to approximately 23.7% after peaking at over 27%. Year to date GDP through Q3 2014 is 1.6%, the highest it has been since before 2008, and Spain's borrowing costs are back to pre-crisis levels. Additionally, housing price declines have started to stabilize, as investors step into the market and the availability of credit improves.

The banking industry has also shown evidence of improvement. Although the real estate industry has not yet seen a substantial increase in available financing, with the consolidation of many smaller and weaker financial institutions, which either entered bankruptcy or merged with larger and more stable institutions, coupled with the reforms discussed above, stronger banks are emerging. According to Bloomberg, after a stress test by the ECB in Q3 2014, Spanish Banks were shown to need no additional capital infusions[5], evidencing the health of the Spanish banking system.

While the outlook is positive and the economic environment appears to be more stable than it has been during the previous six years, current demographics still cause concerns. Unemployment is still at 23.7%, which will continue to impact the consumers' ability to purchase homes. Moreover, the unemployment rate among the Spanish youth is significantly higher than the overall unemployment rate. Economists expect the high youth unemployment rate to slow the absorption of excess supply in the housing market, which resulted from years of over construction during the boom. There are also questions about whether the economic performance of other European countries will affect the recovery in Spain.

Despite conflicting economic indicators, investors have been deploying capital into Spanish real estate assets over the last couple of years. CBRE Spain reported that approximately $5 billion worth of real estate transactions took place during 2013 and investors expect a higher volume of transactions during 2014.[6] According to an October 2014 Cushman and Wakefield report, almost 14 billion euros in transactions have closed during the nine months ended September 2014.[7]

5 Munoz, Macarena. "Spanish Banks Shown Needing No Capital After ECB Exercise." *Bloomberg.com*. Bloomberg, 26 Oct. 2014. Web. 02 Nov. 2014.

Transactions to date

The Spanish real estate market has been attracting distressed investors since the beginning of 2013. According to DealBook, in July 2013, Blackstone bought 1,860 apartments for 125.5 million euros, followed by Goldman Sachs purchasing a block of public housing in Madrid.[6] This was followed by SAREB selling a 51% stake in a portfolio of close to 1,000 homes around Spain in August 2013, valued at approximately 100 million euros, to H.I.G. Capital.[8] Subsequently, in July 2014, Blackstone bought a portfolio of 40,000 mortgage loans for 3.6 billion euros, outbidding other opportunistic investors including Oaktree Capital Management LP and Apollo Global Management.[9]

6 Anderson, Jenny. "Global Investors Looking for Real Estate Bargains Flock to Spain." *DealBook.NYTimes.com*. New York Times, 29 May 2014. Web. 09 Sept. 2014.

7 A Cushman & Wakefield Corporate Finance Publication. "European Real Estate Loan Sales Market." *C&W Corporate Finance Publications* (2014): n. pag. *World Property Journal.com*. Cushman and Wakefield, 1 Oct. 2014. Web. 11 Nov. 2014.

8 White, Sarah. "Spain's Bad Bank Close to Big Land Sale as Disposals Pick up." *Reuters*. Thomson Reuters, 04 Oct. 2013. Web. 02 Nov. 2014.

9 Neumann, Jeannette. "Squatters Welcome Blackstone's Spanish Property Play." *The Wall Street Journal*. Dow Jones & Company, 23 Sept. 2014. Web. 02 Nov. 2014.

More recently, major investment firms such as Apollo Global Management and TPG Capital have been bidding on a contract to market and sell around 50 billion euros worth of property assets held by SAREB, with other bidders including Centerbridge Partners LP and Haya Real Estate SA, owned by Cerberus Capital Management LP.[10]

Moreover, according to the Wall Street Journal, "Spain has seen the most IPOs in Europe in the recent REIT boom, with five listing this year and more to come."[11] Merlin Properties SOCIMI SA raised 1.25 billion euros and expects to have invested 92% of it by the end of the year. Hispania Activos Inmobiliarios also went public during 2014, with investors including Funds managed by George Soros, John Paulson, Moore Capital Management, and Cohen & Steers.[12] While investors appear to be attracted to the risk reward characteristics of the investment opportunities in Spain, despite indications the Spanish economy is improving, there remains a lot of uncertainty that will impact the ultimate success of investments in Spain.

Summary

Since the recent housing crisis in Spain, regulators and the government have enforced structural changes in the economic environment to support the recovery and maturation process of the real estate markets. Following the creation of SAREB, investors from around the world have increasingly pursued deals to gain exposure to Spanish real estate, which has helped support a price floor. Despite uncertainties in Spain's economy, including high unemployment, as real estate prices have stabilized, investors have continued to pursue deals in Spain. Overseas investors, interested in distressed assets coming to market, have provided liquidity and changed the landscape of the real estate sector in Spain. The presence of new debt and equity in the market is a sign that investors are cautiously optimistic that the recovery in Spain may continue forward.

10 Neumann, Jeannette. "Spain's 'Bad Bank' Assets Selloff Goes to Next Round." *The Wall Street Journal.* Dow Jones & Company, 5 Sept. 2014. Web. 02 Nov. 2014.

11 Pirolo, Alessia. "European REITS Are on a Tear." *The Wall Street Journal.* Dow Jones & Company, 9 Sept. 2014. Web. 02 Nov. 2014.

12 Rodriguez, Jose. "Spanish property fund attracts Soros, Paulson ahead of share listing." *Reuters.* Thomson Reuters, 03 Mar. 2014. Web. 19 Nov. 2014.

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Emerging Trends in Real Estate 2015: Sustaining momentum but taking nothing for granted

by Andrew Warren

The following is a summary of the results of the 2015 edition of the Emerging Trends in Real Estate. The findings and opinions reflect those of over 1,400 market participants interviewed and/or surveyed and do not necessarily reflect the views of PwC.

Introduction

Real estate market participants continued to express optimism about 2015 in the current edition of Emerging Trends in Real Estate. Interviewees feel that the fundamental improvement experienced in 2014 may continue during 2015 and that this environment should have an impact on the overall real estate market; influencing both investments and operating decisions in the coming year. Survey respondents overwhelmingly view 2015 as a "profitable" year with 74 percent seeing the prospects for profitability being good or better than the previous year. This is up from the 68 percent of respondents who thought that profitability in 2014 would be good or better. The top 10 trends identified in this year's report, cover a range of themes including: demographics, competition and risk awareness.

Despite a general sense of optimism surrounding the 2015 real estate market, interviewees are taking nothing for granted. Market participants appear to be well aware of a number of risks that could be problematic for the market in 2015. These risks encompass additional geopolitical events and concern about current real estate pricing reaching "bubble" levels not seen since the previous 2007 peak in the market. Accounting for and mitigating these risks may also influence market decisions in 2015.

Trend themes

Demographics are seen as a key driver of a number of 2015's trends. Interviewees see the impact on real estate markets of the maturation of the different demographic groups and the sheer size of these age cohorts as having a significant impact on the economy in general and real estate in particular.

The changing age game – According to the US Census Bureau, the baby boomer and millennial generations are the two largest population cohorts in the US and have been influencing the real estate market for years. So what do interviewee's see that may be different in 2015? Interviewees see that the market may be driven by the fact that a significant number of these two age groups are reaching ages where they will likely be making significant life style choices; for example, where to live, home purchases, job status and the like. The real estate market is contemplating the potential impact on housing and commercial real estate markets.

By 2020, census data suggests that there could be nearly 80 million people who are either millennials age 30 or greater and baby boomers between the ages of 55 to 64. There are a number of questions surrounding the life decisions these groups may make in the next five years, all questions that could influence how different physical locations and real estate sectors will perform in the next five years:

- Will they form households?
- Where will they choose to live?
- Will they remain in the labor force?

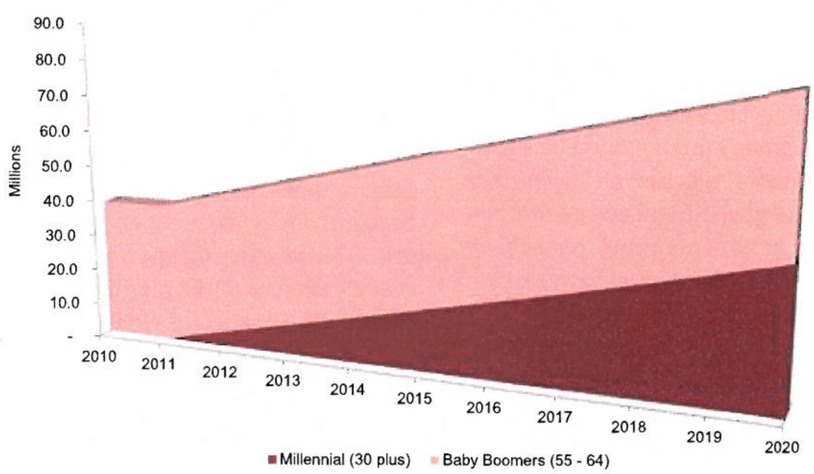
As one interviewee commented, "the biggest risk used to be whether the tenant in a building would renew at the end of their lease term, now you have to be confident that your property will be viable at the end of the term."

Labor markets trending toward tipping point – Relating to the aging of the population is the future size of the US labor force. Interviewees mentioned labor shortages in a number of areas including construction and building maintenance as being problems in 2014, but also raised the issue of labor shortages occurring across the country in the coming years. The concern is not just about shortages of workers, but will those workers have the skills needed to perform the available jobs.

By 2017, the number of baby boomers turning 65 will begin to outpace the number of Generation Z turning 16 (the Bureau of Labor Statistics defines the labor force as non-institutional population ages 16 – 64). The result would be a stabilized decrease in the size of the labor force of approximately 50,000 a year by 2020.

An impending labor shortage likely won't be uniform across the US. Interviewees continue to show interest in those markets that look better positioned to attract a qualified working age population. These markets offer attractive lifestyle amenities, a lower cost of doing business, a lower cost of living or a combination of all three. The concept of jobs chasing people could have a significant impact on individual real estate markets in the near future.

Figure 1 – Population that will be making lifestyle decisions in the next five years



Source: US Census Bureau

Competition

The positive expectations for 2015 are not going unnoticed and interviewees expect increasing competition to drive a number of trends in the future. Competition for investments is expected to rise as the US real estate market remains an attractive destination for both domestic and international capital. In addition, the potential for new sources of capital to enter the market could only serve to increase the competition for attractive investments. Finally, the increases in the development and adoption of technology is seen as having an impact on virtually all sectors of the real estate market.

Love/hate relationship with technology – Interviewees continue to express amazement at the integration of technology into a growing number of aspects in the economy and the influence technology is having on all real estate sectors. The impact of technology includes the continued adoption that is changing how office space is being utilized, continued growth of e-commerce, and the multiple enhancements that technology is making possible to growth in the sharing economy.

It isn't just the adoption of technology that market participants see changing the market, but also the pace of the adoption. New technology is being adopted at an ever faster pace. The combination of integrated devices and a populous that is accepting of technological change is helping to speed how fast technology is changing the industry.

Darwinian market keeps squeeze on companies – Technology and competition aren't only impacting investment decisions, but internal company operations as well. The attractiveness of the real estate market is leading participants to continue to look for ways to get bigger and more efficient. Interviewees are expecting to see continued consolidation in the market from service providers to fund managers. The market's desire to get more efficient and operate at lower costs is a driving force behind this trend as well as service providers looking to expand product offerings or expand geographic footprints.

Risk

The 2015 outlook for the real estate market is good, but that doesn't mean the market is ignoring inherent risks.

Event risk is here to stay – Interviewees feel that the biggest risk to the US economy and subsequently the real estate market would be some type of global "black swan" event. The number of geopolitical events that surfaced in 2014 continue to make the US real estate market look like a favorable location to invest if one of your primary investment objectives is return "of" capital. This is expected to keep competition for market defined trophy assets intense for the foreseeable future.

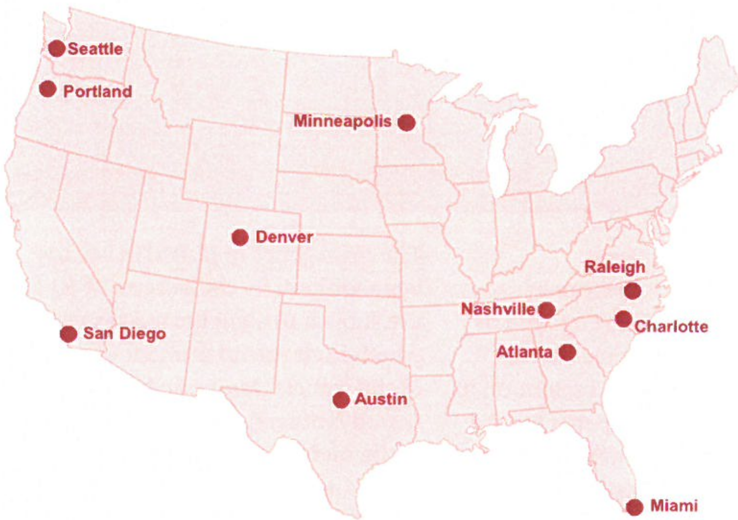
Keeping an eye on the bubble, emerging concerns – While the majority of interviewees don't feel like the overall commercial real estate market is in "bubble" territory, the consensus seems to be that the situation bears watching. Certain product types and markets have seen underlying values bounce back to pre-downturn levels, but values and capital flows to much of the country remain well below previous peak levels.

Market outlook

2015 survey respondents and interviewees expect improvement in most markets for the coming year. Most markets are viewed as benefitting from improved economic growth along with steadily improving fundamentals. The big six markets (New York, Boston, Washington DC, Chicago, Los Angeles and San Francisco) are generally projected to be good performers. The top market trend however, highlights market participants' desire to find opportunities in markets that will benefit from other identified trends.

18-hour city comes of age – Interviewees see 18-hour cities as being strong investment choices in 2015. These cities offer a number of the advantages of the big six markets; urban lifestyle choices, well-educated workforces, diverse employment choices, but they tend to offer these amenities at a more attractive price point.

Figure 2 – Top 18-hour cities



Source: Emerging Trends in Real Estate 2015

These markets are proving to be attractive to millennials entering the workforce so they have the potential to attract skilled labor to their urban core. As the millennials get older they may also find these markets more attractive due to the lower cost of living that offers a better chance of owning a home. 18-hour cities that survey respondents put in the top 10 markets for 2015 are: Austin, Denver, Charlotte, Seattle and Raleigh.

The attractiveness of these markets to potential labor along with what is typically a lower cost of doing business could make these markets attractive to businesses looking to relocate or expand their operations. While these markets are ranked by this year's survey as attractive, they are not without risk. A number of them are not considered supply constrained markets so the potential for oversupply does exist. Despite this risk, the outlook is that they will continue to offer good investment potential over the next several years.

Conclusion

The general consensus of interviewees and survey respondents is that the outlook for commercial real estate in 2015 is positive as market fundamentals continue to improve. The general outlook for a number of markets and property types has improved and the opportunity for investments in more locations and utilizing different strategies should increase. Despite the overall positive outlook, market participants continue to be monitoring a number of demographic, competitive and risk trends to choose where the best opportunities will be in the coming year.

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The resurgence of the mortgage REIT

by Lynn Chin, Dan Sullivan, Chris Merchant and Seth Drucker

Over the past several years, mortgage real estate investment trusts (M-REITs) have re-emerged as popular investment vehicles in the marketplace and attracted attention in the media. The major impetus for the resurgence of M-REITs has been a low interest rate environment. M-REITs can offer investors attractive yields by investing in higher yielding assets and implementing the right leverage.

Changes in the rules related to classification of investment companies have resulted in a greater number of market participants utilizing an M-REIT structure. M-REITs are generally not characterized as an Investment Company. This non-Investment Company characterization is primarily due to the involvement in "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate" (15 U.S.C. § 80a-3(c)(5)(C)). This exemption allows M-REITs more flexibility with the use of leverage and the ability to operate with less rigorous regulatory oversight while meeting the strict provisions set out in the Internal Revenue Code ("IRC") to maintain REIT status.

The resurgence of M-REITs has not been without its challenges. M-REITs are subject to complicated tax rules which limit the investment activities of the vehicle. Maintaining the tax-advantaged status of the M-REIT while managing its operational risks is an ongoing challenge. M-REIT managers must successfully employ a strategy that requires deep understanding of the complex tax, regulatory and US GAAP rules and the interactions between them to create a streamlined operation that ensures ongoing compliance with these rules. The penalties of non-compliance are severe and can significantly impact an M-REIT's tax status and its appeal to investors.

Why are M-REITs attractive to investors?

M-REITs effectively operate as a pass-through entity where the M-REIT manager ("operator") distributes its income to investors which is then taxed as a dividend, thereby eliminating any corporate taxes. M-REITs use committed capital and employ a leverage strategy on their assets, commonly through repo funding to purchase longer-term assets. This strategy in a low interest rate environment can increase revenues and dividend yield to investors.

M-REITs are being used as a funding source for a wider range of assets. M-REITs have generally invested in agency and private label residential mortgage backed securities (MBS), but are now expanding their portfolios into other asset classes such as excess mortgage servicing rights (excess MSRs) and residential whole loans. Utilizing a private letter ruling from the IRS, market participants are interpreting the margin between the loan servicing fee and the cost to service each loan (subject to certain thresholds) as a qualifying asset.[1]

Unlike earlier structures, newer M-REITs are taking advantage of the US housing recovery in loans and securities. M-REITs are accumulating portfolios of loans and, in some cases, monetizing portions of those loans through securitization.

How do the tax rules drive M-REIT activity?

In order to maintain its status and avoid double taxation, M-REITs must follow the IRC's gross income and asset tests and other regulatory requirements. If M-REITs engage in certain impermissible activities, the income generated may be subject to a 100% prohibited transactions tax. For example, a re-securitization transaction that is treated as a tax sale could be deemed dealer activity and considered a prohibited transaction subject to 100% tax. As such, M-REIT operators must ensure that they align their activities with the appropriate tax structures entities to promote tax efficiency.

Most M-REITs utilize efficient tax structures and a robust infrastructure to support these operations. Specialists can assist in evaluating standards and the ongoing tax compliance and reporting calculations incidental to operating any M-REIT. These include certain tax hedge identification requirements, the aforementioned quarterly asset and annual income tests, certain elections with implications to shareholder distributions and M-REIT taxable income.

Operational complexities of new M-REITs strategies

M-REITs investing outside of the agency MBS space commonly have higher data needs. As M-REITs enter into new strategies, including originating and securitizing mortgages, the technology and data required to store and process that data increases significantly. The potential operational hurdles can be quite burdensome and may lead to a re-evaluation of the impact on their existing tax, accounting and operational frameworks.

M-REITs require incremental infrastructure for capturing, monitoring and using data to meet valuation, tax, regulatory and financial reporting needs. The origination and securitization of mortgages for an M-REIT strategy are two primary examples where M-REIT operators are leveraging technology and infrastructure support in order to operate data-intensive businesses while considering all the complexities inherent within the M-REIT.

US GAAP accounting considerations

While REITs are tax driven vehicles, there are numerous US GAAP financial reporting complexities that M-REITs face. As M-REITs expand their activities, their financial statement presentation may incorporate issues historically encountered by originators and securitizers, as opposed to just investors.

In particular, M-REITs are likely to face challenges related to:

- Determining which legal entities will be consolidated into its financial statements based on the M-REIT's legal structure and investment profile;
- The recognition or de-recognition of assets or liabilities from its balance sheet;
- The usage of derivatives for hedging purposes and the associated accounting and valuation for those derivatives;
- The financing strategy and the amount of leverage that a M-REIT employs;

1 PLR 201234006

- Complex accounting issues regarding accounting for investments and certain liabilities, such as embedded derivative analysis, interest income approaches and other-than temporary impairment ("OTTI") evaluation; and
- Extensive disclosure regarding their assets and liabilities, including valuation and accounting policies.

Many M-REITs choose to simplify some accounting complexities by making an irrevocable election, upon acquisition or origination of financial assets or liabilities, to classify and measure instruments at fair value. As a result, all changes in fair value of that instrument will be recorded in net income. This election can cause volatility in earnings, but assists in avoiding the complexity within other areas of US GAAP, such performing embedded derivative analysis.

Summary

In addition to creating a compelling investment strategy, M-REITs are seeking to increase value through focusing on expanding their eligible asset investment profile, implementing appropriate tax strategies for the broader investment profile, and creating an efficient infrastructure to support operations. Rapid improvements in technology are enabling more efficient processing, wider business activities, and more sophisticated analysis. A full understanding of the rules and appropriate planning should be taken for any market participant seeking to enter to the M-REIT marketplace.

The PwC Financial Instruments, Structured Products, and Real Estate (FSR) group helps clients achieve success in the capital markets. FSR's deep product knowledge and industry insight can assist companies wishing to become a leader in the M-REIT marketplace by offering tax, accounting and finance solutions to navigate the changing M-REIT landscape.

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Searching for higher-yielding CRE investments

by Susan Smith

The following is extracted from the Fourth Quarter 2014 issue of the PwC Real Estate Investor Survey, released on December 15, 2014. The findings and opinions reflect those of the investors surveyed and do not necessarily reflect the views of PwC.

As buyers of core assets in major cities face rising prices and declining overall capitalization (cap) rates, a growing number of them are looking for plays outside of core assets and primary markets in search of opportunities to take on greater risk in exchange for higher yield. The aspiration to seek out higher-yielding investments and take on greater risk at this point in the commercial real estate (CRE) cycle reflects investors' confidence in the future performance of both the CRE industry and the US economy. In *Emerging Trends in Real Estate® 2015*, recently published by PwC and ULI, value-added, development, and opportunistic investments are considered to have the best prospects for returns in 2015 – ahead of core-plus and core investments, according *Emerging Trends* respondents.

While certain investors are moving further out on the risk spectrum, it is not yet a uniform strategy, particularly for some conservative institutional players, like pension funds, which continue to prefer the elements of "core" investing – Class-A properties, gateway markets, steady income streams with staggered lease expirations – given the need for adequate returns and conserving the capital entrusted to them as fiduciaries. As it becomes much harder to find core deals that make sense and face the continual challenge of putting accumulating capital to work meeting long-term liabilities, some are "going where they have never gone before," heading for niche property types and secondary markets.

Niche property types, like self storage, medical office, and student housing, continue to grow in popularity among both domestic and international buyers. While many players in these niche sectors were first drawn to them at the peak of the previous cycle as pricing for traditional assets got ahead of market fundamentals, they have stayed because of positive demographic trends and favorable risk-adjusted returns.

The search for higher yield in secondary markets is evident when looking at recent sales data. For the 12 months ended June 2014, investing in secondary markets was up nearly 25.0% and back to nearly 72.0% of the previous peak level, as per Real Capital Analytics. With global capital looking to move outside of its typical comfort zone, which has been core major markets and assets, and more investors willing to go where they see the best opportunities, both niche property sectors and secondary markets could report strong investment activity in 2015.

Tenant improvement (TI) allowances

TI allowances vary for each major property sector, as well as across geographies. Based on our Survey, TIs are rarely provided to tenants in regional malls and power centers, where retail tenants typically receive space as a "vanilla box" and are responsible for their own build-out. In industrial and office properties, TIs are commonplace and vary based on whether the leased area is shell space (raw, new space) or existing, second-generation space.

For the 19 city-specific office markets in the Survey, TI allowances for shell space range up to $125.00 per square foot and average $50.04 per square foot. For second-generation office space, TI allowances range up to $100.00 per square foot and average $29.07 per square foot. For renewals, TIs range up to $100.00 per square foot and average $17.32 per square foot.

For the Survey's warehouse markets, TI allowances for shell space range up to $75.00 per square foot and average $4.21 per square foot. For second-generation space, TI allowances range up to $5.00 per square foot and average $1.29 per square foot. For renewals, TIs range up to $3.00 per square foot and average $0.77 per square foot. For the national warehouse market, up to 20.0% of the leased area is finished office space with an average amount of 8.6%.

Overall cap rates

Fervent competition for a limited pool of quality offerings, still-low interest rates, and an abundance of debt and equity pursuing commercial real estate continue to compress yields for the best properties and the best locations across each major property sector.

This quarter, the aggregate average overall cap rate dips for the Survey's 34 markets (excluding development land) for the eighteenth straight quarter and at 6.52% stands as the lowest aggregate average since 1997.

Cap rate declines are diverse and spread across property sectors and locations with the national regional mall and medical office buildings markets each reporting sizeable quarterly drops along with a few city-specific office markets, like Houston. In contrast, the average overall cap rate holds steady for the national strip shopping center and national CBD office markets, which up until now have mainly been reporting declines.

Overall cap rate compression also continues for the national warehouse market, as well as the Pacific and East North Central region warehouse markets.

CRE sector overviews

Office

The national office market sits solidly in the recovery phase of the real estate cycle as fundamentals improve for both CBD and suburban subsectors. Nationally, additions to supply are expected to trail demand, and the US vacancy rate is forecast to slowly improve as the sector moves into expansion in 2016.

Survey participants describe the buying environment in the national CBD office market as "competitive" and "crowded" as investors vie to capitalize on the office sector's ongoing recovery highlighted by growing absorption levels and limited additions to supply. Over the next 12 months, our Survey results show investors expecting property values in the national CBD office market to increase as much as 15.0% with an average expected value increase of 4.9%.

For the national suburban office market, surveyed investors remain upbeat about its future performance. "Many markets are recovering and providing upside so it's a good time to own suburban office," states one surveyed investor. Suburban office properties for sale on the West Coast, such as in Los Angeles, San Diego, and San Jose, continue to draw significant attention from buyers. Futhermore, Southern and Southwest cities, like Dallas, Phoenix, and Denver, are seeing numerous suburban office assets trade.

Retail

As national retail fundamentals continue to slowly improve, the sector is expected to remain in the recession phase of the real estate cycle before transitioning into recovery by year-end

2015. However, a number of individual markets, like Austin, Houston, and San Antonio, are currently in expansion, buoyed by solid demographic and economic trends.

Despite rising consumer confidence and growing retail sales figures, the still-changing retail landscape continues to suppress demand for physical store space among many retailers. From an investment standpoint, the slow and inconsistent recovery in the retail sector continues to favor high-quality regional mall assets, well-located grocery-anchored shopping centers, and well-leased power centers.

Within the retail sector, most surveyed investors foresee positive trends for the US neighborhood and community shopping center sector. While such expectations open up opportunities for both buyers and sellers, most respondents in *Emerging Trends in Real Estate* give this property category a much higher buy than sell recommendation.

Industrial

Steady demand for industrial space is driving new supply in this sector with new additions to supply in 2014 expected to reach the highest level seen since 2008. Fortunately, tenant demand is expected to outpace supply, keeping the national industrial sector solidly in the recovery phase of the real estate cycle through 2017.

Warehouse industrial ranks as the top pick among investors with regard to investment prospects in the year ahead, as per *Emerging Trends in Real Estate*. Specifically, it scored a 3.72 on a scale of 1 (abysmal) to 5 (excellent), just above CBD office buildings with a score of 3.57 and limited-service hotels with a score of 3.52.

For the flex/R&D segment, certain investors suspect that 2015 could be a good year as rising occupancy levels in suburban office locations spillover into flex/R&D properties, resulting in higher tenant demand, rental rates, and property values. Looking ahead, future rent growth is expected as several surveyed investors are using rent spikes in their cash flow analyses.

Apartment

The national multifamily market remains in the expansion phase of the real estate cycle through the end of 2014, but will likely shift into the contraction phase in 2015 as new apartment supply outpaces demand in many metros, limiting rent growth opportunities during the initial lease-up periods. Major metros currently at the peak of the expansion phase include Charlotte, Chicago, Dallas, Denver, Houston, and Seattle. In 2015 through 2017, the apartment sectors within many cities will move into the contraction phase of the cycle as they work to absorb new construction.

Despite the characterization by certain investors of a "too pricey" and "crowded" apartment market, this asset class placed second again this year for overall investment prospects in *Emerging Trends in Real Estate*, scoring a 3.48 on a scale of 1 (abysmal) to 5 (excellent), compared to a score of 3.61 for the industrial/distribution market.

Along with vigorous sales velocity, this market's average overall cap rate dropped to its lowest point in the Survey since its debut in mid-1990. As shown in Table 29, the average overall cap rate drops 15 basis points this quarter to 5.36%. "Cap rates have compressed in both value-added and core deals," remarks a surveyed investor. In the next six months as the supply and demand dynamics shift due to increases in new development, surveyed investors foresee overall cap rates holding steady in this market.

More information on the PwC Real Estate Investor Survey™ can be found at www.pwc.com/us/realestatesurvey or by calling 1-800-654-3387.

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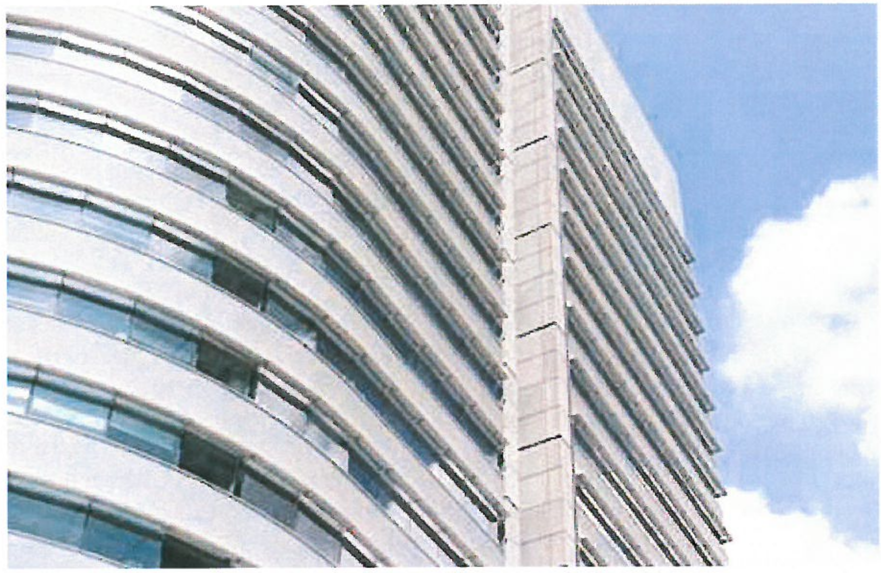
SEC comment letter trends for real estate companies

by Paul Kolodziej



The Securities and Exchange Commission ("SEC") continues to emphasize the importance of providing meaningful and transparent information to investors and recently highlighted this during the 2014 AICPA National Conference on Current SEC and PCAOB Developments. Understanding the SEC Staff's recent areas of focus is an important aspect to consider as part of the upcoming year-end reporting process. To help registrants gain insight into the SEC staff's current areas of focus, PwC analyzed comment letters issued to real estate companies during the last year to identify trends. The trends identified are somewhat consistent with those in other industries, including management's discussion and analysis and results of operations disclosures being the most prevalent.

The four areas that received the most comments for real estate companies were leasing activities, same property comparison, cost capitalization, and consolidation. Below is further detail on the SEC comment letters received over each of these areas.

Leasing activities

The most frequent area of comment by the SEC was over management's discussion and analysis, with leasing activities being a primary focus. Specifically, the SEC staff has requested enhanced discussion of trends in leasing activities for real estate investment trusts (REITs), including disclosure of average occupancy, average rental rates, comparison of rates of expiring leases vs. current market rents, and costs incurred to obtain new leases.

Same property comparison

The SEC staff continues to provide comments on the registrants' explanation of their results of operations, with a focus on same property performance. The SEC staff's comments in this area have focused on providing greater transparency into which properties are included in a registrants' same property portfolio. Specifically, the staff has requested clear disclosure of when development and redevelopment properties are transferred into and out of the same property portfolio and whether acquisitions/dispositions are included. Additionally, the SEC staff has requested enhanced disclosure of the period over period operating performance of the same property portfolio, including the impact of occupancy changes and rental rate changes.

The SEC staff's comments have also focused on registrants providing enhanced disclosure around same property net operating income (NOI). Specifically, the SEC staff has requested that registrants disclose whether management considers same property NOI a key performance measure, define which properties are included in the same property portfolio, include a clear definition of how same property NOI is computed and a reconciliation to the most directly comparable GAAP measure.

Cost capitalization

Recent comment letter trends show that cost capitalization continues to be an area of focus. The SEC staff has asked for disclosure of total soft costs (e.g., interest expense, real estate taxes, payroll, and other general and administrative expenses) capitalized during each period presented. Additionally, the SEC staff has requested further breakout of soft costs capitalized by development, redevelopment, and other capitalized expenditures within MD&A, along with a narrative discussion of fluctuations from year to year. Further, the SEC staff has also requested that registrants disclose in MD&A the anticipated completion date, budgeted costs and costs incurred to date for significant development projects.

The SEC staff has also requested that registrants define when the capitalization period for development begins and ends in their accounting policy footnote and present cash flows used to acquire real estate separate from development costs within the statement of cash flows.

Consolidation

Consolidation continues to be an area of focus for the SEC staff. The SEC staff comments have requested that registrants enhance their disclosures of their accounting policy and the determination of which entities are consolidated and which ones are not. Specifically, the SEC staff has focused on investments in which the registrant owns a greater than 50% interest, but accounts for such investment under the equity method of accounting. Registrants should ensure they clearly disclose the provisions of such governing agreement that led the registrant to determine that consolidation was not necessary.

In addition, the SEC staff has requested additional information about registrant's primary beneficiary assessment, focusing on the significant judgments and assumptions, the qualitative factors considered, and the quantitative analysis used, if any, to determine whether the rights to receive benefits could potentially be significant. The SEC staff has also focused on the existence of any control deficiencies relating to a company's consolidation policy and how management determined the severity of the deficiency.

Conclusion

The uncertainties in the current economic and regulatory environment make the preparation of high-quality reports increasingly important and challenging. The SEC Staff continues to emphasize the importance of providing information to investors that is reliable, meaningful and transparent, particularly in areas that involve significant judgement. With a better understanding of the SEC staff's latest areas of focus, companies will be able to better produce high-quality annual reports for investors and other stakeholders.

For further details on SEC Comment Letter Trends for Real Estate Companies see the Stay informed, 2014 SEC comment letter trends, Financial Services publication at the link below.

http://www.pwc.com/us/en/cfodirect/publications/sec-comment-letter-trends/financial-services.jhtml

For further details on the 2014 AICPA National Conference on Current SEC and PCAOB Developments see the In depth linked below.

http://www.pwc.com/en_US/us/cfodirect/assets/pdf/in-depth/us2014-09-aicpa-conference.pdf

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Real estate state and local taxation: Industry update

by Sean R. Kanousis, Colin M. Coogan and Adam F. Robbins

New York State Tax Reform

On March 31, 2014, New York State enacted legislation that overhauled the state's corporate tax regime as well as makes other significant tax changes. This new legislation is effective for tax years beginning on or after January 1, 2015. In particular, this new legislation replaces the state's existing combined reporting provisions which required the existence of substantial intercorporate transactions between related corporations with a waters-edge unitary combined reporting system.[1]

This new legislation will require two or more corporations engaged in a unitary business to file a combined report when at least one of the following requirements is met: (1) the taxpayer owns or controls either directly or indirectly more than 50 percent of the voting power of the capital stock of another corporation; (2) one or more corporations own or control more than 50 percent of the voting power of the capital stock of the taxpayer either directly or indirectly; or (3) more than 50 percent of the voting power of the capital stock of the taxpayer and such other corporations is owned or controlled directly or indirectly by the same interests.[2] Further, an alien corporation is now required to be included in a combined report if it satisfies these general combined filing requirements unless it is not classified as a "domestic corporation" pursuant to IRC section 7701 and it has no effectively connected income with the United States as determined under IRC section 882.[3]

The definition of a captive real estate investment trust ("REIT") has remained unchanged in the updated New York State Tax Law.[4] Non-captive REITs are now statutorily exempt from combined reporting under the new combined filing regime.[5] On the other hand, captive REITs are

1 NY Tax Law § 211(4)(a).

2 NY Tax Law § 210-C(2)(a).

3 NY Tax Law § 210-C(2)(b)(iii); NY Tax Law § 210-C(2)(c)(iv).

4 NY Tax Law § 2(9).

5 NY Tax Law § 210-C(2)(c)(ii).

6 NY Tax Law § 210-C(2)(a); NY Tax Law § 210-C(2)(c)(ii).

still subject to combined reporting requirements.[6] The new combined filing regime simply requires captive REITs to be included in a combined report with any corporation when the aforementioned updated combined filing standards are met.[7] Accordingly captive REITs should take care to understand the impact of the tax reform on their New York state filings. Captive REIT's that previously filed separately because they did not engage in a substantial intercorporate transaction with a related corporation should analyze their relationships with any taxable REIT subsidiaries or other related corporations to determine whether a combined report is now required.

Whenever a captive REIT is included in a combined report, the updated New York State Tax Code disallows the deduction for any dividends paid to any members of their affiliated group.[8] Business income, including income resulting from the disallowance of the deduction for dividends paid, will be taxed at the general business taxpayer rate of 7.1 percent in 2015 and then 6.5 percent in all subsequent tax years.[9] In addition, unlike non-captive REITs, the capital attributable to the captive REIT will still be included in the capital tax base for the combined group, thus resulting in the captive REIT effectively being subject to the capital tax if the tax calculated using the capital base for the combined group is greater than tax calculated using either the business income base or the fixed dollar minimum base.[10] It must be noted that the effects of this will be mitigated by the fact that the capital tax rate will fall each year during the six-year phased out period beginning on January 1, 2016.[11]

Tennessee Disregarded Entity Clarification

In June 2014, the Tennessee Department of Revenue issued Notice 14-12 reversing its prior stance on the taxation of federally disregarded single member limited liability companies ("SMLLCs") that are wholly owned by REITs.[12] In Tennessee, an entity that is disregarded for federal tax purposes can still be treated as a regarded entity with a separate filing obligation.[13] A SMLLC is only disregarded for Tennessee franchise and excise tax purposes if: (1) it is a disregarded entity for federal tax purposes; and (2) its sole owner is treated as a corporation for federal tax purposes.[14] Despite this rule, the Tennessee Department of Revenue previously had consistently taken the position that a SMLLC owned by a REIT could never be disregarded for Tennessee tax purposes regardless of whether the REIT was treated as a corporation for federal tax purposes.[15] This resulted in SMLLCs wholly owned by REITs being treated as separate taxpayers for Tennessee franchise and excise (income) tax purposes and potentially subjecting them to an income tax liability.[16]

While Tennessee considered the SMLLC of a REIT a separate taxpayer for Tennessee franchise and excise purposes, it was previously unclear whether the SMLLC could benefit from the deduction for dividends paid entitled to its REIT member pursuant to section 857 of the Internal Revenue Code ("dividends paid deduction").[17] Ruling 13-22 states that the federal taxable income of an entity treated as a disregarded entity for federal tax purposes but regarded as a separate taxpayer in Tennessee would be determined on a pro forma basis as if the disregarded entity had filed as a regarded corporation for federal income tax purposes.[18] Tennessee has held that since disregarded entities do not qualify as REITs for federal income tax purposes, such entities must calculate federal taxable income on a pro forma basis without utilizing the dividends paid deduction.[19] This calculation can result in federally disregarded entities having taxable

7 NY Tax Law § 210-C(2)(b)(i).

8 NY Tax Law § 210-C(4)(f)(i).

9 NY Tax Law § 210(1)(a).

10 NY Tax Las § 210-C(1)(ii).

11 NY Tax Law § 210(1)(b).

12, 20 Tennessee Notice 14-12 (June 2014).

13 Tenn. Code Ann. § 67-4-2106(c).

14, 16 Id.

15, 18 Tennessee Revenue Ruling 13-22 (Dec. 2013).

17 IRC § 857(a).

19 IRC § 856(a).

income in Tennessee even though that income is not taxed at the federal level thanks to that income having been recognized at the REIT level and then offset by the dividends paid deduction.

Notice 14-12 reversed Tennessee's stance as it relates to a federally disregarded SMLLCs whose single member is a REIT.[20] Now a SMLLC that is wholly owned by a REIT has no separate Tennessee filing requirement and instead the REIT will file a Tennessee franchise and excise tax return. While a SMLLC filing on a separate company basis may have previously reported an excise tax liability, a REIT should be able to benefit from the dividends paid deduction when calculating its excise tax so long as the REIT is itself not a "captive REIT" for Tennessee purposes.

However, notice 14-12 only extends Tennessee disregarded entity status to SMLLCs owned by REITs.[21] Revenue Ruling 13-22 explicitly states that other non-SMLLC DREs owned by REITs such as qualified REIT subsidiaries and federally disregarded limited partnerships will still be treated as regarded entities and thus separate taxpayers for Tennessee franchise and excise tax purposes.[22] Notice 14-12 has not changed this stance as only the filing position of a federally disregarded SMLLC was addressed in this notice.[23] Given the recent guidance provided by the state, care should be taken to analyze the impact on the Tennessee tax filing requirements of REIT structures owning real property in the state.

Pennsylvania Local Business Privilege Tax

Localities in Pennsylvania (other than Philadelphia) are delegated the authority to impose a tax on the "privilege of doing business" in their respective jurisdictions under the Local Tax Enabling Act ("LTEA").[24] While the LTEA lists a broad base of activities and transactions that can be subjected to this privilege tax, taxation of a number of activities including "leases or lease transactions" is specifically prohibited.[25] Despite this prohibition, the Township of Lower Merion, among other localities, had imposed business privilege taxes "at the rate of 1.5 mills" (0.15 percent) on the gross receipts of lessors who lease real property within the township.[26]

Three taxpayers filed suit in the Court of Common Pleas of Montgomery County arguing that the local business privilege tax imposed by the Township of Lower Merion could not be applied to gross receipts received from lease transactions because the LTEA specifically prohibited it.[27] On September 24, 2013, the Court of Common Pleas ruled against the taxpayers stating that the prohibition on imposing a business privilege tax on "leases or lease transactions" found in the LTEA does not prohibit imposing a business privilege tax to the gross receipts from lease transactions.[28]

The taxpayers appealed the decision of the Court of Common Pleas to the Commonwealth Court of Pennsylvania.[29] The taxpayers cited the LTEA's exemption for lease transactions when arguing that their rental receipts should be exempt from the business privilege tax.[30] On the other hand, the Township of Lower Merion argued that renting real estate constitutes a "business, trade, occupation or profession in the Township" per the Township's Municipal code and thus is subject to the local business privilege tax.[31] On September 19, 2014, the Commonwealth Court reversed the lower court's decision holding that the LTEA prohibits subjecting lease transactions to the local business privilege taxes authorized by that statute.[32] The Court stated that the exemption against taxing lease transactions prohibits both direct and indirect taxes from being imposed on such lease transactions.[33]

21, 28-33 Id.

22 Tennessee Revenue Ruling 13-22 (Dec. 2013).

23 Tenn. Code Ann. § 67-4-2106(c).

24 Pa. Stat. Ann. § 6924.301.1(a.1).

25 Pa. Stat. Ann. § 6924.301.1(f).

26 Township of Lower Merion, Pennsylvania, Municipal Code § 138-42.

27 *Fish v. Twp. of Lower Merion*, No. 1940 C.D. 2013, (Pa. Commw. Ct. 2014).

This decision prevents the future taxation of gross receipts of lessors who lease real property within local jurisdictions in Pennsylvania (other than Philadelphia). This ruling also allows taxpayer to claim refunds for taxes paid on rental real estate receipts for any returns still within the statute of limitations. It must be noted that the Township of Lower Merion could still appeal this decision to the Pennsylvania Supreme Court.

California Proposition 13 Update

In 1978, voters in California adopted Proposition 13 in order to limit property reassessment and taxation. Following this constitutional amendment, yearly reassessment of any property going forward could not exceed 2 percent unless a "change in ownership" occurs. When a change in ownership occurs with regards to a property, the state can fully reassess that property. Generally a transfer of the ownership interest in a legal entity does not constitute a change in ownership with regards to the real property owned by that legal entity.[34] However, a change in ownership in the underlying real property of an entity does occur when any one person or entity obtains control of more than 50 percent of the ownership interest in that entity.[35]

In 2006, 100 percent of the ownership interest of Ocean Avenue LLC ("Ocean") was transferred.[36] Ocean owned a hotel located in California. Michael Dell indirectly acquired approximately 48 percent of the ownership interest of Ocean meanwhile his wife acquired 49 percent of Ocean through a separate property trust.[37] The Los Angeles County Assessor deemed a change in ownership to have occurred and reassessed the hotel despite no one person having acquired a greater than 50 percent interest. Upon appeal by Ocean, the Los Angeles County Assessment Appeals Board upheld the reassessment citing several arguments the most notable of which was that reassessment was appropriate because all of the beneficial ownership rights in the hotel had been transferred.[38] Ocean subsequently filed a refund claim arguing that the hotel could not be reassessed because there was no change in ownership in the ownership interest of Ocean for Proposition 13 purposes.[39] The trial court entered judgment in favor of Ocean.[40]

On appeal, the California Court of Appeals upheld the lower court's ruling on June 24, 2014.[41] The Court rejected the Los Angeles Assessor's argument that substance should take precedence over form.[42] The Court found that the plain statutory language defining a change in ownership was unambiguous and when applied to these facts no change in ownership had occurred with regards to the hotel.[43] Thus, the Los Angeles Assessor was barred from reassessing the hotel. This ruling affirms that prior tax positions taken based on the plain statutory language defining a change in ownership are valid. Further, this ruling indicates that county assessors will follow this interpretation of what constitutes a change in ownership going forward.

California Documentary Transfer Tax Update

In California, documentary transfer taxes have generally been imposed at the local level only when a direct interest in realty is sold.[44] The majority of localities had not previously attempted to impose a documentary transfer tax following a change in ownership for Proposition 13 purposes. Accordingly, the sale or transfer of an entity who indirectly holds real property in the state has not historically been subjected to the documentary transfer tax. However, the Los Angeles County Assessor has been asserting that a documentary transfer tax liability is created under existing law whenever a change in ownership occurs since 2010.[45,46] In

34 Cal Rev. & Tax Code § 64(a).

35 Cal. Rev. & Tax Code § 64(c)(1).

36 *Ocean Avenue LLC v. County of Los Angeles*, B246499.

37-43, 47-48 Id.

44 Cal. Rev. & Tax Code § 11911(a).

45 Los Angeles County Code § 4.60.020.

46 *926 North Ardmore Avenue, LLC v. County of Los Angles*, 178 Cal.Rptr.3d 78 (2014).

one such instance, the Los Angeles County Assessor attempted to collect a documentary transfer tax from 926 North Ardmore LLC ("Ardmore") with regards to a series of transfers of the ownership interests in its sole owner that resulted in an undisputed change in ownership for Proposition 13 purposes.[47] Ardmore paid the documentary transfer tax bill but then filed a claim with the county for a refund of the taxes paid.[48]

After the county rejected this refund claim, Ardmore filed a complaint seeking a tax refund asserting that the Los Angeles County Assessor had an illegal policy of imposing a documentary transfer tax on the transfers of interest in legal entities that directly or indirectly hold real property in the county.[49] The trial court ruled in favor of the county holding that the Los Angeles County Assessor has the authority to impose a documentary transfer tax on the transfer of an interest in a legal entity when it constitutes a change in ownership for Proposition 13 purposes.[50]

On September 22, 2014, the Court of Appeals upheld the lower court's decision stating that whenever a change in ownership occurs for Proposition 13 purposes, it constitutes "realty sold" for California documentary transfer tax purposes thus equating the two terms.[51] While the Court admits that section 11911 of the California Revenue and Tax Code refers to the sale of the real property as the trigger for the documentary transfer tax, it held that the legislative history supports a reading of section 11911 to apply the tax whenever there is a transfer of indirect ownership of real property.[52] As a result of the holding in *926 North Ardmore Avenue, LLC v. County of Los Angles*, all local jurisdictions in California are now authorized to levy a documentary transfer tax whenever there is a change in ownership for Proposition 13 purposes pursuant to their existing documentary transfer tax ordinances. Further, since this holding interprets existing law, the local counties are not precluded from attempting to collect documentary transfer taxes on previous transactions that resulted in a change in ownership for Proposition 13 purposes. However, it must be noted that Ardmore is currently appealing this decision to the California Supreme Court. Further, the California Taxpayers Association has filed a request for depublication, which if granted, would strip the case of any precedential value.

49-50 Id.

51 Id.; Cal. Rev. & Tax Code § 11911(a).

52 *926 North Ardmore Avenue, LLC v. County of Los Angles*, 178 Cal.Rptr.3d 78 (2014).

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SFO Alert (September 25, 2014)

September 25, 2014

PCAOB SEEKS INPUT ON AUDITING ESTIMATES AND FAIR VALUE MEASUREMENTS STAFF CONSULTATION PAPER

On August 19, the Public Company Accounting Oversight Board (PCAOB) issued Staff Consultation Paper *Auditing Estimates and Fair Value Measurements* (Staff Consultation Paper) for public comment. The Staff Consultation Paper solicits stakeholder input on whether the PCAOB should revise existing audit guidance on accounting estimates and fair value measurements. The Staff Consultation Paper cites management's use of specialists and third party pricing services as areas where additional audit requirements could be added. The Staff Consultation Paper could impact NAREIT member companies based on the initial measurement of typical transactions at fair value (*e.g.*, acquisitions of real estate) and subsequent measurement (*e.g.*, fair value measurement of debt and equity securities). If you are interested in participating on a NAREIT Task Force that will evaluate the Staff Consultation Paper and consider whether NAREIT should develop a response, please contact Christopher Drula by October 3. Comments are due to the PCAOB by November 3.

The areas of accounting estimates and fair value measurements are consistently cited in PCAOB inspection reports as significant audit deficiencies. The Staff Consultation Paper seeks input on the following:

- The potential need for changes to the PCAOB's existing auditing standards to better address changes in the financial reporting frameworks related to accounting estimates and fair value measurements;

- Current audit practices that have evolved to address issues relating to auditing accounting estimates and fair value measurements (*e.g.*, the use of centralized pricing desks or groups by accounting firms, and the use of third parties);

- A possible approach to changing existing standards, and the requirements of a potential new standard; and,

- Relevant economic data about potential economic impacts of standard setting in this area, including data to inform the PCAOB's economic analysis associated with standard setting in this area.

The potential new auditing standard that is discussed in the Staff Consultation Paper could be designed to:

- Align with the PCAOB's risk assessments standards;

- Generally retain the approaches to substantive testing in existing auditing guidance, but include requirements that apply to both accounting estimates and fair value measurements;

- Establish more specific audit requirements relating to the use of third parties in developing accounting estimates and fair value measurements; and,

- Create a more comprehensive standard relating to auditing accounting estimates and fair value measurements to promote greater consistency and effectiveness in application.

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SFO Alert (February 13, 2015)

February 13, 2015

SEC AREAS OF FOCUS IN REVIEWING 2014 10-K FILINGS

Through informal conversations with the Staff of the Division of Corporation Finance of the Securities and Exchange Commission (the Staff), NAREIT has identified potential areas of financial reporting that the Staff may focus on in their review of 2014 real estate company (including REITs) 10-K filings. The areas identified in this alert do not impose new disclosure requirements and they are not intended to limit the areas of potential Staff comments. Please remember Staff comments will depend on the facts and circumstances of a particular company.

General Items

Disclosure Effectiveness

The SEC's Disclosure Effectiveness Project is a division-wide initiative that is intended to review the disclosure requirements included in Regulation S-X and Regulation S-K. The SEC is considering ways to modernize disclosures to facilitate timely, material disclosure by registrants and continue to provide decision-useful information to investors. The Staff reminds registrants to consider this initiative as they prepare 10-K disclosures. Key aspects of the disclosure effectiveness initiative include actions that registrants can take today with respect to preparing 2014 Form 10-Ks. They include:

- Reduce repetition;
- Use hyperlinks;

- Use charts if this can convey information more effectively;
- Tailor disclosures to the reporting entity and specific facts and circumstances;
- Eliminate outdated disclosure or disclosure for items that are no longer considered material; and,
- Do not automatically add disclosure when the Staff requests supplemental information.

Staff requests for supplemental information do not automatically need to be disclosed in the document. The Staff encourages registrants to gather the information requested, and then have a dialog with the Staff before revising disclosure.

Non-GAAP Financial Measures

The Staff reminds registrants that non-GAAP financial measures that are included both inside and outside of Form 10-K are subject to Staff review. This would include the earnings release, the transcript of the earnings conference calls, supplemental information that is furnished as exhibits in Form 8-K, company websites and company press releases.

If the non-GAAP financial measure is considered a key performance indicator (KPI), it should be included in the Form 10-K, accompanied by appropriate disclosures required by Item 10(e) of Regulation S-K. If the non-GAAP financial measure is not considered a KPI, but the registrant still has reason to disclose it outside of its filings, it should be presented and reconciled to the most closely related GAAP measure in accordance with Regulation G.

Regardless of whether a non-GAAP financial measure is included within or outside of a filing, it should be clearly labeled. For example, when registrants use NAREIT Funds From Operations (FFO) and Adjusted Funds From Operations (AFFO) as KPIs, they should clearly label such measures, which can be done by reconciling AFFO through NAREIT FFO.

Rule 3-14 Financial Statements

The Staff continues to answer questions regarding the updated interpretative guidance with respect to the application of Rule 3-14 published in the Division of Corporation Finance Reporting Manual and this will continue to be a focus area in 2014. Given the unique sets of circumstances surrounding acquisitions, the Staff encourages registrants to either call the Staff or submit a written question to the Corporation Finance Office of the Chief Accountant in order to determine whether Rule 3-14 Financial Statements are required. If registrants decide to call the Staff directly, they may be asked to submit a formal question that includes all of the facts and circumstances in the fact pattern.

Recent Initial Public Offerings (IPOs)

Registrants that have recently completed REIT conversions and REITs that have recently completed IPOs are reminded that disclosures about property operating data, including disclosures about geographic information, square feet and/or other capacity measures in units, occupancy, rental rate and lease expirations for material property portfolios may continue to be useful information for investors in annual reports.

Registrants operating assets recently appearing in the public securities market (*e.g.*, single family housing) should consider what types of unique operating information would be useful to investors.

Dividends per Share

In previous years, the Staff has provided registrants with comments on whether or not dividends per share information should be included on the face of the annual income statement in accordance with ASC 260, despite the requirement to present dividends per share on the face of the interim income statements under Rule 10-01(b)(2) of Regulation S-X and the annual requirement to disclose dividends per share on the shareholders' equity statement under Rule 3-04 of Regulation S-X. Recognizing these conflicting pieces of literature, the Staff will no longer be commenting in this area.

Areas of Focus related to Equity REITs

MD&A

- Enhance analysis of factors underlying operating results (*e.g.*, reasons behind changes in occupancy or rental rates);
- Robust disclosure of management's known trends and uncertainties;
- Disclosure addressing the relative impact on period-to-period changes of same store portfolio and non-same store portfolio and, within same store portfolio, the relative impact of changes in occupancy and rental rates; and,
- When "same store" metrics are reported, disclosure of how the same store pool is defined (*i.e.*, the basis of including or excluding "stores").

Leasing Activity and Results

- Disclosure summarizing reporting period leasing activity for both new leases and lease renewals, including costs such as tenant improvements and leasing commissions, and quantitative disclosure of rental rate changes (*e.g.*, changes in rent spreads); and,
- When a significant amount of leasable space will expire over the next twelve months, disclosure of material known trends and uncertainties in current market rates on expiring space as compared to rents under current leases.

Areas of Focus related to Mortgage REITs

Fair Value Accounting

Registrants that report assets and/or liabilities at fair value are reminded to review the fair value hierarchy included in ASC 820 *Fair Value Measurements and Disclosures*. The classification of an asset or liability as Level 1, 2, or 3 drives the amount of required disclosures and could also impact loan covenants and/or risk management policies. For example, some loan covenants may limit the amount of financial assets classified as Level 3 within the fair value hierarchy.

Areas of Focus related to Spin-offs

While not directly related to the review of 2014 10-Ks, the Staff indicated a few areas of focus related to spin-offs.

The Staff reminds registrants to file the proper financial statements when executing a spin-off transaction. The following financial statements are typically required:

- Audited opening balance sheet;
- Carve-out financial statements for assets that have a rental history (not necessarily a legal structure prior to the spin-off) or audited schedule of investments for assets without a rental history;
- Rule 3-05 and/or Rule 3-14 financial statements as appropriate (the significance test should be calculated on the carve-out financial statement level, which is typically lower than the pre-spun-off basis);
- Significant tenant financial statements, especially in sale-leaseback transactions (if the spinor/future tenant was a public company, an explicit reference to periodic reports of that company may be sufficient);
- Pro forma financial statements: 1) Ensure that there is disclosure of the assets' basis (typically carryover basis); 2) Discuss the estimation process for significant income statement items; a) Registrants have the option to provide an unaudited financial forecast instead of a pro forma income statement in accordance with Rule 11-03 of Regulation S-X. The financial forecast should comply with the American Institute of Certified Public Accountants (AICPA) Standards for Forecasts and Projections.
- Schedule III disclosure: 1) Rule 12-28 of Regulation S-X requires supplemental information about real estate investments and accumulated depreciation; 2) Registrants may request relief from some of the specific disclosure, for example: a) A registrant may be unable to provide historical information on the initial cost of the real estate or the costs that were subsequently capitalized; or b) There may be a large number of insignificant assets – in this case, aggregation may be appropriate and acceptable.

Given the technical nature of spin-off transactions, registrants are encourages to pre-clear the accounting treatment with the Corporation Finance Office of the Chief Accountant.

CONTACT

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