Accounting Update

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FASB Staff Disclaimer

- Expressions of individual views by members of the FASB and staff are encouraged. The views expressed in this presentation are those of the presenter. Official positions of the FASB on accounting matters are reached only after extensive due process and deliberations.

Agenda

Final Accounting Standards Updates

- **Targeted Improvements to Accounting for Hedging Activities** (ASU 2017-12)
- **Reclassification of Certain Tax Effects from Other Comprehensive Income** (ASU 2018-02)
- **Nonemployee Share-Based Payment Accounting Improvements** (2nd quarter 2018)
- **Changes to Fair Value Measurement Disclosures** (3rd quarter 2018)

Proposed Accounting Standards Updates

- **Collaborative Arrangements**
- **Cloud Computing**

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Targeted Improvements to Accounting for Hedging Activities (Update 2017-12)

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Project History

May 2007
Added project

June 2008
Issued ED

May 2010
Issued ED

2014 - 2016
Project re-activated

Sept. 8, 2016
Issued ED

Q1 – Q3 2017
Re-deliberations and issuance of final ASU

Hedge Accounting: Overview

	Hedge of Nonfinancial Item	Hedge of Financial Instrument
Fair Value Hedge	Hedge of inventory	Swap fixed rate debt to floating
Cash Flow Hedge	Hedge of forecasted purchase or sale of inventory	Swap floating rate debt to fixed

For Qualifying Hedging Relationships

- Effective and ineffective portions of derivative gain / loss recorded in current period earnings
- NEW: Presentation of derivative gain / loss in the same income statement line item as hedged item.
- Basis of hedged item adjusted for changes in FV attributable to hedged risk--also through earnings
- Basis adjustment offsets derivative mark to earnings

- Effective portion of derivative gain / loss deferred in OCI
- NEW: Ineffective portion of derivative gain / loss deferred in OCI
- Amounts previously recorded in AOCI reclassified to earnings when the hedged item affects earnings
- NEW: Presentation of amounts reclassified to earnings in the same income statement line item as hedged item.

The concept of separately recording "ineffectiveness" will be eliminated. The term "ineffectiveness" no longer will be used.

Amended disclosures focus on the effects of hedging on income statement line items.

Other Simplifications

Commodity Hedges: Companies will be able to hedge the index ("component") stated in the contract.

Interest rate risk hedges: Companies will be able to hedge partial-term, the benchmark rate component of the coupon cash flows (rather than total coupon that includes credit spread), consider only interest rate risk when hedging callable instruments, and find it easier to hedge portfolios of prepayable assets.

Benchmark rates: SIFMA index will be added to the list. For floating rate instruments the list is removed and companies can hedge whatever is the specified rate (for example, prime).

Qualitative testing: Companies will be able to assess effectiveness qualitatively on an ongoing basis when criteria are met.

Documentation: Certain timing relief is being provided to both public and private companies.

Shortcut method and Critical Terms Match methods: Given prior restatement risk or computation complexity, amended to make the methods easier to apply.

Hedging Implementation

Public Companies*

- Fiscal years beginning after December 15, 2018, including interim periods within those fiscal years

All Other Organizations

- Fiscal years beginning after December 15, 2019 and interim periods for fiscal years beginning after December 15, 2020

Early Application

- Permitted for all organizations in any interim period after issuance of the Update

* “Public Companies” refers to the following: (1) public business entities, (2) a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an-over-the-counter market, and (3) an employee benefit plan that files or furnishes statements with or to the SEC

Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income
(Update 2018-02)

Background on Tax Bill

- On December 22, 2017, the U.S. federal government enacted a tax bill, 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).
- Consequently, stakeholders in the banking and insurance industries raised a narrow-scope financial reporting issue.

Background on Financial Reporting Issue

- The adjustment of deferred taxes due to the **reduction of the historical corporate income tax rate to the newly enacted corporate income tax rate** is required to be included in income from continuing operations even in situations in which the related income tax effects of items in accumulated other comprehensive income were originally in other comprehensive income.
- Therefore, the tax effects of items in accumulated other comprehensive income (referred to as stranded tax effects for purposes of this presentation) do not reflect the appropriate tax rate.

Summary of Main Provisions

- Allow entities an option to elect to reclassify from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act.
- If an election is made to reclassify the stranded tax effects, the amount of that reclassification should include:
  - The effect of the change in the U.S. federal corporate income tax rate
  - Other income tax effects of the Tax Cuts and Jobs Act that an entity elects to reclassify.

Disclosure Requirements

- Accounting policy for releasing income tax effects from accumulated other comprehensive income
- Whether an entity elects to make the reclassification
- If election is made to reclassify stranded tax effects, then disclose 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.

Transition

Apply the amendments either:

- At the beginning of the annual or interim period in which the amendments are adopted
- Retrospectively to each period (or periods) in which the income tax effects of the Tax Cuts and Jobs Act related to items remaining in accumulated other comprehensive income are recognized.

Effective Date:

- For all entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years.

Early adoption is permitted.

Staff Q&As

- As a result of the Tax Cuts and Jobs Act, stakeholders requested feedback on the following financial reporting issues:

Whether private companies and not-for-profit entities can apply SAB 118	Whether to discount the tax liability on the deemed repatriation	Whether to discount alternative minimum tax credits that become refundable
Accounting for the base erosion anti-abuse tax (BEAT)	Accounting for global intangible low-taxed income (GLTI)	

- In response, the FASB staff issued five Staff Q&A documents

Current FASB Projects

Nonemployee Share-Based Payment Accounting Improvements **(Final in Q2 2018)**

Share-Based Payment – Existing GAAP

Scope	Employee	Nonemployee
Classification	Liability vs Equity under 718	Liability vs Equity under 718
Measurement	**Equity-Classified** → grant-date fair value over service period **Liability-Classified** → remeasured each reporting period	**Measurement Input:** Performance commitment probable (rarely met) or Performance is completed **Attribution** → same manner as paying cash
Recognition	Recognize expense when performance condition is probable	Before performance → lowest aggregate fair value
Subsequent Accounting	Under 718, unless modified or grantee is no longer an employee	Subject to other GAAP once performance is completed

Current GAAP – Equity Award - Employee Example

Period	Outcome

Fact Pattern	• ABC Corp. grants stock option award on January 1, 20X1 to its employee.
	  • Award cliff vests after 3 years of service.
	  • Strike Price = $100
	  • FV of underlying share = $100

Fair Values at each Reporting Date	• FV at Jan 1, 20X1 (grant date) = $150 • FV at Dec 31, 20X1 = $200 • FV at Dec 31, 20X2 = $250 • FV at Dec 31, 20X3 = $300
How to recognize compensation cost?	• Grant-date fair value (GDFV) of award over 3 years (requisite service period).
20X1	• Compensation Cost: $50 (GDFV of $150 / 3)
20X2	• Compensation Cost: $50 (GDFV of $150 / 3)
20X3	• Compensation Cost: $50 (GDFV of $150 / 3)

Current GAAP – Equity Award - Nonemployee Example

Period	Outcome

Fact Pattern	• ABC Corp. grants stock option award on January 1, 20X1 to an independent contractor. Company pays its independent contractor the same way as its employee.
	  • Award cliff vests after 3 years of service.
	  • Strike Price = $100
	  • FV of underlying share = $100

Fair Values at each Reporting Date	• FV at Jan 1, 20X1 (grant date) = $150 • FV at Dec 31, 20X1 = $200 • FV at Dec 31, 20X2 = $250 • FV at Dec 31, 20X3 = $300
How to recognize compensation cost?	• Remeasured until measurement date is achieved.
20X1	• Compensation Cost: $66.67 ($200/3)
20X2	• Compensation Cost: $100 ([$250 * 2/3] - $66.67)
20X3	• Compensation Cost: $133.33 ($300 – $167.76)

What’s Changing? - Overview

- No changes to employee guidance
- Nonemployee aligned with employee model except:
  - (1) Attribution guidance for nonemployee awards.
    - Nonemployee will be same manner as paying cash for goods or services
  - (2) Term input in option pricing model
    - Entity may default to contractual term (or)
    - Entity may estimate the expected term by applying 718. This could be shorter than contractual term

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Transition Guidance

- Effective for fiscal years beginning after:
  - December 15, 2018 (including interim periods) for public business entities
  - December 15, 2019 for all other entities
- Early adoption permitted, but no earlier than an entities adoption of Topic 606 (Rev Rec)
- Modified retrospective approach:
  - Cumulative catch up to retained earnings
  - Adoption date fair value

Changes to Fair Value Measurement Disclosures
(Final in Q3 2018)

Background

- Objective and primary focus of the disclosure framework project are to improve the effectiveness of disclosures in the notes to financial statements
- Improving the effectiveness of notes requires both:
  - Consistent considerations by the Board in each standard-setting activity
  - Appropriate exercise of discretion by reporting entities when assessing disclosure requirements
- The Board decided to test the concepts and improve the effectiveness of disclosure requirements on fair value measurement.
- The amendments in the Update on fair value measurement disclosures reflect the Board's final deliberations in the Concepts Statement.

Topical Reviews

Topic	Comment Deadline
Fair Value Measurement	February 29, 2016
Defined Benefit Plans	April 25, 2016
Income Taxes	September 30, 2016
Inventory	March 13, 2017

Timeline

March 2014
Proposed Concepts Statement 8, Chapter 8 issued

December 2015
Proposed ASU on FVM issued

February 2016
Comments due on proposed ASU on FVM

March 2018
Redeliberations completed on ASU on FVM and Concepts Statement

July 2018
Final issuance of ASU on FVM and Concepts Statement Chapter

Removals

- Amount of and reasons for transfers between Level 1 and Level 2 of the fair value hierarchy
- Policy for timing of transfers between levels
- Valuation processes for Level 3 fair value measurements
- “At a minimum” from the phrase “an entity shall disclose at a minimum.”

Modifications

- For investments in certain entities that calculate net asset value, a requirement to disclose the timing of liquidation of an investee's assets and the date when restrictions from redemption might lapse *only* if the investee has communicated the timing to the entity or announced the timing publicly.
- Clarify that the measurement uncertainty disclosure is to communicate information about the uncertainty in measurement as of the reporting date.

Additions

- Unrealized gains and losses in other comprehensive income for Level 3 recurring fair value measurements held at the end of the period
- Range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements
  - How the entity calculated the weighted average
  - Other quantitative information may be disclosed

Nonpublic Entity Exemptions

- Unrealized gains and losses in earnings and other comprehensive income for Level 3 recurring fair value measurements held at the end of the period
- Range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements
- In lieu of the Level 3 rollforward, nonpublic entities should separately disclose:
  - Purchases and issues
  - Transfers into or out of Level 3 of the fair value hierarchy

Transition

- Effective for **all entities** for fiscal years, and interim periods within those fiscal years, **beginning after December 15, 2019**
- **Prospective** transition method for the following:
  - Changes in unrealized gains and losses
  - The range and weighted average of Level 3 significant unobservable inputs
  - The narrative description of measurement uncertainty
- All other amendments should be applied **retrospectively** to all periods presented upon their effective date.
- **Early adoption is permitted** for any removed or modified disclosures upon issuance.

Collaborative Arrangements: Targeted Improvements (Proposed ASU)

What are Collaborative Arrangements?

- Defined in Master Glossary and by the scope of Topic 808 (emphasis added):
  - A contractual arrangement that involves a joint operating activity. These arrangements involve two (or more) parties that meet both of the following requirements:
    a. They are active participants in the activity.
    b. They are exposed to significant risks and rewards dependent on the commercial success of the activity.
- The joint operating activities might involve joint development and commercialization of intellectual property, a drug candidate, software, computer hardware, or a motion picture.
- Legal entities are outside the scope of Topic 808 (accounted for under Topics 321, 323, or 810)

What is Current GAAP?

- Topic 808 does not provide recognition and measurement guidance
- Presentation guidance in Topic 808 limited to:
  - Principal/agent considerations from Topic 606 (i.e. gross/net considerations)
- Topic 808 tells entities to do the following:
  1. Apply other authoritative literature when in scope (e.g. leases, revenue)
  2. Otherwise apply other authoritative literature by analogy when appropriate (oftentimes revenue concepts)
  3. Otherwise apply a reasonable, rational, and consistently applied accounting policy election
- Topic 808 precludes equity method of accounting for collaborative arrangements

Resulting Issues and Current Practice

- Lack of guidance has led to diversity in practice, specifically around:
  - Determining appropriate presentation—revenue vs. contra-expense vs. other income
  - Determining units of account
  - Allocating consideration to different units of account
  - Determining the recognition period for each unit of account
- These issues are primarily related to the development phase, also described as the activities unrelated to third-party sales

Illustrative Example

- Example—Pharma A / Pharma B, 50/50 Arrangement
  - Two pharmaceutical companies enter into a collaborative arrangement to jointly develop a drug that Pharma A has patented and identified as a strong candidate for commercialization. Assume they meet the scope of Topic 808. Terms:
    - *Upfront payment:* Pharma B pays Pharma A $50M
    - *Cost share:* At the end of each period, the companies report their R&D spending and true up to 50/50 cost sharing
    - *Milestone:* If the drug reaches FDA approval, Pharma B pays Pharma A $25M
    - *Profit sharing:* Companies split profits from sales to third parties 50/50
- Points of diversity:
  - What is the upfront payment for? (license to IP, prepayment of costs, or pay-to-play)
  - Is Pharma B a customer of Pharma A? Vice versa?
  - How should these transactions be split into units of account?
  - Over what period should the upfront and milestone be recognized?
  - How should each unit of account be classified/presented?

Topic 606 – Additional Complexity

- Language in Update No. 2014-09 (Topic 606) led to confusion about whether collaborative arrangements can result in revenue
  - 606-10-15-3 indicates that collaborative arrangements are out of the scope of Topic 606
  - BC 55-56 in Update 2014-09 (Topic 606) indicate that collaborative partners could be in scope of Topic 606 if the partner meets the definition of a customer for some or all of the terms of the arrangement

Project Background and Scope

- Large pharmaceutical stakeholder sent an agenda request for the FASB to address the areas of diversity
- Project added in November 2016
- Current Scope and Goal:
  - Affects collaborative arrangements in Topic 808 (excludes legal entities)
  - Targeted improvements to clarify the interaction between Topic 808 and Topic 606
  - Limited to a) transactions not related to third-party sales and b) the accounting by the recipient

Project Update and Next Steps

- Proposed ASU issued April 26, with comments due June 11
- The proposed amendments would:

1. Add unit-of-account guidance in Topic 808 to align with the guidance in Topic 606 (that is, a distinct good or service) limited to when an entity is assessing the scope of Topic 606.
2. Clarify that certain transactions between collaborative participants should be accounted for as revenue under Topic 606 when the collaborative participant is a customer in the context of the unit of account. In these situations, all of the guidance in Topic 606 should be applied, including recognition, measurement, presentation, and disclosure requirements.
3. Clarify that in a transaction that is not directly related to sales to third parties, presenting the transaction as revenue would be precluded if the collaborative participant counterparty is not a customer.

EITF Issue No. 17-A: Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is Considered a Service Contract (Proposed ASU)

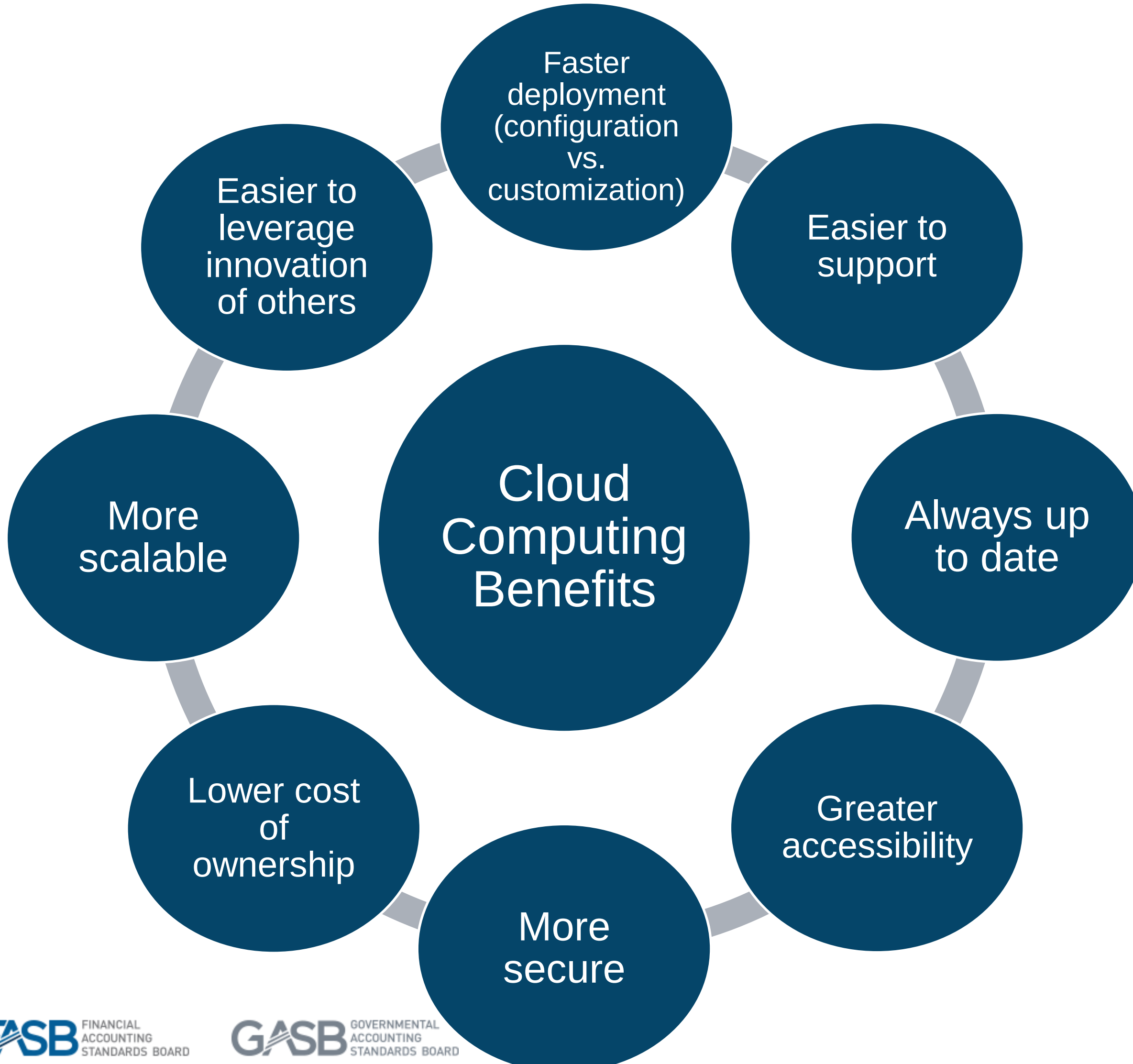
Commercial Computing Today

On-premise Software

Cloud-based software

- Research firm Gartner predicts that the cloud will become the default option for software development by 2020

Benefits of Cloud Computing



FASB Activities Related to Cloud

EITF Issue 00-03 addressed whether a hosting arrangement includes software from a vendor perspective

ASU 2015-05 addressed whether a hosting arrangement includes a license from a customer perspective

EITF now addressing implementation costs of a hosting arrangement that does not include a license

Today's Accounting

EITF Issue addresses

	On-premise software	CCAs with a license	CCAs without a license
Balance sheet - asset	Present an asset for the cost of the software	Present an asset for the portion of the CCA fee related to the cost of the software	No asset is presented for the software, but a prepaid asset may be presented if the CCA fee is paid in advance
Balance sheet - liability	Present a liability for any unpaid amounts	Present a liability for any unpaid amounts	No liability is presented until payment is due
Treatment of implementation costs	Costs to implement the software are capitalized as part of the software asset	Costs to implement the software are capitalized as part of the software asset	Diversity today, but many implementation costs are not capitalized as an asset and are expensed
Income statement presentation	1) Generally straight-line amortization of software cost over useful life of software 2) Interest expense on the liability	1) Generally straight-line amortization of software cost over useful life of software 2) Interest expense on the liability 3) Generally G&A expense for the portion of CCA fee related to the hosting service	1) Generally straight-line G&A expense for CCA fee 2) Many implementation costs are expensed as the underlying activities are performed (near contract inception)

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Two Main Alternatives

Treat hosting arrangement similar to a lease	Treat hosting arrangement as a service contract
Recognize an asset and liability for hosting fees	Do not recognize an asset and liability for hosting fees
Capitalize implementation costs as part of "right of use" asset	Capitalize implementation costs as a contract-related asset

EITF Consensus-for-exposure

- Implementation costs of CCAs that are service contracts would be accounted for in accordance with the guidance in Subtopic 350-40

Results in consistent capitalization of implementation costs across platforms

- The amortization period of the costs would be the term of the arrangement, including periods covered by renewal options of the CCA that are reasonably certain to be exercised
- The amortization of the costs would be recorded in the same line item on the income statement as the fees for the CCA

EITF Consensus-for-exposure (cont.)

- New disclosures required for implementation costs of all arrangements that are within the scope of Subtopic 350-40 (not just CCAs)
- Transition Method Options
  - Prospectively to arrangements entered into, renewed, or materially modified after the effective date
  - Retrospectively
- Next Steps
  - Comments were due April 30, 2018
  - EITF to meet in June to discuss comment letter feedback

Thank You

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