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*Views on, analysis of and news about US GAAP and SEC reporting  
A Canadian perspective*

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# *US GAAP Today*



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## Summer 2013

Issue 2013-3

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### ***Investment companies redefined***

*New definition of an investment company focuses on fundamental and typical characteristics of investment companies and should not have a major impact on the industry. **P4***

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### ***Shifts in lease accounting***

*Revised exposure draft retains core principles of putting leases on balance sheet with a user friendly P&L approach. **P8***

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## US GAAP Today

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## Common abbreviations

<b>ASC</b>	Accounting Standards Codification
<b>ASU</b>	Accountings Standards Update
<b>COSO</b>	The Committee of Sponsoring Organizations of the Treadway Commission
<b>ED</b>	Exposure Draft or Proposed Accounting Standards Update
<b>EITF</b>	Emerging Issues Task Force of the Financial Accounting Standards Board
<b>FAF</b>	Financial Accounting Foundation
<b>FASB</b>	The Financial Accounting Standards Board
<b>FinREC</b>	The Financial Reporting Executive Committee of the American Institute of Certified Public Accountants
<b>IASB</b>	The International Accounting Standards Board
<b>IFRS</b>	International Financial Reporting Standards
<b>IIRC</b>	The International Integrated Reporting Council
<b>&lt;IR&gt;</b>	Integrated Reporting
<b>PCC</b>	Private Company Council
<b>SEC</b>	Securities and Exchange Commission

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# *Investment companies redefined*

Modifications to the standards for investment companies clarify the definition of an investment company based on its characteristics and revises disclosure requirements. Derek Hatoum and Ryan Leopold outline the changes and how they impact existing investment companies.



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ASU 2013-08: *Amendments to Scope, Measurement, and Disclosure Requirements* modifies the guidance for determining whether an entity is an investment company. Investment companies use specialized accounting requiring investments to be measured at fair value. The ASU results from a joint project with the IASB; however, there are some differences between the FASB and IASB final standards.

### **Definition of an investment company**

The new definition requires an entity to have the fundamental characteristics to qualify as an investment company. The fundamental characteristics are:

- The entity does both of the following:
  - Obtains funds from one or more investor and provides the investor(s) with investment management services.
  - Commits to its investor(s) that its business purpose and only substantive activities are investing the funds solely for returns from capital appreciation, investment income or both. Certain non-investment activities such as investment advisory and transfer agent activities that support the investment activities of the entity continue to be consistent with the business purpose of an investment company. Substantive non-investment services to other entities would likely result in the entity not being considered an investment company.
- The entity or its affiliates do not obtain or have the objective of obtaining returns or benefits from an investee or its affiliates that are not normally attributable to ownership interests or that are other than capital appreciation or investment income.

Involvement in day-to-day management of an investee is not considered to be inconsistent with the characteristics of an investment company if those activities are intended to maximize the overall value of the investment.

If an entity meets the above criteria, it would assess whether it has the “typical” characteristics of an investment company. This assessment is based on the entity’s specific facts and circumstances including its purpose and design. These typical characteristics are:

- Holds multiple investments.
- Has multiple investors.
- Its investors are not related parties of a parent entity, if applicable, and the investment management.
- Its ownership interests are in the form of equity or partnership units.
- Manages substantially all of its investments on a fair value basis.

It is expected an investment company would have all of these typical characteristics. However, the absence of one or more typical characteristics would not necessarily preclude an entity from qualifying as an investment company. Entities will have to apply judgment in making its assessment of the typical characteristics.

In addition, the definition includes all entities subject to the Investment Companies Act of 1940 of the United States.

The investment company assessment is made at the formation of the entity and is only reassessed when there is a change in the purpose and design of the entity. Special transitional guidance is provided to account for a change in status.

*The changes in the definition are not expected to change the status of companies that currently report as investment companies.*

The changes in the definition are not expected to change the status of companies that currently report as investment companies. Certain entities that may not have previously qualified may now potentially qualify as investment companies. The FASB did not remove the prohibitions that prevent real estate investment trusts from being classified as investment companies. However, the FASB made it clear that the ASU does not amend current accounting practices for these real estate investment entities.

### **Interests in investment companies**

Investment companies that have interests in other investment companies that are controlled or subject to significant influence are permitted to continue to account for these investments at fair value. An investment company may also consolidate a controlling interest in another investment company. However, an investment company is not permitted to use the equity method of accounting for a non-controlling interest in another entity, except for an interest in an operating entity that provides services to the investment company. While the FASB tried to narrow the alternatives, they were not able to find a consensus and decided not to make changes to existing GAAP.

The FASB also did not change the accounting for interests in investment companies held by a non-investment company parent. Under the existing guidance, non-investment parent companies are permitted to retain the specialized of the investment company upon consolidation.

### **Additional disclosures**

Investment companies will now be required to disclose their investment company status and the specialized accounting applied; information on financial support provided to investees disaggregated between support that was and was not contractually required; and information about future financial support that is contractually required.

### **Effective date**

The amendments are effective for annual and interim reporting periods in fiscal years beginning on or after December 15, 2013. Earlier adoption is prohibited.

The new standards will require companies primarily focused on investing activities, other than those regulated under the Investment Company Act of 1940, to assess whether they qualify as investment companies at the date of adoption. In some cases, the assessment will be simple, but in others the assessment will require judgment when an entity does not have all of the typical characteristics.

### **More information**

If you would like to discuss this update to the accounting standards for investment companies, please contact your local engagement team or Derek Hatoum at [derek.hatoum@ca.pwc.com](mailto:derek.hatoum@ca.pwc.com) or Ryan Leopold at [ryan.e.leopold@ca.pwc.com](mailto:ryan.e.leopold@ca.pwc.com).



## News on other ASUs

### **Liquidation accounting updated**

*ASU 2013-07: Liquidation Basis of Accounting*

The ASU was issued by FASB in April 2013 to clarify when liquidation accounting is applied and guidance on recognition, measurement and presentation of assets and liabilities when liquidation accounting is used. In many respects, the ASU codifies practices currently used by many entities in liquidation.

Liquidation accounting is to be applied when liquidation of the entity is imminent. This would occur when it is remote that the entity will return from liquidation and either the plan for liquidation is approved by parties who have authority to approve the plan and it is remote that the plan will be blocked by other parties or the plan of liquidation is imposed by other forces such as an involuntary liquidation. Liquidation accounting is to be applied prospectively from the date liquidation becomes imminent.

Assets of an entity in liquidation are measured at the amount of cash proceeds expected from liquidation. Any assets not previously recognized (such as trademarks and licenses) are recognized and also measured at the cash proceeds expected on liquidation or the amount to be used to settle liabilities by a transfer of the asset. The measurement of these assets may or may not be at fair value.

Liabilities are recognized and measured using other US GAAP standards and are not removed until the liabilities are legally released by the creditor or judicially. In addition, costs expected to be incurred, including those associated with the sale or settlement of assets and liabilities, and income expected to be earned during the liquidation period are accrued. These future costs and income are not discounted and are to be presented separately from other liabilities and assets.

An entity in liquidation presents a statement of net assets in liquidation and a statement of changes in net assets in liquidation. All disclosures required by other US GAAP standards are to be provided plus disclosures about the plan of liquidation, the methods and significant assumptions used to measure assets and liabilities, the types and amounts of future costs and income accrued and the expected liquidation period.

The requirements are to be applied prospectively for liquidations determined to be imminent during annual periods beginning on or after December 15, 2013 and interim periods within those years. Earlier adoption is permitted.

### **Fed Funds Effective Swap Rate acceptable for hedging**

*ASU 2013-10: Inclusion of Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a benchmark rate for hedge accounting purposes*

The FASB ratified the EITF consensus permitting the Fed Funds Effective Swap Rate to be included as a US benchmark interest rate for hedge accounting purposes under ASC Topic 815: *Derivatives and Hedging*. These changes were made due to the increased prevalence of the overnight index swap rate in the marketplace. The restriction on using different benchmark rates for similar hedges was also removed.

These changes are effective immediately on issuance of the ASU and are to be applied prospectively to qualifying new or redesignated hedging relationships entered into or after the issuance date of the ASU. The ASU was issued on July 17, 2013.

### **Unrecognized tax benefits may be netted against deferred tax assets**

*ASU 2013-11: Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, or a Similar Tax Loss, or a Tax Credit Carryforward Exists*

On June 26, 2013, the FASB ratified the EITF consensus permitting netting of the unrecognized tax benefit (UTBs) against deferred income tax assets in certain cases. UTBs represent an entity's potential future obligation to taxation authorities for a tax position that was recognized because the tax position was more likely than not to be sustained. UTBs can now be netted against a deferred tax asset for a net operating loss carryforward, a similar tax loss or a tax credit carryforward, except when the tax losses or tax credits are not available at the reporting date under the applicable tax legislation to settle the additional income taxes resulting from the resolution of the tax position or the entity does not intend to use the deferred tax for such purposes. In these latter situations, the UTB should be presented as a liability and not netted with the deferred tax assets. The assessment is made at the reporting period end based on the existing UTBs and deferred tax assets and does not consider the future status of either the UTBs or the deferred tax assets.

These amendments will be effective for public companies for annual and interim periods in fiscal years beginning after December 15, 2013, and for non-public companies for annual and interim periods in fiscal years beginning after December 15, 2014. The ASU can be adopted early once it has been issued. The ASU may be adopted either on a prospective or retroactive basis.

# Shifts in lease accounting



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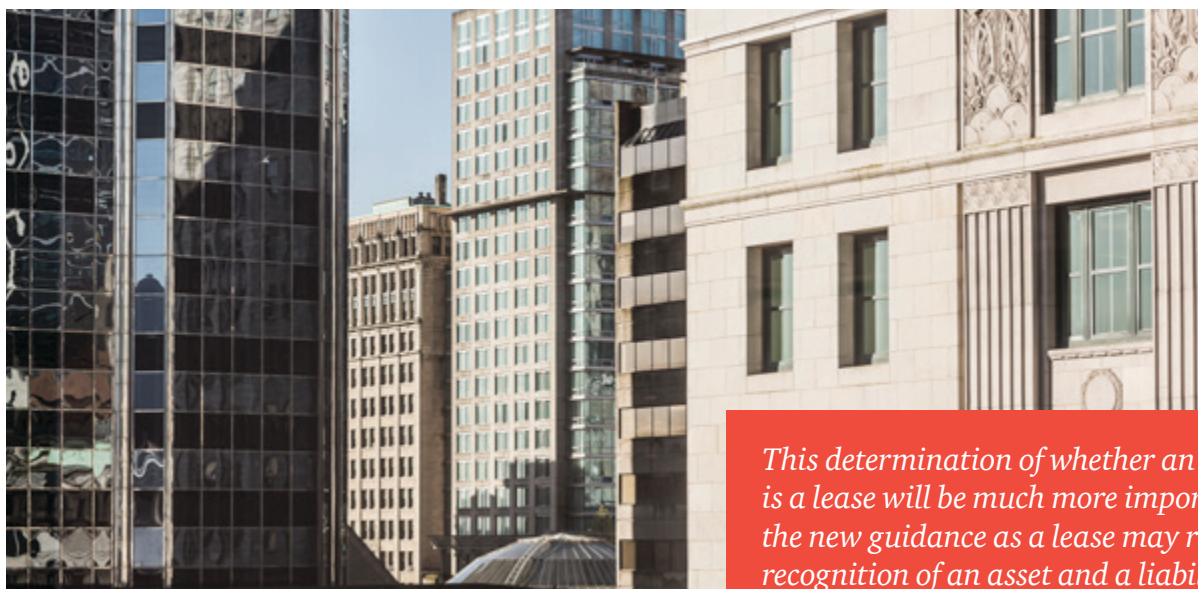
A revised exposure draft on lease accounting updates the FASB's and IASB's approach to putting leases on the balance sheet. The changes will go beyond accounting and affect many areas of a business. Neil Manji and Geoff Leverton review the new proposals and potential consequences.

Accounting for leases, version 2, was released in May 2013 by the FASB and IASB. The proposals, if adopted, will result in significant changes for many companies. Comments are due on the exposure draft by September 13, 2013. A final ASU is expected to be issued in 2014.

Almost all leases will be reflected on the balance sheet, similar to capital leases today. The proposals also introduce two methods for recognizing lease expenses and income in the income statement. For lessees' leasing assets, the balance sheet will look different reflecting more debt. The income statement could also look different.

The proposed ASU would eliminate off-balance presentation for most leases which may warrant a reassessment of lease-buy decisions by many entities. Pre-existing leases will not be grandfathered and all leases will have to be reassessed. This will require entities to reassess the impact of current and future arrangements and to possibly update processes, systems and controls for lease accounting. The impact on the balance sheet and the statements of income and cash flows may require entities to reconsider debt covenants, compensation arrangements and terms of other arrangements.





*This determination of whether an arrangement is a lease will be much more important under the new guidance as a lease may result in the recognition of an asset and a liability.*

### **Scope**

The proposals in the revised ED would be applicable to all leases except for leases of intangible or biological assets and leases to explore for or use minerals, oil, natural gas and similar nonregenerative resources.

### **Identifying a lease**

This determination of whether an arrangement is a lease will be much more important under the new guidance as a lease may result in the recognition of an asset and a liability. As under existing GAAP, the form of the arrangement does not matter and leases embedded in other arrangements will need to be assessed.

The definition of a lease in the proposed ASU requires an asset to be identified and the company to have the right to control the asset. The new guidance on identifying a lease is significantly different than the guidance under existing GAAP. The process of identifying a lease involves considering four key questions as follows:

#### **1. Does the arrangement identify a physical asset?**

Generally the determination of whether an asset is identified will be straight forward. An asset may be identified either explicitly or implicitly in the arrangement. An identified asset could be a physically distinct portion of a larger asset such as a floor of a building; however, it cannot be a capacity portion of an asset such as a percentage of the throughput of a pipeline. In a single lease arrangement, there may be multiple components that may need to be separated and accounted for as separate leases. For example, a master lease for 20 computers would likely be 20 separate leases. Also, a lease of a fully furnished office building would likely be broken up into separate leases for the building and the furniture pieces.

#### **2. Can the asset be substituted?**

In some arrangements, the supplier has a substantive right to substitute the asset at any time throughout the term without the customer's consent and without any economic, practical or other barriers to the supplier's substitution. For example, the supplier may enter into a five year contract to make available to a customer 10 rail cars to transport the customer's products. The supplier determines which rail cars in its fleet will be used at any time. If this were the case, the assets would not be considered to be identified and the arrangement would not be a lease. The assessment of whether such rights are substantive will require judgment and the need to consider, among other things, the nature of the assets and the costs of re-leasing and remarketing assets.

### 3. *Is the entity responsible for the business decisions relating to the use of the asset?*

The assessment of whether the customer has the right to control the use of the assets would consider two indicators:

- Does the customer have the ability to direct the use of the asset? This indicator considers how the asset is used or operated during the arrangement or who operates the asset if the customer does not operate the asset itself. Protective restrictions would not, in isolation, prevent the customer from directing the use of the asset.
- Does the customer have the ability to derive substantially all of the economic benefits from the use of the asset during the term of the arrangement? Economic benefits may be obtained through use, consuming, holding, or subleasing the underlying asset.

### 4. *How dependent are the associated services that the asset provides?*

In a service agreement, a supplier may also include equipment. If so, the lease component must be split out and accounted for separately. In some cases, a customer may be able to use an asset in conjunction with goods and services provided by the supplier that are not sold separately by the supplier and the asset is designed only to function with the goods and services provided by the supplier. These situations are considered to be service arrangements rather than leases.

Components of an arrangement would have to be evaluated and accounted for separately if both of the following criteria are met:

- The lessee can benefit from the use of the component either on its own or together with other resources that are readily available to the lessee such as other assets that are leased or sold separately or resources the lessee has already obtained from either the lessor or other suppliers.
- The component is neither dependent on nor highly interrelated with other underlying components in the arrangement.

The proposed ASU includes several examples to illustrate the application of the principles for identifying a lease.

#### **Modifications to lease arrangements**

Occasionally, leases are modified due to changes in the business of the lessee or the lessor, changes in laws, financial constraints and other matters. If the modifications to the terms of a lease are substantive, the modified lease would be considered to be a new lease when the modifications become effective. A modified contract will need to be classified and remeasured with any differences between the carrying amounts of assets and liabilities for the old lease and the new lease recognized in income.

#### **Key variables in a lease**

Leases have three variables that will be important to lease classification decision and measurement of leases.

##### **Lease term**

The lease term includes the noncancellable term of the lease plus periods covered by any options to extend or terminate when there is a significant economic incentive to exercise such options exists. The assessment of significant economic incentives requires consideration of all relevant

factors including terms of the lease arrangement, termination penalties, residual value guarantees and options; the value of leasehold improvements; the costs to return asset; and the importance of asset to the operations of the lessee. The guidance proposed is relatively consistent with guidance in existing US GAAP for considering renewal terms.

The lease term is only reassessed when there are changes to the relevant factors (other than market conditions) used to assess whether to include or exclude extension and termination options or when the lessee's decision to exercise or not exercise an option differs from the original assessment.

##### **Lease payments**

Lease payments include fixed lease payments net of incentives received or receivable from the lessor, variable lease payments based on a rate or index, disguised or in-substance fixed lease payments, the exercise price of a purchase option if the lessee has a significant economic incentive to exercise the option (e.g., a bargain purchase option), and expected termination penalties based on inclusion of the termination option in the determination of the lease term. The determination of whether a variable payment is a disguised or in-substance fixed payment will require significant judgment. The proposals include illustrative examples to explain this principle.

For a lessee, lease payments would also include any portion of residual value guarantees that are expected to be paid unless the amount is guaranteed by a third party for the lessees. For a lessor, all amounts from residual value guarantees are included in lease payments, regardless of whether they are guaranteed by the lessee or a third party.

Lease payments that are adjusted based on an index such as the consumer price index would only include the base lease payments at the commencement of the lease. Any expected changes in the index or rate are not factored in at the commencement date. When subsequent changes in the index occur, both the asset and the liability would be adjusted to reflect the revised payments.

Variable usage and performance based lease payments that are excluded from lease payments are recognized as an expense when the obligation for the payments is incurred.

Payments in an arrangement may need to be allocated between lease and non-lease components. This may be relevant to real estate leases and other arrangements which include a ROU asset along with services. Payments between the lease and non-lease components are to be allocated based on their relative observable standalone purchase prices. If observable prices are not available for one element, the other element may be measured using the residual amount. However, in the rare circumstances that observable prices are not available for both elements, the entire arrangement must be accounted for as a lease. Judgment may be required to allocate

payments between lease and non-lease components and additional data may be required to make the allocation.

#### Discount rate

The discount rate would be the rate that the lessor charges the lessee and may be based on the implicit rate in the lease or the property yield. If the lessee does not know that lessor's rate, the lessee would use its incremental borrowing rate. The incremental borrowing rate would be the rate applicable to a borrowing over a similar term, with a similar payment profile and security, and sufficient to fund the purchase of a similar asset. Non-public entities may elect to use a risk-free discount rate for a comparable term as the lease term.

#### Classification of leases

Under the proposals, leases will be classified as either Type A or Type B at the commencement of the lease. The lease classification primarily drives the recognition of lease expense/income. For lessors, the classification will determine whether the lease assets are financial or nonfinancial. The initial lease classification would only be reassessed when there is a substantive modification of the lease.

*The four classification tests under existing GAAP have been replaced with a principle based on the consumption of the underlying asset.*

The four classification tests under existing GAAP have been replaced with a principle based on the consumption of the underlying asset. The proposals assume certain consumption patterns based on the nature of the asset. The presumption can be overcome by looking at two criteria which are somewhat similar to the lease term and the minimum lease payments tests under existing GAAP.

The key features of the classification model are outlined in the table below.

Property is narrowly defined to consist of land or a building, or a part of a building or both. The definition of property does not include the concept of "integral equipment". Entities will have to consider whether integral equipment is a separate component or combined with other assets. The new definition will likely result in many items previously considered to be property to be excluded.

Type of asset	Lease classification	Presumption	The presumption can be overcome if one of the following factors exist:
Non-property	Type A	Asset consumed over the term of the lease.	<ul style="list-style-type: none"> <li>The lease term is an insignificant portion of the underlying asset's economic life; or</li> <li>The present value of the fixed lease payments is insignificant to the fair value of the underlying asset.</li> </ul>
Property	Type B	Asset not consumed over the term of the lease.	<ul style="list-style-type: none"> <li>The lease term is for the major part of the underlying asset's economic life; or</li> <li>The present value of the fixed lease payments accounts for substantially all of the fair value of the underlying asset.</li> </ul>

*These changes will be significant for lessees and may have major business consequences.*

In some cases, two or more assets may form a single lease component (as noted on page 9 under *Identifying a lease*). When a lease component includes both property and a major piece of equipment, the primary asset would have to be determined. If the primary asset is the major piece of equipment, the entire component would be evaluated as a non-property lease, whereas if the primary component is the building, the entire component would be accounted for as a property lease. When a lease component includes both land and building, the economic life of the component would be the economic life of the building rather than the economic life of the land.

If the lessee has a significant economic incentive to exercise an option to purchase the underlying asset, the lease would be classified as a Type A lease.

The assessment for overcoming the presumption for Type A leases is based on insignificance and for Type B leases is based on a major part or substantially all. These terms are not defined in the proposals. Entities will have to use their own judgment to determine whether the extent of consumption is insignificant, a major part or substantially all. The decision may be difficult.

This classification model introduces a dividing line for classifying leases which seems inconsistent with the objective of removing bright lines from the standard. It is expected some respondents to the ED will be concerned about this new dividing line. At the same time, it is unclear whether the intent is to use qualitative or quantitative thresholds for assessing the factors under the tests.

### **Lessee accounting**

The model proposed in the ED eliminates the off-balance sheet treatment for leases classified as operating leases under current GAAP. Also, the expense recognition for many leases will change with the introduction of a financing model for non-property leases. These changes will be significant for lessees and may have major business consequences.

### **Initial recognition and measurement**

When a lessor makes the underlying asset available to the lessee, referred to as the commencement date, the lessee would record:

- A lease liability equal to the present value of lease payments to be made over the lease term; and
- A right-of-use asset (ROU asset) measured at the same amount as the lease liability plus any lease payments made at or before the commencement date of the lease, plus any initial direct costs and less any lease incentives received or receivable from the lessor.

The ED provides a simplification for short-term leases with a term of 12 months or less. A policy election is available to recognize lease payments in expense on a straight line basis over the lease term. For determining whether a lease term is short-term, the term would include any options to renew or extend as well as rent-free periods. This policy election can be made on an asset class basis. This will require all assets within the class to be accounted for on a similar basis. This accommodation would result in accounting similar to that for an operating lease under existing GAAP.

### **Subsequent measurement**

Each period-end, the lease liability is increased by unwinding the discount using a constant rate of interest and decreased by lease payments made. The ROU asset is reduced by the accumulated amortization, based on the classification of the lease (see next page), and any impairment charges based on the impairment standards for long-lived assets.



The expense recognition depends on the lease classification as follows:

Lease classification	Presumed asset type	Expense recognition
Type A	Other than property	<ul style="list-style-type: none"> <li>• Amortization of ROU asset would be calculated on a straight line basis (unless another basis is more representative of consumption) generally to the earlier of the end of the useful life of the asset or of the lease term.</li> <li>• Interest expense on the lease liability would be recognized in the income statement.</li> <li>• Variable lease payments not included in the lease liability would be included in expense when the entity becomes obligated for the payments.</li> </ul>
Type B	Property	<ul style="list-style-type: none"> <li>• Straight line rent expense would be recognized in a single line item in the income statement. The rent expense would consist of the unwinding of the discount on the lease liability and amortization of the ROU asset as a balancing figure (calculated as the difference between the straight line rent expense and the amortization of the discount on the lease liability).</li> <li>• Variable lease payments not included in the lease liability would be included in expense when the entity becomes obligated for the payments.</li> </ul>

Subsequent to initial recognition, the lease liability is required to be remeasured for the changes to:

- **Lease payments** resulting from a reassessment of the lease term related to extension and termination options, changes to the factors used in the assessment of the significant economic incentives to exercise or not to exercise a purchase option, changes to amounts expected to be paid under residual value guarantees or changes to an index or a rate used to determine variable lease payments.
- **Discount rates** resulting from following changes which were not reflected at the commencement date of the lease: changes to the lease term related to extension and termination options, changes to the factors used in the assessment of the significant economic incentives to exercise or not to exercise a purchase option or changes to the reference rate used to determine variable payments.

The lease liability would be remeasured by calculating the present value of the revised remaining lease payments over the revised term using the revised discount rate. The revised discount rate would be determined at the date of the reassessment taking into account the remaining lease term. The ROU asset would be adjusted for the change in the lease liability except in the following circumstances:

- The changes result for a change in an index or a rate for variable lease payments for the current or prior periods. This change is reflected in the income statement.
- The carrying amount of the ROU asset is reduced to zero.

Any changes to the lease liability or ROU asset for Type A leases would be accounted for prospectively by revising the interest expense and amortization expense, respectively. Changes to the lease liability and ROU asset for Type B leases would also be accounted for prospectively by re-determining the straight line expense for the remaining term.

**Presentation**

How the financial statements look will be significantly different for leases currently classified as operating leases. These changes along with changes to the statements of income and cash flows for Type A leases may have an impact on covenants, compensation arrangements and other contracts of lessees. This assessment of the impact may take a significant amount of time and entities with significant leases should begin this process well in advance of the effective date of the ASU. The proposed ASU does allow some flexibility in presentation as explained in the table below.

*This assessment of the impact may take a significant amount of time and entities with significant leases should begin this process well in advance of the effective date of the ASU.*

**Disclosures**

The disclosures proposed are based on disclosure objectives designed to enable users of the financial statements to understand the amount, timing and uncertainty of cash flows arising from leases. This disclosure approach will require entities to carefully consider the level of detail, the extent of aggregation or disaggregation and the emphasis placed on each of the various requirements. The disclosure requirements are extensive.

The disclosures proposed for lessees include the information about the nature of leases, the rights and obligations for leases that have not yet commenced, significant assumptions and judgments applied, a reconciliation of lease liability balances, a lease payments maturity analysis, the amounts of variable lease expense for the period, non-cash transactions disclosures and related party disclosures. Non-public entities will not be required to provide a reconciliation of lease liability balances.

Financial statement	Type A lease (Nonproperty)	Type B lease (Property)
Statement of financial position	<p>ROU assets and lease liabilities are either:</p> <ul style="list-style-type: none"> <li>• Presented separately in the statement, or</li> <li>• ROU assets are presented within the same line that would be used if the assets were owned and the lease liabilities with other liabilities in the statement.</li> </ul> <p>Either the statement or the notes should disclose the amount of ROU assets and lease liabilities in total and aggregated by lease classification. If the ROU assets and lease liabilities are combined with other assets and liabilities, the entity should disclose which line items include those assets or liabilities, respectively.</p>	Same presentation and disclosures as required for Type A leases.
Income statement	Separate presentation of amortization and interest expense.	Single line presentation of rent expense consisting of amortization and interest expense.
Statement of cash flows	<p>Operating activities would include:</p> <ul style="list-style-type: none"> <li>• Interest component of lease payments,</li> <li>• Variable lease payments not included in lease liability, and</li> <li>• Short-term lease payments accounted for as expense.</li> </ul> <p>Repayment of the principal component of lease payments would be included in financing activities.</p>	All cash lease payments would be classified within operating activities.

## Lessor's accounting

Under the proposals, lessors will also apply two approaches to accounting for leases based on the lease classification. The approaches appear somewhat similar to the two approaches used under existing GAAP – a financing lease and an operating lease. However, the leverage lease accounting will be eliminated.

### Initial recognition and measurement

#### Type A leases

For a Type A lease, the lessor would apply the receivable and residual approach. Under this approach, the lessor would:

- Derecognize the carrying amount of the asset subject to the lease. If only a portion of the asset is leased, the amount to be relieved will have to be an allocation of the carrying amount of the underlying asset.
- Recognize a receivable measured at the present value of the remaining lease payments plus any initial direct costs.
- Recognize any profit or loss. The profit or loss is calculated as the difference between the amount of the lease receivable and a portion of the carrying amount of the underlying lease. The carrying amount of the underlying asset allocated to profit or loss is calculated by multiplying the carrying amount of the asset by the ratio of the amount of the lease receivable to the fair value of the asset. The remaining portion of the carrying value of the underlying asset is taken into account in the residual asset.

- Recognize a residual asset consisting of the gross residual asset, plus the present value of certain expected variable lease payments, less any unearned profit.

The gross residual asset is the present value of the amount the lessor expects to derive from the leased asset at the end of the lease term either through sale or otherwise.

If variable payments are excluded from lease payments for determining the lease receivable, but the discount rate charged includes an expectation of the variable payments, the variable payments expected to be earned are to be included in the residual asset discounted at the rate charged to lessees.

The amount of unearned profit deferred is the overall profit on the asset (total fair value less total cost) less the profit recognized on commencement of the lease.

#### Type B leases

For Type B leases, the lessor accounting would be similar to method used for operating leases under existing GAAP. The carrying amount of the asset would be retained on the balance sheet of the lessor and no lease receivable would be recognized. Initial direct costs would be recognized as a deferred asset. No profit or loss would be recognized on commencement of the lease.

#### Short-term leases

Similar to lessees, a lessor can elect not to apply the receivable and residual approach to short-term leases with a lease term of 12 months or less. This election would result in the lease being accounted for in a manner similar to Type B leases. This policy election is to be made on an asset class basis.

*Under the proposals, lessors will also apply two approaches to accounting for leases based on the lease classification. The approaches appear somewhat similar to the two approaches used under existing GAAP – a financing lease and an operating lease.*

## Subsequent measurement

### Type A leases

For Type A leases, at each period end, the lessor would measure its assets as follows:

- Lease receivable is adjusted for unwinding the discount and the payments received.

The lease receivable would also be adjusted for any impairment using the guidance in ASC Topic 310: *Receivables*. Any impairment assessment would consider the collateral related to future expected cash flows over the remaining lease term.

The lease receivable would also be remeasured if there are changes to lease payments or discount rates (see next page).

If the lease is terminated before the end of its term, the lease receivable less any amounts expected to be received from the lessee and the residual asset are reclassified and accounted for using the standards applicable to those assets.

- The residual asset is adjusted for the unwinding of the discount, amortization of the portion of the asset related to variable lease payments, and any impairment based on impairment guidance for long-lived assets.

At the end of the lease term, the carrying amount of the residual asset would be reclassified to property, plant and equipment.

The unwinding of the discount on the lease receivable and the gross residual asset and variable lease payment not included in the lease receivable would be recognized in income.

As with the lease liability for a lessee, the lessor is also required to remeasure the lease receivable if there are changes to the following:

- **Lease payments** resulting from changes to the lease term related to extension or termination options, changes to the factors used in the assessment of the significant economic incentives to exercise or not to exercise a purchase option, changes to amounts expected to be paid under residual value guarantees or changes to an index or a rate used to determine lease payments.
- **Discount rates** resulting from changes to the following which were not reflected at the commencement date of the lease: the lease term, the factors used in the assessment of the significant economic incentives to exercise or not to exercise a purchase option or the reference rate used to determine variable payments.

In addition to adjusting the lease receivable for changes in lease payments and the discount rate, the residual asset would be adjusted to reflect the amount the lessor expects to receive from the underlying asset at the end of the lease term. This would occur when the lease term is changed or there is a change in the assessment of whether a purchase option will be exercised. The revised cash flows would be discounted using the rate at the reassessment date that

the lessor would charge the lessee to use the asset for the remaining lease term. Any difference between the lease receivable and the residual asset before and after the remeasurement would be recognized in income.

### Type B leases

For Type B leases, the underlying asset continues to be accounted for in accordance with other standards and depreciation and any impairment charges would generally be recognized in income.

Rental revenue would be recognized on a straight line basis or another systematic basis if that basis is more representative of the pattern in which income is earned over the lease term.

Any unbilled rents receivable or rental revenue deferred would be recognized for the cumulative amount by which the straight line rental revenue exceeds or is below rents currently billable.

## Presentation

The proposed presentation for lessors does not represent a significant change from current presentation required for capital and operating leases. However, the amounts presented may be significantly different due to the new lease classifications and accounting for the residual asset.



Financial statement	Type A lease (Nonproperty)	Type B lease (Property)
Statement of financial position	<p>Lease assets (consisting of the sum of the lease receivable and the residual asset) are presented separately in the statement.</p> <p>The amount of lease receivables and the carrying value of the residual asset are either presented in the statement or disclosed in the notes.</p>	The underlying asset is presented in accordance with other standards.
Income statement	<p>Any profit or loss recognized at the commencement of the lease would be presented in a manner that best reflects the lessor's business model (e.g., revenue and cost of sales if leasing is an alternative to sales or net profit if purpose of leasing is to provide financing).</p> <p>Income from leases can be either presented separately in the statement or combined with other income provided the amount and the line item that includes lease income is disclosed in the notes.</p>	No specific requirements.
Statement of cash flows	All cash flows from the lease are to be reported as operating activities.	All cash flows from the lease are to be reported as operating activities.

## Disclosures

Similar to the requirements for lessees, the disclosure proposals for lessors focuses on disclosure objectives designed to enable users of the financial statements to understand the amount, timing and uncertainty of cash flows arising from leases. This disclosure approach will require entities to carefully consider the level of detail, the extent of aggregation or disaggregation and the emphasis placed on each of the various requirements. The disclosure requirements are extensive.

Lessors will be required to provide information about the nature of leases, significant assumptions and judgments made in applying lease accounting, related party lease transactions and the components of lease income in a tabular format. For Type A leases, additional disclosures are required including a reconciliation of the opening and closing balances of the lease receivable and residual assets, a maturity analysis of the lease payments and information about how the risk associated with residual assets is managed. A maturity analysis of lease payments is also required for Type B lease, separately from the analysis for Type A lease.

For interim financial statements, a lessor is required to disclose in a table all lease related income items.

## Sale-leaseback transactions

Significant changes are proposed for sale-leaseback transactions which will require a separate evaluation of the sale/purchase from the leaseback. The sale of an asset in a sale-leaseback transaction will be subject to the revenue recognition standard, while the leaseback will be subject to the leasing guidance.

If the transferee does not obtain control of the underlying asset based on the revenue recognition guidance, a sale of the underlying asset would not be recognized. In addition, the proposed standard indicates that a leaseback that provides the transferor of the asset the ability to direct the use of and obtain substantially all of the remaining benefits from the asset would not be a sale. The factors that would indicate a sale has not occurred are:

- The leaseback term is for the major part of the underlying asset's economic life; or
- The present value of the fixed lease payments accounts for substantially all of the fair value of the underlying asset.

If the transfer of the asset does not qualify as a sale, the transaction would be accounted for as a financing by both the transferor and transferee. The transferor would retain the asset on its books and recognize any proceeds received as a financial liability. The transferee would not recognize the underlying asset but would recognize the proceeds paid as a receivable.

The proposals also require adjustments to the assets, liabilities, gains or losses recognized on a sale leaseback when the proceeds on the disposal of the underlying assets does not equal fair value or the rentals do not reflect current market rates.

In addition to the disclosures required for leases in general, the transferor is required to disclose the main terms and conditions of the sale-leaseback transaction and the gains or losses recognized separately from gains and losses on other disposals of assets.

Under certain design build arrangements, the lessee may control the underlying asset before the commencement of the lease. This type of transactions would be subject to the sale-leaseback guidance. The existing guidance on these arrangements will be eliminated. Costs incurred by the lessee for the construction and design of the underlying asset would be accounted for as inventory or property, plant and equipment before the commencement of the lease.

## Leases in business combinations

Under the proposals, leases acquired in a business combination will continue to be accounted for as an acquired lease and would be subject to the following accounting requirements:

- Leases would be classified based on contractual terms and conditions at the acquiree's commencement date. The lease would only be considered to be a new lease if the contractual terms and conditions are modified in connection with the acquisition and result in a substantive change to the original lease.
- If the acquiree is a lessee, the lease liability would be measured at the present value of the future lease payments as if the acquired lease were a new lease on the acquisition date. The ROU asset would be recognized at the amount of the lease liability adjusted for any off-market terms and any other intangible associated with the lease.

- If the acquiree is a lessor with Type A leases, any lease receivable would be measured at the present value of future lease payments as if the acquired lease were a new lease at the acquisition date. The residual asset would be measured as the difference between the fair value of the underlying asset at the acquisition date and the carrying value of the receivable.
- If the acquiree is a lessor with Type B leases, the underlying asset would be measured at the acquisition date fair value which would take into account the terms and conditions of the lease. A separate asset or liability for favourable or unfavourable terms when compared to market or for lease customer relationships would not be recognized.
- For leases with a remaining maximum possible lease term of 12 months or less, the acquirer would not recognize any assets or liabilities at the acquisition date.

## Transition

All leases, except for short-term leases subject to the policy election, would be recognized and measured on the balance sheet in accordance with the ASU at the date of initial application, which is the start of the earliest comparative period. Leases would have to be classified to determine the appropriate transition application. There is no grandfathering for existing leases.

Lessors and lessees will need to determine the lease classification to calculate the transition adjustment. A process will be needed to gather information about lease term, renewal options and lease payments. This information will typically exceed the information required under current accounting.

The proposal allows two transitional approaches. Lessees and lessors can elect either of these approaches.

#### **Full retrospective approach**

Under the full retrospective approach, all outstanding leases would be accounted for using the new requirements from their commencement date. Any cumulative catch up adjustment would be recorded in equity.

#### **Modified retrospective approach**

Under the modified retrospective approach, no adjustments would be made to existing assets and liabilities for existing capital leases, direct financing leases and sales-type leases as at the beginning of the earliest comparative period presented. Subsequently, the lease assets and liabilities would be accounted for using the Type A lease guidance, except that the reassessment requirements would not have to be applied.

For existing operating leases, a lease liability and ROU asset would be recorded with the difference recorded in retained earnings at the initial application date. For both Type A and Type B leases, the lease liability would be measured at the present value of remaining lease payments using the discount rate at the effective date. For Type A leases, the ROU asset would be measured based on a proration of the lease liability at the commencement date of the lease. The proration is calculated based on the remaining lease term compared to the total lease term. For Type B leases, the ROU asset is equal to the lease liability adjusted for any prepaid or accrued rent on the balance sheet at the initial application date.

All evidence available, including hindsight, can be used to determine the lease term at the initial date of application. Initial direct costs for existing leases are not considered in any assessment and are not included in the measurement of the ROU asset or lease receivable at the transition date.

The effective date of the final ASU will be set after the FASB and IASB consider the feedback from the revised exposure draft.

#### **More information**

If you have any questions or would like more information about the revised exposure draft on lease accounting, please contact your engagement partner or Neil Manji at [neil.manji@ca.pwc.com](mailto:neil.manji@ca.pwc.com) or Geoff Leverton at [geoff.m.leverton@ca.pwc.com](mailto:geoff.m.leverton@ca.pwc.com).



## News on other proposed ASUs

### **Scope of going concern disclosures broadened** **FASB**

Issued: June 26, 2013

Comments due: September 24, 2013

The purpose of this ASU is to introduce into US GAAP guidance about management's responsibilities in evaluating and disclosing going concern uncertainties. The FASB indicated that currently there are varying interpretations of when and how going concern uncertainties should be disclosed which has resulted in diversity in the timing, nature and extent of disclosures.

The proposal will require all entities to assess at each reporting period end whether the entity will be unable to meet its obligations as they become due within 24 months after the financial statement date. All information about conditions and events are considered in this assessment for public companies until the date the financial statements are issued and for non-public companies until the financial statements are available for issue.

Disclosures are required when:

- It is more likely than not that the entity will not be able to meet its obligations within 12 months after the date of the financial statements without taking actions in the ordinary course of business; or
- It is known or probable that the entity will not be able to meet its obligations within 24 months after the date of the financial statements without taking actions in the ordinary course of business.

The assessment of the likelihood of meeting its obligations, an entity would consider, among other things:

- Sources of liquidity including available liquid funds and available access to credit.
- Funds necessary to maintain operations in the ordinary course of business.
- Conditional and unconditional obligations due or anticipated to be due within 24 months of the date of the financial statements.
- Conditions and events that could adversely affect the entity's ability to meet its obligations such as an anticipated loss of a major customer, maturity of a significant debt or upcoming expiry of a major license.
- Conditions and events that could mitigate the entity's potential inability to meet its obligations including renewal of a major customer contract, reduction of material costs, or increase in demand for its products.
- The effect of management's plans that are in the ordinary course of business, are likely to be effectively implemented and are likely to mitigate the adverse conditions and events.

Disclosures required when the thresholds are met include:

- The principal conditions and events that give rise to the entity's potential inability to meet its obligations.
- The possible effects those conditions and events could have on the entity.
- Management's evaluation of the significance of those conditions and events.
- Mitigating conditions and events.
- Management's plans to address the situation.

The disclosures are to be scaled depending on the stage of the uncertainty and the information available.

SEC issuers are required also to evaluate whether there is substantial doubt about the entity's going concern presumption. This assessment is based on the same factors noted above plus the effect of all of management's plans that are likely to be effectively implemented and likely to mitigate the adverse conditions, including those outside the ordinary course of business. Substantial doubt exists when information about existing conditions and events, after considering the mitigating effect of all of management's plans, indicates that it is known or probable that an entity will be unable to meet its obligations as they become due within 24 months after the date of the financial statements. If substantial doubt exists, companies are required to disclose the determination in the notes to the financial statements by stating "there is substantial doubt about the entity's ability to continue as a going concern within 24 months after the financial statement date" or similar wording.

The requirements for evaluation and disclosures of going concern problems will have to be applied prospectively after the effective date. No effective date has been established in the standard.

### **Common approach exposed for insurance contracts** **FASB**

Issued: June 27, 2013

Comments due: October 25, 2013

The exposure draft on insurance contracts is the result of work by both the FASB and IASB to develop common, high quality guidance for the



recognition, measurement, presentation and disclosure of insurance contracts issued and reinsurance contracts held in an entity's financial statements. The proposals focus on insurance contracts rather than insurance entities and the accounting implications may go beyond those of traditional insurance companies.

Insurance contracts would be broadly defined as a contract under which one party accepts significant insurance risk from another party by agreeing to compensate the policyholder if a specified uncertain future event adversely affects the policyholder. The definition will sweep in non-derivative financial guarantees and the insurance component of title insurance. The proposals specifically exclude most contracts that are issued by entities other than financial institutions such as product warranties, fixed price service contracts, one-time guarantees and other contracts.

Insurance risk is significant if an insured event could cause an insurer to pay significant incremental benefits as compared to the benefits that would be payable if the insured event did not occur. The assessment would take into account time value of money.

Insurance contracts are to be measured at current value using the building block approach. A "current value" liability or asset would be measured using the mean of discounted expected cash flows for expected premiums, claims and expenses necessary to fulfil the contract. The discount rate used should reflect the characteristics of the insurance liability. At origination or inception of the contract, there would be no immediate gain recognition for expected profit. The expected profit would be recorded as a margin liability to be amortized over the coverage and claims settlement period. Expected losses would be recognized immediately.

Short duration contracts that meet certain specified criteria would apply the premium allocation approach which is similar to today's unearned premium approach. Any incurred claim liability would be discounted with some limited exceptions. The portion of premiums and claims representing deposit elements would be excluded from revenue and claims expense.

The income statement presentation would be similar to the current presentation of premium revenue and benefit/claim expense. Changes in the insurance liability caused by changes in discount rates would be recorded in other comprehensive income with interest expense in the income statement based on the locked-in rate determined at the inception of the contract.

The definition of direct acquisition costs is consistent with current FASB guidance, except that direct response advertising can no longer be capitalized. Deferred direct acquisition costs are to be offset against the margin liability rather than be presented as an asset.

The ED proposes retrospective application to all prior periods, unless it is impracticable to do so. The FASB has proposed certain practical expedients for determining the discount rate and will allow redesignation or reclassification of financial assets related to the insurance business. The ED does not propose an effective date.

**Deferral to address potential disclosure of proprietary information**  
**FASB**

Issued: April 30, 2013

Comments were due: May 31, 2013

This exposure draft was issued to address concerns over disclosures required by non-public entities in their employee benefit plans' financial

statements filed on regulatory websites. The proposal would provide an indefinite deferral of certain disclosure of quantitative information about significant unobservable inputs used in level 3 fair value measurements for the sponsor's equity securities held as investments by the plans. The FASB expects discussions between plan regulators and stakeholders to be held to address the potential effect on the dissemination of any proprietary information in the prescribed disclosures. The deferral will be effective upon issuance of the final ASU which is expected soon.

**Removing fair value options to improve comparability**  
**FASB**

Issued: April 12, 2013

Comments were due: May 15, 2013

The FASB has issued a companion document to its earlier exposure draft on *Recognition and Measurements of Financial Assets and Financial Liabilities* which was issued in February 2013. The companion exposure draft includes consequential amendments to various Topics in the ASC that are affected by the proposed ASU on financial instruments and amendments related to the decision to eliminate the fair value option for guarantees and other contingencies, rights and obligations under an insurance contract, rights and obligations under a warranty, written loan commitments and certain other firm commitments. The effective dates of the elimination of the fair value option will depend on the effective date of the proposed ASUs on financial instruments, insurance contracts and revenues.

### ***Reclassifying troubled mortgage loans to other real estate owned*** **EITF**

Issued: July 19, 2013

Comments due: September 17, 2013

The EITF has been considering when vacant or abandoned real estate properties that collateralize mortgage loans should be reclassified from loans to other real estate owned. Current US GAAP requires the loan to be reclassified to real estate when there has been an in-substance repossession or foreclosure by the creditor under which the creditor receives physical possession of the assets. The EITF reached a consensus for exposure that a creditor should be considered to have taken physical possession of the real estate when the creditor obtains legal title to the real estate collateral or when the borrower voluntarily conveys all interest in the real estate property to the lender to satisfy the loan, even though legal title may not have passed.

Additional disclosures will be required about other real estate owned and non-performing loans currently in the process of foreclosure.

The proposals would be applied prospectively to existing and new loans from the date of adoption. Early adoption will be permitted. The date of adoption has not been established.

### ***Accounting for service concessions*** **EITF**

Issued: July 19, 2013

Comments due: September 17, 2013

The EITF is addressing the issue of how an operating entity should account for a public-to-private service concession arrangements. In these arrangements, a public sector entity grants to a private entity the rights to operate and/or maintain the public infrastructure assets (such as an airport, toll road,

prison or hospital). The private entity often is required to construct or upgrade the infrastructure assets under these arrangements.

The EITF has tentatively decided that these arrangements should not be accounted for as leases and operators should refer to other relevant Topics in US GAAP such as revenue recognition, financial instruments accounting and other areas.

The new guidance would be applied to all qualifying service concession arrangements at the beginning of the period of adoption as well as new contracts entered into after the adoption date. The effective date has not yet been determined.

### ***Issues on consolidation of collateralized financing entities*** **EITF**

Issued: July 19, 2013

Comments due: September 17, 2013

This Issue attempts to resolve the diversity in practice in the accounting by a reporting entity for the difference between the fair value of the financial assets and the fair value of the financial liabilities of a consolidated collateralized financing entity (CFE). The objective of the guidance is to require a reporting entity to only recognize in its consolidated income statement those amounts related to its own beneficial interest in a CFE.

In June, the EITF reached a consensus-for-exposure that would require reporting entities to use the fair value of the financial assets (and carrying value of any non-financial assets temporarily held by the CFE) to measure the financial liabilities.

Entities may apply the guidance retrospectively if they had previously elected the fair value option. Entities that did not previously elect the fair

value option may do so upon adoption of the guidance, but will be required to apply the guidance prospectively through a cumulative effect adjustment.

The guidance would be effective for public entities for fiscal years (and interim periods within those years) beginning after December 15, 2013, and for nonpublic entities for the first annual period beginning after December 15, 2014, and interim and annual periods thereafter. Early adoption would be permitted.

### ***Tools for developing alternatives for private company GAAP*** **FASB & PCC**

Issued: April 15, 2013

Comments were due: June 21, 2013

An Invitation to Comment has been issued by the FASB and PCC on *A Guide for Evaluating Financial Accounting and Reporting for Private Companies*. The Guide will be used by the FASB and PCC to determine whether and in what circumstances alternative recognition, measurement, disclosure, presentation, effective date and transitional guidance should be provided for private companies reporting under US GAAP.

### ***Alternative accounting for certain intangible assets for private companies*** **PCC**

Issued: July 1, 2013

Comments due: August 23, 2013

The PCC has proposed amendments to US GAAP that would permit an accounting alternative for private companies for the recognition, measurement and disclosure of identifiable intangible assets acquired in a business combination. The alternative would only require the recognition of identifiable intangible assets arising from contractual rights with noncancellable contractual terms or arising from other legal rights. The

nature of other identifiable intangible assets acquired but not recognized would be described in the notes of the financial statements.

Contractual rights would be measured at fair value taking into account only market participant assumptions about the noncancellable term and not any potential renewals or cancellations. For legal rights, all market participant assumptions would be included in the measurement of the asset's fair value.

The alternative would be applied prospectively for all business combinations entered into during fiscal years, and interim periods within those fiscal years, beginning on or after the effective date of the ASU. The effective date has not yet been determined. Earlier adoption will be permitted.

### **Alternative accounting for goodwill for private companies** **PCC**

Issued: July 1, 2013

Comments due: August 23, 2013

The PCC has proposed amendments to US GAAP to permit private companies to simplify the accounting for goodwill by allowing the following alternatives:

- Private companies may amortize goodwill recognized in a business combination over the useful life of the primary asset acquired, but not to exceed 10 years. The primary asset is the most significant asset acquired in the business combination other than goodwill.
- Goodwill would be tested for impairment only when a triggering event occurs that would more likely than not reduce the fair value of the entity below its carrying amount. This would be an entity-wide test as opposed to the current reporting unit test. Private companies can still make a qualitative assessment to determine whether the step one test is necessary.

- The amount of a goodwill impairment would be determined as the difference between the fair value of the entity (as computed under step one of the current goodwill impairment test) and the carrying of the entity's net assets.

The alternative would be applied prospectively for all goodwill arising on business combinations entered into after the effective date. Goodwill existing at the effective date would be subject to the new alternative.

### **Alternative hedge accounting for private companies** **PCC**

Issued: July 1, 2013

Comments due: August 23, 2013

This proposed ASU issued by the PCC addresses concerns that private companies often find it difficult to access fixed rate borrowings and must enter into interest rate swaps to economically convert variable rate loans into fixed rate borrowings. This proposal would not be available to employee benefit plans and financial institutions.

The proposal allows two additional alternatives for accounting for swaps used to economically convert variable rate borrowings into fixed rate borrowings. The effect to the two alternatives proposed would result in interest expense in the income statement being recognized at an amount similar to that for a fixed rate debt rather than a variable rate debt and a swap.

The two approaches included in the proposal are as follows:

- Combined instruments approach which would account for the debt and the swap as a single instrument and the swap would not be recorded in the balance sheet. The proposal includes a number of criteria to ensure there is a close match between the swap and the borrowing. This approach would have to be applied to all swaps that meet the criteria. Fair value disclosures would not be required for swaps or borrowings accounted for under this approach; however, disclosures will be required of the settlement value of the swaps, the amount of principal for which forecasted interest has been swapped, the remaining principal amount for which forecasted interest has not been swapped, the location and amount of any gains or losses on early termination of swaps and the nature and conditions of any credit-risk contingent features.
- Simplified hedge accounting approach which would account for the swap and the related borrowing as two separate financial instruments; however, no ineffectiveness would be assumed for designated qualifying hedges. The swap may be recorded at its settlement value rather than its fair value. This proposal includes a number of criteria to ensure there is a close match between the swap and the borrowing. The proposal would also allow hedge documentation to be completed within a few weeks of hedge designation. The approach could be applied on a swap by swap basis. Disclosures about swaps would remain unchanged from current GAAP requirements.

The proposals would be applied retrospectively to the beginning of the year of adoption or for all periods presented. The effective date of the proposal has not yet been determined.

## Projects

### FASB

#### **Classification and measurement of financial instruments**

The objective of this project is to improve the decision usefulness and simplification of financial instruments reporting. An exposure draft on a proposed ASU was issued in April 2013. The comment period for the financial instruments project on the classification and measurement of financial instruments ended on May 15, 2013. Approximately 150 comment letters were received. The FASB also conducted additional outreach during the comment period.

The feedback received was mixed. Many respondents supported the classification of financial assets based on cash flow characteristics and the business model. However, concerns were raised about potential unintended consequences of applying the approach, in particular the cash flow characteristics.

The FASB and IASB will start joint redeliberations in July 2013 by considering the concerns raised on the cash flow characteristics test.

#### **Definition of non-public entity**

This project is re-examining the definition of a non-public entity to distinguish between different types of entities for standard-setting purposes and which companies will be included in the Private Company Decision Making Framework.

The FASB continues to discuss the definition of a public company for financial reporting purposes. Tentatively, the FASB had decided that a business entity meeting one of the following criteria would be a public company:

- The entity is required to file or furnish financial statements with the SEC.
- The entity is required to file or furnish financial statements with a regulatory agency in preparation for the sale of securities or for purposes of issuing securities.
- The entity has issued or is a conduit bond obligor for unrestricted securities that can be traded on an exchange or an over-the-counter market.
- The entity's securities are unrestricted and it is required to make US GAAP financial statements publicly available on a periodic basis under a legal or regulatory requirement.

The FASB expects to issue an exposure draft for a proposed ASU in the third quarter of this year.

#### **Investment company disclosures about investments in other investment companies**

The objective of this project is to propose disclosures to be made by investment companies to provide transparency about the risks, obligations and expenses of an investee that is also an investment company. The FASB has proposed requiring information about investees that represent more than 5% of the reporting investment company's net assets. The disclosures about the investee fund would include the percentage of net assets invested by the investment company, the total assets, the total debt outstanding, the net assets, the expense ratio and the proportionate ownership interest held by the investment company. The FASB will continue deliberations on this project.



### **Revenue recognition**

The FASB and IASB are conducting this joint project to clarify the principles for recognizing revenue and to develop a common revenue standard for US GAAP and IFRS. The FASB published an exposure draft in January 2012 with a comment period until March 13, 2012.

During the quarter, the FASB decided the following:

- The guidance in the revenue standard on recognition, measurement and existence of a contract would also apply to transfers of assets that are not an output of an entity's ordinary activities.
- The existence of a customer loyalty program and the promise to transfer award credits does not automatically give rise to a performance obligation. Entities will be required to consider all the facts and circumstances in applying the revenue model to determine whether the promise to transfer award credits result in a performance obligation.

The two Boards have completed their substantive redeliberations of the exposure draft and a final standard is being drafted. A final standard is expected to be issued in the third quarter of 2013.

### **Repurchase agreements and similar transactions**

This project is directed to improving the existing accounting and disclosure guidance on repurchase agreements and similar transactions. The project will address application issues and changes in the market place. A proposed ASU was issued on January 15, 2013 with comments due on March 29, 2013.

During the quarter, the FASB discussed the feedback received on the proposed ASU. The FASB has tentatively decided to address concerns arising from transfers of financial assets with contemporaneous agreements that convey significant risks to the transferor (regardless of the form of the transaction). As a result of these redeliberations, the FASB has concluded that the current effective control model should be retained and additional disclosures should be required for transfers of financial assets with contemporaneous agreements that result in the transferor retaining risks associated with the transferred financial asset. The FASB will continue redeliberations at a future meeting. A final ASU is expected in the fourth quarter of 2013.

### **EITF**

#### ***Affect of performance conditions on share-based payments***

During the quarter, the EITF added an issue to its agenda on share-based payments. The issue will consider how to account for the terms of share-based payments that include performance targets and allow the employees to earn the awards when the performance targets are met after the requisite service had been provided. The question will attempt to resolve whether these features are performance conditions that affect vesting, conditions that affect the grant-date fair value of awards or cause the awards to be liabilities.

## ***News on SEC developments***

### ***SEC Rule on Payments by Resource Extraction Issuers struck down***

On July 2, 2013, the District Court for the District of Columbia struck down the SEC rule which required resource extraction issuers to file annual reports on any payments made to the US federal or foreign governments for the purpose of the commercial development of oil, natural gas or minerals. These reports were required to be publicly filed beginning with fiscal years ending after September 30, 2013. The rule was struck on the basis that the disclosure of the information was not required to be made public under the Dodd Frank Act and the rule did not contain an exemption from the disclosure where the disclosure of such payments is prohibited by law. It is expected the SEC will issue a new rule in order to meet its obligations under the Dodd Frank Act.

### ***FAQs on conflict minerals and payments by resource extraction issuers***

The SEC staff has issued two series of frequently asked questions on new rules that are applicable for the current year as follows:

- Conflict minerals dealing with the scope of the rule, the nature of disclosures and the timing of filing.
- Payments by resource extraction issuers dealing with the scope of the rule, the basis of payments and the timing of filing.

## News on COSO developments

### **COSO modernizing internal control framework**

On May 14, 2013, the COSO published an updated Internal Control-Integrated Framework (the *Framework*) and related illustrative documents. The *Framework* was authored by our US Firm under the direction of COSO. The update refreshes the original 1992 framework and is designed to address reporting, compliance and operational objectives. The original framework will continue to be available until December 15, 2014 at which time COSO will consider that framework to have been superseded.

COSO has stated that the key concepts and principles embedded in the original framework are fundamentally sound and broadly accepted in the marketplace; accordingly, COSO has updated and not fundamentally overhauled the original framework. COSO has recommended that all entities using the original framework should begin to align existing practices and related documentation to the new *Framework* as soon as feasible under the particular circumstances.

The update clarifies and builds on the core strengths of the original framework by:

- Formalizing the concepts within the original framework into seventeen principles associated with the five components of internal control – Control Environment, Risk Assessment, Control Activities, Information and Communication, and Monitoring Activities. The *Framework* also includes points of focus that highlight important characteristics of the principles. The principles will help entities to specify and communicate suitable objectives, to identify and assess related risks and to select and implement controls across the business.
- The *Illustrative Tools* which provide templates and scenarios that may be useful for management when using the *Framework* to assess the effectiveness of a system of internal control based on the requirements set forth therein.
- The *ICEFR Compendium* which is a companion document to the *Framework* and illustrates additional approaches and examples of how the principles set forth in the *Framework* can be applied in the context of external financial reporting, a subset of the reporting category of objectives.

- Considering changes in business and operating environments. For example, new issues may emerge through social media. Controls to monitor social media channels may provide entities with early warning of such issues.
- Expanding the financial reporting objective to address other important forms of reporting such as internal financial reporting, compliance reporting with laws, standards and contracts, and reporting to stakeholders.

COSO has published a number of documents on the *Framework* which can be found at [www.coso.org](http://www.coso.org):

- The *Executive Summary* which provides a high-level overview intended for the board of directors and senior management.
- The *Framework* which defines internal control and describes the requirements for effective internal control.

The new *Framework* provides a perfect opportunity for entities to consider whether their controls are keeping up with the developments in the business. A fresh look at internal controls may be beneficial for a company particularly if there has been a major change in the business, ongoing regulatory oversight and scrutiny, greater complexity in your operating model and structure, expanding reliance on technology, new and evolving expectations for non-financial reporting and business failures and brand damaging events. Your PwC engagement team along with our Risks and Controls Consulting specialists will be happy to discuss with you an assessment of how your company can use the update to build upon their existing controls to address business changes.

## News on other developments

### **Inspiring companies to provide more comprehensive reporting**

The IIRC recently issued for comment its *Consultation Draft of the International <IR> Framework* (the *Framework*). The draft *Framework* can be found on the IIRC website at [www.theiirc.org/consultatondraft2013](http://www.theiirc.org/consultatondraft2013). <IR> is a new corporate reporting model being designed by the IIRC that focuses on communications by an entity about its value creation over time.

The <IR> efforts have been directed towards developing a framework for an integrated report. Under the draft *Framework*, the integrated report would describe and measure, where practicable, the material elements of value creation and the relationships between them. The *Framework* focuses on how the entity's business model creates value through its capitals or resources.

The draft *Framework* also includes content elements or categories of information to include in an integrated report. These content elements are phrased as questions and cover an organization's overview and its external environment, governance, opportunities and risks, strategy and resource allocation, the business model(s) of the entity, the performance of the entity and the future outlook of the entity.

Many of these elements are similar to some of the components now required in management's discussion and analysis, the annual information form or the proxy circular. The IIRC does not contemplate replacing these regulatory reports, but rather having a report that integrates all the elements into a comprehensive report focusing on how these elements contribute to value creation. The adoption of <IR> is not currently mandated in Canada; however, the IIRC is hoping companies will voluntarily adopt the *Framework*.

Comments were due on July 15, 2013.

Our people are ready to help you understand US GAAP. If you have questions or want to discuss the developments in this publication or other developments, our people in the US GAAP Reporting Group will be happy to answer your questions and have a discussion with you.

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