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Preparing Periodic Disclosures for Life Sciences Companies and Areas of SEC Comment

March 7, 2019 | Webinar

Speakers: David Bakst (Mayer Brown), Polia Nair (EY) and Anna Pinedo (Mayer Brown)

Webinar Materials

1. Presentation: Preparing Periodic Disclosures for Life Sciences Companies
2. Legal Update - SEC Expands Definition of Smaller Reporting Company (Mayer Brown)
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Preparing Periodic Disclosures for Life Sciences Companies

March 2019

Agenda

- SEC comment letter trends
- Brexit, LIBOR and cyber disclosures
- Recent accounting pronouncements
- Milestones and collaborations and related disclosures
- Other MD&A disclosures

Presenters

David Bakst
Partner
Mayer Brown LLP
dbakst@mayerbrown.com

Polia Nair
Senior Manager, Professional Practice,
SEC Regulatory Matters
Ernst & Young LLP
Polia.Nair@ey.com

Anna Pinedo
Partner
Mayer Brown LLP
apinedo@mayerbrown.com

SEC COMMENT LETTER TRENDS

Comment areas for life sciences companies

	Comment rank for the 12 months ended 30 June*	
Comment area	**2018**	**2017**
Management's discussion and analysis	1	1
Revenue recognition	2	3
Research and development expenses	3	**
Fair value measurements***	4	5
Liabilities, payables and accrual estimates	5	**

* These rankings are based on topics assigned by research firm Audit Analytics for SEC comment letters issued to registrants about Forms 10-K from 1 July 2016 through 30 June 2018. In some cases, individual SEC staff comments are assigned to multiple topics if the same comment covers multiple accounting or disclosure areas.

** This topic was not among the top five comment areas in 2017.

*** This category includes SEC staff comments on fair value measurements under ASC 820 as well as fair value estimates, such as those related to revenue recognition, stock compensation and goodwill impairment analyses.

Other areas of SEC comment

- In recent years, the number of SEC comment letters issued to SEC-reporting companies has declined
  - The number of reviews with comment letters has declined
  - Roughly half of issuers are reviewed annually but the focus has changed to a risk-based approach with attention concentrated on larger issuers
  - Comments tend to be more thoughtful and more likely to elicit registrant changes in disclosures or reporting
- In addition to the focus on the use of non-GAAP measures, which we will discuss later, SEC comment letters have concentrated on
  - ***Management's Discussion and Analysis***: the Staff continues to emphasize the need for SEC-reporting companies to provide insight for investors regarding changes in line items, the reason for the changes, known trends, material uncertainties, loss contingencies
    - The SEC Staff has begun to comment on "repetition" and "duplicative" disclosures, especially as it relates to Critical Accounting Policies

Other areas of SEC comment *(cont'd)*

Example SEC staff comment: Duplicative disclosure about critical accounting estimates
The disclosure of critical accounting policies within MD&A appears to duplicate your accounting policy disclosure in the notes to your financial statements, and it does not provide investors with a robust discussion of your critical estimates by focusing on the assumptions and uncertainties that underlie the impairment analysis of your most significant assets. Please modify the MD&A disclosure to address the specific methods, assumptions and estimates used in your critical accounting estimate. If you prefer to include this disclosure elsewhere in your filing, such as expanded disclosure in the notes to your financial statements, please consider including a simple cross-reference within your MD&A to avoid repetition.

- The SEC staff has urged registrants to explain fully the impact of factors that cause fluctuations in line items from period to period by providing the amount of change attributable to each factor
  - For instance: volume, price increase/decrease, foreign currency change

Other areas of SEC comment *(cont'd)*

- ***Segment reporting***: the SEC staff frequently comments on the identification of segments, the analysis underlying company's identification of its reportable segments, more transparent and detailed disclosures by segment
- ***Revenue recognition***: disclosing the impact of implementing the new standard, areas of significant judgment like identifying performance obligations, clarity in discussing all material revenue streams separately and identifying the significant assumptions for each stream separately
- ***Taxes***: tax policy, treatment of foreign earnings, repatriation of foreign earnings, deferred tax assets
- ***Internal control over financial reporting***: management's assessment of control deficiencies, remediation, disclosures relating to the impact of material weaknesses, restatements and disclosures relating to ICFR following a restatement

Other areas of SEC comment *(cont'd)*

Example SEC staff comment: **Material error correction and ICFR**
We note in your response that you determined there was a control deficiency in your internal control over financial reporting; however, the deficiency did not rise to the level of a material weakness. A control deficiency constitutes a material weakness if there is a reasonable possibility that a material misstatement of the financial statements would not be prevented or detected in a timely manner. Based on your determination that the disclosure misstatements in your prior SEC filings were material and a result of a control deficiency, we are unable to agree with your conclusion that the related deficiency is not a material weakness. Please explain how you will address and disclose the ineffectiveness of internal control over financial reporting and disclosure controls and procedures for the period the material weakness existed.

Example SEC staff comment: **Immaterial error correction and ICFR**
Please explain the extent to which you considered the effect of the identified errors on your internal controls and explain how management's conclusion regarding the effectiveness of disclosure controls and procedures, as well as internal control over financial reporting, is appropriate in light of the errors. To the extent you determined there were control deficiencies that led to the errors, describe in reasonable detail the deficiencies, how you evaluated the severity of each related deficiency and error in your assessment. Please also include in your analysis a description of the maximum potential amount or total of transactions exposed to each related deficiency and explain how you made that determination.

Other areas of SEC comment *(cont'd)*

Example SEC staff comment: Disclosure controls and procedures and ICFR
Please explain how you concluded that your disclosure controls and procedures were effective as of December 31, 2018, considering that your internal control over financial reporting was not effective as of this date. Your explanation should be comprehensive and address all of the components of the definition of disclosure controls and procedures. We refer you to Sections II.D. and E of SEC Release 33-8238, in which the Commission recognizes that there is substantial overlap between ICFR and DCPs. For example, DCPs often include those components of ICFR that provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP. Please include in your response an explanation as to how you determined that the material weaknesses in your ICFR were not one of the components of ICFR that is also included in disclosure controls and procedures.

- ***Acquisition Pro Forma***: the SEC staff has focused on purchase price allocations in pro forma financial information, the appropriateness of presentation of pro forma information and pro forma adjustments per Article 11

Non-GAAP financial measures

- Following the SEC Staff's non-GAAP financial measures Compliance and Disclosure Interpretations (C&DIs) in May 2016, the SEC Staff stepped up reviews of non-GAAP measures used in filings
- The number of non-GAAP related Staff comments has moderated since 2017; however, non-GAAP measures continue to be an area of focus
- The Staff has commented on:
  - Inherently misleading non-GAAP measures
  - Prominence issues
  - Omission of tax effects from after-tax non-GAAP measure
  - The reasons for using, or the usefulness to investors of, the non-GAAP measure
  - Tailoring GAAP accounting principles
- For life sciences companies, sample comments include:

Non-GAAP financial measures *(cont'd)*

Example of SEC Comments – Excluding normal recurring expenses
• As you appear to incur upfront collaboration expenses in each period and have historically incurred these expenses in multiple periods, it appears that these expenses are normal, recurring, cash operating expenses whose exclusion from your non-GAAP income may be prohibited under CDI 100.01. • We note you define free cash flow as the total of net cash provided or required by operating activities and net cash provided or required by investing activities. Pursuant to Question No. 102.07 of the Staff's Compliance & Disclosure Interpretations ("C&DIs") on Non-GAAP Financial Measures, issued May 17, 2016, please advise of your consideration given to redefining this measure or its computation as they typical calculation of free cash flow (i.e., cash flows from operating activities less capital expenditures). Please provide us with any proposed revisions to your disclosure of free cash flow to be included in future filings.

Non-GAAP financial measures *(cont'd)*

- Example of SEC comment – Explain to us the adjustment as it appears you are using an individually tailored accounting principle (C&DI 100.04)
  - We note your adjustment to remove the step-up cost of the acquired inventory. Please explain to us in detail the adjustments and tell us how you determined that these adjustments are appropriate when they appear to result in individually tailored expense recognition methods.
  - We note that your quarterly earnings releases present combined basic and diluted earnings per share which are labeled as non-GAAP measures. We also note on page 42 of your Form 10-K that the economics and rights of the two classes of common stock are different. It appears that you are not using the two class method but using an individually tailored accounting principle to compute combined earnings per share.
  - We note your adjustment to include milestone payments received in deriving "non-GAAP revenue". Please tell us how you considered C&DI 100.4 and the prohibition to tailoring GAAP to accelerate revenue or change the pattern of expense recognition?

BREXIT, LIBOR AND CYBER

SEC Staff guidance

- The SEC Chair and other SEC Staff have indicated that in connection with annual reports on Form 10-K and 20-F for the year ended December 31, 2018, the Staff would expect that, to the extent relevant and material, issuers should discuss:
  - The impact of Brexit on the issuer's future operations, cash flows or financial position
  - The impact of the discontinuance of LIBOR, which may be relevant to issuers with credit facilities or outstanding debt

Cybersecurity guidance

- The Staff published guidance on cybersecurity in 2011, CF Disclosure Guidance: Topic No. 2, Cybersecurity
- In February 2018, the Commission published an interpretive release
  - The release reaffirms the prior guidance
  - A registrant should consider disclosures in:
    - Risk Factors
    - Management's Discussion and Analysis (MD&A)
    - Business (regulatory and legal proceedings)
    - Financial statements
- Registrants should consider whether cybersecurity risks are material
  - Materiality of risks may depend on company's industry sector and business model, the harm that a breach may have on Company's reputation, effect on financial performance, risk of regulatory investigations, litigation risk, customer and vendor relationships, and reputational risk

Cybersecurity guidance *(cont'd)*

  - How does management and the board manage the risks?
- Tailored disclosures, not generic disclosures
  - Disclosures should reference actual breaches to the extent these have occurred

Sample SEC Comment
We note your disclosure that you continue to face a host of cyber threats; your disclosure that cyber-crimes and denial of service attacks have increased; and your identification of cyber-attacks as a key risk. Please clarify whether you have knowledge of the occurrence of any such attacks in the past. If attacks have occurred, and were material either individually or in the aggregate, revise to discuss the related costs and consequences. Also, describe the particular aspects of your business and operations that give rise to material cybersecurity risks and the potential costs and other consequences of such risks to those businesses and operations. For additional guidance, please refer to the Commission's Interpretive guidance from February 2018.

Cybersecurity guidance *(cont'd)*

  - When does a duty to update or correct arise?
  - What are the triggers for a disclosure?
    - Are there specific regulations requiring disclosure of a breach even while a company is still investigating and assessing?
- MD&A disclosures should address financial consequences such as:
  - Costs related to remedial efforts
  - Costs associated with investigations
  - Loss contingencies

Sample SEC Comment
With respect to the cyber-security incident and related assessments and litigation, please tell us your consideration of the requirement in ASC 450-20-50-4.b. to disclose an estimate of the possible loss or range of loss or to disclose that such an estimate cannot be made.

RECENT ACCOUNTING PRONOUNCEMENTS

REVENUE RECOGNITION

Revenue recognition

- The implementation of the new revenue recognition standard, ASC 606, may raise particular issues for life sciences companies
  - Are transactions between parties to a collaboration agreement within the scope of ASC 606 in addition to ASC 808?
  - Many life sciences companies rely on contracts that have contingent payments or variable payments
  - Life sciences companies are required to consider arrangements pursuant to which performance takes place in steps or in stages

Revenue recognition *(cont'd)*

Illustration – Accounting for R&D services that are a single combined performance obligation versus a single performance obligation under the series provision
Biotech agrees to perform R&D services over a three-year period. In exchange, Pharma agrees to pay Biotech a fixed monthly payment for the R&D services and a $5 million milestone payment upon the enrollment of 100 patients in a phase II clinical trial. ***Analysis:*** If Biotech concludes that all of the R&D services to be provided over the three-year period are a single performance obligation comprising **non-distinct** services, the milestone would be included in the transaction price (subject to the constraint on variable consideration) and recognized based on the single measure of progress determined for the entire period of performance of the R&D services. This may result in a portion of the milestone being recognized as revenue throughout the R&D services period, including during the development period after the milestone is achieved. Conversely, if Biotech concludes that the R&D services are a single performance obligation comprising a series of **distinct** services, Biotech may be able to recognize the milestone payment as it enrolls patients in the clinical trial if certain criteria are met. Assuming those criteria are met and the Biotech concludes that the milestone should be included in the transaction price (because it is not constrained), the $5 million milestone payment is allocated directly to Biotech's efforts to perform the distinct services that led to the enrollment of the 100 patients. The entire $5 million milestone amount is recognized as revenue during the period when Biotech performed the distinct R&D services that led to the enrollment of the 100 patients (i.e., no revenue from the milestone payment would be recognized during the development period after the milestone is achieved).

Revenue recognition *(cont'd)*

Illustration – Accounting for a customer option
A medical device manufacturer contracts with its customer to provide a cancer-screening device, perform installation services and provide 50 consumable cartridges to be used with the device. The medical device manufacturer also offers the customer an option to purchase up to 50 additional consumable cartridges in the future at a 25% discount from the list price. The medical device manufacturer generally sells its products at the list price (i.e., undiscounted). ***Analysis:*** The medical device manufacturer likely will conclude that the customer option for the discounted consumable cartridges is a material right and therefore is a separate performance obligation. That's because the medical device manufacturer does not sell the replacement cartridges at a discount on a standalone basis or offer discounts to new customers that have not entered into a similar contract. Conversely, if the contract did not provide a discount for the additional consumable cartridges (i.e., the customer option to purchase up to 50 additional cartridges was at the medical device manufacturer's standalone selling price), the medical device manufacturer would likely determine that the customer option for additional consumable cartridges was not a material right and therefore would account for it as a separate contract when the customer exercises the option to purchase the additional consumable cartridges.

Collaborative arrangements (ASU 2018-18)

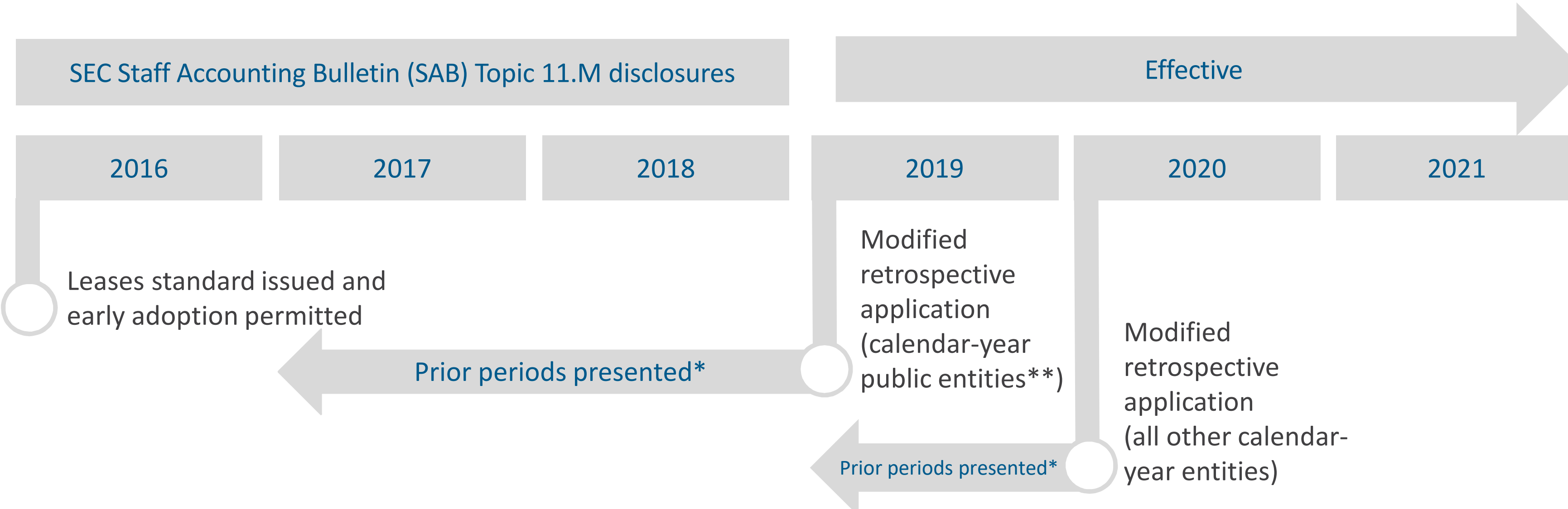
- These are contractual arrangements under which two or more parties actively participate in a joint operating activity and are exposed to significant risks and rewards
- ASU clarifies that transactions in a collaborative arrangement are in the scope of ASC 606 when the counterparty is a customer for a distinct good or service (i.e., a unit of account)
- Amounts from transactions outside the scope of ASC 606 cannot be presented together with revenue from contracts with customers
  - Entities are permitted to apply other guidance in ASC 606 to collaborative arrangements by analogy, even if the counterparty is not a customer, as long as consideration from the transaction is not presented together with revenue from contracts with customers

Effective dates for calendar-year entities		
PBEs	Non-PBEs	Early adoption?
Q1 2020	2021	Yes, only if the entity has adopted ASC 606

PLEASE LISTEN FOR CLE CODE

LEASES

Leases (ASC 842)
Effective date and transition



* ASU 2018-11 gives entities another transition option that allows them to continue to apply ASC 840, including its disclosure requirements, in the comparative periods presented in the year they adopt ASC 842.

** Public entities includes public business entities and certain not-for-profit entities and employee benefit plans.

- Modified retrospective method, either
  - To first day of earliest comparative period
  - To first day of the period of adoption (Q1 2019 or full year 2020)
- Full retrospective adoption is prohibited

Leases (ASC 842)
Overview

- Lessees recognize assets and liabilities for most leases but recognize expenses in a manner similar to today's accounting (ASC 840, Leases)
- For lessors, the new guidance modifies the lease classification criteria, leverages certain guidance in ASC 606 and eliminates leveraged lease accounting
- The new guidance eliminates real estate-specific provisions and changes the sale and leaseback guidance
- The new standard requires entities to make more judgments and estimates and provide more disclosures

Leases (ASC 842)
SEC reporting considerations

- Selected financial data table should follow the transition provisions of the standard
  - Registrants should not revise the years prior to the date of initial application in their five-year selected financial data table
  - Registrants should disclose lack of comparability of the data presented (if material)
- SEC Staff is closely monitoring Staff Accounting Bulletin Topic 11.M disclosures
  - If a registrant does not know or cannot reasonably estimate the effect of adopting the new standard, it should make a statement to that effect and consider providing qualitative disclosures
- The SEC staff expects a registrant's disclosures to evolve as the effective date of a standard approaches

Definition of a lease
Life sciences considerations

- A lease is a contract, or part of a contract, that conveys the right to control the use of identified property, plant or equipment (i.e., an identified asset) for a period of time in exchange for consideration.
- An identified asset can be a physically distinct portion of a larger asset.
- For life sciences entities, determining whether certain contracts, particularly those involving a service component, contain a lease may require judgement.
- Examples of significant service components for life sciences include:
  - Contract manufacturing
  - Supply agreements
  - Contract research arrangements
  - Transportation contracts

Definition of a lease

Life sciences considerations – example on identifying a lease

Illustration 1 – Contract manufacturing
Background: Biotech enters into a three-year agreement with Contract Manufacturing Organization (CMO) for a dedicated production line to manufacture Product X. The contract states that Biotech has the exclusive use of the production line (that is, CMO cannot use the manufacturing equipment for any other customer). The manufacturing qualifications of Product X are specified in the contract. Biotech issues instructions to CMO about the quantity and timing of products to be delivered. If the production line is not producing Product X for Biotech, it does not operate. CMO operates and maintains the production line on a daily basis. Analysis: • Determining whether a customer has the right to direct the use of an asset throughout the period of use may require significant judgment. **This contract contains a lease.** • Biotech has the right to use the dedicated production line for three years. **There is an identified asset.** • The dedicated production line is an implicitly identified asset because CMO has only one line that can fulfill the contract, and CMO does not have the right to substitute the specified production line. • Changes in facts and circumstances may result in a different conclusion.

Definition of a lease
Life sciences considerations – example on identifying a lease *(cont'd)*

Illustration 1 – Contract manufacturing
Analysis (cont'd): • Biotech has the right to control the use of the dedicated production line (i.e., the identified asset) throughout the three-year period of use because: – Biotech has the right to substantially all of the economic benefits from the use of the dedicated production line over the three-year period of use. Biotech has exclusive use of the dedicated production line; it has rights to all the Product X produced throughout the three-year period of use. – Biotech has the right to direct the use of the dedicated production line. Biotech makes the relevant decisions about how and for what purpose the production line is used because it has the right to determine whether, when, and how much the production line will produce (that is, the timing and quantity, if any, of Product X produced) throughout the period of use. Because CMO is prevented from using the production line for another purpose, Biotech's decision-making rights about the timing and quantity of Product X produced, in effect, determines when and whether the production line produces Product X. Although the operation and maintenance of the production line are essential to its efficient use, CMO's decisions in this regard do not give it the right to direct how and for what purpose the production line is used. Consequently, CMO does not control the use of the production line during the period of use. Instead, CMO's decisions are dependent on Biotech's decisions about how and for what purpose the production line is used.

Identifying and separating components
Life sciences considerations

- Medical device companies often enter into arrangements with hospitals to provide a lease of equipment along with non-lease components.
  - Non-lease components, for example, may include:
    - Supply of consumable products to be used with the leased equipment
    - Training services
    - Maintenance services
- In some contracts, the medical device company provides the equipment for no stated consideration.
  - Medical device companies do this because they expect to recover their costs for the equipment from the sales of consumable products.
- Because the medical device company transfers the consumable products at a point in time and lease payments for the equipment over the lease term, the non-lease and lease components do not have the same timing and pattern of transfer.
  - Therefore, the non-lease component relating to the sale of the consumable products is not eligible to be combined with the lease component under the lessor practical expedient.

Identifying and separating components
Life sciences considerations *(cont'd)*

- If a contract includes a lease and multiple non-lease components and a lessor has made an accounting policy election to not separate lease and associated non-lease components, the lessor must combine all components that qualify for the practical expedient and separately account for the non-lease component(s) that do not qualify.
  - That is, they must allocate consideration to and separately account for non-lease components that do not qualify for the practical expedient.
- Careful attention is required to allocate the consideration in the contract and any variable payments not based on an index or rate (e.g., optional purchases of consumable products) between the lease and non-lease components (or the lease and non-lease components not eligible for the lessor practical expedient when such an accounting policy is elected).
  - Additionally, companies will need to review their contracts to determine whether there are legally enforceable minimum purchase commitments or contractual penalties for not meeting contractual minimums.
  - These terms should be included in a company's determination of the consideration in the contract.

Lessee accounting
Life sciences considerations – lease commencement date

- At the commencement date of a lease, a lessee recognizes a liability to make lease payments and an asset representing the right to use the underlying asset during the lease term.
  - The commencement date is the date on which the lessor makes an underlying asset available for use by the lessee.
- In some cases, the commencement date of the lease may be before the date stipulated in the lease agreement (e.g., the date rent becomes due and payable).
  - For life sciences entities, this often occurs when the leased space is modified by the lessee prior to commencing operations in the leased space.
  - In making the assessment of lease commencement, it will often be necessary to distinguish lessee versus lessor assets.

MILESTONES AND COLLABORATIONS

Specific areas of comment: Licensing, partnering or other collaborative arrangements

- Material terms of any license agreement, including:
- Contract terms
- Royalty payments
  - SEC usually is comfortable with a range of royalty payments within a 10% range
- Milestone payment obligations, including the aggregate amounts that may be paid or that are payable under such provisions
- Geographic coverage
- Allocation of responsibilities
- IP rights
- Term and termination

Specific areas of comment: Revenue recognition disclosures

- Milestone method of revenue recognition
  - A description of the arrangement, including each milestone and contingency
  - A determination as to whether a milestone is considered significant
  - How management assesses which milestones are significant
  - The amount of consideration recognized during the period for the milestone

Example of SEC Comments

- Please tell us how your policy to recognize milestone consideration upon achievement of the associated milestone complies with the guidance in ASC 605-28-25-1 and 25-2. This comment also applies to your policy related to milestones in your collaborative licensing and development revenue policy.
- Please address the following:
  - Tell us how your sales based “milestones” meet the GAAP definition of milestones under ASC 605-28-20. If you believe these milestones meet the GAAP definition, demonstrate to us how these milestones are substantive in order to recognize revenue immediately under ASC 605-28-25-1.
  - If your sales-based “milestones” do not meet the GAAP definition of milestones, revise the sales and regulatory milestone portion of your proposed revised policy to differentiate between your regulatory milestones and sales-based contingent payments and separately explain why recognition upon achievement is appropriate.

- How collaborative arrangements will impact the company’s financial results

OTHER MD&A DISCLOSURES

What are the goals for MD&A?

- Focus on material information relating to financial condition, liquidity and capital resources, changes in financial condition and results of operations.
- Avoid immaterial information that does not promote an understanding of the above-referenced categories of information.
- Discuss key performance indicators that management uses to run the business.
- Discuss known trends, events, demands, commitments and uncertainties that are reasonably likely to have a material effect on financial condition or operating results:
  - Focus on material events and uncertainties known to management that would cause reported financial results to not be indicative of future results or financial condition.

What are the goals for MD&A? *(cont'd)*

Example SEC staff comment: Results of operations – known trends and uncertainties
We note a substantial increase in your allowance for doubtful accounts year over year. And, we note a further increase in the first quarter ended March 31, 2017. Please expand MD&A and Risk Factors in future filings to discuss all known material trends, events or uncertainties that have had or are reasonably expected to have a material impact on your financial condition and results of operation. Refer to Item 303(a)(3) of Regulation S-K and SEC Release No. 33-8350.

Example SEC staff comment: Results of operations – Expanding MD&A based on a known material trend discussed in earnings release
We note you highlight in your earnings release that 2017 was "Another Year of Significant Cost Reductions." Please provide a more detailed discussion of the specific components of costs of services in MD&A that management believes can be reduced through the Company's ongoing cost reduction efforts.

- Explain management's view of the implications and significance of information disclosed in MD&A.

Key terms

- "Known trends"
  - In the 1989 Interpretive Release, the SEC set forth a two-step analysis for determining when known trends and uncertainties must be disclosed. This analysis differs from traditional materiality analysis—and sets an arguably lower disclosure threshold.
    - Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required.
    - If management cannot make that determination, it must evaluate the consequences of the known trend, demand, commitment, event or uncertainty on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the company's financial condition or results of operations is not reasonably likely to occur.
  - In the 1989 Interpretive Release, the SEC indicated that the need for trend disclosure in the MD&A does not require companies to reveal ongoing merger negotiations, at least where the company believes that "inclusion of such information would jeopardize completion of the transaction."

Key terms *(cont'd)*

- "Known trends" *(cont'd)*
  - In the 2003 Interpretive Release, the SEC indicated that it expected companies to consider all relevant information (financial and non-financial) available to them, even if that information is not required to be disclosed, noting that such information "over time, may reveal a trend or general pattern in activity, a departure or isolated variance from an established trend, an uncertainty, or a reasonable likelihood of the occurrence of such an event that should be disclosed."
- "Reasonably likely"
  - The SEC has indicated that this disclosure threshold is lower than "more likely than not," however disclosure may be required even when the likelihood of occurrence of known trend or uncertainty is less than 50/50. The 2002 Commission Statement noted that market price changes, economic downturns, defaults on guarantees, or contractions of operations that have material consequences for the company's financial position or operating results can be "reasonably likely" to occur under some conditions. The SEC has repeatedly stated that the "reasonably likely to occur" test is not the same as the probability/magnitude materiality test of *Basic v. Levinson.*

Key terms *(cont'd)*

- The 2003 Interpretive Release states:
  - "When a description of known material trends, events, demands, commitments and uncertainties is set forth, companies should consider including, and may be required to include, an analysis explaining the underlying reasons or implications, interrelationships between constituent elements, or the relative significance of those matters. Identifying the intermediate effects of trends, events, demands, commitments and uncertainties alone, without describing the reasons underlying these effects, may not provide sufficient insight for a reader to see the business through the eyes of management. A thorough analysis often will involve discussing both the intermediate effects of those matters and the reasons underlying those intermediate effects."

Approaching MD&A

- From a speech delivered by former SEC Commissioner Elisse B. Walter on June 25, 2013:
  - "You should address your investors like they are your business partners, and the MD&A should reflect that perspective. You wouldn't address a business partner with boilerplate. Your investors deserve the same respect."
  - Her key questions for MD&A are:
    - What is the company's business today?
    - How did it perform?
    - Where is the cash?
    - What are the company's key business drivers?
    - What are the risks and uncertainties?
    - How flexibly can the company respond to change?
    - What do the company's future prospects look like?

Analysis

- MD&A requires not only a "discussion," but also an "analysis" that explains management's view of the implications and significance of that information and that satisfies the objectives of MD&A.
  - Explaining the reasons or causes and implications of identified known trends and uncertainties may be necessary to allow investors to see the business through the eyes of managements.

Example SEC staff comment: Results of operations – quantification of factors
We note that your comparative discussions of costs and expenses identify multiple variables as the reasons for the period-to-period changes in your operating results. However, you do not quantify the impact of each of these variables. Please revise to quantify the impact of each material factor that you discuss to provide your readers with better insight into the underlying reasons behind the changes in your results. Refer to Instruction 4 to Item 303(a) of Regulation S-K, Section III.D of Release No. 33-6835 and Section III.B of Release No. 33-8350.

Specific areas of comment: R&D, trials and studies

- The SEC comments extensively on R&D expenses and related matters
- Examples:
  - Current status of clinical trials for each product in the pipeline
  - Details on the effectiveness of the trial process
  - Results for each phase of the trial
  - Adverse events from trials that may indicate deficiencies or result in delays
  - Disclosures relating to FDA submissions and communications
- The nature, objective and status of each project
- The costs incurred during each reporting period
- Costs tracked by project and by period

Loss contingencies

- Life sciences companies frequently address patent litigation, which requires consideration of loss contingencies
- The SEC staff has been focusing on disclosures that may not address the requirements of ASC 450. The staff also has questioned issuers that quarter to quarter fail to update their loss contingency disclosures

Example SEC staff comment: Accounting for and disclosure of loss contingencies
We note that you disclose several legal matters and, in some instances, you indicate that you intend to vigorously defend the action and you have not reserved for any potential future payments in addition to the amounts accrued. In accordance with ASC 450-20-50, please revise future filings to clearly disclose the following information for your loss contingencies in aggregate or individually: (1) the amount or range of reasonably possible losses in addition to the amounts accrued or (2) a statement that the reasonably possible losses cannot be estimated or are not material to your financial statements.

CONCLUDING THOUGHTS

Concluding thoughts

- In addition to taking into account the areas of SEC comment letter focus and the disclosure trends highlighted by SEC representatives, preparers of annual reports also should consider:
  - The changes to Form 10-K and Form 20-F requirements resulting from SEC disclosure amendments
  - The new standards for smaller reporting companies

SEC Expands Definition of Smaller Reporting Company

On June 28, 2018, the US Securities and Exchange Commission (SEC) revised the definition of "smaller reporting company" in order to expand the number of registrants that will qualify as smaller reporting companies.[1] The amendments to the definition of smaller reporting company had been proposed in 2016,[2] and the amendments had been well-received by commenters. The change to the definition of smaller reporting company is intended to reduce compliance costs for those registrants, while maintaining appropriate investor protections. At the same time, the SEC amended the definitions of "accelerated filer" and "large accelerated filer" to preserve the existing qualifying thresholds in those definitions. This means that qualifying as a smaller reporting company will no longer automatically make a registrant a non-accelerated filer. These changes and related changes to the cover pages of certain forms applicable to all issuers become effective 60 days after they are published in the *Federal Register*. It is expected that the changes will become effective by the middle of September 2018.

Background

The SEC created the smaller reporting company category in 2008 to provide regulatory relief for smaller companies by allowing them to provide scaled disclosures under Regulation S-K and Regulation S-X. Prior to this most recent SEC action, smaller reporting companies generally were required to have less than $75 million in public float. Companies that did not have any outstanding public equity, or that had no market price for their public equity, had to have less than $50 million in annual revenues in order to be considered a smaller reporting company.

Revisions to Definition of Smaller Reporting Company

The SEC has revised the definition of "smaller reporting company" in Rule 405 under the Securities Act of 1933 (Securities Act); Item 10(f) of Regulation S-K; and Rule 12b-2 under the Securities Exchange Act of 1934 (Exchange Act), to mean an issuer that, as of an applicable determination date, had:

- A public float of less than $250 million or
- Annual revenues of less than $100 million and either:
  - No public float or
  - A public float of less than $700 million.

For reporting companies, the date for determining public float is the last business day of the issuer's most recently completed second fiscal quarter, while for companies filing an initial registration statement, public float is to be determined as of a date within 30 days of the date of the filing of the registration statement. In both cases, annual revenues are as of the most recently completed fiscal year for which audited financial statements are available.

As with the current definition, issuers that are investment companies, asset-backed issuers or majority-owned subsidiaries of a parent that is not a smaller reporting company cannot qualify as a smaller reporting company.

Once an issuer determines that it does not qualify as a smaller reporting company, it will remain unqualified unless when making its annual determination either it determines that:

- Its public float was less than $200 million or
- Its public float and its annual revenues meet the requirements for qualification included in the following chart:

Prior Annual Revenues	Prior Public Float	
	None or less than $700 million	**$700 million or more**
Less than $100 million	Neither threshold exceeded.	**Public float** Less than $560 million and **Revenues** Less than $100 million.
$100 million or more	**Public float** None or less than $700 million and **Revenues** Less than $80 million.	**Public float** Less than $560 million and **Revenues** Less than $80 million.

Revisions to the Definitions of Accelerated Filer and Large Accelerated Filer

The SEC has revised the definitions of "accelerated filer" and "large accelerated filer" in Rule 12b-2 under the Exchange Act to eliminate the prohibition on smaller reporting companies being able to qualify as an accelerated filer or large accelerated filer. This means that a smaller reporting company will now need to consider whether it qualifies as either an accelerated filer or a large accelerated filer as of the end of its second fiscal quarter and, if so, comply with the accelerated filing deadlines for Exchange Act reports and other applicable provisions beginning in its next fiscal year. In addition, accelerated filers and large accelerated filers that aren't emerging growth companies must comply with the auditor attestation requirements relating to internal control over financial reporting imposed by Section 404(b) of the Sarbanes-Oxley Act, while, up to this point, smaller reporting companies were exempt from this requirement as they could not be accelerated filers or large accelerated filers.[3]

In their comments on the proposed amendments, market participants, trade groups and various SEC advisory groups had noted that the threshold for triggering the Section 404(b) auditor attestation requirement ought to be reevaluated given that for many smaller reporting companies the requirement may be unduly burdensome. In the SEC's open meeting, Commissioner Piwowar and Commissioner Peirce both addressed the importance of reevaluating the threshold triggering the Section 404(b) auditor attestation requirement, with Commissioner Piwowar noting that changes to the accelerated filer definition "are inextricably linked to the [smaller reporting company] regime"[4] and Commissioner Peirce noting that "Section 404(b) of Sarbanes-Oxley" is "the most glaring burden on small issuers."[5] In the adopting release, the SEC noted that Chairman Clayton "has directed the staff to formulate recommendations to the SEC for possible additional changes to the 'accelerated filer' definition that, if adopted, would have the effect of reducing the number of registrants that qualify as accelerated filers" and, as a result, reverse, or at least lessen, the impact of the SEC's changes to the definitions of accelerated filer and large accelerated filer.

Changes to Securities Act and Exchange Act Forms

In addition to the changes to the definitions of "smaller reporting company," "accelerated filer" and "large accelerated filer," the SEC also revised the cover pages of Forms S-1, S-3, S-4, S-8 and S-11 under the Securities Act and Forms 10, 10-K and 10-Q under the Exchange Act, in each case to eliminate the instruction informing filers to not check the "Non-accelerated filer" box if the issuer is a smaller reporting company.

Revisions to Rule 3-05(b)(2) of Regulation S-X

Rule 3-05 of Regulation S-X sets forth the requirements for when financial statements of a newly acquired business or a business to be acquired must be provided in Securities Act and Exchange Act filings.

The SEC has amended Rule 3-05(b)(2)(iv) to allow registrants to omit financial statements for the earliest of the three required fiscal years if the net revenues of the business to be acquired are less than $100 million, up from $50 million in the current rule. This rule change applies to all companies, not just smaller reporting companies.

Practical Considerations

In order to make informed decisions for the future, existing smaller reporting companies should consider the new qualification thresholds, particularly those issuers that were close to the current thresholds for losing their status or may lose their status based on the current definition and their annual determination as of the end of the second quarter (June 30, 2018, for most companies). The changes could allow these companies to benefit from the revised smaller reporting company thresholds, particularly the scaled disclosure requirements, for some time going forward.

The amendments did not modify any of the scaled disclosure accommodations for smaller reporting companies, which may continue to be complied with on an item-by-item basis. A smaller reporting company may want to consider undertaking a review regarding the accommodations that it will rely on in light of its prior disclosures, the types of disclosures made by peer companies and the types of information typically sought out by research analysts and other financial professionals.[6] As part of this review and even though there is a substantial overlap in the accommodations provided, a smaller reporting company that also qualifies as an emerging growth company should examine the accommodations provided to emerging growth companies as it determines what types of disclosure it will provide going forward.

A smaller reporting company will now need to determine whether it also qualifies as an "accelerated filer" or a "large accelerated filer." If it does, going forward, this could impact the timing of when the issuer files its quarterly reports on Form 10-Q and its annual reports on Form 10-K, as those filers have shorter filing deadlines for these reports than smaller reporting companies have. In addition, smaller reporting companies that qualify as accelerated filers or large accelerated filers and that aren't otherwise emerging growth companies need to comply with the auditor attestation requirements on the registrant's internal control over financial reporting. Now that the end of the second quarter has passed for most companies, smaller reporting companies should examine whether they will be accelerated filers or large accelerated filers and plan their future filing schedules and attestation processes accordingly, as late filings can result in the loss of eligibility to use Form S-3.

A company that does not qualify as a smaller reporting company under the existing definition should look closely at the new thresholds to determine whether it is eligible to subsequently become a smaller reporting company. If so, the smaller reporting company should take into account the accommodations made for smaller reporting companies when planning their future SEC filings.

When the SEC adopts new or revised rules, it is not unusual for the staff of the Division of Corporation Finance to issue interpretations to help issuers navigate the new provisions. Smaller reporting companies, under either the existing or the revised definitions, should monitor any developments in this area.

Finally, all issuers, whether or not smaller reporting companies, will need to revise the cover pages of various forms that they file with the SEC after the effective date of the revised rules. For most companies, this change will need to be reflected beginning with the Form 10-Q that is to be filed for the quarter ending September 30, 2018.

For more information about the topics raised in this Legal Update, please contact the author, Michael L. Hermsen, at +1 312 701 7960, any of the following lawyers or any other member of our Corporate & Securities practice.

Michael L. Hermsen
+1 312 701 7960
mhermsen@mayerbrown.com

David S. Bakst
+1 212 506 2551
dbakst@mayerbrown.com

John P. Berkery
+1 212 506 2552
jberkery@mayerbrown.com

Robert F. Gray, Jr.
+1 713 238 2600
rgray@mayerbrown.com

Philip J. Niehoff
+1 312 701 7843
pniehoff@mayerbrown.com

Anna T. Pinedo
+1 212 506 2275
apinedo@mayerbrown.com

Laura D. Richman
+1 312 701 7304
lrichman@mayerbrown.com

David A Schuette
+1 312 701 7363
dschuette@mayerbrown.com

Endnotes

[1] Amendments to Smaller Reporting Company Definition, Securities Act Release 33-10513, available at https://www.sec.gov/rules/final/2018/33-10513.pdf ("Adopting Release").

[2] Amendments to Smaller Reporting Company Definition, Securities Act Release 33-10107, available at https://www.sec.gov/rules/proposed/2016/33-10107.pdf.

[3] See Item 308(b) of Regulation S-K.

[4] https://www.sec.gov/news/public-statement/statement-piwowar-src-062818

[5] https://www.sec.gov/news/public-statement/peirce-statement-smaller-reporting-companies-062818

[6] A useful chart summarizing the scaled disclosure accommodations for smaller reporting companies is provided on pages 7 though 9 of the Adopting Release.

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Legal Update
August 29, 2018

Capital Markets Implications of Amendments to Simplify and Update SEC Disclosure Rules

On August 17, 2018, the US Securities and Exchange Commission (SEC) amended certain disclosure requirements that it determined to be redundant, duplicative, overlapping, outdated or superseded in light of other SEC disclosure requirements, US GAAP or changes in the information environment.[1] The SEC initially proposed these amendments as part of its Disclosure Effectiveness Initiative and, subsequently, was required by the Fixing America's Surface Transportation (FAST) Act to undertake a study regarding Regulation S-K disclosure requirements. In addition, a number of other SEC proposed amendments relating to the Industry Guides and other disclosure requirements await SEC action. As a result, these amendments should be viewed as another incremental step in what may be a more comprehensive effort to reduce or modify the disclosure requirements that may be viewed as burdensome or outdated.

In connection with this series of amendments, some disclosure requirements have been modified, eliminated or consolidated with other disclosure requirements. The SEC also referred certain disclosure requirements to the Financial Accounting Standards Board (FASB) for potential incorporation into US GAAP. These amendments, which become effective 30 days after publication in the *Federal Register*, include revisions to Regulation S-K and Regulation S-X and therefore will impact upcoming SEC filings, including quarterly and annual reports, as well as registration statements for securities offerings.

Executive Overview of the Disclosure Amendments

This Legal Update highlights amendments to disclosure rules in several key areas. Individuals who are tasked with preparing SEC filings will need to carefully review the texot of the amended rules, many of which are technical in nature, applicable to such filings.

According to the adopting release, the disclosure update and simplification amendments "are intended to facilitate the disclosure of information to investors and simplify compliance without significantly altering the total mix of information provided to investors." Nevertheless, these amendments impact a large number of SEC rules, regulations and forms, as detailed in Appendix A of this Legal Update.

Business Disclosure. The amendments include changes to Regulation S-K, which contains integrated disclosure rules applicable to domestic issuers and foreign private issuers that elect to make filings with the SEC on forms used by domestic issuers. For example, the following Regulation S-K amendments affect business section disclosure:

- Deletion of the requirement set forth in Item 101 of Regulation S-K to include, if material, the amount spent on research and development activities, with the SEC noting that disclosure of material trend information related to research and development activities and expenses is required to be included in management's discussion and analysis of financial condition and results of operations (MD&A) of Item 303 of Regulation S-K;

- Deletion of the Item 101 requirement to disclose segment financial information, with the SEC observing that these disclosures will continue to be available in notes to the financial statements;
- Deletion of the Item 101 requirement to disclose financial information by geographic area, with an explicit reference to "geographic areas" added to the MD&A disclosure requirement;
- Retention of the Item 101 requirement to provide seasonality disclosure at the segment level to the extent material to understanding the business as a whole (although the SEC deleted instruction 5 to Item 303(b) of Regulation S-K relating to MD&A seasonality disclosure in interim periods because US GAAP and the balance of Item 303 require interim disclosures that convey similar information);
- Deletion of the Item 101 requirement to identify the SEC's public reference room; and
- Expansion of the Item 101 requirement to disclose issuer website addresses of all issuers that have one.

Market Price and Dividend Disclosure. The amendments that changed market price and dividend disclosure requirements include:

- Deletion of the requirement to disclose high and low common stock trading prices for the past two years for most issuers;
- Deletion of the requirements to disclose the amount and frequency of cash dividends declared from Item 201 of Regulation S-K, with Rule 3-04 of Regulation S-X amended to require disclosure of the amount of dividends in interim periods;
- Consolidation of the Item 201 requirement to disclose restrictions on dividends into revised Rule 4-08 of Regulation S-X; and
- Replacement of detailed disclosure of sale or bid prices previously required by Item 201 with the trading symbol for most companies whose common equity is traded in a public trading market.

Ratio of Earnings to Fixed Charges. The amendments deleted the requirement to disclose the ratio of earnings to fixed charges from Item 503 of Regulation S-K and deleted the related Item 601 exhibit requirement. To clarify that the ratio of earnings to fixed charges is not required in registration statements under the Securities Act of 1933, corresponding changes were made to delete the reference to that ratio from the titles of items in SEC forms that refer to Item 503, such as Item 3 of both Form S-1 and Form S-3.

Regulation S-X. The disclosure update and simplification amendments involve more than 50 changes or referrals to the FASB of Regulation S-X rules, including amendments to Regulation S-X to avoid overlapping disclosure requirements, referral of certain Regulation S-X requirements to the FASB for consideration in upcoming FASB rulemaking and corrections to superseded requirements. The Regulation S-X amendments generally relate to domestic issuers and to foreign private issuers that either report under US GAAP or a comprehensive body of accounting principles other than US GAAP or International Financial Reporting Standards with a reconciliation to US GAAP. A few examples of these Regulation S-X changes:

- Deletion of the requirement for pro forma interim financial information for business combinations in Rule 8-03 and 10-01 of Regulation S-X, with the SEC relying on US GAAP and Item 9.01 of Regulation S-K to generate similar disclosures;
- Deletion of the requirement in Regulation S-X to disclose, in interim financial statements, material events subsequent to the end of the most recent fiscal year in light of similar disclosures that result from compliance with a

combination of US GAAP and Item 303(b) of Regulation S-K;

- Retention of the requirement of Rule 4-07 Regulation S-X to present a discount on shares in a manner that is incremental to US GAAP requirements, while referring this Regulation S-X disclosure requirement to the FASB for potential incorporation into US GAAP; and
- Deletion of the requirements in Rule 8-03 and Rule 10-01 of Regulation S-X to present dividends per share on the face of the income statement for interim periods because US GAAP prohibits this disclosure on the face of the financial statements (but permits it in the notes to the financial statements).

Amendments for Specific Issuer Categories. Some of the disclosure update and simplification amendments apply only to specific categories of issuers, such as amendments to SEC forms that only affect the types of issuers using such forms. For example, because exchange rate information is readily available for free on a number of websites, the SEC amended Form 20-F, which is used by foreign private issuers, to delete the requirement for such issuers to provide exchange rate data when financial statements are prepared in a currency other than the US dollar.

Practical Considerations

The amended disclosure rules will impact quarterly and annual reports filed after the effective date of the rule changes. Therefore, companies should begin preparations for their periodic reports earlier than they typically would. It will be particularly important for companies to undertake an updated "form check" for compliance with SEC disclosure requirements when preparing their first quarterly and annual reports affected by the amendments.

Because so many of the amendments involve changes to, or referrals to the FASB of, Regulation S-X rules, company personnel responsible for preparing financial statements should carefully review these amendments and work closely with their auditors to identify the changes they will need to make to presentations of financial information in SEC filings.

The amendments may impact the process for preparing disclosure, as well as the content of disclosure. For example, moving some disclosure items from outside to inside, or from inside to outside, the financial statements impacts audit review and XBRL tagging requirements. Companies should also consider whether they need to update their disclosure controls and procedures and/or their internal control over financial reporting in light of these amendments.

The Private Securities Litigation Reform Act of 1995 does not provide a safe harbor for forward-looking information presented within the financial statements. Therefore, companies should carefully consider whether any disclosures that are moving to the financial statements under the amended rules contain voluntary forward-looking statements that they may not want to include. The SEC noted in the adopting release that "issuers retain the option of providing forward-looking information outside the financial statements and may be required to disclose the information in certain circumstances."

The SEC has requested that the FASB determine whether referred disclosure items will be added to the FASB's agenda for potential standard setting within 18 months after the adopting release is published in the *Federal Register*. To the extent that companies have opinions on provisions that the SEC has referred to the FASB, they should monitor such proposed rulemaking and, when there is an appropriate opportunity, submit comments on those provisions.

Appendix A

The following chart from the SEC's adopting release for the disclosure update and simplification amendments identifies the rules, regulations and forms that the SEC either amended or referred to the FASB:

Commission Reference		CFR Citation (17 CFR)
Regulation S-X[2]	Rule 1-02	§ 210.1-02
	Rule 2-01	§ 210.2-01
	Rule 2-02	§ 210.2-02
	Rule 3-01	§ 210.3-01
	Rule 3-02	§ 210.3-02
	Rule 3-03	§ 210.3-03
	Rule 3-04	§ 210.3-04
	Rule 3-05	§ 210.3-05
	Rule 3-12	§ 210.3-12
	Rule 3-14	§ 210.3-14
	Rule 3-15	§ 210.3-15
	Rule 3-17	§ 210.3-17
	Rule 3-20	§ 210.3-20
	Rule 3A-01	§ 210.3A-01
	Rule 3A-02	§ 210.3A-02
	Rule 3A-03	§ 210.3A-03
	Rule 3A-04	§ 210.3A-04
	Rule 4-01	§ 210.4-01
	Rule 4-07	§ 210.4-07
	Rule 4-08	§ 210.4-08
	Rule 4-10	§ 210.4-10
	Rule 5-02	§ 210.5-02
	Rule 5-03	§ 210.5-03
	Rule 5-04	§ 210.5-04
	Rule 6-03	§ 210.6-03
	Rule 6-04	§ 210.6-04
	Rule 6-07	§ 210.6-07
	Rule 6-09	§ 210.6-09
	Rule 6A-04	§ 210.6A-04
	Rule 6A-05	§ 210.6A-05
	Rule 7-03	§ 210.7-03
	Rule 7-04	§ 210.7-04
	Rule 7-05	§ 210.7-05
	Rule 8-01	§ 210.8-01
	Rule 8-02	§ 210.8-02
	Rule 8-03	§ 210.8-03
	Rule 8-04	§ 210.8-04
	Rule 8-05	§ 210.8-05
	Rule 8-06	§ 210.8-06
	Rule 9-03	§ 210.9-03
	Rule 9-04	§ 210.9-04
	Rule 9-05	§ 210.9-05
	Rule 9-06	§ 210.9-06
	Rule 10-01	§ 210.10-01
	Rule 11-02	§ 210.11-02
	Rule 11-03	§ 210.11-03
	Rule 12-16	§ 210.12-16

Commission Reference		CFR Citation (17 CFR)
	Rule 12-17	§ 210.12-17
	Rule 12-18	§ 210.12-18
	Rule 12-21	§ 210.12-21
	Rule 12-22	§ 210.12-22
	Rule 12-23	§ 210.12-23
	Rule 12-24	§ 210.12-24
	Rule 12-27	§ 210.12-27
	Rule 12-28	§ 210.12-28
	Rule 12-29	§ 210.12-29
Regulation S-K[3]	Item 10	§ 229.10
	Item 101	§ 229.101
	Item 201	§ 229.201
	Item 302	§ 229.302
	Item 303	§ 229.303
	Item 406	§ 229.406
	Item 503	§ 229.503
	Item 504	§ 229.504
	Item 508	§ 229.508
	Item 512	§ 229.512
	Item 601	§ 229.601
Regulation M-A[4]	Item 1010	§ 229.1010
Regulation AB[5]	Item 1118	§ 229.1118
Securities Act of 1933 (Securities Act)[6]	Rule 158	§ 230.158
	Rule 405	§ 230.405
	Rule 436	§ 230.436
	Form S-1	§ 239.11
	Form S-3	§ 239.13
	Form S-11	§ 239.18
	Form S-4	§ 239.25
	Form F-1	§ 239.31
	Form F-3	§ 239.33
	Form F-4	§ 239.34
	Form F-6	§ 239.36
	Form F-7	§ 239.37
	Form F-8	§ 239.38
	Form F-10	§ 239.40
	Form F-80	§ 239.41
	Form SF-1	§ 239.44
	Form SF-3	§ 239.45
	Form 1-A	§ 239.90
	Form 1-K	§ 239.91
	Form 1-SA	§ 239.92
Securities Exchange Act of 1934 (Exchange Act)[7]	Rule 3a51-1	§ 240.3a51-1
	Rule 10A-1	§ 240.10A-1
	Rule 12b-2	§ 240.12b-2
	Rule 12g-3	§ 240.12g-3
	Rule 13a-10	§ 240.13a-10
	Rule 13b2-2	§ 240.13b2-2
	Rule 14a-101	§ 240.14a-101
	Rule 15c3-1g	§ 240. 15c3-1g
	Rule 15d-2	§ 240.15d-2
	Rule 15d-10	§ 240.15d-10

Commission Reference		CFR Citation (17 CFR)
	Rule 17a-5	§ 240.17a-5
	Rule 17a-12	§ 240.17a-12
	Rule 17g-3	§ 240.17g-3
	Rule 17h-1T	§ 240.17h-1T
	Form 10	§ 249.210
	Form 20-F	§ 249.220f
	Form 40-F	§ 249.240f
	Form 10-K	§ 249.310
	Form 11-K	§ 249.311
	Form 10-D	§ 249.312
	Form X-17A-5	§ 249.617
Investment Company Act of 1940 (Investment Company Act)[8]	Form N-8B-2	§ 274.12
Securities Act and Investment Company Act	Form N-5	§ 239.24 and 274.5
	Form N-1A	§ 239.15A and 274.11A
	Form N-2	§ 239.14 and 274.11a-1
	Form N-3	§ 239.17a and 274.11b
	Form N-4	§ 239.17b and 274.11c
	Form N-6	§ 239.17c and 274.11d

For more information about the topics raised in this Legal Update, please contact the authors, Laura D. Richman, at +1 312 701 7304, or Michael L. Hermsen, at +1 312 701 7960, or any of the following lawyers or any other member of our Corporate & Securities practice.

Laura D. Richman
+1 312 701 7304
lrichman@mayerbrown.com

Michael L. Hermsen
+1 312 701 7960
mhermsen@mayerbrown.com

David S. Bakst
+1 212 506 2551
dbakst@mayerbrown.com

Robert F. Gray, Jr.
+1 713 238 2600
rgray@mayerbrown.com

Anna T. Pinedo
+1 212 506 2275
apinedo@mayerbrown.com

Endnotes

[1] See https://www.sec.gov/rules/final/2018/33-10532.pdf.

[2] 17 CFR 210.10 through 210.12-29.

[3] 17 CFR 229.10 through 229.1208.

[4] 17 CFR 229.1000 through 229.1016.

[5] 17 CFR 229.1100 through 229.1125.

[6] 15 U.S.C. 77a *et seq.*

[7] 15 U.S.C. 78a *et seq.*

[8] 15 U.S.C. 80a *et seq.*

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Legal Update
January 3, 2019

10 Tips for 10-Ks and Proxy Statements

With preparations shifting into high gear for calendar-year companies that file annual reports on Form 10-K and proxy statements with the US Securities and Exchange Commission (SEC), here are tips to consider when drafting these documents.

10-K Tips

1. Disclosure Update and Simplification. The SEC adopted “Disclosure Update and Simplification” amendments on August 17, 2018, which became effective on November 5, 2018. The amendments were designed to address disclosure requirements that the SEC considered to be redundant, duplicative, overlapping, outdated or superseded in light of other SEC disclosure requirements, US generally accepted accounting principles or changes in the “information environment.” Annual reports on Form 10-K now need to comply with these amendments.

Many of the disclosure update and simplification amendments impact financial statements and related footnotes and items required by Regulation S-X. In some cases, the new requirements move disclosure from outside to inside the financial statements and, in other cases, from inside to outside the financial statements. These location changes impact audit review, XBRL tagging requirements and the ability to rely on the safe harbor for forward-looking statements under the Private Securities Litigation Reform Act of 1995.

The disclosure update and simplification amendments also affect non-accounting portions of the Form 10-K. For example, companies are no longer required to provide two years of high and low sale prices for their stocks. Similarly, the requirement to disclose the amount and frequency of cash dividends has been eliminated, as has the requirement to include disclosure of the ratio of earnings to fixed charges. Other changes to the Form 10-K include elimination of segment financial information, elimination of amounts spent on research and development and elimination of financial information by geographic area in the business section. In each case, it is important to remember that, although the disclosure was eliminated from specified portions of the Form 10-K, corresponding disclosure may be needed or required in the notes to the financial statements or in the management’s discussion and analysis (MD&A). The amendments also eliminate the requirement for the business section to include the address of the SEC’s public reference room, although companies must state that the SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC and must provide the address of that site. A company must also include its own Internet address, if it has a website, in the Form 10-K.

Companies should work closely with their accountants and counsel to be sure that their annual reports on Form 10-K comply with the new requirements. Companies should also consider whether they need to update their disclosure controls and procedures and/or their internal control over financial reporting in light of these amendments.

For further information about the disclosure update and simplification amendments, see our Legal Update "Capital Markets Implications of Amendments to Simplify and Update SEC Disclosure Rules," dated August 29, 2018.[1]

2. Cybersecurity Disclosure. Cybersecurity continues to grow as a global concern. Accordingly, companies should be sure that they are addressing this topic adequately in their annual reports on Form 10-K. In addition to discussing cybersecurity as a risk factor, companies should consider, based on facts and circumstances, whether they need to discuss cybersecurity more broadly in the context of their business and operations, legal proceedings, MD&A, financial statements, disclosure controls and procedures, and corporate governance. The SEC staff has been focusing on, and providing comments to companies regarding, cybersecurity disclosure. Due to the significance of cybersecurity issues, the SEC staff monitors press reports on cybersecurity incidents and may raise questions about the sufficiency of cybersecurity disclosure in SEC reports on that basis.

On February 21, 2018, the SEC published interpretive guidance to assist public companies in preparing disclosures about cybersecurity risks and incidents. For more information on the SEC's cybersecurity guidance, see our Legal Update "SEC Issues Updated Guidance on Cybersecurity Disclosures," dated February 28, 2018.[2]

3. Brexit Disclosure. Disclosures made in prior years of expectations regarding how "Brexit" (i.e., the United Kingdom's potential withdrawal from the European Union) will impact a company should be re-evaluated to determine if they are still current. Companies impacted by Brexit should include up-to-date disclosure in their annual reports on Form 10-K. Brexit disclosure should describe how Brexit is expected to impact the company and its operations, taking into account the current status of Brexit negotiations and agreements. For example, if a company relies on "passporting" to conduct its business, that should be discussed if the inability to passport is expected to have a material impact. Similarly, to the extent that Brexit is expected to have a material impact on a company's supply chain or employee base, that should be described.

Discussion of Brexit may be needed beyond the risk factor section of the Form 10-K. For example, Brexit disclosure might be appropriate in the business section or the MD&A. Given the impending March 2019 Brexit deadline and the uncertain and potentially changing landscape, Brexit disclosure may need to be reviewed and possibly revised to reflect new developments up to the time a company files its Form 10-K.

4. LIBOR Phase-Out Disclosure. The phase-out of the London Interbank Offered Rate (LIBOR) is another development that may have a significant effect on some companies. To the extent that the LIBOR phase-out presents a material issue for a company, the company should develop disclosure for its Form 10-K, not just as a risk factor but also for other sections of the Form 10-K, such as MD&A and business, as appropriate. For example, companies with outstanding floating rate notes based on LIBOR may need to address the events that trigger the substitution of the rate and implementation of the new rate. Although LIBOR disclosure considerations may evolve in the future as more information on the transition to alternative interest rate benchmarks becomes available, to the extent that the move away from LIBOR is a trend known to management that is expected to have a material impact on a company, disclosure is needed in the upcoming Form 10-K.

5. Technical 10-K Details.

ITRA Compliance. Although there is no corresponding SEC regulation, the Iran Threat Reduction and Syria Human Rights Act of 2012 (ITRA) continues to require Form 10-K disclosure if, during the period covered by the report, the company or any affiliate knowingly engaged in certain sanctionable activities, regardless of whether those actions violate US law and without any materiality threshold. Companies should evaluate ITRA compliance as part of their annual reporting process.

Hyperlinks. The SEC now generally requires the exhibits listed in the exhibit index of specified filings, including annual reports on Form 10-K, to be hyperlinked. It is worthwhile to double check the hyperlinks for exhibits that are being carried forward from the exhibit index contained in last year's annual report to confirm that each properly links to the identified document. SEC rules require that incorrect hyperlinks be fixed.

Cover Page Changes. Remember that there are two technical changes to the cover page of annual reports on Form 10-K this year. One change eliminates the instruction informing filers not to check the "Non-accelerated filer" box if the issuer is a smaller reporting company (the amendments to the thresholds for smaller reporting company status also were recently amended and should be considered in connection with preparation of the annual report on Form 10-K[3]), as shown in the struck-out text below:

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	☐	Accelerated filer	☐
Non-accelerated filer	☐	Smaller reporting company	☐
~~(Do not check if a smaller reporting company)~~		Emerging growth company	☐

The second change, which relates to the SEC's adoption of the inline XBRL format for the submission of operating company financial statement information, reads as follows, with changes shown in struck-out text:

Indicate by check mark whether the registrant has submitted electronically ~~and posted on its corporate Web site, if any,~~ every Interactive Data File required to be submitted ~~and posted~~ pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit ~~and post~~ such files).

Proxy Statement Tips

6. Pay Ratio: Median Employee Determination. The pay ratio rule, which requires disclosure of the ratio of the annual total compensation of a company's median employee to that of its chief executive officer, permits a company to identify its median employee only once every three years as long as the company reasonably believes there has not been a change in its employee population or compensation arrangements that would significantly change the pay ratio disclosure. The analysis of whether a new determination of the median employee is required is a company-specific matter. For example, in some situations, a significant acquisition or divestiture may affect workforce composition or compensation arrangements, but that is not always the case.

In any event, each company needs to review its employee composition and compensation practices in order to assess whether it is required to re-identify its median employee for pay ratio disclosure. Companies should perform this process sufficiently in advance of the date on which they will be filing their proxy statements in order to allow time for the median employee's compensation and the pay ratio for 2018 to be calculated and confirmed. If a company concludes that it does not have to re-identify its median employee for its 2019 proxy statement, it will need to disclose that it is using the same median employee in its pay ratio calculation and describe briefly the reason for its belief that there have not been any changes requiring a newly determined median employee.

If the rules do not require a new determination of the median employee, but the median employee identified for the 2018 proxy statement pay ratio disclosure has left the company or has had compensation changes, the company may substitute another employee with substantially similar compensation as the median employee previously identified. In addition, the rules do not preclude a company from voluntarily conducting a new determination of its median employee, even if it is not technically required to do so. In any event, a company must disclose the date it selected to identify the median employee.

7. Hedging Disclosure. On December 18, 2018, the SEC adopted its final rule requiring disclosure of a company's policies and practices with respect to hedging of company securities by employees, officers and directors by adding new Item 407(i) to Regulation S-K.[4] This rulemaking was mandated by Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Companies will not need to comply with the hedging disclosure rule during the 2019 proxy season. Most companies will not need to provide the new hedging disclosure until their proxy statements for election of directors during fiscal years beginning on or after July 1, 2019 (i.e., the 2020 proxy season). Smaller reporting companies and emerging growth companies will not need to comply with the new hedging disclosure rule until the 2021 proxy season. However, a company nevertheless may choose to include additional hedging disclosure in its 2019 proxy statement, whether or not such disclosure is fully compliant with Item 407(i). To the extent that a company has prohibited or restricted hedging, it may wish to voluntarily include disclosure in this year's proxy statement to call attention to this governance practice. The new hedging disclosure rule does not require companies to adopt or amend hedging policies. For more information on the hedging disclosure rules, see our Legal Update "SEC Adopts Dodd-Frank Hedging Disclosure Rule," dated December 27, 2018.[5]

8. ESG Disclosure. With growing interest in environmental, social and governance (ESG) issues among certain investors, some companies have chosen to discuss sustainability initiatives in distinct sections of their proxy statements. Enhanced ESG proxy disclosures may be well-received by institutional investors, proxy advisory firms and organizations that rate public company corporate governance. This approach may provide an opportunity for companies to control their ESG message and may provide a basis to guide shareholder engagement in this area.

Companies voluntarily adding ESG disclosure to their proxy statements should coordinate such disclosure with statements on their websites and other public statements to ensure consistency. Such disclosure needs to be carefully drafted. For example, aspirational efforts for ESG should not be presented as formal commitments by the company. Because ESG disclosure is multi-faceted, and, in some cases, quite specialized, it may make sense to involve personnel who do not otherwise assist with the proxy process in the drafting and review of the disclosure. Companies considering ESG proxy sections may need additional lead time to develop this disclosure.

9. Shareholder Engagement Disclosure. The compensation discussion and analysis (CD&A) must indicate whether—and, if so, how—the company took into account the prior year's say-on-pay vote. Because shareholder engagement on executive compensation can provide a basis for robust disclosure in response to this requirement, it is common for companies to discuss shareholder engagement in the CD&A section of their proxy statements.

Shareholder engagement, including engagement on issues other than compensation, is increasingly viewed as a positive governance measure. As a result, many companies are adding more comprehensive discussions of shareholder engagement in their proxy statements, including in sections outside of the CD&A. Such enhanced shareholder engagement disclosure may provide details, such as the scope of investors contacted and the actions taken as a result of shareholder feedback.

Expanding shareholder engagement disclosure in proxy statements gives companies the opportunity to present what they are doing to promote this significant corporate governance measure. Recognizing that some institutional investors and proxy advisory firms may judge companies based on their level of engagement with shareholders, companies may want to consider voluntarily expanding descriptions of their shareholder engagement in the proxy statement to get "credit" for what they are already doing.

10. Perquisite Disclosure. The SEC recently has focused on the adequacy of perquisite disclosure. Accordingly, it would be worthwhile for companies to confirm that they are properly disclosing and characterizing perquisites in their proxy statements. Companies should confirm that their disclosure controls and procedures are adequately identifying all perquisites being paid to their executive officers and directors. To the extent that companies include questions regarding perquisites in their director and officer questionnaires, they should be sure that complete responses have been provided to these questions.

Additional Information

For additional information about preparing annual reports and proxy statements this year, see our Legal Update "2019 Proxy and Annual Reporting Season: Let the Preparations Begin," dated September 17, 2018.[6]

For more information about the topics raised in this Legal Update, please contact the author, Laura D. Richman, at +1 312 701 7304, any of the following lawyers or any other member of our Corporate & Securities practice.

Laura D. Richman
+1 312 701 7304
lrichman@mayerbrown.com

David S. Bakst
+1 212 506 2551
dbakst@mayerbrown.com

Paul C. de Bernier
+1 213 229 9542
pdebernier@mayerbrown.com

Robert F. Gray, Jr.
+1 713 238 2600
rgray@mayerbrown.com

Lawrence R. Hamilton
+1 312 701 7055
lhamilton@mayerbrown.com

Michael L. Hermsen
+1 312 701 7960
mhermsen@mayerbrown.com

Anna T. Pinedo
+1 212 506 2275
apinedo@mayerbrown.com

David A. Schuette
+1 312 701 7363
dschuette@mayerbrown.com

Endnotes

[1] Available at https://www.mayerbrown.com/Capital-Markets-Implications-of-Amendments-to-Simplify-and-Update-SEC-Disclosure-Rules-08-29-2018/.

[2] Available at https://www.mayerbrown.com/SEC-Issues-Updated-Guidance-on-Cybersecurity-Disclosures-02-28-2018/.

[3] For more information, see our Legal Update "SEC Expands Definition of Smaller Reporting Company," dated July 9, 2018, available at https://www.mayerbrown.com/SEC-Expands-Definition-of-Smaller-Reporting-Company-07-09-2018/.

[4] Available at https://www.sec.gov/rules/final/2018/33-10593.pdf.

[5] Available at https://www.mayerbrown.com/sec-adopts-dodd-frank-hedging-disclosure-rule-12-27-2018/.

[6] Available at https://www.mayerbrown.com/2019-Proxy-and-Annual-Reporting-Season-Let-the-Preparations-Begin-09-17-2018/.

Scaled Disclosure Accomodations for SRCs

The following chart summarizes the disclosure accommodations available to companies that qualify as smaller reporting companies, or SRCs, under the securities laws.

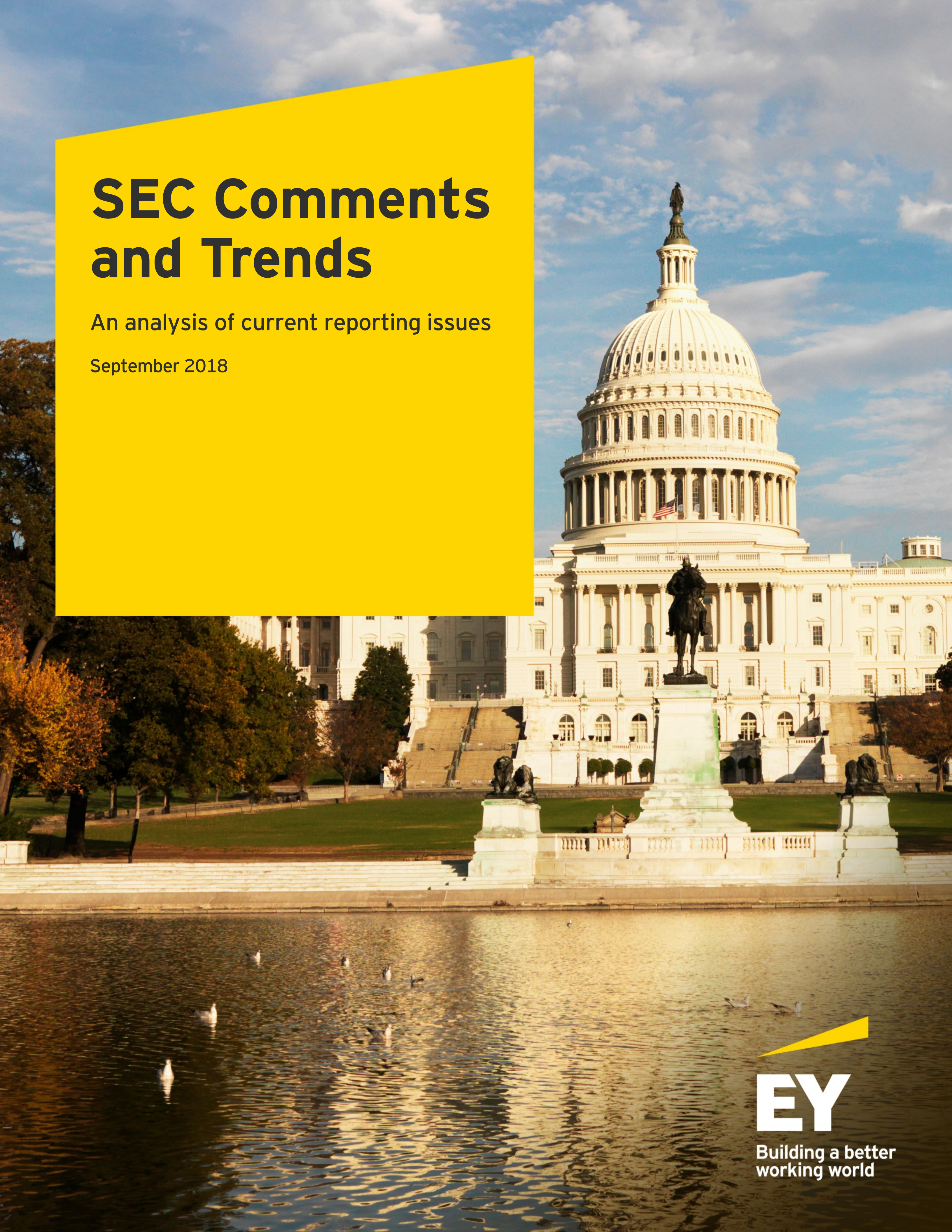
REGULATION S-K RULE	SCALED DISCLOSURE ACCOMMODATION
101 – DESCRIPTION OF BUSINESS	May satisfy disclosure obligations by describing the development of the registrant's business during the last three years rather than five years. Business development description requirements are less detailed than disclosure requirements for non-SRCs.
201 – MARKET PRICE OF AND DIVIDENDS ON THE REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS	Stock performance graph not required.
301 – SELECTED FINANCIAL DATA	Not required.
302 – SUPPLEMENTARY FINANCIAL INFORMATION	Not required.
303 – MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS ("MD&A")	Two-year MD&A comparison rather than three-year comparison. Two-year discussion of impact of inflation and changes in prices rather than three years. Tabular disclosure of contractual obligations not required.
305 – QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK	Not required.
402 – EXECUTIVE COMPENSATION	Three named executive officers rather than five. Two years of summary compensation table information rather than three. Not required: • Compensation discussion and analysis ("CD&A"). • Grants of plan-based awards table. • Option exercises and stock vested table. • Pension benefits table. • Nonqualified deferred compensation table. • Disclosure of compensation policies and practices related to risk management. • CEO pay ratio disclosure.
404 – TRANSACTIONS WITH RELATED PERSONS, PROMOTERS AND CERTAIN CONTROL PERSONS	Description of policies/procedures for the review, approval or ratification of related party transactions not required.
407 – CORPORATE GOVERNANCE	Audit committee financial expert disclosure not required in first annual report. Compensation committee interlocks and insider participation disclosure not required. Compensation committee report not required.
503 – PROSPECTUS SUMMARY, RISK FACTORS AND RATIO OF EARNINGS TO FIXED CHARGES	No ratio of earnings to fixed charges disclosure required. No risk factors required in Exchange Act filings.
601 - EXHIBITS	Statements regarding computation of ratios not required.

REGULATION S-X RULE	SCALED DISCLOSURE ACCOMMODATION
8-02 – ANNUAL FINANCIAL STATEMENTS	Two years of income statements rather than three years. Two years of cash flow statements rather than three years. Two years of changes in stockholders' equity statements rather than three years.
8-03 – INTERIM FINANCIAL STATEMENTS	Permits certain historical financial data in lieu of separate historical financial statements of equity investees.
8-04 – FINANCIAL STATEMENTS OF BUSINESSES ACQUIRED OR TO BE ACQUIRED	Maximum of two years of acquired financial statements rather than three years.
8-05 – PRO FORMA FINANCIAL INFORMATION	Fewer circumstances under which pro forma financial statements are required.
8-06 – REAL ESTATE OPERATIONS ACQUIRED OR TO BE ACQUIRED	Maximum of two years of financial statements for acquisition of properties from related parties rather than three years.
8-08 – AGE OF FINANCIAL STATEMENTS	Less stringent age of financial statements requirements.

SEC Comments and Trends

An analysis of current reporting issues

September 2018



Building a better working world

To our clients and other friends

Every year, we closely monitor the Securities and Exchange Commission (SEC) staff's comments on public company filings to provide you with insights on its areas of focus. Understanding the current financial reporting landscape and the types of issues that the SEC staff is focusing on in its comments will help you as you head into the year-end reporting season.

While this publication highlights areas where the SEC staff has commented in the past, it is not intended to drive changes to your accounting or disclosure unless you determine that changes are necessary to comply with the accounting or disclosure requirements. However, the comments and trends may help you identify disclosure improvements or enhance your documentation of your accounting conclusions.

We recommend that companies refrain from making decisions about disclosures solely to avoid a comment letter. If you receive a comment letter from the SEC staff, view it as an opportunity to educate the staff about your facts and how you arrived at the conclusions leading to your disclosure, which may include clarifying your consideration of materiality. Following the best practices in Appendix D often leads to a relatively short dialogue with the SEC staff. We also note that many companies resolve a comment without changing their disclosures.

The SEC staff continues to focus on many of the same topics that we highlighted last year. The following chart summarizes the top 10 most frequent comment areas in the current and previous years.

	Ranking 12 months ended 30 June		Comments as % of total registrants that received comment letters*
Comment area	2018	2017	2017 and 2018
Management's discussion and analysis**	1	2	43%
Non-GAAP financial measures	2	1	47%
Fair value measurements***	3	3	17%
Segment reporting	4	4	15%
Revenue recognition	5	5	13%
Intangible assets and goodwill	6	6	11%
State sponsors of terrorism	7	8	12%
Income taxes	8	7	12%
Acquisitions and business combinations	9	9	8%
Contingencies	10	****	6%

* These rankings are based on topics assigned by research firm Audit Analytics for SEC comment letters issued to registrants about Forms 10-K from 1 July 2016 through 30 June 2018. In some cases, individual SEC staff comments are assigned to multiple topics if the same comment covers multiple accounting or disclosure areas.

** This category includes comments on MD&A topics, in order of frequency: (1) results of operations (20%), (2) critical accounting policies and estimates (10%), (3) liquidity matters (8%), (4) business overview (6%) and (5) contractual obligations (2%). Many companies received MD&A comments in more than one category.

*** This category includes SEC staff comments on fair value measurements under Accounting Standards Codification (ASC) 820 as well as fair value estimates, such as those related to revenue recognition, stock compensation and goodwill impairment analyses.

**** This topic was not among the top 10 in 2017.

To our clients and other friends

Management's discussion and analysis (MD&A) is back in the top spot as the most frequent area of comment, moving slightly ahead of non-GAAP financial measures. The SEC staff also continues to question registrants' disclosures related to significant judgments and estimates, including those related to segment reporting, goodwill impairment and income taxes.

Comments issued to early adopters of the new revenue recognition standard have also focused on areas of judgment (e.g., identifying performance obligations, determining the timing of satisfaction of performance obligations, determining the amortization period of capitalized contract costs) and may indicate areas the SEC staff will focus on when reviewing the filings of registrants that adopted the standard in 2018.

The main section of this publication discusses recent matters that concern all registrants. Appendices A, B and C highlight emerging trends related to specific industries, companies filing initial public offering (IPO) registration statements and foreign private issuers, respectively. Appendix D provides an overview of the SEC staff's filing review process and best practices for responding to staff comments.

We hope you find this publication helpful. EY professionals are prepared to discuss any concerns or questions you may have.

Ernst + Young LLP

Contents

Management's discussion and analysis

Results of operations

Summary of issues noted

The SEC staff often requests that registrants explain the results of their operations with greater specificity, including identifying underlying drivers for each material factor that affected their earnings or is reasonably likely to have a material effect on future earnings. In addition to commenting on the analysis of changes in revenue, the SEC staff has been commenting on significant components of expenses and provisions.

The SEC staff also has increased its focus on performance metrics, including whether registrants have disclosed key metrics used by management and how those metrics correlate to material changes in the results of operations.

Analysis of current issues

Item 303(a)(3) of Regulation S-K provides general instructions for preparing MD&A disclosures about the results of operations. The SEC staff often asks registrants to provide a more detailed discussion about their results of operations, including requesting that they:

- Describe any unusual or infrequent events or transactions, or any significant economic changes, that materially affect income from continuing operations, as well as the extent to which income was affected (e.g., significant events that have been disclosed in the press but not disclosed in an SEC filing)
- Describe any other significant components of revenue or expense necessary to understand the results of operations (such as components of cost of sales)
- Describe any known trends or uncertainties that have had or are reasonably likely to have a material effect on sales, revenue or income from continuing operations (such as uncertainties arising from foreign operations in countries subject to political or financial risk)
- Discuss how much of any material increase in net sales or revenue is due to business combinations, increased sales volume, introduction of new products or services, or increased sales prices and quantify each factor's effect, if possible
- Discuss segment information needed to understand their results of operations, including the effect that the performance of a particular product line may have had, in addition to discussing the registrant as a whole
- Discuss the reasons for a significant change in the effective income tax rate and whether those drivers are expected to affect the future income tax rate (refer to the income taxes section for further discussion)

The SEC staff typically requests that registrants quantify the effects of factors that contributed to material period-to-period changes, including the underlying business or economic factors and material offsetting factors, and provide a more granular discussion of the effects. For example, when a registrant discloses that two or more factors contributed to a material period-to-period change in a financial statement line item, the SEC staff often requests that the registrant quantify and analyze each factor's effect.

Example SEC staff comment: Results of operations — quantification of factors

We note that your comparative discussions of costs and expenses identify multiple variables as the reasons for the period-to-period changes in your operating results. However, you do not quantify the impact of each of these variables.

Please revise to quantify the impact of each material factor that you discuss to provide your readers with better insight into the underlying reasons behind the changes in your results. Refer to Instruction 4 to Item 303(a) of Regulation S-K, Section III.D of Release No. 33-6835 and Section III.B of Release No. 33-8350.

Some of the factors that may cause material period-to-period changes in revenue and operating costs at a registrant's reportable segments include foreign currency fluctuations and changes in the macroeconomic environments around the world. The SEC staff expects registrants to quantify any material effect of such factors on the reportable segment.

The SEC staff has also requested that companies provide forward-looking information about known trends and uncertainties. This information is required for trends and uncertainties that have had or are reasonably likely to have a material effect on revenues or income from continuing operations. In evaluating this requirement, the registrant must determine whether the trend or uncertainty is reasonably likely to occur. If it isn't, no disclosure is required. If the registrant cannot make that determination, it must assume that the trend or uncertainty will occur, and it must disclose that item in MD&A, unless it is not reasonably likely to have a material effect.

When material effects on results of operations are ascribed to an increase (or decrease) in headcount or other internal initiatives (e.g., implementation of a new information technology system), the SEC staff may ask registrants to discuss their expectations about ongoing investments in these initiatives. When registrants discuss changes in laws or regulations, foreign exchange rates or economic conditions (e.g., increasing interest rates), the SEC staff may ask about the expected effects of these items on revenues and income in future periods.

Example SEC staff comment: Results of operations — known trends and uncertainties

We note a substantial increase in your allowance for doubtful accounts year over year. And, we note a further increase in the first quarter ended March 31, 2017.

Please expand MD&A and Risk Factors in future filings to discuss all known material trends, events or uncertainties that have had or are reasonably expected to have a material impact on your financial condition and results of operation. Refer to Item 303(a)(3) of Regulation S-K and SEC Release No. 33-8350.

To assess the completeness of MD&A disclosures in a registrant's periodic reports (e.g., Forms 10-K, 10-Q), particularly related to material trends or uncertainties, the SEC staff may also listen to a registrant's earnings calls and read other relevant information (e.g., earnings releases, investor presentations). The SEC staff has often asked registrants to expand their MD&A disclosures when a material trend or uncertainty is not discussed in MD&A but the entity had addressed it in an earnings release or call.

Example SEC staff comment: Results of operations — Expanding MD&A based on a known material trend discussed in earnings release
We note you highlight in your earnings release that 2017 was "Another Year of Significant Cost Reductions." Please provide a more detailed discussion of the specific components of costs of services in MD&A that management believes can be reduced through the Company's ongoing cost reduction efforts.

Significant components of expense and changes in reserve balances

The SEC staff has asked registrants to expand their discussions about significant components of operating expenses, such as costs of sales. In their segment discussions, registrants often describe only changes in revenue and operating income and do not directly explain the changes in significant operating expenses. The SEC staff frequently asks registrants to quantify and discuss separately the significant components of operating expenses that have affected segment operating income. The SEC staff believes this information helps investors better understand a registrant's business.

In addition, the SEC staff continues to ask for additional information and disclosure about material provisions or reversals affecting reserve accounts (e.g., bad debt allowance, inventory reserves, sales return reserves) as well as their effects on the results of operations.

Example SEC staff comment: Results of operations — changes in reserve accounts
Please expand your disclosures to explain the reasons for the changes in your provision for credit losses on loans receivable recorded for each period presented. See Item 303 of Regulation S-K and SEC Release No. 33-8350.

Key financial and operating metrics

The SEC staff continues to believe that key financial and operating metrics can be useful for investors to assess operating performance. SEC Chief Accountant Wes Bricker has emphasized the importance of having effective disclosure controls and procedures with respect to these performance metrics. "Similar to non-GAAP financial reporting, key operating metrics and forecasts may also be distorted via bias — for example, painting a potentially misleading picture — error or fraud, all of which undermine the credibility of the reporting. Therefore, it is important that companies proactively and thoughtfully address risks to their reporting," Mr. Bricker said in a speech in May 2017.

When a registrant uses a key metric to discuss operating results in MD&A, the SEC staff frequently requests that it:

- Define the metric, especially when a registrant's definition differs from the definition commonly used in its industry
- Discuss how the metric is calculated

- Provide robust disclosures explaining any changes made to the calculation of the metric
- Discuss any limits on the usefulness of the metric (e.g., individuals may be counted more than once in an "average monthly users" metric)
- Consider providing information about the metric on a disaggregated basis, such as by segment, geography or revenue stream (e.g., breaking down same-store sales between e-commerce and in-store sales)
- Clearly explain how the metric or period-to-period change in the metric links to operating results to reveal a trend (e.g., using the increase in the number of customers to explain revenue growth)

To help investors view the registrant through the eyes of management, the SEC's guidance on MD&A suggests that the registrant disclose in MD&A the key performance indicators, financial or nonfinancial, that are used to manage its business. Key performance metrics vary by industry. For example, retail companies use same-store sales and store openings and closings, while social networking and online gaming companies typically focus on the number of monthly or daily users. The SEC staff may ask a registrant to disclose key performance indicators in its SEC filings if the registrant cites the indictor on its website, in a press release or analyst presentation or in another setting.

Example SEC staff comment: Results of operations — missing key financial metrics

We note your reference, both in your risk factor disclosures and on your earnings calls, to the impact of capacity utilization rates on your financial condition and results of operations. To the extent that utilization rates are a key performance indicator used in managing your business, please include a discussion of this measure along with comparative period amounts or explain why you do not believe this disclosure is necessary.

Refer to Section III.B.1 of SEC Release No. 33-8350.

The SEC staff recognizes the value of using an operating metric in MD&A to help explain operating results. However, the staff has asked for clarification when it believes that a registrant's use of such metrics without the appropriate context is potentially misleading and does not appropriately explain any changes in income statement line items. For example, if a company discloses that it has 10 million total users and expects the number to grow 12%, but doesn't explain that the majority of them are non-paying, investors may incorrectly expect a direct correlation between total user growth and profitability.

Example SEC staff comment: Results of operations — key financial metrics

Your disclosure indicates that the "registered device user metric" is an indicator of the potential size and growth of your paid user community.

To the extent that a prior user of a device continues to be included in this count, please tell us how counting such a user provides an indication of the potential size or growth of your paid user community. Please also explain why this metric represents your potential paid user community when some of the users may not have used your device for an extended period of time.

EY resources

Compendium of significant accounting and reporting issues, *2017 AICPA Conference on Current SEC and PCAOB Developments*

2017 SEC annual reports — Form 10-K

Critical accounting estimates

Summary of issues noted

The SEC staff's comments have frequently targeted repetitive discussions about critical accounting estimates in MD&A. The SEC staff has reminded registrants that MD&A should supplement but not repeat the disclosures in the significant accounting policies note to the financial statements. The SEC staff often asks registrants to focus their MD&A discussion of critical accounting estimates on the quality and variability of management's most significant judgments and assumptions.

Analysis of current issues

Critical accounting estimates are those that are most important to the financial statement presentation and that require the most difficult, subjective and complex judgments. SEC Financial Release No. 72, *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations,* (FRR-72) reminds registrants that MD&A rules require disclosure of critical accounting estimates and assumptions when both of the following conditions are met:

- The nature of the estimates or assumptions is material because of the levels of subjectivity and judgment needed to account for matters that are highly uncertain and susceptible to change.
- The effect of the estimates and assumptions is material to the financial statements.

Disclosures about critical accounting estimates should focus on the quality and variability of management's judgments.

The SEC staff has noted that registrants' disclosures about critical accounting estimates often are too general and should provide a more robust analysis than what is in the significant accounting policies note to the financial statements. The SEC staff has commented that there are numerous examples of portions of the significant accounting policies note being repeated verbatim in MD&A. While accounting policies in the notes to the financial statements generally describe the method used to apply an accounting principle, the discussion in MD&A should provide more insight into the uncertainties involved in applying the principle at a given time and the variability that is reasonably likely to result from its application.

Example SEC staff comment: Duplicative disclosure about critical accounting estimates

The disclosure of critical accounting policies within MD&A appears to duplicate your accounting policy disclosure in the notes to your financial statements, and it does not provide investors with a robust discussion of your critical estimates by focusing on the assumptions and uncertainties that underlie the impairment analysis of your most significant asset.

Please modify the MD&A disclosure to address the specific methods, assumptions and estimates used in your critical accounting estimate. If you prefer to include this disclosure elsewhere in your filing, such as an expanded disclosure in the notes to your financial statements, please consider including a simple cross-reference within your MD&A to avoid repetition.

Registrants can consider including in MD&A a cross-reference to the footnote disclosure about significant accounting policies. However, they should expand the MD&A disclosure to (1) address why the accounting estimate or assumption bears the risk of change and (2) analyze the following, if material:

- How the registrant arrived at the estimate/assumption
- How accurate the estimate/assumption has been in the past
- How much the estimate/assumption has changed in the past
- Whether the estimate/assumption is reasonably likely to change in the future

Because critical accounting estimates and assumptions are based on highly uncertain matters, the SEC staff believes that registrants also should consider analyzing their sensitivity to change based on reasonably likely outcomes that could have a material effect on the financial statements. The SEC staff believes that registrants should provide quantitative information in addition to qualitative information when it is reasonably available and material.

The SEC staff may request enhancements to the MD&A discussion of specific critical accounting estimates, which we discuss separately in this publication (e.g., measurement of accounts receivable, realizability of deferred tax assets, goodwill impairment).

EY resources

2017 SEC annual reports — Form 10-K

Liquidity and capital resources

Summary of issues noted

The SEC staff may request enhanced disclosures in the liquidity and capital resources section of MD&A, particularly when there are trends or uncertainties affecting liquidity. Such requests may focus on:

- Sources and uses of cash and the availability of cash to fund liquidity needs
- Transparency in the contractual obligations table and its footnotes about interest payments and other items

Further, the SEC staff may request more comprehensive disclosures about alternative sources of funding and material debt covenants when there is an elevated risk of default or when management has concluded it is reasonably likely that covenants will not be complied with in the future.

Analysis of current issues

General disclosures

Items 303(a)(1) and (2) of Regulation S-K require that a registrant discuss known material trends, demands, commitments, events or uncertainties that are reasonably likely to affect (either favorably or unfavorably) liquidity or capital resources. For example, if a registrant expects growth in the business from a recently completed acquisition, the SEC staff may ask the registrant to discuss the reasonably likely increase or decrease in liquidity that is expected to be material.

The SEC staff also requests that registrants expand MD&A to include a meaningful analysis and discuss the material components to explain the variability of cash flows. For example, the SEC staff often challenges the discussion about cash flows that recites items that are readily apparent from the statement of cash flows (e.g., changes in working capital) but does not provide analysis about the underlying drivers for material changes.

Example SEC staff comment: Changes in operating cash flows
Your discussion of net cash provided by operating activities does not appear to contribute substantively to an understanding of your historical cash flows. When preparing the discussion and analysis of operating cash flows, you should address material changes in the underlying drivers that affect these cash flows. These disclosures should include a discussion of the underlying reasons for changes in working capital accounts that affect operating cash flows.

The SEC staff also has requested that registrants disclose:

- Whether identified trends will continue, and if so, how long they will continue, as well as steps the registrant is taking to address the trends, including plans to remedy any identified material deficiency in short- or long-term liquidity
- An analysis of all internal and external sources of liquidity, beyond cash on hand, as of the balance sheet date

- Amounts outstanding and available at the balance sheet date under each source of liquidity, with a comparison to cash needs over the next 12 months, including any significant planned capital expenditures
- The sufficiency of the amount available under an existing short-term credit arrangement, the anticipated circumstances requiring its use, any uncertainty surrounding the ability to access funds when needed and the implications of not being able to access the arrangement

Example SEC staff comment: Expected sources and uses of cash over the short- and long-term period
We note your disclosure that you "currently have the ability to raise capital pursuant to an effective shelf registration statement" and that in the future, if your operations do not become cash flow positive, you may seek equity investments. Please revise your future filings as appropriate to discuss your liquidity sources and requirements on a short- and long-term basis; specifically addressing your anticipated sources of capital necessary to achieve your business plan. If your primary anticipated liquidity source is through equity sales, please address any factors that could affect the amount of cash you could raise given the limited authorized shares you have remaining.

When there is a heightened risk of debt default, the SEC staff may request enhanced disclosures about debt covenants and the registrant's compliance with them.

When there is a heightened risk of debt default (e.g., adverse trends in cash flows or operating results, recent covenant waiver requests, significant amount of debt maturing within 12 months), the SEC staff requests enhanced disclosure about alternative sources of funding, debt covenants and the potential risks and effects of noncompliance on the registrant's financial condition and liquidity. Specifically, the SEC staff may request the following types of disclosure:

- Alternative sources of funding to refinance existing debt obligations
- Specific terms of material debt covenants and whether the registrant is in compliance with the covenants
- Actual quantitative ratios or amounts compared with required minimum/maximum values contained in debt covenants, along with explanations of how such ratios or amounts are determined and their relationship to amounts reported under US GAAP
- The nature of waivers or modifications of existing debt covenants obtained to cure or prevent potential violation(s), including how long any waivers apply and a description of the covenant
- Disclosure of the likelihood of violating financial covenants in the future

Example SEC staff comment: Supplemental disclosures when dealing with elevated risk of debt default

You disclose throughout your filing several instances of debt defaults and covenant violations, waivers of violations, and amendments to the terms of your debt agreements, such as the changes made to your revolving credit facility debt covenant ratios disclosed on page XX.

Please revise your MD&A to elaborate on the steps you are taking to avoid a breach of your debt covenants, the impact or reasonably likely impact of a breach on your financial condition or operating performance, and alternate sources of funding to refinance resulting obligations.

Also tell us and disclose whether there are cross default provisions under any of your existing debt obligations and quantitatively disclose the required and actual debt covenant ratios.

Contractual obligations

Item 303 of Regulation S-K requires registrants (other than smaller reporting companies, issuers of asset-backed securities and registered investment companies) to provide tabular presentations of contractual obligations as of the end of the most recent fiscal year.

The goal of the contractual obligations table is to present a meaningful snapshot of the cash requirements arising from such obligations. The MD&A rules permit flexibility so that the presentation can reflect the information in a way that is suitable to a registrant's business. Registrants should develop a presentation that is clear and understandable and that appropriately reflects the categories of obligations that are meaningful in light of their capital structure and business.

Uncertainties about what to include in the table and how to allocate amounts to the required periods should be resolved consistent with the purpose of the disclosure. Registrants should consider providing narrative disclosure, in addition to the table and related footnotes, to promote an understanding of the tabular data.

The SEC staff has questioned the completeness of items included in registrants' contractual obligations tables and has asked those companies to provide the reasons for excluding certain items from the table. Most notably, the SEC staff has asked companies to include amounts for future interest payments in the contractual obligations table or a footnote to the table, if material. The SEC staff also has asked registrants to disclose reasons why interest on variable debt is not included in their contractual obligations table. When interest rates are variable, registrants should also describe the assumptions that were used to estimate future payments.

Example SEC staff comment: Contractual obligations

We note that your disclosure of long term debt in the table of contractual obligations includes interest on your fixed rate financing but does not include interest on variable rate debt. Please revise to disclose the estimated cash requirements for interest on your variable debt obligations, including underlying assumptions used to estimate the future interest payments, or tell us why such disclosure is not necessary.

EY resources

2017 SEC annual reports — Form 10-K

SEC reporting issues

Non-GAAP measures

Summary of issues noted

While the SEC staff has been less vocal on non-GAAP financial measures in 2018, it continues to issue comments on this topic. These comments are consistent with what we observed in the prior year after the SEC staff made its guidance on non-GAAP measures more explicit in an update to its Compliance and Disclosure Interpretations (C&DIs) in May 2016.

The SEC staff has asked registrants to explain how their use of non-GAAP financial measures complies with the C&DIs or to change their presentation of items, including:

- Non-GAAP financial measures that tailor GAAP recognition and measurement principles, don't include the same items in all periods, don't treat similar gains and losses consistently or exclude normal cash operating expenses from performance measures
- Non-GAAP financial measures that are presented more prominently than GAAP measures or disclosures that don't appear to comply with Item 10(e) of Regulation S-K (e.g., presenting a measure that could be misleading, omitting disclosure of the measure's usefulness to investors or management, removing cash-settled charges from liquidity measures, labeling recurring items as nonrecurring)

Many of the SEC staff comments have focused on registrants' use of non-GAAP financial measures in earnings releases and other information (e.g., websites, investor presentations) in addition to their SEC filings.

Analysis of current issues

The C&DIs provide explicit guidance on uses of non-GAAP financial measures that the SEC staff believes could be misleading. A non-GAAP financial measure may be considered misleading if it (1) is presented inconsistently in different fiscal periods or if similar gains and losses are treated differently; (2) excludes normal, recurring cash operating expenses from performance measures; or (3) tailors GAAP recognition and measurement principles, such as accelerating deferred revenue. In its comment letters, the SEC staff has focused on all three areas.

Inconsistent presentation

In the C&DIs, the SEC staff said that presenting a non-GAAP financial measure that adjusts a particular charge or gain in the current period but doesn't adjust similar charges or gains in prior periods could violate Regulation G unless the change is disclosed and the reasons for it are explained. The SEC staff has asked registrants how they define specific non-GAAP measures and challenged whether unusual gains have been eliminated consistently with unusual charges or losses.

Example SEC staff comment: Inconsistent presentation
We note that you disclose the non-GAAP measure "Adjusted earnings," which excludes pension settlement charges, merger and restructuring charges and abandonment and impairment charges. Considering you have not provided any adjustments to exclude net gains on asset sales, please advise us how you have considered Question 100.03 of the updated C&DIs issued on May 17, 2016.

Exclusion of normal, recurring cash operating expenses

In the C&DIs, the SEC staff said that non-GAAP performance measures could be considered misleading if they exclude normal, recurring cash operating expenses necessary to operate the registrant's business. The SEC staff has asked registrants whether non-GAAP performance measures exclude recurring charges such as restructuring charges and litigation costs that should be included as normal, cash operating expenses.

Example SEC staff comment: Exclusion of normal, recurring cash operating expenses
We note several items in the reconciliation of earnings before interest, tax, depreciation and amortization (EBITDA) to adjusted EBITDA remove recurring cash operating expenses, such as professional fees and management fees and expenses. Considering these adjustments include recurring cash operating expenses, tell us how your presentation complies with the May 17, 2016 updated C&DIs on Non-GAAP financial measures.

Tailoring GAAP recognition and measurement principles

In the C&DIs, the SEC staff clarified that non-GAAP performance measures that accelerate the recognition of revenue to the time of sale or customer billing but under GAAP would be recognized ratably over the performance period or that use other accounting methods not allowed under GAAP (e.g., proportionate consolidation) may be misleading.

While the SEC staff initially focused on revenue when asking about compliance with this interpretation, the SEC staff has broadened its approach and challenged other ways registrants modify GAAP recognition and measurement principles in calculating non-GAAP financial measures such as the use of proportionate consolidation for equity investees, accounting for operating leases as capital leases or eliminating the provision for loan losses. We expect this issue to continue to receive attention if companies present non-GAAP financial measures that unwind the effects of new accounting standards (for purposes other than providing transition disclosures).

Example SEC staff comment: tailoring recognition of allowance for loan losses
We note the disclosure of the non-GAAP measure "adjusted allowance for loan losses/non-acquired loans held for investment." We also note you eliminated the allowance for loans losses attributable to XX. Tell us how you considered whether the non-GAAP measure uses an individually tailored recognition and measurement method, which could violate Rule 100(b) of Regulation G. Please refer to Question 100.04 of the Compliance and Disclosure Interpretations for guidance.

Compliance with Item 10(e) of Regulation S-K

Item 10(e)(1)(i)(A) of Regulation S-K requires a presentation, with equal or greater prominence, of the most directly comparable financial measure or measures calculated and presented in accordance with GAAP. However, the SEC staff does not believe that a registrant can comply with this requirement unless a GAAP measure precedes the related non-GAAP measure either in an SEC filing or earnings release.

The SEC staff may object to adjustments that unwind the effects of new accounting standards for reasons other than providing transition disclosures.

The prohibition on presenting non-GAAP financial measures with greater prominence than GAAP measures applies to both the order of presentation and the degree of emphasis. For example, the SEC staff has questioned discussions of non-GAAP financial measures that precede the discussion of the corresponding GAAP measures, use bold or larger font or significantly exceed the length of the discussion of the corresponding GAAP measures.

Example SEC staff comment: Prominence of non-GAAP measures
We note that you present non-GAAP earnings and non-GAAP margin before the most directly comparable GAAP measures. Your presentation appears to give greater prominence to the non-GAAP measures than to the comparable GAAP measures, which is inconsistent with the updated C&DIs issued on May 17, 2016. Please review that guidance when preparing future earnings releases.

The SEC staff also has asked registrants to clarify and expand their disclosures to discuss how a particular measure is useful to investors and how management uses it. Often, these disclosures are boilerplate or too general to help readers understand how they should use a particular measure.

If a registrant cannot explain how a measure is useful to investors, or if the SEC staff believes the presentation could be misleading, the SEC staff has asked registrants to expand the disclosure or remove the non-GAAP measure. Additionally, the SEC staff has questioned the usefulness of adjustments that do not appear to be consistent with the purpose of the measure described by the registrant. When disclosing non-GAAP financial measures, registrants also should consider the following areas of frequent SEC staff comment:

- The labeling of a non-GAAP financial measure that is similar to a standard measure, but adjusted to some extent, should clearly indicate that fact. For example, a measure that includes adjustments to the standard definition of EBITDA should not be labeled "EBITDA."

- Adjustments to non-GAAP measures that are labeled as nonrecurring should only comprise items that are infrequent or unusual in nature, as required by Item 10(e)(1)(ii)(B) of Regulation S-K. If the adjusted item has occurred within the past two years or is likely to recur within two years, it should not be characterized as nonrecurring.

Example SEC staff comment: Usefulness of a non-GAAP measure
We note your disclosure of the non-GAAP measure "adjusted net income" provides a meaningful comparison of financial performance between years and transparency in your operating results. However, your current disclosure is too generic in terms of describing how you use it and why it is useful to investors. Please revise your disclosure to provide more detail regarding how you use it and its usefulness to investors.

In the C&DIs, the SEC staff also noted that constant currency measures are considered non-GAAP financial measures and said that registrants should present the historical amounts and describe their process for calculating constant currency amounts in lieu of a numeric reconciliation of the non-GAAP metric. The SEC staff has commented on registrants' use of constant currency measures and compliance with its interpretation.

Example SEC staff comment: Constant currency measures
You disclose your results on a constant currency basis, which appear to be non-GAAP financial measures. In future periodic filings, please describe the process for calculating the currency effects, including which period's exchange rate is used. Also provide such disclosure in your interim periodic filings and quarterly earnings announcements.

Registrants must present non-GAAP financial measures with quantitative reconciliations to the most directly comparable GAAP measures. This requirement also applies to forward-looking non-GAAP measures if the forward-looking GAAP measure is reasonably available. If a comparable GAAP measure isn't available, the SEC staff expects registrants to disclose why the reconciliation is not presented. The SEC staff has objected to registrants presenting a full non-GAAP income statement as a form of reconciliation because this makes the non-GAAP information more prominent. The SEC staff has also objected to registrants presenting reconciliations that begin with the non-GAAP information.

Example SEC staff comment: full non-GAAP income statement
You present a full non-GAAP income statement when reconciling non-GAAP measures to the most directly comparable GAAP measures. Please be advised it is not appropriate to present a full non-GAAP income statement for purposes of reconciling non-GAAP measures to the most directly comparable GAAP measure. Please revise and reconcile without presenting a full non-GAAP income statement. See Question 102.10 of the Compliance and Disclosure Interpretations issued on May 17, 2016.

Liquidity versus performance measures

Non-GAAP financial measures may be presented as performance measures, liquidity measures or both. When a registrant uses a non-GAAP measure as both a performance and liquidity measure, the registrant should include separate reconciliations and disclosures for each type of measure. For example, a registrant should reconcile EBITDA to both net income and cash flows from operations if EBITDA is presented as both a performance measure and a liquidity measure.

The SEC staff has asked registrants to revise future disclosures to comply with the Regulation S-K requirements for liquidity measures. Registrants cannot present non-GAAP liquidity measures on a per-share basis, and they cannot adjust liquidity measures to remove charges or liabilities that require or will require cash settlement.

Example SEC staff comment: Non-GAAP liquidity measures

It appears that your presentation of operating cash flow per share is not consistent with the guidance in our response to Question 102.05 of the updated C&DIs issued on May 17, 2016. Please review this guidance and tell us how you intend to revise your future earnings releases.

EY resources

Technical Line, A closer look at the SEC's staff scrutiny of non-GAAP financial measures

2017 SEC annual reports – Form 10-K

Executive compensation disclosures

Summary of issues noted

The SEC staff focuses its reviews on registrants' compensation discussion and analysis (CD&A) in an effort to promote more direct, specific and clear executive compensation disclosures. The CD&A should explain how and why a registrant's compensation committee establishes executive compensation policies and reaches specific executive compensation decisions. The SEC staff may perform these reviews separately from or in conjunction with its review of other sections of a company's filing.

The SEC staff recently has commented on:

- Effects of performance criteria and targets, and shareholder advisory votes on compensation decisions
- Requirements to update executive compensation disclosures in registration statements

Analysis of current issues

Item 402 of Regulation S-K requires registrants to include disclosures related to director and executive officer compensation in most proxy or information statements, Form 10-K filings and various registration statements.

The SEC staff has asked registrants to provide details on individual and corporate performance criteria and targets, both quantitative and qualitative, for each named executive. Such details include how the targets were met and how meeting those targets aligns with the overall strategy of the company. Registrants are not required to disclose the targets if doing so would result in competitive harm. A registrant that doesn't disclose targets must disclose how difficult it will be for the executive or how likely it will be for the registrant to achieve those targets.

Example SEC staff comment: Executive compensation disclosures
We note that the corporate performance measures used to determine bonus awards under your incentive plan were consolidated revenue and adjusted earnings per share (EPS). In future filings, please clearly disclose the minimum, target and maximum for both the performance goals and payout levels for your incentive plan. The grants of plan-based awards tables should include threshold, target and maximum estimated future payouts under equity and non-equity incentive plans. Refer to Item 402(b)(2)(v) of Regulation S-K. To the extent you believe that disclosure of the targets is not required because it would result in competitive harm such that you may omit this information under Instruction 4 to Item 402(b) of Regulation S-K, please provide a detailed explanation of such conclusion.

Item 402(b) of Regulation S-K requires a registrant to disclose how the results of the most recent shareholder advisory vote on executive compensation were considered in determining compensation policies and decisions. The SEC staff has asked registrants to disclose in future filings the results of shareholder advisory votes and their effect on executive compensation.

Example SEC staff comment: Shareholder advisory vote
In future filings, please disclose whether and, if so, how the compensation committee has considered the results of your most recent shareholder advisory vote on executive compensation in determining compensation policies and decisions.

The SEC staff also may request that a registrant clarify the factors that its compensation committee considered when it exercised its discretion in granting equity awards.

EY resources

2018 proxy statements: *An overview of the requirements and observations about current practice*

SAB 74 disclosures

The SEC expects a registrant's disclosures to evolve and be more specific as the effective date of a standard nears.

Summary of issues noted

With registrants preparing to adopt new standards on leases and credit impairment, and in some cases the new revenue recognition standard, SEC officials have continued to emphasize the disclosures registrants should provide to comply with Staff Accounting Bulletin (SAB) Topic 11.M (issued as SAB 74) and the announcement the SEC staff made in 2016 about its expectations.

The SEC staff has been closely monitoring registrants' disclosures about the revenue standard, which was effective 1 January 2018 for calendar-year registrants that aren't emerging growth companies using private company adoption dates, and we expect the SEC staff to closely monitor disclosures related to the pending adoption of the leases and credit impairment standards.

Analysis of current issues

The SEC staff expects registrants to include a description of the process they are using to assess the effect of a new standard, indicate where they are in the implementation process and what matters still need to be addressed, and identify the additional steps they plan to take.

The SEC staff also expects a registrant's disclosures to evolve as the effective date of a standard nears, and the registrant makes progress on its implementation plan. That is, the SEC staff expects a registrant's disclosures to be more specific each quarter. It is important for management to consider these expectations when developing a company's disclosures and discuss them with the audit committee each quarter.

If a registrant does not know or cannot reasonably estimate the effect that adopting a new standard will have on its financial statements, it should make a statement to that effect and consider providing qualitative disclosures to help a user assess the potential significance on the financial statements. These qualitative disclosures should include a description of the new standard's effect on the registrant's accounting policies and provide a comparison to the registrant's current accounting policies.

For example, for the new revenue standard, the SEC staff has said that a registrant should consider the full scope of the new standard, including presentation in the financial statements and disclosures in the notes to the financial statements, when evaluating the standard's effect on its financial statements.

Example SEC staff comment: SAB 74 disclosure

You state that you are in the process of evaluating the impact that ASC 842, *Leases*, will have on your consolidated financial statements. Please revise to provide a qualitative discussion of the potential impact that this standard will have on your financial statements when adopted. In this regard, include a description of the effects of the standard that you expect to apply and a comparison to your current lease accounting and disclosure policies. Describe the status of your process to implement the new standard and the significant implementation matters yet to be addressed. In addition, to the extent that you determine the quantitative impact that adoption of ASC 842 will have on your results or financial position, please also disclose such amounts.

Exhibits and signatures

Summary of issues noted

The SEC staff has questioned the completeness and adequacy of exhibits, consents, auditor's reports, management signatures and certifications filed by registrants as required by various rules and regulations. Although deficiencies in these items may seem inconsequential, they may require registrants to amend their filings.

Analysis of current issues

Compliance with Item 601(b)(10) of Regulation S-K

When a registrant has discussed significant transactions or agreements in its disclosures, the SEC staff has asked why the related contracts were not filed as exhibits under Item 601(b)(10) of Regulation S-K. In addition, the SEC staff has asked registrants to file missing schedules, exhibits or appendices of material contracts (e.g., a credit agreement should be filed with all of its schedules, exhibits and appendices). Registrants often can provide the missing information in a subsequent filing. That is, they don't have to amend the original filing.

Example SEC staff comment: Compliance with Item 601(b)(10)

In future filings, please file all related party contracts as exhibits, consistent with Item 601(b)(10). If you do not believe that any of these related contracts you reference in your filing are required to be filed, please provide us with that analysis at this time.

Consents and auditors' reports

Item 601 of Regulation S-K requires registrants to file the consents of experts (e.g., auditors) and counsel as exhibits to various forms filed with the SEC. Independent registered public accounting firms must consent to the use of their names and related reports in Securities Act registration statements. The SEC staff has issued comments when such required consents (1) are missing from the filing, (2) omit the signature of the accounting firm or the date of the consent, or (3) refer to the incorrect auditor's report or periods covered by that report.

Example SEC staff comment: Missing consent

It appears your Form 10-K is incorporated by reference into Form S-8 filed XXX. Please tell us why you did not file an auditor's consent related to the use of the audit report. Refer to Item 601(23) of Regulation S-K.

Registrants should make sure that the "Report of Independent Registered Public Accounting Firm" also includes the signature and location of the accounting firm and appropriately identifies all periods, financial statements and schedules that have been audited.

Management and the audit committee should also confirm that the auditor has changed its auditor's report to comply with a new Public Company Accounting Oversight Board (PCAOB) standard that requires auditors to include significantly more information in their reports. While certain requirements are already in effect, the requirement to report critical audit matters is being phased in over the next few years.

Section 302 certifications

The management certification required under Section 302 of the Sarbanes-Oxley Act must be filed as Exhibit 31 to the Form 10-K. The specified form of the Section 302 certification must be filed exactly as specified in Item 601(b)(31)(i) or (ii) of Regulation S-K. Separate certifications must be filed by the principal executive officer and principal financial officer.

The SEC staff frequently has asked registrants to correct these certifications by refiling the entire report in an amendment (i.e., not simply filing a revised certification). When preparing officer certifications, registrants should:

- Follow the exact form specified by Item 601(b)(31) of Regulation S-K
- Not include the certifying individual's title in the first line of the certification
- Include the required language on internal control over financial reporting (ICFR) in the fourth paragraph of the certification when management's report on ICFR is included in the Form 10-K (this language may be omitted during the transition period allowed for newly public companies to comply with Item 308(a) of Regulation S-K)
- Include a conformed signature of the signing officer, the officer's job title and the date the certification was signed at the bottom of the certification

Example SEC staff comment: Section 302 certifications
We note that your certification filed on Exhibit 31.1 does not include the signature of the officer completing the certification, the job title(s) of the officer and the date that the certification was signed. Please file an amended Form 10-K to revise this certification accordingly. Refer to the guidance in Item 601(B)(31) of Regulation S-K.

Form 10-K signatures

General Instruction D of Form 10-K requires the annual report to be signed by the registrant and on the registrant's behalf by (1) its principal executive officer(s), (2) its principal financial officer(s), (3) its controller or principal accounting officer and (4) a majority of the board of directors or others acting in a similar capacity. If an officer signs the filing in multiple capacities (e.g., the chief financial officer is also the principal accounting officer), his or her signature line should indicate all such roles.

The SEC staff requires registrants to include the signature of the person serving as the controller or principal accounting officer or indicate who signed the report in that capacity. It's also important that the Form 10-K include officers' signatures on behalf of the registrant, as well as in their capacity as officers. Officers sometimes incorrectly sign only on behalf of the registrant and not individually, or vice versa.

Example SEC staff comment: Form 10-K signatures

Please note that your annual report on Form 10-K must be signed by your controller or principal accounting officer. Any person who occupies more than one of the specified positions should indicate each capacity in which he or she signs the report. Please refer to General Instruction D(2) of Form 10-K and advise.

EY resources

2017 SEC annual reports — Form 10-K

Internal control over financial reporting and disclosure controls and procedures

Summary of issues noted

ICFR continues to be an area of significant focus of the SEC staff. The SEC staff has questioned the following areas related to ICFR and disclosure controls and procedures:

- The nature and timely identification of material weaknesses
- The implications for ICFR when a registrant discloses an error correction, regardless of whether it is material
- The omission of disclosures about changes in ICFR after significant events that make material changes likely, such as a business combination or a significant accounting change
- The effectiveness of disclosure controls and procedures when management concludes that ICFR is ineffective

Analysis of current issues

The SEC staff has expressed concerns that material weaknesses are not being identified timely and that control deficiencies are not being evaluated appropriately before a material misstatement occurs. A registrant's conclusion about the severity of a control deficiency depends on its evaluation of both the likelihood and magnitude of an error occurring without being prevented or detected by its ICFR. That is, in making this evaluation, a registrant does not just focus on whether an error requiring correction occurred or how large such an error was.

The SEC staff has said that registrants sometimes focus their interim or annual disclosures related to a material weakness on the accounting error itself rather than describing whether a control had an ineffective design or failed to operate effectively. In these cases, the SEC staff has asked for additional information on the deficiency, including:

- The nature and cause of the material weakness (and financial statement error, if applicable)
- Who identified the material weakness and when it was identified
- Whether the material weakness affects certain other accounts or processes or is more pervasive
- The planned actions, costs and timeframe to remedy the material weakness
- How the registrant compensates for the material weakness to make sure that the financial statements are free from material misstatement
- The status of any unremediated material weakness that was previously disclosed
- The effect on disclosure controls and procedures when ICFR is ineffective, given that ICFR constitutes a substantial element of disclosure controls and procedures

The SEC staff also has questioned why a registrant's disclosures under Item 308(c) of Regulation S-K did not identify a material change in ICFR during the most recent quarter if a registrant (1) concludes its ICFR and/or disclosure controls and procedures are ineffective due to a new material weakness or (2) reports the remediation of a previously reported material weakness. The SEC staff may question management's judgment when management attributes a material error to a control deficiency but does not conclude that the deficiency is a material weakness.

Example SEC staff comment: Material weakness

We note in your response that you determined there was a control deficiency in your internal control over financial reporting; however, the deficiency did not rise to the level of a material weakness. A control deficiency constitutes a material weakness if there is a reasonable possibility that a material misstatement of the financial statements would not be prevented or detected in a timely manner.

Based on your determination that the disclosure misstatements in your prior SEC filings were material and a result of a control deficiency, we are unable to agree with your conclusion that the related deficiency is not a material weakness. Please explain how you will address and disclose the ineffectiveness of internal control over financial reporting and disclosure controls and procedures for the periods the material weakness existed.

When correcting an accounting error, management should carefully reassess the implications for its ICFR and disclosure controls and procedures.

In addition, if there are indicators of control deficiencies in filings, the SEC staff may ask registrants to explain whether those deficiencies were identified by management and, if so, describe their severity, including whether the deficiencies are material weaknesses.

For example, the SEC staff may challenge the effectiveness of ICFR when a registrant corrects an immaterial out-of-period error during the current period without revising prior-period amounts. The SEC staff may question whether the correction of immaterial errors affects current and previous conclusions related to the effectiveness of ICFR and disclosure controls and procedures.

If a registrant determines that ICFR or its disclosure controls and procedures (or both) were effective despite the immaterial error correction, the SEC staff may challenge the basis of these conclusions. In particular, SEC staff often questions the nature of the deficiency that resulted in the error and the likelihood that the deficiency could result in a material misstatement.

Example SEC staff comment: Immaterial error correction and ICFR

Please explain the extent to which you considered the effect of the identified errors on your internal controls and explain how management's conclusion regarding the effectiveness of disclosure controls and procedures, as well as internal control over financial reporting, is appropriate in light of the errors.

To the extent you determined there were control deficiencies that led to the errors, describe in reasonable detail the deficiencies, how you evaluated the severity of each related deficiency and error in your assessment. Please also include in your analysis a description of the maximum potential amount or total of transactions exposed to each related deficiency and explain how you made that determination.

Items 307 and 308 of Regulation S-K require that management's conclusions about effectiveness explicitly state whether disclosure controls and procedures and ICFR are either "effective" or "ineffective." Generally, the SEC staff challenges registrants that inappropriately express management's conclusions, saying that disclosure controls and procedures are "adequate," "effective, except for" or "effective, to the best of our knowledge."

Example SEC staff comment: Inappropriate management's assesments

We note your certifying officers concluded your disclosure controls and procedures are effective "subject to the limitations noted above." It is not appropriate to indicate your disclosure controls and procedures are effective subject to certain limitations. You must clearly state whether or not the disclosure controls and procedures are effective. Please amend the Form 10-K to delete the qualification and provide an unqualified conclusion as to the effectiveness of your disclosure controls and procedures.

Disclosure controls and procedures include components of ICFR that (1) relate to the maintenance of records that fairly reflect an issuer's transactions, (2) provide reasonable assurance that the transactions are properly recorded to permit the preparation of financial statements in accordance with GAAP and (3) provide reasonable assurance that unauthorized transactions that could have a material effect on the financial statements have been prevented.

The scope of these procedures would generally include ICFR because they apply to all material information to be included in a report, within and outside the financial statements. The SEC staff has challenged registrants that say they concluded that ICFR was ineffective but disclosure controls and procedures were effective.

Example SEC staff comment: Disclosure controls and procedures and ICFR

Please explain how you concluded that your disclosure controls and procedures were effective as of December 31, 2016, considering that your internal control over financial reporting was not effective as of this date. Your explanation should be comprehensive and address all of the components of the definition of disclosure controls and procedures.

We refer you to Sections II.D and E of SEC Release 33-8238, in which the Commission recognizes that there is substantial overlap between ICFR and DCPs. For example, DCPs often include those components of ICFR that provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP. Please include in your response an explanation as to how you determined that the material weaknesses in your ICFR were not one of the components of ICFR that is also included in disclosure controls and procedures.

EY resources

2017 SEC annual reports — Form 10-K

Compendium of significant accounting and reporting issues, 2017 AICPA Conference on Current SEC and PCAOB Developments

Financial reporting developments, *Accounting changes and error corrections*

Materiality

Summary of issues noted

The SEC staff requests that registrants identify and discuss the quantitative and qualitative factors they considered when they assessed the materiality of error corrections. If a registrant concludes that a large error was immaterial, the SEC staff will challenge that conclusion.

Analysis of current issues

SAB Topic 1.M, which appears in ASC 250-10-S99-1, includes a list of possible qualitative and quantitative factors that a registrant might consider when assessing how a reasonable investor might consider the materiality of a financial statement item, including a financial statement error. The factors listed in SAB Topic 1.M are not intended to be exhaustive, and therefore each registrant should consider all qualitative and quantitative factors that may be relevant in its circumstances.

Evaluating whether an item is material requires judgment. Both quantitative and qualitative factors should be considered. Registrants must consider qualitative factors especially when the error is small. It is unusual for a registrant to conclude that a large error is not material based on qualitative factors.

When assessing materiality, a registrant should analyze both qualitative and quantitative factors.

The SEC staff frequently requests that registrants identify the factors they considered when assessing materiality with respect to current-period and prior-period financial statements when they correct errors relating to a prior period. Management should avoid relying on a "check-the-box" approach that is limited only to the indicators in the staff guidance. Instead, management should develop a qualitative and quantitative analysis that is specific to the registrant's facts and circumstances and considers each period affected by the error, including quarterly and annual periods. The analysis also should consider the effects of errors on key performance indicators that may be important to investors, even if the indicators are non-GAAP measures.

The SEC staff may question management's judgment when the error has a large effect on certain key measures.

The SEC staff also challenges materiality assessments for "Little r" restatements. Such a restatement occurs when an error is immaterial to the prior-year financial statements, but correcting the error in the current period would materially misstate the current-period financial statements. As a result, the prior-year financial statements are restated, even though the revision is immaterial to the results for the prior year(s).

In these situations, registrants generally are not required to file an Item 4.02 Form 8-K, *Non-reliance on previously issued financial statements or a Related Audit Report or Completed Interim Review*, or amend prior filings. Instead, they may correct the prior-period financial statements, with appropriate disclosure, in the next periodic report that includes the prior-period financial statements, as outlined in SAB Topic 1.N. The SEC staff may request the registrant's materiality assessment to evaluate whether the method of correcting the error and related reporting are appropriate.

Example SEC staff comment: Materiality

You indicate that you identified errors in previously issued financial statements associated with a subsidiary that were immaterial to each of the prior reporting periods affected. You also indicate that you have revised the prior-period results in the current filing since the cumulative effect of correcting the errors in 2017 would materially misstate your 2017 financial results. Please tell us:

- The analysis of how you determined these errors were both quantitatively and qualitatively immaterial to the current period and all previously reported periods (please refer to SAB Topics 1.M and 1.N when preparing your response)
- The specific nature of these errors, how and why you believe they occurred, and when and how you discovered them
- Your consideration of the potential effect of these errors on your conclusions on the effectiveness of your internal controls over financial reporting and disclosure controls and procedures

EY resources

Financial reporting developments, *Accounting changes and error corrections*

Other entity financial statements

Summary of issues noted

SEC regulations require registrants to provide financial information about other entities in certain situations, including when they (1) make a significant acquisition of a business (Rule 3-05 of Regulation S-X), (2) have a significant equity method investee (Rules 3-09 and 4-08(g) of Regulation S-X) or (3) are subject to guarantor reporting requirements (Rule 3-10). The financial statement requirements for each rule are based on whether certain thresholds or criteria are met, and each rule has specific requirements for which financial statements to include in a filing. The SEC staff frequently questions whether registrants have appropriately applied these rules.

Analysis of current issues

Financial statements of an acquired business (Rule 3-05)

When an acquisition of a significant business has occurred or is probable, Rule 3-05 requires the registrant to file separate, pre-acquisition historical financial statements for the acquired business. The SEC staff frequently requests that the registrant provide its detailed analysis (including the tests of significance) to help the SEC staff determine whether Rule 3-05 was applied appropriately. The SEC staff also questions the completeness of acquiree financial statements included in a filing.

Example SEC staff comment: Significance tests

It appears that you have not filed historical financial statements pursuant to Rule 3-05 of Regulation S-X. Please submit the analysis you performed to determine that this acquisition was not significant under the investment test, asset test and income test based on the guidance in Rule 3-05 of Regulation S-X, and you were therefore not required to file historical and pro forma financial statements on Form 8-K related to this acquisition, if this is your view.

When a registrant has disclosed letters of intent regarding a potential acquisition in the months before filing a new registration statement, the SEC staff may question whether it is probable that an acquisition exceeding 50% significance will occur, and if so, the SEC staff will ask the registrant to include pro forma information and historical financial statements for the target acquiree in the registration statement.

Furthermore, for purposes of complying with Rule 3-05 in registration statements, tests of significance should be conducted for each consummated and probable acquisition individually and in the aggregate since the last audited balance sheet appearing in the registration statement.

Example SEC staff comment: Disclosures about probable acquisitions

We note that you have entered into letters of intent regarding potential acquisitions. Please confirm to us that these pending probable acquisitions are not significant and there are no other probable acquisitions that would be significant such that additional historical and pro forma financial statements could be required by Rule 3-05 of Regulation S-X.

Financial statements of equity method investees (Rules 3-09 and 4-08(g))

When there are indications that a registrant may have significant equity method investees in any of the periods presented but the registrant has not included the separate financial statements or summarized financial information required by Rules 3-09 and 4-08(g), the SEC staff has asked the registrant to provide its analysis, including the detailed significance test computations.

The SEC staff's comments depend on the registrant's facts and circumstances. However, the SEC staff expects strict application of the significance tests. Registrants that inappropriately apply the requirements or fail to timely file investee financial statements may face consequences, such as the loss of Form S-3 eligibility or SEC staff comments challenging whether their disclosure controls and procedures are effective.

Financial statements of guarantors (Rule 3-10)

The SEC staff often asks registrants about their compliance with the criteria that permit financial reporting relief under Rule 3-10 of Regulation S-X. The staff asks registrants to confirm and disclose that (1) the subsidiary issuers and guarantors are 100% owned rather than "wholly owned," (2) the guarantees are full and unconditional and (3) the guarantees are joint and several.

The SEC staff may also focus on the form and content of condensed consolidating financial information disclosed in the parent company's consolidated financial statements in lieu of separate financial statements for each subsidiary issuer and guarantor of registered debt securities, including whether the individual columns in the consolidating financial information comply with Regulation S-X and are prepared in accordance with US GAAP.

EY resources

2017 SEC annual reports — Form 10-K

Compendium of significant accounting and reporting issues, 2017 AICPA Conference on Current SEC and PCAOB Developments

Financial reporting developments, *Equity method investments and joint ventures*

Technical Line, *Tips for complying with the SEC reporting requirements for equity method investees*

Pro forma adjustments

Summary of issues noted

The SEC staff has asked registrants about pro forma financial information disclosed in filings, including registration statements, proxy statements and Forms 8-K. The SEC staff has asked registrants to explain how they have met the requirements of Article 11 of Regulation S-X. The SEC staff also has asked for more transparent disclosure about the calculation of pro forma adjustments.

Analysis of current issues

The objective of pro forma financial information is to provide investors with information about the continuing impact of a particular transaction, such as an acquisition or disposition, that has occurred or is probable after the date of the historical financial statements (or is not fully reflected in the historical financial statements) by showing how it might have affected the registrant's historical financial statements "as if" the transaction had occurred at an earlier time. Article 11 of Regulation S-X describes the circumstances when pro forma information should be presented in SEC filings and the form and content for the presentation.

Pro forma adjustments included in pro forma financial information to provide this "as if" perspective of a transaction must be (1) directly attributable to each specific transaction, (2) factually supportable and (3) expected to have a continuing impact (for the pro forma income statement only). The SEC staff's questions about pro forma adjustments often cite these criteria and ask how pro forma adjustments comply with them.

Directly attributable

Pro forma adjustments should be directly attributable to the transaction reflected in the pro forma financial information. Pro forma financial information should exclude adjustments that reflect how the acquirer might have changed the acquiree's management practices and operating decisions had the acquirer had control over the acquiree during the period of the pro forma presentation.

The SEC staff has questioned adjustments that do not appear to be directly attributable to the transaction reflected in the pro forma financial information. For example, in pro forma information giving effect to a significant acquisition, a restructuring charge recognized in the target's historical financial statements would generally not be considered directly related to the business combination and should not be eliminated from the pro forma financial information. Furthermore, any integration restructuring activities and anticipated cost savings that the acquirer intends to implement after the acquisition would also generally not be considered directly related to the business combination and their effects should not be included in the pro forma financial information.

Example SEC staff comment: Pro forma adjustments

We note that you have included a pro forma adjustment to eliminate compensation to the company's chief executive officer because he or she will perform limited duties under a consulting agreement subsequent to this offering and acquisition. Since we assume that the compensation historically paid was commensurate with the duties he or she performed, please revise to eliminate this adjustment.

Factually supportable

Pro forma adjustments should be factually supportable. The SEC staff has indicated that an adjustment generally would be considered factually supportable if there is reliable documented evidence, such as an executed contract or completed transaction. For example, the SEC staff has challenged registrants when they include in their adjustments the effects of a new compensation arrangement that they expect to implement following a business combination if an agreement for such compensation was not executed in conjunction with the business acquisition negotiations.

The SEC staff also has indicated that the effects of some events and transactions are too uncertain to be considered factually supportable. For example, a company should not eliminate compensation expense on a pro forma basis for employees terminated following a business combination because the effects on revenues and operations from having fewer employees would be too uncertain.

Continuing impact

Pro forma income statement adjustments must have a continuing impact on the registrant or remove from the historical financial statements transaction-related costs or other items that are not expected to have a continuing impact. The SEC staff has asked registrants to explain how an adjustment has a continuing impact.

Registrants should clearly disclose the nature of pro forma adjustments and how they are calculated.

The SEC staff has historically used a 12-month rule of thumb to evaluate the continuing impact criterion. However, certain items that affect the pro forma income statement for a period of less than 12 months may still be considered to have a continuing impact. The evaluation will depend on the registrant's facts and circumstances. For example, an adjustment for interest expense on a bridge loan that may be incurred for a period of less than 12 months might be considered to have a continuing impact because such loans are typically replaced with permanent financing shortly after an acquisition closes.

Example SEC staff comment: Pro forma adjustments
We note your disclosure that you have included an adjustment to the pro forma statement of operations to recognize a $5 million 3% call premium for the repayment of debt. Please tell us how you determined that this expense is a recurring item and revise your disclosures accordingly. Please refer to Articles 11-02(b)(5) and 11-02(b)(6) of Regulation S-X for guidance.

Transparency of pro forma adjustments

In addition to meeting the criteria in Article 11 of Regulation S-X, pro forma adjustments should be clearly presented. The following disclosures should be included in the notes to the pro forma financial information:

- The nature of pro forma adjustments
- How pro forma adjustments are calculated
- The assumptions used to determine such amounts

For example, if two partially offsetting pro forma adjustments are presented in the aggregate to adjust deferred tax liabilities in the pro forma balance sheet, the notes to the pro forma financial information should explain the two gross adjustments in the net adjustment presented on the face of the pro forma financial information. The SEC staff often asks for clarification or additional disclosure when it's unclear how pro forma adjustments were calculated or when the amount of the total or net adjustment does not agree with the underlying gross pro forma adjustments explained in the notes.

Example SEC staff comment: Pro forma adjustments

Please expand your disclosure to provide a more detailed description of all of the pro forma adjustments reflected. Your revised disclosure should include a discussion of the methodologies used by the company to determine fair value as well as a listing of any material assets or liabilities currently shown net in the footnote (i.e., above-market lease intangibles and lease origination costs reflected as "lease intangible assets").

EY resources

Pro forma financial information: *A guide for applying Article 11 of Regulation S-X*

Rule 4-08(e) disclosures

Summary of issues noted

The SEC staff has asked registrants about third-party restrictions that appear to limit their ability to (1) pay dividends to shareholders or (2) transfer net assets from subsidiaries. If such restrictions exist, the SEC staff asks registrants to disclose them as required by Rule 4-08(e) of Regulation S-X. The SEC staff has also asked registrants about how they considered the requirements under Rule 5-04 of Regulation S-X to present condensed financial information on an unconsolidated basis (i.e., parent company financial statements).

Analysis of current issues

The SEC staff often issues comments about Rule 4-08(e) disclosures to registrants in the insurance and midstream oil and gas industries because of their legal structures, but the disclosure requirement applies to all registrants.

The SEC staff may use a registrant's debt agreements filed as exhibits, risk factor disclosures and financial statement disclosures about debt as the basis for inquiring about compliance with the requirements of Rule 4-08(e).

For example, a registrant's risk factor disclosure may indicate that a subsidiary's debt agreements limit the subsidiary's ability to pay distributions to the registrant. The SEC staff has asked such registrants to quantify in their response letter the amount of the subsidiary's restricted net assets, as defined in Rule 4-08(e)(3) of Regulation S-X, as of the end of the most recently completed fiscal year and explain how this amount was computed.

The SEC staff also has asked registrants about their compliance with Rules 5-04(c) and 12-04 of Regulation S-X. Rule 5-04(c) requires registrants to include parent-only condensed financial information on Schedule I, *Condensed financial information of registrant*, using the form and including the content required by Rule 12-04 when restricted net assets of only the registrant's consolidated subsidiaries exceed 25% of the registrant's consolidated net assets. This schedule shows investors the amount of net assets, operations and cash flows at the parent level on a standalone basis with all subsidiaries reflected on an unconsolidated basis (i.e., under the equity method).

Example SEC staff comment: Rule 4-08(e) disclosures and parent-only financial information

You disclose that the restricted payments covenant in the indenture governing your subsidiaries' notes as well as restrictions in your credit facility generally limit your ability to pay dividends. Please discuss any restrictions on your ability to declare dividends and the impact on your liquidity, financial condition and results of operations based on these restrictions. Please provide, if necessary, the disclosures required by Rule 4-08(e) of Regulation S-X. Please also tell us what consideration you gave to the need for parent-only financial statements under Rules 5-04 and 12-04 of Regulation S-X.

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Other SEC reporting issues

Summary of issues noted

The SEC staff has questioned how a registrant complies with the various disclosure requirements of Regulation S-K or other SEC rules and has requested additional disclosures, if material.

Analysis of current issues

The following is a brief overview of SEC disclosure areas where the staff continues to issue comments requesting compliance.

Business disclosures

Item 101 of Regulation S-K requires disclosure about the registrant's business, including a description of its products or services and geographic areas. Although the nature of SEC staff comments varies significantly in this area, depending on the registrant's facts and circumstances, the SEC staff typically has commented on the required disclosures about backlog, customer concentration, material supply/collaboration agreements and patents. The SEC staff has used a registrant's publicly available information (e.g., quarterly earnings calls, investor presentations) to challenge the completeness and accuracy of the disclosures provided.

Selected quarterly financial data

When disclosing quarterly financial data required by Item 302 of Regulation S-K, the registrant must explain the effect of any disposals of segments of a business, any unusual or infrequently occurring items recognized in each quarter (e.g., data security incidents, restructurings, acquisitions) and the aggregate effect and nature of year-end or other adjustments that are material to the results of the fourth quarter (e.g., changes in pension plan assumptions). The SEC staff issues comments when such items are not transparently disclosed as a note to the table of selected quarterly financial data, even if they are addressed elsewhere in the filing (e.g., MD&A).

Example SEC staff comment: Selected quarterly financial data

We note from your disclosure of selected quarterly financial data that the net loss recorded in the third quarter of 2017 was significantly different from the net incomes recorded in the other 2017 quarterly periods. Please revise to include disclosure of your restructuring activities, acquisition costs, legal settlements or impairment charges that materially affected the results of operations in your quarterly periods for 2017. See guidance in Item 302(a)(3) of Regulation S-K.

When preparing their tabular disclosure of selected quarterly financial data, registrants should keep in mind the definition of gross profit in Item 302(a)(1) of Regulation S-K. Expenses associated directly with or allocated to products and services are expected to include depreciation of property and amortization of intangibles deployed in the production and delivery of the products or performance of the services. Accordingly, the SEC staff may question a registrant's basis for presenting all of its depreciation and amortization outside of gross profit in the table of selected quarterly financial data or may request that the registrant change the composition of its quarterly gross profit altogether.

Registrants are expected to exercise particular diligence and judgment in preparing disclosures about their transactions with related parties.

Risk factors

Item 503(c) of Regulation S-K requires a registrant to disclose the significant risks it faces and how it is affected by each of them. Risk factors should be specific to the registrant's facts and circumstances and should not be general risks that could apply to any registrant. The SEC staff has questioned risk factor disclosures that could apply to any public company as well as limitations that some registrants include in their risk factor disclosures that do not comply with item 503(c) of Regulation S-K. The SEC staff also has questioned the completeness of a registrant's risk factor disclosures based on information included elsewhere in the document or in other public information (i.e., an earnings call).

With the increase in the frequency and severity of cyberattacks and data breaches, cybersecurity continues to be an area of focus. The SEC has issued an interpretive release to help companies prepare disclosures about cybersecurity risks and incidents. The release includes a framework for registrants to consider when evaluating whether to disclose information about risks and incidents involving cybersecurity. The framework is similar to the one previously established by the SEC staff in CF Disclosure Guidance: Topic No. 2. The release also reminds registrants to consider cyber matters in the context of various policies such as those for insider trading and selective disclosure (Regulation FD).

Related-party transactions

The SEC staff may request that registrants clarify or expand their disclosures about related-party transactions as required by Item 404(a) of Regulation S-K. Item 404(a) requires a registrant to describe related-party transactions (both actual and proposed) exceeding $120,000 since the beginning of its last fiscal year and in which any related party had or will have a direct or indirect material interest. The SEC staff expects the description of a particular transaction to summarize the nature of the transaction in quantitative and qualitative terms and include any material additional information.

The SEC staff often questions the completeness of disclosures provided under Item 404(a) and inconsistencies with the notes to registrants' annual and interim financial statements, disclosures in the business and risk factors sections, and any new agreements filed as exhibits. Preparing complete related-party disclosures is often challenging because registrants and their advisers have to consider whether information regarding a related-party transaction or the related person in the context of the transaction is material to investors in light of the circumstances of the particular transaction.

For example, the SEC staff recently has questioned registrants that fail to disclose indemnification provisions included in agreements with their executive officers.

Registrants sometimes overlook the fact that the requirements for disclosures about notes payable from officers to a registrant are much more prescriptive and granular than those for other related-party transactions. In those cases, the SEC staff has reminded registrants about the requirements of Item 404(a)(5) to disclose not only the principal balance outstanding as of the end of the reporting period and the interest rate but also the largest aggregate amount of principal outstanding during the period and the amount of principal repaid during the period.

The SEC staff requires that registrants comply with Rule 4-08(k) of Regulation S-K and identify all of their related-party transactions on the face of the balance sheet and statements of income and cash flows when their related-party disclosures are material.

State sponsors of terrorism

The SEC staff may comment on disclosures about liquidity, risk factors and results of operations for registrants with foreign operations in countries that have been identified by the US Department of State as state sponsors of terrorism, including Syria, Iran, North Korea and Sudan. The SEC staff will search a registrant's publicly available information (e.g., websites, news articles) for connections to the restricted countries, including comments related to unaffiliated retail locations where a registrant's branded product is sold. For further discussion, please refer to *Appendix C: Foreign private issuers*.

EY resources

2017 SEC annual reports — Form 10-K

Pro forma financial information — *A guide for applying Article 11 of Regulation S-X*

New SEC Chairman Jay Clayton outlines views in policy speech

SEC Reporting Update, *SEC issues guidance on cybersecurity*

Financial statement presentation

Income statement presentation

Summary of issues noted

The SEC staff continues to ask registrants to provide information supporting their conclusions on the appropriate presentation of revenue and cost of sales in the income statement. Specifically, the SEC staff focuses on the income statement presentation guidance in Rules 5-03(b)(1) and (2) of Regulation S-X.

Analysis of current issues

Many registrants derive revenues from the sale of different product categories or the sale of both products and services. In such cases, presentation of revenues by category may provide meaningful information to the users of the financial statements, particularly if the gross margins of the various categories of sales transactions are disparate. Rule 5-03(b)(1) of Regulation S-X requires the following items to be separately stated on the face of the income statement, unless the amount is less than 10% of total revenue:

- Net sales of tangible products (gross sales less discounts, returns and allowances)
- Operating revenue of public utilities or others
- Rental income
- Revenue from services
- Other revenues

Rule 5-03(b)(2) of Regulation S-X requires that costs and expenses applicable to sales and revenues be presented on the face of the income statement in the same categories as the corresponding revenue.

When other disclosures in a registrant's filings (e.g., MD&A discussion) or public materials (e.g., an earnings release) refer to revenue being derived from various sources, the SEC staff asks registrants to provide their analyses and other information (including quantitative data by revenue source) that was used to conclude on the income statement presentation of revenue and cost of sales. Registrants should continuously monitor the relative proportion of revenue earned from each source to make sure they are properly presenting revenue and cost of sales attributable to each significant category.

The SEC staff continues to challenge the income statement presentation of revenue and related costs attributable to various products and services.

Example SEC staff comment: Rule 5-03(b)
Please separately present sales and cost of sales for products and services on the face of your statements of operations pursuant to Rules 5-03(b)(1) and (2) of Regulation S-X.

Furthermore, under ASC 606, registrants are required to provide a note disaggregating revenue recognized from contracts with customers into categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. This disaggregation should be performed using the criteria outlined in ASC 606-10-50-89 through 91 and is in addition to the disaggregated revenue presentation on the face of the income statement required by Rule 5-03(b) of Regulation S-X. Refer to the *Revenue recognition — Disaggregated revenue disclosures* section for further information on SEC staff comments about this disclosure requirement.

Accounts receivable

Allowance for doubtful accounts

Summary of issues noted

The SEC staff asks registrants to provide a robust description of their accounting policies and methods used to estimate the allowance for doubtful accounts. The staff also asks registrants to explain both significant changes in the allowance from the prior period and changes that appear unusual in relation to other financial statement accounts. Further, the staff asks registrants for additional information on the credit quality of accounts receivable. In some cases, the staff asks questions about portfolio segments or customers that may be material to a registrant's operations.

Analysis of current issues

ASC 310 provides the disclosure requirements for accounts receivable. Registrants with sales that result in accounts receivable should have accounting policies and methods to estimate the allowance for doubtful accounts. They also should have policies for tracking delinquencies, determining when receivables become impaired and writing off uncollectible receivables. The SEC staff requests disclosure about how a registrant assesses collectability of receivables and determines its allowance for doubtful accounts, including the significant assumptions used and any uncertainty relative to those assumptions.

The staff asks for more details on the methods and assumptions used to determine the allowance.

Example SEC staff comment: Allowance for doubtful accounts

Given the nature and impact of the estimates and assumptions surrounding your assessment of the collectability of your accounts receivable, expand your disclosures to address the material implications of uncertainties associated with the methods, assumptions and estimates underlying your accounting for accounts receivable and the related allowance for doubtful accounts.

The expanded disclosure should also address, to the extent material, factors such as how you arrived at your estimates, how accurate the estimates have been in the past, how much the estimates have changed in the past, and whether the estimates are reasonably likely to change in the future.

When conditions cause significant or unusual changes in accounts receivable or in the allowance for doubtful accounts, the SEC staff asks registrants to disclose the factors that led to the changes. The staff asks registrants to disclose whether any specific customers or portfolio segments disproportionately drove the changes. The staff also questions whether the changes indicate trends that may have a material effect on the registrant's financial condition and/or results of operations, which would have to be disclosed in MD&A.

Business combinations

Business combinations disclosure

The SEC staff has asked whether registrants have properly characterized changes to initial amounts recognized as measurement period adjustments rather than error corrections.

Summary of issues noted

The SEC staff has asked registrants to enhance or explain their disclosures about business combinations by:

- Presenting all of the disclosures required by ASC 805, including the pro forma information required by ASC 805-10-50-2(h)
- Providing supplemental information related to the appropriateness of measurement period adjustments
- Providing the SEC staff with information and expanding disclosures about contingent consideration arrangements
- Providing the SEC staff with information about how they identified and determined the fair value of acquired intangible assets, especially when goodwill is a substantial portion of the consideration transferred
- Explaining how they evaluated whether the acquired set of assets and activities constituted a business or an asset

Analysis of current issues

General disclosures

The disclosures in ASC 805 are intended to help financial statement users evaluate:

- The nature and financial effect of business combinations that occur during the current reporting period or after the balance sheet date but before the financial statements are issued
- The financial effects of adjustments recognized in the current reporting period that relate to a business combination that occurred in the current or previous reporting periods

The SEC staff has questioned whether registrants' disclosures about business combinations are sufficient and requested that registrants expand their disclosures to provide material information required by ASC 805.

Example SEC staff comment: General disclosures

Please address the following:

- Provide a table in the footnotes for the fair value of the major classes of assets acquired and liabilities assumed. As part of this presentation, please separately present each major class of property, plant and equipment and identifiable intangible assets acquired. Refer to ASC 805-20-50-1.
- Please tell us where you disclosed the primary reasons for the acquisition as required by ASC 805-10-50-2(d). If this disclosure was not provided, please provide it in your upcoming filing.

When goodwill resulting from a business combination represents a significant portion of the consideration transferred, the SEC staff has asked registrants to revise their disclosures to provide more specifics in their qualitative descriptions of the factors that make up the amount of goodwill recognized (e.g., the specific synergies expected from the business combination) as required by ASC 805-30-50-1.

Example SEC staff comment: Disclosures relating to goodwill recognized

Given the significant amount of purchase consideration allocated to goodwill, please describe the qualitative factors that make up goodwill, such as expected synergies from the combining operations, intangible assets that do not qualify for separate recognition or other factors. Refer to the guidance outlined in ASC 805-30-50-1.

ASC 805-10-50-2(h) requires pro forma disclosures assuming the acquisition occurred as of the beginning of the comparable prior annual reporting period. When pro forma disclosures are not provided, the SEC staff has asked the registrant to explain why it is impracticable for the registrant to prepare the disclosures or to explain why the disclosure is not material. It is important to note that the evaluation of materiality for this purpose is separate and distinct from the significance test performed for the purposes of presenting Article 11 pro forma financial information.

Example SEC staff comment: Pro forma disclosures

Please tell us your consideration of disclosing the following information to enable users of your financial statements to evaluate the nature and financial effect of the acquisition in accordance with ASC 805-10-50-2(h):

- The amounts of revenue and earnings of the acquiree since the acquisition date included in the consolidated income statement for the reporting period
- The revenue and earnings of the combined entity for the current reporting period as though the acquisition date for the business combination that occurred during the year had been as of the beginning of the annual reporting period
- The revenue and earnings of the combined entity as though the acquisition that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period

Measurement period adjustments

The SEC staff has asked registrants to provide supplemental information about whether adjustments to provisional amounts recognized for assets acquired or liabilities assumed in a business combination qualify as measurement period adjustments, including whether registrants have properly characterized changes to the provisional amounts recognized in the acquisition as measurement period adjustments rather than error corrections.

The measurement period, which cannot exceed one year, ends when a registrant obtains the additional information that it was seeking about facts and circumstances that existed as of the acquisition date or when it concludes that such information is not obtainable. The SEC staff also asks registrants to disclose that the initial measurement of provisional items is incomplete.

Example SEC staff comment: Measurement period adjustment

We note your disclosures regarding the acquisition of a business. Please more fully address the following:

- You indicate that additional measurement period adjustments to indefinite and finite-lived assets, customer relationships and license agreements were the result of changes in assumptions used for valuation purposes such as projected growth rates, profitability and discount rates. More fully explain your revised assumptions, the reasons for the revisions, and the reasons for the significant differences in the allocations disclosed here relative to amounts disclosed in your Form 10-K.
- Explain the nature of any additional information you are awaiting to finalize the purchase price allocation.

Contingent consideration arrangements

The SEC staff has asked registrants to provide more robust descriptions of any contingent consideration arrangements and the basis for estimating the amount of the future payments. The SEC staff also has asked registrants to explain how they account for and determine the fair value of contingent payments to former owners both as of the acquisition date and in subsequent periods, including whether payments represent compensation or consideration. In addition, the SEC staff may request that registrants enhance their disclosures based on its review.

Identification and valuation of acquired intangible assets

The SEC staff has challenged whether additional intangible assets should have been recognized in a business combination and whether the valuation of an acquired intangible asset is appropriate. This is often the case when registrants have allocated a significant portion of the purchase price to goodwill. For further discussion, please refer to the *Intangible assets* section of this publication.

Determination of business or asset acquisition

When a registrant's disclosure about the acquired assets and activities is unclear, the SEC staff has asked registrants to explain how they evaluated whether the acquired set constitutes a business or an asset. The SEC staff has said that it may question a registrant's conclusion when the difference in accounting could be material, such as in transactions involving significant premiums, transaction costs or contingent consideration.

EY resources

Financial reporting developments, *Business combinations*

Consolidation

Variable interest entity consolidation, noncontrolling interests and disclosures

The SEC staff expects registrants to avoid boilerplate disclosures about their consolidation conclusions.

Summary of issues noted

The SEC staff has asked registrants to:

- Explain how they determined whether an entity is a variable interest entity (VIE), including how they evaluated details of the arrangement and the registrants' involvement with the entity
- Explain how they determined whether they were or were not the primary beneficiary of a VIE
- Provide additional details related to their noncontrolling interests, including their computation of ownership interests and net income or loss attributable to their noncontrolling interests
- Provide enhanced disclosures about their consolidation accounting policy and how they determined whether they have controlling financial interests

Analysis of current issues

Primary beneficiary determination

The SEC staff has asked registrants to provide supplemental information about their primary beneficiary determination, focusing particularly on the decisions about the activities that most significantly impact the VIE's economic performance.

Example SEC staff comment: Primary beneficiary determination
We note from your disclosure that Entity A is determined to be a VIE, which you consolidate as a result of being the primary beneficiary. Please provide us with your analysis of how you determined that you are the primary beneficiary. Please cite the applicable guidance in your response.

Income and losses attributable to noncontrolling interests

The SEC staff has asked registrants to explain how they determine income and losses attributable to noncontrolling interests, including their valuation methodology. In certain cases, the SEC staff has requested example calculations to support their attribution.

Example SEC staff comment: Income and losses attributable to noncontrolling interests
Provide us with further detail to support the allocation of net income (loss) attributable to the noncontrolling interests.

Disclosures

The SEC staff continues to remind registrants that ASC 810-10-50 requires disclosure of qualitative and quantitative information about involvement with a VIE, including, but not limited to, the nature, purpose, size and activities of the VIE. ASC 810-10-50-2AA(a) requires registrants to disclose the significant judgments and assumptions they made in determining whether they must consolidate a VIE or disclose information about their involvement with a VIE. ASC 810-10-50-2AA(d) also requires registrants to disclose how their involvement with a VIE affects their financial position, financial performance and cash flows.

Example SEC staff comment: Disclosures

It appears based on your disclosure that most of your operations stem from the consolidation of your VIE, Entity A. As such, please expand your disclosure to include the disclosures required by ASC 810-10-50-2AA(b) and (c). Also, in accordance with ASC 810-10-50-2AA(d), disclose how your involvement with your VIEs affects your cash flows.

The SEC staff expects registrants to avoid making boilerplate disclosures of the facts and circumstances they evaluated to determine the primary beneficiary and reach their consolidation conclusions. For example, the SEC staff has cautioned registrants that merely listing the contractual arrangements between a registrant and the VIE does not provide sufficient insight into the judgments the registrant made in evaluating whether to consolidate the VIE.

EY resources

Financial reporting developments, *Consolidation — Determination of a controlling financial interest and accounting for changes in ownership interests*

Contingencies

Accounting for and disclosure of loss contingencies

Summary of issues noted

Over the past few years, we have seen loss contingencies reemerge as a frequent area of comment. In its comments on registrants' compliance with loss contingency disclosure requirements, the SEC staff focuses on disclosures about reasonably possible losses and the clarity and timeliness of loss contingency disclosures.

Analysis of current issues

The SEC staff questions a registrant's failure to make required note disclosures when losses are considered reasonably possible or to disclose the range of reasonably possible losses, including when there is a reasonable possibility of a loss in excess of the amount accrued. The SEC staff seeks to verify that a registrant has considered and disclosed an estimate of the amount or range of reasonably possible losses or, if applicable, made a specific disclosure that the amount of loss cannot be estimated.

The SEC staff generally has not objected when registrants make either of the following disclosures, as applicable, about reasonably possible losses to comply with ASC 450:

- The amount or range of reasonably possible losses on an aggregate basis[1]
- The amount or range of reasonably possible losses in certain cases and a statement that the registrant cannot estimate an amount for other cases

The SEC staff has questioned how a registrant has determined that an estimate of a reasonably possible loss or range of loss cannot be made in a reporting period. If a registrant cannot make an estimate, the SEC staff expects the registrant to undertake sufficient procedures to support its conclusion and may request additional information about the process.

If a registrant says an estimate cannot be made, the SEC staff looks for information (such as the registrant's history with similar legal matters and the age of the litigation) that may indicate otherwise. The SEC staff challenges disclosures that imply a need for precision in estimating the loss or range of loss because US GAAP does not require a level of "certainty" or "confidence" for such an estimate.

The SEC staff also has challenged the use of limited time periods to develop a loss estimate when losses are reasonably expected to continue beyond the timeframe used to develop the estimate. An example would be a contingency measured using expected payments over a five-year period if losses are expected to continue beyond that period.

[1] While it is acceptable to aggregate the amount or range of all reasonably possible losses, the SEC staff has objected to the aggregation of losses in all categories (i.e., it is not acceptable to disclose one estimate combining probable, reasonably possible and remote loss contingencies).

Example SEC staff comment: Accounting for and disclosure of loss contingencies
We note that you disclose several legal matters and, in some instances, you indicate that you intend to vigorously defend the action and you have not reserved for any potential future payments in addition to the amounts accrued. In accordance with ASC 450-20-50, please revise future filings to clearly disclose the following information for your loss contingencies in aggregate or individually: (1) the amount or range of reasonably possible losses in addition to the amounts accrued or (2) a statement that the reasonably possible losses cannot be estimated or are not material to your financial statements.

The SEC staff requests that a registrant's disclosures use terms that are consistent with the language in ASC 450 when discussing the likelihood of occurrence (i.e., probable, reasonably possible or remote) and the estimated reasonably possible loss (i.e., additional loss, range of loss, an estimate cannot be made or the estimated additional loss or range of loss is not material).

The SEC staff also expects management to evaluate its loss contingency disclosures (or lack thereof) in each reporting period. The SEC staff expects those disclosures to evolve to include more quantitative information as the loss contingency progresses. The SEC staff sometimes issues comments on the same matter in subsequent annual and quarterly periods.

Further, the SEC staff may challenge the adequacy of historical disclosures when loss contingencies have been settled. In particular, the SEC staff reviews prior-period disclosures and inquires whether disclosures or accruals were sufficient in the prior periods based upon the development of the matter.

Presentation of insurance recoveries

The SEC staff has questioned the presentation of any insurance recoveries on the balance sheet (i.e., whether they are presented as assets versus as reductions of the related loss contingencies) as well as their disclosure. ASC 210-20, *Balance Sheet — Offsetting*, provides guidance on how to determine whether assets and liabilities can be offset and presented on a net basis. We believe it would be rare for all of the criteria in ASC 210-20 to be met for insurance recoveries related to loss contingencies.

Modifications, exchanges, extinguishments or troubled debt restructurings

Summary of issues noted

Registrants continually evaluate their liquidity and capital structure and often refinance existing debt in response to changes in the economic environment (e.g., declining interest rates, improved entity-specific credit). They may amend the terms of existing debt and/or exchange existing debt for new debt. They also may partially prepay amounts outstanding or borrow more, possibly as a result of exercising rights provided for in the existing agreement. The accounting for such transactions varies significantly, depending on whether a transaction is considered a debt modification or extinguishment, or a troubled debt restructuring. The SEC staff may ask for supplemental information to better understand how the registrant applied the relevant accounting guidance to these transactions.

Analysis of current issues

Registrants should consider the guidance in ASC 470-50 and ASC 470-60 when evaluating debt modifications and should be prepared to provide a thorough accounting analysis for the transaction in response to questions from the SEC staff.

The SEC staff may ask for supplemental information to better understand how a registrant applied the relevant accounting guidance to such transactions.

Example SEC staff comment: Debt modification or exchange

We noted that you refinanced your existing 2018 term loan with another term loan with an aggregate principal amount of $500 million maturing on 31 December 2020 and accounted for the transaction as a modification. Please refer to ASC 470-50-40-10 and tell us how you determined that these instruments were not substantially different.

In the past, the SEC staff has requested registrants to explain:

- The calculation of the gain or loss recognized in a debt modification or exchange transaction, including the amount of costs or fees that were capitalized or expensed and the amount included in the gain or loss
- How a modification or exchange of a cash convertible instrument accounted for under ASC 470-20 was considered in accordance with ASC 470-50, and the determination of the fair value of the modified instrument, gain or loss and related journal entries
- Whether the recognition of a gain or loss is appropriate for an extinguishment when the transaction is between related parties
- How a remarketing was considered under ASC 470-50, and the determination of whether a third-party intermediary was acting as an agent or a principal in the transaction

EY resources

Financial reporting developments, *Issuer's accounting for debt and equity financings*

Earnings per share

Allocation of income and losses under the two-class method

The SEC staff has asked registrants how income and losses are allocated to participating securities under the two-class method.

Summary of issues noted

The SEC staff has asked registrants for additional information about how they allocate income and losses to each class of common stock and participating securities under the two-class method used to compute earnings per share.

Analysis of current issues

Companies sometimes issue securities that participate in distributions with common stock based on a predetermined formula. These securities are referred to as participating securities. ASC 260 requires entities that issue participating securities or that have multiple classes of common stock to apply the two-class method to compute basic and diluted EPS.

A common example of a participating security is preferred stock that receives dividends based on the dividends paid on common stock. Under the two-class method, EPS is calculated for each class of common stock and participating security considering both dividends declared (or accumulated) and the contractual participation rights in undistributed earnings as if all such earnings had been distributed during the period.

Under the two-class method, the income allocated to a participating security is based only on objectively determinable, nondiscretionary participation rights. Other terms that are subjective or in management's control (e.g., management's determination of an extraordinary dividend) would not be considered. Additionally, losses are allocated to a participating security based on its contractual rights and obligations. However, it is unusual for securities other than common stock to have terms that require a company to allocate its losses to those securities.

The SEC staff has asked registrants to clarify and provide additional disclosure about the basis for allocating income and losses to each class of common stock and participating security and how they determined the effect on earnings per share under the two-class method.

Example SEC staff comment: Allocation of income and losses under the two-class method
Please tell us, and revise to disclose, your basis (including your consideration of ASC 260-10-45-60 to 60B) for allocating net income and losses and determining earnings per unit for each participating security. Please also specifically address the impact on earnings per unit.

EY resources

Financial reporting developments, *Earnings per share*

Financial reporting developments, *Share-based payment*

Fair value measurements

Disclosures of valuation techniques and inputs

Summary of issues noted

Fair value measurement continues to be a frequent area of scrutiny by the SEC staff. In its comments on registrants' compliance with fair value measurement disclosure requirements, the SEC staff focuses on disclosures about valuation techniques and inputs used in fair value measurements.

Analysis of current issues

The SEC staff asks registrants to provide more robust disclosures about the valuation techniques and inputs they use in determining fair value, including valuation techniques and inputs used by third parties. The staff's questions continue to be granular, frequently focusing on specific inputs to a fair value measurement. For example, the staff may inquire about the basis for the valuation methodology applied and the basis for inputs used in the valuation, such as discount rates, selected valuation multiples, cash flow forecasts and discounts/premiums applied. Further, the staff may inquire about the "weighting" assigned to multiple value indications when registrants use more than one valuation technique (e.g., internal model valuations and pricing indications from independent sources). In other instances, the SEC staff asks registrants to explain the basis for the valuation methods used to allocate the purchase price among acquired tangible and intangible assets in a business combination.

Example SEC staff comment: Valuation methodology and inputs
Tell us in reasonable detail how you determined the fair value of your reporting unit. Please include the specific methods utilized. Tell us the material assumptions used under each method utilized. Examples might include how cash flows were estimated, which discount rate was used and which principal market and market participants were selected. Please make sure your response addresses how you determined that each of the assumptions used was appropriate.

Example SEC staff comment: Multiple valuation techniques
Please address the following comments related to your interim goodwill impairment test. You indicate that you used a discounted cash flow analysis method (income approach) along with the market multiples method (market approach), which you used for additional validation of your fair value calculations. Please tell us whether you weighted both the income and market approaches in developing the fair value of your reporting unit. If so, tell us the relative weighting you used for each approach and how you determined such weighting was appropriate. Tell us whether there would have been any change in your impairment analysis had you solely used a market or income approach or had you changed the relative weighting.

The SEC staff continues to ask registrants to describe the procedures they perform to validate the fair value measurements obtained from third-party pricing services, including how they concluded bid quotes were a reliable indicator of fair value.

Example SEC staff comment: Third-party pricing information

We note you disclose that you determine the fair value of your investment securities based upon fair value estimates obtained from multiple third-party pricing services and dealers. Also, we note your disclosure that third-party pricing sources use various valuation approaches, including market and income approaches, and you disclose various inputs but no specific techniques. Please describe the specific valuation techniques used, and the inputs applicable to such valuation techniques, to determine the fair value of securities categorized within Level 2.

Example SEC staff comment: Third-party pricing information

Please tell us how you concluded bid quotations were a reliable indicator of fair value, considering that the quotations don't necessarily represent actual transactions, the market illiquidity of your shares, the large number of shares issued in the exchange, the value at which you issued shares for cash during the same period and other factors.

The SEC staff also comments on disclosures about fair value measurements categorized in Level 3 of the fair value hierarchy. These comments generally focus on a registrant's failure to provide required disclosures about valuation techniques and inputs and quantitative information about the significant unobservable inputs used in the fair value measurement. For example, the staff may ask why a registrant does not disclose the sensitivity of the Level 3 measurement to changes in significant unobservable inputs or may request that the registrant provide the range of unobservable inputs used to value Level 3 measurements.

Example SEC staff comment: Level 3 disclosures

Please revise future filings to provide all of the disclosures required by ASC 805-30-50-1(c) when a business combination that includes contingent consideration occurs in the reporting period. Revise future filings to reconcile the opening and closing balance and disclose the valuation techniques and the quantitative information about the significant unobservable inputs underlying the Level 3 fair value measurements for the contingent consideration.

EY resources

Financial reporting developments, *Fair value measurement*

Redeemable equity instruments and redeemable noncontrolling interests

The SEC staff may ask registrants how they account for redeemable equity instruments (including noncontrolling interests).

Summary of issues noted

The SEC staff has asked registrants how they account for redeemable equity instruments and redeemable noncontrolling interests (NCI).

Analysis of current issues

Redeemable equity instruments (e.g., preferred shares) may be classified as liabilities under ASC 480 if the registrant is unconditionally obligated to redeem them. Otherwise, they often are classified in temporary equity or the "mezzanine" section of the balance sheet and measured at, or accreted to, their redemption values. The accounting for these instruments is complex and based partly on the nature of the redemption feature.

Holders (or issuers) of NCI may have many reasons to contractually agree to sell (or buy) the NCI at some point in the future through a contractual redemption feature. When accounting for such a redemption feature, registrants need to consider the feature's form (i.e., whether it is embedded or freestanding), its nature (i.e., option-like or forward-like) and its pricing (i.e., fixed, variable or fair value), along with the guidance that applies to each of the variables.

The primary guidance to be considered for classification of and accounting for these instruments is in ASC 480, ASC 810, ASC 815 and the SEC's guidance in ASC 480-10-S99-1, ASC 480-10-S99-2 and ASC 480-10-S99-3A.

The SEC staff has asked registrants general questions about how redemption provisions affect the classification of preferred stock and NCI as a liability, permanent equity or temporary equity. Additionally, the SEC staff has asked registrants how they applied specific elements of the guidance, or how a specific redemption provision was analyzed under the relevant guidance. For example, the SEC staff has asked about a registrant's accounting policy for subsequent measurement of a redeemable noncontrolling interest, and how it complies with the measurement guidance in ASC 480-10-S99-3A.

Example SEC staff comment: Redeemable noncontrolling interests

We note you classify non-redeemable noncontrolling interest in permanent equity and redeemable noncontrolling interest in temporary equity on the consolidated balance sheets. Tell us in detail and disclose your accounting policy regarding the initial recognition and measurement, subsequent measurement and classification of your redeemable and non-redeemable noncontrolling interests.

EY resources

Financial reporting developments, *Derivatives and hedging*

Financial reporting developments, *Issuer's accounting for debt and equity financings*

Financial reporting developments, *Consolidation: Determination of a controlling financial interest and accounting for changes in ownership interests*

Foreign currency matters

Disclosure of the effects of foreign currency adjustments

Summary of issues noted

The SEC staff asks registrants to expand their disclosures to more comprehensively discuss and analyze the effects that foreign currency translation and remeasurement adjustments have on their financial statements. The SEC staff frequently requests registrants to quantify and describe how changes in foreign currency rates and transactions, including those with offsetting effects, affected their results of operations.

Analysis of current issues

The recent comments state that registrants with material foreign operations and transactions should consider:

- Disclosing the nature and extent of the currency risks to which the company is exposed and the effects of exchange rate changes on its financial statements
- Describing in MD&A any material effects of exchange rate changes on reported revenues, costs and business practices and plans
- Quantifying 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 analyzing any materially different trends in operations or liquidity that would be apparent if reported in the functional currency
- Identifying the currencies of the environments in which material business operations are conducted where exposures are material
- Identifying material unhedged monetary assets, liabilities or commitments denominated in currencies other than the operation's functional currency, and describing strategies for managing currency risk

The staff continues to ask registrants to revise how they format their disclosures on foreign currency and other market risks to comply with one of the three acceptable disclosure approaches described in Item 305(a) of Regulation S-K (i.e., tabular presentation, value at risk and sensitivity analysis to hypothetical changes in market rates).

Example SEC staff comment: Quantitative disclosure about foreign currency exchange rate risk
In future periodic filings, please revise your foreign currency exchange rate risk disclosures to include quantitative information in one of the formats outlined in Item 305(a)(i) through (iii) of Regulation S-K.

Goodwill

Impairment analysis and disclosures

The SEC staff has requested additional disclosures on reporting units at risk of impairment.

Summary of issues noted

The SEC staff has requested additional information about goodwill, including:

- Disclosures about reporting units that may be at risk of goodwill impairment and the timing of impairment losses
- Information about the registrant's impairment testing policies
- Disclosure of goodwill impairment testing policies
- Information on how reporting units were identified and components were aggregated, particularly when only a single reporting unit is identified

Analysis of current issues

Reporting units at risk of impairment

The SEC staff has frequently asked registrants to provide additional disclosure when the future impairment of goodwill represents a known uncertainty required to be disclosed in MD&A. In order to assist registrants in meeting this disclosure obligation, the SEC staff provides disclosures in Financial Reporting Manual (FRM) Section 9510.3 that registrants should consider when any reporting unit's estimated fair value does not substantially exceed its carrying value (i.e., the reporting unit is at risk of failing a future impairment test under ASC 350). This request is particularly common when the registrant's operating results (or that of the relevant segment) have declined significantly.

Example SEC staff comment: Reporting units at risk of impairment

To the extent that any of your reporting units have estimated fair values that are not substantially in excess of the carrying value and to the extent that goodwill for these reporting units, in the aggregate or individually, if impaired, could materially impact your operating results, please provide the following disclosures for each of these reporting units:

- Identity of the reporting unit
- The percentage by which fair value exceeds the carrying value as of the most recent impairment test
- The amount of goodwill
- A description of the methods and key assumptions used and how the key assumptions were determined
- A discussion of the degree of uncertainty associated with the key assumptions
- A discussion of any potential events and/or circumstances that could have a negative effect on the estimated fair value

The SEC staff has stated that it expects a registrant to apply judgment when determining whether the fair value is not substantially in excess of the carrying amount, and thus a reporting unit's goodwill is considered at risk. If goodwill impairment is identified as a critical accounting estimate, but the registrant does not have any reporting units that are at risk of failing the goodwill impairment test, the SEC staff expects the registrant to disclose that fact in MD&A.

The SEC staff has highlighted the importance of disclosing the percentage by which the fair value exceeded the carrying value of reporting units that are at risk of impairment as of the most recent goodwill impairment test.

The SEC staff also has challenged the timing of a goodwill impairment charge, particularly when the conditions that resulted in the charge also existed in prior periods. The SEC staff has questioned whether adequate disclosure was made in previous filings when a goodwill impairment charge was recorded for a reporting unit that was not previously disclosed as being at risk.

Information on impairment analysis

The SEC staff has asked for information about a registrant's impairment analysis, including:

- Details of the goodwill impairment analysis for each reporting unit, including how reporting units are identified and how assets, liabilities and goodwill are assigned to reporting units
- Sensitivity analyses regarding material assumptions used in testing goodwill for impairment, including qualitative and quantitative factors, and how changes in those assumptions might affect the outcome of the goodwill impairment test
- The reconciliation of the aggregate fair values of the reporting units to the registrant's market capitalization and justification of the implied control premium, including relevant transactions reviewed to support the control premium
- Details of the registrant's analysis of events that have occurred since the latest annual goodwill impairment assessment and whether those events are indicators of impairment that require an interim goodwill impairment assessment
- The reasons for and the result of any goodwill impairment test, even if no impairment was recognized
- The type of events that could lead to a future goodwill impairment

The SEC staff also has asked registrants whether they performed interim impairment tests when publicly available information indicated that such a test may have been necessary (e.g., the company's market capitalization declined, the company reduced prices, the company faced more competition). If the registrant didn't perform a test, the SEC staff has requested an explanation. The staff has also challenged the results of interim impairment testing.

The SEC staff has asked registrants to disclose additional information about their impairment analyses in critical accounting estimates in MD&A after reviewing the information provided.

Disclosure of accounting estimates

The SEC staff has asked registrants to provide robust disclosures in their critical accounting estimates section in MD&A about assessing goodwill for impairment and frequently requested additional information about the facts and circumstances leading to any recognized goodwill impairment. These requests often focus on:

- The accounting policies related to the goodwill impairment tests, including when the impairment test is performed, whether the optional qualitative assessment was performed for any reporting units, how reporting units are identified and aggregated, and how goodwill is assigned to reporting units
- The facts and circumstances leading to an impairment or that could lead to a future impairment
- How the fair value of each reporting unit was estimated, including the significant assumptions and estimates used
- Reporting units with material amounts of goodwill that are at risk of future impairment

Example SEC staff comment: Factors that could lead to a future impairment
Please expand your disclosures to discuss any material uncertainties, such as operational, economic and competitive factors specific to the key assumptions underlying the fair value estimate used in your impairment testing that have a reasonable possibility of changing and could lead to additional material goodwill impairment charges in the future.

Identification of reporting units and aggregation of components

A reporting unit is either an operating segment, as defined in ASC 280, or a component, which is one level below an operating segment, depending on whether certain criteria are met.

An operating segment is the highest level within a company that can be a reporting unit (i.e., the operating segment level is the ceiling), and a component is the lowest level within the company that can be a reporting unit (i.e., the component level is the floor). For further discussion on segment reporting, please refer to the *Segment reporting* section of this publication.

The SEC staff has asked registrants to clarify the number and type of reporting units (i.e., operating segments or components) identified for impairment testing and include the reasons for any changes in the number of reporting units. In particular, if a registrant has completed an acquisition or reorganization, the SEC staff has requested information on the reason for a change (or lack of change) in the number of reporting units and the effect on goodwill impairment testing.

Example SEC staff comment: Identification of reporting units

Please tell us the level at which you evaluate goodwill for impairment. We interpret your disclosures to indicate that you have only one operating segment. If our interpretation is incorrect, please clarify. If you evaluated goodwill at a component level, please explain how you determined each reporting unit and provide us a summary of the reporting units evaluated along with the related goodwill associated with each unit. If you evaluated goodwill on a single operating segment basis, please explain in detail your basis for this designation given your history of discrete business acquisitions.

Example SEC staff comment: Change in reporting units

Based on disclosures in your current- and prior-year Forms 10-K, it appears to us that there was a reduction in your reporting units from three to two. Please explain to us the reason for this change and address the effect, if any, it had on your annual goodwill impairment testing. Also, please ensure future filings adequately address any changes in reporting units.

A component of an operating segment is a reporting unit if it constitutes a business for which discrete financial information is available, and segment management regularly reviews its operating results. Segment management consists of one or more segment managers.[2] Two or more components in the same operating segment should be aggregated and deemed a single reporting unit if the components have similar economic characteristics.[3]

The SEC staff has asked registrants to clarify whether a single reporting unit exists or whether multiple components were aggregated into a single reporting unit. In the latter case, the SEC staff has asked registrants to explain the specific facts and circumstances (e.g., analysis of similar economic characteristics) that support this conclusion.

When reviewing the aggregation of components into a single reporting unit, the SEC staff considers public information available from a registrant's earnings calls and website, as well as industry and analyst presentations. The SEC staff has asked registrants to explain any perceived inconsistencies in how the businesses (i.e., components) are described in public information and how components are evaluated for aggregation into a single reporting unit.

EY resources

Financial reporting developments, *Intangibles — goodwill and other*

[2] For purposes of ASC 350, the term "segment manager" has the same meaning as in ASC 280.

[3] ASC 350-20 states that ASC 280-10-50-11 must be considered when determining whether the components of an operating segment have similar economic characteristics.

Income taxes

Disclosures related to deferred tax assets and their realizability

Summary of issues noted

The SEC staff continues to focus on valuation allowances and registrants' disclosures about their assessment of the realizability of deferred tax assets in both the financial statements and in MD&A.

In particular, the SEC staff may question the realizability of deferred tax assets recorded by registrants that have recognized consecutive annual losses or a significant loss in the current year. The SEC staff also may ask registrants to explain their reasons for reversing or significantly changing a valuation allowance if the reason is not readily apparent. Also, the SEC staff often comments if a registrant's disclosures related to its assessment of the realizability of deferred tax assets are not sufficient.

Analysis of current issues

A valuation allowance is required if, based on the weight of available evidence (both positive and negative), it is more likely than not (i.e., a likelihood of more than 50%) that some portion or all of a deferred tax asset will not be realized.

There are four sources of taxable income to be considered when determining whether a valuation allowance is required (ASC 740-10-30-18). Ultimately, the realizability of deferred tax assets depends on the existence of sufficient taxable income of the appropriate character in either the carryback or carryforward period available under the tax law.

The SEC staff frequently asks registrants to provide more information about their:

- Assessment of all available positive and negative evidence used to determine the realizability of deferred tax assets, how the evidence was weighted and the extent to which the evidence was objectively verifiable
- Consideration of the four sources of taxable income, including how deferred tax liabilities are factored into the assessment, how much future taxable income the registrant would need to fully realize the deferred tax assets and the nature of any tax planning strategy that is factored into the analysis
- Deferred tax asset valuation allowance, particularly when negative evidence suggests it might be necessary or positive evidence suggests it is unnecessary
- Change in a previously recorded valuation allowance when the evidence that led to this decision is not readily apparent

Overall, the questions that the SEC staff typically raises stem from what it perceives to be inadequate or overly general (i.e., boilerplate) disclosures in the financial statements and MD&A regarding how a registrant evaluated the realizability of deferred tax assets.

As noted above, the SEC staff has asked registrants about the positive and negative evidence they considered when a valuation allowance was reversed or significantly changed if the reason for that change is not readily apparent. When determining the weight to place on each piece of evidence, registrants should consider how objectively verifiable the evidence is. By its very nature, future taxable income (exclusive of the reversal of existing temporary differences and carryforwards) requires estimates and judgments about future events.

Registrants should carefully assess the realizability of their deferred tax assets and make transparent and complete disclosures in their financial statements and MD&A about their assessment.

Example SEC staff comment: Realizability of deferred tax assets
We have read your disclosures which indicate that you had loss carryforwards for federal income tax purposes and that you have not provided a valuation allowance related to these carryforwards. Please provide us with a comprehensive analysis of the positive and negative evidence that you considered to determine that no valuation allowance for the federal loss carryforwards was appropriate. We note you are currently in a cumulative three-year net loss position at the end of fiscal 2016. Further, in future periodic filings, please provide a more robust description of the positive and negative evidence you consider when determining whether your deferred tax asset valuation allowance is appropriate.

EY resources

Financial reporting developments, *Income taxes*

Income tax rate reconciliations and foreign earnings

Summary of issues noted

The SEC staff continues to express concern about the clarity of registrants' income tax rate reconciliations and the transparency of their disclosures about the effect of foreign earnings on their effective tax rates. More specifically, for material rate reconciliation items associated with foreign jurisdictions, the SEC staff asks registrants to disclose which jurisdictions materially affect their effective tax rates, the tax rates in those jurisdictions and information about how the tax rates in those jurisdictions (e.g., magnitude, mix) affect the effective tax rate.

Further, the SEC staff has expressed concerns about the quality of registrants' MD&A disclosures related to income taxes. The SEC staff has indicated that the income tax disclosures in MD&A often aren't cohesive and don't tell a complete story about the company's tax positions and related trends and uncertainties. The SEC staff often asks registrants for the following information:

- Reasons for historical changes in the effective tax rate
- Discussion about changes in reconciling items between the effective and statutory tax rates
- Whether and why past income tax rates are indicative of future tax rates
- Trends and uncertainties related to changes in unrecognized tax benefits
- Reasons why certain items affect or do not affect the effective tax rate

Analysis of current issues

The SEC staff reminds registrants to clearly label items in the income tax rate reconciliation. Registrants are required to provide a reconciliation between the amount of reported total income tax expense (benefit) and the amount computed by multiplying the income (loss) before tax by the applicable statutory federal income tax rate and showing the estimated dollar value of each of the underlying causes for the difference (ASC 740-10-50-12). Reconciling items that are individually less than 5% of the computed amount may be combined in the reconciliation (Article 4-08(h) of Regulation S-X).

Example SEC staff comment: Income tax rate reconciliation

We note your discussion and analysis of the changes in your effective income tax rate. Please expand your disclosures to provide a more robust analysis around the material items impacting your effective tax rate including the underlying facts and circumstances that drove those changes and whether you expect such changes to continue in the future. With reference to your tabular reconciliation, please explain the material factors impacting the Other line item that positively impacted your effective tax rate by 4% in 2017 and only 1% in 2016.

The SEC staff also questions whether large "provision to return" or "true-up" adjustments included in the income tax rate reconciliation reflect the correction of prior-year errors rather than changes in estimates.

Foreign earnings

A registrant may report a relatively low effective tax rate if it derives substantial income from low-tax-rate jurisdictions. In these circumstances, the registrant's income tax reconciliation may include a large reconciling item related to these low-tax-rate jurisdictions.

The SEC staff often asks registrants to quantify and describe the nature of the significant components of the international items that affect their tax rates, including the primary international taxing jurisdictions where foreign earnings are derived, the location of tax credits and the relevant statutory rates in those jurisdictions that may affect registrants' current or future tax expense.

Example SEC staff comment: Foreign earnings

You have disclosed that the effective tax rate for 2016 was lower than the US statutory rate due to the benefit of overall lower tax rates in certain international jurisdictions as well as the benefit of certain discrete items. Please tell us and expand your disclosure to specifically identify the international jurisdictions that have impacted your rate, their respective statutory tax rates and any expectations about trends in these jurisdictions that may impact your current or future tax expense. Please also quantify any significant items that have impacted your income tax expense and expand your disclosure in management's discussion and analysis to describe any expectations about trends that may impact your current or future tax expense. Please refer to Item 303(a)(3) of Regulation S-K and SEC Release No. 33-8350.

EY resources

Financial reporting developments, *Income taxes*

Accounting for US tax reform

Summary of issues noted

SEC staff members have said they are monitoring disclosures companies make under SAB 118, especially as the deadline for companies to complete their accounting for the enactment-date income tax effects of the Tax Cuts and Jobs Act (Act) approaches.

The SEC staff issued the SAB to provide guidance for registrants that could not complete their accounting for the income tax effects of the Act under ASC 740 in the period of enactment (i.e., the period including 22 December 2017). The SAB gave registrants a measurement period of up to one year to obtain, prepare and analyze the information needed and required detailed disclosures of their progress.

In a recent speech, Sagar Teotia, the SEC's Deputy Chief Accountant, noted that the SAB does not provide a deferral and said the staff expects companies to "keep moving in good faith" to complete their accounting as soon as they can. "This should not be interpreted as a window to put pencils down until we are close to one year from the enactment date to get started on the accounting," he said.

These comments suggest that the SEC staff could raise questions if a registrant records significant changes to its provisional amounts toward the end of the measurement period or has not updated provisional amounts recorded in the period of enactment. That is, the SEC staff could ask such a registrant to provide supplemental information about whether it has appropriately disclosed the material financial reporting effects of the Act for which the accounting was incomplete or request additional information supporting the timing of when the company recorded an adjustment to provisional amounts. The SEC staff has issued these types of comments in the past when registrants have made significant changes to provisional amounts recorded during the measurement period allowed in accounting for business combinations.

Analysis of current issues

SAB 118 *requires companies to disclose information about the material financial reporting effects of the Act for which the accounting under ASC 740 is incomplete, including:*

- Qualitative information about the income tax effects of the Act for which the accounting is incomplete
- The items reported as provisional amounts
- Existing current or deferred tax amounts for which the income tax effects of the Act have not been completed
- The reason the initial accounting is incomplete
- The additional information that needs to be obtained, prepared or analyzed to complete the accounting requirements under ASC 740
- The nature and amount of any measurement period adjustments recognized during the reporting period

Further, we understand that the SEC staff expects a company that has elected to account for global intangible low-taxed income (GILTI) as part of deferred taxes, but is still evaluating its accounting method for measuring those deferred tax amounts, to disclose that its method for measuring GILTI is provisional and may be changed during the measurement period. Similarly, when a company has not yet elected an accounting policy for GILTI during the SAB 118 measurement period, it should disclose that it is still evaluating the Act's GILTI provisions and has not yet elected an accounting policy.

In light of the US tax reform, registrants must also consider MD&A disclosure for any material short- and long-term liquidity implications of paying the required one-time transition tax on their accumulated foreign earnings on which they have previously deferred the US income taxes.

Mr. Teotia said in his speech that a company's disclosures during the measurement period provide important information to users of the financial statements and are a meaningful component of SAB 118.

EY resources

Technical Line, *A closer look at accounting for the effects of the Tax Cuts and Jobs Act*

Intangible assets

Recognition, measurement, amortization and impairment

Summary of issues noted

The SEC staff has requested that registrants provide the following details about their intangible asset disclosures:

- Information about intangible assets recognized as part of a business combination
- An explanation of how the useful lives were determined, and for finite-lived intangible assets (e.g., customer relationships) the factors leading to the amortization method selected
- Supplemental information on how intangible assets were assessed for impairment

After reviewing this information, the SEC staff has asked registrants to enhance or revise their intangible asset disclosures.

Analysis of current issues

Intangible assets recognized in a business combination

ASC 805 requires a registrant to determine the fair value of identifiable assets acquired (with certain limited exceptions), including intangible assets that (1) arise from contractual or other legal rights or (2) are separable.

The SEC staff's comments have focused on the values assigned to specific identifiable intangible assets, as well as the significant estimates and assumptions used in calculating fair value measurements and the subsequent accounting for such recognized intangibles. Specifically, the SEC staff has requested that registrants discuss in MD&A the valuation method and principal assumptions they used to determine the fair value of each major class of intangible assets acquired.

Useful life determination — indefinite-lived intangible assets

When determining the useful life of an intangible asset, a registrant should consider the period over which the asset is expected to contribute directly or indirectly to its future cash flows. Registrants should consider all of the factors listed in ASC 350 and all other relevant information when determining the useful lives of intangible assets.

The SEC staff has asked how a registrant has considered its own historical experience in renewing or extending similar arrangements (consistent with the intended use of the asset by the registrant). A registrant should consider its own historical experience even if similar arrangements did not have explicit renewal or extension provisions.

A registrant should consider the useful life of an intangible asset to be indefinite only after considering all relevant facts and determining that there are no legal, regulatory, contractual, competitive, economic or other factors that limit the useful life of the intangible asset. The SEC staff also has challenged a registrant's assertions that intangible assets have an indefinite life and has asked registrants to explain the factors they considered when making this determination.

Example SEC staff comment: Useful life determination — indefinite-lived intangible assets

Tell us how you determined that the acquired intangible assets from your acquisition of ABC Company were deemed to have an indefinite useful life. In your response, please tell us why you believe that no legal, regulatory, contractual, competitive, economic, expected use or other factors could limit the useful life of these intangible assets. We refer you to ASC 350-30-35-1 through 4.

Useful life determination and amortization method — finite-lived intangible assets

The SEC staff focuses on the useful life and amortization method of acquired finite-lived intangible assets (e.g., trade names, customer lists, customer contracts, customer relationships). The SEC staff has asked registrants to disclose how they determined the useful life of these assets and challenged such useful lives when the underlying assumptions do not appear consistent with information disclosed in other areas of the filing. The SEC staff also has inquired about the amortization method chosen for these assets (e.g., straight-line versus accelerated) and requested that registrants explain their key assumptions about the expected future cash flows from an acquired intangible asset to support their chosen amortization method.

Example SEC staff comment: Useful life determination — finite-lived intangible assets

Please help us better understand how you determined the 36-year period over which the acquired customer relationships are expected to contribute directly or indirectly to your future cash flows. Tell us in more detail about the attrition analysis of the customer relationships acquired, including, but not limited to, the historical length of those relationships and rates of attrition. Also tell us how contractual renewals and other extensions were considered in your analysis. Describe your own historical experience renewing or extending similar arrangements and how it affected your analysis and what, if any, market participant assumptions were considered and incorporated into your conclusion. In this regard, we note from your disclosures that the useful lives of customer relationships acquired in prior periods range from five to ten years for the fiscal year ended December 31 and that most of your contracts have terms ranging from three to five years, including renewal terms at the option of the customer.

Example SEC staff comment: Amortization method — finite-lived intangible assets
We note that you amortize other intangible assets, including customer relationships, on a straight-line basis over their estimated useful lives of 20 years. Customer relationships generally dissipate at a more rapid rate in the earlier periods following a company's succession to these relationships, with the rate of attrition declining over time. Under this pattern, a significant amount of cash flows derived from the acquired customer base may be recognized in earlier periods and then fall to a materially reduced level in later years. Please tell us why you believe that the straight-line method of amortization rather than an accelerated method reflects the pattern in which the economic benefits are consumed or explain why you cannot reliably determine the pattern in accordance with ASC 350-30-35-6.

Supplemental information on impairment analysis

An indefinite-lived intangible asset should be tested for impairment annually or more frequently (in accordance with ASC 350) if events or changes in circumstances indicate that the asset might be impaired. The SEC staff has requested that registrants explain how indefinite-lived intangible assets are tested for impairment, including the valuation method and significant assumptions used to determine the estimated fair values of the assets. As it has done with goodwill impairment, the SEC staff has challenged whether impairments of indefinite-lived intangibles should be recognized when the market capitalization or operating results of the registrant (or of the relevant segment) have declined significantly.

When a goodwill or long-lived asset impairment charge has been incurred, the SEC staff has requested an explanation of how the registrant considered the factors that led to impairment in evaluating the need for an impairment test of other finite-lived intangible assets in the period. Additionally, if a registrant doesn't record an impairment charge when other companies in the same industry or market are experiencing an economic downturn and recognizing impairment charges, the SEC staff is more likely to request an explanation.

The SEC staff has challenged whether impairments of indefinite-lived intangibles should be recognized if a registrant's market capitalization or operating results (or the operating results of the relevant segment) have declined significantly.

EY resources

Financial reporting developments, *Intangibles — goodwill and other*

Financial reporting developments, *Business combinations*

Revenue recognition

ASC 606, *Revenue from Contracts with Customers*, and ASC 340-40, *Other Assets and Deferred Costs — Contracts with Customers*

Overview

Comment letters that were issued to certain early adopters of ASC 606 and ASC 340-40 are now public and may provide an indication of the types of comments the SEC staff is issuing to registrants that adopted the new standard this year. This section will focus on those comments and highlight emerging topics.

As expected, the SEC staff's comments on the application of ASC 606 and ASC 340-40 have focused on areas of judgment (e.g., identifying performance obligations, determining timing of satisfaction of performance obligations, determining the amortization period of capitalized contract costs). Based on what we have seen, registrants appear to have been able to resolve these comments in the same manner as comments on other topics. That is, the registrants have helped the staff gain a better understanding of the judgments made by management or provided additional disclosures in future filings. Contemporaneous documentation of the judgments made in applying ASC 606 and ASC 340-40 will help facilitate the dialogue with the SEC staff during the comment process.

For trends regarding ASC 605, please refer to the 2017 SEC Comments and Trends publication since current-year trends are generally consistent with last year's trends.

EY resources

Financial reporting developments, *Revenue from contracts with customers* (ASC 606)

Identifying performance obligations

The SEC staff has asked registrants how they determined their performance obligations in contracts with customers.

Summary of issues noted

The SEC staff has asked registrants how they determine their performance obligations in contracts with customers. In particular, the SEC staff is interested in how registrants support their conclusions that certain promised goods and services are not separately identifiable.

Analysis of current issues

To apply ASC 606, an entity must first identify the promised goods and services within a contract with a customer and then determine which of those goods and services are separate performance obligations. Promised goods and services represent separate performance obligations if the goods or services are distinct (by themselves or as part of a bundle of goods and services) or if the goods and services are part of a series of distinct goods and services that are substantially the same and have the same pattern of transfer to the customer.

A promised good or service is distinct if both of the following criteria are met: (1) 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 (i.e., the good or service is capable of being distinct), and (2) the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (i.e., the promise to transfer the good or service is distinct within the context of the contract). If a promised good or service does not meet the criteria to be considered distinct, it is required to be combined with other promised goods or services until a distinct bundle of goods or services exists.

The SEC staff has requested that registrants provide an analysis supporting their determination that certain promised goods or services in a contract were not separately identifiable from other promises in the contract and, therefore, were not distinct performance obligations.

Example SEC staff comment: Identifying performance obligations
We note some of your contracts have multiple performance obligations. Please tell us and revise to disclose the nature of these performance obligations pursuant to ASC 606-10-50-12(c). For maintenance, support and warranty services, please provide us with your analysis as to why these services were not separately identifiable in accordance with the guidance of ASC 606-10-25-21, as applicable.

Registrants should carefully identify the promises in a contract and evaluate the criteria for determining whether the promised goods and services are separately identifiable from other promises in the contract (i.e., whether the promise to transfer the good or service is distinct in the context of the contract), which may require significant judgment. ASC 606-10-25-21 includes three factors that are intended to help entities determine when the promises in a bundle of promised goods or services are not separately identifiable and, therefore, should be combined into a single performance obligation: (1) the presence of a significant integration service, (2) the presence of significant modification or customization or (3) the promised goods or services are highly interdependent or highly interrelated.

Thorough and contemporaneous documentation of this analysis is critical to determine the performance obligations (i.e., the unit of account for revenue recognition) in a contract with a customer.

Registrants should review their disclosures to verify that they meet the requirement of ASC 606-10-50-12(c) which states that an entity shall disclose information about its performance obligations in contracts with customers, including a description of the nature of the goods or services that the entity has promised to transfer.

EY resources

Financial reporting developments, *Revenue from contracts with customers* (ASC 606)

Satisfaction of performance obligations

Summary of issues noted

The SEC staff has asked registrants why the method they used to measure progress toward satisfaction of an over time performance obligation provides a faithful depiction of the transfer of goods or services in a contract with a customer.

Analysis of current issues

When an entity has determined that a performance obligation is satisfied over time, ASC 606 requires the entity to select a single revenue recognition method (i.e., measure of progress) that depicts the entity's performance in transferring control of the goods or services. The standard provides two methods for measuring progress: (1) input methods (e.g., resources consumed, labor hours expended, costs incurred, time elapsed, machine hours used) and (2) output methods (e.g., surveys of performance completed to date, appraisals of results achieved, milestones reached, time elapsed, units produced or units delivered).

ASC 606-10-50-18(b) requires entities to disclose the method used to recognize revenue (e.g., a description of the input or output methods used and how those methods are applied) and why the method selected provides a faithful depiction of the transfer of goods or services. The SEC staff has commented when registrants have not included the latter disclosure.

Example SEC staff comment: Satisfaction of performance obligations
You disclose you recognize revenue over time using an input measure (e.g., costs incurred to date relative to total estimated costs at completion). Revise to disclose why this method is a faithful depiction of the transfer of goods or services pursuant to ASC 606-10-50-18(b).

In determining the method of measuring progress that faithfully depicts an entity's performance, the entity should consider both the nature of the promised goods or services and the nature of the entity's performance. In other words, an entity's selection of the method used to measure its performance should be consistent with the nature of its promise to the customer and what the entity has agreed to transfer to the customer.

Registrants should review their disclosures to verify that they not only meet the specific requirements of ASC 606-10-50-18(b) but also meet the overall objective discussed above.

EY resources

Financial reporting developments, *Revenue from contracts with customers* (ASC 606)

Disaggregated revenue disclosures

The SEC staff has asked about registrants' disaggregated revenue disclosures and how categories for disaggregation were determined.

Summary of issues noted

The SEC staff has asked about registrants' disaggregated revenue disclosures and how the categories for disaggregation were determined in accordance with the disclosure requirements in ASC 606.

Analysis of current issues

In accordance with the disclosure requirements in ASC 606-10-50-5, registrants are required to disclose disaggregated revenue information to illustrate how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors.

The implementation guidance in ASC 606 (i.e., ASC 606-10-55-89 through 55-91) indicates that the most appropriate categories for a particular entity will depend on its facts and circumstances, but an entity should consider how it disaggregates revenue in other communications (e.g., press releases, information regularly reviewed by the chief operating decision maker for evaluating the financial performance of operating segments) when determining which categories are most relevant and useful.

While ASC 606 does not specify how revenue should be disaggregated, the implementation guidance suggests categories for entities to consider. Example categories include, but are not limited to, all of the following:

- Type of good or service (e.g., major product lines)
- Geographical region (e.g., country or region)
- Market or type of customer (e.g., government and nongovernment customers)
- Type of contract (e.g., fixed-price and time-and-materials contracts)
- Contract duration (e.g., short-term and long-term contracts)
- Timing of transfer of goods or services (e.g., revenue from goods or services transferred to customers at a point in time versus over time)
- Sales channels (e.g., goods sold directly to consumers and goods sold through intermediaries)

The SEC staff has requested that registrants explain how they considered the implementation guidance in ASC 606-10-55-89 through 55-91 when selecting the appropriate categories to disaggregate revenue. Specifically, the SEC staff would like to understand how the registrant's disclosures meet the objective of depicting how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. Similar to how it reviews segment disclosures, the SEC staff may review all publicly available information to evaluate whether the objectives of this disclosure requirement have been met.

Example SEC staff comment: Disaggregated revenue disclosures

We note your presentation of disaggregated revenue by major source on page XX. With respect to the disclosure requirements of ASC 606-10-50-5, please tell us how you considered the guidance in paragraphs ASC 606-10-55-89 through 55-91 in selecting the appropriate categories to use to disaggregate revenue. Please tell us why you believe your current disclosures meet the objective of depicting how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors.

We believe that when determining categories for disaggregation of revenue, registrants should analyze specific risk factors for each of their revenue streams to determine the proper level of revenue disaggregation that will be beneficial to users of the financial statements. If certain risk factors could lead to changes in the timing of revenue recognition, those factors should be evaluated as potential categories for this disclosure.

In addition, an entity is required by ASC 606-10-50-6 to explain the relationship between the disclosure of disaggregated revenue and revenue information that is disclosed for each reportable segment. Registrants should review their disclosures to verify that they meet this disclosure requirement.

EY resources

Financial reporting developments, *Revenue from contracts with customers (ASC 606)*

Significant payment terms

Summary of issues noted

The SEC staff has asked registrants to disclose significant payment terms in contracts with customers, as well as how the timing of satisfaction of registrants' performance obligations relates to the typical timing of payment.

Analysis of current issues

ASC 606-10-50-12(b) states that an entity has to disclose information about its performance obligations in contracts with customers, including a description of significant payment terms. This could include when payment typically is due, whether the contract has a significant financing component, whether the consideration amount is variable and whether the estimate of variable consideration is typically constrained.

Further, ASC 606-10-50-9 requires that an entity explain how the timing of satisfaction of performance obligations relates to the typical timing of payment, as well as the effect those factors have on the contract asset and liability balances. Under ASC 606, a contract asset or contract liability is generated when either party to a contract performs, depending on the relationship between the entity's performance and the customer's payment. When an entity satisfies a performance obligation by transferring a promised good or service, the entity has earned a right to consideration from the customer and, therefore, has a contract asset. When the customer performs first (e.g., by prepaying its promised consideration), the entity has a contract liability.

The SEC staff has commented when registrants have not included a robust disclosure of their significant payment terms.

Example SEC staff comment: Significant payment terms
Tell us your significant payment terms and how the timing of satisfaction of performance obligations relates to the timing of payment and the effect on the contract asset and liability balances. Disclose the information required by ASC 606-10-50-9 and 50-12(b) in future filings.

Registrants should review their disclosures to verify that they meet the disclosure requirements in ASC 606-10-50-12(b) and ASC 606-10-50-9.

EY resources

Financial reporting developments, *Revenue from contracts with customers* (ASC 606)

Amortization of capitalized contract costs

The SEC staff has asked registrants to explain how they determined the amortization period for contract costs capitalized under ASC 340-40.

Summary of issues noted

The SEC staff has asked registrants to explain how they determined the amortization period for contract costs capitalized under ASC 340-40. In particular, the SEC staff asks for more information about costs to obtain a contract with a customer, including how renewal sales commissions (if any) are considered in the amortization period determination.

Analysis of current issues

Under ASC 340-40, the incremental costs of obtaining a contract with a customer (e.g., sales commissions) are recognized as an asset if the entity expects to recover those costs. Any capitalized contract costs are amortized over a period that is consistent with the transfer to the customer of the related goods or services. This can also be thought of as the expected period of benefit of the asset capitalized that likely would extend beyond the contract term if the capitalized contract costs relate to goods or services being transferred under multiple contracts or to a specific anticipated contract (e.g., certain contract renewals).

When evaluating whether the amortization period for an initial sales commission extends beyond the original contract period, an entity should evaluate whether an additional commission is paid for any expected renewals and, if so, whether the renewal commission is "commensurate" with the original commission (i.e., reasonably proportional to the contract values). For example, a 6% commission on an initial contract and a 2% commission on a renewal would not be commensurate. If the entity's past experience indicates that a renewal is likely, the amortization period would be longer than the initial term if the renewal commission is not commensurate with the initial commission.

When the expected period of benefit extends beyond the initial contract term, it may be the expected customer relationship period, but that is not always the case. To determine the appropriate amortization period, an entity will need to evaluate the type of capitalized costs, what the costs relate to and the specific facts and circumstances of the arrangement.

When evaluating the appropriate amortization period for renewal commissions, an entity would also consider whether additional commissions are expected for further renewals and whether those commissions would be commensurate. For example, if an entity expects to renew an annual contract in years two through four and pay a 2% commission upon each renewal, each renewal commission would be considered commensurate, and the appropriate amortization period for each renewal commission would likely be one year.

The SEC staff has requested that registrants provide more information about capitalized costs to obtain a contract with a customer. Specifically, the SEC staff has asked whether additional sales commissions are paid for contract renewals, if those renewal commissions are commensurate with the initial commissions and how expected renewals are considered when determining the amortization period for commissions capitalized under ASC 340-40. In addition, the staff has also asked about how renewal commissions are amortized. The SEC staff also asks registrants to include such information in their disclosures in accordance with ASC 340-40-50-2(b).

Example SEC staff comment: Amortization of capitalized contract costs
Please tell us, and revise to clarify if appropriate, whether additional sales commissions are paid upon contract renewal and, if so, whether such amounts are commensurate with the initial commissions. Please also disclose how commissions paid for renewals are considered in your five-year period of benefit for the initial commission. Finally, please disclose the period of time over which you amortize commission costs related to contract renewals. Refer to ASC 340-40-35-1 and 340-40-50-2(b).

In determining the appropriate amortization period or the period of benefit for capitalized contract costs, the entity should consider its facts and circumstances and may use similar judgment to that used when estimating the amortization period for intangible assets (e.g., a customer relationship intangible acquired in a business combination). This could include considering factors such as customer "stickiness" and how quickly the entity's products and services change. It will be important for registrants to document the judgments made when determining the appropriate amortization period.

ASC 340-40 disclosure requirements include judgments made in determining the amounts of costs that are capitalized, the amortization method chosen and other quantitative disclosures. Registrants should review their disclosures to verify that they meet the requirements in ASC 340-40-50-2(b).

EY resources

Financial reporting developments, *Revenue from contracts with customers* (ASC 606)

Segment reporting

Identification and aggregation of operating segments, disclosures and internal control over financial reporting

Summary of issues noted

The SEC staff continues to focus on segment reporting and how registrants apply ASC 280. The areas the SEC staff is focusing on include:

- How registrants identify operating segments
- How registrants aggregate operating segments into reportable segments
- Whether registrants provide appropriate disclosures, including general information disclosures, reconciliations and entity-wide disclosures related to products and services, revenues attributable to individual foreign countries and revenues from major customers
- Whether registrants have inappropriately included non-GAAP measures in their segment disclosures

Analysis of current issues

The SEC staff continues to focus on segment disclosures and the application of ASC 280, including the basic objectives and principles outlined in the segment reporting guidance.

The SEC staff continues to challenge assessments made under ASC 280.

The SEC staff has emphasized the importance of ICFR including whether the design and operation of internal controls over a registrant's segment reporting judgments are appropriate. The SEC staff has said that the guidance on segment reporting requires a registrant to apply reasonable judgment. Therefore, input from, and interaction with, the chief operating decision maker (CODM) may be an important element in the design of effective internal controls over financial reporting, specifically how the CODM allocates resources and assesses performance.

The SEC staff also has reminded registrants that documenting the design and effective operation of management's controls over these judgments is an integral part of management's support for the effectiveness of its ICFR and is essential to the auditor's ability to evaluate these controls.

When reviewing segment reporting, the SEC staff considers information within the registrant's public filings as well as information available from a registrant's earnings calls, website and industry or analyst presentations. The SEC staff has asked registrants to explain any inconsistencies between how the business is described in public information and how it is described in their segment footnotes. For example, the SEC staff has challenged registrants when they say the basis for identifying operating segments is something other than product or service lines (e.g., geography) but publicly disclosed information suggests that management uses financial information by product or service lines to make decisions and allocate resources.

The SEC staff expects registrants to continually monitor business developments and has inquired about changes in the business that could affect the identification or aggregation of operating segments.

While the SEC staff has historically commented on segment reporting, we continue to see a high level of focus in this area, even when the SEC staff has previously commented on a registrant's segment reporting. Questions on segment reporting have often resulted in multiple rounds of comments, particularly when the registrant's initial response was not comprehensive. The review process also has led to requests for a teleconference with the SEC staff, including representatives of the SEC's Office of the Chief Accountant.

Identification of operating segments

The segment reporting guidance is based on a "management approach" (ASC 280-10-5). That is, segment disclosures should be consistent with a registrant's internal management reporting structure to enable investors to view the registrant similarly to the way management does. Registrants should challenge any conclusions they reach on operating segments that are not consistent with the basic organizational structure of their operations. To support the management approach concept, the SEC staff has requested that registrants include a discussion of their internal structure or an organizational chart and the processes used to make operating decisions in their comment letter responses.

Identifying operating segments (ASC 280-10-50-1 through 50-9) is the first step in preparing segment disclosures. A critical element of this analysis is identifying the CODM. Under ASC 280, the CODM is a function, not necessarily a manager with a specific title. The SEC staff has said that a registrant should focus on who makes the key operating decisions in the organization and not default to who makes the strategic decisions or has the ultimate decision-making authority. That is, the registrant should not default to the chief executive officer or the chief operating officer when determining the CODM, and the registrant's ICFR should identify and assess those responsible for the key operating decisions that are necessary to run the business.

To evaluate a registrant's identification of operating segments, the SEC staff often requests a description of the registrant's organizational structure and detailed information about employees who report directly to the CODM, including their roles and responsibilities and interactions with the CODM. The SEC staff also considers the basis on which budgets and forecasts are prepared and how performance objectives are evaluated, including how executive compensation is determined (e.g., performance criteria underlying compensation plans). This information allows the SEC staff to challenge whether the identified operating segments are consistent with how the CODM assesses performance and allocates resources.

To qualify as an operating segment, a component must have discrete financial information available that the CODM uses to assess performance and make resource allocation decisions. This financial information must be sufficiently detailed to allow the CODM to make decisions. When determining whether discrete financial information is available, the SEC staff has cautioned that a registrant shouldn't conclude that discrete financial information is not available simply because certain costs are shared and not allocated specifically to each component. Gross profit information or other operating measures provided to the CODM and used to assess performance and make resource allocation decisions could be considered discrete financial information.

The SEC staff frequently has requested that registrants describe the financial information provided to the CODM so the SEC staff can understand the information used by the CODM to assess performance and allocate resources. However, the SEC staff has clarified that the fact that information is included in a reporting package is not the only factor it considers in its assessment of identified operating segments.

Further, when a registrant identifies only one operating segment, the SEC staff has challenged how decisions can be made about performance and resources for the company as a whole without evaluating discrete financial information on a more disaggregated basis. The SEC staff has said that if the application of the guidance in ASC 280 results in the identification of a single operating segment, a registrant should disclose that it allocates resources and assesses financial performance on a consolidated basis and explain the basis for that management approach.

Example SEC staff comment: Identification of operating segments

Please tell us who your CODM is and provide us with your analysis in determining the CODM. As part of your response, please provide us with an organizational chart that includes the titles and roles of the individuals who report directly to the CODM. In doing so, specifically explain to us the responsibilities of these individuals and the manner in which they typically interact with the CODM. In addition, please respond to the following:

- Tell us the nature of the resource allocation and performance assessment decisions the CODM makes, including examples to illustrate the description.
- Describe the information regularly provided to the CODM and how frequently it is prepared.
- Describe the information regularly provided to the Board of Directors and how frequently it is prepared.
- Explain how budgets are prepared, who approves the budget at each step of the process, the level of detail discussed at each step and the level at which the CODM makes changes to the budget. Also describe the level of detail communicated to the CODM when actual results differ from budgets and who is involved in the meetings with the CODM to discuss budget-to-actual variances.
- Describe the basis for determining the compensation of the individuals that report to the CODM.

Identifying operating segments also affects goodwill impairment testing. As discussed in the *Goodwill* section of this publication, the SEC staff has requested information about how a registrant identifies its reporting units. If a registrant incorrectly identifies operating segments, this could cause a registrant to incorrectly identify reporting units used in goodwill impairment testing.

The SEC staff considers meeting the criteria to aggregate operating segments a high hurdle.

Aggregation of operating segments

ASC 280 allows, but does not require, a registrant to aggregate operating segments for reporting purposes. To aggregate operating segments, a registrant must determine that all three criteria in ASC 280-10-50-11 are met. The criteria, which all require the use of judgment, are:

- The aggregation must be consistent with the objective and basic principles of ASC 280.
- The operating segments must be economically similar.
- The following five qualitative characteristics of the operating segments must be similar: (1) the nature of the products and services, (2) the nature of the production processes, (3) the type or class of customer for their products and services, (4) the methods used to distribute their products or provide their services and (5) the nature of the regulatory environment, if applicable.

To be consistent with the objective and basic principles of ASC 280, the aggregation of operating segments should help users of the financial statements make better-informed judgments about the registrant by improving their understanding of the registrant's performance and their assessment of the prospects for future net cash flows. That is, a registrant may aggregate operating segments only if reporting them separately will not add significantly to the investor's understanding of the entity because the segments' characteristics are so similar that they can be expected to have essentially the same future prospects.

It's important to understand that while the identification of operating segments follows a management approach, the aggregation of operating segments should be viewed from the investor's perspective. The SEC staff has said that it is important for registrants to consider information such as industry reports and other analyses by users of the financial statements that may provide evidence of how a reasonable investor would analyze the company.

ASC 280 requires that aggregated operating segments have "similar economic characteristics," such that they would be expected to have similar long-term financial performance. The similarity of the economic characteristics should be evaluated based on both current performance and future projections (ASC 280-10-55-7A). However, the SEC staff has said that the expectation that operating segments will have similar economic characteristics (e.g., long-term average gross margins) in the future does not take precedence over a lack of similarity in their current and past performance.

The SEC staff often reviews the registrant's website, analyst presentations and information in public filings and raises questions if any of that information is inconsistent with the registrant's conclusion that aggregating operating segments is appropriate. For example, a discussion of diverging trends or differing results at two business lines could indicate that these two business lines, if they qualify as operating segments, may not be economically similar.

The SEC staff has requested historical and projected operating margins, gross margins, revenues and other measures of operating performance when challenging a registrant's aggregation of operating segments.

When a registrant has aggregated operating segments into a reportable segment, the SEC staff has frequently asked for an explanation of why the registrant believes the five qualitative characteristics of the operating segments are similar, as required by ASC 280.

The SEC staff also has reminded registrants that the guidance on determining whether two operating segments are similar requires a company to consider the range of its business activities and the economic environment in which it operates. For example, while a registrant with a diversified product portfolio may consider certain products similar, a registrant with a more narrow range of activities may not consider those same products similar.

In addition, the SEC staff has asked why a company's organizational structure caused it to identify separate operating segments and whether those reasons provide evidence that the operating segments are not similar.

Example SEC staff comment: Aggregation of operating segments

We note that your five operating segments are aggregated into one reportable segment. Please address the following:

- Compare and contrast your operating segments relative to the areas listed in ASC 280-10-50-11(a) through (e). With respect to any differences among your operating segments, tell us why you determined that disaggregation was not warranted.
- Provide us with each operating segment's historical and projected revenues, gross margin, operating margin and measure of segment profitability.
- Tell us the basis of organization (i.e., why the company is organized in the manner that it is).

Ongoing assessment of reportable segments

The SEC staff has challenged registrants' identification and aggregation of operating segments when there have been changes to the business. We believe this is linked to the SEC staff's emphasis on registrants having processes in place to continuously reassess their conclusions because circumstances may change over time. For example, the SEC staff has inquired about how a change in a registrant's internal reporting due to a significant acquisition, a restructuring or changes in performance among operating segments affected segment reporting conclusions.

Example SEC staff comment: Identification and aggregation of operating segments including a recent acquisition
We note your disclosure that you have determined it appropriate to aggregate your operating segments into one reportable segment. Please tell us the consideration given by management in determining your reportable segment in light of the acquisition of XYZ Company (XYZ), which operates in a different region of the country. We note from XYZ's website that it appears to continue to operate as a separate entity under the XYZ name. In this regard, please tell us how you considered these characteristics of XYZ's operations in determining that it is appropriate to present one reportable segment. Your response should address how you identified the operating segments under ASC 280-10-50-1 and 280-10-50-3 through 50 and further, how you evaluated each of the aggregation criteria in ASC 280-10-50-11.

The SEC staff may challenge whether a registrant has inappropriately included a non-GAAP measure in its segment disclosures.

Disclosures

General disclosures

ASC 280-10-50-21 requires registrants to disclose the factors they used to identify their reportable segments, including whether operating segments have been aggregated. If a registrant has not included this information in the segment footnote, the SEC staff has asked the registrant whether it has aggregated operating segments when determining reportable segments and has asked it to expand its disclosure in future filings. ASC 280-10-50-21 also requires disclosure of the types of products and services from which each reportable segment derives its revenues. The SEC staff has asked registrants to expand their disclosures when the information is not provided or does not include enough detail.

Reconciliations

ASC 280-10-50-30 requires registrants to provide reconciliations of the reportable segments' total revenues, measure of profit or loss, assets and other significant items, if disclosed, to the corresponding consolidated amounts. The SEC staff has asked registrants to revise their disclosures if they have not disclosed the reconciliations in the consolidated financial statements. The SEC staff also has asked registrants about amounts included in an "other" reconciling item, since ASC 280-10-50-31 requires significant reconciling items to be separately identified and described.

Non-GAAP measures

By definition, a segment measure of profit or loss that a company is required to disclose in accordance with ASC 280 (i.e., a measure that is reported to the CODM for purposes of making decisions about allocating resources to the segment and assessing its performance) is not a non-GAAP measure and is not subject to the rules and regulations on the use of non-GAAP financial measures.

The SEC staff's C&DIs on the use of non-GAAP financial measures address this point. The C&DIs say "because [ASC 280] requires or expressly permits the footnotes to the company's consolidated financial statements to include specific additional financial information for each segment, that information also would be excluded from the definition of non-GAAP financial measures."

However, the SEC staff may challenge whether a registrant has inappropriately included a non-GAAP measure in its segment disclosures. For example, registrants should be aware that a consolidated measure of segment profit may create a non-GAAP financial measure.

Example SEC staff comment: Non-GAAP measures in the segment footnote
While we note that your CODM uses segment operating income (loss) and segment operating margin percentage to evaluate segment performance, the format and labeling of your presentation include non-GAAP measures that are not measures of segment performance and you are not allowed to present them in your financial statements pursuant to Item 10(e)(1)(ii)(C) of Regulation S-K. The amounts you present in the consolidated column for operating income (loss) and operating margin percentage are not amounts presented on your statement of income or which can be directly calculated therefrom. While you may present the total of profit or loss of individual segments as part of the reconciliation required by ASC 280-10-50-30(b), such presentations must be correctly labeled and the reconciliations should be to the consolidated amounts presented in your financial statements. Please revise the format and labeling of your presentation to eliminate the non-GAAP measures consolidated operating income (loss) and consolidated operating profit margin percentage. See also Question 104.04 of the Compliance & Disclosure Interpretations for Non-GAAP Financial Measures.

The SEC staff also has said that registrants should not attempt to circumvent the non-GAAP rules by disclosing multiple measures of a segment's profit or loss in their financial statements. Similarly, the SEC staff may challenge a registrant that discloses a measure of segment profit or loss when it discloses only one reportable segment.

For further discussion, please refer to the *Non-GAAP measures* section of this publication.

Entity-wide disclosures

<u>Disaggregated revenue by product and service</u>

ASC 280 also requires a registrant to disclose the revenues it derived from transactions with external customers for each product or service or each group of similar products or services, if this information is not already provided as part of the segment information required by the standard. Entities that have only one reportable segment also are required to disclose such products and services revenues. For example, a registrant with one reportable segment that sells consumer products and provides services would be required to disclose the revenues from each significant product line or service, or groups of similar products or services, in its segment disclosure.

Example SEC staff comment: Disaggregated revenue by product

Please revise to disclose revenues from external customers for each product and service or each group of similar products and services. As part of your response, please describe the similarities and differences between the products and services presented as a group. Please refer to ASC 280-10-50-40.

The SEC staff often has asked registrants that have not disclosed disaggregated revenue information to do so or explain why such disclosure was not necessary. The SEC staff has challenged the absence of such a disclosure when the registrant's publicly disclosed information indicates that its reportable segments contain a range of products or services. The SEC staff also has questioned the absence of such a disclosure when a registrant has asserted that providing the disclosure was impracticable but the information was provided elsewhere (e.g., MD&A, earnings calls).

Disaggregated revenue by geography

ASC 280 requires a registrant to disclose certain revenue information attributed to its country of domicile and foreign countries. A registrant also is required to disclose this revenue information for each foreign country (ASC 280-10-50-41(a)) if it is material. The SEC staff has asked registrants to disclose revenues attributed to specific countries in light of their other disclosures about foreign locations.

Revenue contributed by significant customers

ASC 280-10-50-42 requires registrants to disclose the total revenue from each major customer (i.e., one that contributes 10% or more of total revenues) and the segment(s) in which the revenues are reported. The SEC staff has requested that registrants disclose such information when other disclosures indicate that there may be a concentration of sales to a particular customer.

EY resources

Compendium of significant accounting and reporting issues, *2016 AICPA National Conference on Current SEC and PCAOB Developments*

Financial reporting developments, *Segment reporting — Accounting Standards Codification 280*

Share-based payments

Presentation and disclosure

Summary of issues noted

The SEC staff comments when a registrant has omitted disclosures required by ASC 718 (e.g., general terms of an award, method used for measuring compensation cost from an award) and it is unclear to the staff why the disclosures were omitted.

Analysis of current issues

Required disclosures

ASC 718-10-50-1 requires a registrant with one or more share-based payment arrangements to disclose information that enables users of the financial statements to understand: (1) the nature and terms of such arrangements that existed during the period and the potential effects of those arrangements on shareholders, (2) the effect of compensation cost arising from share-based payment arrangements on the income statement, (3) the method of estimating the fair value of the goods or services received, or the fair value of the equity instruments granted (or offered to grant), during the period and (4) the cash flow effects resulting from share-based payment arrangements. Although ASC 718 appears to take a principles-based approach to disclosure requirements, the guidance in ASC 718-10-50-2 includes several pages of detailed disclosure requirements described as the "minimum information" required to achieve these disclosure objectives.

The SEC staff often comments when a registrant omits a disclosure identified by ASC 718-10-50-2. If a registrant has not provided a required disclosure, the SEC staff often asks the registrant to explain and generally will not object if the omitted information is immaterial.

Example SEC staff comment: Required disclosures
Please tell us why you have not provided the disclosures required by ASC 718-10-50-2 for your stock-based compensation plans.

EY resources

Financial reporting developments, *Share-based payment*

Appendix A: Industry supplements

Insurance supplement

In this supplement, we analyze trends in SEC staff comment letters to registrants in the insurance industry. The following table summarizes the topics that the SEC staff focused on most often in comment letters sent to insurance registrants. Many of these topics are frequent areas of comment in letters received by registrants in other industries and are covered in the rest of this publication.

	Comment rank for the 12 months ended 30 June*	
Comment area	**2018**	**2017**
Short-duration disclosures	1	2
Non-GAAP financial measures	2	1
Income taxes	3	4
Revenue recognition	4	**
Internal control over financial reporting	5	5

* These rankings are based on topics assigned by research firm Audit Analytics for SEC comment letters issued to registrants about Forms 10-K from 1 July 2016 through 30 June 2018. In some cases, individual SEC staff comments are assigned to multiple topics if the same comment covers multiple accounting or disclosure areas.

** This topic was not among the top five in 2017.

This supplement should be read in conjunction with the topics in the main section of this publication.

In its comments, the SEC staff may request additional information about a topic and compliance with SEC rules or accounting literature. However, the SEC staff comments are based on the registrant's facts and circumstances, including judgments about materiality. This supplement can help companies identify the SEC staff's areas of focus, but registrants should also consider the significance of the disclosures to investors when including the disclosures in their filings.

Short-duration disclosures

Summary of issues noted

The SEC staff continues to ask insurance registrants questions to further understand their disclosures about short-duration contracts under ASC 944, *Financial Services — Insurance*.

Analysis of current issues

Insurance registrants with short-duration insurance contracts adopted revised disclosure requirements during the 2016 financial reporting cycle. The SEC staff has asked insurance registrants to further explain how their disclosures comply with the guidance and meet the overall objectives of increasing the decision usefulness of the information about a reporting entity's insurance liabilities and improving the comparability between reporting entities.

The SEC staff's questions have focused on understanding the registrant's level of disaggregation and how loss reserve development in the required tables correlates to both the aggregate rollforward of loss reserves and the discussion in the MD&A. The SEC staff has also questioned whether registrants are adequately disclosing claim frequency and incurred-but-not-reported methodologies and properly labeling required supplementary information.

Life sciences supplement

In this supplement, we analyze trends in SEC staff comment letters to registrants in the life sciences industry. The following table summarizes the topics the SEC staff focused on most often in comment letters sent to life science registrants. Many of these topics are frequent areas of comment in letters received by registrants in other industries and are covered in the rest of this publication.

	Comment rank for the 12 months ended 30 June*	
Comment area	**2018**	**2017**
Management's discussion and analysis	1	1
Revenue recognition	2	3
Research and development expenses	3	**
Fair value measurements***	4	5
Liabilities, payables and accrual estimates	5	**

* These rankings are based on topics assigned by research firm Audit Analytics for SEC comment letters issued to registrants about Forms 10-K from 1 July 2016 through 30 June 2018. In some cases, individual SEC staff comments are assigned to multiple topics if the same comment covers multiple accounting or disclosure areas.

** This topic was not among the top five comment areas in 2017.

*** This category includes SEC staff comments on fair value measurements under ASC 820 as well as fair value estimates, such as those related to revenue recognition, stock compensation and goodwill impairment analyses.

This supplement should be read in conjunction with the topics in the main section of this publication.

In its comments, the SEC staff may request additional information about a topic and compliance with SEC rules or accounting literature. However, the SEC staff comments are based on the registrant's facts and circumstances, including judgments about materiality. This supplement can help companies identify the SEC staff's areas of focus, but registrants should also consider the significance of any disclosures to investors when including the disclosures in their filings.

Research and development expenses

Summary of issues noted

The SEC staff has asked life sciences registrants to expand disclosures about research and development (R&D) costs by project and by type of cost.

Analysis of current issues

Life sciences registrants incur significant R&D costs to develop the product candidates in their pipeline. These costs often include a combination of internal (e.g., salaries and related expenses for personnel, laboratory equipment and supplies) and external (i.e., payments to contract research organizations and contract manufacturers) expenditures.

ASC 730-20-50 requires registrants to disclose the costs incurred under significant R&D arrangements but permits those disclosures to be aggregated by type of arrangement. Generally, registrants with multiple product candidates have a variety of R&D arrangements. As a result, the SEC staff may request that life sciences registrants provide further details about R&D arrangements and costs by project for each period presented. In addition, the SEC staff has requested that registrants provide disclosures of R&D costs that are not directly attributable to individual projects by type (e.g., facility depreciation, stock-based compensation, R&D support services).

Example SEC staff comment: Research and development expenses
As required by ASC 730-20-50-1, please provide us a schedule by type and amounts of costs incurred included in research and development expenses for each significant agreement.

Oil and gas supplement

In this supplement, we analyze trends in SEC staff comment letters to registrants in the oil and gas industry. The following table summarizes the topics the SEC staff focused on most often in comment letters sent to registrants in the oil and gas industry. Many of these topics are frequent areas of comment in letters received by registrants in other industries and are covered in the rest of this publication.

	Comment rank for the 12 months ended 30 June*	
Comment Area	**2018**	**2017**
Oil and gas reserves	1	3
Management's discussion and analysis	2	2
Non-GAAP financial measures	3	1
Fair value measurements***	4	4
Inventory and cost of sales	5	**

* These rankings are based on topics assigned by research firm Audit Analytics for SEC comment letters issued to registrants about Forms 10-K from 1 July 2016 through 30 June 2018. In some cases, individual SEC staff comments are assigned to multiple topics if the same comment covers multiple accounting or disclosure areas.

** This topic was not among the top five comment areas in 2017.

*** This category includes SEC staff comments on fair value measurements under ASC 820 as well as fair value estimates, such as those related to revenue recognition, stock compensation and goodwill impairment analyses.

This supplement should be read in conjunction with the topics in the main section of this publication.

In its comments, the SEC staff may request additional information about a topic and compliance with SEC rules or accounting literature. However, the SEC staff comments are based on the registrant's facts and circumstances, including judgments about materiality. This supplement can help companies identify the SEC staff's areas of focus, but registrants should also consider the significance of the disclosures to investors when including the disclosures in their filings.

Oil and gas reserves

Summary of issues noted

Registrants are required to disclose a significant amount of information about their oil and gas reserves under ASC 932-235 and Regulations S-X and S-K. In addition to the areas discussed below, the SEC staff continues to monitor consistency between a registrant's reserve disclosures in the supplemental information accompanying its financial statements and:

- Information in MD&A
- Prior filings (e.g., the prior-year annual report)
- Other publicly available information (e.g., information on its website, information discussed in earnings calls)
- Market data (e.g., market prices)

The SEC staff has also requested additional information to support reserve amounts, including well information, income forecasts, engineering reports, maps and other documentation. The SEC staff inquires about how information that may be relevant to the recognition of oil and gas reserves is evaluated by management. This information may include current and expected market prices, development costs and other estimates that may be relevant to the recognition of oil and gas reserves.

Recognition of proved undeveloped reserves (PUDs)

To recognize PUDs, a registrant must have made a final investment decision to develop an oil and gas property within five years of initial disclosure, with limited exceptions. To meet this criterion, the registrant must be able to demonstrate, with reasonable certainty, that it will execute the development plan within the five-year period. The SEC staff expects development plans to include management's expectations about capital expenditures and related financing. If the registrant changes its development plan, the SEC staff may question whether the registrant had reached a final investment decision.

The SEC staff may request historical information, such as rollforwards of PUD properties, to evaluate how closely the registrant's drilling activities on specific properties align with its plans for those properties. A registrant that cites a significant change in prices to explain a change in its development plan may receive questions from the SEC staff about whether it has identified the appropriate period to recognize PUDs. If planned drilling has not occurred, the staff may challenge whether the registrant appropriately recognized PUDs in the past and whether the registrant should continue to do so.

Example SEC staff comment: Final investment decision
Please provide us with your development schedule, indicating for each future period, the net quantities of proved reserves and estimated capital expenditures necessary to convert all of the proved undeveloped reserves disclosed as of December 31, 2016, to be developed. Please refer to Rule 4-10(a)(31)(ii) of Regulation S-X and Question 131.04 in the Compliance and Disclosure Interpretations, and either confirm or tell us the extent to which all of the proved undeveloped locations are part of a development plan that has been adopted by your management, including approval by your Board of Directors, if such approval is required, and is current as of December 31, 2016. Include details specifying the steps you have taken to demonstrate more than the mere intent to develop these PUDs.

Routine evaluation of PUD classification

The SEC staff often requests that the registrants that revise their PUD reserves describe the procedures and controls they have in place to evaluate the appropriateness of PUD classification. Additionally, the SEC staff requests clarification regarding any instances in the last five years when PUDs were not converted to proved developed reserves.

Example SEC staff comment: Routine evaluation of PUD classification
Describe the steps routinely taken to evaluate interim and annual changes in your development schedule to determine whether your PUDs continue to meet the requirements for disclosure. In addition, tell us about any instances in the last five fiscal years where drilling activity was deferred from the original drilling schedule and PUDs were not converted to proved developed reserves within their five-year life.

Conversion of PUDs

The SEC staff requests that registrants with a large percentage of proved reserves classified as PUDs provide additional information about the amount and percentage of PUDs that were converted to developed reserves over the past several years. When the average historical conversion rates are less than 20%, the SEC staff may challenge whether the registrant will be able to execute plans to develop PUDs within the five-year guideline. The SEC staff also may request that registrants expand their disclosures about factors that affected historic conversion rates and their current expectations about the development plan for PUDs.

Example SEC staff comment: PUD conversion

You disclose that you converted approximately 10% of the PUD reserves available at year-end 2016 to developed status. In part, the Glossary of FASB ASC Section 932-235-20 limits "Proved Undeveloped Oil and Gas Reserves" as follows, "Undrilled 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." Given that your rate of development, if sustained, would not be sufficient to develop your reserves over the next five years, disclose the reasons for the limited progress made during 2016 and explain how your plans relating to the conversion of your remaining proved undeveloped reserves have changed to ensure that your reserve estimates adhere to the criteria in Rule 4-10(a)(31)(ii) of Regulation S-X. Please note, disclosure under Item 1203(c) of Regulation S-K should inform readers regarding progress, or lack thereof, and any factors that affected progress in converting proved undeveloped reserves to developed status.

The SEC staff has asked registrants to expand disclosures about the cost of developing PUDs.

The SEC staff has asked registrants to expand disclosures about the cost to develop PUDs. Additionally, the SEC staff has inquired about the effects of expected reductions in capital spending on PUD development plans or challenged expected development cost assumptions in the standardized measure of discounted future net cash flows when these assumptions deviate significantly from historic results.

Example SEC staff comments: PUD conversion costs

We note that you disclosed that in preparing your 2016 capital expenditure budget of approximately $50 million, you had assumed there would be an improvement in commodity prices by the summer of 2016, although you also indicate that if commodity prices stayed at current levels or declined further, your capital expenditure budget could be reduced to approximately $20 million. You also disclose that substantially all of the $20 million would be spent on completing previously drilled wells in the XYZ Field in the ABC region and that these wells were classified as proved developed non-producing as of December 31, 2016. Please tell us and expand your disclosure to explain how your development plan schedules comply with the timeframe stipulated in Rule 4-10(a)(31)(ii) of Regulation S-X, regarding the proved undeveloped reserves that you have disclosed as of December 31, 2016.

Explanation of changes in PUD reserves

Item 1203(b) of Regulation S-K requires disclosures about material changes in PUD reserves. The SEC staff frequently asks registrants to expand their disclosures relating to the nature of changes to PUD reserves to include all relevant factors that affected the change in PUDs, including offsetting amounts.

Example SEC staff comment: Explanation of changes in PUDs
Please expand your disclosure to provide an explanation for the material changes in the net quantities of your proved undeveloped reserves that occurred during the year. Your disclosure should reconcile the overall change for the line item by separately identifying and quantifying each factor, including any offsetting factors, that contributed to a material change in your proved undeveloped reserves so that the change in net reserves between periods is fully explained. For example, for revisions in previous estimates, identify such factors as changes caused by commodity prices, well performance, uneconomic proved undeveloped locations or the removal of proved undeveloped locations due to changes in a previously adopted development plan. Refer to Item 1203(b) of Regulation S-K.

Expiring acreage

Item 1208(b) of Regulation S-K requires disclosures under appropriate captions in SEC filings about undeveloped acreage, both leases and concessions, including, if material, the minimum remaining terms of leases and concessions. When a registrant has a significant number of lease expirations in the near term, the SEC staff frequently asks whether there are significant PUD reserves associated with those properties and whether they will be developed prior to lease expiration.

Example SEC staff comment: PUDs and expiring acreage
You disclose that leases for 25% of your undeveloped acreage will expire in 2016. Please tell us the extent to which your proved undeveloped reserves are attributed to acreage having expiration dates that precede the scheduled date for initial development, and explain how you expect to forestall the expiry of such acreage.

Presentation of NGLs

ASC 932-235-50-4(a) requires separate disclosure of natural gas liquids (NGLs) reserves if those volumes are significant. When a registrant refers to NGLs in other portions of a filing but does not separate these volumes for reserve reporting, the SEC staff asks the registrant to address the significance of NGLs.

Example SEC staff comment: Presentation of NGLs
Explain to us how you have evaluated the significance of your NGL volumes for purposes of reserve reporting. Please note that FASB ASC 932-235-50-4(a) requires separate disclosure for natural gas liquids reserves, when such reserve quantities are significant.

Real estate supplement

In this supplement, we analyze trends in SEC staff comment letters to registrants in the real estate industry. The following table summarizes the topics the SEC staff focused on most often in comment letters sent to registrants in the real estate industry. Many of these topics are frequent areas of comment in letters received by registrants in other industries and are covered in the rest of this publication.

	Comment rank for the 12 months ended 30 June*	
Comment area	**2018**	**2017**
Non-GAAP financial measures	1	1
Fair value measurements***	2	2
Consolidation	3	5
Fixed assets (including valuation issues)	4	**
Intangible assets and goodwill	5	**

* These rankings are based on topics assigned by research firm Audit Analytics for SEC comment letters issued to registrants about Forms 10-K from 1 July 2016 through 30 June 2018. In some cases, individual SEC staff comments are assigned to multiple topics if the same comment covers multiple accounting or disclosure areas.

** This topic was not among the top five in 2017.

*** This category includes SEC staff comments on fair value measurements under ASC 820 as well as other fair value estimates, such as those related to revenue recognition, stock compensation and goodwill impairment analyses.

This supplement should be read in conjunction with the topics in the main section of this publication.

In its comments, the SEC staff may request additional information about a topic and compliance with SEC rules or accounting literature. However, the SEC staff comments are based on the registrant's facts and circumstances, including judgments about materiality. This supplement can help companies identify the SEC staff's areas of focus, but registrants should also consider the significance of the disclosures to investors when including the disclosures in their filings.

Funds from operations and other non-GAAP financial measures

Summary of issues noted

The SEC staff often asks registrants to reconcile funds from operations (FFO) and other non-GAAP measures to the most directly comparable US GAAP financial measure. The staff also comments on non-standard adjustments to FFO, challenges the labeling of the resulting non-GAAP measure and questions whether related per-share presentations are in substance impermissible per share liquidity measures.

Analysis of current issues

Many real estate investment trusts (REITs) disclose FFO, a non-GAAP measure of financial performance that is defined by the National Association of Real Estate Investment Trusts (NAREIT). The SEC staff accepts NAREIT's definition of FFO as a performance measure and will not object to the presentation of FFO per share. The market closely follows REITs' FFO expectations, and investors and analysts view FFO as a key performance indicator.

The SEC staff frequently asks registrants to reconcile FFO and other non-GAAP financial measures to comparable US GAAP measures.

However, some real estate companies provide modified calculations of FFO, such as "adjusted" FFO (AFFO), "modified" FFO and "core" FFO, and they may use different methods to calculate these measures. In some cases, registrants have used entity-specific adjustments that management says are important to investors.

The SEC staff asks management to explain modifications and adjustments to calculations of FFO disclosures. In some cases, registrants are asked to revise or remove adjustments or provide additional information to clarify the purpose of an adjustment. For example, the SEC staff has commented on adjustments for the amortization of certain intangibles, which are inconsistent with the FFO measure as defined by NAREIT.

The SEC staff also has focused on the calculations and presentation of FFO included in a REIT's earnings release, including forward-looking guidance. The staff frequently has asked entities to reconcile calculations of FFO and other non-GAAP measures in the earnings release to the most directly comparable US GAAP financial measures.

Example SEC staff comment: Non-GAAP measures — reconciliation
We note that you provide quarterly and full-year FFO guidance ranges. Given the lack of similar GAAP information and quantitative reconciliation between the GAAP and non-GAAP information, please clarify how your presentation satisfies the requirements outlined within Item 10(e)(1)(i)(A) of Regulation S-K. Reference is also made to Question 102.10 of the updated Compliance and Disclosure Interpretations issued on May 17, 2016.

Real estate registrants should also evaluate any adjustments they make to FFO to make sure that, when they report AFFO per share, they don't violate Item 10(e) of Regulation S-K that prohibits presenting liquidity measures on a per-share basis. The SEC staff focuses on the substance of a non-GAAP per-share measure rather than management's characterization of it as a performance measure.

The SEC staff has also focused on making sure that non-GAAP measures are not more prominent than GAAP measures and has asked registrants to re-characterize non-GAAP measures that include unusual adjustments (i.e., adjustments made for items other than interest, taxes, depreciation and amortization in the calculation of EBITDA would require the measure to be labeled "adjusted EBITDA").

Registrants that present non-GAAP financial measures (e.g., adjusted EBITDA, same-store operating income) are also frequently asked to describe the usefulness of the measure to investors, as required by the SEC's rules.

Example SEC staff comment: Non-GAAP measures

To provide for ease of understanding the non-GAAP discussion, please consider expanding the first paragraph of this section to name the non-GAAP measures you are presenting (i.e., adjusted income before taxes and related income tax effect, adjusted net income, adjusted diluted earnings per share and EBITDA) and to explain that these measures have been reconciled to the directly comparable GAAP measures as presented in the tables that follow. Also, please define what you consider to be your "core" financial measures or indicate if such measures represent your income before taxes, net income and diluted earnings per share.

Further discussion about SEC comments related to non-GAAP financial measures can be found in the *SEC reporting issues* section of this publication.

Resources

Technical Line, *A closer look at the SEC staff's scrutiny of non-GAAP financial measures*

2017 SEC annual reports — Form 10-K

Other industries

The following tables summarize the topics the SEC staff focused on most often in comment letters to registrants in several other industries. Many of these topics are frequent areas of comment in letters received by registrants that are covered in the rest of this publication.

Aerospace and defense industry

	Comment rank for the 12 months ended 30 June*	
Comment area	**2018**	**2017**
Non-GAAP financial measures	1	**
Management's discussion and analysis	2	1
Revenue recognition	3	**
Segment reporting	4	2
Intangible assets and goodwill	5	**

Automotive industry

	Comment rank for the 12 months ended 30 June*	
Comment area	**2018**	**2017**
Management's discussion and analysis	1	2
Non-GAAP financial measures	2	1
State sponsors of terrorism	3	**
Income taxes	4	3
Segment reporting	5	**

Airlines industry

	Comment rank for the 12 months ended 30 June*	
Comment area	**2018**	**2017**
Management's discussion and analysis	1	**
Pension and other post-retirement benefit plans	2	**
Fixed assets (including valuation issues)	3	**
Non-GAAP financial measures	4	1
Depreciation, depletion and amortization	5	**

Banking industry

	Comment rank for the 12 months ended 30 June*	
Comment area	**2018**	**2017**
Non-GAAP financial measures	1	**
Loans receivables — valuation and allowance	2	1
Acquisitions and business combinations	3	3

Healthcare industry

	Comment rank for the 12 months ended 30 June*	
Comment area	2018	2017
Segment reporting	1	3
Non-GAAP financial measures	2	1
Management's discussion and analysis	3	2
Debt, warrants and equity securities	4	**
Fair value measurements***	5	**

Retail and consumer products industry

	Comment rank for the 12 months ended 30 June*	
Comment area	2018	2017
Management's discussion and analysis	1	1
Non-GAAP financial measures	2	2
Intangible assets and goodwill	3	**
Fair value measurements***	4	5
Segment reporting	5	3

Media and entertainment industry

	Comment rank for the 12 months ended 30 June*	
Comment area	2018	2017
Management's discussion and analysis	1	2
Segment reporting	2	3
State sponsors of terrorism	3	**
Fair value measurements***	4	**
Non-GAAP financial measures	5	1

Mining and metals industry

	Comment rank for the 12 months ended 30 June*	
Comment area	2018	2017
Non-GAAP financial measures	1	2
Mining reserves	2	1
Asset sales, disposals, divestures and reorganization issues	3	3
Pro forma financial information	4	**
Fixed assets (including valuation issues)	5	**

Power and utilities industry

	Comment rank for the 12 months ended 30 June*	
Comment area	**2018**	**2017**
Non-GAAP financial measures	1	1
Fair value measurements***	2	2
Fixed assets (including valuation issues)	3	**
Debt, warrants and equity securities	4	**
Internal control over financial reporting	5	**

Technology industry

	Comment rank for the 12 months ended 30 June*	
Comment area	**2018**	**2017**
Management's discussion and analysis	1	2
State sponsors of terrorism	2	3
Non-GAAP financial measures	3	1
Revenue recognition	4	5
Fair value measurements***	5	**

Telecommunications industry

	Comment rank for the 12 months ended 30 June*	
Comment area	**2018**	**2017**
Non-GAAP financial measures	1	1
Management's discussion and analysis	2	2
Depreciation and amortization	3	5
Internal control over financial reporting	4	**
Leases	5	**

* These rankings are based on topics assigned by research firm Audit Analytics for SEC comment letters issued to registrants about Forms 10-K from 1 July 2016 through 30 June 2018. In some cases, individual SEC staff comments are assigned to multiple topics if the same comment covers multiple accounting or disclosure areas.

** This topic was not among the top five comment areas in 2017.

*** This category includes SEC staff comments on fair value measurements under ASC 820 as well as fair value estimates, such as those related to revenue recognition, stock compensation and goodwill impairment analyses.

Appendix B: IPO supplement

This supplement should be read in conjunction with the topics in the main section and industry supplements that may be relevant to a company's IPO registration statement.

The following chart summarizes the 10 most frequent comment areas related to registration statements on Form S-1 in the current and previous years:

	Comment rank for the 12 months ended 30 June		Comments as % of total registrants that received comment letters*
Comment area	**2018**	**2017**	**2017 and 2018**
Management's discussion and analysis	1	1	51%
Risk factors	2	2	56%
Use of proceeds	3	5	36%
Signatures, exhibits and agreements	4	3	39%
Fair value measurements***	5	8	23%
Pro forma financial information	6	6	26%
Executive compensation	7	9	22%
Revenue recognition	8	**	22%
Terms of the offering	9	4	24%
Debt, warrants and equity security issues	10	7	21%

* These rankings are based on topics assigned by research firm Audit Analytics for SEC comment letters issued to companies about Form S-1 IPO registration statements from 1 July 2016 through 30 June 2018. The analysis excludes comments related to the general updating of prospectus information, testing-the-waters communications and related-party transactions.

** This topic was not among the top 10 comment areas in 2017.

*** This category includes SEC staff comments on fair value measurements under ASC 820 as well as fair value estimates, such as those related to revenue recognition, stock compensation and goodwill impairment analyses.

This supplement excludes SEC staff comments related to several comment areas that are discussed elsewhere in this publication. It discusses specific matters and topics that the SEC staff has raised in comments related to IPO registration statements, including matters related to stock compensation, pro forma financial information and disclosure of intended use of proceeds of the offering.

In its comments, the SEC staff has requested additional information about the topic and compliance with SEC rules or accounting literature. However, the SEC staff comments vary based on facts and circumstances, including judgments about materiality. This supplement can help companies identify the SEC staff's areas of focus, but companies should consider the significance of any disclosures to investors when determining which disclosures to include in their filings.

Valuation of pre-IPO equity securities

Summary of issues noted

The SEC staff has continued to ask companies for information to support their valuations underlying share-based payment awards, especially when the fair value of the company's pre-IPO common stock is significantly less than the expected IPO price.

Analysis of current issues

One of the key accounting issues in many IPO transactions is the valuation of equity securities (including stock options) issued as compensation while a company is privately held. In many cases, the estimated fair value of equity securities granted in the months before the IPO is significantly less than the IPO price. As a result, the SEC staff may question pre-IPO fair value estimates that are outside the offering price range and the adequacy of the related disclosures in the financial statements and MD&A.

The SEC staff may ask registrants for additional information about their valuation of pre-IPO equity securities issued as compensation.

Example SEC staff comment: Valuation of pre-IPO equity securities
Once you have an estimated offering price or range, please explain to us how you determined the fair value of the common stock underlying your equity issuances and the reasons for any differences between the recent valuations of your common stock leading up to the IPO and the estimated offering price. This information will help facilitate our review of your accounting for equity issuances including stock compensation.

The SEC's FRM states that companies should disclose all of the following information on share-based compensation in the financial statements included in an IPO filing:

- The methods used to determine the fair value of the company's shares and the material assumptions used in determining the fair value
- The extent to which such estimates are considered highly complex and subjective
- That such estimates will not be necessary for new awards once the shares begin trading

Companies should discuss the material assumptions used and describe the methodology and judgments used, highlighting that they may be complex and subjective.

However, the FRM states that, while the SEC staff may issue comments to help it understand unusual valuations, the staff will not expect expanded disclosure in MD&A about the underlying events and business developments that affected such valuations.

The SEC staff expects registrants to support judgments and estimates about the fair value of their securities any time they grant significant share-based payments. The AICPA's Accounting and Valuation Guide, *Valuation of Privately-Held-Company Equity Securities Issued as Compensation* (the Guide), provides a framework and best practices for valuing private company securities. The SEC staff expects privately held companies contemplating IPOs to apply the Guide's valuation guidance when granting share-based payments.

The Guide recommends that private companies obtain contemporaneous valuations from independent valuation specialists to determine the fair value of securities issued as compensation. The SEC staff frequently has asked about estimates of the fair value of share-based payments issued before the IPO, even if a contemporaneous independent valuation has been obtained. Accordingly, a well-documented timeline of significant events (e.g., significant new customer contracts, regulatory approval of products and services), along with contemporaneous valuations supporting grants throughout the 12-month period before an IPO, can help a company support its judgments and assumptions.

The SEC staff expects private companies to consider other relevant data points when valuing equity securities. For example, private companies may sell equity securities to third parties, or employees and other stockholders may sell shares in secondary markets. The SEC staff expects registrants to provide an analysis of the weightings assigned to any stock sales on or before the valuation date.

EY resources

Financial reporting developments, *Share-based payment*

Best practices when going through the IPO registration process

Pro forma financial information in IPO registration statements

Summary of issues noted

Certain circumstances related to IPOs may warrant the presentation of pro forma financial information on the face of the financial statements included in the IPO registration statement. In these situations, the SEC staff has asked registrants about how they have considered the need to present pro forma information in light of the SEC staff's guidance. The staff also asks whether the pro forma adjustments are appropriate under Article 11 of Regulation S-X.

Analysis of current issues

When IPO proceeds are used to pay dividends to the issuer's prior owners, promoters and/or parents, SAB Topic 1.B.3 requires the issuer to evaluate whether it is required to present pro forma EPS or a pro forma balance sheet on the face of the financial statements included in the IPO filing. Companies should provide a pro forma balance sheet alongside the historical financial statements to reflect an accrual, with an offsetting amount to retained earnings if the dividends are not reflected in the latest balance sheet. In addition, the SAB requires pro forma EPS to be presented if dividends paid at or before the closing of an IPO are greater than the earnings for the most recent year.

The SEC staff has also commented on the application of the SAB when the registrant has paid dividends during the 12 months before the offering or disclosed its intent to pay dividends using IPO proceeds.

Example SEC staff comment: SAB Topic 1.B.3
We note that as part of your use of the net proceeds from this offering you intend to make a distribution to shareholders. Please explain to us what consideration you gave to providing a pro forma balance sheet alongside your latest historical balance sheet reflecting the distribution accrual (but not giving effect to the full offering proceeds) and providing pro forma earnings per share information giving effect to the number of shares whose proceeds would be necessary to pay the distribution. Reference is made to SAB Topic 1.B.3.

Companies also may be required to present pro forma EPS or a pro forma balance sheet in connection with an IPO when there are material changes in their capital structure or tax status or when IPO proceeds will be used to extinguish debt.

The SEC has provided certain criteria in Article 11 of Regulation S-X for pro forma adjustments that registrants must comply with when preparing pro forma financial information under S-X Article 11. However, it isn't always clear how an issuer should apply the criteria in S-X Article 11 for identifying what constitutes an appropriate pro forma adjustment. The SEC staff, in fact, frequently comments on pro forma adjustments. The staff in the SEC's Division of Corporation Finance also has included some interpretive guidance for certain adjustments in its FRM.

Example SEC staff comment: Appropriateness of Pro forma adjustments

We note from pro forma adjustment (C) that you plan to recognize a gain on the forgiveness of interest in the amount of XXX and reduction of debt to XXX that occurred on July 25, 2017. In light of the fact that this is a nonrecurring gain, it should not be included in your pro forma statements of operations.

See guidance in Article 11 of Regulation S-X and revise your pro forma financial information accordingly.

Issuers need to carefully consider the criteria in Article 11 to support each adjustment. They also need to focus on making clear and transparent disclosures about pro forma adjustments.

EY resources

Financial reporting developments, *Earnings per share*

Pro forma financial information — A guide for applying Article 11 of Regulation S-X

Best practices when going through the IPO registration process

Use of proceeds

Summary of issues noted

The SEC staff has continued to ask registrants to clearly disclose the principal purposes for which the net proceeds of the offering will be used and the approximate amount they will spend from the net proceeds for each purpose.

Analysis of current issues

Item 504 of Regulation S-K requires registrants to describe their planned uses and amounts of offering proceeds. These disclosures are intended to help users understand whether any proceeds will be used to discharge debts, to complete an acquisition or for working capital, for example. The SEC staff may request that a company provide additional details about how it will use proceeds from the offering, particularly when other disclosures in the filing imply a use omitted from the Item 504 disclosures.

The staff often asks registrants to quantify the proceeds that will be used for each major purpose. For example, when an issuer discloses a broad purpose, the staff may ask the company to be more specific and to quantify the amounts that will be used for each major purpose.

Example SEC staff comment: Quantification of planned uses of proceeds
We note your disclosure in the third paragraph that you "plan to use the net proceeds [you] will receive from this offering for general corporate purposes in line with [your] strategies." Please revise to more specifically identify and quantify the principal intended uses of the net proceeds.

EY resources

Best practices when going through the IPO registration process

Appendix C: Foreign private issuers

The SEC staff's comments to foreign private issuers (FPIs) that prepare their financial statements in accordance with either US GAAP or IFRS often are similar to its comments to domestic registrants.

Many of the topics in the main section of this publication and industry supplements are relevant for FPIs and therefore are not discussed at length here, such as:

- MD&A matters, including comments on critical accounting estimates, results of operations and liquidity
- Consolidation, including variable interest entities
- Fair value measurements
- Business combinations
- Oil and gas reserves
- Operating items, including revenue recognition, hedging and impairment
- Segment reporting
- Intangible assets and goodwill

The following chart summarizes the 10 most frequent comment areas in 2018 and 2017 related to annual reports on Form 20-F:

Comment area	Ranking 12 months ended 30 June		Comments as % of total registrants that received comment letters*
	2018	2017	2017 and 2018
Management's discussion and analysis	1	1	37%
State sponsors of terrorism	2	4	27%
Non-GAAP financial measures	3	2	26%
Fair value measurements***	4	3	18%
Revenue recognition	5	10	8%
Oil and gas reserves	6	7	9%
Intangible assets and goodwill	7	8	8%
Acquisitions, mergers and business combinations	8	**	6%
Fixed assets	9	5	10%
Segment reporting	10	6	11%

* These rankings are based on topics assigned by research firm Audit Analytics for SEC comment letters issued to registrants about Form 20-F from 1 July 2016 through 30 June 2018. In some cases, individual SEC staff comments are assigned to multiple topics if the same comment covers multiple accounting or disclosure areas.

** This topic was not among the top 10 comment areas in 2017.

*** This category includes SEC staff comments on fair value measurements under ASC 820 and IFRS 13, *Fair Value Measurement*, as well as fair value estimates, such as those related to revenue recognition, stock compensation and goodwill impairment analyses.

Below are unique matters that the SEC staff often raised in comments to FPIs.

Activities with countries designated as state sponsors of terrorism

Summary of issues noted

The SEC staff frequently asks FPIs to provide additional information about business activities in or with countries identified by the US State Department as state sponsors of terrorism, which currently are Iran, Sudan, North Korea and Syria. The SEC staff reviews various sources of information, including past filings and correspondence, news articles, company websites and press releases that include company locations and contact information, to identify registrants with operations in these countries. If an FPI has been identified as having any business in or with one of those countries, the SEC staff periodically (e.g., every year or two) asks for updates on those activities.

Analysis of current issues

US securities laws do not impose a specific disclosure requirement that addresses business activities in or with a country based on its designation as a state sponsor of terrorism. However, Rule 408 of Regulation C and Exchange Act Rule 12b-20 require a registrant to disclose additional information if it is material and necessary to make a company's statements, in light of the circumstances under which they were made, not misleading. Because of these rules, the SEC staff frequently asks registrants to provide the following information and to disclose it if it is material:

- The nature and extent of past, current and any anticipated operations in or activities with a country designated as a state sponsor of terrorism, whether through subsidiaries, partners, customers, affiliates, joint ventures, distributors, resellers or other direct or indirect arrangements
- Any services, products, information or technology provided to and agreements, commercial arrangements or other contracts entered with governments or entities controlled by the governments designated as state sponsors of terrorism
- Whether any of the technologies or materials provided or intended to be provided to a country designated as a state sponsor of terrorism are controlled items included in the US Department of Commerce's Commerce Control List
- Whether operations in or with state sponsors of terrorism constitute a material risk in quantitative terms by discussing revenues, assets and liabilities associated with such operations and qualitative factors that a reasonable investor would deem important in making an investment decision, including any potential adverse effect on company reputation and share value

In addition to these requests for information, the Iran Threat Reduction and Syria Human Rights Act of 2012 amended the Securities Exchange Act of 1934 to require all issuers, including FPIs, to disclose in their annual and quarterly reports filed with the SEC whether they or their affiliates knowingly engaged in various prohibited activities involving Iran.

Example SEC staff comment: Activities with countries designated as state sponsors of terrorism
In the Distributor Network section of your website, you append a map that appears to identify Sudan as one of the countries where you sell your products. Sudan is designated by the U.S. Department of State as a state sponsor of terrorism and is subject to U.S. export controls. You do not provide disclosure about Sudan in your Form 20-F. Please describe to us the nature and extent of any past, current and anticipated business with Sudan, whether through distributors, customers or other direct or indirect arrangements.

Non-GAAP financial measures

Summary of issues noted

Non-GAAP financial measures continue to be an area of significant focus of the SEC staff. Since the SEC staff updated its C&DIs on the use of non-GAAP financial measures in May 2016, the staff has challenged FPIs on their compliance with these interpretations.

The SEC staff has questioned whether FPIs that apply IFRS have disclosed financial measures in their filings that are required by their other local accounting and disclosure standards. If they are required, an FPI may present the non-GAAP measures (i.e., non-IFRS for FPIs reporting under IFRS) under an exemption in Item 10(e)(5) without complying with the non-GAAP disclosure requirements in the rest of Item 10(e) of Regulation S-K.

Analysis of current issues

When an FPI presents non-GAAP financial measures and it is unclear whether the FPI qualifies for the Item 10(e)(5) exemption, the SEC staff asks the registrant to address the following:

- Whether the measure is required or permitted by local accounting and disclosure standards
- The literature that the FPI relied on to conclude that its local accounting and disclosure standards either require or permit disclosing the measure

When a non-GAAP financial measure does not qualify for the exemption under Item 10(e)(5) of Regulation S-K, the SEC staff has asked FPIs whether the measure provides useful information to investors about the entity's financial condition and results. The SEC staff has also questioned FPIs about the appropriateness of the reconciliation to the most directly comparable measure under the accounting framework (i.e., US GAAP or IFRS) the FPI is using.

The SEC staff also evaluates all non-GAAP items, including those expressed as percentages or per-share amounts and questions their labeling if it is inconsistent with the nature of the adjustments to GAAP measures.

Example SEC staff comment: Reconciliation of non-GAAP measures

You have asserted that the measures specified are not non-GAAP measures defined by Item 10(e)(2) of Regulation S-K. Instead you believe they are Regulatory Performance Measures. Please tell us whether the measures are required by a regulatory agency. If the measures are not currently required to be disclosed by IFRS, Commission Rules or other regulatory requirements, you should disclose that the measures are non-GAAP measures and comply with Item 10(e) of Regulation S-K. Please refer to Item 10(e)(5) in Regulation S-K and to our updated Compliance and Disclosure Interpretations issued on May 17, 2016, specifically question 102.12.

Appendix D: SEC review process and best practices

In its filing reviews, DCF staff focuses on disclosures and accounting methods that may conflict with FASB or SEC rules or that need clarification.

The DCF of the SEC selectively reviews filings made under the Securities Act of 1933 and the Securities Exchange Act of 1934 (Exchange Act) to monitor and enhance compliance with disclosure and accounting requirements. In its filing reviews, DCF accountants concentrate on disclosures and accounting methods that may conflict with US GAAP or SEC rules or that may need clarification. Other DCF staff may review other aspects of SEC filings for compliance with the federal securities laws and regulations. DCF performs its primary review responsibilities through staff in 11 offices that each focus on an industry. The DCF assigns public companies in a particular industry to one of these 11 Assistant Director Offices as shown below based upon their Standard Industrial Classification (SIC) code. Each company's office assignment is listed in EDGAR in the basic company information that precedes the company's filing history.

Office	Primary industries
1	Healthcare and insurance
2	Consumer products
3	Information technologies and services
4	Natural resources
5	Transportation and leisure
6	Manufacturing and construction
7	Financial services
8	Real estate and commodities
9	Beverages, apparel and mining
10	Electronics and machinery
11	Telecommunications

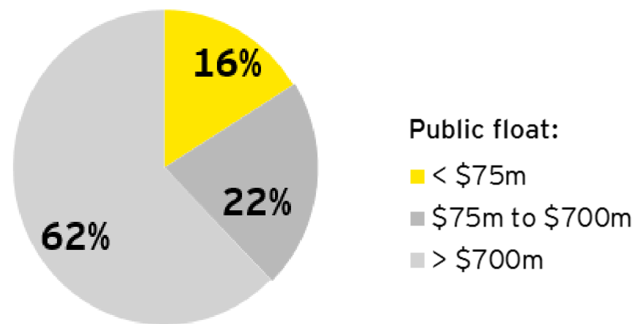
The SEC also has a number of legal and accounting technical offices staffed by people who support the filing reviews by focusing on highly technical matters without regard to specific industries. The staff in the assistant director offices consult most often with staff in the Offices of Chief Accountant, Chief Counsel, Mergers and Acquisitions, and International Corporate Finance. The DCF also has a Chief Risk Officer who focuses on internal controls related to the review program to maintain the quality of the staff's filing reviews.

Required and selective review

As required by the Sarbanes-Oxley Act of 2002, DCF staff reviews, at some level, every registrant at least once every three years, but it reviews many registrants more frequently. In addition, DCF staff generally reviews all IPOs and selectively reviews other transactional filings, such as those made in connection with business combination transactions, proxy statements or other public offerings. The DCF staff sends "no review" letters when it has not selected an issuer's registration statement for review.

The SEC staff has reviewed slightly over 50% of registrants each year since 2013. In addition, the SEC staff has sent the majority of its comment letters to larger public companies, as illustrated below:[4]

Size of registrants receiving comment letters on Form 10-K filings



***Source:** Audit Analytics — Comment letters issued related to Forms 10-K for the 12-month period ended 30 June 2018*

Levels of review

If the DCF staff selects a filing for review, the extent of that review will depend on many factors. The level of review may be:

- A full cover-to-cover review in which DCF staff examines the entire filing for compliance with the applicable requirements of the federal securities laws and regulations
- A financial statement review in which DCF staff examines the financial statements and related disclosures, such as MD&A, for compliance with the applicable accounting standards and SEC disclosure requirements
- A targeted issue review in which DCF staff examines one or more specific items of disclosure in the filing for compliance with the applicable accounting standards or the disclosure requirements of the federal securities laws and regulations

DCF staff may not always inform registrants of the type of review performed (such as a targeted review or a full review), but it will focus on what it considers necessary in the company's circumstances. When DCF staff believes that a registrant can enhance its disclosure or improve its compliance with the applicable disclosure requirements, it provides comments in a letter to the registrant. The range of possible comments is broad and depends on the issues that arise in a particular filing review. The DCF staff completes many filing reviews without issuing any comments. In those cases, the registrant will not be notified that its SEC filing was reviewed.

In addition to an initial reviewer, at least one other more senior DCF staff member typically reviews a filing and proposed comments. This second-level review is intended to enhance quality and consistency across filing reviews.

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[4] This graph shows the size (based on public float) of companies that received comment letters on Form 10-K filings during the 12 months ended 30 June 2018. However, the SEC staff may not send a comment letter to every registrant that it reviews.

DCF staff comments

DCF staff views the comment process as a dialogue with a registrant about its disclosures. DCF staff's comments are in response to a registrant's disclosures and other public information and are based on DCF staff's understanding of that registrant's facts and circumstances.

In its initial comments, DCF staff often requests information so it can better understand the registrant's facts and circumstances. These requests should not be interpreted to mean that the staff has concluded that the disclosures must change. In many cases, comments are resolved once the DCF staff has gained a full understanding of a registrant's facts and circumstances and has obtained sufficient insight into the judgments made by management that led to the disclosures. Registrants may commit to modifying their disclosure in the future in order to resolve certain comments. The DCF staff rarely requires a registrant to amend a filing unless the staff's comment relates to a transactional filing such as an IPO or results in a material restatement to the financial statements.

Best practices for registrant responses to comments

A registrant generally responds to an SEC comment letter by sending a letter back to DCF staff. When responding to DCF staff comment letters, registrants should consider the following:

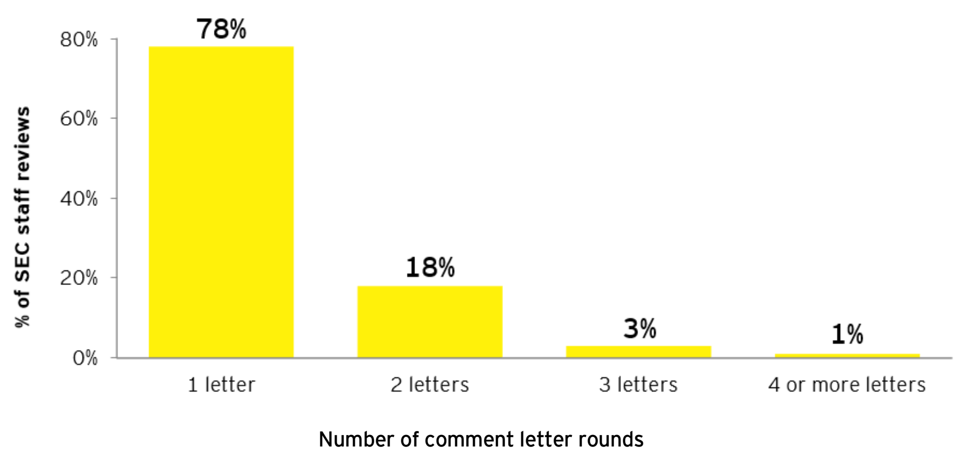
- Registrants should assume that DCF staff has not yet concluded on a matter and merely needs more information, unless the staff clearly indicates in its comment this is not the case.
- Responses to each comment should focus on the question(s) asked by the SEC staff, and those responses should cite authoritative literature wherever possible.
- Responses should address the registrant's unique facts and circumstances and provide insight into any judgments made. While it may be helpful to consider responses from other registrants on similar topics, registrants should not copy those responses.
- Registrants should file all response letters on EDGAR redacting any specific information for which they are seeking confidential treatment.
- If revisions are being made to a filing as a result of a comment from DCF staff, responses should indicate specifically where these revisions are being made. If disclosure will be modified in a future filing, it can be helpful for the registrant to provide proposed language in its response letter. Registrants should make it clear that facts and circumstances may change in a way that could require disclosure different than that proposed.
- Companies should seek the input of all appropriate internal personnel and professional advisers (such as legal counsel and independent auditors) so that they fully respond to the comment letter in a complete and accurate manner. Waiting for a later round of comments to involve the necessary resources may delay or hinder a successful resolution.

Providing a thorough explanation or analysis of an issue to DCF staff may help DCF staff better understand the accounting and disclosure, and it often will resolve the comment. To facilitate such responses, registrants should maintain contemporaneous documentation of significant accounting and disclosure decisions. Contemporaneous documentation that already exists is more persuasive than a retrospective defense following receipt of a DCF staff comment.

Depending on the nature of the issue, DCF staff's concerns and the registrant's response, DCF staff may issue more comments following its review of the registrant's response. This comment and response process continues until the DCF staff and the registrant resolve all comments.

The following graph shows the number of comment letters (or rounds) that were issued by the SEC staff for reviews completed during the 12 months ended 30 June 2018:

Number of comment letters issued to complete review



Source: *Audit Analytics – Comment letters related to Forms 10-K posted to EDGAR during the 12-month period ended 30 June 2018*

Proactive communication with DCF staff may expedite the comment letter process.

A substantial majority of reviews are closed after one comment letter, and nearly all are resolved after two letters.

Comment letters from the DCF staff on certain filings often request a written response in 10 business days. If a registrant needs more time to respond, it should contact the DCF staff, which is generally accommodating in granting extensions that will enhance the quality of the response letter. A registrant also may consider contacting the DCF staff if it needs clarification about a comment or informal feedback regarding its approach to responding.

Closing a filing review

When a registrant has satisfactorily resolved all DCF staff's comments on a filing, DCF staff provides the registrant with a "completion of review letter" to confirm that the SEC staff's review is complete. To increase the transparency of the review process, after the DCF staff completes a filing review, it publicly releases its comment letters and registrant responses to those letters on the SEC's EDGAR system no earlier than 20 business days after the review's completion.

Reconsideration process

DCF staff and the registrant may ultimately disagree about an accounting or disclosure matter. A registrant should, in any instance it wishes, seek reconsideration of a comment by other SEC staff, including those in DCF's Office of the Chief Accountant (DCF-OCA).

DCF staff members, at all levels, are available to discuss disclosure and financial statement presentation matters with a registrant and its legal, accounting and other advisers. A registrant may request that more senior DCF staff reconsider a comment or reconsider a DCF staff member's view of the registrant's response at any point in the filing review process. DCF does not have a formal protocol for registrants to follow when seeking reconsideration; a request for reconsideration may be oral or written.

Registrants also may ask the SEC's Office of the Chief Accountant (OCA), which is distinct from the DCF-OCA, to reconsider an accounting conclusion of the DCF staff at any stage in the process. Generally, the SEC's OCA addresses questions about the application of accounting principles while DCF resolves matters concerning the age, form and content of financial statements required to be included in a filing. Even before a registrant requests reconsideration, DCF staff may have consulted internally about the issue with DCF-OCA and then with OCA.

A registrant should initiate a reconsideration with OCA by informing the staff in DCF of its intention to request such reconsideration. In these circumstances, a registrant does not need to make a submission directly to OCA if all of the relevant information is contained in comment letter responses from the registrant to DCF, although a separate submission to OCA may serve to expedite the process.

Disclosure requirements

The SEC requires that all entities defined as an accelerated filer, a large accelerated filer or a well-known seasoned issuer disclose, in their annual reports on Form 10-K or Form 20-F, written comments DCF staff has made in connection with a review of Exchange Act reports that:

- The registrant believes are material
- Were issued more than 180 days before the end of the fiscal year covered by the annual report
- Remain unresolved as of the date of the filing of the Form 10-K or Form 20-F

The disclosure must identify the substance of the unresolved comments. DCF staff comments that have been resolved, including those that DCF staff and the registrant have agreed will be addressed in future Exchange Act reports, do not need to be disclosed. Registrants can provide other information, including their positions regarding any such unresolved comments. This information is not required in the registrant's quarterly reports on Form 10-Q.

Requests for waivers, pre-clearance and interpretive guidance

In line with their efforts to promote capital formation, SEC officials are actively encouraging companies to use Rule 3-13 of Regulation S-X to request relief from burdensome financial statement requirements that result in the disclosure of information that exceeds what is material to investors. The DCF staff may use its authority under Rule 3-13 to modify or waive a company's financial reporting obligations under Regulation S-X, based on the facts and circumstances, as long as modifying or omitting the disclosure is consistent with investor protection.

Companies should consider discussing any matters they believe have merit with the staff before drafting a written request for relief under Rule 3-13. Conversations with the staff can be especially valuable when a company has a novel or complex fact pattern. In these situations, a company can learn which points will be most relevant to the staff's evaluation. To make it easier for companies to reach the right person, the SEC staff has updated its FRM[5] to include the names of staff members and the topics on which they answer questions.

Registrants also may request informal interpretive guidance from DCF staff on a named or no-named basis in a telephone call to DCF staff or in a request form for interpretive guidance and other assistance on the SEC's website. Requests made by telephone or an online request form[6] are informal and may remain anonymous; therefore, responses to such requests cannot be relied upon as formal positions of the DCF staff.

In addition, companies may pre-clear conclusions on the application of US GAAP (or IFRS) with the SEC's OCA. OCA staff encourages companies to consult on a pre-filing basis when companies are uncertain about accounting issues. Further discussion of the procedures for consulting with OCA is on the SEC's website at http://www.sec.gov/info/accountants/ocasubguidance.htm.

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5 DCF Financial Reporting Manual at: https://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf.

6 The online request form is available at: https://tts.sec.gov/cgi-bin/corp_fin_interpretive.

Appendix E: Abbreviations

Abbreviation	FASB Accounting Standards Codification
ASC 210	FASB ASC Topic 210, *Balance Sheet*
ASC 250	FASB ASC Topic 250, *Accounting Changes and Error Corrections*
ASC 260	FASB ASC Topic 260, *Earnings Per Share*
ASC 280	FASB ASC Topic 280, *Segment Reporting*
ASC 310	FASB ASC Topic 310, *Receivables*
ASC 350	FASB ASC Topic 350, *Intangibles — Goodwill and Other*
ASC 350-20	FASB ASC Topic 350-20, *Intangibles — Goodwill and Other — Goodwill*
ASC 450	FASB ASC Topic 450, *Contingencies*
ASC 470	FASB ASC Topic 470, *Debt*
ASC 480	FASB ASC Topic 480, *Distinguishing Liabilities from Equity*
ASC 606	FASB ASC Topic 606, *Revenue from Contracts with Customers*
ASC 740	FASB ASC Topic 740, *Income Taxes*
ASC 805	FASB ASC Topic 805, *Business Combinations*
ASC 810	FASB ASC Topic 810, *Consolidation*
ASC 820	FASB ASC Topic 820, *Fair Value Measurement*
ASC 842	FASB ASC Topic 842, *Leases*
ASC 932	FASB ASC Topic 932, *Extractive Activities — Oil and Gas*
ASC 932-235	FASB ASC Topic 932-235, *Extractive Activities — Oil and Gas — Notes to Financial Statements*
ASC 944	FASB ASC Topic 944, *Financial Services — Insurance*
SAB Topic 1.B.3	SEC Staff Accounting Bulletin Topic 1.B.3, *Financial Statements, Allocation Of Expenses And Related Disclosure In Financial Statements Of Subsidiaries, Divisions Or Lesser Business Components Of Another Entity, Other Matters*
SAB Topic 1.M	SEC Staff Accounting Bulletin Topic 1.M, *Financial Statements, Materiality*
SAB Topic 1.N	SEC Staff Accounting Bulletin Topic 1.N, *Financial Statements, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*
SAB Topic 11.M	SEC Staff Accounting Bulletin Topic 11.M, *Miscellaneous Disclosure, 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 Topic 14.D.1	SEC Staff Accounting Bulletin Topic 14.D.1, *Share-Based Payment, Certain Assumptions Used in Valuation Methods, Expected Volatility*
SAB Topic 14.D.2	SEC Staff Accounting Bulletin Topic 14.D.2, *Share-Based Payment, Certain Assumptions Used in Valuation Methods, Expected Term*
SAB Topic 14.F	SEC Staff Accounting Bulletin Topic 14.F, *Share-Based Payment, Classification of Compensation Expense Associated with Share-Based Payment Arrangements*
SAB 118	SEC Staff Accounting Bulletin Topic 118, *Income Tax Accounting Implications of the Tax Cuts and Jobs Act*

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No. 2018-03
Updated 4 October 2018

Technical Line

A closer look at accounting for the effects of the Tax Cuts and Jobs Act

Revised 4 October 2018

Given the complexities involved, companies should not underestimate the effort needed to appropriately account for the financial reporting effects of the Act.

What you need to know

- The Tax Cuts and Jobs Act significantly changes US income tax law, and companies need to account for the effects of these changes in the period that includes the 22 December 2017 enactment date.
- The SEC staff issued Staff Accounting Bulletin 118 to provide guidance for companies that are not able to complete their accounting for the income tax effects of the Act in the period of enactment.
- The Act reduces the corporate income tax rate to 21%, creates a territorial tax system (with a one-time mandatory tax on previously deferred foreign earnings), broadens the tax base and allows for immediate capital expensing of certain qualified property. It also requires companies to pay minimum taxes on foreign earnings and subjects certain payments from corporations to foreign related parties to additional taxes.
- Companies with fiscal years that end on a date other than 31 December need to use a blended tax rate because the new rate is administratively effective at the beginning of their fiscal year.
- The financial reporting effects of the Act may be complex, especially for multinationals. Companies also need to make appropriate disclosures.

Overview

The Tax Cuts and Jobs Act, which President Donald Trump signed into law on 22 December 2017, aims to encourage economic growth and bring back jobs and profits from overseas by reducing US corporate income tax rates, creating a territorial tax system, allowing for immediate

Building a better working world

expensing of certain qualified property and providing other incentives. The Act also includes various base-broadening provisions (e.g., the elimination of existing deductions) and anti-base erosion provisions.

On 22 December 2017, the Securities and Exchange Commission (SEC) staff issued Staff Accounting Bulletin (SAB) 118[1] to provide guidance for companies that are not able to complete their accounting for the income tax effects of the Act in the period of enactment. In doing so, the SEC staff acknowledged the challenges companies may face in accounting for the effects of the Act by their financial reporting deadlines and said the guidance is intended to help companies provide investors with timely, decision-useful information.

The SEC staff noted that Accounting Standards Codification (ASC) 740, *Income Taxes*, doesn't address these challenges and said a clarification was needed to address uncertainty or diversity in views about the application of ASC 740 in the period of enactment. If a company does not have the necessary information to determine a reasonable estimate to include as a provisional amount, the SEC staff said that it would not expect a company to record provisional amounts in its financial statements for the income tax effects for which a reasonable estimate cannot be determined. In these cases, the SEC staff said a company should continue to apply ASC 740 (e.g., when recognizing and measuring current and deferred taxes) based on the provisions of the tax laws that were in effect immediately prior to the Act being enacted. The Financial Accounting Standards Board (FASB) also issued an accounting standards update[2] to amend the SEC paragraphs in ASC 740 to reflect SAB 118.

The FASB staff has expressed views on implementation issues related to the accounting for the effects of the Act and finalized Staff question and answer (Q&A) documents on these matters. In one of the Q&As, the FASB staff said that if a private company or not-for-profit entity applies SAB 118, it would be in compliance with US GAAP.

This publication incorporates our views on the accounting implications of the Act and the SAB and provides additional discussion on other accounting effects from the Act. It also addresses the accounting implications for companies that use fiscal years that end on a date other than 31 December, among other things.

[1] SAB 118, *Income Tax Accounting Implications of the Tax Cuts and Jobs Act*.

[2] ASU 2018-05, *Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 118*.

Summary of key updates

The following sections and topics have been added or updated substantively since our last update on 30 August 2018:

Section 10.12 Treasury regulations

- Updated section 10.12.1, *US Treasury Department and IRS notices*, for further accounting considerations around proposed Section 951A regulations

Section 16 End of SAB 118 measurement period accounting considerations

- Added section 16, *End of SAB 118 measurement period accounting considerations*

Contents

1 Summary of key provisions of the Tax Cuts and Jobs Act

The Tax Cuts and Jobs Act makes the following key changes to US tax law:

- Establishes a flat corporate income tax rate of 21% to replace current rates that range from 15% to 35% and eliminates the corporate alternative minimum tax (AMT)
- Creates a territorial tax system rather than a worldwide system, which will generally allow companies to repatriate future foreign source earnings without incurring additional US taxes by providing a 100% exemption for the foreign source portion of dividends from certain foreign subsidiaries
- Subjects certain foreign earnings on which US income tax is currently deferred to a one-time transition tax
- Creates a "minimum tax" on certain foreign earnings and a new base erosion anti-abuse tax (BEAT) that subjects certain payments made by a US company to a related foreign company to additional taxes
- Creates an incentive for US companies to sell, lease or license goods and services abroad by effectively taxing them at a reduced rate
- Reduces the maximum deduction for net operating loss (NOL) carryforwards arising in tax years beginning after 2017 to a percentage of the taxpayer's taxable income, allows any NOLs generated in tax years ending after 31 December 2017 to be carried forward indefinitely and generally repeals carrybacks
- Eliminates foreign tax credits or deductions for taxes (including withholding taxes) paid or accrued with respect to any dividend to which the new exemption (i.e., the 100% exemption for the foreign source portion of dividends from certain foreign subsidiaries) applies, but foreign tax credits will continue to be allowed to offset tax on foreign income taxed to the US shareholder subject to limitations
- Limits the deduction for net interest expense incurred by US corporations
- Allows businesses to immediately write off (or expense) the cost of new investments in certain qualified depreciable assets made after 27 September 2017 (but would be phased down starting in 2023)
- May require certain changes in tax accounting methods for revenue recognition
- Repeals the Section 199 domestic production deductions beginning in 2018
- Eliminates or reduces certain deductions (including deductions for certain compensation arrangements, certain payments made to governments for violations of law and certain legal settlements), exclusions and credits and adds other provisions that broaden the tax base

Many of the provisions could have state and local tax implications. Most state income tax laws use federal taxable income as a starting point for determining state income tax. While some states automatically adopt federal tax law changes, other states conform their laws with federal law on specific dates. States also may choose to decouple from new federal tax provisions and continue to apply current law. A company may need to follow one set of rules when determining taxable income for US income tax purposes and multiple sets of rules when determining state and local taxable income.

Since states generally do not conform their income tax rates with changes in the federal tax rate but generally conform to the federal definition of taxable income, state income taxes could rise as the federal tax base expands. Companies should understand the conformity rules in the states in which they operate so they can appropriately account for the effects on their state income taxes.

How we see it

The law could have significant income tax accounting implications for companies, beginning in the period of enactment. As a result, companies should not underestimate the time needed to focus on their accounting and disclosure for the financial reporting effects of the new law.

2 Timing of accounting for enacted tax law changes

ASC 740 requires the effects of changes in tax rates and laws on deferred tax balances (including the effects of the one-time transition tax discussed below) to be recognized in the period in which the legislation is enacted. See section 8.1, *Changes in tax laws and rates*, of our Financial reporting developments (FRD) publication, *Income Taxes*. US income tax laws are considered enacted on the date that the president signs the legislation.

While the effective date of the new corporate tax rates is 1 January 2018, a company is required to calculate the effect on its deferred tax balances as of the enactment date. For companies with fiscal years that don't end on 31 December, the new lower corporate rate is applied by determining a blended tax rate for the fiscal year that includes the enactment date. Therefore, the effect of the rate change on a non-calendar year-end company's current and deferred income taxes is considered in the first interim period that includes the enactment date (refer to section 8, *Special considerations for non-calendar year-end companies*, below).

2.1 Subsequent events

If a company's fiscal year ended before the enactment date but it hadn't yet issued its financial statements on that date, the company should make appropriate disclosures about the change in tax law as a subsequent event. ASC 740 states that a company should not include the effect of a new tax law in its financial statements earlier than the period that contains the enactment date.

3 Effects of a lower corporate income tax rate

3.1 Accounting considerations related to deferred tax assets and liabilities

The Act established a flat corporate income tax rate of 21% to replace previous rates that ranged from 15% to 35%. Companies need to apply the new corporate tax rate when calculating the effects of the tax law change on their deferred tax balances as of the enactment date.

Calendar year-end companies may determine the effects of the rate change using year-end temporary differences if the temporary differences are expected to approximate the companies' deferred tax balances as of the enactment date. However, these companies may need to make adjustments for material unusual or infrequent transactions that occurred between the enactment date and year end. Further, any assets or liabilities that are measured at fair value on a recurring basis (e.g., available-for-sale-securities) should be adjusted to fair value at the enactment date. Companies that use a fiscal year ending on a date other than 31 December are also required to account for the effects of the change in the tax law on its deferred tax balances as of the enactment date. Estimating temporary differences as of the enactment date may present additional challenges for these companies (see section 8, *Special considerations for non-calendar year-end companies*, below).

Under the guidance in SAB 118, companies that have not completed their accounting for the effects of the lower corporate tax rate but can determine a reasonable estimate of those effects should include a provisional amount based on their reasonable estimate in their financial statements. If they cannot make a reasonable estimate of the effects of the Act, companies should continue to apply ASC 740 (e.g., when recognizing and measuring current and deferred taxes) based on the provisions of the tax laws that were in effect immediately prior to the Act being enacted. See section 9, *SEC guidance on accounting for US tax reform*, below.

The lower corporate income tax rate reduces the future tax benefits of existing deductible temporary differences, such as accruals for pension liabilities and net operating loss carryforwards. It also reduces the expected future taxes payable from the reversal of existing taxable temporary differences, such as those related to accelerated depreciation on property and equipment.

Companies need to remeasure existing deferred tax assets (including loss carryforwards) and liabilities and record an offset for the net amount as a component of income tax expense from continuing operations in the period of enactment. If a company changes the amount of a previously recorded valuation allowance as a result of remeasuring existing temporary differences and loss carryforwards, the amount of the change in the valuation allowance is also reflected in continuing operations.

Illustration 1 — How changing the tax rate affects taxable temporary differences

Assume that at the end of 2017, a calendar year-end company's only temporary difference is a $1 million taxable temporary difference that arose in the prior year and is expected to reverse in 2018 and 2019. The deferred tax liability at the beginning of 2017 is $350,000, reflecting the 35% corporate tax rate in effect at that date. On 22 December 2017, legislation was enacted that reduced the tax rate to 21%, effective 1 January 2018.

The company's deferred tax liability at 22 December 2017 would be $210,000 ($1 million x 21%). As a result of applying the new 21% tax rate, the deferred tax liability would be reduced by $140,000 ($350,000 — $210,000) as of 31 December 2017. The $140,000 adjustment would be recorded as an income tax benefit in continuing operations in 2017.

Note: If a portion of the temporary difference was expected to reverse in 2017, the company would first be required to estimate its temporary differences as of the enactment date rather than using the beginning of the year balance.

3.1.1 *Prohibition on backward tracing (updated 8 February 2018)*

In some situations, deferred tax assets and deferred tax liabilities relate to transactions that initially were accounted for as direct adjustments to shareholders' equity or other comprehensive income (OCI), and the offsetting tax effects also were accounted for as equity or OCI adjustments. Examples include the deferred tax effects on foreign currency translation adjustments, unrealized holding gains and losses for available-for-sale securities, and cash flow hedges and pensions and other postretirement benefits that are reported in OCI.

The effect of income tax law changes on deferred taxes initially recorded as shareholder equity or in OCI is recorded as a component of tax expense related to continuing operations in the period in which the law is enacted. Similarly, the effects of tax law changes on deferred tax assets and liabilities related to prior-year items reported in discontinued operations or initially recorded in connection with a prior business combination are reflected in continuing operations in the period the tax law is enacted. This is consistent with ASC 740's general prohibition on backward tracing (i.e., an entity wouldn't consider where the previous tax effects were allocated in the financial statements). See section 8.6, *Change in tax law or rates related to items not recognized in continuing operations*, of our FRD on income taxes.

The following illustration shows the effect of the change in law when a deferred tax asset has been recognized for operating loss carryforwards.

Illustration 2 — Effect of income tax law change on items not originally recognized in continuing operations
Assume that a calendar-year company has only one deferred tax item, an NOL carryforward related to losses of $100 million from discontinued operations recognized in the prior year. The carryforward is expected to reduce taxes payable in 2018 and beyond and the company does not have income in the carryback periods. The effect of a decrease in the tax rate to 21% from 35% ($14 million) enacted in December 2017 would be reflected in continuing operations in 2017, despite the fact that the deferred tax asset was originally recorded in discontinued operations.

3.1.2 *Reclassification of certain tax effects from accumulated other comprehensive income (updated 16 March 2018)*

Stakeholders, particularly those with material amounts of unrealized losses on available-for-sale securities, expressed concerns about ASC 740's prohibition of backward tracing of the income tax accounting effects of the Act to items originally recognized through OCI. Because of the prohibition against backward tracing, debits or credits related to income taxes will be stranded in accumulated other comprehensive income (AOCI). The FASB issued guidance[3] that gives entities the option to reclassify to retained earnings tax effects related to items in AOCI that the FASB refers to as having been stranded in AOCI as a result of tax reform. See section 3.1.2.2, *Effective date and transition,* below for additional information on the effective date of this guidance.

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[3] Accounting Standards Update (ASU) 2018-02, *Income Statement — Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income*.

Excerpt from Accounting Standards Codification

Income Statement — Reporting Comprehensive Income — Overall

Other Presentation Matters

Presentation of Income Tax Effects

220-10-45-12A

H.R.1, An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018 (Tax Cuts and Jobs Act), reduced the U.S. federal corporate income tax rate and made other changes to U.S. federal tax law. An entity may elect to reclassify the income tax effects of the Tax Cuts and Jobs Act on items within accumulated other comprehensive income to retained earnings. If an entity does not elect to reclassify the income tax effects of the Tax Cuts and Jobs Act, it shall provide the disclosures in paragraph 220-10-50-3. If an entity elects to reclassify the income tax effects of the Tax Cuts and Jobs Act, the amount of that reclassification shall include the following:

a. The effect of the change in the U.S. federal corporate income tax rate on the gross deferred tax amounts and related valuation allowances, if any, at the date of enactment of the Tax Cuts and Jobs Act related to items remaining in accumulated other comprehensive income. The effect of the change in the U.S. federal corporate income tax rate on gross valuation allowances that were originally charged to income from continuing operations shall not be included.

b. Other income tax effects of the Tax Cuts and Jobs Act on items remaining in accumulated other comprehensive income that an entity elects to reclassify, subject to the disclosures in paragraph 220-10-50-2(b).

An entity that elects to reclassify these amounts must reclassify stranded tax effects related to the change in federal tax rate for all items accounted for in OCI (e.g., available-for-sale securities, employee benefits, cumulative translation adjustments, hedging items). These entities can also elect to reclassify other stranded tax effects that relate to the Act but do not directly relate to the change in the federal rate (e.g., state taxes, changing from a worldwide tax system to a territorial system). Tax effects that are stranded in OCI for other reasons (e.g., prior changes in tax law, a change in valuation allowance) may not be reclassified.

3.1.2.1 ASU 2018-02 Disclosures

Excerpt from Accounting Standards Codification

Disclosure

General

Certain Income Tax Effects within Accumulated Other Comprehensive Income

220-10-50-1

An entity shall disclose a description of the accounting policy for releasing income tax effects from accumulated other comprehensive income.

220-10-50-2

An entity that elects to reclassify the income tax effects of H.R.1, An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018 (Tax Cuts and Jobs Act), in accordance with paragraph 220-10-45-12A shall disclose in the period of adoption both of the following:

a. A statement that an election was made to reclassify the income tax effects of the Tax Cuts and Jobs Act from accumulated other comprehensive income to retained earnings.

b. A description of other income tax effects related to the application of the Tax Cuts and Jobs Act that are reclassified from accumulated other comprehensive income to retained earnings, if any (see paragraph 220-10-45-12A(b)).

220-10-50-3

An entity that does not elect to reclassify the income tax effects of the Tax Cuts and Jobs Act in accordance with paragraph 220-10-45-12A shall disclose in the period of adoption a statement that an election was not made to reclassify the income tax effects of the Tax Cuts and Jobs Act from accumulated other comprehensive income to retained earnings.

When adopted, the standard requires all entities to make new disclosures, regardless of whether they elect to reclassify stranded amounts. Entities are required to disclose whether or not they elected to reclassify the tax effects related to the Act as well as their policy for releasing income tax effects from accumulated OCI.

Disclosures required by all entities

There is currently diversity in practice in how entities release tax effects remaining in accumulated OCI. Some entities release them as individual units of account are sold, terminated or extinguished (e.g., individual security approach for available-for-sale securities), while others release them only when an entire portfolio (i.e., all related units of account) of the type of item is liquidated, sold or extinguished (i.e., portfolio approach). Entities will be required to disclose their policy for releasing the income tax effects from accumulated OCI.

Disclosures required by entities that elect to reclassify stranded effects

In the period of adoption, entities that elect to reclassify the income tax effects of the Act from accumulated OCI to retained earnings must disclose that they made such an election. They must also disclose a description of other income tax effects related to the Act that are reclassified from accumulated OCI to retained earnings, if any.

Disclosures required by entities that do not elect to reclassify stranded effects

In the period of adoption, entities that do not elect to reclassify the income tax effects of the Act from accumulated OCI to retained earnings must disclose that such an election was not made.

3.1.2.2 Effective date and transition

The guidance is effective for all entities for fiscal years beginning after 15 December 2018, and interim periods within those fiscal years. Early adoption is permitted for periods for which financial statements have not yet been issued or made available for issuance, including in the period the Act was enacted (i.e., the reporting period including 22 December 2017). SEC registrants that do not adopt the guidance in the current period need to make disclosures about the anticipated effect of a new accounting standard, as required by SAB Topic 11.M. An entity that adopts the guidance in an annual or interim period after the period of enactment will be able to choose whether to apply the amendments retrospectively to each period in which the effect of the Act is recognized or to apply the amendments in the period of adoption. If retrospective application is selected, an entity would generally make a reclassification adjustment in the period of enactment (e.g., the fourth quarter of 2017 for a calendar-year entity) and any subsequent period when changes to provisional amounts recorded under SEC SAB 118 result in additional amounts stranded in accumulated OCI. An entity that elects to record the adjustment in the period of adoption will make an adjustment in the statement of shareholders' equity as of the beginning of the reporting period and any subsequent period if changes to provisional amounts result in additional amounts stranded in accumulated OCI.

An entity that elects to apply the new standard at the beginning of the period (annual or interim) of adoption shall disclose the following in the first interim and annual period of adoption:

- The nature of and reason for the change in accounting principle
- The effect of the change on the affected financial statement line items

An entity that elects retrospective transition shall disclose the following in the first interim and annual period of adoption:

- The nature of and reason for the change in accounting principle
- A description of the prior-period information that has been retrospectively adjusted
- The effect of the change on the affected financial statement line items

3.1.2.3 Adopting ASU 2016-01 may affect reclassification adjustments recorded under ASU 2018-02 (updated 16 March 2018)

Under the new guidance on recognizing and measuring financial instruments in ASU 2016-01[4], entities will measure equity investments (except those accounted for under the equity method, those that result in consolidation of the investee and certain other investments) at fair value and recognize any changes in fair value in net income. Entities with unrealized gains or losses on AFS equity securities are required to reclassify those amounts, along with the related tax effects, from AOCI to beginning retained earnings in the year of adoption.

Companies that historically classified equity securities as available for sale should consider how adopting ASU 2016-01 may affect the reclassification adjustment recorded under ASC 2018-02. Because both standards require tax amounts to be reclassified from AOCI upon adoption, companies with available-for-sale equity securities may want to consider adopting ASU 2018-02 in the same period that they adopt ASU 2016-01.

Calendar-year public business entities (PBEs) adopted ASU 2016-01 in the first quarter of this year because it is effective for PBEs for annual periods beginning after 15 December 2017, and interim periods therein. For all other entities, it is effective for fiscal years beginning after 15 December 2018, and interim periods within fiscal years beginning after 15 December 2019. Non-PBEs can early adopt the standard as of the effective date for PBEs.

3.2 Changes in tax rates and adoption of new accounting standards (updated 16 January 2018)

Many PBEs adopted new accounting standards (most notably, ASC 606, *Revenue from Contracts with Customers*) on 1 January 2018 (or shortly thereafter, depending on their fiscal year end). The following discussion focuses on ASC 606, but the concepts apply to any new accounting standard or accounting change that revises amounts previously reported for periods prior to the enactment date of the new tax law. For a broader discussion of the interaction of changes in tax law and the adoption of new accounting standards, see section 8.5, *Changes in tax rates following adoption of new accounting standards*, of our FRD on income taxes.

3.2.1 Accounting for the year of enactment

Companies that have not adopted a new accounting standard prior to the enactment date need to first calculate the tax accounting effects of the new tax law (e.g., remeasure deferred taxes for the tax rate change and record an offset to tax expense) without considering the change

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[4] ASU 2016-01, *Financial Instruments — Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*.

in accounting that will occur in the future. For example, if a calendar year-end company is adopting ASC 606 on 1 January 2018, its 2017 annual financial statements included in the 2017 10-K will show the effects of the enactment of the new tax law but not the effects of ASC 606.

3.2.2 Accounting in the year of adoption

Companies that account for the adoption of a new accounting standard after accounting for the effects of changes in the tax law will likely need to calculate the enactment-date effects of the Act for a second time if the new accounting standard changes the financial results for transactions that occurred prior to the enactment date. The first calculation would be for the reporting period that included the enactment date (e.g., the period ended 31 December 2017). The company will then need to account for the income tax effects of adopting the new standard, which will change the previously reported financial results (i.e., a change to the previously issued financial statements that included the period of enactment or a change reflected in the cumulative catch-up effect of adoption).

For example, if a company adopts the new revenue standard on 1 January 2018 and elects to use the full retrospective method, it will first recast its 2016 financial results and its 2017 financial results for the period prior to enactment based on the tax law in effect during those periods. The effects of tax reform on the enactment date will then be recalculated based on the revised ASC 606 results. This means that the enactment-date effects of the Act in a company's recast financial results will generally differ from the amounts reported in the 2017 financial statements that a company issues.

Under the modified retrospective method, a company will first need to elect either to apply the new revenue guidance to all contracts as of the date of initial application or only to contracts that are not completed as of that date. Based on that election, a company will recognize a cumulative catch-up adjustment to the opening balance of retained earnings on the date of initial application. Like companies that use the full retrospective approach, companies will need to consider the tax laws in effect during the contract period to calculate the income tax effects of the cumulative catch-up adjustment. Therefore, for companies electing to use the modified retrospective approach, the change in the enactment-date effects of the Act as a result of applying ASC 606[5] will be embedded in the tax effect of the cumulative catch-up adjustment.

3.3 Measuring uncertain tax benefits, NOL carrybacks and carryforwards (updated 22 February 2018)

ASC 740 requires companies to remeasure deferred tax assets (including loss carryforwards) and liabilities existing as of the enactment date based on the new corporate tax rate. A company also needs to carefully consider how the Act affects existing uncertain tax positions (UTPs). Questions have arisen about the rate a company should use when measuring NOL carryforwards and tax uncertainties. This section provides additional discussion on remeasuring existing NOL carryforwards and tax uncertainties as a result of the Act.

Net operating losses

The tax rate applied to net operating loss carryforwards that exist as of the enactment date (and in subsequent periods) will depend on how the entity expects to realize them (i.e., carry back or carry forward). For example, if a calendar year-end company has a $1 million loss carryforward as of 31 December 2017 and expects the loss carryforward to be realized by carrying it back to 2016, the loss carryforward should be tax effected at the 35% enacted rate that was effective for 2016 (i.e., measured at $350,000). Alternatively, if the loss carryforward

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[5] That is, the difference between (1) what was originally reported (and will continue to be reported in the 2017 financials) as the effects of enactment prior to the adoption of ASC 606 and (2) the recomputed effects of enactment after factoring in the adoption of ASC 606.

is determined to be realizable and is expected to be carried forward and used in years ending after 31 December 2017, it should be tax effected at the newly enacted 21% rate (i.e., measured at $210,000).

Tax uncertainties

Liabilities for tax uncertainties may exist for taxes that would be due for prior tax periods. In addition, a tax uncertainty may also affect a recorded temporary difference. The tax rate to be applied to a tax uncertainty is determined based on the nature of the tax uncertainty and the period to which it relates. For example, if a calendar year-end company has recorded a liability for a tax uncertainty that, if the company's position does not prevail in its tax position, would result in an increase in its tax liability for a tax return related to 2017 or prior years, that liability would be measured at the enacted rate effective for the related year (i.e., 35%). Alternatively, if the uncertainty affects the measurement of a temporary difference that existed as of 31 December 2017, and it is expected to reverse in subsequent years (i.e., it's expected to affect taxes payable in a year after 2017), that UTP is reflected in the related temporary difference that is measured at the new 21% tax rate.

3.3.1 *Interaction of uncertain tax benefits and NOLs*

Questions have arisen about the rate a company should use when measuring NOL carryforwards and tax uncertainties as a result of the change in the corporate income tax rate. Consider the following examples:

Illustration 3 — UTP related to a permanent difference

The company recorded in its 2015 tax return a $1 million tax deduction for federal income tax purposes. The tax position did not meet the more-likely-than-not recognition criteria in ASC 740-10-25-6. As a result, the company recorded a liability for the uncertain tax benefit of $350,000 ($1 million x 35%). For illustration purposes, penalties and interest are ignored, and the tax position is assumed to be a permanent difference. The company did not have NOLs (carryforwards or carrybacks) available as of 31 December 2015 to offset the UTP.

During 2016, the company generated a $1 million taxable loss and recognized a deferred tax asset of $350,000 for the related NOL carryforward. On 31 December 2016, the company, based on the guidance in ASC 740-10-45-10A, offset the $350,000 uncertain tax benefit with the NOL as permitted under the tax law. The company intends to carry back the loss to offset the tax position if the outcome of the settlement of the UTP is unfavorable to the company.

On 22 December 2017, the corporate tax rate is reduced to 21% from 35%. If the tax position is not settled in its favor, the company will be required to pay additional federal income taxes of $350,000 (before penalties and interest) since that was the amount of the uncertain tax benefit from the $1 million deduction it realized on its 2015 tax return. Since the tax law permits the 2016 NOL to be carried back, and the company intends to use the NOL to offset this amount, the company should continue to measure the NOL at $350,000 after the enactment date.

Assume in 2020, the UTP settled in the company's favor. As a result, the company recognized a tax benefit of $350,000. Further, since the company will no longer need the NOL carryback to offset the UTP and there are no other carryback periods available, the NOL is available to be carried forward to offset future taxable income (assuming it cannot be used to satisfy a 2017 liability). In the period the UTP is settled, the company remeasures the NOL at the current corporate tax rate and reduces the NOL from $350,000 to $210,000 ($1 million x 21%). The company recognizes a net tax benefit of $210,000 and records the following journal entries in 2020:

Journal entry to recognize tax benefit from the favorable settlement of the UTP:

Uncertain tax benefit	350,000	
Current tax benefit		350,000

Journal entry to remeasure the NOL carryforward at the new 21% corporate tax rate based on planned usage after the favorable resolution of the UTP:

Deferred tax expense	140,000	
Deferred tax asset (NOL carryforward)		140,000

If the UTP is resolved during an interim reporting period, the income tax effects should be treated as a discrete item in the period in which a change in judgment occurred or the UTP is settled.

Illustration 4 — UTP related to differences in timing

On 1 January 2016, the company acquired a separately identifiable intangible asset for $15 million that has an indefinite life for financial reporting purposes and is not subject to amortization. The company deducted the entire cost of the asset in 2016. Based on its interpretation of the tax code, the company is certain that the full value of the intangible asset is deductible for tax purposes and only the timing of deductibility is uncertain. The company determined that the tax position qualifies for recognition and determined it could sustain a 15-year amortization for tax purposes (under the ASC 740 measurement principles).

At the end of 2016, the company recognized a deferred tax liability of $350,000, representing the tax effect of the temporary difference created by the difference between the financial statement basis of the asset ($15 million) and the tax basis of the asset computed in accordance with ASC 740 ($14 million, representing the cost of the asset reduced by $1 million of amortization). The entity recorded a liability for the uncertain tax benefit of $4.9 million ($14 million x 35%), the tax effect of the difference between the as-filed tax position ($15 million) and the deduction that is considered more likely than not of being sustained ($1 million). Interest and penalties are ignored for purposes of this example.

On 22 December 2017, the corporate tax rate is reduced to 21% from 35%. On the enactment date, the company estimated the deferred tax liability and uncertain tax benefit based on the temporary difference between the financial statement basis of the asset ($15 million) and the tax basis of the asset computed in accordance with ASC 740 ($13.02 million, which is the cost of the asset reduced by $1.98 million of accumulated amortization through the enactment date). As a result, the company estimated its deferred tax liability to be $416,000 ($1.98 million x 21%). The company continues to measure the uncertain tax benefit using the tax rate related to the period the uncertainty originated. Therefore, the company recorded a liability of $4.56 million ($13.02 million x 35%).

Illustration 5 — UTP related to differences in timing — Company offsets UTP with available NOLs

Assume the same facts as in the previous example except that the company has sufficient NOL carryforwards to offset the tax position if the outcome is unfavorable to the company. Further, the company intends to and is permitted under the law to use the NOLs. Since the tax law permits the NOLs to be carried forward, and the company intends to use the NOL to offset this amount, the company continues to measure the portion of its NOL carryforward that would be used to settle the tax liability associated with the UTP for 2016 and 2017 based on the 35% tax rate or $4.56 million (NOLs of $13.02 million x 35%). For simplicity purposes, we have ignored the additional 2017 liability post-enactment amortization).

At 31 December 2018, the tax position remains uncertain. The company updated its analysis to reflect an additional year of amortization for tax purposes. The company estimated the deferred tax liability and uncertain tax benefit based on the temporary difference between the financial statement basis of the asset ($15 million) and the tax basis of the asset computed in accordance with ASC 740 ($12 million, which is the cost of the asset reduced by $3 million of amortization recognized through 2018). As a result, the company estimated its deferred tax liability to be $630,000 ($3 million x 21%). The company continued to measure the uncertain tax benefit using the tax rate related to the period the uncertainty originated. Therefore, the company recorded a liability of $4.2 million ($12 million x 35%).

At 31 December 2018, the company recorded the following entries:

Journal entry to record the tax effects from $1 million of additional tax amortization at 21%:

Deferred tax expense	210,000	
Deferred tax liability		210,000

Journal entry to adjust the UTP for the additional benefit from the additional tax amortization of $1 million at 35%:

Uncertain tax position	350,000	
Current tax benefit		350,000

Journal entry to remeasure the NOL carryforward from 35% to 21% based on planned usage after the partial resolution of the UTP ($1 million x (35% − 21%)):

Deferred tax expenses	140,000	
Net operating loss carryforward		140,000

Note: For simplicity purposes, these entries ignore possible interest and penalties.

A company presenting the tabular reconciliation required by ASC 740-10-50-15A would reflect the UTPs at the amounts consistent with the examples above and disclose the effect on the effective tax rate if the UTP settled in each subsequent year until the UTP is resolved.

4 One-time transition tax

Foreign earnings on which US income taxes were previously deferred are subject to a one-time tax as the company transitions to the new dividend-exemption system. Generally, US corporations need to include in income for each specified foreign subsidiary's last tax year beginning before 2018 their pro rata share of the net post-1986 historical earnings and profits (E&P) of the foreign subsidiaries if E&P has not been previously subject to US tax. The foreign earnings subject to the transition tax need to be measured on 2 November 2017 and on 31 December 2017, and the transition tax is based on the greater amount.

The portion of the E&P comprising cash and other specified assets is taxed at a 15.5% rate, and any remaining amount is taxed at an 8% rate. A company can elect to pay its tax liability over a period of eight years, interest free, based on the payment schedule included in the law.

4.1 Cash versus other specified asset rate

The portion of the E&P comprising cash and other specified assets is taxed at a 15.5% rate, and any remaining amount is taxed at an 8% rate. To determine the aggregate foreign cash position of the US shareholder, cash is measured on the following three dates:

- Date 1 — The close of the last taxable year beginning before 1 January 2018 (31 December 2017 for a calendar year-end company)
- Date 2 — The close of the last taxable year that ends before 2 November 2017 (31 December 2016 for a calendar year-end company)
- Date 3 — The close of the taxable year preceding Date 2 (31 December 2015 for a calendar year-end company)

The aggregate foreign cash position for a US taxpayer is the greater of the foreign cash position determined as of Date 1 or the average of the foreign cash positions determined as of Date 2 and Date 3.

A company with a non-calendar year-end foreign subsidiaries may not be able to determine its aggregate foreign cash position until the end of its 2018 fiscal year. As a result, such a company would need to consider whether the amount it recognized for its one-time transition tax payable can be completed earlier than that date (see section 8, *Special considerations for non-calendar year-end companies*, below).

Existing net operating loss and foreign tax credit carryforwards can be used to offset the transition tax. However, the Act sets certain limits that may restrict a company's use of any foreign tax credits generated from the one-time transition tax.

4.2 Accounting considerations related to the one-time transition tax (updated 24 January 2018)

A company needs to recognize the income tax accounting consequences of the one-time transition tax as a component of income tax expense from continuing operations in the period of enactment. Companies that recognized deferred taxes for prior foreign earnings may need to adjust previously recognized deferred tax liabilities and consider the classification of the transition income tax payable.

While the transition tax is intended to apply to all post-1986 taxable E&P of a company's non-US investees that were previously tax deferred, it doesn't necessarily eliminate book and tax basis differences. Companies still need to determine the outside basis differences for each of their foreign subsidiaries after taking into consideration payment of the transition tax. For example, there still may be a book and tax basis difference related to the investment that requires the company to evaluate whether any of the exceptions for recording deferred taxes under

ASC 740-30 apply (e.g., indefinite reinvestment assertion or the prohibition on recognizing deferred tax assets related to an investment in a subsidiary unless it will reverse in the foreseeable future). Also, there may be withholding taxes in foreign jurisdictions that are only triggered on distribution of earnings to shareholders and taxes that apply upon disposition of the investments.

Additionally, companies need to consider the effect on the balance sheet classification between current and noncurrent if they elect to pay the transition tax over the allowed period of time. Companies can elect to pay the transition tax without incurring interest over a period of up to eight years.

We understand that questions existed about whether the guidance in ASC 835-30, *Interest — Imputation of Interest*, applies to long-term income taxes payable. In response to these questions, the FASB staff made the following recommendations in its Staff Q&A:

FASB Staff question and answer on whether to discount the tax liability on the deemed repatriation

Question

Does the FASB staff believe that the tax liability on the deemed repatriation of earnings should be discounted?

Response

The FASB staff believes that the tax liability on the deemed repatriation of earnings should not be discounted. The FASB staff notes that paragraph 740-10-30-8 prohibits the discounting of deferred tax amounts. Due to the unique nature of the tax on the deemed repatriation of foreign earnings, the staff believes that the guidance in paragraph 740-10-30-8 should be applied by analogy to the payable recognized for this tax.

Further, the FASB staff does not believe that Subtopic 835-30 on the imputation of interest applies to the unique circumstances related to this tax liability. The guidance in Subtopic 835-30 addresses the accounting for business transactions that often involve the exchange of cash or property, goods, or services for a note or similar instrument. Subtopic 835-30 is premised on the fact that when a note is exchanged for property, goods, or services in a bargained transaction entered into at arm's length, the interest rate should represent fair and adequate compensation to the supplier. The FASB staff believes that the transition tax liability is not the result of a bargained transaction and that the scope exception in paragraph 835-30-15-3(e) for transactions where interest rates are affected by tax attributes or legal restrictions prescribed by a governmental agency (such as, income tax settlements) would apply.

The FASB staff also notes that the tax liability may not be a fixed obligation because it may be subject to estimation and future resolution of uncertain tax positions (for example, amount of earnings and profits from foreign subsidiaries, amount of earnings held in cash and cash equivalents, reduction of the tax for foreign tax credits). Any recognized uncertain tax position related to the deemed repatriation of foreign earnings would not be discounted, and the staff does not believe it is appropriate to have a discounted tax liability when the uncertain tax position is undiscounted.

See Appendix C for the full contents of the FASB Staff Q&A.

4.3 SAB 118 and documentation supporting the one-time transition tax (updated 24 January 2018)

Companies applying the guidance in SAB 118 when their accounting for the one-time transition tax is incomplete should include a provisional amount in their financial statements if they can determine a reasonable estimate. If they cannot make a reasonable estimate of the effects, companies should continue to apply ASC 740 based on the provisions of the tax laws that were in effect immediately prior to enactment. For example, if a company previously asserted indefinite reinvestment for a particular entity, we believe the company could continue to follow its existing accounting until it has the necessary information to determine a reasonable estimate for the transition tax for that entity. See section 9, *SEC guidance on accounting for US tax reform*, below.

SAB 118 was issued to allow companies a reasonable period of time to finalize their accounting for the Act. We expect that many companies will apply the provisions of SAB 118 when accounting for the transition tax as they seek additional information to support and refine their calculations during the SAB 118 measurement period. Questions have arisen in differentiating accounting that is provisional under SAB 118 from the assessment of an uncertain tax position — particularly as it related to the absence of supporting documentation of a tax position. For example, a company may have historical information to support income tax payments made by its foreign subsidiaries but may not have finished researching or gathering all the evidence that typically is required by the Internal Revenue Service (IRS) to support the company being able to claim a foreign tax credit (FTC). We recognize assessing the accounting effects of the absence of data or documentation during the SAB 118 measurement period will require the exercise of judgment.

We believe that the SAB 118 measurement period is intended to provide a company with reasonable time to research and gather data to perform and support its analysis of a tax position. A company that is continuing to analyze the available support for a tax position, searching for additional data or analyzing the sufficiency of its information under the recognition and measurement provisions of ASC 740 (including those related to uncertain tax positions) would likely conclude that the accounting is provisional when applying the provisions of SAB 118.

As part of finalizing its accounting, a company will need to conclude on the adequacy of the support it has gathered for a tax position in accordance with ASC 740. In evaluating the effects of potential shortfalls in documentation as part of a company's final accounting, a company will need to consider the necessary information to support a conclusion that the tax position meets the more-likely-than-not recognition threshold in ASC 740 (including the applicability of the administrative practices of the IRS) as well as the effects of any deficiencies on the measurement of that tax position.

5 The new territorial system

Under the worldwide taxation system previously in effect, US corporate income tax applied to all of a company's income, regardless of whether it was earned in the US or overseas. However, foreign income earned by a foreign subsidiary of a US corporation was generally not taxed until the foreign earnings were repatriated to the US.

The Act created a territorial tax system that allows companies to repatriate certain foreign source earnings without incurring additional US tax by providing for a 100% dividend exemption. Under the dividend-exemption provision, 100% of the foreign source portion of dividends paid by certain foreign corporations to a US corporate shareholder are exempt from US taxation. The dividend exemption does not apply to foreign income earned by a domestic corporation through foreign branches (including foreign corporations for which the company made check-the-box elections) or to gain on sales attributable to the appreciation of stock. However, the dividend exemption generally applies to the gain on the sale of foreign stock attributable to the foreign subsidiary's E&P.

This provision applies to E&P distributions made after 31 December 2017.

5.1 Accounting considerations related to the territorial system

Outside basis differences represent the difference between the financial reporting basis and the tax basis of an investment. Under ASC 740, a company may have historically applied certain exceptions for recording deferred tax amounts related to the outside basis differences of its foreign subsidiaries or foreign corporate joint ventures (i.e., asserted indefinite reinvestment). In other instances, a company may have not met the criteria to apply those exceptions or may have been required to record the related deferred tax amounts, as would have been the case with an investee accounted for using the equity method (that did not meet the definition of a corporate joint venture).

Under the new territorial tax system, a company still needs to apply the guidance in ASC 740-30 to account for the tax consequences of outside basis differences from investments in foreign investees and consider the required disclosures. Companies need to carefully evaluate the provisions of the law for each individual foreign investee to determine whether they can assert indefinite reinvestment or otherwise are required to recognize deferred tax liabilities related to outside basis differences (even after considering the one-time transition tax discussed in section 4, *One-time transition tax*, above) and the appropriate tax effects of the outside basis differences.

The following are some of the matters related to outside basis differences that companies will need to consider in evaluating taxes that may need to be provided on outside basis differences and whether the exceptions in ASC 740-30 apply:

- Outside basis differences — The one-time transition tax applies to post-1986 tax E&P. That basis difference may not equate to the entire outside basis difference of some entities' international subsidiaries. The remaining outside basis difference will need to be examined to understand any federal, foreign or state taxes that could arise and whether the exceptions in ASC 740-30 related to indefinite reinvestment apply. In addition, companies will need to evaluate their intention for the reinvestment or continued reinvestment of E&P subject to the transition tax. There may be additional taxes (e.g., state, local, foreign) that would be due on these earnings, if remitted. While future earnings may be subject to 100% dividend exemption, companies will need to continue to evaluate their reinvestment intentions on future earnings and any other residual basis differences in order to determine whether they can continue to assert indefinite reinvestment or whether they will be required to provide for additional taxes that would be due on future earnings if remitted and/or the recognition of other basis differences.

- Foreign taxes (e.g., withholding taxes) — Companies will still need to assess whether they can assert indefinite reinvestment of foreign earnings (including E&P subject to the one-time transition tax). Although a company will need to provide US taxes on E&P due to the one-time transition tax, it will need to evaluate whether it can continue to assert indefinite reinvestment of those earnings with respect to withholding taxes and other foreign income taxes that could potentially be assessed.
- Gains on sale — Because gains from the sales of shares in a foreign investee are not eligible for the dividend exemption, companies need to separately track basis differences related to their investment balances and consider any intentions for disposal of a foreign investee.
- State and local taxes — Many states may have existing statutes, or will choose to enact legislation, to decouple from federal treatment of foreign sourced dividends. These differences could apply to both post-1986 E&P taxed under the federal one-time transition tax as well as pre-1987 E&P. As a result, companies will need to continue to assess their outside basis differences created by all book to tax differences and the state taxes that might apply. Individual state and local tax law changes should be accounted for when enacted in accordance with ASC 740.
- Foreign-to-foreign investments — The guidance in ASC 740-30 on accounting for outside basis differences still applies to the local country taxes applicable to foreign-to-foreign structures despite ultimate US ownership.

Companies may not have the necessary information to complete their analysis of the reversal of outside basis differences in their investments in foreign subsidiaries, after considering the one-time transition tax, by their financial reporting deadline. Companies applying the guidance in SAB 118 should include provisional amounts in their financial statements if they can determine reasonable estimates of the future tax effects of their outside basis differences and the tax cost of any transition taxes (see section 9, *SEC guidance on accounting for US tax reform*, below). If they cannot make a reasonable estimate, companies should continue to apply ASC 740 based on the provisions of the tax law that was in effect immediately prior to the enactment of the new law, including their historical accounting for outside basis differences for which they asserted indefinite reinvestment.

6 Anti-deferral and anti-base erosion provisions

The Act includes anti-deferral and anti-base erosion provisions targeting both US-based and foreign-based multinational companies, including:

- A new minimum tax on global intangible low-taxed income
- A lower effective tax rate (after deduction) on a US company's sales, leases or license of goods and services abroad that provides an incentive for these activities
- A new tax on certain payments from a corporation subject to US tax to a related foreign corporation that are otherwise deductible (e.g., royalty payments)

6.1 Global intangible low-taxed income

The Act subjects a US shareholder to current tax on "global intangible low-taxed income" (GILTI) of its controlled foreign corporations. GILTI is calculated based on the following formula: the excess of the aggregate of a US shareholder's pro rata share of net income of its controlled foreign corporations (CFCs) over a calculated return on specified tangible assets of the CFCs. The income inclusion under GILTI (GILTI inclusion) is eligible for a deduction that is intended to lower the effective tax rate to 10.5% for taxable years beginning after 31 December 2017 and ending in 2025. The deduction applied to GILTI income will be lowered resulting in the intended effective rate rising to 13.125% for taxable years beginning after 31 December 2025.

Further, the Act limits FTCs to 80% of the foreign tax paid and properly attributable to GILTI income. It also limits a company's ability to use these FTCs against other foreign source income or to carry these FTCs back or forward to other years.

6.1.1 Accounting considerations for GILTI provisions (updated 30 August 2018)

The income subject to tax under the GILTI provisions will be treated in a manner similar to a Subpart F income inclusion (i.e., it should be included in the US shareholder's taxable income in the current year) and included in its US income tax provision. However, questions existed about whether companies should include the effects of the Act in income tax in the future period the tax arises or as part of deferred taxes on the related investments. In response to these questions, the FASB staff issued the following response in a Staff Q&A:

FASB Staff question and answer on the accounting for global intangible low-taxed income

Question

Does the FASB staff believe that an entity should recognize deferred taxes for temporary basis differences expected to reverse as global intangible low-taxed income (GILTI) in future years or should the tax on GILTI be included in tax expense in the year it is incurred?

Response

The FASB staff does not believe that Topic 740 is clear as to the treatment of GILTI.

> Some stakeholders believe that it would not be appropriate to provide deferred taxes on individual inside basis differences or the outside basis difference (or portion thereof) because a taxpayer's GILTI is based on its aggregate income from all foreign corporations. Because the computation is done at an aggregate level, the unit of account is not the taxpayer's investment in an individual foreign corporation or that corporation's assets and liabilities. These stakeholders believe that the guidance on deferred tax accounting in Topic 740 using the asset and liability approach does not address taxes on aggregated income because basis differences of a foreign corporation in one jurisdiction may be offset by basis differences in a foreign corporation in another jurisdiction and ultimately may never be taxed. Furthermore, these stakeholders believe that the GILTI computation is dependent on contingent or future events (for example, future foreign income versus loss, the amount of foreign qualified business asset investment in a given year, future foreign tax credits, or future taxable income), which suggests that taxes on GILTI should be accounted for as period costs similar to special deductions.
>
> Other stakeholders believe that the current tax imposed on GILTI is similar to the tax imposed on existing Subpart F income. Deferred taxes generally are provided under Topic 740 for basis differences that are expected to result in Subpart F income upon reversal. Because GILTI is included in the US shareholder's taxable income when earned by the foreign corporations, similar to Subpart F income, these stakeholders believe that a US shareholder should recognize deferred tax assets and liabilities when basis differences exist that are expected to affect the amount of GILTI inclusion upon reversal.
>
> Based on the different views provided, the FASB staff believes that Topic 740 is not clear as it relates to the accounting for GILTI, and an entity may apply either interpretation of Topic 740. The staff believes that an entity must disclose its accounting policy related to GILTI inclusions in accordance with paragraphs 235-10-50-1 through 50-3.
>
> The staff plans to monitor how entities that pay tax on GILTI are accounting for and disclosing its effects by reviewing annual or quarterly reports issued over the next few quarters. Following this review, the staff will provide an update to the Board so it can consider whether improvements may be needed for the accounting or disclosures for the tax on GILTI.
>
> See Appendix C for the full contents of the FASB Staff Q&A.

6.1.1.1 *Measurement of GILTI deferred taxes (updated 30 August 2018)*

The following discusses an acceptable approach for companies electing to account for GILTI in deferred taxes. The accounting for GILTI is complex because of the nature of the tax law and the various assumptions that are needed to calculate the GILTI inclusion. A company should carefully consider its ability to estimate GILTI in deferred taxes and to design and execute appropriate related internal controls before electing its GILTI accounting policy.

In the FASB staff Q&A on accounting for GILTI,[6] the staff noted that companies could either (1) account for taxes on GILTI as period costs similar to special deductions or (2) recognize deferred tax assets and liabilities when basis differences exist that are expected to affect the amount of the GILTI inclusion when the basis differences reverse. Questions have arisen about how companies that elect an accounting policy to recognize deferred taxes for GILTI-related temporary basis differences should measure those deferred taxes.

The GILTI inclusion is based on the aggregate activities of all of a US shareholder's controlled foreign corporations (CFCs), not just the activity of individual CFCs. Additionally, under the tax law, the GILTI inclusion is contingent on future events (e.g., future foreign income and the

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[6] FASB staff Q&A, Topic 740, No. 5, Accounting for Global Intangible Low-Taxed Income

amount of the return on investment in qualified business asset investments (QBAI)), and it may be reduced by a deduction referred to as the GILTI deduction. As a result, questions have arisen about whether GILTI-related deferred taxes should be measured (1) based on looking through to the inside basis differences of each CFC, (2) only to the extent that a taxable outside basis difference exists on a particular CFC or (3) by using another approach.

The FASB staff and the SEC staff have indicated in discussions that the two-step model described below is consistent with the framework of ASC 740[7] and would be an acceptable approach when electing an accounting policy to account for GILTI in deferred taxes. However, because it's unclear how entities should apply the guidance in ASC 740 to account for GILTI in deferred tax accounting, other acceptable approaches for measuring deferred taxes for GILTI may exist. A company that applies the model described below or another acceptable model should apply that method consistently.

The approach discussed with the FASB staff and the SEC staff focuses on how a US shareholder would expect to recover its investment in the CFC.

Under ASC 740, a temporary difference arises when events have been recognized in the financial statements but will result in taxable or deductible amounts in future years based on provisions of the current tax law. Therefore, a company that elects a policy to recognize deferred tax assets and liabilities related to the future GILTI inclusion and applies the two-step model would only recognize deferred tax balances for GILTI when it expects a GILTI inclusion in its taxable income for the foreseeable future. In other words, a company applying this model would not record deferred tax balances for GILTI if, for example, it expects its CFCs to incur net losses or it expects to have enough net deemed tangible income to reduce the GILTI inclusion to zero for the foreseeable future (see the discussion below on the calculation of GILTI income).

A company that determined that it expects a GILTI inclusion in its taxable income for the foreseeable future could measure deferred taxes using the following two-step model.

Step 1	**Look through** each CFC to the underlying recorded assets and liabilities
Step 2	Determine whether a **residual outside basis** difference exists

The two-step model recognizes that part of the basis difference will reverse through ordinary operations (i.e., the look-through concept). It also recognizes that the residual outside basis difference, if any, may not result in a future GILTI inclusion (e.g., if income was earned prior to 1987) or may reverse in a sale, distribution or liquidation (i.e., the outside basis concept). In some cases, the entire reversal of the residual outside basis difference or a portion of it may not be subject to tax.

Step 1: Look through each CFC to the underlying recorded assets and liabilities

A US shareholder would first identify and measure the inside temporary basis differences by comparing the carrying amount to the tax basis (measured under US tax law) of the assets and liabilities held by each CFC. Once these items are identified, the US shareholder would assess which of those temporary differences, when realized, would be expected to affect the GILTI inclusion.

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[7] This discussion focuses on US federal tax law. Similar considerations would apply for state tax law purposes in states that conform to the US federal tax GILTI provisions.

For any inside temporary basis difference that is expected to affect the GILTI inclusion when realized, a US shareholder would measure the tax effects of those differences, considering the effects of a GILTI-related deduction or other adjustments (e.g., section 250(a)(1)(B) or other adjustments such as QBAI return, both of which are discussed in further detail below).

A US shareholder will then recognize the deferred tax consequences of anticipated US foreign tax credits (FTCs) for each CFC's local deferred tax balances (generally limited to 80% of the CFC's local deferred tax balances multiplied by the ratio of the GILTI inclusion over the aggregate income of related CFCs and subject to additional limitations under the tax law).

For any recognized deferred tax assets for GILTI, a realizability assessment would be required under ASC 740-10-30-17. See section 6.1.1.2, *Accounting considerations for the effect of GILTI on the realizability of US federal DTAs,* below for additional considerations related to GILTI and the realization of US deferred tax assets and NOL carryforwards and chapter 6, *Valuation Allowances*, of our FRD on income taxes for additional information on assessing the realizability of deferred taxes.

See the *Considerations when measuring GILTI deferred taxes* section below for additional considerations for measuring deferred taxes related to GILTI.

Step 2: Determine whether a residual outside basis difference exists

After determining the temporary inside basis differences that upon their reversal will generate GILTI, a US shareholder will determine whether a residual outside basis difference exists. A residual outside basis difference for US federal purposes may exist when a portion of the outside basis will affect future US federal taxes but does not relate to the inside basis differences that upon reversal will affect the amount of GILTI inclusion in future periods. Any residual outside basis difference that does not relate to the underlying recorded assets and liabilities would be subject to the guidance and exceptions in ASC 740-30-25 for outside basis differences.

When using this approach, a company will not be able to look to the exceptions for recording deferred taxes in ASC 740-30-25 for the portion of the temporary difference that upon reversal affects the GILTI inclusion.

Additionally, under this approach, when a company is subject to GILTI, deferred taxes will be recognized for the future GILTI effect of the inside basis differences even if the outside book and tax basis are the same, and thus, the net outside basis difference is zero. This would be the same if the outside tax basis exceeds the outside book basis.

The following illustration shows an example of how this model would be applied in a simple scenario.

Illustration 6

Assume that a US shareholder looks through each CFC to the underlying recorded assets and liabilities and identifies an inside taxable temporary difference of $500 that is expected to reverse into a $500 GILTI inclusion in the future. The company would record deferred taxes related to the $500 taxable temporary difference, regardless of whether an outside basis difference exists (i.e., even if the outside book and tax basis are the same or the outside basis difference is less than $500).

Also assume that after determining the $500 taxable temporary difference, no overall outside basis temporary difference exists (i.e., the outside basis difference is zero). The US shareholder would still need to determine whether a residual outside basis difference exists after determining the $500 taxable temporary difference. In this situation, the outside basis difference can be separated into the following two components:

- Taxable temporary inside basis difference of $500 that upon reversal will affect future GILTI
- Residual deductible outside basis difference of $500 that will not reverse in the ordinary course of business (e.g., a future sale or liquidation)

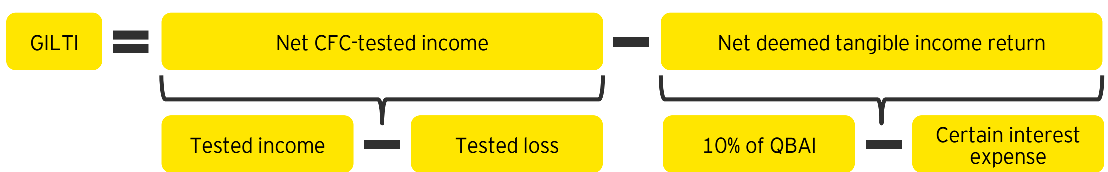
While the taxable temporary inside basis difference will reverse in the ordinary course of business and affect the future GILTI inclusion, the residual deductible outside basis difference will need to be further analyzed under ASC 740-30-25-9 to determine whether a deferred tax asset can be recognized.

Note: The above illustration is a simplified example of when the effects of GILTI deferred taxes and residual outside basis difference net to zero. In other situations, the overall outside basis difference could result in a net deferred tax asset or liability. In these cases, a company would still need to determine if a residual outside basis difference exists and then further evaluate to determine if the exceptions to recording outside basis differences are available under ASC 740-30-25-3 or ASC 740-30-25-9.

Overview of GILTI

The following discussion includes a high-level summary of how the GILTI inclusion is measured under US tax law. The discussion and illustrations that follow include many simplifying assumptions. The calculation of GILTI is extremely complex, depends on a company's facts and circumstances and likely will require the involvement of experienced tax professionals.

The following discussion provides a high-level summary of how the GILTI inclusion is calculated.



As mentioned above, pursuant to US tax law, a US shareholder of a CFC must include in its gross taxable income its GILTI for each taxable year, generally in a manner similar to subpart F income. A US shareholder's GILTI for any taxable year equals, on an aggregate basis of all CFCs, the excess, if any, of its net CFC-tested income (tested income[8] less tested losses[9]) over its net deemed tangible income return for such taxable year. A company that has a net CFC-tested loss for the period cannot carry forward the tested loss to reduce GILTI-tested income in a future period.

Net deemed tangible income return with respect to any US shareholder is the excess, if any, of:

- 10% of the aggregate of the shareholder's pro rata share of the qualified business asset investment (QBAI) of each CFC with tested income (QBAI of CFCs with tested losses are excluded), over

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[8] The tax law defines the tested income of a CFC as the excess, if any, of: (1) the CFC's gross income for that year – excluding certain categories of income taxed in the US under historical provisions such as effectively connected income, subpart F, gross income excluded from "foreign base company income" or "insurance income" under the high-tax exception, dividends received from certain related persons, and certain foreign oil and gas extraction income — over (2) the deductions (including taxes) properly allocable to such tested gross income.

[9] The tax law defines the tested loss of a CFC as the excess (if any) of the deductions (including taxes) properly allocable to the corporation's gross income determined without regard to the tested income exceptions over the amount of such gross income.

- The amount of interest expense allocable to net CFC-tested income for the taxable year to the extent the interest income attributable to such expense is not taken into account in determining net CFC-tested income

QBAI equals the CFC's average aggregate adjusted bases for specified tangible property (i.e., tangible property used in the production of tested income) during the taxable year, which should be calculated using the measurement rules included in the tax law.

The Act also provides the US shareholder with:

- A deduction (section 250(a)(1)(B) deduction) for up to 50% of GILTI through 2025 and up to 37.5% of GILTI for taxable years beginning after 31 December 2025
- A deemed paid FTC of up to 80% of foreign taxes attributable to the GILTI inclusion of the underlying CFCs with a full inclusion for foreign taxes paid (section 78 gross-up), but unused FTCs associated with GILTI cannot be carried forward or back or used against other foreign source income

See the *Foreign-derived intangible income (FDII) deduction* section below for additional considerations related to the interaction with the FDII deductions.

Considerations when measuring GILTI deferred taxes

Because of the complexity of the GILTI measurement, there are additional accounting considerations for measuring deferred taxes related to temporary differences affecting the GILTI inclusion, as explained in the sections below.

Net deemed tangible income return

Questions exist regarding how the net deemed tangible income return should be considered in the measurement of deferred taxes related to GILTI. Based on discussions with the FASB staff and SEC staff, the following two methods are consistent with the accounting framework of ASC 740 when a company applies the two-step model discussed above:

- A company may account for the net deemed tangible income return in the period it arises, hence the treatment would be analogous to a special deduction.
- A company may account for the net deemed tangible income return in measuring the deferred taxes related to a temporary difference that would be included in the future GILTI calculation. Under this approach, the GILTI inclusion is assumed to be taxed at a zero percent tax rate up to the net deemed tangible income return and any amount greater than the net deemed tangible return would be subject to GILTI tax. This treatment would be analogous to a zero percent tier in a graduated GILTI tax rate structure.

If the latter method is used and the graduated tax rate is a significant factor for the US shareholder, deferred tax liabilities or assets related to GILTI should be measured using the average graduated tax rate as discussed in ASC 740-10-30-9. See section 5.1.1, *Average graduated tax rates*, of our FRD on income taxes for additional discussion on graduated tax rates.

While the two alternative approaches above are reasonable under ASC 740, other acceptable alternatives may exist. A company that applies one of the two alternatives described above or another acceptable method should apply that method consistently.

The GILTI (section 250(a)(1)(B)) deduction

As described above, the US tax law provides for a deduction that, when applied, lowers the GILTI inclusion. This may lower the effective tax rate on the GILTI inclusion to 10.5% for taxable years beginning after 31 December 2017 and to 13.125% for taxable years beginning after 31 December 2025. ASC 740-10-55-24 requires deferred taxes to be measured using enacted tax rates applicable based on the expected type of taxable or deductible amounts in future years.

A company applying the two-step model discussed above therefore needs to assess whether it expects to be able to take the full GILTI deduction for the foreseeable future or expects the deduction to be limited because:

- A company that generally expects to be able to fully apply the GILTI deduction in the foreseeable future should consider this deduction in the measurement of GILTI deferred taxes.
- A company that generally expects limitations on its ability to fully apply the GILTI deduction (e.g., if it expects US losses to offset GILTI inclusions) or expects to use NOL carryforwards or other tax attributes to offset taxable income in future periods may conclude that factoring some or all of the deduction into the rate is not appropriate.

There may be other acceptable alternatives to account for the GILTI deduction. A company that applies the method described above or another acceptable method should apply that method consistently.

See section 6.1.1.2, *Accounting considerations for the effect of GILTI on the realizability of US federal DTAs*, for additional considerations for a US shareholder electing an accounting policy of considering the effect of the limitations on the GILTI deductions on the realizability of its US deferred tax attributes.

Foreign tax credits

Companies should consider the effects of foreign tax credits that would be available to reduce GILTI when measuring deferred taxes for GILTI (similar to the guidance in ASC 740-10-55-24). However, the effect of FTCs should be considered only if they relate to events already recognized in the CFC's financial statements.

Foreign-derived intangible income (FDII) deduction

The tax law limits the amount of GILTI and FDII deductions to the US shareholder's taxable income. Therefore, a US shareholder will need to consider both the GILTI deduction and the FDII deduction to determine whether these deductions are limited (see section 6.2, *Export incentive on foreign-derived intangible income*, for additional discussion of the FDII deduction). While existing inside basis differences may affect future FDII calculations, FDII generally depends on future book income from a sale, lease, license or exchange of property or future service revenue. We believe the accounting for the FDII deduction is similar to a special deduction and, therefore, any expected tax effect of future FDII deductions should not be considered when measuring GILTI deferred taxes.

6.1.1.2 Accounting considerations for the effect of GILTI on the realizability of US federal DTAs (updated 26 July 2018)

Under the Act, a US shareholder includes GILTI in its taxable income, which generally is the excess of its aggregated "net CFCs tested income" over its "calculated return on specified tangible net assets of the CFCs." The Act also provides the US shareholder with:

- A deduction (section 250(a)(1)(B) deduction) for up to 50% of GILTI through 2025 and up to 37.5% of GILTI for taxable years beginning after 31 December 2025

- A deemed paid FTC of up to 80% of foreign taxes attributable to the underlying CFCs with a full inclusion for foreign taxes paid (section 78 gross-up), but unused FTCs associated with GILTI cannot be carried forward or back or used against other foreign source income

The Act requires a US shareholder to first use available NOL carryforwards to offset its US taxable income including any GILTI before taxable income can be reduced by the section 250(a)(1)(B) deduction or before FTCs can be applied against taxes due. Therefore, when a US shareholder uses NOL carryforwards that fully offset the current year's US taxable income, the US shareholder will not realize any additional tax benefit from the section 250(a)(1)(B) deduction or the GILTI-related FTCs attributable to the underlying CFC(s). The section 250(a)(1)(B) deduction and the GILTI-related FTCs may be limited if an NOL carryforward partially offsets US taxable income.

In these situations, the utilization of the NOL carryforwards may result in either reduced or no additional cash tax savings to the US shareholder from the section 250(a)(1)(B) deduction or the GILTI-related FTCs. Absent any NOL carryforwards, the US shareholder would have reduced its tax liability by using the section 250(a)(1)(B) deduction and foreign tax credits permitted under GILTI to achieve the same cash tax savings as a US shareholder that has available NOL carryforwards. For example, consider a US shareholder that has no US-based pretax earnings, and its US taxable income is solely due to GILTI. If the expected GILTI-related FTCs were significant enough, the US shareholder would have the same cash tax savings from applying the section 250(a)(1)(B) deduction and FTCs as it would from using NOL carryforwards to offset the current year's US taxable income. That is, the section 250(a)(1)(B) deduction and the GILTI-related FTCs would reduce the US shareholder's federal income tax payable to zero. This could also be the case for companies that have existing deferred tax assets (DTAs) that, upon reversal, are expected to result in future NOLs.

If a company elects to account for GILTI as a period cost

Because of the Act's ordering rules for using NOL carryforwards, questions have arisen about how GILTI affects a US shareholder's assessment of the realizability of its US federal NOL carryforwards and DTAs when it has elected to account for GILTI as a period cost. We understand that two views have developed in practice, as follows:

View A

A company should follow the tax-law NOL carryforward ordering rules to determine whether any existing DTAs are expected to be realized. The Act requires a US shareholder to first use available NOL carryforwards to reduce GILTI before considering the effects of the section 250(a)(1)(B) deduction and GILTI-related FTCs. Based on the tax-law ordering requirements, a company that expects to generate taxable income (including GILTI) in the future and expects NOL carryforwards to reduce its tax liability related to that income may conclude that the NOL carryforwards are realizable and should not record a valuation allowance related to the NOLs that will be used in the future. Under this view, the fact that a company is unable to benefit from future section 250(a)(1)(B) deductions or GILTI-related FTCs that will be generated in the future is not relevant for this assessment.

View B

A US shareholder should assess the realizability of its NOL carryforwards and DTAs that upon their reversal are expected to result in future NOL carryforwards on the basis of the incremental economic benefit expected to be realized. Under this view, the US shareholder would determine the benefit of NOL carryforwards and DTAs based on the incremental cash tax savings on a with-and-without basis. An entity using a with-and-without approach may measure the expected benefit from its NOLs and DTAs as the difference between (1) the expected cash taxes considering the use of the NOL carryforwards and other DTAs, and (2) the expected cash taxes without considering the use of the NOL carryforwards and other DTAs. If the expected benefit from NOLs and DTAs is less than their carrying amounts, the entity may conclude a valuation allowance is necessary.

In our discussions with the FASB staff, the staff said both views have merit under ASC 740, and a company could elect an accounting policy to apply either view. The accounting policy would have to be applied consistently and, if the effect of the policy is material to the financial statements, it should be disclosed as a significant accounting policy. Any change to a company's initial policy election would be considered a voluntary accounting change subject to the guidance in ASC 250-10-45-2 (i.e., the entity would need to justify that the use of the allowable alternative accounting principle is preferable).

If a company elects to provide deferred taxes for GILTI

We also believe that a company that elects an accounting policy to provide deferred taxes related to GILTI could make similar policy elections when evaluating the realizability of federal NOL carryforwards and DTAs. However, a company that elects to account for deferred taxes related to GILTI will need to make sure that its accounting policy for evaluating the realizability of federal NOLs and DTAs is consistent with its conclusions for measuring GILTI-related deferred taxes.

SAB 118 considerations

We believe that under SAB 118, a company that has not yet finalized its accounting for the enactment-date effects of the Act and believes the GILTI ordering rules may affect the realizability of its DTAs should disclose that it has not yet finalized its assessment and that the amounts recorded are provisional. See section 9, *SEC guidance on accounting for US tax reform*, for further details on the SAB 118 measurement period.

6.1.2 SAB 118 considerations for GILTI provisions (updated 31 January 2018)

As noted in section 9, *SEC guidance on accounting for US tax reform*, the FASB staff concluded that a company can elect an accounting policy to account for GILTI in either of the following ways:

- As a period charge in the future period the tax arises
- As part of deferred taxes related to the investment or subsidiary

Questions have arisen about whether companies can "provisionally" elect a GILTI accounting policy under the guidance in SAB 118 and change their election during the SAB 118 measurement period. SAB 118 does not address changes to an elected accounting policy. Instead, it recognizes that companies may need time to analyze and assess the effects of the Act and allows them to record provisional amounts until they complete their accounting.

We understand that the SEC staff will not object to the following views:

- A company that records either a material provisional or final amount that reflects GILTI as a component of its deferred taxes has elected an accounting policy.
- If a company has elected to account for GILTI as part of deferred taxes (i.e., selected an accounting policy of recording GILTI as deferred taxes) but is still evaluating its accounting method for measuring those deferred tax amounts (i.e., recording GILTI taxes based on inside basis versus outside basis), it should disclose that its method for measuring GILTI is provisional and that method may be changed during the measurement period.
- When a company has not yet elected an accounting policy for GILTI during the SAB 118 measurement period, it should disclose that it is still evaluating the Act's GILTI provisions and has not yet elected an accounting policy.

- Once a company elects an accounting policy for GILTI, any change in that policy would be considered an accounting change that would be subject to ASC 250-10-45-2.

See Illustration 14 — *Disclosures a calendar year-end company might make in the period of enactment* regarding a company's GILTI accounting policy election and SAB 118.

6.1.2.1 *GILTI policy election during interim periods following the enactment date (updated 31 January 2018)*

Companies that have disclosed that they have not selected a GILTI accounting policy will also need to be mindful of how they consider GILTI in establishing the estimated annual effective tax rate (EAETR) in subsequent interim periods (e.g., the first quarter of 2018 for calendar year-end companies). A company that has not yet finalized its accounting policy for GILTI (i.e., determined whether to treat it as a period cost or as part of deferred taxes) should not compute its EAETR with GILTI as part of its deferred taxes. Consistent with the discussion in the section above, a company that calculates its EAETR including a significant effect from deferred tax balances triggered by GILTI has elected an accounting policy to treat GILTI as part of its deferred taxes.

6.2 Export incentive on foreign-derived intangible income

The law provides tax incentives to US companies to earn income from the sale, lease or license of goods and services abroad in the form of a deduction for foreign-derived intangible income (FDII). Foreign-derived intangible income is taxed at an effective rate of 13.125% for taxable years beginning after 31 December 2017 and 16.406% for taxable years beginning after 31 December 2025.

6.2.1 *Accounting considerations for the export incentive for foreign-derived intangible income*

We believe the accounting for the deduction for foreign-derived intangible income is similar to a special deduction and should be accounted for based on the guidance in ASC 740-10-25-37. The tax benefits for special deductions ordinarily are recognized no earlier than the year in which they are deductible on the tax return. See section 5.7, *Special deductions*, of our FRD on income taxes.

6.3 Tax on otherwise deductible payments to related foreign corporations

The Act establishes a tax on certain payments from corporations subject to US tax to related foreign persons, also referred to as base erosion payments. Base erosion payments generally include payments from a corporation to foreign related parties for any amounts that are deductible, including royalty payments or payments to acquire depreciable or amortizable property. Base erosion payments do not include payments for costs of goods sold, payments for certain qualified services and qualified derivative payments, if certain requirements are met.

Companies that meet certain thresholds are required to pay the new minimum base erosion and anti-abuse tax. The minimum BEAT is based on the excess of a percentage of the corporation's modified taxable income over its regular tax liability for the year reduced by certain credits, but the amount cannot be less than zero. The modified income is taxed at 5% in 2018, 10% in 2019 through 2025 and 12.5% for years beginning after 31 December 2025.

This provision generally applies to corporations that are subject to US net income tax with average annual gross receipts of at least $500 million and that have made related-party deductible payments totaling 3% (2% for banks and securities dealers) or more of the corporation's total deductions for the year. The BEAT is effective for base erosion payments paid or accrued in taxable years beginning after 31 December 2017.

6.3.1 *Accounting considerations for BEAT provisions (updated 24 January 2018)*

For companies that meet certain thresholds, the base erosion provision of the Act creates additional tax on net income by effectively excluding deductions on certain payments to foreign related entities.

Questions existed about whether this tax should be considered part of the regular US tax system, which would require the effects of the BEAT to be included in income tax in the period the tax arises, or a separate parallel tax regime. If the tax is determined to be part of a separate parallel tax regime, a question would arise about the appropriate tax rate to be applied in measuring certain US deferred taxes, including temporary differences existing on the enactment date, by entities subject to the BEAT regime (i.e., the new US corporate tax rate of 21% or the BEAT rate). In response to these questions, the FASB staff issued the following response in a Staff Q&A:

FASB Staff question and answer on the accounting for the base erosion anti-abuse tax

Question

Does the FASB staff believe that deferred tax assets and liabilities should be measured at the statutory tax rate of the regular tax system or the lower BEAT tax rate if the taxpayer expects to be subject to BEAT?

Response

The FASB staff believes that the BEAT is similar to the alternative minimum tax (AMT) under prior tax law. The AMT was a parallel tax system that resulted in a minimum level of corporate taxation in situations in which regular taxable income was lower than the alternative minimum taxable income due to "preference items" that were not deductible for AMT purposes. An entity that paid the AMT received a tax credit for the tax paid in excess of the amount computed on the basis of the regular tax system. An entity subject to the BEAT does not receive a tax credit for the tax paid in excess of the amount computed on the basis of the regular tax system, but the FASB staff believes that the BEAT is similar to the AMT in that it is designed to be an incremental tax in which an entity can never pay less, and may pay more, than their regular tax liability.

Paragraphs 740-10-30-11 and 740-10-55-32 address the AMT and require an entity to measure deferred taxes using the statutory tax rate under the regular tax system. Paragraph 740-10-30-11 states:

> *"…[I]t would be counterintuitive if the addition of alternative minimum tax provisions to the tax law were to have the effect of reducing the amount of an entity's income tax expense for financial reporting, given that the provisions of alternative minimum tax may be either neutral or adverse but never beneficial to an entity."*

Therefore, the FASB staff believes that an entity that is subject to BEAT should measure deferred tax assets and liabilities using the statutory tax rate under the regular tax system. The FASB staff believes that measuring a deferred tax liability at the lower BEAT rate would not reflect the amount an entity would ultimately pay because the BEAT would exceed the tax under the regular tax system using the 21 percent statutory tax rate.

Although an entity may believe that it expects to be subject to the BEAT for the foreseeable future, paragraph 740-10-30-11 further states that "no one can predict whether an entity will always be an alternative minimum tax taxpayer." The FASB staff believes that a similar conclusion could be applied to BEAT. In addition, taxpayers may take measures to reduce their BEAT exposure and, therefore, ultimately pay taxes at or close to the 21 percent statutory tax rate.

The FASB staff believes that the guidance in Topic 740 therefore indicates that the incremental effect of BEAT should be recognized in the year the BEAT is incurred. The staff also believes that an entity would not need to evaluate the effect of potentially paying the BEAT in future years on the realization of deferred tax assets recognized under the regular tax system because the realization of the deferred tax asset (for example, a tax credit) would reduce its regular tax liability, even when an incremental BEAT liability would be owed in that period. Regardless of any year-over-year effective tax rate fluctuations, the effective tax rate (excluding other permanent items) under this approach would always be equal to or in excess of the statutory tax rate of 21 percent.

See Appendix C for the full contents of the FASB Staff Q&A.

7 Effects of certain other key provisions

7.1 Changes to NOL carryback and carryforward rules (updated 16 January 2018)

The Act limits the amount taxpayers are able to deduct for NOL carryforwards generated in taxable years beginning after 31 December 2017 to 80% of the taxpayer's taxable income. The law also generally repeals all carrybacks for losses generated in taxable years ending after 31 December 2017. However, any NOLs generated in taxable years ending after 31 December 2017 can be carried forward indefinitely.

NOLs generated in taxable years ending after 31 December 2017	‣ Not eligible for carryback ‣ Eligible for indefinite carryforward
NOLs generated in taxable years beginning after 31 December 2017	‣ Usage limited to 80% of taxable income each year

7.1.1 Accounting implications of changes to NOL carryback and carryforward rules (updated 24 January 2018)

Companies need to reevaluate the realizability of any remaining NOL carryforwards (after appropriate remeasurement for the change in tax rates) after considering NOLs used to offset their transition tax, as discussed above. Further, a company that relies on projections of future taxable income when evaluating the realizability of existing deferred tax assets, including NOL and tax credit carryforwards, needs to consider whether other provisions of the Act will affect its ability to use NOLs in the future (e.g., the limitation on the use of an NOL created after 31 December 2017 to 80% of the taxable income in any year).

Companies applying the guidance in SAB 118 that have not completed the accounting for the effects of the Act but can determine a reasonable estimate of those effects on their NOL carryforwards should include a provisional amount based on their reasonable estimate in the financial statements. If they cannot make a reasonable estimate of the effects, companies should continue to apply ASC 740 and continue to account for their NOL carryforwards based on the provisions of the tax laws that were in effect immediately prior to enactment. See section 9, *SEC guidance on accounting for US tax reform*, below.

Companies need to consider other provisions in the law and how they may affect projections of future taxable income (e.g., interest limitations and expense deductibility discussed below) on valuation allowance conclusions.

It is not appropriate to assume deferred tax assets that will reverse in taxable years beginning after 31 December 2017 and will result in post-2017 NOLs will ultimately be realized simply because the related NOL does not expire. Similarly, NOLs that arise in taxable years beginning after 31 December 2017 also need to be evaluated for realizability, and the lack of an expiration date does not mean they are realizable. A valuation allowance for NOLs that do not expire, and deferred tax assets that will become that type of NOL, may still be necessary if, based on the weight of available evidence, it is more likely than not (likelihood of more than 50%) that the deferred tax asset will not be realized. See chapter 6, *Valuation allowances*, of our FRD on income taxes.

Naked credits

Because NOLs generated in taxable years beginning after 31 December 2017 can be carried forward indefinitely but are limited to 80% of taxable income in any year, questions have arisen about whether the reversal of taxable temporary differences related to indefinite-lived intangible assets (including tax-deductible goodwill) may be used as a source of future taxable income when assessing the realizability of these loss carryforwards. We believe it is appropriate for a company to consider the reversal of a taxable temporary difference from an indefinite-lived intangible asset as a source of future taxable income when assessing the realizability of loss carryforwards that do not expire when they are in the same jurisdiction and of the same character.

We also believe it is appropriate to consider the reversal of taxable temporary differences related to indefinite-lived intangible assets when assessing the realizability of deferred tax assets that upon reversal would give rise to NOLs that do not expire (i.e., NOLs that can be carried forward indefinitely). However, we understand that under an alternative view a company may have previously concluded that in certain jurisdictions it would not be appropriate to consider the future reversal of a taxable temporary difference associated with an indefinite-lived intangible asset (including tax-deductible goodwill) as the timing of recognition of the necessary taxable income cannot be predicted. We do not object to this alternative view, but also recognize that the significance of the change in tax law associated with the Act may lead companies to conclude that the most appropriate way to assess the realizability for NOLs under the Act that do not expire, and deferred tax assets that will reverse and become NOLs that do not expire, is to consider the reversal of temporary differences related to indefinite-lived intangible assets as a source of income to consider when evaluating their realizability.

For a company with NOL carryforwards that arose in a period prior to the change in NOL carryforward rules under the Act, we continue to believe it is not appropriate to consider the reversal of taxable temporary differences related to indefinite-lived intangible assets when evaluating the realizability of those NOLs. Companies with US federal NOLs generated prior to the effective date of the new NOL rules under the Act are required to apply those NOLs first (after applying the reversal of deductible temporary differences in that year) before utilizing NOLs created in taxable years ending after 31 December 2017. These companies may need to schedule expected usage of their NOLs in performing this analysis.

Illustration 7 — Assessing the realizability of deductible temporary differences that will reverse and generate NOLs with an indefinite carryforward

At 31 December 2017, an entity has deductible temporary differences of $500 and taxable temporary differences of $700. These temporary differences are ordinary in nature (no capital gains or losses) and are in the same jurisdiction. Assume the company is projecting that it will break even in 2018 and 2019 and have no pretax book income in the related jurisdiction. The deductible temporary differences are expected to reverse over the next two years and will generate NOLs with an indefinite carryforward. Also assume loss carryback is prohibited. The taxable temporary differences relate to indefinite-lived intangible assets. Assume the company is projecting no pretax book income in 2018 and 2019.

		Expected period of reversal	
	Balance as of 12/31/2017	**2018**	**2019**
Deductible temporary differences	$ 500	$ (250)	$ (250)
Taxable temporary differences (related to indefinite-lived intangible assets)	(700)	0	0
		$ (250)	$ (250)

In determining the realizability of the deductible temporary differences, the entity may consider the $700 of taxable temporary differences related to the indefinite-lived intangible assets that currently exist, subject to the limits on using NOLs discussed below.

Companies need to consider that the usage of NOLs generated in the example is limited to 80% of the annual taxable income when performing this analysis. For example, when the taxable temporary difference reverses in the future, the NOLs could offset up to 80% of that year's taxable income. Therefore, if the $700 of taxable temporary differences related to indefinite-lived intangibles reverses in the future and is the only source of taxable income in that year, an entity could use the NOL carryforwards up to $560 in that year (80% of $700). Because $560 is greater than the $500 of deductible temporary differences, the company may be able to conclude that those deductible temporary differences are realizable at 31 December 2017. See the *Consideration of the limits on usage of NOLs* section below for further discussion.

Consideration of the limits on usage of NOLs

The Act limits the amount taxpayers are able to utilize for NOL carryforwards generated in taxable years beginning after 31 December 2017 to 80% of the taxpayer's taxable income in any year. Companies that cannot rely on projections of future taxable income and rely on the reversal of taxable temporary differences as a source of future taxable income should carefully consider the reversal pattern of temporary differences when evaluating the realizability of deferred tax assets. A company may need to schedule the reversal of its temporary differences when performing this evaluation.

Illustration 8 — Limits on usage of NOLs

At 31 December 2017, Company A has $1,200 of deductible temporary differences and $1,200 of taxable temporary differences. These temporary differences are ordinary in nature (no capital gains or losses). The deductible and taxable temporary differences are expected to reverse over the next three and four years, respectively, starting in 2018. When they reverse, a portion of the deductible temporary differences will create NOLs with an indefinite carryforward but the usage of these NOLs is limited to 80% of the taxpayer's taxable income. Also assume loss carryback is prohibited. Assume that for each year presented, the company breaks even and has no pretax book income, the company cannot rely on its projections of taxable income and there are no available tax planning strategies. For purposes of this illustration, assume all of Company A's NOLs are subject to limitations (e.g., no NOL carryforwards exist at 31 December 2017).

Company A assesses the realizability of its deductible temporary differences as of 31 December 2017, and schedules the reversal of its existing taxable temporary differences as follows:

	Balance at 12/31/2017	**2018**	**2019**	**2020**	**2021**
Deductible temporary differences	$ 1,200	$ (400)	$ (400)	$ (400)	$ -
Taxable temporary differences	(1,200)	300	300	300	300
Taxable income (loss)		$ (100)	$ (100)	$ (100)	$ 300
NOL used subject to limit of 80% of current-year taxable income		N/A	N/A	N/A	240
NOL carryforward generated		(100)	(100)	(100)	-
Cumulative NOL carryforward		(100)	(200)	(300)	(60)

In 2021, Company A uses a portion of its NOL carryforwards that is limited to 80% of that year's taxable income, or $240. Based on this analysis, even though Company A has $1,200 of taxable temporary differences at 31 December 2017, it can consider only $1,140 ($300 in each year from 2018 to 2020 and $240 in 2021) of the taxable temporary differences as a source of future taxable income when assessing the realizability of its deductible temporary differences. As a result, Company A recorded a valuation allowance of $13 ($60 x 21% tax rate).

How we see it

Companies should consider the effects of changes to NOL carryback and carryforward rules, including the new limits on using NOLs, on the realizability of their deferred tax assets and NOL and tax credit carryforwards. This may require companies to perform more precise scheduling or additional scheduling of the reversal of temporary differences than they have in the past. Non-calendar year-end companies may need to perform additional analysis regarding the realizability of their deferred tax balances.

7.2 Repeal of the corporate alternative minimum tax

The corporate alternative minimum tax was repealed. Taxpayers with AMT credit carryovers can use the credits to offset regular tax liability for any taxable year. In addition, the AMT credit is refundable in any taxable year beginning after 2017 and before 2022 in an amount equal to 50% (100% in the case of taxable years beginning in 2021) of the excess of the minimum tax credit for the taxable year over the amount of the credit allowable for the year against regular tax liability. Thus, a taxpayers' entire AMT credit carryforward amounts are fully refundable by 2022.

7.2.1 Accounting implications of AMT repeal (updated 24 January 2018)

How we see it

We believe it would be appropriate for a company to either continue to classify AMT credits along with its other deferred tax balance or reclassify credits that are expected to be refundable in future periods to an income tax receivable. If AMT credits are significant, a company should disclose in the notes to its financial statements how it classified the AMT credits.

We understand that questions existed about whether it is appropriate to discount a receivable for amounts refundable and how to classify the related accretion. In response to these questions, the FASB staff issued the following response in a Staff Q&A:

FASB Staff question and answer on whether to discount alternative minimum tax credits that become refundable

Question

Does the FASB staff believe that AMT credit carryforwards should be discounted at December 31, 2017, because they will be refundable in future years?

Response

The FASB staff notes that paragraph 740-10-30-8 prohibits discounting deferred taxes. Accordingly, any AMT credit carryforwards presented as a deferred tax asset would not be discounted. Likewise, the FASB staff believes that any AMT credit carryforward presented as a receivable should not be discounted because the staff does not believe that Subtopic 835-30 on the imputation of interest applies.

The guidance in Subtopic 835-30 addresses the accounting for business transactions that often involve the exchange of cash or property, goods, or services for a note or similar instrument. Subtopic 835-30 is premised on the fact that when a note is exchanged for property, goods, or services in a bargained transaction entered into at arm's length, the interest rate should represent fair and adequate compensation to the supplier. The FASB staff believes that the AMT credit carryforward is not the result of a bargained transaction and that the scope exception in paragraph 835-30-15-3(e) for transactions where interest rates are affected by tax attributes or legal restrictions prescribed by a governmental agency (such as, income tax settlements) would apply.

The FASB staff notes that paragraph 740-10-50-3 requires an entity to disclose the amounts of tax credit carryforwards for tax purposes. The staff believes this disclosure would apply whether an entity presents the AMT credit carryforward as a deferred tax asset or a receivable and would provide useful information to investors in evaluating the amount that is to be utilized or refunded.

See Appendix C for the full contents of the FASB Staff Q&A.

Since AMT credits can either be credited against future income or refunded, a company that previously recorded a full valuation allowance against its AMT credits will need to reevaluate realizability.

7.3 Interest expense deduction limits

The law limits the deduction for net interest expense that exceeds 30% of the taxpayer's adjusted taxable income (ATI) for that year. ATI is computed initially excluding depreciation, amortization or depletion (approximating earnings before interest, taxes, depreciation and amortization) and includes these items beginning in 2022 (approximating earnings before interest and taxes).

The Act permits an indefinite carryforward of any disallowed business interest. This provision applies to taxable years beginning after 31 December 2017 and provides exceptions to the interest limitation for companies with gross receipts not exceeding $25 million.

7.3.1 Accounting implications of interest expense deduction limits (updated 8 February 2018)

Going forward, companies with interest limited under the new law will have to assess the realizability of any resulting deferred tax assets for interest carried forward. A company whose interest deduction is already limited may not be able to realize the benefits of amounts carried forward. This is because the annual limitation on deductions for interest expense will also apply in future years, and it applies to not only the interest expense incurred in those future years but also to the utilization of any amounts carried forward.

While the resulting deferred tax asset can be carried forward indefinitely, companies may be prevented from considering the full reversal of an indefinite-lived intangible asset as a source of future income when assessing the realizability of disallowed business interest carryforwards due to the limitation on the amount of net interest a company can deduct in an annual period. For example, if a company recorded a $1,000 deferred tax asset related to interest carryforwards and a $2,000 deferred tax liability related to an indefinite-lived intangible asset, as a result of the taxable income limitation on the deduction of interest, the company could only consider $600 ($2,000 x 30%) as a source of future taxable income from the reversal of the deferred tax liability. See section 7.1, *Changes to NOL carryback and carryforward rules*, for further discussion on using the reversal of an indefinite-lived intangible asset as a source of future income.

In addition, if a company is relying on projections of future taxable income, it will also need to consider the effects of the limitations in its projections of future taxable income, including any projections of future interest expense, as it does for other originating temporary differences.

7.4 Immediate expensing

Companies are able to claim bonus depreciation to accelerate the expensing of the cost of certain qualified property acquired and placed in service after 27 September 2017 and before 1 January 2024. For the first five-year period (through 2022), companies can deduct 100% of the cost of qualified property. During the period starting in 2023, the additional bonus depreciation is gradually phased out by 20% each year through 2027.

Companies need to implement processes to identify eligible capital expenditures and revise tax depreciation to properly measure deferred tax liabilities related to qualified property.

7.4.1 Accounting implications of immediate expensing

Companies need to carefully determine the appropriate rate to apply when calculating their deferred taxes and current taxes at the enactment date when claiming the bonus depreciation. Given the retroactive nature of this provision, a calendar year-end company should record deductions in the 2017 current tax provision calculation at 35%, while measuring the related deferred tax liability at the newly enacted rate.

7.5 Limit on employee remuneration

The Act expanded the number of individuals whose compensation is subject to a $1 million cap on deductibility under Section 162(m) and includes performance-based compensation such as stock options and stock appreciation rights in the calculation.

Until now, a public company has been able to deduct up to $1 million of compensation paid to covered employees consisting of the chief executive officer and the next three highest compensated officers (but not the chief financial officer (CFO)). However, the limit didn't apply to performance-based compensation.

The new law expands the definition of covered employees to include the CFO and any individual who has been considered a covered employee, even if that individual is no longer a covered employee. Thus, once an individual is a covered employee, the deduction limitation applies to compensation paid to that individual at any point in the future, including after a separation from service. Any individual who is a covered employee for a tax year after 31 December 2016 will remain a covered employee for all future years. The law also eliminates the exception for performance-based compensation.

The provision generally applies to taxable years beginning after 31 December 2017 and provides a transition for compensation paid pursuant to a written binding contract that is in effect on 2 November 2017. Companies will need to carefully review the terms of their compensation plans and agreements to assess whether they are considered to be written binding contracts in effect on 2 November 2017.

7.5.1 Accounting implications of limits on employee remuneration

Companies need to evaluate the effect of these changes on their deferred tax assets in the period of enactment as well as the effect on their effective tax rate.

7.6 Tax method changes

In certain cases, the Act requires companies to change their tax accounting methods for revenue recognition to conform with their financial reporting methods. The law generally requires a taxpayer to recognize revenue no later than the taxable year in which it is recognized in the taxpayer's financial statements. As a result, a company will automatically conform its tax method with its book method for all revenue items recognized sooner under the book method. This provision is effective for years beginning after 31 December 2017. See section 8.7, *Changes in tax accounting method*, of our FRD on income taxes.

7.7 Restriction or elimination of exclusions, deductions and credits

The Act repeals or limits deductions for amounts previously deductible (beginning in 2018 unless otherwise noted), including:

- Repeals the Section 199 domestic production deduction (see section 5.7.1, *Domestic production activities deduction*, of our FRD on income taxes)
- Creates additional restrictions on deductions for meals and entertainment
- Reduces the allowable deduction against the dividends received from a domestic corporation other than certain small businesses or those treated as "qualifying dividends" from 70% to 50%, and from 80% to 65% for dividends received from 20% owned corporations
- Extends the amortization period of research and experimental expenses incurred in the US to five years and for expenses incurred outside the US to 15 years, beginning in years after 2021
- Eliminates the deductibility of payments made or incurred to a government after 22 December 2017 in connection with the violation of a law, except for restitution payments to come into compliance with the law and amounts subject to a binding agreement as of the enactment date, meaning deferred tax assets related to the accrual of such settlements may need to be adjusted at the enactment date
- Eliminates the deductibility of payments made for settlements of certain harassment suits, meaning any deferred tax amounts related to accruals for potential settlements before the enactment date will need to be adjusted

Companies applying SAB 118 should include a provisional amount based on a reasonable estimate of the effects of these provisions in their financial statements. If they cannot make a reasonable estimate of the effects they should continue to apply ASC 740 based on the provisions of the tax laws that were in effect immediately prior to enactment. See section 9, *SEC guidance on accounting for US tax reform*, below.

8 Special considerations for non-calendar year-end companies

8.1 Effects of a lower corporate income tax rate for non-calendar year-end companies — blended rate (updated 16 January 2018)

Based on language in the Act, non-calendar year-end companies might conclude that the 21% corporate tax rate would be effective in the first taxable year beginning on or after 1 January 2018. However, existing tax law,[10] which was not amended by the Act, governs when a change in tax rate is effective. The tax law provides that if the taxable year includes the effective date of any rate changes (unless the effective date is the first day of the taxable year), taxes should be calculated by applying a blended rate to the taxable income for the year. To compute the blended rate, a company calculates the weighted average tax rate based on the ratio of days in the fiscal year prior to and after enactment.

Illustration 9 — Blended rate

Assume Company A has a fiscal year ending 30 June 2018. To determine its blended rate, Company A calculates an average tax rate weighted based on the ratio of days in the fiscal year prior to and after the enactment date, as follows:

Days prior to enactment	184
Days after enactment	181
Total days	365

	Percentage of days at that rate	Weighted average tax rate
Tax based on 35% tax rate	50.41%	17.65%
Tax based on 21% tax rate	49.59%	10.41%
Blended rate for the year ended 30 June 2018		28.06%

Company A's blended tax rate for its year ended 30 June 2018 is 28.06%.

As explained above, the blended rate does not depend on a company's taxable income for the period and therefore can be calculated using only its fiscal year end. The following table lists the blended rates based on certain fiscal 2018 year-end dates. Companies with periods ending on dates other than the end of the month will need to determine their blended tax rate based on their specific fiscal year end.

Fiscal year ending on	Blended rate	Fiscal year ending on	Blended rate
31 January 2018	33.81%	31 July 2018	26.87%
28 February 2018	32.74%	31 August 2018	25.68%
31 March 2018	31.55%	30 September 2018	24.53%
30 April 2018	30.40%	31 October 2018	23.34%
31 May 2018	29.21%	30 November 2018	22.19%
30 June 2018	28.06%	31 December 2018	21.00%

ASC 740-10-50-12 requires a public company to disclose a reconciliation of the reported amount of income tax expense attributable to continuing operations for the year to the amount of income tax expense that would result from applying the domestic federal statutory tax rate to pretax income from continuing operations.

[10] Internal Revenue Code, Section 15 *Effect of changes.*

How we see it

We believe the blended rate calculated as described in this section is the appropriate domestic federal statutory tax rate for non-calendar year-end companies to use in their rate reconciliation.

8.2 Accounting considerations related to deferred tax assets and liabilities for non-calendar year-end companies

Companies with a non-calendar year end may face additional complexities in calculating their deferred tax assets and liabilities at the enactment date and determining the appropriate rate to use. These companies need to schedule when temporary differences are expected to reverse to apply the appropriate rate. Temporary differences reversing during the fiscal year that includes the enactment date should be remeasured using the blended rate described in section 8.1, *Effects of a lower corporate income tax rate for non-calendar year-end companies — blended rate*, above. Temporary differences reversing after that fiscal year should be remeasured at the new 21% rate.

Estimating temporary differences as of the most recent quarter end (e.g., 31 December) for purposes of remeasuring deferred tax amounts at the enactment date is often adequate with appropriate consideration of significant adjustments between the enactment date and the quarter end. However, if the enactment date is not near the beginning or end of a reporting period, companies need to estimate temporary differences as of the enactment date (i.e., estimate temporary differences (to the extent significant) using a short-period tax return or estimate that temporary differences will be generated and reverse ratably or will be generated in the same period as the financial reporting income occurs during the year). Since non-calendar year-end companies do not typically estimate the reversal of temporary differences during interim periods, they may require additional effort to determine the effect on their temporary differences at the enactment date.

The effects of a change in tax laws or rates on deferred tax assets or liabilities should be recognized as a discrete event as of the enactment date and should not be allocated to subsequent interim periods by an adjustment of the estimated annual effective tax rate.

For a company that is applying the guidance in SAB 118, the remeasurement of deferred tax balances should be recorded in the period of enactment if it can complete its accounting or a reasonable estimate can be made. If a company cannot complete its accounting or make a reasonable estimate, it should continue to account for its deferred taxes based on the provisions of the tax laws that were in effect immediately prior to enactment. See section 9, *SEC guidance on accounting for US tax reform*, below.

8.3 Non-calendar year-end interim reporting considerations (updated 24 January 2018)

Non-calendar year-end companies also need to consider the effects of the tax rate change on interim reporting if the enactment date is in an interim period. Under ASC 740-270-25-5, the tax effect of a change in tax laws or rates on taxes currently payable or refundable for the current year must be recorded after the effective dates prescribed in the statutes and reflected in the EAETR beginning no earlier than the first interim period that includes the enactment date of the new legislation. In addition, the implementation guidance in ASC 740-270-55-49 and 50 indicates that the effect of new legislation would not be reflected until it is effective or administratively effective.

ASC 740 indicates that tax legislation may prescribe changes that become effective during an entity's fiscal year that are administratively implemented by applying a portion of the change to the full fiscal year. Existing tax law provides that if the taxable year includes the effective date of any rate changes (unless the effective date is the first day of the taxable year), taxes should be calculated by applying a blended rate to the taxable income for the entire year. The tax rate changes thus are administratively effective on the enactment date.

In addition, a non-calendar year-end company may need to consider temporary differences that originate or reverse between the enactment and the end of its fiscal year when estimating its EAETR. Since these temporary difference will affect the current-year income tax payable at the non-calendar year-end company's blended rate and the related deferred tax will be measured at the new 21% corporate income tax rate at the end of the year, the effects of this rate differential should be considered in computing the EAETR.

8.3.1 Accounting for the effects of rate change on EAETR

The effects of new tax law legislation on taxes currently payable must be recognized in the period of enactment with allocation to earlier or later interim periods prohibited. See sections 8.1, *Changes in tax laws and rates*, and 15.1.2, *Changes in tax laws, rates or tax status*, of our FRD on income taxes.

Illustration 10 — Effects of rate change on EAETR

Assume that for the full fiscal year, an entity with a 30 June year end anticipates ordinary taxable income of $100,000. All income is taxable in one jurisdiction at a 35% rate. All anticipated transactions will have tax consequences.

New legislation enacted in the second quarter of the entity's fiscal year reduces the tax rate to 21%. The new tax rate is administratively effective as of the beginning of the company's fiscal year. The new legislation is administratively implemented by applying a portion of the change to the full fiscal year. As a result, the entity revises its EAETR computation using the appropriate blended rate as described above.

Tax at statutory rate ($100,000 at 28.06%)	$ 28,060

The effect of the new legislation is not reflected until it is effective or administratively effective. Accordingly, quarterly tax computations are as follows:

	Ordinary income		Tax			
Reporting period	**Quarter**	**Year to date**	**EAETR**	**Year to date**	**Less previously reported**	**Reporting period**
Q1	$ 20,000	$ 20,000	35.00%	$ 7,000	$ -	$ 7,000
Q2	20,000	40,000	28.06%	11,224	7,000	4,224
Q3	20,000	60,000	28.06%	16,836	11,224	5,612
Q4	40,000	100,000	28.06%	28,060	16,836	11,224
	$ 100,000					$ 28,060

8.3.2 Accounting for changes in provisional amounts

For companies that are applying the guidance in SAB 118 during an interim period of enactment, the accounting for the effects of certain aspect of the Act may be incomplete. Until a company can complete its analysis, it may not be able to determine the effects certain aspects of the Act may have on its tax provision. See section 9, *SEC guidance on accounting for US tax reform*, below.

8.4 Non-calendar year-end transition tax considerations

The portion of E&P comprising cash and other specified assets is taxed at a 15.5% rate, and any remaining amount is taxed at an 8% rate, as discussed in section 4, *One-time transition tax*, above. To determine the aggregate foreign cash position of the US shareholder, cash is measured on the following three dates:

- Date 1 — The close of the last taxable year beginning before 1 January 2018
- Date 2 — The close of the last taxable year that ends before 2 November 2017
- Date 3 — The close of the taxable year preceding Date 2

The aggregate foreign cash position for a US taxpayer is the greater of the foreign cash position determined as of Date 1 or the average of the foreign cash position determined as of Date 2 and Date 3. For example, a company with a 30 September fiscal year end, Dates 1, 2 and 3 would fall on 30 September 2018, 2017 and 2016 respectively.

Because a company with non-calendar year-end CFCs may not be able to determine the aggregate foreign cash position until the CFC completes its 2018 fiscal year, a company needs to consider whether the amounts recognized for its one-time transition tax payable can be completed earlier than that date. Companies applying SAB 118 may need to consider the disclosure requirements until they can complete their analysis of the one-time transition tax payable.

The tax effect of the one-time transition tax should be recognized as a discrete event as of the enactment date (or, if the company is applying SAB 118, in the period when a reasonable estimate can be made) and should not be allocated to subsequent interim periods by adjusting the EAETR.

8.5 Non-calendar year-end entities' interim disclosures

For financial reporting purposes, ASC 740 requires disclosure of the effect of adjustments to deferred tax amounts for enacted changes in tax laws or rates as well as, for interim periods, the effect of the change in the estimated annual effective rate. See section 18.4, *Disclosure of changes in tax laws or rates*, of our FRD on income taxes.

Illustration 11 — Disclosure example for a 30 June year-end company

In the second quarter, the Company revised its estimated annual effective rate to reflect a change in the federal statutory rate from 35% to 21%, resulting from legislation that was enacted on 22 December 2017. The rate change is administratively effective at the beginning of our fiscal year, using a blended rate for the annual period. As a result, the blended statutory tax rate for the year is 28.06%.

In addition, we recognized a tax benefit in our tax provision for the period related to adjusting our deferred tax balance to reflect the new corporate tax rate. As a result, income tax expense reported for the first six months was adjusted to reflect the effects of the change in the tax law and resulted in a decrease in income tax expense of $400,000 during the second quarter. This amount comprises a reduction of $100,000 in income tax expense for the six-month period ended 31 December 2017 related to the lower corporate rate and $300,000 from the application of the newly enacted rates to existing deferred balances.

The accounting for the effects of the rate change on deferred tax balances is complete and no provisional amounts were recorded for this item.

Note: If the company also recorded provisional amounts, additional disclosure would be required by SAB 118. See section 11, *Disclosures*, below for an example disclosure for the period of enactment.

9 SEC guidance on accounting for US tax reform (updated 16 January 2018)

The SEC staff issued SAB 118[11] to provide guidance for companies that have not completed their accounting for the income tax effects of the Act in the period of enactment. The SEC staff noted that ASC 740 doesn't address these challenges and said a clarification was needed to address uncertainty or diversity in views about the application of ASC 740 in the period of enactment.

FASB Staff question and answer on whether private companies and not-for-profit entities can apply SAB 118

Question

Given the longstanding practice of private companies electing to apply SABs, would the FASB staff object to private companies and not-for-profit entities applying SAB 118?

Response

Based upon the longstanding practice of private companies electing to apply SABs, the FASB staff would not object to private companies and not-for-profit entities applying SAB 118. If a private company or not-for-profit entity applies SAB 118, they would be in compliance with GAAP.

The FASB staff believes, however, that if a private company or a not-for-profit entity applies SAB 118, it should apply all relevant aspects of the SAB in its entirety. This would include the disclosures listed in SAB 118. The FASB staff also believes that a private company or a not-for-profit entity that applies SAB 118 should disclose its accounting policy of applying SAB 118 in accordance with paragraphs 235-10-50-1 through 50-3 of the Accounting Standards Codification

See Appendix B for the full contents of the FASB Staff Q&A.

Excerpt from SAB 118

Applicability

This staff guidance is only applicable to the application of ASC Topic 740 in connection with the Act and should not be relied upon for purposes of applying ASC Topic 740 to other changes in tax laws.

SAB 118 provides the following guidance:

- **Accounting for income tax effects is completed —** When reporting the effects of the Act on the enactment date, a company must first reflect in its financial statements the income tax effects of the Act for which the accounting under ASC 740 is complete. These completed amounts will not be provisional amounts.
- **Accounting for income tax effects is incomplete but the company has a reasonable estimate** — If a company's accounting for certain income tax effects of the Act is incomplete but it can determine a reasonable estimate of those effects, the SEC staff said that it will not object to a company including the reasonable estimate in its financial statements. The staff said it would not be appropriate for a company to exclude a reasonable estimate

[11] SAB 118, *Income Tax Accounting Implications of the Tax Cuts and Jobs Act*.

from its financial statements if one had been determined. The reasonable estimate should be included in a company's financial statements in the first reporting period in which a company is able to determine the estimate. The estimate would be reported as a provisional amount in the financial statements[12] during a "measurement period."[13] Provisional amounts could include, for example, reasonable estimates that give rise to new current or deferred taxes based on certain provisions of the Act, as well as adjustments to current or deferred taxes that existed prior to the Act's enactment date.

- **Accounting for income tax effects is incomplete and the company doesn't have a reasonable estimate** – If a company does not have the necessary information to determine a reasonable estimate to include as a provisional amount, the SEC staff said that it would not expect a company to record provisional amounts in its financial statements for the income tax effects for which a reasonable estimate cannot be determined. In these cases, the SEC staff said a company should continue to apply ASC 740 (e.g., when recognizing and measuring current and deferred taxes) based on the provisions of the tax laws that were in effect immediately prior to enactment. That is, the staff does not believe a company should adjust its current or deferred taxes to account for the income tax effects of the Act until the first reporting period in which a reasonable estimate can be determined.

How we see it

The Act's one-time transition tax requires companies that have deferred recognizing income taxes on certain foreign earnings and profits earned in prior periods (i.e., asserted indefinite reinvestment) to now pay income taxes on those earnings. If a company previously asserted indefinite reinvestment, we believe the company could continue to follow its existing accounting until it has the necessary information to determine a reasonable estimate for the transition tax.

Excerpt from SAB 118

Question 1: If the accounting for certain income tax effects of the Act is not completed by the time Company A issues its financial statements that include the reporting period in which the Act was enacted, what amounts should Company A include in its financial statements for those income tax effects for which the accounting under ASC Topic 740 is incomplete?

Interpretive Response: To the extent that Company A's accounting for certain income tax effects of the Act is incomplete, but Company A can determine a reasonable estimate for those effects, the staff would not object to Company A including in its financial statements the reasonable estimate that it had determined. Conversely, the staff does not believe it would be appropriate for Company A to exclude a reasonable estimate from its financial statements to the extent a reasonable estimate had been determined. The reasonable estimate should be included in Company A's financial statements in the first reporting period in which Company A was able to determine the reasonable estimate. The reasonable estimate would be reported as a provisional amount in Company A's financial statements during a "measurement period". The measurement period is described in further detail below.

The staff believes reporting provisional amounts for certain income tax effects of the Act will address circumstances in which an entity does not have the necessary information available, prepared, or analyzed (including computations) in reasonable detail to complete

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[12] The SEC staff also said it would not object to a foreign private issuer reporting under IFRS applying a measurement period solely for purposes of completing the accounting requirements for the income tax effects of the Act under International Accounting Standard 12, *Income Taxes*.

[13] SAB 118 says, "The staff was informed, in part, by the measurement period guidance applied in certain situations when accounting for business combinations under ASC Topic 805, *Business Combinations*. The measurement period guidance in ASC paragraph 805-10-25-13 addresses situations where the initial accounting for a business combination is incomplete upon issuance of the financial statements that include the reporting period the business combination occurred."

the accounting under ASC Topic 740.

An entity may not have the necessary information available, prepared, or analyzed (including computations) for certain income tax effects of the Act in order to determine a reasonable estimate to be included as provisional amounts. The staff would expect no related provisional amounts would be included in an entity's financial statements for those specific income tax effects for which a reasonable estimate cannot be determined. In circumstances in which provisional amounts cannot be prepared, the staff believes an entity should continue to apply ASC Topic 740 (e.g., when recognizing and measuring current and deferred taxes) based on the provisions of the tax laws that were in effect immediately prior to the Act being enacted. That is, the staff does not believe an entity should adjust its current or deferred taxes for those tax effects of the Act until a reasonable estimate can be determined.

Therefore, to summarize the above and for the avoidance of doubt, in Company A's financial statements that include the reporting period in which the Act was enacted, Company A must first reflect the income tax effects of the Act in which the accounting under ASC Topic 740 is complete. These completed amounts would not be provisional amounts. Company A would then also report provisional amounts for those specific income tax effects of the Act for which the accounting under ASC Topic 740 will be incomplete but a reasonable estimate can be determined. For any specific income tax effects of the Act for which a reasonable estimate cannot be determined, Company A would not report provisional amounts and would continue to apply ASC Topic 740 based on the provisions of the tax laws that were in effect immediately prior to the Act being enacted. For those income tax effects for which Company A was not able to determine a reasonable estimate (such that no related provisional amount was reported for the reporting period in which the Act was enacted), Company A would report provisional amounts in the first reporting period in which a reasonable estimate can be determined.

9.1 SAB 118 and subsequent event considerations (updated 16 January 2018)

We have received questions about whether companies need to update provisional amounts through the date the financial statements are issued or are available to be issued.

How we see it

While SAB 118 does not address this question, we believe it is appropriate for a company to record provisional amounts based on the information available through the date it closes its books, unless it identifies a significant error. We believe that significant errors need to be corrected in the current period.

Under this approach, any changes to provisional amounts that would result from a company obtaining additional information or analyzing information after it closes its books but before it issues its financial statements or makes them available to be issued would be recorded in the next reporting period. We believe a company that has identified significant unrecorded adjustments between the date it closes its books and the date it issues its financial statements should consider disclosing the pending adjustments.

9.2 Measurement period

The measurement period begins in the reporting period that includes the Act's enactment date and ends when a company has obtained, prepared and analyzed the information needed to complete the accounting requirements under ASC 740. The measurement period should not extend beyond one year from the enactment date (i.e., the measurement period must be completed by 22 December 2018). During the measurement period, the staff said it expects companies to act in good faith to complete the accounting under ASC 740.

Excerpt from SAB 118

The measurement period begins in the reporting period that includes the Act's enactment date and ends when an entity has obtained, prepared, and analyzed the information that was needed in order to complete the accounting requirements under ASC Topic 740. During the measurement period, the staff expects that entities will be acting in good faith to complete the accounting under ASC Topic 740. The staff believes that in no circumstances should the measurement period extend beyond one year from the enactment date.

A company should carefully evaluate the Act prior to reaching the conclusion that its accounting for the enactment-date effects of the Act is complete. Appendix A includes some of the considerations a company should evaluate, along with questions management should ask itself before reaching the conclusion that its accounting is complete.

9.3 Initial and subsequent reporting of provisional amounts

Any provisional amounts or adjustments to provisional amounts included in a company's financial statements during the measurement period (including the period of enactment) should be included in income from continuing operations as an adjustment to tax expense or benefit in the reporting period the amounts are determined.

During the measurement period, a company may need to reflect adjustments to its provisional amounts if it obtains, prepares or analyzes additional information about facts and circumstances that existed as of the enactment date that, if known, would have affected the income tax effects initially reported as provisional amounts. A company may also need to report additional tax effects during the measurement period that were not initially reported as provisional amounts, if it obtains, prepares or analyzes additional information about facts and circumstances that existed as of the enactment date. While SAB 118 allows a company to make changes to provisional amounts during the measurement period, a company may still need to evaluate whether those changes result from obtaining additional information about the facts that existed on the enactment date or are a result of errors. This evaluation should be made based on the guidance in ASC 250.[14]

As discussed throughout this publication, several of the provisions of the Act could affect a company's DTA realizability assessment. A company should disclose that its valuation allowance is provisional until the accounting for all provisions that could affect the conclusion is complete.

Any income tax effects of events unrelated to the Act should not be reported as measurement period adjustments. Hence, companies will need to make sure they have procedures in place to distinguish between changes to provisional amounts that are related to the Act and transactions entered into after the enactment date. For example, a company may enter into a business combination after the enactment date. The tax accounting consequences of the business combination, including the effects on a company's pre-business combination tax attributes (e.g., realizability of deferred tax assets) will need to be considered separately from any changes in provisional amounts related to the accounting for the tax consequences of the Act.

SAB 118 does not address the accounting effects of the Act in interim periods.

[14] ASC 250, *Accounting changes and error corrections*.

How we see it

- We believe that, if a company is unable to estimate the effects of certain aspects of the Act on its estimated annual effective rate, the company should make disclosures describing what part of the Act the company did not consider in calculating its estimated annual effective tax rate. Because companies can make reasonable estimates or adjust those estimates, the effect of those changes should be included in the first interim period that those estimates can be made (or can be adjusted) as an adjustment to the estimated annual effective tax rate.
- We also believe the effects of initially recording provisional amounts related to the enactment date of the Act and making adjustments to those amounts, if significant, should be recognized as a discrete event similar to the accounting for tax law changes in the period of enactment. Accordingly, companies should not allocate the effect of changes in the enactment-date provisional amounts to subsequent interim periods by adjusting the EAETR.

Excerpt from SAB 118

Changes in subsequent reporting periods

During the measurement period, an entity may need to reflect adjustments to its provisional amounts upon obtaining, preparing, or analyzing additional information about facts and circumstances that existed as of the enactment date that, if known, would have affected the income tax effects initially reported as provisional amounts. Further, an entity may also need to report additional tax effects during the measurement period, based on obtaining, preparing, or analyzing additional information about facts and circumstances that existed as of the enactment date that was not initially reported as provisional amounts. Any income tax effects of events unrelated to the Act should not be reported as measurement period adjustments.

Reporting

Any provisional amounts or adjustments to provisional amounts included in an entity's financial statements during the measurement period should be included in income from continuing operations as an adjustment to tax expense or benefit in the reporting period the amounts are determined.

SAB 118 does not specify how a company should determine whether it can make a reasonable estimate. A company will need to determine whether a reasonable estimate can be made based on its facts and circumstances. This includes the availability of records to complete the necessary calculations, technical analysis of the new tax law and finalization of its accounting analysis, including its assessment of how certain provisions of the Act may affect its outside basis differences related to foreign subsidiaries.

To help companies with their accounting during the measurement period, SAB 118 provides the following examples. Each example assumes the company has only one foreign subsidiary. A company that has more than one foreign subsidiary may reach different conclusions for each subsidiary, depending on the facts and circumstances, including the availability of information necessary to complete the analysis.

Excerpt from SAB 118

Example 1 — Analysis is incomplete and company cannot reasonably estimate provisional amounts

Prior to the reporting period in which the Act was enacted, Company X did not recognize a deferred tax liability related to unremitted foreign earnings because it overcame the presumption of the repatriation of foreign earnings.[15]

Upon enactment, the Act imposes a tax on certain foreign earnings and profits at various tax rates. Based on Company X's facts and circumstances, it was not able to determine a reasonable estimate of the tax liability for this item for the reporting period in which the Act was enacted by the time that it issues its financial statements for that reporting period; that is, Company X did not have the necessary information available, prepared, or analyzed to develop a reasonable estimate of the tax liability for this item (or evaluate how the Act will impact Company X's existing accounting position to indefinitely reinvest unremitted foreign earnings).

As a result, Company X would not include a provisional amount for this item in its financial statements that include the reporting period in which the Act was enacted, but would do so in its financial statements issued for subsequent reporting periods that fall within the measurement period, beginning with the first reporting period falling within the measurement period by which the necessary information became available, prepared, or analyzed in order to develop the reasonable estimate, and ending with the first reporting period within the measurement period in which Company X was able to obtain, prepare, and analyze the necessary information to complete the accounting under ASC 740.

Excerpt from SAB 118

Example 1a — Analysis is incomplete and company can reasonably estimate provisional amounts

Assume a similar fact pattern as Example 1; however, Company Y was able to determine a reasonable estimate of the income tax effects of the Act on its unremitted foreign earnings for the reporting period in which the Act was enacted.

Company Y, therefore, reported a provisional amount for the income tax effects related to its unremitted foreign earnings in its financial statements that included the reporting period the Act was enacted. In a subsequent reporting period within the measurement period, Company Y was able to obtain, prepare and analyze the necessary information to complete the accounting under ASC 740, which resulted in an adjustment to Company Y's initial provisional amount to recognize its tax liability.

Excerpt from SAB 118

Example 2 — Analysis is incomplete and company may need to recognize a valuation allowance

Company Z has deferred tax assets (assume Company Z was able to comply with ASC Topic 740 and re-measure its deferred tax assets based on the Act's new tax rates) for which a valuation allowance may need to be recognized (or released) based on application of certain provisions in the Act.

If Company Z determines that a reasonable estimate cannot be made for the reporting period [in which] the Act was enacted, no amount for the recognition (or release) of a valuation allowance would be reported.

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[15] ASC 740-30-25-17.

In the next reporting period (following the reporting period in which the Act was enacted), Company Z was able to obtain, prepare and analyze the necessary information in order to determine that no valuation allowance needed to be recognized (or released) in order to complete the accounting under ASC 740.

We developed the following example of another situation that might arise.

Illustration 12 — Analysis is incomplete and company can reasonably estimate provisional amounts related to the one-time transition tax but cannot reasonably estimate tax effects of remaining outside basis difference

Facts

Assume a similar fact pattern to Example 1, but assume that Company W was able to determine a reasonable estimate of the income tax effects of the Act on its unremitted foreign earnings for the reporting period in which the Act was enacted as it relates to the one-time transition tax (i.e., the tax due based on accumulated earnings and after 1986).

Company W did not have the necessary information available, prepared or analyzed to develop a reasonable estimate of the tax liability, if any, for its remaining outside basis difference as well as any other current or deferred tax accounting that may be required for foreign earnings subject to the transition tax. In addition, remaining outside basis differences may have deferred tax consequences due to other provisions in the Act.

Analysis

Company W reported a provisional amount for the income tax effects of the one-time transition tax in its financial statements that included the reporting period the Act was enacted. In a subsequent reporting period within the measurement period, Company W was able to obtain, prepare and analyze the necessary information to complete the accounting under ASC 740 for the one-time transition tax, and Company W adjusted the provisional amount it had previously reported to recognize its tax liability.

Company W was not able to determine a reasonable estimate of the tax liability, if any, under the Act for its remaining outside basis difference (or evaluate how the Act will affect Company W's existing accounting position to indefinitely reinvest unremitted foreign earnings) by the time it issued its financial statements for the reporting period in which the Act was enacted. As a result, Company W would not include a provisional amount for this item in its financial statements for the reporting period in which the Act was enacted, but would do so in its financial statements issued for subsequent reporting periods that fall within the measurement period, beginning with the first reporting period in the measurement period in which the necessary information became available, prepared or analyzed so Company W could develop the reasonable estimate, and ending with the first reporting period in the measurement period in which Company W was able to obtain, prepare and analyze the necessary information to complete the accounting under ASC 740.

9.4 Investment companies affected by the Act

The SEC's Division of Investment Management issued guidance in IM Information Update 2017-07 in which the SEC staff confirmed that investment companies can rely on SAB 118 for purposes of calculating their net asset value (NAV) and reporting measurement period adjustments. The SEC staff also reminded investment companies to make disclosures, where applicable, about any material effects of the Act on their NAV calculations and information about material provisions for which the accounting is incomplete. Such disclosures could be made in a press release, on a website or in another reasonable manner.

10 Other effects

10.1 Investments in qualified affordable housing projects accounted for using the proportional amortization method

Investors in qualified affordable housing projects that meet certain conditions can elect to use the proportional amortization method to account for their investment. In applying the proportional amortization method, an investor amortizes the cost of its investment in proportion to the tax credits and other tax benefits it receives and presents the amortization as a component of income tax expense. Investors in these projects receive tax benefits in the form of tax deductions from operating losses and low-income housing tax credits over a 10-year period.

Under the proportional amortization method, an investment shall be tested 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. An impairment loss is measured as the amount by which the carrying amount of the investment exceeds its fair value. While ASC 323-740 does not address how an impairment loss should be presented, we believe that it should be included as a component of income tax expense from continuing operations. Previously recognized impairment losses cannot be reversed.

Although the Act does not change existing tax law for low-income housing tax credits, investors in these projects will need to consider the effects of the reduction in the corporate tax rate to 21% from 35% when applying the proportional amortization method. Companies should first consider whether it is more likely than not that the carrying amount of the investment will not be realized. If events or changes in circumstances indicate that it is more likely than not that the carrying amount of the investment will not be realized, an impairment would be recorded. If a company concludes that the investment is not impaired, it should revise its proportional amortization schedule to reflect the revised expected future tax benefits from the remaining tax credits and the lower corporate tax rate. The reduction in the corporate rate will likely reduce the expected tax benefits during the remaining investment period.

How we see it

ASC 323-740-35 does not provide guidance on how to account for the effects of a change in a tax rate during the investment period when the investment is not impaired. We believe one acceptable approach is to record a "cumulative catch-up" adjustment to the proportional amortization balance so that it reflects the remaining tax benefits at the new rate. Consistent with the guidance in ASC 323-740-45-2, the catch-up charge should be recognized in the income statement as a component of income tax expense from continuing operations. There may be other acceptable ways to account for the effects of a tax rate change.

10.2 Tax effects of intercompany asset transfers prior to the enactment of the Act

Transactions may occur among entities that are part of a consolidated reporting entity. In accordance with ASC 810-10-45-1, intercompany balances and transactions are eliminated in the preparation of the consolidated financial statements. However, income tax consequences may result from intra-entity transactions. Companies may have entered into intra-entity transfers of assets prior to the Act's enactment date and deferred the taxes paid or accrued on the intra-entity profit that is eliminated in consolidation in accordance with ASC 810-10-45-8. Prepaid (accrued) taxes arising from intercompany transactions are different from deferred taxes under ASC 740. Since prepaid (accrued) taxes on intercompany transactions are attributable to taxes paid (incurred) on prior transactions, the reversal of those amounts will generally not be subject to the new tax laws or rates and, therefore, are generally not subject to remeasurement due to a change in tax rate or law.

A company with a non-calendar year end will need to consider the Act's new corporate tax rates by applying a blended tax rate retroactively to the beginning of its 2018 fiscal year (see section 8, *Special considerations for non-calendar year-end companies*). These companies will need to consider the effects of using a blended tax rate and adjust the related prepaid or accrued income taxes from intercompany transfers arising in fiscal 2018 in the reporting period that includes the enactment date.

In 2016, the FASB issued ASU 2016-16, *Intra-Entity Transfers of Assets Other Than Inventory*. ASU 2016-16 requires companies to recognize the income tax effects of intra-entity transfers of assets, other than inventory, in the period the sale or transfer occurs. Unless a company early adopted the ASU, the ASU is effective for annual periods beginning after 15 December 2017 for PBEs and one year later for all other entities. Companies that have not yet adopted the ASU prior to the Act's enactment date first need to account for the tax effects of the Act prior to considering the tax consequences of ASU 2016-16 on their deferred tax balances.

10.3 Leveraged leases

For companies with existing leveraged leases, the Act may require the recognition of an additional adjustment in the reporting period that includes 22 December 2017. Income tax rates are an important assumption in determining the rate of return on a leveraged lease. If tax rates change, all components of a leveraged lease must be recalculated from inception of the lease. That is, lessors must recalculate the allocation of income on the leveraged lease based on after-tax cash flows as revised for the change in tax rates.

If a lessor considered the effects of the AMT in its assumptions, it must also consider the effects of AMT being repealed. The difference between the amounts originally recorded and the recalculated amount would be included as a cumulative catch-up in pretax income. Additionally, if the effect of the change in tax rates results in a significant variation from the customary relationship between income tax expense and pretax accounting income and the reason for that variation is not otherwise apparent, the reason for that variation should be disclosed.

10.4 Business combinations (updated 18 January 2018)

10.4.1 Acquisitions before the enactment date

New information about the facts and circumstances that existed at the acquisition date for tax positions acquired in or that arose from a business combination may result in an adjustment to goodwill during the business combination measurement period. However, a change in tax rate after the business combination occurred would not result in a business combination measurement period adjustment. That is, a change in income tax position attributable to a change in tax law, including the remeasurement of deferred tax balances or a change in the assessment of realizability of acquired deferred tax assets, should be recognized in income tax expense attributable to continuing operations.

Questions have arisen about how to account for the tax effects of changes to a company's preliminary purchase accounting made during the ASC 805 measurement period but after the enactment date. We believe that ASC 805 measurement period adjustments should consider the tax effects based on the law in place at the acquisition date. That is, the deferred tax effects from ASC 805 measurement period adjustments would first be measured using the tax rate as of the acquisition date (e.g., 35%). A second adjustment would be recorded to adjust those deferred tax balances to the new tax rate under the Act (e.g., 21%). The second adjustment would be recorded as a component of income tax expense attributable to continuing operations.

Illustration 13 —Accounting for a business combination that occurred before the enactment date

Assume that a company entered into a business combination on 1 September 2017. At that date, the company did not finalize its accounting for intangible assets and expects to finalize its accounting during the ASC 805 measurement period. On the date of the acquisition, the company recorded a provisional amount of $1 million for the fair value of its intangible assets. Assume that the tax basis is zero. At the date of the acquisition, the company would have recorded a $350,000 deferred tax liability for the book and tax basis difference, with an offsetting adjustment to goodwill (based on the tax law in effect on that date).

The company records the following journal entries on 1 September 2017 to recognize the intangible asset and related tax effects:

Dr. Intangible assets	1,000,000	
Cr. Goodwill		1,000,000
Dr. Goodwill	350,000	
Cr. Deferred tax liabilities		350,000

On 22 December 2017, the new tax law was enacted and it reduced the tax rate to 21%. The company reduces the deferred tax liability associated with the acquired intangible asset by $140,000, with the offsetting adjustment to income tax expense.

The company records the following journal entry on 22 December 2017:

Dr. Deferred tax liabilities	140,000	
Cr. Income tax expense		140,000

On 1 May 2018, the company finalizes its accounting under ASC 805 for the intangible assets and increases the business combination provisional amount by $100,000. The company records the following entries to record the ASC 805 measurement period adjustment and related deferred tax effects based on the tax law that was in place at the acquisition date:

Dr. Intangible assets	100,000	
Cr. Goodwill		100,000
Dr. Goodwill	35,000	
Cr. Deferred tax liabilities		35,000

Also on 1 May 2018, the company would adjust the deferred tax liability to reflect the effects of the new tax rate on the final adjustment:

Dr. Deferred tax liability	14,000	
Cr. Income tax expense		14,000

10.4.2 Acquisitions after the enactment date

If a business combination occurs after the enactment date, the acquirer may recognize provisional amounts associated with income tax assets and liabilities in accordance with ASC 805-740. These amounts may include an estimate for the effects of the new tax law. We believe that changes to provisional amounts resulting from new information about the facts and circumstances that existed at the acquisition date, including additional information about estimates related to the new tax law, should be recognized as measurement period adjustments under ASC 805 rather than under SAB 118.

10.5 Goodwill impairment testing (updated 18 January 2018)

Many companies performed their annual goodwill impairment testing on a date prior to the enactment date that fell within the reporting period that includes the enactment date (e.g., a 1 October 2017 annual goodwill impairment assessment date for a calendar year-end company). Questions have arisen about whether the effect of US tax reform should be considered in performing annual goodwill impairment testing during the quarter that includes the enactment date when the annual goodwill impairment testing date precedes the enactment date.

The annual goodwill impairment test, including the determination of fair value, should be based on the facts and circumstances that existed as of the annual assessment date and should consider market participant assumptions at that date. If the annual goodwill assessment date occurred prior to the 22 December 2017 date of enactment, the fair value analysis would include market participant assumptions related to income taxes that existed as of that date. The valuation would consider the uncertainty that existed on the annual testing date about whether tax reform would be enacted and should not factor in the hindsight of ultimate enactment.

When an event occurs or circumstances change between annual tests that indicate it is more likely than not that the fair value of a reporting unit is below its carrying amount, companies are required to perform an interim goodwill impairment test. We believe the enactment of the new tax law is an event that companies should consider when determining whether an interim goodwill impairment test is necessary (i.e., it may be an impairment indicator). Companies should evaluate the effects of the Act on the carrying amount and fair value of a reporting unit to determine whether it is more likely than not that the fair value of a reporting unit is below its carrying amount. For example, the carrying amount of a reporting unit may change when a company remeasures its deferred tax assets and liabilities under the Act. Similarly, the fair value of a reporting unit may change, depending on whether the assumptions used to measure fair value change as a result of the Act. Judgment will be required to determine whether an interim goodwill impairment test should be performed.

10.6 After-tax hedging of foreign currency risk (updated 31 January 2018)

Companies that designate hedges of foreign currency risk on an after-tax basis will need to consider whether the Act affects the hedging arrangement. For example, for companies that assert indefinite reinvestment of a net investment in a foreign subsidiary under ASC 740 and enter into net investment hedges, it is common to designate the hedging instrument on an after-tax basis in order to compensate for the nontaxable nature of the translation gain or loss that results from the net investment.

In these situations, companies will need to consider how the change in tax rates will affect the hedging relationship, including whether the hedge remains highly effective or whether any ineffectiveness after the enactment date needs to be recorded in earnings if the company has not yet adopted ASU 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*.

We understand that the SEC staff would not object to a registrant concluding that the enactment of the Tax Cuts and Jobs Act on 22 December 2017 does not cause these hedging relationships to no longer be highly effective in the period of enactment. However, we also understand that the SEC staff would expect registrants that did not yet adopt ASU 2017-12 to recognize in earnings any material ineffectiveness related to these hedging relationships that resulted from the Act for the period from 22 December 2017 to 31 December 2017. We also understand that the SEC staff would not expect registrants to apply these views to reporting periods after the one that includes the enactment date or to hedging relationships designated or redesignated on or after 22 December 2017.

Given that the provisions in the Act can affect both the amount of a foreign net investment eligible to be hedged and the tax-effected gains and losses on the hedging instrument, companies should assess their original hedging relationships to determine whether to dedesignate and redesignate new hedging relationships in the first assessment period after the enactment date. Companies need to consider not only the reduction in US corporate income tax rates but how the BEAT and GILTI provisions of the Act may affect their effective tax rates when redesignating or entering into new net investment hedges. The shift to a territorial tax system may also affect a company's ongoing use of after-tax hedging strategies.

10.7 Annual pension and other postretirement benefit plans

Companies that have defined pension and other postretirement benefit plans need to consider the effects of the new corporate tax rates on deferred tax balances related to these plans. Companies that are performing their annual measurement of pension and other postretirement benefits as of 31 December 2017 should first calculate the tax effect of enactment on their pension and postretirement benefit deferred tax balances on the enactment date. The tax effect of a remeasurement of existing deferred taxes should be recorded in income tax expense.

The tax effect of a change in the benefit obligation resulting from a company's annual remeasurement or any remeasurement performed after the enactment date that is recorded in OCI would also be recorded in OCI (using the new 21% rate). If the change in benefit obligation resulting from a remeasurement is recorded in income, the tax effect would also be recorded in income.

10.8 Share-based payments (updated 16 January 2018)

10.8.1 Accounting considerations for withholding taxes

The IRS requires employers to withhold and remit tax on income generated when an employee exercises a nonqualified stock option or when stock awards vest. Companies often repurchase shares equal in value to the tax owed and remit the cash on behalf of the employee to satisfy the tax withholding requirements. ASU 2016-09,[16] which was effective for PBEs for fiscal years beginning after 15 December 2016, amended ASC 718 to allow entities to withhold up to the maximum statutory tax rate in the employee's jurisdiction, instead of the minimum tax rate required by the IRS, without causing liability classification of the award.

Because the Act reduces the maximum federal statutory tax rate to 37% from 39.6% and the minimum federal statutory rate to 22% from 25%, companies should reduce the applicable tax withholding rates to continue to avoid liability classification for the related awards. Companies should verify that they are withholding amounts in accordance with the 2018 IRS income tax withholding tables that were issued on 11 January 2018, regardless of whether they outsource their payroll and related tax responsibilities to third-party service providers or perform these processes in-house.

10.8.2 Accounting considerations for performance conditions based on after-tax metrics

Companies that have issued awards with performance conditions based on after-tax metrics (e.g., earnings per share, net income) should consider the effect of the Act on the probability that the performance condition will be met. For example, vesting in an award with a performance condition may have been assessed as improbable prior to the enactment of the Act. However, as a result of the reduced corporate income tax rate, the vesting may be probable. The effect of the change in estimate of an award's probability of vesting should be accounted for in the period of change by recording a cumulative catch-up adjustment to compensation cost to retroactively apply the new estimate.

[16] ASU 2016-09, *Improvements to Employee Share-Based Payment Accounting*.

Companies may modify the terms and conditions of awards with performance conditions based on after-tax metrics to remove the effects of the Act, as they often do for unanticipated events. Companies that make this type of change will apply the modification accounting guidance in ASC 718-20 for adjustments to awards resulting from the application of the Act.

See section 5.2.6, *Broker-assisted cashless exercises and statutory withholding requirements*, section 4.4.2.3, *Changes in estimate of the probability of achievement of the performance condition*, and section 8.4, *Modifications of vesting conditions*, in our FRD publication, *Share-based payment*, for more guidance on these topics.

10.9 Non pro-rata profit and loss allocations among investors (updated 8 February 2018)

Investees or subsidiaries may have contractual profit-sharing arrangements that allocate earnings or losses among the investors (e.g., an equity method investor) in amounts that differ from the investors' pro-rata ownership interests. When these arrangements are substantive, the profit-sharing provisions should be used to allocate earnings and losses to investors.

One approach applied in practice to account for substantive profit-sharing arrangements is the hypothetical-liquidation-at-book-value (HLBV) method. The use of this approach is appropriate when the terms of the substantive profit-sharing arrangement are consistent with the HLBV calculation. See section 6.7, *Equity method investments and joint ventures*, of our FRD publication, and section 16.1.1, *Consolidation*, of our FRD for more guidance on assessing whether a profit-sharing arrangement is substantive and the HLBV method.

The substantive profit-sharing arrangement may refer to a target internal rate of return (IRR) or preferential return to allocate earnings or losses. If the IRR or preferential return is stated on an after-tax basis, generally the terms of the arrangement will specify the tax rate to be applied. When determining equity method income or losses, or allocating income or losses to the non-controlling interest, it is important to obtain an understanding of the terms and conditions of the specific arrangement.

When the terms of the arrangement refer to the tax rate in effect when the benefits are delivered, we believe the tax rate in effect at the date HLBV is applied should be used. For example, an investor that applies HLBV to a calendar year-end investee to determine its share of the investee's earnings or losses for the period ending 31 December 2017 would use the tax rate in effect on that date because the investor would assume the investee was liquidated on that date (rather than the rate in effect as of 1 January 2018). If the terms of the arrangement require a fixed tax rate to be used (e.g., 35%), the fixed tax rate would be used in an investor's application of HLBV to determine its share of an investee's earnings or losses.

A company that uses HLBV to allocate profits and losses of a subsidiary to a noncontrolling interest or to measure its equity method earnings in an investee may be required by the agreement to use the new tax rate in the HLBV calculation covering the periods in which the new rate is effective (i.e., 1 January 2018). If using the new corporate tax rate is expected to materially change the allocation as compared to prior periods and could change the company's results in the future, it should consider disclosing the nature of the event and an estimate of its financial effect, or disclose that such an estimate cannot be made, in accordance with ASC 855.[17]

[17] ASC 855, *Subsequent Events*.

10.10 Fair value measurements (updated 16 January 2018)

The Act may have immediate and long-term implications for valuations of businesses, equity interests and other assets and liabilities (e.g., intangible assets). Companies should review their fair value estimates and consider whether and, if so, how the Act has affected a market participant's view of fair value.

The implications may go beyond the change in the assumed tax rate. Changes in the calculation of taxable income, which may be affected by the industry and location of a company's operations, should also be considered. For this reason, companies that use an income approach will need to carefully model and appropriately support the changes in taxable income due to the Act. It might also be appropriate for a company to use a market approach, such as using a market multiple based on public company stock prices for comparable companies (e.g., a price to earnings ratio), because these prices should reflect a market participant view of fair value as of the measurement date. While the tax rate for most companies is expected to drop, how a company is affected will depend on its facts and circumstances.

Companies should make a good faith effort to estimate fair value based on the market participant view using available information that is known or knowable to a market participant as of the measurement date. The overall objective of a fair value measurement is to reflect the price a market participant would pay for the asset or receive to assume the liability on the measurement date, assuming customary and normal due diligence. As such, it is possible that the market participant assumptions will evolve in subsequent periods when the market has had more time to fully assess the effects of the Act.

10.11 Equity method impairment considerations (updated 18 January 2018)

An equity method investor should evaluate whether the effects of tax reform indicate that its investment is impaired in accordance with ASC 323-10-35-31 through 35-32A. Investors should evaluate whether the effects of tax reform have reduced the fair value of its investment below its carrying amount. The determination of fair value should consider all facts and circumstances at the measurement date, including market participants' assumptions about enacted tax rates and other effects of tax reform. If the fair value is less than the carrying amount of the equity method investment, the investor evaluates whether the impairment is other than temporary. An investor's determination of whether any indicated impairment is other than temporary will depend on the facts and circumstances. See section 6.8 of our FRD on equity method investments and joint ventures for guidance on assessing other-than-temporary impairment of an equity method investment.

10.12 Treasury regulations (updated 4 October 2018)

We expect the US Treasury Department and the IRS to issue notices and regulations clarifying provisions of the Act. When a company is applying the provisions of SAB 118, they will likely only finalize the recognition of the effects of specific aspects of the Act when they are able to apply a reasonable interpretation of the law. Adjustments to provisional amounts will occur during the measurement period as a company gains a better understanding of how the law operates, and, in some cases, that clarification may come through the issuance of tax notices or regulations. However, adjustments identified due to clarifications of tax law from notices or regulations issued after the measurement period ends or when a company has completed its enactment date accounting for the related provisions of the Act would be evaluated under the guidance for accounting for uncertainty in income taxes in ASC 740 or a change in tax law depending on the type of regulation that is issued. In other words, once the accounting is final, a company will no longer be able to adjust its provisional amounts and will need to evaluate the effects of any Treasury Department actions on its existing tax positions. Companies should continue to monitor regulatory developments.

10.12.1 US Treasury Department and IRS notices (updated 4 October 2018)

The US Treasury Department and the IRS have begun issuing tax guidance on some of the provisions enacted on 22 December 2017. The new guidance includes Notice 2018-07 (29 December 2017), Notice 2018-13 (19 January 2018), Rev. Proc. 2018-17 (13 February 2018), Notice 2018-26 (2 April 2018), Frequently Asked Questions (FAQs, posted 13 March 2018 and updated on 13 April 2018 and 4 June 2018) and proposed Section 965 regulations (1 August 2018) that provide additional guidance on computing the transition tax under the Act. On 13 September 2018, the US Treasury Department proposed Section 951A regulations regarding the GILTI regime.

Notice 2018-07 clarifies the tax treatment of distributions made during the inclusion year and provides that any foreign exchange gain or loss recognized in the future from the distribution of amounts subject to the mandatory inclusion will be subject to the lower effective tax rate (i.e., 15.5% or 8%).

Notice 2018-07 and 2018-13 clarify the definition of cash for purposes of measuring amounts of E&P deemed to be cash, and Notice 2018-13 describes the appropriate foreign exchange rates to use when translating E&P and cash amounts on the measurement dates. Notice 2018-26 clarifies that an election to not use losses to offset the mandatory E&P inclusion applies to losses generated in the inclusion year as well as loss carryovers.

The proposed Section 965 regulations provide rules related to the transition tax described in Notices 2018-07, 2018-13 and 2018-26, with certain modifications, as well as additional guidance, including additional rules for determining the foreign tax credit consequences of the transition tax and providing a tax basis adjustment election to the stock of certain foreign corporations.

The proposed Section 951A regulations provide additional guidance regarding the GILTI included in the gross income of US shareholders. While the proposed regulations provide important guidance on fundamental elements underlying the GILTI inclusion, the proposed regulations do not provide guidance on deemed paid foreign taxes in connection with the GILTI inclusion amount. We expect the US Treasury Department to address that guidance in a package of foreign tax credit regulations later this year. The preamble to the proposed regulations states, "It is anticipated that the proposed regulations relating to foreign tax credits will provide rules for assigning the section 78 gross-up attributable to foreign taxes deemed paid under section 960(d) to the separate category described in section 904(d)(1)(A)." That section is the GILTI category of income, which is important for purposes of calculating a company's foreign tax credit limitations (the GILTI basket).

ASC 740-10-25-7(b) introduces the concept of administrative practice in dealing with a particular tax position. The administrative practice concept is intended to deal with limited technical violations of the tax law for which there is a broad understanding in practice that the taxing authority will not take issue with a company's position or limit the scope of the issue. Given the language in the preamble, we believe that it is reasonable for a company to take the position that the Section 78 gross-up for deemed paid foreign taxes in connection with a GILTI inclusion amount is assigned to the GILTI basket for purposes of computing its foreign tax credit limitation. However, until final regulations are issued addressing the categorization of the deemed foreign taxes on a GILTI inclusion, we believe it is also acceptable for companies to take an alternate approach such as categorizing the gross-up as a general limitation income or allocating the gross-up between categories of taxable income (e.g., between the GILTI and general limitation categories) in accordance with existing principles for the allocation and apportionment of taxes to separate categories of income.

If a notice or regulation (including a proposed regulation) is released after the date a company closed its books but before it issues its financial statements, we do not believe a company that has accounted for the provisions of the Act as provisional under SAB 118 would be required to adjust the provisional amounts in its current financial statements. However, a company should consider disclosing the effect of significant adjustments related to any new guidance that is issued but not yet reflected in the company's financial statements. See section 9.1, *SAB 118 and subsequent event considerations*, for additional considerations during the SAB118 measurement period and section 16, *End of SAB 118 measurement period accounting considerations*, for accounting and disclosure considerations for periods after the end of the SAB 118 measurement.

10.13 Other considerations

Companies also need to consider:

- The effect of the tax law change on previously recorded federal, state and foreign unrecognized tax benefits and assessment of uncertain tax positions as well as related recognition, measurement and disclosure requirements
- Any effects related to existing deferred state tax amounts
- Assessment of any deferred tax assets for realizability
- The potential effect on other accounting assumptions that incorporate a company's US tax rate

11 Disclosures (updated 8 February 2018)

ASC 740 requires companies to disclose the effect of adjustments to deferred tax amounts for enacted changes in tax laws or rates. Companies also need to carefully consider how other aspects of the Act, such as the one-time transition tax, may affect each of the income tax disclosures required under ASC 740. Companies also need to consider whether their accounting policy to account for the effects of the GILTI provisions of the Act is significant and disclose it if it is. ASC 235[18] requires entities to disclose accounting policies that materially affect the determination of their financial position, cash flows or results of operations.

In addition to the disclosures required by ASC 740, SAB 118 requires companies to disclose information about the material financial reporting effects of the Act for which the accounting under ASC 740 is incomplete, including:

- Qualitative information about the income tax effects of the Act for which the accounting is incomplete
- The items reported as provisional amounts
- Existing current or deferred tax amounts for which the income tax effects of the Act have not been completed
- The reason the initial accounting is incomplete
- The additional information that needs to be obtained, prepared or analyzed to complete the accounting requirements under ASC 740
- The nature and amount of any measurement period adjustments recognized during the reporting period

SAB 118 also requires companies to disclose the following information about material financial reporting effects of the Act, which companies will likely disclose in financial reporting periods after the period in which the Act was enacted:

- The effect of measurement period adjustments on the effective tax rate
- Disclosures of when the accounting for the income tax effects of the Act has been completed

The following illustration highlights disclosure that the enactment date accounting is incomplete for certain items at the financial statement reporting date. The actual disclosure a company will need to make may be different from this illustration depending on the specific items for which a company's enactment date accounting is incomplete. See Appendix A for additional items a company may need to consider when evaluating the disclosures required by SAB 118.

Illustration 14 — Disclosures a calendar year-end company might make in the period of enactment about incomplete accounting

A calendar year-end company that has not yet completed its accounting might make the following disclosures in the notes to its financial statements for the period ended 31 December 2017.

[18] ASC 235-10-50-3, *Notes to Financial Statements — Disclosure — What to Disclose*.

This is a simple example that addresses only federal income tax effects and doesn't reflect other disclosures required by ASC 740. Depending on its facts and circumstances, a company will need to provide more information. Disclosures should be sufficiently detailed for a reader to understand the status of a company's accounting for the tax effects of the Act (i.e., effects for which the accounting is complete, effects for which the accounting is incomplete but a reasonable estimate can be made, and effects for which the accounting is incomplete and no provisional amounts have been recorded) and the additional information needed to complete the accounting under ASC 740. In many cases, a company's calculation will be subject to further refinement as additional analysis is completed and as the company gains a more thorough understanding of the tax law, and this possibility should be disclosed.

Example disclosure:

The Tax Cuts and Jobs Act was enacted on 22 December 2017. The Act reduces the US federal corporate tax rate from 35% to 21%, requires companies to pay a one-time transition tax on earnings of certain foreign subsidiaries that were previously tax deferred and creates new taxes on certain foreign sourced earnings. At 31 December 2017, we have not completed our accounting for the tax effects of enactment of the Act; however, in certain cases, as described below, we have made a reasonable estimate of the effects on our existing deferred tax balances and the one-time transition tax. In other cases, we have not been able to make a reasonable estimate and continue to account for those items based on our existing accounting under ASC 740, *Income Taxes*, and the provisions of the tax laws that were in effect immediately prior to enactment. For the items for which we were able to determine a reasonable estimate, we recognized a provisional amount of $XXXX, which is included as a component of income tax expense from continuing operations. In all cases, we will continue to make and refine our calculations as additional analysis is completed. In addition, our estimates may also be affected as we gain a more thorough understanding of the tax law.

Provisional amounts

Deferred tax assets and liabilities: We remeasured certain deferred tax assets and liabilities based on the rates at which they are expected to reverse in the future, which is generally 21%. However, we are still analyzing certain aspects of the Act and refining our calculations, which could potentially affect the measurement of these balances or potentially give rise to new deferred tax amounts. The provisional amount recorded related to the remeasurement of our deferred tax balance was $XXX.

<u>Foreign tax effects</u>

One-time transition tax: The one-time transition tax is based on our total post-1986 earnings and profits (E&P) that we previously deferred from US income taxes. We recorded a provisional amount for our one-time transition tax liability for XX of our foreign subsidiaries, resulting in an increase in income tax expense of $XXX. We have not yet completed our calculation of the total post-1986 E&P for these foreign subsidiaries. Further, the transition tax is based in part on the amount of those earnings held in cash and other specified assets. This amount may change when we finalize the calculation of post-1986 foreign E&P previously deferred from US federal taxation and finalize the amounts held in cash or other specified assets. No additional income taxes have been provided for any remaining undistributed foreign earnings not subject to the transition tax, or any additional outside basis difference inherent in these entities, as these amounts continue to be indefinitely reinvested in foreign operations. Determining the amount of unrecognized deferred tax liability related to any remaining undistributed foreign earnings not subject to the transition tax and additional outside basis difference in these entities (i.e., basis difference in excess of that subject to the one-time transition tax) is not practicable, but the related cumulative temporary difference as of 31 December 2017 was $XX.

We have not made sufficient progress on the E&P analysis for the remaining XX of our foreign subsidiaries to reasonably estimate the effects of the one-time transition tax and, therefore, have not recorded provisional amounts. We continued to apply ASC 740 based on the provisions of the tax laws that were in effect immediately prior to the Act being enacted. Because we had previously determined these amounts were indefinitely reinvested, no deferred taxes have been recorded. It is impracticable to determine unrecognized deferred tax liabilities related to these entities, but the cumulative temporary difference as of 31 December 2017 was $XX.

Global intangible low-taxed income:

A company that has not determined its GILTI accounting policy

The Act subjects a US shareholder to tax on global intangible low-taxed income (GILTI) earned by certain foreign subsidiaries. The FASB Staff Q&A, Topic 740, No. 5, *Accounting for Global Intangible Low-Taxed Income*, states that an entity can make an accounting policy election to either recognize deferred taxes for temporary basis differences expected to reverse as GILTI in future years or provide for the tax expense related to GILTI in the year the tax is incurred. Given the complexity of the GILTI provisions, we are still evaluating the effects of the GILTI provisions and have not yet determined our accounting policy. At 31 December 2017, because we are still evaluating the GILTI provisions and our analysis of future taxable income that is subject to GILTI, we are unable to make a reasonable estimate and have not reflected any adjustments related to GILTI in our financial statements.

A company that has determined its GILTI accounting policy and recorded a material deferred tax liability

The Act subjects a US shareholder to current tax on global intangible low-taxed income (GILTI) earned by certain foreign subsidiaries. The FASB Staff Q&A, Topic 740, No. 5, *Accounting for Global Intangible Low-Taxed Income*, states that an entity can make an accounting policy election to either recognize deferred taxes for temporary basis differences expected to reverse as GILTI in future years or provide for the tax expense related to GILTI in the year the tax is incurred. We have elected to recognize deferred taxes for temporary differences expected to reverse as GILTI in future years. However, given the complexity of the GILTI provisions, we have not finalized our analysis of GILTI. We were able to make a reasonable estimate of the deferred taxes on the temporary differences expected to reverse in the future and provided a provisional deferred tax liability of $XXX at 31 December 2017.

Disclosure of the methodology used for measuring deferred taxes associated with GILTI:

The provisional amount is based on the evaluation of certain temporary differences inside each of our foreign subsidiaries that are expected to reverse as GILTI. However, as we continue to evaluate the Act's GILTI provisions during the measurement period, we may revise the methodology used for determining the deferred tax liability associated with GILTI.

Or

The provisional amount is based on the evaluation of the outside basis difference of our foreign subsidiaries that are expected to reverse as GILTI. However, as we continue to evaluate the Act's GILTI provisions during the measurement period, we may revise the methodology used for determining the deferred tax liability associated with GILTI.

> ***A company that has determined that its accounting policy will be to record GILTI in the period the tax is incurred***
>
> The Act subjects a US shareholder to current tax on global intangible low-taxed income (GILTI) earned by certain foreign subsidiaries. The FASB Staff Q&A, Topic 740 No. 5, *Accounting for Global Intangible Low-Taxed Income*, states that an entity can make an accounting policy election to either recognize deferred taxes for temporary differences expected to reverse as GILTI in future years or provide for the tax expense related to GILTI in the year the tax is incurred. We have elected to recognize the tax on GILTI as a period expense in the period the tax is incurred.

11.1 Additional SEC disclosure considerations (updated 18 January 2018)

When the effects of the tax law changes are or will be material to a registrant, the registrant should consider the disclosure implications in preparing its management's discussion and analysis (MD&A) under Item 303 of Regulation S-K, including its discussion of results of operations and liquidity and capital resources.

The remeasurement of deferred tax assets and liabilities, recording the one-time transition tax and any reassessment of the realizability of deferred tax assets may have a material effect on many registrants' tax provisions.

In addition, the Act will likely result in changes to a registrant's effective tax rates in future periods. When disclosing results of operations, registrants should disclose and explain the effect of the new tax law on the 2017 tax provision as well as the expected effects on the effective tax rate in future years.

Registrants' MD&A must consider any material liquidity implications of paying the required one-time transition tax. Registrants should also include their one-time transition tax liability in the table of contractual obligations based on the estimated installments and describe any related uncertainties.

The SEC staff has historically requested that registrants disclose the amount of cash held overseas that is unavailable for use domestically if the registrant has asserted it will indefinitely reinvest foreign earnings. Registrants may revisit their permanently reinvested assertions about foreign earnings in light of the tax law changes and should update liquidity and capital resources disclosures in MD&A, taking into account the additional funds that would be available to meet the needs of domestic operations net of transition tax payments.

Additionally, the SEC expects registrants to tell investors in MD&A about critical accounting policies, which are the most important methods, assumptions and estimates underlying the financial statements and those that require the most difficult, subjective and complex judgments. Registrants should consider whether their accounting policy to account for the effects of the GILTI provisions of the Act should be included in the critical accounting policy discussion in MD&A.

11.2 Form 8-K reporting considerations

The SEC staff issued Compliance and Disclosure Interpretation (C&DI) 110.02 in response to questions it has received from companies regarding whether the remeasurement of a DTA to reflect the new tax rates or other provisions of the Act would trigger an obligation to file a Form 8-K under Item 2.06, Material Impairments. The C&DI states that the remeasurement of a DTA to reflect the effect of a change in tax rate or tax laws is not an impairment under ASC 740 and wouldn't trigger the reporting requirement. However, the enactment of new tax rates or tax laws could have financial reporting implications, including whether it is more likely than not that the DTA will be realized.

In the C&DI, the SEC staff also noted that registrants employing the measurement period approach described in SAB 118 and concluding that an impairment has occurred (e.g., a valuation allowance) for the period that includes the enactment date due to changes resulting from the enactment of the Act may rely on the Instruction to Item 2.06, which exempts registrants from filing a Form 8-K if the conclusion is made in connection with the preparation, review or audit of financial statements to be included in the next periodic report to be filed. In those situations, registrants must disclose the impairment, or a provisional amount with respect to that possible impairment, in that next timely filed report.

Excerpt from C&DI

Question 110.02

Question: Does the re-measurement of a deferred tax asset ("DTA") to incorporate the effects of newly enacted tax rates or other provisions of the Tax Cuts and Jobs Act ("Act") trigger an obligation to file under Item 2.06 of Form 8-K?

Answer: No, the re-measurement of a DTA to reflect the impact of a change in tax rate or tax laws is not an impairment under ASC Topic 740. However, the enactment of new tax rates or tax laws could have implications for a registrant's financial statements, including whether it is more likely than not that the DTA will be realized. As discussed in Staff Accounting Bulletin No. 118 (Dec. 22, 2017), a registrant that has not yet completed its accounting for certain income tax effects of the Act by the time the registrant issues its financial statements for the period that includes December 22, 2017 (the date of the Act's enactment) may apply a "measurement period" approach to complying with ASC Topic 740. Registrants employing the "measurement period" approach as contemplated by SAB 118 that conclude that an impairment has occurred due to changes resulting from the enactment of the Act may rely on the Instruction to Item 2.06 and disclose the impairment, or a provisional amount with respect to that possible impairment, in its next periodic report. [December 22, 2017]

How we see it

While the C&DI clarifies Item 2.06 of Form 8-K, companies should continue to discuss with their securities counsel whether they are required to report any effects of the Act on Form 8-K.

12 Internal control considerations (updated 8 February 2018)

Companies need to evaluate whether changes to their existing processes and controls are necessary to account for the effects of the Act and comply with the provisions of SAB 118. That is, companies need effective internal controls to make sure that the accounting implications of the transition and future tax provision calculations are accurately recorded in their financial statements.

Key areas where changes to existing or new controls may be needed include the processes for estimating and finalizing provisional amounts, calculating the one-time transition tax, tracking outside basis differences after enactment, determining the timing of the reversal of temporary differences, assessing the realizability of deferred tax assets and carryforwards, calculating any minimum taxes and making disclosures.

Additionally, companies need to evaluate whether they need any new information to account for the effects of the tax law changes and whether they will use any new information in their internal controls. If new information will be used in internal controls, companies need to consider the effectiveness of their controls over the completeness and accuracy of that new information.

During the measurement period, controls need to be designed to make sure the company complies with the disclosure requirements of SAB 118. The SAB requirements include disclosure of qualitative information about the status of the accounting and a description of the additional information that needs to be obtained, prepared or analyzed for the company to complete the accounting requirements under ASC 740.

A company that doesn't make appropriate disclosures about its use of the SAB 118 measurement period is effectively telling users of the financial statements that it has completed its accounting for the enactment-date effects of the Act. Controls on amounts that are finalized need to be designed and operated with a level of precision to prevent material subsequent changes. Those changes made after an amount is finalized will need to be analyzed to determine whether there was an error.

13 What companies need to do now

Personnel in a company's finance, treasury and tax departments need to work together to execute a plan to respond to items such as the new corporate tax rate, the one-time transition tax, an immediate write-off of certain assets, any changes to existing tax attributes and any changes to internal controls that might be required.

Steps companies should take include:

- **Calculate changes to federal deferred tax balances —** Companies need to measure their deferred tax balances using the new tax rates in the period the tax law was enacted. Companies with fiscal years that don't end on 31 December need to estimate and schedule their temporary differences in the interim period that includes enactment to account for the effects of the tax law change.
- **Calculate the one-time transition tax on previously deferred foreign earnings and its accounting implications —** Companies should validate US tax attributes such as current and accumulated E&P, previously taxed income and foreign tax credit pools. Further, companies need to identify the amount of accumulated E&P that is held in cash and other specified assets or in illiquid assets for purposes of measuring the transition tax. Companies should consider whether earnings subject to the transition tax are expected to be remitted and any additional tax consequences.
- **Evaluate whether NOL and foreign tax credits are available to offset the transition tax and whether any remaining carryforwards are realizable** — Companies should determine whether there are excess carryforwards and credits that will remain and whether these carryforwards and credits are more likely than not to be realized.
- **Estimate which outside basis differences related to foreign subsidiaries exist after considering any one-time transition tax** — Companies should evaluate whether any of the exceptions to recording deferred taxes are available for those basis differences. For any remaining outside basis differences that do not meet any of the exceptions in ASC 740, companies need to determine the appropriate tax rate to measure related deferred tax amounts. Companies should keep in mind that capital gains are not exempted.
- **Evaluate whether AMT credit carryforwards are realizable** — Companies need to evaluate whether a deferred tax asset is currently recognized in connection with an AMT credit carryforward, the realizability of AMT credit carryforwards and whether amounts should be reclassified to a current or long-term receivable at the enactment date.
- **Evaluate which assets qualify for immediate expensing** — Companies need to finalize their inventory of qualified depreciable assets purchased since 27 September 2017.
- **Evaluate compensation plans —** Companies should determine whether their existing plans are subject to the grandfather provisions and whether any adjustments are needed to recorded deferred tax assets in the period of enactment.

14 Preparing for reporting after the effective date

Steps companies should take to prepare for the ongoing effects of the new tax law include:

- **Evaluate the effect of the GILTI inclusion, FDII and BEAT provisions** — Companies should evaluate what effect these provisions may have on their existing systems and processes to comply with these potential new tax laws.
- **Evaluate the effect on the estimated annual effective tax rates —** Companies should evaluate the Act's effects on their effective tax rate, including the effects of the new tax rates, GILTI and BEAT provisions.
- **Evaluate compensation plans** — Companies should determine whether additional employees are considered covered persons who are subject to existing deductibility limits.
- **Evaluate the effects of limiting deductions related to other expenses (e.g., meals and entertainment expenses)** — Companies need to consider the effect on their estimated effective tax rates if this change is significant.

15 Interim reporting (updated 16 March 2018)

For calendar year-end companies, the new corporate tax rate and many of the Act's other provisions were effective on 1 January 2018. For non-calendar year-end companies, the tax rate was administratively effective under ASC 740 at the beginning of the current fiscal year, but many of the other provisions are effective the first day of the taxable year beginning after 31 December 2017 (e.g., for a company with a 30 September tax year end, many of these provisions are effective on 1 October 2018).

ASC 740-270 provides guidance on accounting for income taxes in interim periods, including a requirement to use an EAETR to compute income tax expense (or benefit) related to ordinary income. Companies that apply SAB 118 need to consider the effects of changes to provisional amounts during the SAB 118 measurement period in calculating tax expense in the interim period.

15.1 Estimated annual effective tax rate reminders

At the end of each interim reporting period, a company is required to make its best estimate of the annual effective tax rate for the full fiscal year. That rate is then used to recognize income taxes on a current year-to-date basis. The estimated effective tax rate should be based on a company's best estimate and reflect enacted federal, state and local income tax rates, foreign tax rates and credits, percentage depletion, capital gains rates, other taxes and credits and available tax-planning alternatives. Additionally, the tax effect of a valuation allowance expected to be necessary at the end of the year for deferred tax assets related to deductible temporary differences and carryforwards originating during the year should be included in the effective tax rate.

Other provisions of the Act besides the new 21% federal tax rate may affect a company's EAETR. Careful consideration of the Act's provisions on a company's EAETR will be necessary.

Additionally, a company that was unable to complete the accounting for the effects of the Act in the period that included the enactment date, could apply SAB 118 and record provisional amounts, if a reasonable estimate of those effects could be determined, or it could continue to apply the tax law that was in effect immediately before enactment if a reasonable estimate could not be determined. SAB 118 provides a measurement period of up to one year for companies to make adjustments to enactment date provisional amounts or record provisional amounts if no reasonable estimate could be made previously. Provisional amounts may relate to both the enactment date and subsequent accounting effects of the Act throughout the measurement period.

Adjustments to enactment-date provisional amounts should be recorded discretely in the interim period. This would also include the effects of adjustments to provisional amounts attributable to post-enactment date prior year activity. Adjustments to provisional amounts related to current year tax effects of ordinary income would be included in the EAETR. See section 9 and section 11 for additional discussion of SAB 118 and its disclosure requirements.

15.2 Key provisions of the Act that could affect the EAETR

15.2.1 Change to the income tax rate

Under ASC 740-270-25-5, the tax effect of a change in tax laws or rates on taxes currently payable or refundable for the current year must be recorded after the effective dates prescribed in the statutes and reflected in the EAETR beginning no earlier than the first interim period that includes the enactment date of the new legislation. In addition, the implementation guidance in ASC 740-270-55-49 and 50 states that the effect of new legislation would not be reflected until it is effective or administratively effective.

For a calendar year-end company the effective date of the new corporate tax rate is 1 January 2018. Therefore, a calendar year-end company must use the new 21% rate in its calculation of the EAETR during the first quarter of 2018. Additionally, the corporate AMT was repealed and should therefore no longer be considered as an alternative tax system when calculating the EAETR.

Non-calendar year-end companies are required to use a blended rate during the fiscal year that includes the enactment date. See section 8, *Special considerations for non-calendar year-end companies*.

15.2.2 Restrictions or eliminations of exclusions, deductions and credits

The Act eliminates or reduces certain deductions that could affect a company's EAETR. For example, it increases the restriction on deductibility of meals and entertainment expenses, reduces the allowable dividend received deduction and repeals the Section 199 domestic production deduction. Section 7.7, *Restriction or elimination of exclusions, deductions and credits*, discusses these provisions.

Further, the Act expands the number of individuals whose compensation is subject to the $1 million deductibility cap under Section 162(m), and compensation subject to the cap now includes performance-based compensation. See section 7.5 of this publication.

The Act limits the deduction for net interest expense that exceeds 30% of the taxpayer's adjusted taxable income. A company whose interest deduction is already limited may not be able to realize the benefits of amounts carried forward. This is because the annual limitation on deductions for interest expense will also apply in future years, and it applies to not only the interest expense incurred in those future years but also to the utilization of any amounts carried forward (i.e., the total interest deduction attributable to the aggregation of current year and carryforward interest deduction is limited to 30% of the taxpayer's adjusted taxable income). Accordingly, a company may determine that a valuation allowance is necessary for the deferred tax asset related to the disallowed interest deduction originating in the current year.

The EAETR should reflect anticipated deductions, limitations and exclusions under the current tax law. Companies will need to carefully evaluate deductions, limitations, exclusions or credits that were historically considered in previous periods' EAETR (i.e., under the prior tax law) and only reflect the currently available provisions when estimating their full fiscal year effective tax rate. Companies also will need to consider the potential effect of the new limitations on interest expense deductions and whether related originating deductible temporary differences are realizable. See section 7.3 of this publication.

15.2.3 Anti-deferral and anti-base erosion provisions

15.2.3.1 GILTI

As discussed in section 6, *Anti-deferral and anti-base erosion provisions,* the Act subjects a US shareholder to current tax on GILTI of its controlled foreign corporations. A company can make a policy election to account for tax on GILTI as a period cost only or to also recognize deferred tax assets and liabilities when basis differences exist that are expected to affect the amount of GILTI inclusion upon reversal. Companies that elect to include tax on GILTI as a period cost only will need to factor the anticipated current-year additional US tax (net of anticipated special deductions and FTCs) into their EAETR. Companies that elect to account for tax on GILTI in their deferred tax balances are required to also project the deferred tax effects of expected year-end temporary differences in their EAETR.

As mentioned in section 6.1.2.1, *GILTI policy election during interim periods following the enactment date*, companies that have disclosed that they have not selected a GILTI accounting policy will need to be mindful of how they consider GILTI in establishing the EAETR in interim periods. We believe that a company subject to GILTI will need to include an estimate of the current-year tax on GILTI when determining its EAETR, even if it has not yet finalized its accounting policy election. A company that has not yet finalized its accounting policy for GILTI (i.e., determined whether to treat it as a period cost or accrue deferred taxes) should not compute its EAETR with GILTI as part of its deferred taxes. We believe a company that calculates its EAETR including a significant effect from deferred tax balances triggered by GILTI has effectively elected an accounting policy to treat GILTI as part of its deferred taxes. We believe including an estimate of GILTI as a period cost in EAETR does not establish an accounting policy as long as the company has not disclosed its accounting policy.

15.2.3.2 BEAT

For companies that meet certain thresholds, the Act creates additional tax on net income by effectively excluding deductions on certain payments (i.e., base erosion payments) to foreign related entities. As discussed in more detail in section 6.3.1, the FASB staff believes that a company should account for the effect of BEAT in the year the BEAT is incurred. A company that expects to be subject to BEAT should estimate the BEAT in its EAETR.

15.2.4 New territorial system and dividend exemption

Under the dividend-exemption provisions of the Act, 100% of the foreign sourced portion of dividends paid by certain foreign corporations to a US corporate shareholder are exempt from US taxation (see section 5, *The new territorial system*). Companies need to carefully assess the effect the new territorial tax system may have on their EAETR, including changes to indefinite reinvestment assertions.

We believe that if a company is unable to estimate the effects of the new territorial system, the company should make disclosures describing what part of the Act the company did not consider in calculating its tax expense as required by SAB 118. This would be the case if a company is not able to estimate the effect of the one-time transition tax and continues to assert indefinite reinvestment on foreign earnings based on the prior tax law, for example. If a company ultimately changes its indefinite reinvestment assertion once it is able to make a reasonable estimate of the effect of moving to the new territorial system, the effect of changing its assertion on its prior-year deferred taxes should be recorded as a discrete charge in the period, including the effect on earnings that are not subject to the one-time transition tax.

However, as a reminder, if a company also changes its assertion about current-year earnings (i.e., 2018 earnings for calendar year-end companies) the effects of changing the assertion should be recognized as an adjustment to the EAETR in the period in which the change in assertion occurs. For example, if a company changes its assertion in the second quarter of 2018 and will no longer assert indefinite reinvestment of 2018 earnings, it may need to accrue additional taxes for state and local taxes and, if applicable, foreign withholding taxes on those earnings. The tax effects of changing the indefinite reinvestment assertion for current-year earnings should be recognized as an adjustment to the EAETR in the period in which the change in assertion occurs.

15.2.5 Changes to state income taxes

Most state income tax laws use federal taxable income as a starting point for determining state income tax. As a result, state income taxes could rise as the federal tax base expands. While some states automatically adopt federal tax law changes, other states conform their laws with federal law on specific dates. States also may choose to decouple from new federal tax provisions and continue to apply current law.

The estimated effective tax rate should reflect not only the enacted federal income tax law but also the enacted state income tax law. Therefore, companies should understand the conformity rules in the states in which they operate and monitor any change in state tax law so they can appropriately account for the effects of changes in tax law separate and apart from their EAETR.

Companies need to consider how to respond to the following situations involving the state conformity:

- If a state automatically adopts federal tax changes, we believe that a company could apply the guidance in SAB 118 if it has not yet completed its analysis of the effects of the state law change on the period that included the Act's enactment date.
- If the state automatically adopts federal tax changes but subsequently enacts a new tax law to decouple from them, we believe a company should account for the decoupling tax law as a tax law change in the period of enactment.
- If the state does not automatically adopt federal tax changes and subsequently enacts new legislation to conform with them, we believe a company should account for the enactment of the law as a change in tax law in the period of enactment.

15.3 Ability to estimate the annual effective tax rate

ASC 740-270-25-3 states, "If an entity is unable to estimate a part of its ordinary income (or loss) or the related tax (or benefit) but is otherwise able to make a reliable estimate, the tax (or benefit) applicable to the item that cannot be estimated shall be reported in the interim period in which the item is reported." ASC 740-270-30-18 goes on to state, "If a reliable estimate of the annual effective tax rate cannot be made, the actual effective tax rate for the year to date may be the best estimate of the annual effective tax rate." In some cases, minor changes in estimated ordinary income can have a significant effect on the EAETR. This can occur when a company is estimating that its operating results will be at or about breakeven or when temporary differences without tax consequences (i.e., permanent differences) are significant compared to estimated income.

We generally do not believe the Act (including any provisions for which the company is not able to make a reasonable estimate under SAB 118) would affect a company's ability to make a reliable estimate for its annual effective tax rate.

15.4 Changes to provisional amounts under SAB 118

SAB 118 does not address the accounting effects of the Act in interim periods. This section discusses our views on how changes in provisional amounts recorded under SAB 118 affect a company's EAETR.

15.4.1 Changes to enactment date provisional amounts in the subsequent annual period

We believe the effects of making adjustments to provisional amounts related to the effects of the Act on the period that contains the enactment date (e.g., changes in a subsequent interim period in 2018 to provisional amounts originally recorded by a calendar year-end company in the period ended 31 December 2017), if significant, should be recognized as a discrete event similar to the accounting for tax law changes in the period of enactment. Accordingly, companies should not allocate the effect of changes in the enactment period provisional amounts to subsequent interim periods in the succeeding year by adjusting the EAETR.

15.4.2 Changes to provisional amounts effecting the EAETR

A company may still be analyzing the effects of certain of the Act's provision at the time it is preparing interim financial statements and determining its EAETR. We believe that a company should include its estimate of the income tax effects of these provisions when estimating its EAETR. If a company is still evaluating the effects of the Act, we believe it should disclose which provisions it is still evaluating and that the EAETR may change in subsequent interim periods.

15.4.3 Changes to enactment-date provisional valuation allowances

Changes in valuation allowances as a result of a change in a SAB 118 enactment-date provisional amount will require careful consideration.

ASC 740-270-25-7 states, "The effect of a change in the beginning-of-the-year balance of a valuation allowance as a result of a change in judgment about the realizability of the related deferred tax asset in future years shall not be apportioned among interim periods through an adjustment of the effective tax rate but shall be recognized in the interim period in which the change occurs."

We believe this guidance also applies when a company makes an adjustment during the measurement period to a SAB 118 provisional amount that affects a prior-year valuation allowance or the adjustments recorded to a beginning-of-the-year valuation allowance that was provisional under SAB 118. That is, both the change in prior-year provisional amounts and the change in the beginning-of-the-year valuation allowance should be recorded as discrete events.

Companies will need to distinguish between items that should be reflected as an adjustment to the EAETR (e.g., the effect of finalizing its GILTI accounting policy election) and those that should be recognized as discrete items in the interim period in which they occur.

15.5 Interim reporting disclosure

Companies will need to make disclosures about the specific items for which their accounting is incomplete at the interim financial statement reporting date. As a reminder, disclosures need to be sufficiently detailed for a reader to understand the status of a company's accounting for the tax effects of the Act (i.e., effects for which the accounting is complete, effects for which the accounting is incomplete but a reasonable estimate can be made and effects for which the accounting is incomplete and no provisional amounts have been recorded) and the additional information needed to complete the accounting under ASC 740. In many cases, a company's calculation will be subject to further refinement as additional analysis is completed and as the company gains a more thorough understanding of the tax law. This possibility should also be disclosed. See section 11.1 for SEC disclosure considerations and *Appendix* A for additional items a company may need to consider when evaluating the disclosures required by SAB 118.

SAB 118 indicates an entity should include financial statement disclosures to provide information about the material financial reporting effects of the Act for which the accounting under ASC Topic 740 is incomplete. Therefore, companies should fully disclose all matters for which their accounting is incomplete.

The following illustration provides an example of disclosures a company may make in an interim period about its accounting for income taxes and its incomplete accounting for the effects of the Act under SAB 118.

Illustration 15 — Interim disclosure for a calendar year-end company with incomplete accounting — income taxes footnote

A calendar year-end company that has not yet completed its accounting might make the following disclosures in the notes to its interim financial statements for periods after the period that includes the enactment date.

This is a simple example that addresses only federal income tax effects. Depending on its facts and circumstances, a company will need to provide more or different information.

Note X Income Taxes

The Company's provision for income taxes for the three months ended 31 March 2018 and 2017 is based on the estimated annual effective tax rate, plus discrete items.

The following table presents the provision for income taxes and the effective tax rates for the three months ended 31 March 2018 and 2017:

	Three Months Ended March 31	
(in millions)	**2018**	**2017**
Income (loss) before income taxes	**$ xxx**	**$ XXX**
Income tax expense (benefit)	**$ xx**	**$ XX**
Effective tax rate	**XX%**	**XX%**

The difference between the Company's effective tax rates for the three months ended 31 March 2018 and 2017 and the US statutory tax rates of 21% and 35%, respectively, primarily relates to changes in the valuation allowances against deferred tax assets, non-deductible expenses, state income taxes (net of federal income tax benefit), the effect of taxes on foreign earnings, and changes to provisional amounts recorded for certain aspects of the Act. The changes to provisional amounts increased the effective tax rate by X%. The effective tax rate may vary significantly due to fluctuations in the amount and source, including both foreign and domestic, of pretax income and changes in amounts of non-deductible expenses and other items that could impact the effective tax rate.

Provisional amounts in effective rate

The Tax Cuts and Jobs Act was enacted on 22 December 2017. The Act reduces the US federal corporate income tax rate from 35% to 21%, requires companies to pay a one-time transition tax on earnings of certain foreign subsidiaries that were previously tax deferred and creates new taxes on certain foreign sourced earnings. We are applying the guidance in SAB 118 when accounting for the enactment-date effects of the Act. At 31 March 2018, we have not completed our accounting for all of the tax effects of the Act; however, in certain cases, as described below, aspects of our accounting are complete. Additionally, we have made a reasonable estimate of other effects. In other cases, we have not been able to make a reasonable estimate and continue to account for those items based on our existing accounting under ASC 740, *Income Taxes*, and the provisions of the tax laws that were in effect immediately prior to enactment. As further discussed below, during the three month period ended 31 March 2018, we recognized adjustments of $XXX to the provisional amounts recorded at 31 December 2017 and included these adjustments as a component of income tax expense from continuing operations. In all cases, we will continue to make and refine our calculations as additional analysis is completed. Our estimates may also be affected as we gain a more thorough understanding of the tax law. These changes could be material to income tax expense.

Deferred tax assets and liabilities: We remeasured certain deferred tax assets and liabilities based on the rates at which they are expected to reverse in the future, which is generally 21%. We recorded a provisional amount of $XXX as of 31 December 2017 related to the remeasurement of certain deferred tax balances. Upon further analyses of certain aspects of the Act and refinement of our calculations during the three months ended 31 March 2018, we adjusted our provisional amount by $XXX, which is included as a component of income tax expense from continuing operations. Due to the continued refinement of our transition tax calculation, discussed further below, and the effect it may have on the measurement of NOLs and other carryforwards, we will continue to analyze and refine our calculations related to the measurement of these balances. We consider the enactment-date remeasurement of all other deferred tax assets and liabilities to be complete.

Foreign tax effects

One-time transition tax: The one-time transition tax is based on our total post-1986 earnings and profits (E&P) which we had deferred from US income taxes under previous US law. We originally recorded a provisional amount for our one-time transition tax liability for XX of our foreign subsidiaries, resulting in a transition tax liability of $XXX being recorded at 31 December 2017. At 31 December 2017, we were unable to make a reasonable estimate of the transition tax liability related to YY of our foreign subsidiaries.

Upon further analyses of certain aspects of the Act and refinement of our calculations for these XX foreign subsidiaries during the three months ended 31 March 2018, we increased our provisional amount by $XXX, which is included as a component of income tax expense from continuing operations. As of 31 March 2018, XX of our foreign subsidiaries have provisional amounts recorded for the one-time tax liability. During the three months ended 31 March 2018, we made sufficient progress in the E&P analysis for the remaining YY of our foreign subsidiaries to reasonably estimate the effects of the one-time transition tax and, therefore, have recorded an initial provisional amount of $XXX. For XX of our subsidiaries we are still unable to make a reasonable estimate of the transition tax liability as of 31 March 2018. As we continue to refine our E&P analysis, we will refine our calculations of the one-time transition tax, which could affect the measurement of this liability. No additional income taxes have been provided for any remaining undistributed foreign earnings not subject to the transition tax, or any additional outside basis difference inherent in these entities, as these amounts continue to be indefinitely reinvested in foreign operations.

Global intangible low-taxed income (GILTI):

A company that has not determined its GILTI accounting policy

The Act subjects a US shareholder to tax on GILTI earned by certain foreign subsidiaries. The FASB Staff Q&A, Topic 740, No. 5, *Accounting for Global Intangible Low-Taxed Income*, states that an entity can make an accounting policy election to either recognize deferred taxes for temporary basis differences expected to reverse as GILTI in future years or provide for the tax expense related to GILTI in the year the tax is incurred as a period expense only. Given the complexity of the GILTI provisions, we are still evaluating the effects of the GILTI provisions and have not yet determined our accounting policy. At 31 March 2018, because we are still evaluating the GILTI provisions and our analysis of future taxable income that is subject to GILTI, we have included GILTI related to current-year operations only in our EAETR and have not provided additional GILTI on deferred items.

A company that has determined that its accounting policy will be to record GILTI as a period cost only in the period it is incurred and can reasonably estimate a provisional amount

The Act subjects a US shareholder to current tax on GILTI earned by certain foreign subsidiaries. The FASB Staff Q&A, Topic 740 No. 5, *Accounting for Global Intangible Low-Taxed Income*, states that an entity can make an accounting policy election to either recognize deferred taxes for temporary differences expected to reverse as GILTI in future years or provide for the tax expense related to GILTI resulting from those items in the year the tax is incurred. We have elected to recognize the resulting tax on GILTI as a period expense in the period the tax is incurred and expect to incur tax for the year ended 31 December 2018. We have made sufficient progress in our calculations to reasonably estimate the effect on our estimated annual effective tax rate. This adjustment increased our effective tax rate by XX%. We will continue to refine our calculations, which may result in changes to this amount.

A company that establishes its accounting policy for GILTI during an interim period needs to disclose that policy. Further, a company that elects to early adopt ASU 2018-02 in an interim period also needs to disclose its accounting policy for releasing the income tax effects from AOCI, as required by that standard (see section 3.1.2, *Reclassification of certain tax effects from accumulated other comprehensive income*) The following are examples of disclosures a company may make in these situations if they are significant to that company's financial statements.

Illustration 16 — Disclosure for a company that has adopted accounting policies for GILTI or the early adoption of ASU 2018-02

A company that makes changes to a significant accounting policy in an interim period should disclose that change in the period in which the change is made. Additional disclosures are required for a company that adopts ASU 2018-02. See Illustration 18 for an example of the additional disclosures.

Note X Summary of Significant Accounting Policies

Accounting for income taxes on GILTI

We recognize the tax on GILTI as a period expense in the period the tax is incurred. Under this policy, we have not provided deferred taxes related to temporary differences that upon their reversal will affect the amount of income subject to GILTI in the period.

Accounting for the release of income tax effects from accumulated other comprehensive income

We use a portfolio approach to release the income tax effects in AOCI related to our available-for-sale debt securities. Under this approach, the income tax effects are released from AOCI upon the sale of an available-for-sale debt security based on the enacted tax rate at the date of sale. Any tax effects remaining in AOCI are released only when the entire portfolio of the available-for-sale debt securities is liquidated, sold or extinguished.

If a company has other items in AOCI, it will need to disclose its accounting policy for releasing income tax effects from AOCI for each of those items.

Companies should also consider the effect of the FASB's new guidance on reclassifying certain tax effects of the Act from AOCI. The following illustrations highlight disclosure that companies may make related to the adoption of this new guidance. See section 3.1.2 for further discussion on the guidance and disclosure requirements.

Illustration 17 — Disclosure for a company that has not adopted ASU 2018-02

Income Taxes

In January 2018, the FASB issued ASU 2018-02, *Income Statement — Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income*, which gives entities the option to reclassify to retained earnings the tax effects resulting from the Act related to items in AOCI that the FASB refers to as having been stranded in AOCI.

The new guidance may be applied retrospectively to each period in which the effect of the Act is recognized in the period of adoption. The Company must adopt this guidance for fiscal years beginning after 15 December 2018 and interim periods within those fiscal years. Early adoption is permitted for periods for which financial statements have not yet been issued or made available for issuance, including the period the Act was enacted. The guidance, when adopted, will require new disclosures regarding a company's accounting policy for releasing the tax effects in AOCI and permit the company the option to reclassify to retained earnings the tax effects resulting from the Act that are stranded in AOCI. The Company is currently evaluating how to apply the new guidance and has not determined whether it will elect to reclassify stranded amounts. The adoption of ASU 2018-02 is not expected to have a material effect on its consolidated financial statements.

Illustration 18 — Disclosure for a company that has early adopted ASU 2018-02

Income Taxes

In January 2018, the FASB issued ASU 2018-02, *Income Statement — Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income*, which gives entities the option to reclassify to retained earnings tax effects resulting from the Act related to items in AOCI that the FASB refers to as having been stranded in AOCI.

The new guidance may be applied retrospectively to each period in which the effect of the Act is recognized or in the period of adoption. The Company must adopt this guidance for fiscal years beginning after 15 December 2018 and interim periods within those fiscal years. Early adoption is permitted for periods for which financial statements have not yet been issued or made available for issuance, including the period the Act was enacted. We elected to early adopt ASU 2018-02. As a result of adopting this standard, we reclassified $XXX from AOCI to retained earnings.

Or, if the amount reclassified relates to deferred tax amounts that are provisional under SAB 118

The new guidance may be applied retrospectively to each period in which the effect of the Act is recognized or in the period of adoption. The Company must adopt this guidance for fiscal years beginning after 15 December 2018 and interim periods within those fiscal years. Early adoption is permitted for periods for which financial statements have not yet been issued or made available for issuance, including the period the Act was enacted. We elected to early adopt ASU 2018-02. As a result of adopting this standard, we reclassified $XXX from AOCI to retained earnings. The effect of the Act on temporary differences related to amounts initially recorded in AOCI are provisional (see footnote X for additional discussion). As we finalize the accounting for tax effects of the Act on the related temporary differences, additional reclassification adjustments may be recorded in future periods.

16 End of SAB 118 measurement period accounting considerations (updated 4 October 2018)

The SEC staff issued SAB 118[19] to provide companies that had not completed their accounting for the income tax effects of the Act in the period of enactment with a measurement period of up to a year. Under SAB 118, a company that had not completed its accounting in the period of enactment would record a reasonable estimate of the enactment-date effects of the Act or continue to apply ASC 740 based on the provisions of the tax laws that were in effect immediately prior to enactment if it couldn't make a reasonable estimate.

The SAB 118 measurement period ends when a company has obtained, prepared and analyzed the information needed to complete the accounting requirements under ASC 740. The measurement period should not extend beyond one year from the enactment date (i.e., the measurement period must be completed by 22 December 2018).

During the measurement period, a company applying the provisions of SAB 118 is expected to finalize recognition of the effects of specific aspects of the Act when it has completed analyzing and gathering the necessary information and is able to apply a reasonable interpretation of the law. The SEC staff expects a company that applies SAB 118 to make adjustments to its provisional amounts throughout the measurement period as it obtains the necessary information and gains a better understanding of the requirements of the law. In some cases, a company may develop that understanding because of tax notices or regulations issued by the Treasury Department or the IRS.

16.1 Accounting considerations after the measurement period ends or accounting is complete

When a company determines that it has completed its accounting for the enactment-date effects of the Act or the measurement period ends, the company will no longer be able to apply the "reasonable estimate" guidance in SAB 118. At that time, the company will need to reflect the enactment-date effects based on the recognition and measurement guidance in ASC 740.

ASC 740 requires a two-step approach for evaluating the uncertainty in tax positions. Recognition (Step 1) occurs when an entity concludes that a tax position, based solely on its technical merits, is more likely than not to be sustained upon examination. Measurement (Step 2) is addressed only if Step 1 has been satisfied (i.e., the position is more likely than not to be sustained). Under Step 2, the tax benefit is measured as the largest amount of benefit, determined on a cumulative probability basis, that is more likely than not to be realized upon ultimate settlement. Tax positions failing to qualify for initial recognition are recognized in the first subsequent interim period in which they (1) meet the more-likely-than-not standard, (2) are resolved through negotiation or litigation with the taxing authority or (3) the statute of limitation expires. (See chapter 19, *Accounting for uncertainty in income taxes*, of our FRD on income taxes for additional information)

At the end of the measurement period, there may be aspects of the Act that remain unclear, or a company may expect the Treasury Department and the IRS to issue more regulations or notices to clarify certain provisions of the Act. When the measurement period ends or the company finalizes its accounting, the company will need to evaluate its tax positions based on the existing tax law and other sources of authority that exist at that time (e.g., tax law, Internal Revenue Code, regulations interpreting such statutes, IRS rulings) to determine whether its tax positions related to the Act meet the recognition guidance in ASC 740.

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[19] SAB 118, *Income Tax Accounting Implications of the Tax Cuts and Jobs Act*.

Because a company will no longer be able to apply the guidance in SAB 118 when it completes its accounting or the measurement period ends, the company may need to adjust its previously recorded amounts to reflect the recognition and measurement of its tax position in accordance with ASC 740. If a company previously filed its tax return for 2017 (as will be the case for calendar-year companies that end their measurement period on 22 December 2018) and new information is obtained or new notices are issued, the company may recognize a different amount of enactment-date effects in its financial statements than it reported in its tax return. If that is the case, the company will need to consider the effect of the new information on its previously filed tax return, remedies allowed for any resulting adjustments to its positions taken on the return and any additional disclosures that may be required related to its uncertain tax positions.

16.2 Treasury regulations issued after the measurement period ends or the accounting for the Act is completed

The US Treasury Department and the IRS have issued tax guidance on certain provisions of the Act since the enactment date. We understand that additional regulations or notices are expected in the future, potentially after the measurement period ends and after 31 December 2018.

Regulatory or interpretative guidance that is issued after the measurement period ends or after a company completes its accounting would constitute new information that could trigger changes in the recognition and/or measurement of tax positions in the period in which the change in judgment occurs (based on the new information). A tax position that previously failed to qualify for initial recognition could be recognized in the period when the new information becomes available, if as a result of the new information, the tax position would meet the more-likely-than-not standard. Additionally, a company would derecognize a tax position that it previously recognized if, based on the new information, the company determines that the tax position no longer meets the more-likely-than-not threshold of being sustained.

Subsequent measurement of a tax position meeting the recognition requirements of ASC 740 should be based on management's best judgment, given the facts, circumstances and information available at the reporting date. If new information such as a notice is released after the measurement period has ended, a company will need to consider the timing of when that information becomes available when recognizing or measuring its tax positions. For example, if the US Treasury or IRS issues a notice in January 2019, a calendar year-end company would not consider that new information when measuring its tax positions in 2018 but would reflect that change in its first interim period of 2019. This is consistent with the guidance in ASC 740 that does not permit a tax position to be recognized, derecognized or remeasured due to changes after the balance sheet date but prior to the issuance of the financial statements. The guidance requires that subsequent changes in judgment that lead to changes in measurement result from the evaluation of new information and not from a new evaluation or new interpretation by management of information that was available in a previous financial reporting period.

16.3 Example disclosure when a company completes its accounting

The following illustration highlights disclosures a company might make when it has completed its accounting for the enactment-date income tax effects of the Act. The actual disclosure a company will need to make may differ from this illustration depending on the items for which the company's enactment-date accounting was previously incomplete. See Appendix A for additional considerations for companies finalizing their accounting of the enactment-date effects of the Act.

Illustration 19 — Year-end income tax note for a calendar year-end company that completes its accounting in the fourth quarter

A calendar year-end company that completes its accounting might make the following disclosures in the notes to its financial statements for the period in which the accounting is complete (either in the period the measurement period ends or in an earlier period). This example assumes the company is an SEC registrant with a calendar year end that completed its accounting during its fourth quarter. Certain disclosures presented in this example may not be required for non-SEC filers (i.e., a nonpublic company may choose not to present a rate reconciliation and may include only a discussion of the nature of the major reconciling items).

This is a simple example that addresses only federal income tax effects of the enactment-date effects and does not present all of the required disclosures a company may need to make in its interim or annual financial statements. Depending on its facts and circumstances, a company will need to provide more or different information.

Note X Income Taxes

The provision for income taxes differs from the amount computed by applying the statutory federal income tax rate to income before provision for income taxes. The sources and tax effects of the differences are as follows:

	Year ended 31 December		
(in millions)	**2018**	**2017**	**2016**
Income tax provision at the statutory rate	$ XXX	$ XXX	$ XXX
Permanent differences, net	$ XX	$ XX	$ XX
Valuation allowance changes affecting the provision for income taxes	$ XX	$ XX	$ XX
Effect of taxes on foreign earnings	$ XX	$ XX	$ XX
Enactment date and measurement period adjustments from the Act	$ XX	$ XX	n/a
	$ XX	$ XX	$ XX

The Tax Cuts and Jobs Act (the Act) was enacted in the US on 22 December 2017. The Act reduced the US federal corporate income tax rate to 21% from 35%, required companies to pay a one-time transition tax on earnings of certain foreign subsidiaries that were previously tax deferred and created new taxes on certain foreign-sourced earnings. In 2017 and the first nine months of 2018, we recorded provisional amounts for certain enactment-date effects of the Act by applying the guidance in SAB 118 because we had not yet completed our enactment-date accounting for these effects. In 2018 and 2017, the Company recorded tax expense related to the enactment-date effects of the Act that included recording the one-time transition tax liability related to undistributed earnings of certain foreign subsidiaries that were not previously taxed, adjusting deferred tax assets and liabilities and recognizing the effects of electing to account for GILTI in deferred taxes [if the company makes this policy election]. The changes to 2017 enactment-date provisional amounts increased the effective tax rate in 2018 by X.

SAB 118 measurement period

We applied the guidance in SAB 118 when accounting for the enactment-date effects of the Act in 2017 and throughout 2018. At 31 December 2017, we had not completed our accounting for all of the enactment-date income tax effects of the Act under ASC 740, *Income Taxes*, for the following aspects: remeasurement of deferred tax assets and liabilities, one-time transition tax, and tax on global intangible low-taxed income. At 31 December 2018, we have now completed our accounting for all of the enactment-date income tax effects of the Act. As further discussed below, during 2018, we recognized adjustments of $XXX to the provisional amounts recorded at 31 December 2017 and included these adjustments as a component of income tax expense from continuing operations.

One-time transition tax

The one-time transition tax is based on our total post-1986 earnings and profits (E&P), the tax on which we previously deferred from US income taxes under US law. We recorded a provisional amount for our one-time transition tax liability for each of our foreign subsidiaries, resulting in a transition tax liability of $XXX at 31 December 2017.

Upon further analyses of the Act and Notices and regulations issued and proposed by the US Department of the Treasury and the Internal Revenue Service, we finalized our calculations of the transition tax liability during 2018. We increased our 31 December 2017 provisional amount by $XXX, which is included as a component of income tax expense from continuing operations. We have elected to pay our transition tax over the eight-year period provided in the Act. As of 31 December 2018, the remaining balance of our transition tax obligation is $XXX, which will be paid over the next seven years.

Deferred tax assets and liabilities

As of 31 December 2017, we remeasured certain deferred tax assets and liabilities based on the rates at which they were expected to reverse in the future (which was generally 21%), by recording a provisional amount of $XXX. Upon further analysis of certain aspects of the Act and refinement of our calculations during the 12 months ended 31 December 2018, we adjusted our provisional amount by $XX, which is included as a component of income tax expense from continuing operations.

Global intangible low-taxed income (GILTI)

A company that had not determined its GILTI accounting policy in the period of enactment:

The Act subjects a US shareholder to tax on GILTI earned by certain foreign subsidiaries. The FASB Staff Q&A, Topic 740, No. 5, *Accounting for Global Intangible Low-Taxed Income*, states that an entity can make an accounting policy election to either recognize deferred taxes for temporary basis differences expected to reverse as GILTI in future years or to provide for the tax expense related to GILTI in the year the tax is incurred as a period expense only.

Because we were evaluating the provision of GILTI as of 31 December 2017, we recorded no GILTI-related deferred amounts in 2017. After further consideration in the current year, we have elected to account for GILTI in deferred taxes. In 2018, we recorded additional deferred tax liabilities as a net $XXX deferred tax expense related to GILTI in deferred taxes.

Or when a company elects to account for GILTI as a period cost:

We have elected to account for GILTI in the year the tax is incurred.

Note: Disclosure of additional tax expense from GILTI affecting a company's effective tax rate may arise under a policy of accounting for GILTI as a period cost or in deferred taxes. A company may need to consider whether to include additional information as part of its rate reconciliation disclosures.

16.4 Internal control considerations

Internal control over financial reporting needs to be designed and operating effectively throughout the SAB 118 measurement period in order to prevent or detect a material misstatement in the financial statements and related footnote disclosures. Controls executed during the measurement period that relate to amounts for which the accounting is incomplete may be designed to operate differently than other controls. That is, controls over provisional amounts and disclosures need to be designed to assess whether adjustments being recorded constitute measurement-period adjustments and whether the company's disclosures comply with the requirements of SAB 118 to communicate the provisional nature of the amounts recognized.

Controls over amounts that are finalized need to be designed and operated with a level of precision to prevent or detect material misstatements in the financial statements and footnote disclosures. Any changes made after an amount is finalized will need to be analyzed to determine whether the change was made as a result of new information, such as the issuance of a new proposed or final regulation, or due to an error. In addition, the design and operation of the controls need to address the completeness and accuracy of the information obtained, prepared and analyzed to complete the accounting.

When the measurement period ends, recognition, measurement, changes in tax positions and disclosures should be subject to the company's existing processes and controls over uncertain tax positions. However, companies will need to consider whether changes to their existing processes and controls are necessary, especially companies that have complex organizational structures and are subject to the territorial tax provisions of the Act such as those involving GILTI and BEAT.

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Appendix A What companies should consider in evaluating whether their accounting for the enactment-date effects of the Act is final (updated 24 January 2018)

Given the complexities involved and the fact that the US Treasury Department may clarify how to apply certain provisions of the Act, companies should not underestimate the effort needed to appropriately interpret and apply all the provisions of the Act prior to concluding that their accounting for the enactment-date effects of the Act is complete.

The following are some of the considerations a company should evaluate before determining that its accounting for the enactment-date effects of the Act is complete, along with questions management should ask itself. This listing is not intended to be all-inclusive and the applicability of the items on this listing will vary by entity.

General considerations

- **Evaluation of tax law and all underlying provisions** — The Tax Cuts and Jobs Act is the most significant and complex change to the US tax code in more than 30 years and requires the combined effort of companies' finance, treasury and tax departments.

  Has the company assessed all parts of the Act, identified all instances where the Act applies and appropriately evaluated all instances where the Act has accounting effects upon enactments?

  Has the company been able to reasonably interpret each provision of the Act based on currently available rules and regulations with sufficient precision to consider the accounting for the effects as of the enactment date to be complete?

  Has the company considered whether additional clarifications or interpretations of the Act (Treasury Notices, etc.) may affect its analysis and computations?

  Does the company plan to engage specialists to assist in analysis of any components of the Act?

  Will the company be performing additional analysis and computations before finalizing amounts for inclusion in the related tax returns?

  Has the company obtained all documentation and support for all matters addressed in the Act or has the company relied on summary schedules and data for purposes of its accounting?

Effects on deferred tax assets and liabilities

- **Effects of change in corporate income tax rate on temporary differences and tax loss carryforwards and credits as of enactment date —** Calendar year-end companies may need to make adjustments for material unusual or infrequent transactions that occurred between the enactment date and year end. Estimating temporary differences as of the enactment date for non-calendar year-end companies presents even more challenges.

  Have all temporary differences and tax loss carryforwards and credits at the enactment date been appropriately identified and calculated with sufficient precision to consider the measurement of the change in rate upon enactment to be complete?

- **Immediate expensing —** Under the Act, companies are able to claim bonus depreciation to accelerate the expensing of the cost of certain qualified property acquired and placed in service after 27 September 2017.

  Have all assets purchased since 27 September 2017 that qualify for immediate expensing (and that will be treated as such in the company's tax return) been identified?

  For those assets acquired after 27 September 2017 for which the company is claiming immediate expense in the year including enactment, have they been confirmed to have been placed in service by the end of the year or will there be more work done to confirm placed in service dates for the tax return?

- **Valuation allowance reassessment —** Numerous provisions of the Act could increase or decrease a company's need for valuation allowances. Examples of those provisions include the one-time transition tax, interest expense deduction limits, GILTI, FDII, immediate expensing of qualified assets, changes to NOL rules, repeal of the domestic manufacturing deduction, repeal of the corporate alternative minimum tax and limits on employee remuneration.

  Have all of the provisions in the Act been appropriately identified and considered in the evaluation of the realizability of deferred tax assets?

  Have all qualifying dividends from foreign subsidiaries been eliminated as a source of foreign source income to support the realizability of foreign tax credits or other deferred tax assets?

  Have the effects of GILTI and FDII provisions been appropriately considered in projections of future taxable income?

Repeal of the corporate alternative minimum tax

- **Classification of AMT credits —** We believe it would be appropriate for a company to either continue to classify AMT credits along with its other deferred tax balances or reclassify credits that are expected to be refundable in future periods to an income tax receivable.

  Has the company determined the refundable component of its AMT credits and finalized its determination of the appropriate classification of AMT credits?

One-time transition tax

- **Calculating E&P subject to the one-time transition tax —** Identifying post-1986 E&P of each foreign subsidiary that has not been previously subject to US tax could be a complex and time-consuming process that companies should carefully execute and review.

  Has all necessary information to calculate E&P amounts to determine the one-time transition tax payable been obtained?

  Has the company obtained the appropriate support for all E&P amounts or will additional work be performed to gather support for the underlying amounts?

  Has the company assessed the adequacy of its final support for sustaining its E&P determination with the tax authority?

  Have all uncertainties the company identified as reasons to record provisional amounts been resolved?

- **Calculating and supporting foreign tax credits available to offset the one-time transition tax —** Identifying and supporting foreign taxes generated with the mandatory Subpart F inclusion could be a complex and time-consuming process that companies should carefully execute and review.

  Has all necessary information to calculate tax pools to determine the foreign tax credits been obtained?

  Has the company obtained the appropriate support for all foreign tax amounts or will additional work be performed to gather support for the underlying amounts?

  Has the company assessed the adequacy of its final support for sustaining its foreign tax credits with the tax authority?

  Have all uncertainties the company identified as reasons to record provisional amounts been resolved?

- **Utilization of available tax attributes to offset the one-time mandatory Subpart F inclusion —** Companies may utilize certain tax attributes to offset the mandatory inclusion. Elections are available to forego the utilization of certain attributes to allow other attributes.

  Has the company completed its evaluation of the optimal source of attributes to utilize to offset the one-time mandatory Subpart F inclusion?

- **Calculating the aggregate foreign cash position of the US shareholder —** Cash and other specified assets are defined in the Act and effectively taxed at different rates. Identifying assets that qualify for the lower effective rate could be complex. Non-calendar year-end companies might face additional challenges in determining the amount of cash and other specified assets subject to the one-time transition tax because one of the tax years on which the measurement is based may not have closed yet (i.e., the last taxable year beginning before 1 December 2017).

  Have all cash and other specified assets, as defined in the Act, been appropriately identified and measured at each proscribed date?

Move to a territorial system

- **Determining outside basis differences for each foreign subsidiary after taking into consideration the one-time transition tax —** Companies still need to determine the outside basis differences for each of their foreign subsidiaries after taking into consideration the transition tax. Companies will need to finish their evaluation of any remaining outside basis differences and determine whether they can assert indefinite reinvestment on the related foreign earnings. Companies that are not asserting indefinite reinvestment will need to finalize their calculation and measurement of any remaining deferred tax balances, considering the appropriate tax rate to apply, the effects of state and local income taxes, foreign withholding taxes, other applicable foreign taxes and other attributes that could affect those amounts.

  Have outside basis differences for each foreign subsidiary been recalculated after considering the incremental US tax basis created as a result of the one-time transition tax?

  Has the evaluation of the remaining outside basis differences been finalized to assess if any residual tax would be due on recovery of the book investment?

  Has the evaluation been completed related to the determination of whether the company can assert indefinite reinvestment on the related foreign earnings?

Has the company evaluated whether its indefinite reinvestment assertion, including that on the earnings subject to the transition tax, is consistent with treasury and other expectations of repatriating cash to the US?

Has the company evaluated withholding taxes, other foreign taxes and/or state and local taxes that may apply?

Is the company in any states for which the treatment of the transition tax and/or dividends received deduction is undetermined at this time?

Other international provisions

- **Global intangible low-taxed income —** Companies need to select an accounting policy to determine whether to account for the tax effects of GILTI as period costs or provide deferred taxes. A company that selects a policy of providing deferred taxes will need to finalize the calculation of the related deferred tax balances, which may require significant judgment. A company that selects an accounting policy of recording GILTI taxes as period costs should have considered the effects on its EAETR.

  Has the company completed its analysis of the tax effects of the GILTI provisions?

  Has an accounting policy been selected on how to account for the tax effects of GILTI?

  Have the effects of the selected accounting policy been fully considered and computed?

- **Base erosion and anti-deferral provisions —** For companies that meet certain thresholds, the base erosion provision of the Act creates additional tax on net income by effectively excluding deductions on certain payments to foreign related entities. This incremental tax should be included in a company's EAETR.

  In the periods after enactment (e.g., 2018 for calendar year-end companies), has the company considered whether it will be subject to BEAT, and has an estimate of this additional tax been included in its EAETR?

  Has the company completed its analysis of the tax effect of the BEAT provisions?

- **Compensation plans —** The Act expanded the number of individuals whose compensation is subject to a $1 million cap on deductibility under Section 162(m), and the calculation now includes performance-based compensation such as stock options and stock appreciation rights. The provision generally applies to taxable years beginning after 31 December 2017 and provides a transition for compensation paid pursuant to a written binding contract that was in effect on 2 November 2017. Companies will need to carefully review the terms of their compensation plans and agreements to assess whether they are considered to be written binding contracts in effect on 2 November 2017.

  Have all the compensation plans in which the covered individuals participate been identified?

  Have all compensation plans in which covered individuals participate been evaluated to determine whether they are grandfathered under the Act?

  Have the deferred tax consequences associated with the perpetual status as a covered employee been considered in the evaluation of the deferred tax assets associated with plans in which covered individuals participate?

State and local taxes

- **Determining the effects of the Act on state and local taxes —** Companies need to understand the conformity rules in each state in which they operate so they can appropriately account for the effects on their state income taxes. Companies should consider the tax effects of state and local income taxes in finalizing their income tax provision calculation.

  Have the tax effects of state and local income taxes been appropriately considered?

  Has the evaluation of the state income tax effects of the transition tax been completed for each state in which the company operates?

  Has the evaluation of the state income tax conformity with the US Internal Revenue Code been completed for each material position in each state in which the company operates?

  Have the state income tax effects of changes in US tax law been incorporated into the determination of the estimated deferred state income tax rate?

  Has the evaluation of the realization of state income tax deferred tax assets been revised to consider changes in US tax treatment and revised projections of state taxable income?

Appendix B Full content of FASB Staff Q&A: Whether private companies and not-for-profit entities can apply SAB 118 (updated 16 January 2018)

Background

The staff of the Division of Corporation Finance and the Office of the Chief Accountant of the Securities and Exchange Commission (SEC staff), from time to time, issue statements in staff accounting bulletins (SABs) that express a view on the application of the Financial Accounting Standards Board (FASB) Accounting Standards Codification® and/or other disclosure requirements. The statements in SABs are not rules or interpretations of the Commission, nor are they published as bearing the Commission's official approval. They represent interpretations and practices followed by the SEC Staff in administering the disclosure requirements of the federal securities laws.

The views and interpretations of the SEC staff are not directly applicable to private companies and not-for-profit entities (as defined in the FASB Codification Master Glossary). However, in the past some private companies and not-for-profit entities have voluntarily applied the guidance in SABs.

The SEC staff recently issued SAB 118 on the application of Topic 740 on income taxes in the reporting period that includes the date on which the 2017 Tax Cuts and Jobs Act (Act) was signed into law.

Question

Given the longstanding practice of private companies electing to apply SABs, would the FASB staff object to private companies and not-for-profit entities applying SAB 118?

Response

Based upon the longstanding practice of private companies electing to apply SABs, the FASB staff would not object to private companies and not-for-profit entities applying SAB 118. If a private company or not-for-profit entity applies SAB 118, they would be in compliance with GAAP.

The FASB staff believes, however, that if a private company or a not-for-profit entity applies SAB 118, it should apply all relevant aspects of the SAB in its entirety. This would include the disclosures listed in SAB 118. The FASB staff also believes that a private company or a not-for-profit entity that applies SAB 118 should disclose its accounting policy of applying SAB 118 in accordance with paragraphs 235-10-50-1 through 50-3 of the Accounting Standards Codification.

Appendix C Full content of FASB Staff Q&A documents on implementation questions (updated 24 January 2018)

FASB Staff Q&A: Whether to discount the tax liability on the deemed repatriation

Background

The Tax Cuts and Jobs Act (Act) imposes a tax on undistributed and previously untaxed post-1986 foreign earnings and profits. The Act permits a company to pay the one-time transition tax over eight years on an interest free basis. The earnings are reported on the 2017[20] tax return and the tax is generally due in annual installments of 8% per year for the first five years, 15% in year 6, 20% in year 7, and 25% in year 8, if properly elected. The payments are due without regard to whether a company has future taxable income or losses.

Question

Does the FASB staff believe that the tax liability on the deemed repatriation of earnings should be discounted?

Response

The FASB staff believes that the tax liability on the deemed repatriation of earnings should not be discounted. The FASB staff notes that paragraph 740-10-30-8 prohibits the discounting of deferred tax amounts. Due to the unique nature of the tax on the deemed repatriation of foreign earnings, the staff believes that the guidance in paragraph 740-10-30-8 should be applied by analogy to the payable recognized for this tax.

Further, the FASB staff does not believe that Subtopic 835-30 on the imputation of interest applies to the unique circumstances related to this tax liability. The guidance in Subtopic 835-30 addresses the accounting for business transactions that often involve the exchange of cash or property, goods, or services for a note or similar instrument. Subtopic 835-30 is premised on the fact that when a note is exchanged for property, goods, or services in a bargained transaction entered into at arm's length, the interest rate should represent fair and adequate compensation to the supplier. The FASB staff believes that the transition tax liability is not the result of a bargained transaction and that the scope exception in paragraph 835-30-15-3(e) for transactions where interest rates are affected by tax attributes or legal restrictions prescribed by a governmental agency (such as, income tax settlements) would apply.

The FASB staff also notes that the tax liability may not be a fixed obligation because it may be subject to estimation and future resolution of uncertain tax positions (for example, amount of earnings and profits from foreign subsidiaries, amount of earnings held in cash and cash equivalents, reduction of the tax for foreign tax credits). Any recognized uncertain tax position related to the deemed repatriation of foreign earnings would not be discounted, and the staff does not believe it is appropriate to have a discounted tax liability when the uncertain tax position is undiscounted.

[20] In some cases, amounts are reported on the 2018 tax return (for example, when a calendar-year-end company has a controlled foreign corporation with a November 30 year-end).

FASB Staff Q&A: Accounting for global intangible low-taxed income

Background

The Tax Cuts and Jobs Act requires a US shareholder of a foreign corporation to include in income its global intangible low-taxed income (GILTI). In general, GILTI is described as the excess of a US shareholder's total net foreign income over a deemed return on tangible assets, which is defined as 10% of its foreign qualified business asset investment reduced by certain interest expense amounts. There is no loss carryforward mechanism to allow GILTI losses in one year to offset GILTI income in another year.

The Tax Cuts and Jobs Act allows a deduction of 50%[21] of GILTI, but this deduction is limited by the taxpayer's taxable income. An entity also is allowed a deemed paid foreign tax credit of up to 80% of foreign taxes attributable to the underlying foreign corporation. Unused foreign tax credits associated with GILTI cannot be carried forward or back or used against other foreign source income. A US shareholder would increase its tax basis in the foreign corporation for the GILTI inclusion.

Question

Does the FASB staff believe that an entity should recognize deferred taxes for temporary basis differences expected to reverse as global intangible low-taxed income (GILTI) in future years or should the tax on GILTI be included in tax expense in the year it is incurred?

Response

The FASB staff does not believe that Topic 740 is clear as to the treatment of GILTI.

Some stakeholders believe it would not be appropriate to provide deferred taxes on individual inside basis differences or the outside basis difference (or portion thereof) because a taxpayer's GILTI is based on its aggregate income from all foreign corporations. Because the computation is done at an aggregate level, the unit of account is not the taxpayer's investment in an individual foreign corporation or that corporation's assets and liabilities. These stakeholders believe that the guidance on deferred tax accounting in Topic 740 using the asset and liability approach does not address taxes on aggregated income because basis differences of a foreign corporation in one jurisdiction may be offset by basis differences in a foreign corporation in another jurisdiction and ultimately may never be taxed. Further, these stakeholders believe that the GILTI computation is dependent on contingent or future events (for example, future foreign income versus loss, the amount of foreign qualified business asset investment in a given year, future foreign tax credits, future taxable income), which suggests that taxes on GILTI should be accounted for as period costs similar to special deductions.

Other stakeholders believe that the current tax imposed on GILTI is similar to the tax imposed on existing Subpart F income. Deferred taxes generally are provided under Topic 740 for basis differences that are expected to result in Subpart F income upon reversal. Because GILTI is included in the US shareholder's taxable income when earned by the foreign corporations, similar to Subpart F income, these stakeholders believe that a US shareholder should recognize deferred tax assets and liabilities when basis differences exist that are expected to affect the amount of GILTI inclusion upon reversal.

Based on the different views provided, the FASB staff believes that Topic 740 is not clear as it relates to the accounting for GILTI, and an entity may apply either interpretation of Topic 740. The staff believes that an entity must disclose its accounting policy related to GILTI inclusions in accordance with paragraphs 235-10-50-1 through 50-3.

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[21] The deduction is reduced to 37.5% for tax years beginning after December 31, 2025.

The staff plans to monitor how entities that pay tax on GILTI are accounting for and disclosing its effects by reviewing annual or quarterly reports issued over the next few quarters. Following this review, the staff will provide an update to the Board so it can consider whether improvements may be needed for the accounting or disclosures for the tax on GILTI.

FASB Staff Q&A: Accounting for the base erosion anti-abuse tax

Background

Under the Tax Cuts and Jobs Act, an entity must pay a Base Erosion Anti-Abuse Tax (BEAT) if the BEAT is greater than its regular tax liability. The BEAT calculation eliminates the deduction of certain payments made to foreign affiliates (referred to as base erosion payments) but applies a lower tax rate on the resulting BEAT income.

Question

Does the FASB staff believe that deferred tax assets and liabilities should be measured at the statutory tax rate of the regular tax system or the lower BEAT tax rate if the taxpayer expects to be subject to BEAT?

Response

The FASB staff believes that the BEAT is similar to the alternative minimum tax (AMT) under prior tax law. The AMT was a parallel tax system that resulted in a minimum level of corporate taxation in situations in which regular taxable income was lower than the alternative minimum taxable income due to "preference items" that were not deductible for AMT purposes. An entity that paid the AMT received a tax credit for the tax paid in excess of the amount computed on the basis of the regular tax system. An entity subject to the BEAT does not receive a tax credit for the tax paid in excess of the amount computed on the basis of the regular tax system, but the FASB staff believes that the BEAT is similar to the AMT in that it is designed to be an incremental tax in which an entity can never pay less, and may pay more, than their regular tax liability.

Paragraphs 740-10-30-11 and 740-10-55-32 address the AMT and require an entity to measure deferred taxes using the statutory tax rate under the regular tax system. Paragraph 740-10-30-11 states:

> *"…[I]t would be counterintuitive if the addition of alternative minimum tax provisions to the tax law were to have the effect of reducing the amount of an entity's income tax expense for financial reporting, given that the provisions of alternative minimum tax may be either neutral or adverse but never beneficial to an entity."*

Therefore, the FASB staff believes that an entity that is subject to BEAT should measure deferred tax assets and liabilities using the statutory tax rate under the regular tax system. The FASB staff believes that measuring a deferred tax liability at the lower BEAT rate would not reflect the amount an entity would ultimately pay because the BEAT would exceed the tax under the regular tax system using the 21 percent statutory tax rate.

Although an entity may believe that it expects to be subject to the BEAT for the foreseeable future, paragraph 740-10-30-11 further states that "no one can predict whether an entity will always be an alternative minimum tax taxpayer." The FASB staff believes that a similar conclusion could be applied to BEAT. In addition, taxpayers may take measures to reduce their BEAT exposure and, therefore, ultimately pay taxes at or close to the 21 percent statutory tax rate.

The FASB staff believes that the guidance in Topic 740 therefore indicates that the incremental effect of BEAT should be recognized in the year the BEAT is incurred. The staff also believes that an entity would not need to evaluate the effect of potentially paying the BEAT in future years on the realization of deferred tax assets recognized under the regular tax system because the realization of the deferred tax asset (for example, a tax credit) would reduce its regular tax liability, even when an incremental BEAT liability would be owed in that period. Regardless of any year-over-year effective tax rate fluctuations, the effective tax rate (excluding other permanent items) under this approach would always be equal to or in excess of the statutory tax rate of 21 percent.

FASB Staff Q&A: Whether to discount alternative minimum tax credits that become refundable

Background

Under prior tax law, an entity paid the corporate alternative minimum tax (AMT) if the amount payable under the AMT system was greater than the amount payable under the regular tax system. An entity that paid the AMT received a tax credit (AMT credit carryforward) for the tax paid in excess of the amount owed under the regular tax system. This AMT credit carryforward has no expiration date.

The AMT tax regime is repealed under the Tax Cuts and Jobs Act. Any existing AMT credit carryforward can be used to reduce the regular tax obligation in years 2018 through 2020. Any AMT credit carryforwards that do not reduce regular taxes generally are eligible for a 50% refund in 2018 through 2020 and a 100% refund in 2021. This generally will result in the full realization of any AMT credit carryforwards existing at December 31, 2017, irrespective of future taxable income.

Question

Does the FASB staff believe that AMT credit carryforwards should be discounted at December 31, 2017, because they will be refundable in future years?

Response

The FASB staff notes that paragraph 740-10-30-8 prohibits discounting deferred taxes. Accordingly, any AMT credit carryforwards presented as a deferred tax asset would not be discounted. Likewise, the FASB staff believes that any AMT credit carryforward presented as a receivable should not be discounted because the staff does not believe that Subtopic 835-30 on the imputation of interest applies.

The guidance in Subtopic 835-30 addresses the accounting for business transactions that often involve the exchange of cash or property, goods, or services for a note or similar instrument. Subtopic 835-30 is premised on the fact that when a note is exchanged for property, goods, or services in a bargained transaction entered into at arm's length, the interest rate should represent fair and adequate compensation to the supplier. The FASB staff believes that the AMT credit carryforward is not the result of a bargained transaction and that the scope exception in paragraph 835-30-15-3(e) for transactions where interest rates are affected by tax attributes or legal restrictions prescribed by a governmental agency (such as, income tax settlements) would apply.

The FASB staff notes that paragraph 740-10-50-3 requires an entity to disclose the amounts of tax credit carryforwards for tax purposes. The staff believes this disclosure would apply whether an entity presents the AMT credit carryforward as a deferred tax asset or a receivable and would provide useful information to investors in evaluating the amount that is to be utilized or refunded.

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Technical Line

FASB — final guidance

How the new revenue standard affects life sciences entities

In this issue:

What you need to know

- Life sciences entities have to use more judgment and may need to make more estimates than they do today.
- Life sciences entities have to update their policies, systems and controls to meet the new requirements, even though their pattern of revenue recognition may not change. The standard also requires more interim and annual disclosures.
- We don't anticipate further significant changes to the recognition and measurement principles in the new revenue standard, so life sciences entities should focus on implementation. Many entities are finding that implementation requires significantly more effort than they expected.
- While many transactions between parties to collaborative arrangements are in the scope of ASC 808, the FASB has added a project to its agenda to clarify when these transactions should be accounted for under the new revenue standard. Life sciences entities with collaborative arrangements should monitor developments.

Overview

The 2018 effective date[1] of the new revenue recognition standard[2] (the standard) issued by the Financial Accounting Standards Board (FASB) is fast approaching. As life sciences entities work on implementation, they need to consider all developments. For example, the FASB amended its guidance in the standard on accounting for licenses of intellectual property (IP), identifying performance obligations, assessing collectibility and measuring noncash consideration. In addition, the Joint Transition Resource Group for Revenue Recognition (TRG)[3] generally agreed on several issues that may affect the life sciences industry.

This publication highlights key aspects of applying the standard to life sciences arrangements, addresses significant changes to legacy practice and reflects the latest implementation insights.

This publication, which contains a summary of the standard in the appendix, supplements our Financial reporting developments (FRD) publication, *Revenue from contracts with customers (ASC 606)*, and should be read in conjunction with it. The views we express in this publication may evolve as implementation continues and additional issues are identified.

Collaborative arrangements

In certain life sciences arrangements, a counterparty may not be a customer of the entity. Instead, the counterparty may be a collaborator or partner that shares in the risks and benefits of developing a product to be marketed. These arrangements generally are in the scope of Accounting Standards Codification (ASC) 808.[4] However, depending on the facts and circumstances, these arrangements may also contain vendor-customer aspects. Such transactions could be within the scope of the new revenue guidance, at least partially, if the collaborator or partner meets the definition of a customer for at least some aspects of the arrangement. Therefore, the parties to such arrangements need to consider all of the facts and circumstances to determine which transactions have a vendor-customer relationship that is subject to the new guidance.

The FASB is considering clarifying when transactions between parties to a collaborative arrangement are in the scope of ASC 606.

The FASB did not provide further guidance in the new revenue standard for determining whether certain collaborative arrangements would be in the scope of the new guidance. To help entities with assessing the scope of collaborative arrangements, the FASB added a narrow-scope project to its agenda in November 2016 to clarify when transactions between parties to collaborative arrangements are in the scope of the revenue standard. In doing so, the FASB noted that today, some entities apply the revenue guidance to some or all of the elements in collaborative arrangements, while others develop policies that may not be consistent with or analogous to the revenue guidance.

ASC 808 states that when payments between parties in a collaborative arrangement are not within the scope of other authoritative accounting literature, the income statement classification should be based on an analogy to authoritative accounting literature or, if there is no appropriate analogy, a reasonable, rational and consistently applied accounting policy election. The FASB noted[5] in the Background Information and Basis for Conclusions of Accounting Standards Update (ASU) 2014-09 that in some circumstances (e.g., when more relevant guidance that could be applied is not available), it may be appropriate for an entity to apply by analogy the principles in the new revenue standard to collaborative arrangements.

How we see it

Today, many life sciences entities apply legacy revenue guidance by analogy to certain transactions with a collaboration partner. Absent further guidance from the FASB, ASC 808 would allow an entity to apply the new revenue guidance by analogy to these types of arrangements if it makes a policy election to do so.

The FASB project to clarify when transactions between parties to collaborative arrangements should be accounted for under the new revenue standard is in the early stages, and it is unclear if or when additional guidance will be issued. Therefore, life sciences entities with collaborative arrangements should monitor developments.

Effect of termination clauses on contract duration (Updated December 2017)

Life sciences contracts may include clauses that allow a customer to terminate a contract without penalty, or the customer may be required to pay a termination penalty that is not substantive. The absence of a substantive termination penalty may affect an entity's determination of the length of the contract, the number of performance obligations, the transaction price, the timing of revenue recognition and the required disclosures.

The standard does not explicitly address the effect of termination penalties on the length of the contractual period. However, the TRG generally agreed[6] that a substantive termination penalty payable by a customer is evidence of enforceable rights and obligations on the part of both parties throughout the period when the substantive termination penalty applies.

The amount, nature and purpose of the termination penalty are factors to consider when determining whether the termination penalty is substantive. TRG members observed that the determination of whether a termination penalty is substantive, and what the enforceable rights and obligations are under a contract, requires judgment and consideration of the facts and circumstances. If the termination penalty is not substantive, the contract may be shorter than the stated contractual term. For example, entities may be required to account for contracts with stated terms as shorter-term contracts, such as month to month, if the parties to the contracts can terminate them without paying a substantive penalty, even if the stated terms are for multiple years.

If a contract is accounted for as a shorter-term contract, life sciences entities may need to evaluate whether the implicit renewal option created by the customer's decision not to exercise its option to terminate the contract represents a material right.

Illustration 1 — Determining contract duration for a contract without a substantive termination penalty

Biotech enters into an arrangement with Pharma to provide Pharma with a research, development and commercialization license to a phase 1 product candidate and perform R&D services. The license is determined to be a functional license of IP. In exchange, Pharma agrees to pay Biotech a nonrefundable, up-front fee and market rates for the R&D services. The stated contract term extends through commercialization, but Pharma can terminate the contract without paying Biotech a monetary penalty at any time with six months' notice.

Analysis:

Biotech would determine the legally enforceable contract period by evaluating Pharma's right to terminate the contract without penalty if it provides six months' notice. If Biotech concludes that the enforceable rights and obligations in the contract exist for six months (i.e., there is no substantive termination penalty), Biotech effectively would have a rolling six-month contract, and the contract duration would extend to the first available cancelation date, which is six months after the contract begins. Biotech would evaluate whether Pharma's ability to renew the contract after the initial six-month period (i.e., the effective renewal each day Pharma doesn't exercise its option to terminate the contract) constitutes a material right because Pharma is not obligated to pay any consideration (beyond the up-front fee) each time it renews the contract.

Accounting when the license and R&D services are not distinct

If Biotech concludes that the license is not distinct from the R&D services, Biotech allocates the transaction price to the separate performance obligations: (1) a six-month term license with related R&D services and (2) the material right associated with the daily renewal options. Biotech recognizes the portion of the transaction price allocated to the six-month term license and R&D services as revenue over the six-month contract term using a single measure of progress (e.g., following the pattern of performance of the R&D services). Biotech recognizes the portion of the transaction price allocated to the material right as revenue as Pharma exercises its renewal options over the expected renewal period of the contract (see section 6.1.5 of our FRD, *Revenue from contracts with customers (ASC 606)*, for a discussion on allocating the transaction price to a material right).

Accounting when the license and R&D services are distinct

If Biotech concludes that the license is distinct from the R&D services, Biotech allocates the transaction price to: (1) the six-month license right, (2) the six months of R&D services and (3) the material right associated with the daily renewal options. Biotech recognizes the portion of the transaction price allocated to the six-month license as revenue on the date that control of the license is transferred to Pharma and recognizes the portion of the transaction price allocated to six months of R&D services as revenue as the services are performed. Biotech recognizes the amount allocated to the material right as revenue as Pharma exercises its renewal options over the expected renewal period of the contract (see section 6.1.5 of our FRD, *Revenue from contracts with customers (ASC 606)*, for a discussion on allocating the transaction price to a material right).

Some life sciences contracts have stated terms of multiple years, but they also have provisions that allow the customer to terminate the contract without cause. If the customer terminates the contract, it is common for any payments made under the contract prior to the termination date to be nonrefundable and for all rights conveyed under the license of IP to revert back to the entity, along with any know-how developed or obtained during the contract, upon (or shortly after) termination. The requirement for the customer to forgo all rights under the license should be evaluated as a factor to consider when determining contract duration. In particular, if the customer decides to terminate the contract, the return of rights to the IP to the entity may represent a substantive nonmonetary penalty that would compensate the entity for termination of the contract (i.e., the surrender of the licensed rights). This could indicate that the contract duration aligns with the period for which the penalty would be incurred (rather than only through the date that the customer can terminate the contract).

Entities will need to exercise significant judgment to determine whether the reversion of a license of IP is a substantive termination penalty that compensates the entity for termination of a contract. Entities may find this assessment challenging because there are often a number of uncertainties and potential contingent events, many of which are outside of the control of the parties to the contract that could negatively affect the value of the rights conveyed in the contract at the termination date. For example, a customer may exercise its termination rights because of a failure to obtain regulatory approval, product safety or efficacy issues or other market factors. The payment terms associated with the license of IP are also important to consider (e.g., surrendering rights to IP that have been fully or significantly prepaid would be viewed differently than surrendering rights to IP and avoiding ongoing licensing payments).

At contract inception, entities likely will have estimated the probability of success of the contracted-for activities and both parties will be committed to perform under the terms of the contract, but they may not be able to assert with a high degree of certainty that the rights to the IP will have substantive value at any future termination date. Instead, the customer may decide to terminate the contract because there is a significant decline in the value of the rights and continuation under the contract is not viable. In such cases, an entity may determine that the reversion of the rights to the IP may not be a substantive termination penalty.

In other cases, an entity may evaluate the nature of the IP (e.g., the stage of development), together with any payment terms in the contract and other relevant factors, and determine that the reversion of the rights to the IP represents a substantive termination penalty. For example, an entity may license the IP for an approved drug formula to a customer for development and commercialization by the licensee in a different market. The licensee pays a nonrefundable, up-front fee for the license that is consistent with market terms for an approved drug and will pay royalties if the drug is approved and sold in the new market. The contract permits the licensee to terminate the contract with six months' notice, and the rights conveyed by the license revert back to the entity if the contract is terminated. In this fact pattern, the entity might conclude that the up-front fee is compensation for providing the licensee with the right to use the IP. It may also conclude that any subsequent reversion of the rights to the IP is a substantive nonmonetary penalty that provides compensation for termination of the contract. This means the licensee's ability to terminate the contract does not affect the contract term.

How we see it

Life sciences entities should carefully evaluate the terms of their contracts with customers, including all substantive termination penalties, to determine the period in which enforceable rights and obligations exist in the contract. The evaluation of substantive termination penalties requires significant judgment and is critical because the conclusions on the enforceable rights and obligations in a contract, including contract duration, can affect the identification of performance obligations and determination and allocation of the transaction price.

Questions an entity may consider when assessing whether a reversion of licensed rights represents a substantive termination penalty include:

- Is the licensee receiving a right to use an "unproven" or "early stage" drug formula (such that there is likely greater uncertainty about the value of the rights to the IP during the license term), or is the license for rights to an approved drug (such that the value of the licensed rights is more certain at contract inception)?
- Is the licensee required to pay an amount at contract inception that is consistent with or greater than market terms for similar technologies at a similar development stage, or is the licensee primarily making payments as the IP is developed or is commercialized?

Identifying performance obligations

Promised goods and services

When identifying performance obligations in a contract, the first step is to identify the promised goods or services. To do so, a life sciences entity should consider whether the customer has a reasonable expectation that the life sciences entity will transfer certain goods or services. If it does, the life sciences entity is likely to view those goods or services as promises that are part of the negotiated exchange. The life sciences entity needs to distinguish between the promised goods or services that transfer to a customer and the activities that are more administrative in nature. That is, the activities that a life sciences entity must undertake to fulfill a contract and that do not transfer a good or service to the customer are not promised goods or services.

As entities assess whether promised goods or services are performance obligations, the standard allows them to disregard promises that they determine to be immaterial in the context of a contract. As a result, life sciences entities that make this election do not need to aggregate and assess immaterial items at the entity level. For example, in an arrangement to sell medical equipment to a hospital and provide basic education and training services on the product, a medical technology entity may determine that the education and training services are immaterial in the context of the contract through an evaluation of qualitative factors (e.g., the lack of complexity of the education and training services) and quantitative factors.

Free goods and services

Some items that are considered marketing incentives or incidental goods or services under legacy GAAP have to be evaluated under the new standard to determine whether they are promised goods or services in the contract. Although an entity might not consider them to be the main items that the customer contracts to receive, the FASB concluded[7] that they are goods or services for which the customer pays, and the entity should therefore evaluate whether they are separate performance obligations. If they are separate performance obligations, the entity allocates a portion of the transaction price to those free goods or services and recognizes that revenue when those free goods or services are transferred to the customer.

For example, a medical technology entity may provide a product and a free service in a contract with a customer. The medical technology entity likely needs to allocate a portion of the transaction price to the service (unless the medical technology entity determined that the service was immaterial in the context of the contract based on qualitative and quantitative factors).

Government vaccine stockpile programs (Updated December 2017)

Life sciences entities may participate in government vaccine stockpile programs under which they produce vaccines and bill the government but hold the goods until requested. Under updated Securities and Exchange Commission (SEC or Commission) guidance specific to certain types of vaccine stockpile programs,[8] entities participating in these programs should recognize revenue and provide the disclosures required by the revenue standard when vaccines subject to the guidance are placed into federal government stockpile programs.

Participation on a joint steering committee

Life sciences entities often enter into collaborative research and development (R&D) arrangements with counterparties that include multiple promised goods and services. It is common for an arrangement to include provisions that call for the development of and participation on a joint steering committee (JSC) to make decisions about the collaborative activities. For example, a biotechnology (biotech) entity that has a revenue contract with a pharmaceutical (pharma) entity could be required to participate on a JSC in addition to licensing a product candidate and performing R&D services.

Participation on a JSC should be evaluated to determine whether it is a promised service in the arrangement. This determination may require judgment based on a careful evaluation of the facts and circumstances (e.g., whether participation on the JSC is required or optional, whether the life sciences entity can terminate its participation at any time). If participation on the JSC is determined to be a promised service in the arrangement, the life sciences entity has to consider whether that promised service is distinct from other promised goods or services (e.g., whether other parties could perform the service, whether participation on the JSC requires unique skills or expertise that results in a significant integration of goods and services).

Determining whether a promise is distinct

Under the standard, life sciences entities have to first identify the promised goods or services in the contract and determine which ones (or which bundles of goods or services) are distinct (i.e., a separate performance obligation, which is the unit of accounting for purposes of applying the standard). A good or service is distinct if both (1) the good or service is capable of being distinct, and (2) the promise to transfer the good or service is distinct within the context of the contract. The standard provides three factors that are intended to help entities identify when promises in a bundle of promised goods or services are *not* separately identifiable and, therefore, should be combined into a single performance obligation. These three factors include: (1) the presence of a significant integration service, (2) the presence of significant modification or customization or (3) whether the promised goods or services are highly interdependent or highly interrelated. Life sciences entities may need to apply significant judgment when determining whether a promise is distinct, especially to determine whether a promised good or service is distinct in the context of the contract.

Case E in Example 11[9] in the standard addresses a common situation for medical technology entities that sell equipment and specialized consumables for use in the equipment. In the example, the equipment doesn't require significant customization or modification. The entity is the only producer of the consumables, but the consumables are sold separately. The entity concludes that the equipment and consumables are distinct promises because it can satisfy each of them independently of the other. Medical technology entities will need to carefully evaluate the terms of their contracts with customers to determine whether equipment and specialized consumables are distinct performance obligations. Significant judgment will likely be needed in many cases.

Life sciences entities are required to evaluate whether certain promises meet the criteria to be accounted for as a series.

Application of the series of distinct goods and services provision

After identifying the distinct goods or services in a contract, life sciences entities will need to determine whether any of those distinct goods or services represent a series of distinct goods or services that must be combined and accounted for as a single performance obligation. Life sciences entities may need to evaluate this guidance when assessing R&D, manufacturing or other services provided to customers. Determining whether an entity's promise is a single combined performance obligation comprising goods or services that are not distinct from one another or a single performance obligation comprising a series of distinct goods or services is important because the determination can affect the allocation of variable consideration and the accounting for contract modifications and changes in the transaction price.

Distinct goods or services have to meet certain criteria in the standard to be accounted for as a series, including the requirement that they be substantially the same. To determine whether the distinct goods or services are substantially the same, life sciences entities first determine the nature of the promised goods or services. If the nature of the promise is the delivery of a specified amount of services, the entity evaluates whether each service is distinct and substantially the same. If the nature of the promise is the act of standing ready or providing a single service for a period of time (i.e., because there is an unspecified amount of services to be delivered), the entity evaluates whether each time increment, rather than the underlying activities, is distinct and substantially the same.

When evaluating whether the series provision applies to R&D services, a life sciences entity may determine that the series provision does not apply because the daily R&D services that are provided are not distinct (i.e., the R&D services provided throughout the development period are dependent on and interrelated with the R&D services provided on other days). This would result in the R&D services being accounted for as a single combined performance obligation or multiple performance obligations (but not under the series provision). In contrast, a life sciences entity may determine that the series provision applies because the nature of the overall promise is to provide a daily R&D service that is distinct and that its performance of the overall promise to provide R&D services each day is substantially the same (assuming the other series provision criteria are met). This could be the case even though the life sciences entity performs a number of different activities to provide R&D services throughout a day and from day to day (e.g., enrollment of patients, laboratory testing, opening/closing clinical trial sites, preparation of regulatory filings).

If promised goods or services are required to be accounted for as a series of distinct goods or services, any variable consideration received for providing the goods or performing the services (e.g., milestone payments received for completing a phase of R&D services) should be recognized as the life sciences entity provides those specific services if certain criteria are met (see Step 4 of the standard). Consider the following example:

Illustration 2 — Accounting for R&D services that are a single combined performance obligation versus a single performance obligation under the series provision

Biotech agrees to perform R&D services over a three-year period. In exchange, Pharma agrees to pay Biotech a fixed monthly payment for the R&D services and a $5 million milestone payment upon the enrollment of 100 patients in a phase II clinical trial.

Analysis:

If Biotech concludes that all of the R&D services to be provided over the three-year period are a single performance obligation comprising **non-distinct** services, the milestone would be included in the transaction price (subject to the constraint on variable consideration) and recognized based on the single measure of progress determined for the entire period of performance of the R&D services. This may result in a portion of the milestone being recognized as revenue throughout the R&D services period, including during the development period after the milestone is achieved.

Conversely, if Biotech concludes that the R&D services are a single performance obligation comprising a series of **distinct** services, Biotech may be able to recognize the milestone payment as it enrolls patients in the clinical trial if certain criteria are met. Assuming those criteria are met and the Biotech concludes that the milestone should be included in the transaction price (because it is not constrained), the $5 million milestone payment is allocated directly to Biotech's efforts to perform the distinct services that led to the enrollment of the 100 patients. The entire $5 million milestone amount is recognized as revenue during the period when Biotech performed the distinct R&D services that led to the enrollment of the 100 patients (i.e., no revenue from the milestone payment would be recognized during the development period after the milestone is achieved).

How we see it

A life sciences entity needs to first determine the nature of its promise to the customer when evaluating whether any of its promises are distinct and meet the criteria to be accounted for under the series provision. This evaluation may require significant judgment, and life sciences entities need to consider all of the facts and circumstances of the arrangement.

Customer options for additional goods or services

Some contracts give the customer an option to purchase additional goods or services (e.g., consumables for use with medical devices, additional R&D services, manufacturing), which may be priced at a discount or may even be provided free of charge.

When a life sciences entity grants a customer an option to purchase an additional good or service, that option is a separate performance obligation only if it provides a material right to the customer that the customer would not receive without entering into the contract (e.g., a discount that exceeds the range of discounts typically given for that good or service to that class of customer in that geographical area or market). In those cases, the customer in effect pays the life sciences entity in advance for a future good or service. If an entity concludes that a customer option for additional goods or services provides a material right, the option itself is deemed to be a performance obligation in the contract, but the underlying goods or services are not accounted for until the option is exercised.

If a customer has the option to acquire an additional good or service at a price that reflects the standalone selling price for that good or service, that option does not provide the customer with a material right. In these cases, the life sciences entity has made a marketing offer that it should account for when the customer exercises the option to purchase the additional good or service. However, if the contract includes variable consideration (rather than a customer option), a life sciences entity may need to estimate at contract inception the variable consideration expected over the life of the contract.

Determining whether a customer option is a material right will require significant judgment. See Questions 4-12 through 4-14 in our FRD, *Revenue from contracts with customers (ASC 606)*, for further discussion.

Consider the following example:

Illustration 3 — Accounting for a customer option

A medical device manufacturer contracts with its customer to provide a cancer-screening device, perform installation services and provide 50 consumable cartridges to be used with the device. The medical device manufacturer also offers the customer an option to purchase up to 50 additional consumable cartridges in the future at a 25% discount from the list price. The medical device manufacturer generally sells its products at the list price (i.e., undiscounted).

Analysis:

The medical device manufacturer likely will conclude that the customer option for the discounted consumable cartridges is a material right and therefore is a separate performance obligation. That's because the medical device manufacturer does not sell the replacement cartridges at a discount on a standalone basis or offer discounts to new customers that have not entered into a similar contract.

Conversely, if the contract did not provide a discount for the additional consumable cartridges (i.e., the customer option to purchase up to 50 additional cartridges was at the medical device manufacturer's standalone selling price), the medical device manufacturer would likely determine that the customer option for additional consumable cartridges was not a material right and therefore would account for it as a separate contract when the customer exercises the option to purchase the additional consumable cartridges.

How we see it

Contracts in the life sciences industry often include contingent deliverables, such as manufacturing and marketing services that will be provided upon the successful development and approval of a product candidate.

Under the new standard, life sciences entities are required to evaluate whether a contingent good or service represents (1) a customer option to purchase additional goods or services that is a material right, (2) a variable quantity of goods or services that generates variable consideration that is considered in the estimation of the transaction price for the contract or (3) a customer option to purchase additional goods or services that is not a material right and therefore is accounted for as a separate contract when the customer exercises the option to purchase the additional goods or services. This determination likely requires significant judgment and may result in a life sciences entity accounting for a contingency as a component of the initial contract, either in the form of the material right or variable consideration.

Under legacy GAAP, a contingent deliverable often is not accounted for before the resolution of the contingency if considerable uncertainty exists about the outcome of the contingency and the fee for the contingent good or service is consistent with the contingent deliverable's estimated selling price.

Variable consideration

Life sciences entities commonly enter into arrangements with customers that include variable consideration. To apply the guidance on variable consideration, life sciences entities need to evaluate the facts and circumstances of each contract (or type of contract) and likely need to apply more judgment than they do under legacy GAAP. The timing of revenue recognition also may change.

Forms of variable consideration

Variable consideration is defined broadly and can take many forms (e.g., discounts for prompt payment, rebates, credits, price concessions, outcomes-based pricing, milestone payments, performance bonuses). Variable consideration can result from explicit contract terms or can be implied by a life sciences entity's past business practices or intentions when it entered into a contract. It is important for a life sciences entity to appropriately identify and evaluate the different instances of variable consideration included in a contract because it will need to separately estimate and apply a constraint (as discussed below) to all variable consideration.

Life sciences entities are required to evaluate contingent goods or services at contract inception.

Life sciences entities that provide rebates and/or discounts to customers whose orders meet specific volume thresholds have to determine whether to apply the guidance on variable consideration or the guidance on customer options. As discussed in Question 4-14 of our FRD, *Revenue from contracts with customers (ASC 606)*, if a volume rebate or discount is applied prospectively, we believe it generally will be accounted for as a customer option rather than as variable consideration. This is because the consideration for the goods or services in the initial contract is not affected by future purchases, and the volume rebates or discounts affect only the price of future (optional) purchases. If this is the case, life sciences entities will need to evaluate whether the option to purchase future goods or services is a material right and therefore is required to be accounted for as a separate performance obligation, as discussed above.

However, we believe a volume rebate or discount that is applied retrospectively should be accounted for as variable consideration because the final price of each good or service sold depends on the customer's total purchases subject to the rebate program. That is, the consideration is contingent on the occurrence or non-occurrence of future events. These concepts are illustrated in Example 24[10] in the standard.

Life sciences entities should keep in mind that the definition of variable consideration is broad, and they need to evaluate whether contract terms other than those specific to their rebate or discount programs create variable consideration that needs to be separately evaluated (e.g., if the goods subject to a rebate program are also sold with a right of return).

Estimating variable consideration and applying the constraint

To include variable consideration in the estimated transaction price, a life sciences entity must conclude that it is "probable" that a significant reversal of the cumulative revenues recognized under the contract will not occur in future periods when the uncertainty related to the variable consideration is resolved. This requirement, known as the variable consideration constraint, is aimed at preventing the over-recognition of revenue.

Variable consideration estimation methods

A life sciences entity is required to estimate variable consideration using either the "expected value" method or the "most likely amount" method, depending on which method better predicts the amount of consideration to which it will be entitled.

Under the expected value method, life sciences entities determine the expected value of variable consideration using the sum of probability-weighted amounts in a range of possible amounts under the contract. To do this, a life sciences entity needs to identify the possible outcomes and the probabilities of those outcomes.

The FASB indicated in the Basis for Conclusions of ASU 2014-09[11] that this method may better predict expected consideration when an entity has a large number of contracts with similar characteristics (e.g., returns). This method also may better predict consideration when an entity has a single contract with a large number of possible outcomes. The FASB clarified in the Basis for Conclusions of ASU 2014-09[12] that an entity preparing an expected value calculation is not required to consider all possible outcomes, even if it has extensive data and can identify many possible outcomes. Instead, the FASB indicated that, in many cases, a limited number of discrete outcomes and probabilities can provide a reasonable estimate of the expected value.

Under the most likely amount method, life sciences entities will determine the amount of variable consideration using the single most likely amount in a range of possible amounts. The FASB indicated in the Basis for Conclusions of ASU 2014-09[11] that this method may be the better predictor when an entity expects to be entitled to one of two possible amounts. That would be the case if a life sciences entity is entitled to receive all or none of a milestone payment for successfully completing a stage of clinical development or if a life sciences entity grants a discount if a customer pays within a stated period of time.

Life sciences entities should consider all information (historical, current and forecasted) that is reasonably available to them when applying either of these methods. They will likely have to update accounting policies, accounting systems and/or internal control over financial reporting to estimate variable consideration. For example, a life sciences entity may need to update its documentation, processes and controls for calculating rebates on product sales to estimate these rebates using the expected value method or the most likely amount method.

Illustration 4 — Estimating variable consideration and applying the constraint

Biotech enters into an arrangement with Pharma under which Biotech provides a license to a product candidate that is starting phase II clinical studies and performs R&D services for a specified period of time. Assume that these two promises are determined to be distinct. Biotech receives an up-front payment upon execution of the arrangement and may receive milestone payments upon (1) enrollment of a specified number of patients in a phase II clinical study, (2) completion of phase III clinical studies, (3) regulatory approval in the US and (4) regulatory approval in the European Union.

Analysis:

Under the standard, Biotech will include in the transaction price the up-front payment and its estimate of the milestone payments it expects to receive. The amount of consideration that Biotech can include in the transaction price is limited to amounts for which it is probable that a significant reversal of cumulative revenues recognized under the contract will not occur in future periods.

Because the milestone for patient enrollment only has two possible outcomes (e.g., Biotech enrolls or doesn't enroll the specified number of patients), Biotech determines that the most likely amount method is the better predictor of the milestone payment. It then determines that it can include the amount associated with the enrollment milestone in the transaction price because it is probable that doing so will not result in a significant revenue reversal, based on its prior experience with enrolling participants in similar studies, clinical trial results on the product candidate to date and the significance of the milestone payment compared to the cumulative revenues expected to be recognized under the contract at the time of the enrollment milestone.

Due to the significant uncertainty associated with the other future events that would result in milestone payments, however, Biotech initially determines that it cannot include these amounts in the transaction price (i.e., the other milestone payments are fully constrained at contract inception). At the end of each reporting period, Biotech will update its assessment of whether the milestone payments are constrained by considering both the likelihood and magnitude of a potential revenue reversal.

How we see it

Life sciences entities may recognize revenue related to some bonuses and milestone payments sooner than they do under legacy GAAP because the new standard requires them to include in the transaction price the consideration to which they expect to be entitled, after applying the variable consideration constraint. This will be a change in practice for life sciences entities that, under legacy GAAP, generally do not recognize revenue that is contingent on a future event, such as achieving a milestone, until that event occurs because the sales price is not "fixed or determinable," as required by SEC Staff Accounting Bulletin Topic 13.

However, we expect life sciences entities to conclude in many instances that the variable consideration constraint prevents them from recognizing bonuses and milestone payments that are contingent on regulatory approval (e.g., FDA approval of a new drug) until the uncertainty associated with these payments is resolved.

Questions will likely arise about how to apply the variable consideration constraint to specific fact patterns, including how to determine whether it is probable that a significant revenue reversal will not occur.

Rights of return

Life sciences entities often provide customers with a right to return a transferred product for a specified period of time after sale. A right of return creates variability in the transaction price that a life sciences entity needs to estimate.

A life sciences entity will recognize the amount of consideration it expects to return to customers as a refund liability. The standard also requires a return asset to be recognized at the time of the initial sale (when recognition of revenue is deferred due to the anticipated return), if an entity expects to receive the returned product in salable or reparable condition. This return asset represents an entity's right to recover the goods returned by the customer. Life sciences entities have to present the return asset (if recognized) separately from both the refund liability (i.e., on a gross basis) and inventory.

Life sciences entities can no longer wait until a product is sold to an end consumer to recognize revenue from a distributor or reseller if the only uncertainty is variability in pricing.

Consider the following example, which is similar to Example 22[13] in the standard:

Illustration 5 — Right of return

Pharma enters into 50 contracts with customers. Each contract includes the sale of a product for $100 (50 products × $100 = $5,000 total consideration). Cash is received when control of a product transfers. Pharma's return policy allows a customer to return products six months before expiration and up to 12 months after expiration.

Pharma decides to use the portfolio approach described in ASC 606-10 through 10-4 to estimate the variable consideration. Pharma has significant experience in estimating returns for this product and customer class. Pharma decides to use the expected value method and estimates variable consideration of $4,700 ($100 x 47 products not expected to be returned).

Pharma considers the variable consideration constraint and determines that although the returns are outside its influence, it has significant experience in estimating returns for this product and customer class. Pharma concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized (i.e., $4,700) will not occur over the return period.

Upon transfer of control of the 50 products, Pharma does not recognize revenue for the three products that it expects to be returned. Pharma records revenue of $4,700 and a refund liability of $300. No return asset is recorded because the product cannot be resold.

How we see it

While treating rights of return as variable consideration under the new standard may not significantly change the timing of revenue recognition compared to legacy GAAP, life sciences entities may have to revise their policies and processes to address the variable consideration constraint.

While returns often have no value for life sciences entities because the products expire or must be destroyed, separately presenting a return asset and a refund liability on the balance sheet will be a change in practice for some medical technology entities. Under legacy GAAP, the carrying value of any product expected to be returned typically remains in inventory and is not subject to separate impairment testing (although inventory is fully expensed at the time of sale if the value of the returned product is expected to be zero).

Distributor and reseller arrangements

Under the standard, life sciences entities that sell their products through distributors, or resellers may recognize revenue sooner than under legacy GAAP. This is because the standard requires entities to estimate variable consideration (i.e., the end sales price) based on the information available at contract inception, taking into consideration the effect of the constraint (similar to the "sell-in" method under legacy GAAP). That is, life sciences entities have to estimate the transaction price, taking into consideration the amounts of returns and other variable components of pricing (e.g., chargebacks). They recognize the amount included in the transaction price as revenue at the time that control of the products transfers to the distributor or reseller.

How we see it

Under the new standard, it is no longer acceptable for life sciences entities that sell their products through distributors or resellers to wait until the product is sold to the end consumer to recognize any revenue (i.e., the "sell-through" method) if the only uncertainty is the variability in the pricing. However, in some cases, the outcomes under the standard and legacy GAAP could be similar if a significant portion of the estimated revenue is constrained.

Under legacy GAAP, many life sciences entities apply the sell-through method and wait until the product is prescribed to a patient or sold to the end consumer to recognize revenue because they do not consider the sales price fixed or determinable until then.

Significant financing component

To determine whether a significant financing component exists, a life sciences entity will need to consider all relevant facts and circumstances, including (1) the difference between the cash selling price and the amount of promised consideration for the promised goods or services and (2) the combined effect of the expected length of time between the transfer of the goods or services and the receipt of consideration and the prevailing market interest rates.

The standard describes several factors that indicate that there isn't a significant financing component. They include situations when a substantial amount of the consideration promised by the customer is variable, and the amount or timing of that consideration varies based on a future event that is not within the control of the customer or the entity (e.g., a sales-based royalty).

It may be reasonable for a life sciences entity to attribute an adjustment for a significant financing component to one or more, but not all, of the performance obligations in the contract. For example, a life sciences entity that receives an up-front payment as part of the consideration transferred in exchange for a license of functional IP (described below) and R&D services will need to evaluate whether the contract contains a significant financing component associated with the R&D services. If certain criteria are met, the life sciences entity may apply guidance in the standard that requires specific forms of consideration (such as variable consideration or discounts) to be allocated to one or more (but not all) performance obligations to determine how much of the up-front payment relates to the license and how much relates to the R&D services. However, this determination of whether a significant financing component exists will require the use of judgment, especially because cash is fungible.

As a practical expedient, a life sciences entity may decide not to adjust the promised amount of consideration for the effects of a significant financing component if it expects, at contract inception, that the period between the transfer of a promised good or service to a customer and the payment for that good or service will be one year or less.

Licenses of IP

A license provides a customer with rights to use or access an entity's IP. Life sciences entities commonly enter into arrangements with customers that include licenses of IP such as licenses for product candidates or patented drug formulas. The new standard provides guidance for recognizing revenue from licenses of IP and sales-based royalties provided in exchange for licenses of IP that differs in some respects from the guidance for other promised goods and services.

When applying the guidance on licenses of IP, a life sciences entity will have to analyze the facts and circumstances of each contract (or type of contract) and may need to use more judgment than it does under legacy GAAP. The units of accounting and timing of revenue recognition also may change under the standard.

Determining whether a license is distinct

Contracts for licenses of IP frequently include explicit or implicit promises for additional goods or services. Under the standard, an entity must first determine whether the license and additional goods or services are distinct and, therefore, separate performance obligations, by applying the guidance on identifying performance obligations from Step 2 of the standard. Consistent with the guidance in Step 2 of the standard, a license of IP that is not distinct is combined with other goods or services into a single performance obligation. Consider the following two examples, which are similar to Cases A and B in Example 56[14] in the standard:

Illustration 6 — Identifying performance obligations — license is not distinct
Pharma licenses its patent rights to an approved mature drug to a customer for 10 years. Pharma promises to manufacture the drug for five years while the customer develops its own manufacturing capability. There is no expectation that Pharma will undertake activities to change the drug (e.g., to alter its chemical composition). No other entity can perform the manufacturing while the customer develops its manufacturing capability because of the highly specialized nature of the process. As a result, the license cannot be purchased separately from the manufacturing. *Analysis:* Because the customer cannot benefit from the license without the manufacturing, the license and the manufacturing are not capable of being distinct, and the promises are accounted for as a combined performance obligation. The nature of the combined good or service for which the customer contracted is a sole sourced supply of the drug for the first five years.

Illustration 7 — Identifying performance obligations — license is distinct
Assume the same facts as in Illustration 6 above, except that the manufacturing process is not specialized and can be performed by other entities. *Analysis:* Pharma concludes that the promises are capable of being distinct because the customer can benefit from the (1) license together with other readily available resources (i.e., because other entities can provide the manufacturing) and (2) manufacturing together with the license that transfers to the customer up front. Pharma also concludes that the promises are distinct in the context of the contract because they (1) are not inputs that Pharma integrates into a combined output, (2) do not significantly modify or customize each other and (3) are not highly interrelated or highly interdependent (i.e., the entity will be able to fulfill its promise to transfer the license independently of fulfilling its promise to manufacture the drug for the customer). As a result, Pharma concludes that the license and the manufacturing should be accounted for as separate performance obligations.

Contractual restrictions

The standard requires life sciences entities to distinguish between contractual provisions that define the attributes of a license of IP (e.g., restrictions of use or geography) and others that represent additional promised goods or services to the customer. Contractual provisions that are attributes of a promised license define the scope of a customer's rights to IP and do not affect whether a performance obligation is satisfied at a point in time or over time. These provisions also don't affect the number of performance obligations in the contract.

Significant judgment will be required to determine whether a contractual provision results in additional promises (e.g., additional licenses) or is an attribute that defines the scope of the license. If a life sciences entity determines that a license contains multiple promises, it has to evaluate whether the promises represent multiple performance obligations. The guidance on contractual restrictions in ASC 606-10-55-64 does not replace the requirement to appropriately identify the goods or services promised to the customer in accordance with Step 2 of the standard.

When analyzing contractual restrictions, a life sciences entity should consider whether a restriction requires it to grant additional rights to the customer at a future date to fulfill its promises under the contract. The presence of such a requirement indicates that there may be multiple promises that need to be accounted for under Step 2 of the standard.

In many life sciences contracts, multiple, distinct rights may be transferred to a customer at the same point in time (e.g., licenses for multiple rights to use product candidates or patented drug formulas) or over the same period of time (e.g., licenses for multiple rights to access brands or trade names). The FASB indicated[15] that an entity is not required to separately identify each set of distinct rights if those rights are transferred concurrently.

How we see it

Licenses in the life sciences industry often restrict where and/or how a customer can use a product candidate or patented drug formula. For example, a license may provide the customer with a right to use a patented drug formula in Country A starting in Year 1 of the contract and Country B starting in Year 2 of the contract. These rights generally are viewed under the standard as multiple promises that are separate performance obligations because additional distinct rights are granted to the customer in Year 2.

Life sciences entities need to apply judgment to determine (based on the requirements in Step 2 of the standard) whether contractual restrictions represent multiple promises to the customer and, if so, whether those multiple promises are distinct.

Effect of contractual restrictions on the distinct analysis

Contractual restrictions do not change the evaluation of whether a license of IP and manufacturing are distinct.

Contractual restrictions that require a customer to obtain goods or services from a specific life sciences entity (e.g., manufacturing, R&D services) are common in contracts in the life sciences industry. As described in Example 11, Case D,[16] of the standard, a contractual restriction that requires a customer to purchase goods or services from the entity (and not from alternate suppliers) does not change the evaluation of whether promised goods or services are distinct if the contractual restriction does not change (1) the characteristics of the goods or services themselves and (2) the entity's promises to the customer.

For example, although a customer may be contractually required to use a life sciences entity to manufacture a drug once it obtains regulatory approval, the contractual requirement does not change the characteristics of the license to the drug or the manufacturing, and it does not change the life sciences entity's promises to the customer (i.e., the contractual requirement does not change the evaluation of whether the license to the drug and the manufacturing are distinct).

How we see it

It is common in the life sciences industry for regulators (e.g., the FDA) to restrict manufacturing to entities with approved facilities and manufacturing processes. Determining how such restriction affects the distinct analysis may require significant judgment.

Careful consideration should be given to factors such as whether a third party would be able to implement the necessary processes and how long it would take for that third party to develop those processes and obtain regulatory approval to manufacture the product. For example, certain products (e.g., some biologics) may be more complex to manufacture than others (e.g., some generic drugs), and it could take longer for a third party to develop the processes and obtain the regulatory approval to do so. This may have a significant effect on the utility of the promised goods or services in the contract (e.g., a license of IP and manufacturing).

Determining the nature of the entity's promise

Entities are required to classify IP as either functional or symbolic to determine whether to recognize the revenue associated with the license of that IP at a point in time or over time. If contracts include multiple licenses of IP (e.g., a contract that grants a license to a drug formula and a license to a brand), entities have to classify each license of IP as either functional or symbolic to determine the appropriate timing of revenue recognition.

Functional IP has significant standalone functionality and derives a substantial portion of its utility (i.e., the IP's ability to provide benefit or value) from that standalone functionality. A licensor's ongoing activities generally do not significantly affect the standalone functionality of functional IP. Examples of functional IP include biological compounds and drug formulas. Revenue from functional IP typically is recognized at a point in time. If the functional IP is not distinct, the licensor combines the functional IP with other goods and services in a single performance obligation and recognizes revenue based on the nature of the combined performance obligation.

Symbolic IP does not have significant standalone functionality because substantially all of its utility is derived from its association with the licensor's ongoing or past support (e.g., activities that support the value of the IP). Examples of symbolic IP include a brand or a trade name. Licenses of symbolic IP always represent a right to access a licensor's IP, and therefore, revenue from symbolic IP is recognized over time as the performance obligation is satisfied.

The following example illustrates how a life sciences entity may determine when to recognize revenue for a license of functional IP:

Illustration 8 — Determining the nature of the entity's promise

Example A

Assume the same facts as Illustration 6 above.

Analysis:

The license provides a right to use Pharma's IP. Pharma concludes that it is licensing functional IP because the license is for a mature drug that has significant standalone functionality (i.e., it can be used to treat a disease or condition). There is also no expectation that Pharma will undertake activities to change the standalone functionality of the IP.

If the license is the only distinct promise in the contract, revenue is recognized at the point in time that control of the license is transferred to the customer. However, in this example, the license and the manufacturing are combined into a single performance obligation, and Pharma applies the requirements in Step 5 of the standard to determine whether the combined performance obligation is satisfied at a point in time or over time. Pharma will likely determine that the combined performance obligation is satisfied over time up to the end of the fifth year when the manufacturing is complete.

Example B

Assume the same facts as in Illustration 7 above.

Analysis:

Pharma assesses the nature of its promise to grant the license and concludes that the patented drug formula is functional IP because it is a mature drug that can be used to treat a disease or condition. There is also no expectation that Pharma will undertake activities to change the standalone functionality of the IP. Pharma will likely determine that the license is a performance obligation satisfied at the point in time when control of the license is transferred to the customer.

In assessing the timing of recognition of the revenue from the license, Pharma does not consider the manufacturing because it is a separate performance obligation in the contract.

If a life sciences entity is required to bundle a license of IP with other promised goods and services in a contract into a combined performance obligation, it considers the guidance on licenses of IP to determine the nature of its promise to the customer. For example, if the license in Illustration 8, Example A, above provided a right to access the life sciences entity's IP (i.e., symbolic IP), the combined performance obligation will not be fully satisfied until the end of the 10-year license period, which will likely extend the period of revenue recognition beyond the date when the manufacturing is complete.

License arrangements that include sales- or usage-based royalties

Life sciences entities commonly enter into arrangements that require the customer to pay a sales- or usage-based royalty in exchange for a license of IP. For example, a licensee may be required to pay royalties based on a percentage of its drug product sales.

Sales- or usage-based royalties received in exchange for licenses of IP are recognized at the later of when (1) the subsequent sale or usage occurs or (2) the performance obligation to which some or all of the sales- or usage-based royalty has been allocated is satisfied (in whole or in part). That is, an entity recognizes the royalties as revenue when (or as) the customer's subsequent sales or usage occurs, unless that recognition pattern accelerates revenue recognition ahead of the entity's satisfaction of the performance obligation to which the royalty relates.

The standard requires the royalty recognition constraint to be applied to the overall royalty stream when the sole or predominant item to which the royalty relates is a license of IP (including when no single license is the predominant item to which the royalty relates, but the royalty predominantly relates to two or more licenses in the contract). Entities cannot analogize to it for other situations.

Life sciences entities will need to apply judgment to assess whether a license of IP is the sole or predominant item to which the royalty relates in a combined performance obligation or in relation to other distinct goods or services in a contract. One way for a licensor to make this determination is for it to assess whether the licensee would ascribe significantly more value to the license than to the other goods and services in the contract. For example, in a contract that provides a license of IP and R&D services that are combined into a single performance obligation, a life sciences entity would determine whether the license is the predominant item to which the royalty relates by evaluating whether the customer considers the license significantly more valuable than the R&D services. This determination may require significant judgment based on the facts and circumstances (e.g., the remaining clinical trial studies that need to be completed, the expected size of the market).

The standard requires a royalty stream to be accounted for either entirely under the royalty recognition constraint or entirely under the variable consideration constraint. That is, an entity should not split a single royalty and apply the royalty recognition constraint to a portion of it and the variable consideration constraint to the other portion.

Scope of the sales- or usage-based royalty recognition constraint

The FASB concluded in the Basis for Conclusions of ASU 2016-10[17] that, when entities determine whether to apply the royalty recognition constraint, they should not attempt to determine whether a license of IP is in substance a sale of IP (i.e., a promise that is in the form of a license but has the characteristics of a sale). Therefore, life sciences entities should follow the legal form of a license of IP for purposes of determining whether they can apply the royalty recognition constraint.

It is also important to note that the royalty recognition constraint applies only to licenses of IP for which some or all of the consideration is in the form of a sales- or usage-based royalty. This would include certain types of variable consideration even if payments are not referred to as royalties in the contract but are based on a customer's sale or usage and predominantly related to a license of IP. For example, we generally believe the royalty recognition constraint should be applied to fixed dollar amounts of variable consideration that are contingent on the occurrence of a future event (e.g., sales-based milestone payments), provided that the amounts are determined by reference to sales- or usage-based thresholds.

However, life sciences entities cannot analogize to the royalty recognition constraint for other situations, such as when consideration in a contract is in the form of a sales- or usage-based royalty but there is no license of IP (e.g., royalties paid in exchange for a sale of IP). When the royalty recognition constraint cannot be applied, a life sciences entity follows the general guidance on estimating and applying the variable consideration constraint. Life sciences entities need to apply judgment to determine whether their contracts for licenses of IP contain payments that should be accounted for using the royalty recognition constraint. See Question 8-4 in our FRD, *Revenue from contracts with customers (ASC 606)*, for an illustration and further discussion.

Estimating a sales- or usage-based royalty when there is a lag in reporting

Life sciences entities have questioned whether they can recognize revenue for sales- or usage-based royalties for licenses of IP on a lag if actual sales or usage data is not available at the end of a reporting period. If the sales or usage has occurred and the performance obligation to which the royalties relate has been satisfied (or partially satisfied), we believe that licensors without actual sales or usage data from the licensee need to estimate the royalties earned in the current reporting period.

Life sciences entities without actual sales or usage data have to estimate the royalties they earned in a reporting period.

The SEC's Chief Accountant noted in a speech[18] that because the FASB did not provide "a lagged reporting exception" in the standard, the reporting of sales- and usage-based royalties may require estimation in some circumstances. This may result in a change in practice for entities that have previously recorded revenue from royalties on a lag (i.e., in a reporting period subsequent to when the underlying sales or usage occurs).

How we see it

Estimating royalties earned in the current reporting period is a significant change in practice for entities that don't have actual sales or usage data from the licensee and report on a lag under legacy practice. Significant judgment is required for these estimates. Licensors without this data need to implement processes and controls to collect data and develop assumptions to make a reasonable estimate.

Recognition of revenue from a license of IP

The standard doesn't allow entities to recognize revenue for a license of IP before they provide the IP or make it available to the customer or before the beginning of the period during which the customer is able to use and benefit from the license. Assuming that all other criteria have been met, a life sciences entity will recognize revenue from a license of functional IP at the point in time when the customer is able to use and benefit from the product or product candidate (i.e., the start of the license period).

Restrictions on a licensee's ability to use and benefit from the license

Renewals of licenses of IP

The standard requires an entity to wait until the beginning of a renewal period to recognize revenue from a renewal of a license of IP. This requirement may change practice for some life sciences entities. For example, assume the same facts as in Illustration 8, Example A, above except that during Year 8 of the 10-year license period, Pharma agrees to renew the license for an additional three years (i.e., through Year 13). Assuming the price of the renewal reflects the license's standalone selling price, the renewal is considered a separate license from the initial 10-year license, and Pharma does not recognize revenue for the renewal performance obligation before the beginning of Year 11 (i.e., the date the renewal period begins). Case B in Example 59[19] in the standard illustrates the revenue recognition for a license renewal.

Distinct rights added through a modification

Life sciences entities frequently modify the terms of arrangements to provide customers with additional rights. The terms of each license of IP are defined by the contract, which establishes the customer's rights (e.g., period of time, area of use). We believe that when a contract for a license of IP is modified, the additional and/or modified license of IP is distinct from the original license because the new and/or modified rights will always differ from those conveyed by the original license.

The standard's contract modification guidance requires a modification in which the additional promised goods or services are distinct to be accounted for on a prospective basis either as a separate contract or a termination of the old contract and creation of a new contract. As discussed above, a life sciences entity cannot recognize revenue for the transaction price allocated to the new license until the customer has the right to use and benefit from it.

Consideration paid or payable to a customer

The standard requires an entity to account for payments made to a customer or another party that purchases the entity's goods or services from the customer, regardless of whether the purchaser receiving the consideration is a direct or indirect customer of the entity. This requirement applies to consideration payable to any purchasers of an entity's products or services at any point along the distribution chain, including customers of resellers or distributors that purchase directly from a life sciences entity (e.g., retail pharmacies, governmental agencies).

Common forms of consideration paid or payable by a life sciences entity to its direct or indirect customers include:

- Rebates paid to governmental entities (e.g., Medicaid, Medicare, TRICARE, Department of Veterans Affairs, Department of Defense), managed care entities or other health insurers
- Fee-for-service amounts paid to wholesalers or other resellers
- Chargebacks paid to wholesalers
- Prompt payment discounts to wholesalers and specialty pharma companies
- Patient assistance programs and co-pay assistance

To determine the appropriate accounting treatment for consideration paid or payable to a customer, a life sciences entity must first determine whether the consideration is a payment for a distinct good or service, a reduction of the transaction price or a combination of both. The payment is treated as something other than a reduction of the transaction price only if the entity receives a distinct good or service from the customer in exchange for that payment. See Question 5-22 in our FRD, *Revenue from contracts with customers (ASC 606)*, for further discussion.

How we see it

Questions have arisen as to whether a contribution to a not-for-profit or other organization that funds co-pay assistance programs is a form of consideration paid or payable to an indirect customer because the contribution funds may be used by a patient to obtain the entity's products.

Life sciences entities that contribute to not-for-profit or other organizations that may fund co-pay assistance programs should carefully evaluate the facts and circumstances of each contribution to determine whether it represents consideration paid or payable to an indirect customer (i.e., whether it should be accounted for as a reduction of the transaction price from a contract with a customer because the amount is not provided in exchange for a distinct good or service). Life sciences entities will need to apply significant judgment when making this determination.

Transition

Life sciences entities need to consider contingent amounts that may be received at a future date (e.g., royalties, milestones) when evaluating which contracts are complete.

The standard requires either a "full retrospective" adoption in which the standard is applied to all of the periods presented or a "modified retrospective" adoption. Certain practical expedients are available if the full retrospective adoption method is used. The modified retrospective adoption method can be applied to all contracts at transition or only to contracts that are not completed as of that date.

The standard considers a contract to be completed at transition if all (or substantially all) of the revenue has been recognized under legacy GAAP. When evaluating which contracts are complete, life sciences entities need to consider all potential contract revenues in the assessment, including contingent amounts that may be received at a future date (e.g., royalties, milestones). In the Basis for Conclusions of ASU 2016-12,[20] the FASB explained that in certain circumstances in which less than 100% of the revenue from a contract was recognized under legacy GAAP, an entity could recognize the remaining revenue (e.g., an adjustment to the sales returns reserve) in accordance with legacy GAAP. This determination requires life sciences entities to apply judgment in some cases.

Presentation and disclosure

Presentation

When either party to a contract has performed, an entity presents the contract in the statement of financial position as a contract asset or a contract liability, depending on the relationship between the entity's performance and the customer's payment. Members of the TRG generally agreed[21] that contract assets and liabilities should be determined at the contract level and not at the performance obligation level. That is, an entity does not separately recognize an asset or liability for each performance obligation within a contract but aggregates them into a single contract asset or liability.

Under the standard, entities do not have to use the terms "contract asset" or "contract liability" but have to disclose sufficient information to allow users of the financial statements to clearly distinguish between unconditional rights to consideration (e.g., receivables) and conditional rights to receive consideration (e.g., contract assets, unbilled receivables).

When a life sciences entity expects to refund some or all of the consideration received (or receivable) from a customer, it records a refund liability. We believe that a refund liability does not typically meet the definition of a contract liability because a refund liability generally does not represent an obligation to transfer goods or services in the future. However, as discussed in the

Basis for Conclusions of ASU 2016-20,[22] an entity should determine whether a contract refund liability should be characterized as a contract liability based on the specific facts of circumstances of the arrangement. When a life sciences entity concludes that a refund liability is not a contract liability, it should present the refund liability separately from any contract liability (or asset), and the refund liability is not subject to the disclosure requirements for contract assets and liabilities included in ASC 606-10-50-8 and 50-10. See Question 10-4 in our FRD, *Revenue from contracts with customers (ASC 606)*, for further discussion.

Disclosure

For public entities (as defined in the standard), disclosures include qualitative and quantitative information about contracts with customers, significant judgments made to apply the standard and costs to obtain or fulfill a contract. Nonpublic entities can choose to provide the same or streamlined disclosures.

Required qualitative and quantitative disclosures about contracts with customers include information about performance obligations, contract assets and contract liabilities.

The standard also requires disclosure of significant accounting estimates and judgments made in determining the transaction price and amounts allocated to performance obligations. For life sciences entities, this may include information about estimating the standalone selling price of promised goods or services, estimating variable consideration and allocating variable consideration to a specific part of a contract. These disclosures exceed the requirements for significant accounting estimates under legacy GAAP.

The standard also expands disclosure requirements for interim financial statements and requires certain disclosures upon transition, depending on the transition method an entity selects (i.e., full retrospective or modified retrospective).

Prior to adopting the standard, life sciences entities that are SEC registrants must make certain disclosures about the potential effects of the standard,[23] including the expected transition method once a decision is made. Nonpublic life sciences entities should consider making similar disclosures.

Some of the specific disclosure requirements that may affect life sciences entities are discussed in further detail below.

Disclosure of disaggregated revenue

The requirement to disclose disaggregated revenue information is intended to illustrate how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. When determining how to disaggregate revenue, a life sciences entity should consider how information is presented for other purposes, including information presented outside the financial statements (e.g., investor presentations), information reviewed by the chief operating decision maker to evaluate operating segments and information used to evaluate the life sciences entity's financial performance. Categories may include type of services, type of customer, type of contract and geographical location.

The standard states that an entity does not have to duplicate disclosures required by another standard. For example, a life sciences entity that provides disaggregated revenue disclosures as part of its segment disclosures does not have to separately provide disaggregated revenue disclosures if the segment-related disclosures are sufficient to illustrate how the nature, amount, timing and uncertainty of revenue and cash flows from contracts with customers are affected by economic factors. However, the FASB stated in the Basis for Conclusions of ASU 2014-09[24] that segment revenue disclosures may not always provide users of financial statements with enough information to help them understand the composition of revenue recognized in the period. If a life sciences entity provides disaggregated revenue disclosures in addition to segment disclosures, the standard requires an entity to explain the relationship between the disclosures.

Disclosure of revenue related to satisfied performance obligations

The standard requires entities to disclose the amount of revenue recognized in the period that relates to amounts allocated to performance obligations that were satisfied (or partially satisfied) in previous periods (e.g., due to a change in transaction price or in estimates related to the variable consideration constraint).

Disclosure of remaining performance obligations

A public entity is required to disclose information about remaining performance obligations, including the amount of the transaction price allocated to performance obligations that are unsatisfied (or partially unsatisfied) as of the end of the reporting period and when it expects to recognize the amount(s) in its interim and annual financial statements. The FASB provided optional exemptions that allow an entity not to make quantitative disclosures about remaining performance obligations in certain situations, including when contracts have an original expected duration of less than one year and when an estimate of the transaction price is made solely for disclosure purposes.

These situations also include: (1) when an entity applies the right to invoice practical expedient in ASC 606-10-55-18, (2) when variable consideration in the contract is due to a sales- or usage-based royalty promised in exchange for a license of IP accounted for under ASC 606-10-55-65 through 65B and (3) when variable consideration is allocated entirely to a wholly unsatisfied performance obligation or to a wholly unsatisfied promise to transfer a distinct good or service that forms part of a single performance obligation (i.e., a series of distinct goods or services) when certain criteria are met.

These optional exemptions only apply to the portion of the transaction price that is variable consideration and meets the conditions of the exemptions. If a contract includes both fixed consideration and variable consideration and the variable consideration meets one of the conditions for applying the exemptions, an entity will still be required to disclose the remaining fixed consideration. For example, a guaranteed minimum amount of consideration included in a sales- or usage-based royalty is fixed consideration, and the remaining amount to be recognized under the minimum should be disclosed.

Entities that elect to use any of the standard's optional exemptions that allow them not to disclose the aggregate transaction price allocated to the remaining performance obligations must disclose which optional exemption(s) they are applying, the nature of the performance obligations, the remaining duration of the contract and a description of the variable consideration that has been excluded from the disclosure (e.g., the nature of the variability and how that variability will be resolved).

How we see it

Disclosing the revenue recognized from performance obligations satisfied in previous periods is likely to be a change in practice for life sciences entities. This type of revenue includes sales- or usage-based royalties a life sciences entity receives in a reporting period after it delivers functional IP. Life sciences entities need to make sure they have appropriate systems, policies and procedures and internal controls in place to collect and disclose the required information.

Endnotes:

[1] Under US GAAP, public entities, as defined, will be required to adopt the standard for annual reporting periods beginning after 15 December 2017 (1 January 2018, for calendar-year public entities), and interim periods therein. Nonpublic entities will be required to adopt the standard for annual reporting periods beginning after 15 December 2018, and interim periods within annual reporting periods beginning after 15 December 2019. Public and nonpublic entities can adopt the standard as early as the original public entity effective date (i.e., annual reporting periods beginning after 15 December 2016, and interim periods therein). Early adoption prior to that date is not permitted.

[2] Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers*, as amended, and created by Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers*.

[3] The FASB and the International Accounting Standards Board (IASB) created the TRG to help them determine whether more guidance is needed on their new revenue standards (ASC 606 and the IASB's standard IFRS 15 *Revenue from Contracts with Customers*) and to educate constituents. While the group met jointly in 2014 and 2015, only FASB TRG members participated in the meetings in 2016.

[4] ASC 808, *Collaborative Arrangements.*

[5] Paragraph BC56 of ASU 2014-09.

[6] 9 November 2015 TRG meeting; agenda paper no. 48.

[7] Paragraph BC89 of ASU 2014-09.

[8] The SEC issued Interpretive Release, *Commission Guidance Regarding Accounting for Sales of Vaccines and Bioterror Countermeasures to the Federal Government for Placement into the Pediatric Vaccine Stockpile or the Strategic National Stockpile*, in response to public policy concerns and, therefore, this guidance should not be used by analogy for other bill-and-hold arrangements. The release, issued on 5 December 2005, says the exception is limited to a specific list of "enumerated vaccines" related to federal governmental stockpile programs. In August 2017, the SEC issued a release to update the guidance in the previous release (SEC Release Nos. 33-8642, 34-52885 and IC-27178). The updated guidance applies to the same vaccines as the previous guidance.

[9] ASC 606-10-55-150G through 55-150K.

[10] ASC 606-10-55-216 through 55-220.

[11] Paragraph BC200 of ASU 2014-09.

[12] Paragraph BC201 of ASU 2014-09.

[13] ASC 606-10-55-202 through 55-207.

[14] ASC 606-10-55-368 through 55-370.

[15] Paragraph BC47 of ASU 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing*.

[16] ASC 606-10-55-150E through 55-150F.

[17] Paragraph BC78 of ASU 2016-10.

[18] Speech by Wesley R. Bricker, 9 June 2016. Refer to SEC website at https://www.sec.gov/news/speech/bricker-remarks-35th-financial-reporting-institute-conference.html.

[19] ASC 606-10-55-392A through 55-392C.

[20] Paragraph BC52 of ASU 2016-12, *Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*.

[21] 31 October 2014 TRG meeting; agenda paper no. 7.

[22] Paragraph BC37 of ASU 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers*.

[23] Codified in SEC Staff Accounting Bulletin, 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.

[24] Paragraph BC340 of ASU 2014-09.

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Appendix: The five-step revenue model and contract costs

The standard's core principle is that an entity recognizes revenue at an amount that reflects the consideration to which the entity expects to be entitled in exchange for transferring goods or services to a customer. That principle is applied using five steps that will require entities to exercise judgment when considering the terms of their contract(s) and all relevant facts and circumstances. Entities have to apply the requirements of the standard consistently to contracts with similar characteristics and in similar circumstances. This table summarizes the new revenue model and the guidance for contract costs.

Step 1: Identify the contract(s) with the customer

Definition of a contract

An entity must first identify the contract, or contracts, to provide goods and services to customers. A contract must create enforceable rights and obligations to fall within the scope of the model in the standard. Such contracts may be written, oral or implied by an entity's customary business practices but must meet the following criteria:

- The parties to the contract have approved the contract (in writing, orally or based on their customary business practices) and are committed to perform their respective obligations
- The entity can identify each party's rights regarding the goods or services to be transferred
- The entity can identify the payment terms for the goods or services to be transferred
- The contract has commercial substance (i.e., the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract)
- It is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer

If these criteria are not met, an entity would not account for the arrangement using the model in the standard and would recognize any nonrefundable consideration received as revenue only when certain events have occurred.

Contract combination

The standard requires entities to combine contracts entered into at or near the same time with the same customer (or related parties of the customer) if they meet any of the following criteria:

- The contracts are negotiated as a package with a single commercial objective
- The amount of consideration to be paid in one contract depends on the price or performance of another contract
- The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation

Contract modifications

A contract modification is a change in the scope and/or price of a contract. A contract modification is accounted for as a new contract separate from the original contract if the modification adds distinct goods or services at a price that reflects the standalone selling prices of those goods or services. Contract modifications that are not accounted for as separate contracts are considered changes to the original contract and are accounted for as follows:

- If the goods and services to be transferred after the contract modification are distinct from the goods or services transferred on or before the contract modification, the entity should account for the modification as if it were the termination of the old contract and the creation of a new contract
- If the goods and services to be transferred after the contract modification are not distinct from the goods and services already provided and, therefore, form part of a single performance obligation that is partially satisfied at the date of modification, the entity should account for the contract modification as if it were part of the original contract
- A combination of the two approaches above: a modification of the existing contract for the partially satisfied performance obligations and the creation of a new contract for the distinct goods and services

Step 2: Identify the performance obligation(s) in the contract

An entity must identify the promised goods and services within the contract and determine which of those goods and services (or bundles of goods and services) are separate performance obligations (i.e., the unit of accounting for purposes of applying the standard). An entity is not required to assess whether promised goods or services are performance obligations if they are immaterial in the context of the contract.

A promised good or service represents a performance obligation if (1) the good or service is distinct (by itself or as part of a bundle of goods or services) or (2) the good or service is part of a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer.

A good or service (or bundle of goods or services) is distinct if both of the following criteria are met:

- 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 (i.e., the good or service is capable of being distinct)
- The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (i.e., the promise to transfer the good or service is distinct within the context of the contract)

In assessing whether an entity's promise to transfer a good or service is separately identifiable from other promises in the contract, entities will need to consider whether the nature of the promise is to transfer each of those goods or services individually or to transfer a combined item or items to which the promised goods or services are inputs. Factors that indicate two or more promises to transfer goods or services are not separately identifiable include, but are not limited to, the following:

- The entity provides a significant service of integrating the goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted
- One or more of the goods or services significantly modify or customize, or are significantly modified or customized by, one or more of the other goods or services promised in the contract
- The goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract

If a promised good or service is not distinct, an entity is required to combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct.

Series guidance

Goods or services that are part of a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer must be combined into one performance obligation. To meet the same pattern of transfer criterion, each distinct good or service in the series must represent a performance obligation that would be satisfied over time and would have the same measure of progress toward satisfaction of the performance obligation (both discussed in Step 5), if accounted for separately.

Customer options for additional goods or services

A customer's option to acquire additional goods or services for free or at a discount is accounted for as a separate performance obligation if it provides a material right to the customer that the customer would not receive without entering into the contract (e.g., a discount that exceeds the range of discounts typically given for those goods or services to that class of customer in that geographical area or market).

Principal versus agent considerations

When more than one party is involved in providing goods or services to a customer, an entity must determine whether it is a principal or an agent in these transactions by evaluating the nature of its promise to the customer. An entity is a principal and therefore records revenue on a gross basis if it controls a promised good or service before transferring that good or service to the customer. An entity is an agent and records as revenue the net amount it retains for its agency services if its role is to arrange for another entity to provide the goods or services. Because it is not always clear whether an entity controls a specified good or service in some contracts (e.g., those involving intangible goods and/or services), the standard also provides indicators of when an entity may control the specified good or service as follows:

- The entity is primarily responsible for fulfilling the promise to provide the specified good or service
- The entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer (e.g., if the customer has a right of return)
- The entity has discretion in establishing the price for the specified good or service

Step 3: Determine the transaction price

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. When determining the transaction price, entities need to consider the effects of all of the following:

Variable consideration

An entity needs to estimate any variable consideration (e.g., amounts that vary due to discounts, rebates, refunds, price concessions, bonuses) using either the expected value method (i.e., a probability-weighted amount method) or the most likely amount method (i.e., a method to choose the single most likely amount in a range of possible amounts). An entity's method selection is not a "free choice" and must be based on which method better predicts the amount of consideration to which the entity will be entitled. To include variable consideration in the estimated transaction price, the entity has to conclude that it is probable that a significant revenue reversal will not occur in future periods. This "constraint" on variable consideration is based on the probability of a reversal of an amount that is significant relative to cumulative revenue recognized for the contract. The standard provides factors that increase the likelihood or magnitude of a revenue reversal, including the following: the amount of consideration is highly susceptible to factors outside the entity's influence, the entity's experience with similar types of contracts is limited or that experience has limited predictive value, the contract has a large number and broad range of possible outcomes. The standard requires an entity to estimate variable consideration, including the application of the constraint, at contract inception and update that estimate at each reporting date.

Significant financing component

An entity needs to adjust the transaction price for the effects of the time value of money if the timing of payments agreed to by the parties to the contract provides the customer or the entity with a significant financing benefit. As a practical expedient, an entity can elect not to adjust the transaction price for the effects of a significant financing component if the entity expects at contract inception that the period between payment and performance will be one year or less.

Noncash consideration

When an entity receives, or expects to receive, noncash consideration (e.g., property, plant or equipment, a financial instrument), the fair value of the noncash consideration at contract inception is included in the transaction price.

Consideration paid or payable to the customer

Consideration payable to the customer includes cash amounts that an entity pays, or expects to pay, to the customer, and credits or other items (vouchers or coupons) that can be applied against amounts owed to the entity. An entity should account for consideration paid or payable to the customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service. However, if the payment to the customer exceeds the fair value of the distinct good or service received, the entity should account for the excess amount as a reduction of the transaction price.

Step 4: Allocate the transaction price to the performance obligations in the contract
For contracts that have multiple performance obligations, the standard generally requires an entity to allocate the transaction price to the performance obligations in proportion to their standalone selling prices (i.e., on a relative standalone selling price basis). When allocating on a relative standalone selling price basis, any discount within the contract generally is allocated proportionately to all of the performance obligations in the contract. However, there are two exceptions. One exception requires variable consideration to be allocated entirely to a specific part of a contract, such as one or more (but not all) performance obligations or one or more (but not all) distinct goods or services promised in a series of distinct goods or services that forms part of a single performance obligation, if both of the following criteria are met: ‣ The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service ‣ Allocating the variable consideration entirely to the performance obligation or the distinct good or service is consistent with the objective of allocating consideration in an amount that depicts the consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer The other exception requires an entity to allocate a contract's entire discount to only those goods or services to which it relates if certain criteria are met. To allocate the transaction price on a relative standalone selling price basis, an entity must first determine the standalone selling price of the distinct good or service underlying each performance obligation. The standalone selling price is the price at which an entity would sell a good or service on a standalone (or separate) basis at contract inception. Under the model, the observable price of a good or service sold separately in similar circumstances to similar customers provides the best evidence of standalone selling price. However, in many situations, standalone selling prices will not be readily observable. In those cases, the entity must estimate the standalone selling price by considering all information that is reasonably available to it, maximizing the use of observable inputs and applying estimation methods consistently in similar circumstances. The standard states that suitable estimation methods include, but are not limited to, an adjusted market assessment approach, an expected cost plus a margin approach or a residual approach (if certain conditions are met).
Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation
An entity recognizes revenue only when (or as) it satisfies a performance obligation by transferring control of the promised good(s) or service(s) to a customer. The transfer of control can occur over time or at a point in time. A performance obligation is satisfied at a point in time unless it meets one of the following criteria, in which case it is satisfied over time: ‣ 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 The transaction price allocated to performance obligations satisfied at a point in time is recognized as revenue when control of the goods or services transfers to the customer. If the performance obligation is satisfied over time, the transaction price allocated to that performance obligation is recognized as revenue as the performance obligation is satisfied. To do this, the standard requires an entity to select a single revenue recognition method (i.e., measure of progress) that faithfully depicts the pattern of the transfer of control over time (i.e., an input method or an output method).

Licenses of intellectual property
The standard provides guidance on the recognition of revenue for licenses of intellectual property (IP) that differs from the model for other promised goods and services. The nature of the promise in granting a license of IP to a customer is either: ‣ A right to access the entity's IP throughout the license period (a right to access) ‣ A right to use the entity's IP as it exists at the point in time in which the license is granted (a right to use) To determine whether the entity's promise is to provide a right to access its IP or a right to use its IP, the entity should consider the nature of the IP to which the customer will have rights. The standard requires entities to classify IP in one of two categories: ‣ Functional: This IP has significant standalone functionality (e.g., many types of software, completed media content such as films, television shows and music). Licenses of functional IP generally grant a right to use the entity's IP, and revenue for these licenses generally is recognized at the point in time when the IP is made available for the customer's use and benefit. This is the case if the functionality is not expected to change substantially as a result of the licensor's ongoing activities that do not transfer an additional promised good or service to the customer. If the functionality of the IP is expected to substantively change because of activities of the licensor that do not transfer additional promised goods or services, and the customer is contractually or practically required to use the latest version of the IP, revenue for the license is recognized over time. ‣ Symbolic: This IP does not have significant standalone functionality (e.g., brands, team and trade names, character images). The utility (i.e., the ability to provide benefit or value) of symbolic IP is largely derived from the licensor's ongoing or past activities (e.g., activities that support the value of character images). Licenses of symbolic IP grant a right to access an entity's IP, and revenue from these licenses is recognized over time as the performance obligation is satisfied (e.g., over the license period). Revenue cannot be recognized from a license of IP before both (1) an entity provides (or otherwise makes available) a copy of the IP to the customer and (2) the beginning of the period during which the customer is able to use and benefit from its right to access or its right to use the IP. The standard specifies that sales and usage-based royalties on licenses of IP are recognized when the later of the following events occurs: (1) the subsequent sales or usage occurs or (2) the performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied). This guidance must be applied to the overall royalty stream when the sole or predominant item to which the royalty relates is a license of IP (i.e., these types of arrangements are either entirely in the scope of this guidance or entirely in the scope of the general variable consideration constraint guidance).
Contract costs
ASC 340-40 specifies the accounting for costs an entity incurs to obtain and fulfill a contract to provide goods and services to customers. The incremental costs of obtaining a contract (i.e., costs that would not have been incurred if the contract had not been obtained) are recognized as an asset if the entity expects to recover them. The standard provides a practical expedient that permits an entity to immediately expense contract acquisition costs when the asset that would have resulted from capitalizing these costs would have been amortized in one year or less. An entity accounts for costs incurred to fulfill a contract with a customer that are within the scope of other authoritative guidance (e.g., inventory, property, plant and equipment, internal-use software) in accordance with that guidance. If the costs are not in the scope of other accounting guidance, an entity recognizes an asset from the costs incurred to fulfill a contract only if those costs meet all of the following criteria: ‣ The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify. ‣ The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future. ‣ The costs are expected to be recovered. Any capitalized contract costs are amortized, with the expense recognized as an entity transfers the related goods or services to the customer. Any asset recorded by the entity is subject to an impairment assessment at the end of each reporting period.

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Technical Line

FASB — final guidance

How the new leases standard affects life sciences entities

In this issue:

What you need to know

- Life sciences entities will need to exercise judgment to determine whether a contract is a lease or contains a lease, even if they didn't account for the contract as a lease under legacy guidance.
- Identifying a complete population of leases to be accounted for during transition and after the effective date will likely be one of the more challenging aspects of implementing the new standard.
- Entities need to change their accounting policies, processes, systems and internal controls, even if applying the standard doesn't have a significant effect on their financial statements.
- Entities with a significant number of leases are finding that implementation requires significantly more effort than they expected. They're also finding that transition can be complex.

Overview

The effective date[1] of the new leases standard[2] issued by the Financial Accounting Standards Board (FASB or Board) is fast approaching for many entities. While lessees with significant operating leases will be most affected by the requirement to record assets and liabilities for most of these leases, all lessees and lessors will have to make changes to their accounting policies, processes, systems and internal controls to implement the standard.

Building a better working world

This publication summarizes the new standard (and certain amendments) and describes some relevant industry considerations for entities in the life sciences sector. Entities should consider these industry-specific issues when implementing the standard. Like all entities, life sciences entities need to apply the standard to leases of office space, office equipment and all other leased assets.

This publication complements our Financial reporting developments (FRD) publication, *Lease accounting: Accounting Standards Codification 842, Leases* (SCORE No. 00195-171US), which provides an in-depth discussion of Accounting Standards Codification (ASC) 842. We refer to that publication as our ASC 842 FRD.

Recent standard setting activity

The FASB recently issued an Accounting Standards Update (ASU)[3] that adds a transition option that allows entities to not apply the new guidance in the comparative periods they present in their financial statements in the year of adoption. The ASU also provides an optional practical expedient for lessors to elect, by class of underlying asset, to not separate lease and associated non-lease components when certain criteria are met.

The FASB also issued an ASU[4] that makes narrow-scope amendments to the new leases standard to allow lessors to make an accounting policy election to not evaluate whether sales taxes and other similar taxes are lessor costs. The amendments also require lessors to (1) exclude lessor costs paid directly by lessees to third parties on the lessor's behalf from variable payments and therefore variable lease revenue and (2) include lessor costs that are reimbursed by the lessee in the measurement of variable lease revenue and the associated expense. The amendments also clarify that lessors are required to allocate the variable payments to the lease and non-lease components and follow the recognition guidance in Accounting Standards Codification (ASC) 842 for the lease component and other applicable guidance, such as ASC 606[5], for the non-lease component.

For life sciences entities, identifying leases will require a careful and thorough analysis. Once life sciences entities have identified arrangements with one or more lease component(s), they will need to determine whether there are any non-lease components in the arrangement. If the entity is the lessee in the arrangement, the entity will need to separately account for the lease and non-lease components if it doesn't elect the practical expedient to not separate the lease and associated non-lease components. If the entity is a lessor, it also will be required to separate lease and non-lease components unless it elects and qualifies to use the lessor practical expedient to not separate lease and associated non-lease components.

Key considerations

Scope and scope exceptions

The scope of ASC 842 is limited to leases of property, plant and equipment (i.e., land and depreciable assets), including subleases of those assets. ASC 842 does not apply to any of the following:

- Leases of intangible assets
- Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources, including the intangible right to explore for those natural resources and rights to use the land in which those natural resources are contained (unless those rights to use include more than the right to explore for natural resources), but not equipment used to explore for the natural resources

- Leases of biological assets, including timber
- Leases of inventory (i.e., assets held for sale in the ordinary course of business, assets in the process of production for sale, and assets to be currently consumed in the production of goods or services to be available for sale)
- Leases of assets under construction

Definition of a lease

A lease is a contract (i.e., an agreement between two or more parties that creates enforceable rights and obligations), or part of a contract, that conveys the right to control the use of identified property, plant or equipment (i.e., an identified asset) for a period of time in exchange for consideration. See Appendix A for a flowchart from ASC 842 of how to determine whether an arrangement is or contains a lease.

Identified asset

In some cases, evaluating whether the customer has the right to direct the use of an identified asset will require judgment.

The requirement that there be an identified asset is fundamental to the definition of a lease. Under ASC 842, an identified asset could be either implicitly or explicitly specified in a contract. An identified asset also can be a physically distinct portion of a larger asset. Examples include a floor of a building or a production line within a contract manufacturing facility. Even if an asset is specified, a customer does not have the right to use an identified asset if, at inception of the contract, a supplier has the substantive right to substitute the asset throughout the period of use (i.e., the total period of time that an asset is used to fulfill a contract with a customer, including the sum of any nonconsecutive periods of time). A substitution right is substantive when both of the following conditions are met:

- The supplier has the practical ability to substitute alternative assets throughout the period of use.
- The supplier would benefit economically from the exercise of its right to substitute the asset.

Entities will need to evaluate whether substitution rights in contracts are substantive. If a supplier's substitution right is substantive, the arrangement would not include a lease. The assessment of whether a supplier's substitution right is substantive will depend on the facts and circumstances of each contract and require the use of judgment.

In many cases, it will be clear that the supplier will not benefit from the exercise of a substitution right because of the costs associated with substituting an asset. The physical location of the asset may affect the costs associated with substituting the asset. For example, if a supplier's asset is located at the pharmaceutical manufacturing entity's premises, the cost associated with substituting it is generally higher than the cost of substituting a similar asset located at the supplier's premises. However, simply because the cost of substitution is not significant doesn't mean that the supplier would benefit economically from the right of substitution. Contract terms that allow or require a supplier to substitute alternative assets only when the underlying asset is not operating properly (e.g., a normal warranty provision) or when a technical upgrade becomes available do not create a substantive substitution right.

Right to control the use of the identified asset

A contract conveys the right to control the use of an identified asset for a period of time if, throughout the period of use, the customer has both of the following:

- The right to obtain substantially all of the economic benefits from the use of the identified asset
- The right to direct the use of the identified asset

If the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term.

A customer can obtain economic benefits either directly or indirectly (e.g., by using, holding or subleasing the asset). Economic benefits include the asset's primary outputs (i.e., goods or services) and any by-products (e.g., renewable energy credits that are generated through use of the asset), including potential cash flows derived from these items. Economic benefits also include benefits from using the asset that could be realized from a commercial transaction with a third party. However, economic benefits arising from ownership of the identified asset (e.g., tax benefits related to excess tax depreciation and investment tax credits) are not considered economic benefits derived from the use of the asset and therefore are not considered when assessing whether a customer has the right to obtain substantially all of the economic benefits.

A customer has the right to direct the use of an identified asset throughout the period of use when either:

- The customer has the right to direct how and for what purpose the asset is used throughout the period of use.
- The relevant decisions about how and for what purpose the asset is used are predetermined and the customer either (1) has the right to operate the asset, or direct others to operate the asset in a manner it determines, throughout the period of use without the supplier having the right to change the operating instructions or (2) designed the asset, or specific aspects of the asset, in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

When evaluating whether a customer has the right to direct how and for what purpose the asset is used throughout the period of use, the focus should be on whether the customer has the decision-making rights that will most affect the economic benefits that will be derived from the use of the asset. The decision-making rights that are most relevant are likely to depend on the nature of the asset and the terms and conditions of the contract.

Under ASC 842, determining whether certain contracts, particularly those involving a significant service component (e.g., contract manufacturing, supply agreements, transportation arrangements), contain a lease is more important for lessees than it is under the legacy guidance because lessees are now required to account for most leases on their balance sheet.

While evaluating whether the customer directs the use of an identified asset will be straightforward in many arrangements, evaluating other arrangements — particularly those with a significant service component — may require more consideration.

The supplier may retain certain rights, such as the rights to make certain decisions to protect its investment in the asset (e.g., determining whether conditions are safe for operation), known as protective rights. However, a supplier's protective rights, in isolation, do not prevent the customer from having the right to direct the use of the underlying asset.

Life sciences entities will have to carefully analyze contract manufacturing and supply arrangements to determine whether a contract is or contains a lease. For example, the customer in a contract manufacturing arrangement may have the right to control the use of the identified asset (e.g., a production facility, a dedicated production line) when it has the right to decide what type of output will be produced and the timing and quantity of production, and has the right to obtain substantially all of the economic benefits from use of the identified asset throughout the period of use.

Determining whether certain contracts, particularly those involving a service component, contain a lease may require judgment.

Illustration 1 — Contract manufacturing

Biotech enters into a three-year agreement with Contract Manufacturing Organization (CMO) for a dedicated production line to manufacture Product X. The contract states that Biotech has the exclusive use of the production line (that is, CMO cannot use the manufacturing equipment for any other customer).

The manufacturing qualifications of Product X are specified in the contract. Biotech issues instructions to CMO about the quantity and timing of products to be delivered. If the production line is not producing Product X for Biotech, it does not operate.

CMO operates and maintains the production line on a daily basis.

Analysis

This contract contains a lease. Biotech has the right to use the dedicated production line for three years.

There is an identified asset. The dedicated production line is an implicitly identified asset because CMO has only one line that can fulfill the contract, and CMO does not have the right to substitute the specified production line.

Biotech has the right to control the use of the dedicated production line (i.e., the identified asset) throughout the three-year period of use because:

- Biotech has the right to substantially all of the economic benefits from the use of the dedicated production line over the three-year period of use. Biotech has exclusive use of the dedicated production line; it has rights to all the Product X produced throughout the three-year period of use.
- Biotech has the right to direct the use of the dedicated production line. Biotech makes the relevant decisions about how and for what purpose the production line is used because it has the right to determine whether, when, and how much the production line will produce (that is, the timing and quantity, if any, of Product X produced) throughout the period of use. Because CMO is prevented from using the production line for another purpose, Biotech's decision-making rights about the timing and quantity of Product X produced, in effect, determines when and whether the production line produces Product X.

Although the operation and maintenance of the production line are essential to its efficient use, CMO's decisions in this regard do not give it the right to direct how and for what purpose the production line is used. Consequently, CMO does not control the use of the production line during the period of use. Instead, CMO's decisions are dependent on Biotech's decisions about how and for what purpose the production line is used.

Determining whether a customer has the right to direct the use of an asset throughout the period of use may require significant judgment. Changes in facts and circumstances may result in a different conclusion.

Examples 8 and 9 in the standard[6] provide contract manufacturing illustrations of the evaluation of whether a customer controls the use of an asset throughout the period of use.

How we see it

Because the accounting for operating leases under ASC 840 is similar to the accounting for service contracts, entities may not have always focused on determining whether an arrangement is a lease or a service contract. Some entities may need to revisit assessments of existing leases and service arrangements because, under ASC 842, most operating leases are recognized on lessees' balance sheets, and the effects of incorrectly accounting for a lease as a service may be material.

The FASB noted in the Background Information and Basis for Conclusions of ASU 2016-02 (BC393(a)) that the practical expedient that permits entities not to reassess whether any expired or existing contracts contain leases does not grandfather incorrect assessments made under ASC 840 (i.e., the practical expedient applies only to arrangements that were appropriately assessed under ASC 840).

Identifying and separating components of a contract and allocating contract consideration

For contracts that contain the rights to use multiple assets but not land (e.g., a building and equipment, multiple pieces of equipment), the right to use each asset is considered a separate lease component if both of these conditions are met:

- The lessee can benefit from the right of use either on its own or together with other resources that are readily available to the lessee.
- The right of use is neither highly dependent on, nor highly interrelated with, the other right(s) to use underlying assets in the contract.

If one or both of these criteria are not met, the right to use multiple assets is considered a single lease component.

For contracts that involve the right to use land and other assets (e.g., land and a manufacturing facility), ASC 842 requires an entity to classify and account for the right to use land as a separate lease component, unless the accounting effect of not separately accounting for land is insignificant.

Many contracts contain a lease coupled with an agreement to purchase or sell other goods or services (non-lease components). For example, a life sciences entity may lease a floor in a building where the landlord provides common area maintenance (CAM) services (e.g., cleaning a lobby of a building). CAM is considered a non-lease component. The non-lease components are identified and accounted for separately from the lease component in accordance with other US GAAP (except when a lessee or lessor applies the practical expedients to not separate lease and non-lease components). For example, the non-lease components may be accounted for as executory arrangements by lessees (customers) or as contracts subject to ASC 606 by lessors (suppliers).

In some leases, a lessee also may reimburse the lessor, or make certain payments on behalf of the lessor, that relate to the leased asset such as payments for insuring the lessor's asset and real estate taxes associated with such asset. Insurance that protects the lessor's interest in the underlying asset and taxes related to such asset (e.g., real estate taxes on the underlying asset) are not separate components of the contract because they do not represent payments for goods or services (i.e., the payments are for the use of the leased asset and are attributable to the lease component or allocated between the lease and non-lease components). For lessees, if an arrangement does not contain a non-lease component, fixed and variable payments for insuring the lessor's asset and real estate taxes associated with such asset are attributable to the lease component. If the same arrangement contains a lease and a non-lease component (e.g., maintenance), fixed payments are included in the consideration in the contract and allocated between the lease and non-lease components on a relative standalone price basis, regardless of how the contract was negotiated (e.g., as a net lease rather than a gross lease).

Illustration 2 — Allocating contract consideration if a lessee does not elect the practical expedient to combine the lease and non-lease components

On 1 January 20X0, Pharma (lessee) leases one floor of a building from Owner (lessor) for three years. Under the terms of the arrangement, Pharma agrees to pay the following for the right to use the one floor of the building and CAM (e.g., cleaning services):

- A fixed payment payable on 31 December of each year of $300,000
- A variable payment per year based on an allocated portion (e.g., by square footage of tenants in the building) of the actual costs Owner incurs for Owner's property taxes and insurance related to the leased asset and CAM

In this example, the right to use the floor for three years is a lease component, with a standalone price of $800,000. The lease is classified as an operating lease. The CAM services are a non-lease component, with a standalone price of $125,000. Pharma's payments for Owner's real estate taxes and insurance related to the leased asset are not components of the contract because they do not represent payment for goods or services, in addition to the right to use the space, transferred to the lessee.

Assume Pharma incurs no initial direct costs, and its incremental borrowing rate is 5%.

Also, Pharma does not elect the practical expedient to combine the lease and non-lease components.

In this example, Pharma allocates the fixed consideration in the contract as follows:

Component	**Relative %**	**Allocation of fixed consideration***			
		Year 1	Year 2	Year 3	Total
Lease	86.5% (a)	$ 260,000	$ 260,000	$ 260,000	$ 780,000
CAM	13.5% (b)	40,000	40,000	40,000	120,000
	100%	$ 300,000	$ 300,000	$ 300,000	$ 900,000

(a) 800,000 / (800,000 + 125,000) = 86.5%

(b) 125,000 / (800,000 + 125,000) = 13.5%

* Allocated amounts are rounded for purposes of this illustration

The initial measurement of the right-of-use (ROU) asset and lease liability is $708,000 using the allocated consideration in the contract of $780,000 discounted using Pharma's incremental borrowing rate of 5%.

At the end of year one, Pharma pays the annual rental payment of $300,000, of which $260,000 is allocated to the lease component and $40,000 is allocated to CAM services.

At the end of year one, Pharma records the following for the fixed consideration:

Lease liability	$ 224,600 (a)	
Lease expense	$ 260,000 (b)	
Maintenance expense	$ 40,000 (c)	
ROU asset		$ 224,600 (a)
Cash		$ 300,000 (d)

(a) Difference between the initial measurement of the lease liability (and right-of-use asset) at lease commencement ($708,000) and the present value of remaining lease payments at the end of year one ($483,400)

(b) Payments allocated to the lease component recognized on a straight-line basis (total lease expense of $780,000 over 3 years)

(c) Expense attributable to the non-lease component

(d) Cash payment

Pharma makes a variable payment of $50,000 at the end of year one based on the lessor's costs incurred for property taxes, property insurance and CAM services. Pharma allocates variable payments to the lease and non-lease component (i.e., CAM) on the same basis as the initial allocation of the consideration in the contract.

In this example, Pharma allocates the variable payment in the contract as follows:

Component	Relative %	Allocation of variable payment
Lease	86.5%	$ 43,250
Non-lease	13.5	6,750
	100%	$ 50,000

At the end of year one, Pharma records the following for the variable payment:

Lease expense	$ 43,250	
Maintenance expense	$ 6,750	
Cash		$ 50,000

Immaterial differences may arise in the recomputation of amounts in the example above due to rounding.

Lessees can make a policy election to not separate a lease component from its associated non-lease components.

Practical expedient to not separate non-lease and associated lease components — lessees

ASC 842 provides a practical expedient that permits lessees to make an accounting policy election (by class of underlying asset) to account for each separate lease component of a contract and its associated non-lease components as a single lease component.

Lessees that do not make an accounting policy election to use this practical expedient are required to allocate the consideration in the contract to the lease and non-lease components on a relative standalone price basis. Lessees are required to use observable standalone prices (i.e., prices at which a customer would purchase a component of a contract separately) when readily available. If observable standalone prices are not readily available, lessees estimate standalone prices, maximizing the use of observable information. A residual estimation approach may be appropriate when the standalone price for a component is highly variable or uncertain.

Illustration 3 — Allocating contract consideration if a lessee elects the practical expedient to combine lease and non-lease components

Assume the same facts as in Illustration 2 except Pharma elects the practical expedient to combine lease and non-lease components. Pharma has concluded the lease is an operating lease.

In this example, Pharma allocates all of the consideration to the lease component. Therefore, it recognizes all of the fixed consideration in the contract of $900,000 as lease payments.

The initial measurement of the right-of-use (ROU) asset and lease liability is $817,000 using Pharma's incremental borrowing rate of 5%.

At the end of year one, Pharma pays the annual rental payment of $300,000 and a variable payment of $50,000 based on lessor's actual costs incurred for property taxes, property insurance and CAM.

At the end of year one, Pharma records the following for the fixed and variable consideration:

Lease liability	$ 259,200 (a)	
Lease expense	$ 350,000 (b)	
ROU asset		$ 259,200 (a)
Cash		$ 350,000 (c)

(a) Difference between the initial measurement of the lease liability (and the right-of-use asset) at lease commencement ($817,000) and the present value of remaining lease payments at the end of year one ($557,800).

(b) Fixed and variable payments allocated to the lease component; fixed payments recognized on a straight-line basis (total lease expense of $900,000 over three years) plus the variable payment of $50,000 in year one.

(c) Actual cash payment.

Immaterial differences may arise in the recomputation of amounts in the example above due to rounding.

How we see it

For many lessees in the life sciences industry, identifying non-lease components of contracts may be a change in practice. As discussed earlier, entities may not have focused on identifying lease and non-lease components because their accounting treatment (e.g., the accounting for an operating lease and a service contract) was often the same. However, because most leases are recognized on lessees' balance sheets under ASC 842, lessees may need to put more robust processes in place to identify the lease and non-lease components of contracts.

Practical expedient to not separate non-lease and associated lease components — lessors

ASC 842 provides a practical expedient that allows lessors to elect, by class of underlying asset, to not separate non-lease components from the associated lease components if the non-lease components otherwise would be accounted for in accordance with the new revenue standard and both of the following criteria are met:

- The lease component and the associated non-lease components have the same timing and pattern of transfer.
- The lease component, if accounted for separately, would be classified as an operating lease.

A lessor that concludes the above criteria are met, then evaluates if the lease or non-lease component(s) are the predominant component. A lessor that determines that the non-lease component(s) associated with the lease component are the predominant components in the contract is required to account for the combined component in accordance with ASC 606, including its disclosure requirements.

If the non-lease components aren't the predominant components, the lessor accounts for the combined components as an operating lease in accordance with ASC 842. An entity that elects the lessor practical expedient to not separately account for qualifying lease and non-lease components must apply the expedient to all qualifying leases in that class and provide certain disclosures.

In determining whether a non-lease component or components are the predominant component(s) in a combined component, a lessor must consider whether the lessee would be reasonably expected to ascribe more value to the non-lease components than to the lease component. The Board said in BC35 of the Background Information and Basis for Conclusions of ASU 2018-11 that a lessor should be able to reasonably determine which guidance to apply (based on predominance) without having to perform a detailed quantitative analysis or a theoretical allocation to each component.

Considerations for medical device companies

Medical device companies often enter into arrangements with hospitals to provide a lease of equipment along with non-lease components (e.g., training services, maintenance services, supply of consumable products to be used with the leased equipment). These arrangements are often referred to as reagent rental agreements. In some contracts, the medical device company provides the equipment for no stated consideration. Medical device companies do this because they expect to recover their costs for the equipment from the sales of consumable products.

Because the medical device company transfers the consumable products at a point in time and lease payments for the equipment over the lease term, the non-lease and lease components do not have the same timing and pattern of transfer. Therefore, the non-lease component relating to the sale of the consumable products is not eligible to be combined with the lease component under the lessor practical expedient.

However, if a contract includes a lease and multiple non-lease components (e.g., consumable products and maintenance services for the equipment) and a lessor has made an accounting policy election to not separate lease and associated non-lease components, the lessor must combine all components that qualify for the practical expedient (i.e., those for which the timing and pattern of transfer of the lease and associated non-lease components are the same) and separately account for the non-lease component(s) that do not qualify.

Careful attention is required to allocate the consideration in the contract and any variable payments not based on an index or rate (e.g., optional purchases of consumable products) between the lease and non-lease components (or the lease and non-lease components not eligible for the lessor practical expedient when such an accounting policy is elected). Additionally, companies will need to review their contracts to determine whether there are legally enforceable minimum purchase commitments or contractual penalties for not meeting contractual minimums. These terms should be included in a company's determination of the consideration in the contract.

Medical device companies must carefully consider all the facts and circumstances to identify embedded leases in each reagent rental agreement.

Illustration 4 — Lessor allocation of lease and non-lease components

MedCo enters into a three-year contract with Hospital Co to lease equipment (e.g., an MRI machine) at no stated cost and to sell consumables that will be used specifically with the equipment for $3.50 per unit. Under the contract, Hospital Co has a minimum purchase commitment of 5,000 consumable products for each year of the three-year lease term.

Under the terms of the contract, Hospital Co cannot use the equipment without the consumable products purchased exclusively from MedCo. Additionally, MedCo expects Hospital Co to purchase and use different amounts of consumable products each month.

At the lease commencement date, MedCo determines the following standalone selling prices for the lease and non-lease components in the contract based upon observable transactions in which Medco leases the equipment and sells consumable products separately in similar circumstances to similar customers: $25,000 for the equipment for the three-year lease term and $2.50 per unit for the sale of consumables.

Analysis

MedCo determines that there is one lease component (for the medical equipment) and one non-lease component (sales of consumable products) in the agreement. The lessor practical expedient does not apply in this example because the timing and pattern of transfer of the lease and non-lease components are not the same.

At lease commencement, MedCo calculates the consideration in the contract to be $52,500 ($3.50 per unit x three-year lease term x 5,000 minimum required purchase of consumable units per year). MedCo applies the principles of ASC 606 to determine the standalone selling price of each component and the amount to allocate to each lease and non-lease component, as follows:

Component	Standalone selling price	Relative percentage	Allocation of contract consideration
Lease of equipment	$ 25,000	40%	$ 21,000
Consumable products	$ 37,500 (a)	60%	$ 31,500
Total	$ 62,500	100%	$ 52,500

(a) $2.50/unit x 3 years x 5,000 units per year = $37,500

Refer to our ASC 842 FRD and our ASC 606 FRD for additional details regarding recognition and measurement of the lease and non-lease components, respectively.

Lease payments

Lease payments are payments made by a lessee to a lessor, relating to the right to use an underlying asset during the lease term and are used to measure a lessee's' lease assets and liabilities.

Some lease agreements include payments that are described as variable or may appear to contain variability but are in-substance fixed payments because the contract terms require the payment of a fixed amount that is unavoidable. Such payments are included in the lease payments at lease commencement and, thus, are used in the classification test and to measure entities' lease assets and lease liabilities.

Variable lease payments that are not based on an index or rate are not included in lease payments and are recognized (by lessees) when the achievement of the specified target that triggers the variable payments is considered probable.

Entities will need to analyze their contracts carefully to determine whether the payments must be included in lease payments (e.g., fixed or variable payments based on an index or rate) or whether the payment is excluded from lease payments (variable payments not based on an index or rate). Significant judgment may be required.

Lease classification

At lease commencement, a lessee classifies a lease as a finance lease and a lessor classifies a lease as a sales-type lease if the lease meets **any one** of the following criteria:

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
- The lease term is for a major part of the remaining economic life of the underlying asset. This criterion is not applicable for leases that commence at or near the end of the underlying asset's economic life.
- The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already included in the lease payments equals or exceeds substantially all of the fair value of the underlying asset.
- The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

A lessee classifies a lease as an operating lease when it does not meet any of the criteria above.

A lessor classifies a lease as a direct financing lease when none of the criteria above are met but the lease meets **both** of the following criteria:

- The present value of the sum of lease payments and any residual value guaranteed by the lessee and **any other third party unrelated to the lessor** equals or exceeds substantially all of the fair value of the underlying asset.
- It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee.

A key difference between the sales-type lease and direct financing lease classification tests is the treatment of residual value guarantees provided by unrelated third parties other than the lessee. Those third-party guarantees are excluded from the evaluation of the "substantially all" criterion in the sales-type lease test. However, they are included in the evaluation in the direct financing lease test. In addition, the evaluation of the collectibility of lease payments and residual value guarantees affects direct financing lease classification, whereas it does not affect sales-type lease classification. However, the evaluation of collectiblity does affect sales-type lease recognition and measurement.

For lessors, all leases not classified as sales-type leases or direct financing leases are classified as operating leases.

Lessees and lessors reassess lease classification as of the effective date of a modification (i.e., a change to the terms and conditions of a contract that results in a change in the scope of or consideration for the lease) that is not accounted for as a separate contract. Lessees also are required to reassess lease classification when there is a change in their assessment of either the lease term or whether they are reasonably certain to exercise an option to purchase the underlying asset.

How we see it

Medical device companies may have additional considerations for a reagent rental agreement depending upon the lease classification. For example, if a lease arrangement includes significant variable lease payments that do not depend on an index or rate, the net investment in the lease recognized for a sales-type or a direct financing lease may be lower than the carrying amount of the underlying asset at lease commencement. In such circumstances, the difference between the initially recognized net investment in the lease and the carrying amount of the underlying asset derecognized is recognized as a selling loss at lease commencement.

Lessee accounting

At the commencement date of a lease, a lessee recognizes an asset representing the right to use the underlying asset during the lease term (i.e., the right-of-use asset) and a liability to make lease payments (i.e., the lease liability).

At the commencement date of a lease, a lessee recognizes an asset representing the right to use the underlying asset during the lease term and a liability to make lease payments.

The initial recognition of the right-of-use asset and the lease liability is the same for operating leases and finance leases, as is the subsequent measurement of the lease liability. However, the subsequent measurement of the right-of-use asset for operating leases and finance leases differs under ASC 842.

For finance leases, lessees are required to separately recognize the interest expense on the lease liability and the amortization expense on the right-of-use asset. This generally results in a front-loaded expense recognition pattern. The periodic lease expense for operating leases is generally recognized on a straight-line basis.

Lease term

The lease term begins at the lease commencement date and is determined on that date based on the noncancelable term of the lease, together with all of the following:

- Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option
- Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option
- Periods covered by an option to extend (or not terminate) the lease in which the exercise of the option is controlled by the lessor

Determining whether the reasonably certain threshold has been met requires significant judgment.

Commencement date

The commencement date is the date on which the lessor makes an underlying asset (i.e., the property, plant or equipment that is subject to the lease) available for use by the lessee. In some cases, the commencement date of the lease may be before the date stipulated in the lease agreement (e.g., the date rent becomes due and payable). This often occurs when the leased space is modified by the lessee prior to commencing operations in the leased space (e.g., during the period a lessee uses the leased space to construct its own leasehold improvements). In making the assessment of lease commencement, it will often be necessary to distinguish lessee versus lessor assets.

Illustration 5 — Determining lease commencement date

Biotech Co enters into an agreement to lease manufacturing equipment from Entity A for three years in exchange for fixed annual lease payments. The agreement was executed on 1 November 20X7 (lease inception). Entity A makes the equipment available for use to Biotech Co on 15 January 20X8. The equipment will be used to manufacture a drug that the Food and Drug Administration has just approved, but the equipment requires significant customization to produce the product. Biotech Co completes customization of the equipment on 1 April 20X8 and begins production of the drug that day. Under the terms of the agreement, Biotech Co pays Entity A annual fixed payments with its first payment not required until Biotech Co begins manufacturing the new drug (i.e., 1 April 20X8).

Analysis

The lease commencement date is 15 January 20X8, the date on which Entity A made the underlying asset available for use by Biotech Co. On the commencement date (i.e., 15 January 20X8), Biotech Co would recognize a right-of-use asset and a lease liability.

Short-term leases recognition and measurement exemption

Lessees can make an accounting policy election (by class of underlying asset to which the right of use relates) to apply accounting similar to ASC 840's operating lease accounting to leases that meet ASC 842's definition of a short-term lease (i.e., the short-term lease exemption). A short-term lease is defined as a lease that, at the commencement date, has a lease term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise. The short-term lease election can only be made at the commencement date.

When determining whether a lease qualifies as a short-term lease, a lessee evaluates the lease term and the purchase option in the same manner as all other leases. That is, the lease term includes the non-cancelable term of the lease and all of the following:

- Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option
- Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option
- Periods covered by an option to extend (or not terminate) the lease in which the exercise of the option is controlled by the lessor

A lessee that makes this accounting policy election does not recognize a lease liability or right-of-use asset on its balance sheet. Instead, the lessee recognizes lease payments as an expense on a straight-line basis over the lease term and variable lease payments that do not depend on an index or rate as expense in the period in which the achievement of the specified target that triggers the variable lease payments becomes probable. Any recognized variable lease expense is reversed if it is probable that the specified target will no longer be met.

A life sciences company may have a master lease agreement that covers a fleet of vehicles used by its sales team personnel. The master lease agreement may have a noncancelable lease term of 12 months or less for each leased vehicle but may grant the lessee the option to extend the lease for each vehicle on a month-by-month basis. If this is the case, a life sciences company should carefully assess the lease term for each vehicle. Entities should consider all relevant factors (e.g., residual value guarantees, expected location of the leased assets) that create an economic incentive for the lessee to exercise lease renewal options at the lease commencement date. For example, if an entity had a practice of exercising its option to extend vehicle leases for periods beyond the 12-month noncancelable term, it may be appropriate to understand why and determine if similar contract-based, asset-based, entity-based and market-based factors exist that indicate the lessee is reasonably certain to exercise a renewal option for each leased vehicle. If an entity determines at the commencement date that its lease term is greater than 12 months, the lessee cannot account for the lease as a short-term lease.

Lessor accounting

Sales-type lease accounting under ASC 842 generally requires lessors to derecognize the carrying amount of the underlying asset, recognize the net investment in the lease and recognize, in net income, any selling profit or selling loss. However, if collection of lease payments and any residual value guarantee provided by the lessee is not probable at lease commencement, a lessor does not derecognize the underlying asset and does not recognize its net investment in the lease. Instead, a lessor continues to account for the underlying asset using other US GAAP (e.g., depreciates, evaluates the asset for impairment in accordance with ASC 360) and recognizes lease payments received, including variable lease payments that do not depend on an index or rate, as a deposit liability until the earlier of either of the following:

- Collection of lease payments, plus any amounts necessary to satisfy a residual value guarantee provided by the lessee, becomes probable.
- Either of the following events occurs:
  - The contract is terminated, and the lease payments received from the lessor are nonrefundable.
  - The lessor repossesses the underlying asset and has no further obligation to the lessee under the contract, and the lease payments received from the lessee are nonrefundable.

Lessors account for direct financing leases using an approach that is similar to the accounting for sales-type leases for which collectibility is probable. However, for a direct financing lease, any selling profit is deferred at lease commencement and included in the initial measurement of the net investment in the lease (i.e., selling profit reduces the net investment in the lease). Any selling loss is recognized at lease commencement. The lessor recognizes interest income over the lease term in an amount that produces a constant periodic discount on the remaining balance of the net investment in the lease.

For operating leases, lessors continue to recognize the underlying asset and do not recognize a net investment in the lease on the balance sheet or initial profit (if any). If collectibility of lease payments and residual value guarantees is probable at lease commencement, a lessor subsequently recognizes lease income over the lease term on a straight-line basis unless another systematic and rational basis better represents the pattern in which benefit is expected to be derived from the use of the underlying asset. However, when collectibility of lease payments and any residual value guarantees is not probable at the commencement date for an operating lease (including a lease that would otherwise have qualified as a direct financing lease if it had met the related collectibility requirements), lease income is limited to the lesser of (1) the straight-line amount and (2) the lease payments, including any variable lease payments, that have been collected from the lessee.

Other considerations

Sale and leaseback transactions

Because lessees are required to recognize most leases on the balance sheet (i.e., all leases except for short-term leases if the lessee makes an accounting policy election to use this exemption), sale and leaseback transactions do not provide lessees with a source of off-balance sheet financing.

Both the seller-lessee and buyer-lessor are required to apply ASC 842 and certain provisions of ASC 606 to determine whether to account for a sale and leaseback transaction as a sale (seller-lessee) and purchase (buyer-lessor) of an asset. If control of an underlying asset passes to the buyer-lessor, the transaction is accounted for as a sale (seller-lessee) or purchase (buyer-lessor) and a lease by both parties. If not, the transaction is accounted for as a financing by both parties. Also, note that sale and leaseback transactions among entities under common control are subject to ASC 842-40's sale and leaseback guidance.

Lessee involvement in asset construction

A life sciences entity may enter into an agreement with a real estate developer for the construction and subsequent lease of a building (e.g., a manufacturing facility).

ASC 842 makes significant changes to how lessees and lessors will evaluate their involvement in asset construction. ASC 842 focuses on whether the lessee controls the asset being constructed to determine whether it is the accounting owner of an asset under construction, while ASC 840 focuses on whether the lessee has substantially all of the construction-period risk.

If the lessee controls the asset during the construction period, lessees and lessors will apply the sale and leaseback guidance when the construction of the asset is complete and the lease commences. If the lessee does not control the underlying asset being constructed, any payments made for the right to use the underlying asset are lease payments, regardless of the timing or form of those payments. Lease payments made prior to lease commencement are recognized as a prepaid asset and evaluated in the lease classification test. Costs incurred by the lessee (when the lessee does not control the asset during construction) that relate specifically to construction or design of an asset that are not payments for the use of an asset to be leased are recognized in accordance with other US GAAP (e.g., ASC 330, *Inventory*; ASC 360, *Property, Plant, and Equipment*).

For guidance on accounting for lessee involvement in construction and related transition guidance, refer to our ASC 842 FRD.

Lease modifications

ASC 842 defines a lease modification as a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease. For example, a modification may occur when entities agree to expand the lease of space to include an additional floor in a building or when entities agree to terminate a portion of a contract, such as a reduction in the lease term in a contract to use medical equipment.

In a change from today's guidance, lessees and lessors account for a lease modification as a separate contract (i.e., separate from the original lease) when certain conditions are met. How an entity will account for modifications that do not result in a separate contract will depend on whether the entity is a lessee or lessor, the nature of the modification and the classification of the lease before and after the modification.

Refer to our ASC 842 FRD for details on accounting for lease modifications.

Related party lease transactions

ASC 842 requires lessees and lessors to account for related party leases on the basis of the legally enforceable terms and conditions of the lease. This eliminates the requirement in ASC 840 for lessees and lessors to evaluate the economic substance of a lease to determine the appropriate accounting.

Lessees and lessors are required to apply the disclosure requirements for related party transactions in accordance with ASC 850, *Related Party Disclosures*.

Transition

For public business entities and certain other entities, ASC 842 is effective for annual periods beginning after 15 December 2018 (i.e., 1 January 2019 for a calendar-year entity), and interim periods within those years. For all other entities, ASC 842 is effective for annual periods beginning after 15 December 2019 (i.e., 1 January 2020 for a calendar-year entity), and interim periods beginning after 15 December 2020 (i.e., 1 January 2021 for a calendar-year entity).

Entities are required to adopt ASC 842 using a modified retrospective approach. Upon the adoption of ASC 842, an entity applies the standard's transition provisions at one of the following initial application dates:

- The later of (1) the beginning of the earliest comparative period presented in the financial statements and (2) the commencement date of the lease.
- The beginning of the period of adoption (i.e., on the effective date).

For transition guidance, refer to our ASC 842 FRD.

Next steps

- Entities will have to develop new processes, controls and/or systems to identify a complete population of leases and gather information necessary to perform the accounting and make the disclosures required by the standard.
- Implementation of the new standard should involve cross-functional teams that include personnel with knowledge of how lease contracts are initiated and monitored across the entity.
- Securities and Exchange Commission (SEC) registrants should provide disclosures about the effects of the new leases standard on the financial statements as required by Staff Accounting Bulletin Topic 11.M. The SEC staff expects a registrant's disclosures to evolve and become more specific as the effective date of a standard approaches and the registrant makes progress in its implementation plan.

Endnotes:

[1] The standard is effective for public business entities and certain not-for-profit entities and employee benefit plans for annual periods beginning after 15 December 2018, and interim periods within those years. For all other entities, it is effective for annual periods beginning after 15 December 2019, and interim periods the following year. Early adoption is permitted for all entities.

[2] Accounting Standards Codification (ASC) 842, *Leases*.

[3] ASU 2018-11, *Leases (Topic 842): Targeted Improvements*.

[4] ASU 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*.

[5] ASC 606, *Revenue from Contracts with Customers*.

[6] ASC 842-10-55-100 through 55-123.

Appendix A: How to determine whether an arrangement is or contains a lease

The following flowchart is included in ASC 842's implementation guidance and depicts the decision-making process for determining whether an arrangement is or contains a lease. Refer to our ASC 842 FRD for further guidance on these topics.