Accounting methods recent developments: tax reform, financial accounting changes, and selected provisions
Notice

The following information is not intended to be “written advice concerning one or more Federal tax matters” subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230.
The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

Tax Accounting Methods Agenda

Revenue recognition
Bonus Depreciation Update
UNICAP overview
Leasing standard ASC 842
Revenue recognition – Proposed regulations and ASC 606

Background: Section 451(b)

Requires recognition of income of the earlier of:
When the all events test is met for an item of income; or
When the taxpayer takes the income into account on its applicable financial statement

*Applicable Financial Statement (“AFS”) includes:
Certain financial statements that are certified as prepared in accordance with generally accepted accounting principles;
A financial statement based on international financial reporting standards that is filed by the taxpayer with a foreign governmental agency similar to the SEC; and
A financial statement filed by the taxpayer with any other regulatory or governmental body specified by the Secretary
Prop. Reg. § 1.451-3

Released on September 5, 2019
Proposed to be effective for tax years beginning after date issued as final regulation
Early adoption available for TYBA 12/31/17 (12/31/18 for specified credit card fees)

Preamble discussion of amount realized
The AFS inclusion rule does not change the treatment of the transaction (for example, sale vs. lease), consistent with Footnote 872

Establishes an “income inclusion rule” for determining when AFS inclusion trumps all-events test

Income inclusion rule is based on the “transaction price”
Amount of gross consideration taken into account for AFS purposes that taxpayer expects to become entitled to for providing goods/services/property is presumed to be part of the transaction price
This is a rebuttable presumption

Background: Section 451(c)

Generally codified the Deferral Method provided under Rev. Proc. 2004-34 as the exclusive advance payment deferral method

- Provides an election to defer the recognition of certain advance payments to the taxable year following the year of receipt to the extent such income is deferred in the AFS
  - Alternatively, if no AFS, when earned
- Applies generally to most advance payments for provision of goods and services
  - Specifically excludes rent, insurance premiums, financial instruments, others
- Acceleration required if taxpayer’s obligation or taxpayer cease to exist

Notice 2018-35, released on April 12, 2018, permits taxpayers to rely on Rev. Proc. 2004-34 until it issues final regulations

Caused the separate deferral method in Reg. §1.451-5, which provided a longer deferral period for advance payments for goods, including gift cards redeemable for goods, to sunset.

- On July 15, 2019, Reg. § 1.451-5 was withdrawn for tax years ending on or after July 15, 2019
Prop. Reg. § 1.451-8

Released on Sept. 5, 2019, taxpayers may early adopt for TYBA 12/3/2017
Provides additional rules for use of deferral method

Similarities
- Non AFS taxpayer can similarly defer income using an "earned" standard
- 92-day rule for short taxable years: 92 day rule – if advance payment is received in the year before a short taxable year of 92 days or less, follow AFS and recognize remainder in subsequent year
- Acceleration of deferral if taxpayer ceases to exist, or taxpayer’s obligation ends
  - Similar step in shoes for transfers under section 351 in consolidated group or section 381
- Does not provide an accelerated cost offset as under Reg. sec. 1.451-5 when advance payments had to be included in income in the second year after the year of receipt

Differences
- Reward points for an eligible item explicitly qualify if a separate performance obligation
- Liabilities treated as contra revenue may not be treated as deferred revenue (e.g., chargeback example)
- Any advance payment not included in year of receipt and written down in the AFS (e.g., as a result of a stock acquisition) is include in the subsequent year

Significant exclusion for long-term production contracts (Specified Goods)
Allocation of transaction price must be consistent with financial statements
Increased expensing overview (Sec. 168(k))

**100% bonus for qualified property**
- Acquired and placed in service after September 27, 2017, and before January 1, 2023
- Phase down in 20% increments beginning 2023 through 2026

**50%, 40%, & 30% bonus for qualified property**
- Acquired before September 28, 2017, and placed in service before January 1, 2018
- Phase down in 10% increments for 2018 and 2019
## Bonus depreciation guidance overview

**TCJA: 100% bonus depreciation for qualified property acquired and placed in service after 9/27/2017 and before 2023**

### 2018 ProposedRegs:
- Acquisition date rules
- Series of related transaction rules

### Final Regs (9/2019):
- Revised acq. date rules
- Minor changes and clarifications

### 2019 ProposedRegs:
- Additional acq. date rules
- Related party transaction rules

## Effective date provisions

All regulations are effective for assets placed in service in tax year of finalization.

All regs may be early adopted:
- No procedures for early adoption in years already filed.

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>2018 Prop. Regs</th>
<th>2019 Final Regs</th>
<th>2019 Prop Regs*</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017</td>
<td>May adopt</td>
<td>May adopt</td>
<td>May adopt</td>
</tr>
<tr>
<td>2018</td>
<td>May adopt</td>
<td>May adopt</td>
<td>May adopt</td>
</tr>
<tr>
<td>2019</td>
<td>Cannot use</td>
<td><strong>Must follow</strong></td>
<td>May adopt</td>
</tr>
<tr>
<td>2020 &amp; Subseq.</td>
<td>Cannot use</td>
<td><strong>Must follow</strong></td>
<td><strong>Must follow</strong></td>
</tr>
</tbody>
</table>

*Expected to be finalized in 2020*
Acquisition date

For 100% bonus, qualified property must be acquired after 9/27/2017

Five types of acquisitions:

- Purchase via a WBC
- Self-constructed
- Purchase via a non-WBC
- Constructed by 3rd party via a WBC
- Constructed by 3rd party via a non-WBC

WBC = Written Binding Contract

Reg guidance by acquisition type

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase / WBC</td>
<td>Use WBC Acquisition Date Rules</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchase / Non-WBC</td>
<td>No Rule: Use Physical Possession / Control</td>
<td>Use 10% Rule</td>
<td></td>
</tr>
<tr>
<td>Self-constructed</td>
<td>Use S-C Property Acquisition Date Rules</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Constructed / WBC</td>
<td>Use WBC Acq. Date Rules</td>
<td>Use S-C Property Acq. Date Rules</td>
<td></td>
</tr>
<tr>
<td>Constructed / Non-WBC</td>
<td>No Rule: Use Physical Possession / Control</td>
<td>Use 10% Rule</td>
<td></td>
</tr>
</tbody>
</table>
Final 263A Regulations Overview

— Significant changes:
  - Definition and requirements of Section 471 Costs
  - Changes to operation of simplified 263A methods
  - Negative 263A costs
  - Modified Simplified Production Method
  - Significant complexity added

Effective Date:
  - Tax years beginning after November 19, 2018 (calendar year 2019)
  - Early adoption available for tax years ending on or after November 19, 2018 (calendar year 2018)
  - Waiver of 5-year scope limitation rules for limited time
Significant Change: Modified Simplified Production Method

**Simplified Production Method (Single Ratio):**

\[
\text{Additional Section 263A Costs} \times \frac{\text{Section 471 Costs in EI}}{\text{EI}} = \text{Allocable 263A Costs}
\]

**Modified Simplified Production Method (Dual Ratios):**

**Pre-Production Ratio:**

\[
\text{Pre-production Add. Section 263A Costs} \times \frac{\text{Pre-production Section 471 costs in EI}}{\text{EI}} = \text{Allocable Pre-production 263A Costs}
\]

**Production Ratio:**

\[
\frac{\text{Pre-production Section 471 Costs}}{\text{Pre-production Section 471 Costs}} \times \frac{\text{Pre-production Section 471 Costs}}{\text{EI}} = \text{Allocable Pre-production 263A Costs}
\]

\[
\text{Production Add. Section 263A Costs + Residual Pre-production 263A Costs} \times \frac{\text{Sec. 471 WIP & FG}}{\text{EI}} = \text{Allocable Production 263A Costs}
\]

Significant Change: Section 471 costs

New General Definition: Controls type and amount of costs capitalized for financial statement purposes.

- Alternative Method Election = use book costs
- Direct Cost Rules
  - Complex de minimis tests and allocations
- Variance Rules
  - Complex safe harbor tests and allocations
- Negative 263A costs

These new rules may require changes for resellers and manufacturers.
Significant Change: Negative section 263A costs

Negative section 263A costs
— Costs capitalized for books that are not required to be capitalized for tax
— Examples include unfavorable book-tax differences, overcapitalized amounts
— IRS had concerns with distortions
— Interim guidance existed in Notice 2007-29

Taxpayers may not include negative adjustments in section 263A costs. Exceptions are permitted for:
— Producers using new modified simplified production method
— Resellers using simplified resale method
— Taxpayers using simplified production method that meet the small taxpayer exception ($50 million)

Implementation/practical application

— Generally requires method change for producers on simplified production method
— Resellers on simplified resale method should evaluate whether the de minimis rules for direct costs are met
— An election to use an “other reasonable method” for allocating direct and indirect costs to inventory still precluded from automatic changes – potential non-automatic changes to adopt 471 rules if modified simplified production method not adopted?
— Consider data requirements for computing safe harbors and de minimis calculations (must be done annually) as well as for allocating costs between pre-production and production activities
Leasing standard ASC 842 – Tax considerations

Lease inception

Right of Use (ROU) Assets are created under ASC 842 for both finance & operating leases:

- Initial Measurement of Lease Liability
- Initial Direct Costs
- Prepaid Lease Payments
- Incentives Received

Compare to tax, which sets up a fixed asset only when the transaction is a capital lease – no fixed asset for true leases:
Book/tax considerations – Rent expense

<table>
<thead>
<tr>
<th>Finance Lease</th>
<th>GAAP</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease expense (under IRC §461 or 467)</td>
<td>Amortization of right-of-use asset (straight-line over shorter of useful life or lease term)</td>
<td>Depreciation of tax asset (accelerated over recovery period)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Operating Lease</th>
<th>GAAP</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease expense (straight-line over lease term)</td>
<td>Interest expense on lease liability (implicit rate in lease/lessee’s incremental borrowing rate)</td>
<td>Interest expense on lease liability (implicit rate in lease/AFR)</td>
</tr>
</tbody>
</table>

Finance lease vs. operating lease

<table>
<thead>
<tr>
<th>Test</th>
<th>Tax (Sale/Financing if Test Met)</th>
<th>Current GAAP (Capital Lease if Test Met)</th>
<th>New GAAP (Finance Lease if Test Met)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ownership transfer by EOL</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Lessee Purchase Option</td>
<td>Less than FMV/exercise reasonably likely</td>
<td>Bargain Purchase Option</td>
<td>Exercise reasonably certain</td>
</tr>
<tr>
<td>Useful Life</td>
<td>≥ 80% of asset’s economic life</td>
<td>≥ 75% of asset’s economic life</td>
<td>Term is for “major part” of asset’s economic life</td>
</tr>
<tr>
<td>Residual Value</td>
<td>≤ 20% of asset’s FMV</td>
<td>Lease pmts PV ≥ 90% of asset’s FMV</td>
<td>Lease pmts PV ≥ “substantially all” of asset’s FMV</td>
</tr>
<tr>
<td>Alternative Use</td>
<td>Limited-use property</td>
<td>N/A</td>
<td>No Alt Use at EOL</td>
</tr>
</tbody>
</table>

Modified procedures for changing treatment of transactions
— Lease to sale, and vice versa
— Tenant allowances
  - Treatment from depreciable interest to no depreciable interest, and vice versa
Changes now permitted with audit protection and section 481(a) adjustment
Requirement to provide name of counterparty
— Eliminated the requirement to obtain certification on tax treatment

Q&A
Accounting and Financial Reporting Update

Agenda

- 2019 AICPA Conference on SEC and PCAOB Developments
- LIBOR reform
- Major accounting standards
- Other FASB activity
2019 AICPA conference – Key messages

Rising to the challenges of rapid change

— Preparers’ response to emerging issues
— New accounting standards
— Technology changes
— The SEC’s response to rapid change
— PCAOB activity
Preparers’ response to emerging issues

- LIBOR reference rate reform (discussed in a later slide)
- Demands for additional corporate information
- Disclosures about other emerging issues (e.g. Brexit or cybersecurity incidents)

New accounting standards

**Revenue recognition**
- Principal versus agent
- Identifying performance obligations
- Applying ASC 606 to sale-leaseback transactions

**Leases**
- Discount rate
- Embedded leases
- Collectability

**Credit losses** (discussed in a later slide)
Technology changes

- Digitization of financial analysis (IASB response)
- Blockchain technology
- Challenges presented by digital assets

The SEC's response to rapid change

- Non-GAAP financial measures
- Structured payables disclosures
- Audit committees
- Interacting with the SEC staff
- SEC enforcement
PCAOB activity

How will the PCAOB’s work affect your company?

- Critical audit matters (discussed in a later slide)
- Improving outreach
- Improving auditor inspections and quality control standards

2019 AICPA conference

Critical audit matters (CAMs)

The PCAOB staff released a Spotlight publication that focuses on initial observations from inspections, outreach and data analysis activities.

At the 2019 AICPA conference, representatives from the SEC and PCAOB emphasized that CAMs are a priority for them.
What is LIBOR and why change?

Libor is a benchmark rate that some of the world's leading banks charge each other for unsecured loans of varying (7) tenors and currencies (U.S. dollar, Pound sterling, Japanese yen, Swiss franc and Euro).

— Calculated based on the rates submitted by the panel of banks.
— Increasingly based on the expert judgment due to the declining amount of unsecured wholesale borrowings by banks since the financial crisis.
— Becoming less robust, less transaction-based and potentially unsustainable market interest rate.*
— The products types affected: OTC and exchange traded derivatives, securitized products, loans, deposits, bonds, mortgages, REPO and financing transactions.
— The uncertainty around LIBOR creates potential risks to the safety and soundness of the financial system.

Other rates also are expected to be discontinued or fundamentally restructured
— For example, other interbank offered rates (IBOR) or rates that are calculated using an IBOR as an input

*Based on International Organization of Securities Commissions’ (IOSCO) and the Financial Stability Board (FSB) reports in 2013 and 2014.
Reference rate reform

Sustainability concerns for U.S. Dollar LIBOR

Alternative Reference Rate Committee - convened by the Fed to identify an alternative to LIBOR for U.S. markets

AARC June 2017 announcement - Secured Overnight Financing Rate (SOFR) will replace LIBOR

ASU 2018-16 adds SOFR as a permissible benchmark interest rate for hedge accounting

FASB added project to its agenda on August 29, 2018 to consider changes to GAAP necessitated by reference rate reform.

Reference rate reform – Potential accounting impact

Modification or extinguishment assessment (e.g. debt, loans and leases)

Hedge accounting

Embedded derivatives

HTM securities
Reference rate reform – Overview

Proposed ASU issued September 5, 2019

FASB meeting November 13, 2019 to discuss feedback

New codification topic would be created with a limited life

• Applied prospectively to contract modifications made, and hedging relationships entered into or evaluated after, the effective date
• Applied from the beginning of the interim period in which the final guidance is issued
• Relief would expire December 31, 2022

Relief provided would include:

• Optional expedients for contract modifications and hedging relationships
• Option to make a one-time transfer from HTM (to AFS or trading) for securities:
  • that reference LIBOR or another reference rate is expected to be discontinued as a result of rate reform; and
  • that were classified as HTM before January 1, 2020

Reference rate reform – Contract modifications

Optional expedients for modifications that meet both of the following:

• Contract references LIBOR or a reference rate that is expected to be discontinued as a result of rate reform
• Modifications change terms that affect the amount and timing of contractual cash flows (that is, critical terms), and those changes are related to reference rate reform

Available optional expedients:

• Account for loan, lease and debt modifications as a continuation of the existing contract without performing detailed analysis otherwise required
• Not required to reassess whether embedded derivatives are clearly and closely related

Election to apply expedients is applied consistently for all contract modifications that would otherwise be accounted for under the same Topic (or intersecting Subtopic within industry Topics)
Reference rate reform – All hedging relationships

Optional expedients to continue hedge accounting when certain critical terms of the hedging relationship change due to reference rate reform

- Changes to a hedging instrument's contractual terms that are related to replacement of the reference rate
- Rebalancing a hedging relationship
- Hedged risk or the method of assessing effectiveness are changed pursuant to other optional expedients
- Hedge documentation is changed (as required when applying the optional expedients)

Elections to apply hedging-related expedients are applied on a hedge-by-hedge basis

- Each expedient may be elected independently of other elections
- Includes elections related to fair value and cash flow hedges

Reference rate reform – Fair value hedges

Optional expedient to change the designated benchmark interest rate for existing fair value hedges

- Available when hedging instrument’s contractual terms are changed or the relationship is rebalanced in certain ways, and the revised relationship is expected to be highly effective
- Change to another eligible benchmark interest rate
- Make an accounting policy election related to the cumulative basis adjustment for the hedged item’s fair value (either adjust or maintain)
- A change in the basis adjustment is immediately recognized in earnings

Optional expedient to continue to apply short-cut method to existing fair value hedges

- Available when changes are made to a hedging instrument's contractual terms that are related to reference rate reform
- Certain conditions to apply short-cut method may be disregarded
Reference rate reform – Cash flow hedges

Optional expedients if the designated hedged risk is affected by rate reform

- Assert the hedged forecasted transaction is probable even if the hedged risk is expected to change
- Continue hedge accounting for an existing cash flow hedge if the hedge continues to be highly effective

Optional expedients related to effectiveness assessments

- Available when hedged forecasted transaction or hedging instrument is affected by reference rate reform
- Shortcut method or another method that assumes (or results in) perfect effectiveness: Certain conditions for each method may be disregarded
- Quantitative methods: Adjust application of methods in ways that essentially disregard potential mismatches in the variable rate index
- Qualitative method (subsequent assessments only): Certain conditions are revised

Optional expedient for hedges of portfolios of forecasted transaction

- Disregard the requirement that groups of individual transactions share the same risk exposure

Major accounting standards
Leases – ‘Day 2’ accounting for lessees

Understanding the accounting

Lease reassessments
Understand which estimates and judgments are subject to reassessment and when reassessments are required.

Right-of-use (ROU) asset impairment
Evaluate ROU assets under the same ASC 360 framework that applies to all other long-lived nonfinancial assets.

Lease modifications – Lessees
Understand the new requirements under ASC 842, and design and implement processes and controls to timely identify modifications and to properly account for them.

Internal control considerations

System readiness
Understand your system's capabilities and deficiencies, and be careful not to rely on a system’s lease accounting output without testing it first.

Management’s disclosure of changes in internal control
SEC filers may need to disclose changes in their control structure, either to address their initial adoption of ASC 842 or to compensate for lease system limitations, in the period in which those changes occur.
Credit losses – Recent developments

**Federal banking agencies propose to update their guidance**
- The federal banking agencies have proposed to update their guidance to reflect the new expected credit losses methodology. This includes guidance:
  - that explains their views on a bank’s accounting for the allowance for credit losses; and
  - related to supervisory expectations for effective credit risk reviews.

**SAB 119**
- The SEC staff issued SAB 119 to align certain portions of its interpretive guidance with ASC 326.
- The SAB is applicable on adoption of ASC 326.

Comment period ended December 16

**Other FASB activity**
Effective date deferral (ASU 2019-10)

<table>
<thead>
<tr>
<th>Credit losses (ASU 2016-13) and goodwill impairment (ASU 2017-04)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Entity type</strong></td>
</tr>
<tr>
<td>SEC filers that are not eligible to be SRCs*</td>
</tr>
</tbody>
</table>

* Smaller reporting company, as defined by the SEC.

Effective date deferral (ASU 2019-10)

<table>
<thead>
<tr>
<th>Credit losses (ASU 2016-13) and goodwill impairment (ASU 2017-04)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Entity type</strong></td>
</tr>
<tr>
<td>SEC filers that are not eligible to be SRCs*</td>
</tr>
<tr>
<td>SEC filers that are eligible to be SRCs</td>
</tr>
<tr>
<td>Public business entities that are not SEC filers</td>
</tr>
<tr>
<td>All other companies, including not-for-profits and employee benefit plans</td>
</tr>
</tbody>
</table>

* Smaller reporting company, as defined by the SEC.
Effective date deferral (ASU 2019-10)

Leases (ASU 2016-02) and derivatives and hedge accounting (ASU 2017-12)

<table>
<thead>
<tr>
<th>For entities that are not public business entities</th>
<th>Original effective dates for calendar year-end entities</th>
<th>Revised effective dates for calendar year-end entities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual periods</td>
<td>January 1, 2020</td>
<td>January 1, 2021</td>
</tr>
<tr>
<td>Interim periods</td>
<td>January 1, 2021</td>
<td>January 1, 2022</td>
</tr>
</tbody>
</table>

ASUs effective in 2019*

*For public companies

ASU 2017-08, Premium amortization period for purchased non-contingently callable debt securities

— Shortens the premium amortization period for these types of securities. This standard more closely aligns the period in which interest income is recognized with the expectations incorporated into the market pricing of the underlying securities.

A proposed Codification improvement would clarify that if a security has additional future call dates, an entity should consider whether the amortized cost basis exceeded the amount repayable by the issuer at the next call date.

ASU 2017-11, Accounting for certain instruments with down round features

— Clarifies that equity-linked instruments or embedded equity-linked features should not be accounted for as liabilities solely because they contain a down round feature.

— Fewer free standing equity-linked instruments with down round features will be accounted for as liabilities and fewer embedded equity-linked features with down round features will be bifurcated from the host contract.
ASUs effective in 2019*

**ASU 2018-02, Reclassifying residual tax effects from AOCI**
- Permits companies to reclassify residual tax effects from accumulated other comprehensive income (AOCI) to retained earnings in each period in which they recognize the effects of the Tax Cuts and Jobs Act, and requires certain disclosures.

**ASU 2018-07, Nonemployee share-based payment accounting**
- Eliminates differences in employee and nonemployee share-based payment accounting except for expense attribution and a contractual-term election for valuing nonemployee equity share options. The ASU also includes policy elections offering relief to nonpublic companies when measuring nonemployee equity share options.

**ASU 2018-16, New benchmark interest rate**
- Adds the Secured Overnight Financing Rate (SOFR) as a benchmark interest rate for hedge accounting purposes. This expands the list of eligible benchmark interest rates.

---

**Other recent FASB developments**

**FASB public roundtable - Accounting for identifiable intangible assets and goodwill**
- Constituents discussed:
  - how moving from an impairment-only model for the subsequent accounting for goodwill to an amortization model would affect users and preparers;
  - ways to simplify the current accounting models; and
  - ways to improve disclosures.

**FASB proposal - Clarifications for certain hedges**
- Proposals would address:
  - whether an entity can change the hedged risk in a cash flow hedge; and
  - documentation for cash flow hedges of a contractually specified component of a nonfinancial forecasted transaction.

Comment period ends January 13
Private company update (September and December meetings)

Practical expedient: Equity-classified share-based payment awards

- The PCC and Board discussed an alternative practical expedient based on US Internal Revenue Code, Section 409A.
- The PCC voted to move forward with the project and asked the staff to draft an Exposure Draft for a potential 409A solution.

Other topics discussed

- Leases implementation
- Reference rate reform
- Identifiable intangible assets and goodwill
- Balance sheet classification of debt
- Liabilities/equity
- EITF Issue 19-C, Warrant modifications

Thank you
Are you keeping pace with regulatory change?

Stay current. Stay informed.

Sign up now to receive timely updates on accounting and regulatory topics: