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Global Review Board

From the Accounting Issue Co-editors

This new Special Accounting Issue of the *Review of Business* journal contains five excellent articles discussing recent important developments in financial accounting and reporting resulting from newly issued standards by the Financial Accounting Standards Board (FASB), as well as developments related to sustainability reporting. Various new FASB standards affecting publicly traded companies as well as not-for-profit entities are discussed and analyzed.

Furthermore, the current status of the conceptual framework for financial accounting and reporting—that is, a theoretical underpinning of the standards issued by the FASB and the International Accounting Standards Board (IASB)—is examined in the national and international standard setting context.

The impacts of these new developments on the preparers and users of financial statements, as well as on the accounting profession, are carefully considered. Here is a brief description of what you will find in this issue:

The first article, "Toward Sustainability and Integrated Reporting," discusses why sustainability reporting has increasingly become common practice by large corporations and why recent developments, discussed in this paper, may result in a further rise in the prominence of this type of reporting. Sustainability reporting is often characterized broadly as that addressing environmental, social, and governance matters.

The authors of this paper, **Victoria Shoaf**, **Eva K. Jermakowicz,** and **Barry Jay Epstein,** explain that the drivers of companies' voluntary sustainability reporting today are: (1) a recognition that sustainability-related issues can materially affect a company's long-term performance, (2) demands from various stakeholder groups—including investors, employees, consumers, communities, and regulators—for increased transparency and disclosure, and (3) the need to respond to issues of sustainable development, which is commonly defined as "meeting the needs of the present generation without compromising the ability of future generations to meet their own needs."

The authors also review the various systems currently used by major firms for voluntary sustainability reporting, and examine and categorize the responses to the Securities and Exchange Commission's recent Concept Release, which seeks input on making sustainability reporting mandatory and on an appropriate framework to adopt for this purpose. They conclude that there is mounting public desire for firms to report on their sustainability efforts, and that the growing market for sustainability assurance and related advisory services presents an opportunity for the accounting profession.

In the second article, "An Analysis of the FASB's New Going Concern Standard and Its Relation to Liquidation Basis of Accounting Requirements," authors **Joseph E. Trainor**, **Cynthia R. Phillips**, and **Maryanne Cangialosi** explain why the FASB provided recent guidance regarding a company's going concern assumption, which will provide an entity's management with guidance for evaluating or disclosing conditions about its ability to continue as a going concern.

The burden of assessing the going concern assumption has historically resided with the entity's independent auditor, and disclosure of going concern issues was not required if management was able to satisfy the auditor that the conditions raising uncertainty would be alleviated. The FASB's new guidance now requires an entity's management to evaluate the going concern assumption, stipulate stricter requirements for disclosure of going concern uncertainties, and address financial reporting requirements if an entity's liquidation becomes imminent.

In this paper, the authors discuss the major provisions of the new going concern standard and explain how it relates to the liquidation basis of the accounting standard. They also perform a content analysis of responses in comment letters sent to FASB regarding the exposure draft previously issued on this topic, and provide data that is useful when evaluating the accounting standard setting process. They also present unanswered questions related to the cost versus benefit of the new going concern standard, the effect on the capital markets of implementation of the new guidance, and the impact of the new disclosure requirements on U.S. auditing standards.

Their results suggest that stakeholder feedback from the FASB's Comment-Letter process can have significant influence on the accounting standard-setting process. The analysis also revealed stakeholders' concern about the possible economic consequences of implementation; the true cost versus-benefit of the new standard; the legal ramifications and consequences for going concern disclosures; whether more timely and detailed disclosures, even when substantial doubt is alleviated, will create confusion in the market place as firms implement the new guidance; and how analysts' forecasts will be affected by early-warning disclosures.

The third article, "FASB Issues New Guidance to Improve Financial Reporting for Not-for-Profit Organizations," deals with the FASB's recently issued Accounting Standards Update (ASU) 2016-14—Not-for-Profit Entities (Topic 958): *Presentation of Financial Statements of Not-for-Profit Entities*. This Update is the result of a multi-year FASB project conducted to review the financial reporting model for not-for-profits (NFPs) that has been in place for approximately 20 years. In the process, the FASB identified several areas of the financial reporting model that needed improvements or updates to provide better information to those that rely on the financial statements issued by NFPs.

In this article, authors **Adrian P. Fitzsimons**, **Irene N. McCarthy**, and **Benjamin R. Silliman** examine and illustrate the main provisions of ASU 2016-14. They explain how this new guidance makes several improvements to the current reporting requirements for the NFP entities. The major changes include streamlining the net asset classification scheme, adding new disclosure requirements regarding information useful in assessing liquidity and availability of resources, presenting an analysis of functional expenses by their natural classifications, and presenting investment returns net of external and direct internal investment expenses.

In the forth article, entitled "The Conceptual Framework: Past, Present, and Future," authors **Sylwia Gornik-Tomaszewski** and **Yeong C. Choi** provide a comprehensive analysis of the purpose and status of the conceptual framework projects conducted by the FASB and the IASB. The conceptual framework is an attempt to provide a meta-theoretical structure for financial reporting. It is intended to set forth objectives and fundamental concepts that will be the basis for the development of all financial reporting standards.

The authors address the importance of the conceptual framework to all financial reporting stakeholders, from standard setters to investors, preparers, auditors, and regulators. As the two most important financial reporting standard-setting bodies in the world continue to move toward principles-based standards, they have concluded that they need a complete, internally consistent, and logical conceptual framework to provide direction and structure to their work in developing requirements for financial reporting. Historical backgrounds of their respective conceptual framework projects, convergence attempts, as well as the most current developments are discussed in this article.

The fifth and final article, by authors **Patrick A. Casabona** and **Timothy Coville**, is entitled "FASB's New Accounting Standard on Leases: Overview of Some Key Requirements for Lessees and Implementation Considerations." It discusses, illustrates, and evaluates the long-awaited new standard on the accounting for leases in FASB ASU 2016-02. Since ASU 2016-02 focuses primarily on lessee accounting, this article emphasizes new key requirements for lessees and provides information about the ASU 2016-02's effective date and transition provisions, as well as implementation considerations.

In this article, the authors emphasize that the central theme conveyed in the lease standard is that lessees need to recognize the assets and liabilities that arise from lease contracts in both their balance sheet and income statement, because they create the equivalent of an asset and a liability, as defined in FASB Concepts Statement No. 6, *Elements of Financial Statements*.

Therefore, the new guidance on leases is a significant improvement over the FASB's previous accounting standard, which did not require lease assets and lease liabilities to be recognized for many lease contracts. Now, the sole exception for not capitalizing leases will be for certain lease contracts with a term of 12 months or less. Therefore, reporting entities that will be faced with these new accounting and related disclosure requirements must consider potential changes to their accounting and internal control systems and other implementation considerations discussed in this paper.

This volume would not be possible without the support and collaboration of people involved in the publication process. First of all, as the guest co-editors of this special accounting issue, we would like to thank Dr. Igor Tomic, Editor of the *Review of Business*, for his support and encouragement. In addition, we would like to thank all the reviewers for their expertise and insightful comments. All manuscripts were blind reviewed by academic and professional experts, and each manuscript was revised before final acceptance.

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Reviewers

The field of accounting is constantly evolving. Thus, academic and practitioner experts in the field were engaged to review the articles, to ensure that they incorporate the correct current accounting and reporting guidance, regulations, and processes of the accounting profession.

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Toward Sustainability and Integrated Reporting

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Abstract

In recent years, sustainability reporting has increasingly become common practice by large corporations. The Governance and Accountability Institute reported that 75% (375) of the companies of the S&P 500 Index prepared sustainability reports in 2014 (GAI, 2014). This voluntary reporting responds to the demands made by various stakeholder groups—investors, employees, consumers, communities, and regulators—and a growing recognition that sustainability-related issues can materially affect a company's long-term performance (Eccles, Ioannou, and Serafeim, 2014).

Sustainability reporting is often characterized broadly as that addressing environmental, social, and governance (ESG) concerns (SEC, 2016). Recent developments may result in a further rise in the prominence of sustainability reporting.

Included in the April 2016 Securities and Exchange Commission (SEC) *Concept Release* on disclosure reform are 12 pages (pp. 204–215) of discussion about sustainability disclosure, including a historical analysis of the items on which it seeks comment, and eight questions posed to elicit feedback (with a 90-day period of public comment that was open until July 21, 2016).

We study the letters sent in response to the *Concept Release*, as well as the global context in which it was made, including various accepted sustainability reporting frameworks currently in use and worldwide calls for sustainability reporting, such as the United Nations' *2030 Agenda for Sustainable Development*, which includes a set of 17 Sustainable Development Goals (SDGs) to end poverty, fight inequality and injustice, and tackle climate change by 2030 (UN, 2015), and the European Parliament's Directive 2014/95/EU requiring disclosure of information on policies, risks, and outcomes on environmental matters, social and employee-related aspects, respect for human rights, anti-corruption and bribery issues, and diversity on boards of directors.

Global harmonization of sustainability reporting is already often suggested, and we investigate potential frameworks for achieving it.

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INTRODUCTION

Sustainability reporting has become an increasingly common practice among large corporations. The Governance and Accountability Institute reported that 75% (375) of the companies of the S&P 500 Index prepared sustainability reports in 2014, up significantly from 2011, when 20% (100) of those companies prepared such reports (GAI, 2014).

Bloomberg has researched 20,000 of the most actively traded public companies and obtained ESG data disclosed by over 12,000 companies in 52 countries (Park and Ravenel, 2013).

The apparent drivers of voluntary sustainability reporting are: (1) a recognition that sustainability-related issues can materially affect a company's long-term performance (e.g., Fink 2016), (2) demands from various stakeholder groups—including investors, employees, consumers, communities, and regulators—for increased transparency and disclosure, and (3) the need to respond to issues of sustainable development (Eccles, Ioannou, and Serafeim, 2014), which is commonly defined as "meeting the needs of the present generation without compromising the ability of future generations to meet their own needs" (Brundtland Report, 1987).

Sustainability reporting is a broad term used to describe a company's reporting on its economic, environmental, and social performance (AICPA, 2015). These matters often are characterized broadly as environmental, social, and governance (ESG) concerns (SEC, 2016).

While certain of these issues have been studied and reported upon for a number of years, this newer terminology is now used to encompass such topics as corporate social responsibility (CSR), triple-bottom-line, and corporate citizenship reporting (Lydenberg, Rogers, and Wood, 2010).

In a 2017 survey of 320 global institutional investors by EY, 82% said that ESG risks have been ignored for too long by the business world, while 81% said companies are inadequate in their disclosure of nonfinancial risks that could affect their businesses. Recent developments may fuel a further rise in the prominence of sustainability reporting.

THE SEC'S CONCEPT RELEASE

In April 2016 the Securities and Exchange Commission (SEC) issued a *Concept Release* on disclosure reform, which seeks comment on virtually all Regulation S-K provisions applicable to U.S. reporting companies. The SEC is examining how to evolve disclosure to meet the needs of today's market.

The *Concept Release* is organized around three topics:

1. The disclosure framework
2. The line-item requirements of Regulation S-K, including expanded requirements related to sustainability and corporate citizenship and potential revisions to existing quarterly reporting requirements
3. The presentation and delivery of information

Included in the *Release* are 12 pages (pp. 204–215) of discussion about sustainability disclosures, including a historical analysis of the items on which it seeks comment, and eight questions posed to elicit feedback (with a 90-day period of public comment that closed July 21, 2016).

The overwhelming view now on record with the SEC is that investors consider environmental, social, and governance (ESG) matters to be important and that change is needed in the existing corporate reporting and disclosure requirements. In 1975, the Commission concluded that it would require disclosure relating to environmental and social performance "only if such information…is important to the reasonable investor—material information" (SEC, 2016).

Regulation S-K already requires the disclosure of material information. However, what information is deemed to be "material" to investors is rapidly changing. In seeking public input on sustainability disclosures, the SEC recognizes that some stakeholders historically have not considered this information to be material, but may consider it material currently and/or in the future.

Increasingly, management of ESG risks and opportunities is seen as influencing corporate success and is therefore material to investors. Indeed, in a 2015 CFA Institute survey of 1,322 institutional investors, 75% of the investors responding take ESG issues into account in their investment analysis and decisions. Therefore, the issue of further defining "materiality," especially regarding ESG factors, is addressed throughout the *Release*.

Voluntary sustainability reports may not be comparable because companies can choose different time periods on which to report and may choose to report on different indicators in varying formats (Lydenberg, Rogers, and Wood, 2010). Also, existing sustainability disclosure in the Form 10-K is subject to the risk that boilerplate language will be employed, and the practice of selective disclosure through ESG questionnaires often yields immaterial information (SASB, 2016).

The SEC recognizes that among some investors and interest groups there is a desire for additional disclosure on sustainability issues, including such ESG topics as climate change, resource scarcity, corporate social responsibility, and corporate citizenship. It also recognizes that the costs of compiling and disclosing information about sustainability and public policy issues are borne by the registrant, and thus ultimately by its shareholders.

Therefore, a cost-benefit analysis needs to be performed, using reliable relevant information, before new mandates for disclosures are imposed on reporting entities.

In seeking comment on whether and how such disclosures should be drafted, the *Concept Release* poses the following questions:

- Are there specific public policy issues important to informed voting and investment decisions?
  - If so, what are they?
  - If we were to adopt specific disclosure requirements involving sustainability or public policy issues, how could our rules elicit meaningful disclosure on such issues?
  - How could we create a disclosure framework that would be flexible enough to address such issues as they evolve over time?
  - Alternatively, what additional Commission or staff guidance, if any, would be necessary to elicit meaningful disclosure on such issues?

- Would line-item requirements for disclosure about sustainability or public policy issues cause registrants to disclose information that is not material to investors?
- Would these disclosures obscure information that is important to an understanding of a registrant's business and financial condition?

- There is already ESG information available outside of Commission (S-K) filings:
  - Why do some companies publish sustainability and CSR reports?
  - Is the information sufficient to address investor needs?
  - How important to investors is integrated reporting?
- If the SEC adopted line-item disclosure requirements on sustainability and public policy, which, if any, sustainability reporting frameworks (e.g., GRI or SASB for U.S. company reporting) should be considered in developing additional disclosures?
  - Which standards?
- Are there sustainability and public policy issues for which line-item disclosure requirements would be consistent with the Commission's rulemaking authority and mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation?
  - If so, how should the evolving nature of such issues be addressed to keep these disclosure requirements current?
- What challenges would corporate reporters face if sustainability reporting were mandated?
  - What would be the additional costs of complying with sustainability or public policy line-item disclosure requirements, including the administrative and compliance costs of preparing and disseminating disclosures, beyond the costs associated with current levels of disclosure?
- If the SEC adopted line-item disclosure requirements on sustainability and public policy, should any registrants be exempted from such requirements?
- Are existing disclosure requirements *regarding climate change matters* adequate to elicit the information that would permit investors to evaluate material climate change risk?
  - What additional disclosure requirements—or SEC guidance—would be appropriate?

RESPONSES TO THE CONCEPT RELEASE

The *Concept Release* received 369 responses, 42 of them after the July 21, 2016, deadline, and 29 of those after the end of July (the latest posted February 27, 2017). As noted, the *Release* presented a very comprehensive overhaul of disclosure and presentation issues, with numerous sub-topics and 340 questions that requested comment. Many respondents focused on one or two issues.

Still, 104 letters omitted a mention of the sustainability issue, focusing instead on such issues as intellectual properties or foreign tax havens or permitting companies "going dark" if they did not meet certain thresholds. The remaining

265 letters (72%) dealt with sustainability in some manner; for 128, it was the only issue addressed in the letter.

Few of the respondents addressing sustainability engaged all of the questions posed. (Indeed, some of the respondents did not address the SEC's specific questions at all.) For the most part, respondents seemed to avoid the questions on the cost of compliance and identifying who should be exempted from disclosure.

Most of those who commented on the existing disclosure requirements for climate change matters believed that they were insufficient; and that, moreover, they are not followed, and such failure to fully disclose is neither monitored nor enforced.

The question that elicited the most response was whether sustainability reporting should be mandated by the SEC. The other questions that respondents commented on most frequently were whether mandatory disclosure would result in delivery of immaterial and confusing information; whether sustainability reporting should be integrated with other required financial reports; whether it is within the SEC's authority and mission to mandate sustainability reporting; and whether the SEC should adapt an existing framework for detailed mandatory sustainability disclosure.

The respondents to the *Release* fall into types: industry associations (e.g., American Gas Association, National Association of Manufacturers); government agencies and officials (e.g., EPA, California Commissioner of Insurance, Attorney General of Oklahoma); retirement funds (e.g., California State Teachers' Retirement System, AFL-CIO); religious associations (e.g., School Sisters of St. Francis, Presbyterian Church USA, Christian Brothers Investment Services); accounting and legal firms (e.g., KPMG, Sullivan & Cromwell); businesses and business associations (e.g., Exxon Mobil, Aflac, AICPA); specifically ESG-focused associations (e.g., Ceres, International Corporate Responsibility Roundtable, GRI); financial services, including investment management, asset management, foundation investors (e.g., Allianz Global Investors, BMO Global Asset Management, PNC Financial Services); investment firms and foundations that specifically promote ESG (e.g., Domini Social Investments, Alliance for Impact Investing).

Unaffiliated individuals wrote 102 of the responses, but 81 of those followed, or included, a short template, which stated: "Public corporations should at a minimum be required to: (1) Disclose their political spending; (2) Disclose their oversea tax payments, country-by-county; and (3) Disclose their sustainability plan." (For an example, see letter from Glen Anderson, SEC, 2016.)

As indicated in Table 1, most, but not all, of those who opined on the importance of sustainability reporting believe that it should be mandatory rather than voluntary, although some oppose regulating disclosure, and a few omit preference. Those who oppose the SEC issuing a mandate to report on sustainability argue that if the issues are material, they would need to be reported anyway under existing materiality standards.

Defenders of mandatory reporting point out that their immediate financial effects might be immaterial, but they are still important to investors because they may have significant long-term effects. A prevalent comment is: "The current framework, which leaves it up to the corporation to determine when such an item is material, however, has not produced the comprehensive and comparable

TABLE 1. Responses to Specific Questions; Respondents Grouped by Type

		Should the SEC mandate sustainability and ESG disclosures?		Could this mandate require disclosure of immaterial information?		Should the mandate be part of the SEC's integrated reporting?		Is such a mandate within the SEC's authority and mission?		Should the SEC adapt an existing sustainability reporting framework?	
Respondent groups		**Yes**	**No**	**Yes**	**No**	**Yes**	**No**	**Yes**	**No**	**Yes**	**No**
Industry associations	10		10	9			10		8		8
Government agencies/officials	10	6	4	2	2	6	4	1	2	3	1
Retirement funds	13	13			8	11		2		8	
Religious associations	22	22			14	21		7			15
Businesses/associations	18	5	10	7	1	3	4	1	3	5	1
Legal/accounting firms	9	3	4	2			1		2	3	
ESG associations	36	35		4	15	20		7	1	18	1
Financial services/associations	26	22	4	6	4	20		5	3	17	
ESG investors	19	19		2	2	10		4		12	
Individual	21	13	5	3	1	5	1	1	2	9	
Individual (Template)	81	81									
Totals	265	219	37	35	47	96	20	28	21	75	26

information that we are seeking" (letter from Gary W. Kidwell, President, Christian Church Foundation, p. 2, SEC, 2016).

The issue of materiality is discussed elsewhere in the *Concept Release*, but this debate makes it particularly relevant to the issue of sustainability reporting, where currently quantitatively immaterial items with high risk can potentially become very material. For this reason, many of those said that mandatory reporting would not result in immaterial disclosures because they view them to be material in a long-term context.

Most of the opponents of the SEC mandating sustainability reporting believe that it would exceed the SEC's authority and mission. They commonly argue that it "would deviate from the SEC's role as the nation's dispassionate regulator of market information, suggesting that the SEC is willing to favor some 'policy-driven disclosure requirements' over others" (letter from Cynthia H. Coffman, Attorney General of Colorado, SEC, 2016).

Only a relatively small percentage of those who favor mandatory sustainability reporting directly confront the issue of whether the SEC has the authority to mandate this disclosure, although such authority would seem to be implicit.

About 44% of those who support mandatory sustainability and ESG disclosures believe that they should be part of the SEC's integrated reporting. They most commonly mention this as a matter for the annual 10-K, but some advocate for inclusion in all SEC filings.

The comment letters widely acknowledge the prevalence of existing sustainability reporting frameworks. Many of those who oppose mandatory reporting believe that these frameworks provide reporting that is sufficient to inform the public of companies' sustainability efforts.

Those who favor the SEC mandating sustainability reporting praise the existing frameworks, but generally find them insufficient in some respect or another for SEC reporting. Few would adopt any of the frameworks outright, but many believe that one or more of these frameworks would make a good starting point for the SEC to develop reporting requirements.

More than half of those who believe in adapting an existing framework mentioned that of the Sustainability Accounting Standards Board (SASB). The qualities particularly commended or lauded were flexibility and industry specificity.

Other frameworks mentioned in the letters include the Global Reporting Initiative (GRI), International Integrated Reporting Council (IIRC), the World Federation of Exchanges (WFE) and the United Nations Global Compact, and a few referred to those established by CDP (formerly, the Carbon Disclosure Project), Climate Disclosure Standards Board (CDSB), International Organization for Standardization (ISO), and AccountAbility AA 1000.

SUSTAINABILITY REPORTING FRAMEWORKS

There are a number of sustainability reporting frameworks currently in use, with differing perspectives. The SASB was created in 2011 to develop a full set of industry-specific nonfinancial material issues and their associated performance indicators for U.S. companies.

The SASB now issues industry-specific standards for disclosing material sustainability information in mandatory filings to the Securities and Exchange Commission (SEC), such as in Forms 10-K or 20-F. The GRI and IIRC have produced international voluntary frameworks for reporting to a broader range of stakeholders.

Recently the SASB and Institute of Management Accountants (IMA) announced a new Memorandum of Understanding to advance the management and disclosure of nonfinancial information in corporate reports (IMA, 2015). In 2016, SASB and GRI each published important documents showing the way toward the advancement and comparability of sustainability reporting.

SASB

In April 2016, upon completion of provisional standards for 79 industries in 10 sectors, the Sustainability Accounting Standards Board launched the next phase of its standards development, and entered a period of consultation on the provisional standards and the proposed process to codify and maintain them (SASB, 2016). The SASB is consulting on three key documents:

1. The SASB Conceptual Framework (CF)
2. The SASB Rules of Procedure
3. The Sustainable Industry Classification System™ (SICS™)

Also, SASB invites consultation on the provisional standards regarding the likely materiality of the topics, and the usefulness and cost-effectiveness of the metrics, with an SASB sector analyst. Because sustainability issues affect different industries in various ways, SICS was developed for industries based on shared sustainability risks and opportunities, according to industries' sustainability profiles.

SICS is linked to the Bloomberg Industry Classification System (BICS), and has a multi-level taxonomy consisting of sectors, sub-industries, and industries. Table 2 shows the SASB's Proposed SICS Taxonomy by sector and industry.

Since 2012, the SASB has developed for each industry sector a list of disclosure topics and sample standards, including accounting metrics (e.g., total energy consumed, percentage grid electricity, percentage renewable energy), category (e.g., quantitative versus discussion and analysis), unit of measure (e.g., gigajoules, percentage) and code. When considering topics for which to develop accounting standards, SASB adheres to the following basic principles (SASB, CF, p. 12):

- *Applicability to investors*—considering issues that are likely to be material and provide decision-useful disclosures to investors of all types;
- *Relevance across an industry*—addressing issues that are systemic and/or endemic to the industry, and therefore are likely to apply to most, if not all, companies within an industry;
- *Potential to affect value creation*—striving to ascertain the link between performance on each issue with long-term value creation, traditional corporate valuation, and/or risk mitigation;
- *Benefits exceeding the perceived costs*—striving to determine that disclosure on a proposed issue fills a significant need on the part of investors and that the perceived costs it imposes, compared with possible alternatives, are justified in relation to the overall expected benefits;
- *Actionable by companies*—assessing if performance on the issue is measurable by, attributable to, and within, the control or influence of companies;
- *Reflective of the views of stakeholders*—actively soliciting input and carefully weighs all stakeholder views in considering issues and developing standards.

As to accounting metrics, SASB employs criteria to ensure that the particular metrics adopted will produce the highest quality decision-useful information for corporate management and investors. The accounting metrics are evaluated for the following qualities:

- *Relevant*: The proposed metric adequately describes performance related to the material issue, or is a proxy for performance;
- *Useful*: The metric will provide decision-useful information to companies and investors;
- *Applicable*: The metric is applicable to most companies in the industry;
- *Cost-effective*: The data are already collected by most companies or can be collected in a timely manner and at a reasonable cost;
- *Comparable*: The data allow for peer-to-peer benchmarking within the industry;

TABLE 2. SASB Proposed Standards by Sector and Industries

Consumer Goods	Financials	Food and Beverage	Health Care	Infra-structure	Non-Renewable Resources	Renewable Resources and Alternative Energy	Resource Transform-ation	Services	Technology and Commun-ication	Transport-ation
Apparel, Accessories, and Footwear	Asset Manage-ment and Cus-tody Activities	Agriculture Products	Biotechnology	Electric Utilities and Power Generators	Coal Operations	Biofuels	Aerospace and Defense	Advertising and Marketing	E-commerce	Airlines
Appliance Man-ufacturing	Commercial Banking and Finance	Alcoholic Bev-erages	Drug Retailers	Engineering and Construction Services	Construction Materials	Forestry Management	Chemicals	Casinos and Gaming	Electronic Manufacturing Services and Original Design Manufacturing	Air Freight and Logistic
Building Products and Furnishings	Consumer Finance	Food Retailers and Distributors	Health Care Delivery	Gas Utilities and Distributors	Iron and Steel Producers	Fuel Cells and Industrial Batteries	Containers and Packaging	Education	Hardware	Automobiles
Household and Personal Products	Insurance	Meat, Poultry, and Dairy	Health Care Distributors	Home Builders	Metals and Mining	Pulp and Paper Products	Electrical and Electronic Equipment	Hotels and Lodging	Internet Media and Services	Auto Parts
Multiline and Specialty Retailers and Distributors	Investment Banking and Brokerage	Non-Alcoholic Beverages	Managed Care	Real Estate	Oil and Gas: Exploration and Production	Solar Energy	Industrial Machinery and Goods	Leisure Facilities	Semi-conduc-tors	Car Rental and Leasing
Toys and Sport-ing Goods	Mortgage Finance	Processed Foods	Medical Equipment and Supplies	Real Estate Services	Oil and Gas: Mid-stream	Wind Energy		Media Pro-duction and Distribution	Software and IT Services	Cruise Lines
	Security and Commodity Exchanges	Restaurants	Pharmaceuticals	Water Utilities and Services	Oil and Gas: Refining and Marketing			Professional and Business Support Services	Telecommunica-tion Services	Marine Trans-portation
		Tobacco		Waste Manage-ment	Oil and Gas: Services					Rail Transpor-tation Road Transpor-tation

- *Complete*: Individually, or as a set, the metrics provide enough information to understand and interpret performance associated with the material issue;
- *Directional*: The metric provides clarity about whether an increase/decrease in the numerical value signals improved/worsened performance;
- *Auditable*: The data underlying this metric can be verified and/or attested to by auditors.
- *Neutral*: The data must report performance as faithfully as possible, emphasizing objective measurement rather than value judgments.

In order to meet the dual challenges of comparability and practicability for establishing key performance indicators (KPIs) by industry and sector, SASB has developed a six-step method, as follows:

1. Identify a broad universe of sustainability issues. For example, the universe of indicators created by the Global Reporting Initiative (GRI) can be organized under the headings of community, customer, employees, supply chain, environment, and governance.
2. Select an industry classification system.
3. Establish a definition of materiality to address nonfinancial issues.
4. Apply the materiality test to the sustainability issues.
5. Rank the materiality of these issues within each industry and establish a threshold that defines those issues that are key.
6. Create KPIs for the most material issues for each sector (Lydenberg, Rogers, and Wood, 2010).

SASB has applied this methodology to six industry subsectors, as defined by its Industry Classification Benchmark: airlines, automobiles, diversified REITS, conventional electricity, paper, and retail banks. These six industry subsectors were chosen in order to represent a diversity of business practices—from manufacturing (automobiles, paper) to investment products (REITs) to services (airlines, electricity, and retail banks).

GRI

In April 2016, GRI issued exposure drafts of an initial set of six GRI Standards issued by the Global Sustainability Standards Board (GSSB), an independent standard-setting body that acts in the public interest to develop and approve GRI Standards. Launched on October 19, 2016, the GRI Standards replace the G4 Sustainability Reporting Guidelines, which will be phased out by June 30, 2018. Thus, the GRI Standards are required for all GRI sustainability reporters publishing as of July 1, 2018.

The GRI Standards are organized in a modular structure, with three "universal" Standards applicable to all organizations preparing a report in accordance with the GRI Standards, and approximately 35 "topic-specific" Standards to choose from, depending on which from its list of material topics are germane in a given reporting situation.

The content from the G4 Sustainability Reporting Guidelines is being restructured to form a set of modular, interrelated reporting standards. The modular approach will be helpful for GSSB to update the reporting guidance over time. The Standards feature clearer distinctions between requirements (denoted by *shall*), recommendations (denoted by *should*), and guidance sections.

The first set of exposure drafts includes the three "universal" GRI Standards that will be applicable to all organizations:

- *The Foundation Standard*, including the reporting principles and "in accordance" criteria.
- *The General Disclosures Standard*, covering organizational profile, governance, stakeholder engagement, reporting practice, strategy, and analysis.
- *The Management Approach Standard*, including the disclosure on management approach (DMA) from G4, which may be used with any topic-specific GRI Standard.

The GRI Standards also include three topic-specific GRI Standards: Emissions, Indirect Economic Impacts, and Public Policy (there will ultimately be approximately 35 topic-specific standards based on the Aspects within G4). GRI Standards are primarily intended to be used together as a set of standards.

Organizations preparing sustainability reports "in accordance" with GRI Standards will use all three universal standards and will be able to make their own selection of relevant topic-specific standards, based on those that are *material*.

Organizations can also use individual GRI Standards or their contents to disclose specific sustainability information and are required to include a reference in any published materials.

The Coalition for Environmentally Responsible Economies (CERES) founded the Global Reporting Initiative (GRI) in the 1990s to provide a sustainability reporting framework and facilitate comparison between companies on sustainability measures. This framework provides guidance to companies for determining the content and ensuring the quality of reported information (GRI, G4 Sustainability Reporting Guidelines, pp. 16–18).

The GRI principles for defining report content, which help companies identify topics and related indicators that are relevant to report, include:

- *Stakeholder inclusiveness*: stakeholders should be identified and the report should explain how the company has responded to their reasonable expectations and interests.
- *Sustainability context*: the report should present the organization's performance in the wider context of sustainability, including how an organization contributes—or aims to contribute in the future—to the improvement or deterioration of economic, environmental, and social conditions, developments, and trends at the local, regional, or global level.
- *Materiality*: the report should reflect how the organization's significant economic, environmental, and social actions impact or substantively influence the assessments and decisions of stakeholders.

- *Completeness*: the report (its scope, boundary, and time) should be sufficient to reflect significant economic, environmental, and social impacts and to enable stakeholders to assess the organization's performance in the reporting period.

GRI reporting principles for defining quality include:

- *Balance*: the report should reflect positive and negative aspects of the company's performance (i.e., it should come across as unbiased).
- *Comparability*: issues and information should be selected, compiled, and reported consistently and presented in a manner that stakeholders can analyze over time.
- *Accuracy*: the information should be sufficiently accurate and detailed and verifiable. A best practice gaining traction is to have the information third-party assured.
- *Timeliness*: reporting should be done on a regular schedule and made available in time for stakeholders to make informed decisions.
- *Clarity*: the information should be understandable and accessible to the stakeholder using the report.
- *Reliability*: information and processes used to prepare the report should be gathered, recorded, compiled, analyzed, and disclosed in a way that could be examined and that establishes the quality and materiality of the information.

IIFRC

The International Integrated Reporting Committee (IIRC) was formed in 2010 by HRH Prince Charles of Wales' Accounting for Sustainability Project (A4S), the GRI, and the International Federation of Accountants (IFAC) to create a globally accepted integrated reporting framework. This framework focuses on a strategy to achieve value creation in the short, medium, and long term for society and its stakeholders (IIRC, 2015).

The AICPA is one of the founding members of the Accounting Bodies Network, formed in 2010 to support the work of the A4S in the accounting profession worldwide. Core principles of the A4S include embedding sustainability into the day-to-day decisions of an organization, and the concept of connected, or integrated, reporting.

The Integrated Report (IR) links the organization's financial and nonfinancial (societal and environmental) strategies and impacts. It portrays the main connections between social, environmental, and economic actions and outcomes that are material for the reporting organizations. While many large companies issue separate, or stand-alone sustainability reports, the trend is in the direction of integrated reporting (AICPA, 2015; Eccles, Serafeim, and Krzus, 2011).

According to Owen (2013), an integrated report should not only provide information on both financial and nonfinancial performance, but also should show the relationship between financial and nonfinancial performance and how these interrelated dimensions are creating and destroying value for shareholders and other stakeholders.

SUSTAINABILITY REPORTING WORLDWIDE

On April 15, 2014, The European Parliament adopted the Directive 2014/95/EU on disclosure of nonfinancial and diversity information by large companies and groups. Companies affected will disclose information on policies, risks, and outcomes as regards environmental matters, social and employee-related aspects, respect for human rights, anti-corruption and bribery issues, and diversity on boards of directors.

Regarding diversity on company boards, large listed companies will be required to provide information on their diversity policy, addressing, for instance: age, gender, educational and professional background. Large public-interest entities with more than 500 employees will be required to disclose certain nonfinancial information in their management reports. The scope includes about 6,000 large companies and groups across the EU.

EU member states were granted two years to translate the Directive into national legislation. Therefore, affected companies will have significant time to adapt to the new requirements, and will start reporting as of their financial year 2017.

Similar to the U.S. SEC's *Concept Release*, in January 2016, the European Commission launched a public consultation to collect views from stakeholders on non-binding guidance on the methodology for reporting of nonfinancial information by certain large companies across all sectors.

In October 2015 the World Federation of Exchanges (WFE) Sustainability Working Group issued the Exchange Guidance & Recommendations, which identified material ESG metrics which exchanges can incorporate into disclosure guidance to companies listed on their markets.

Specifically, the enhanced guidance highlights 34 key performance indicators, including energy consumption, water management, CEO pay ratio, gender diversity, human rights, child and forced labor, temporary worker rate, corruption and anti-bribery, and tax transparency, in addition to other corporate policies. It also offers practical advice on how to roll out enhanced sustainability disclosure (voluntary).

Also, the Sustainable Stock Exchanges (SSE) initiative is a project of the UN that provides a multi-stakeholder learning platform for stock exchanges, investors, regulators, and companies to adopt best practices in promoting corporate sustainability. For those exchanges that have signed up for the UN's Sustainable Stock Exchanges initiative, the adoption of the WFE guidance is a way to meet their SSE commitments (WFE, 2015).

OPPORTUNITIES FOR THE ACCOUNTING PROFESSION

As more companies are reporting on their environmental, social, and governance performance, a growing demand for assurance on this information, and the systems and processes used to generate it, can be anticipated. CPAs are well positioned to offer expertise in implementing, tracking, and verifying the sustainability efforts of an organization.

According to the AICPA's *The State of Sustainability Assurance and Related Advisory Services in the U.S.*, published in June 2015, it is expected that the total market size for sustainability assurance and related advisory services will grow in the United States from $171 million to $258 million in 2017 (AICPA, 2015).

Sustainability auditing is performed in accordance with the profession's assurance standards, including AICPA AT 101, *Attest Engagements*, (assurance on subject matter or assertion about the subject matter that is the responsibility of another party), or International Standard for Assurance Engagements (ISAE) 3000.

In the United States, CPAs must follow AT 101; whereas IFAC's standard, ISAE 3000, is the predominant global standard for providing assurance over sustainability reports, and other standards also exist. *AccountAbility* is a global, non-profit organization that has issued a corporate responsibility assurance standard (AA 1000AS) that is used by some organizations.

According to the AICPA, investors, regulators, and an expanding array of other stakeholders are increasingly interested in greater transparency about company strategy, performance drivers, and the reporting of both financial and nonfinancial information, including information about company sustainability initiatives (AICPA, 2015).

Recent stock exchanges' initiatives and the actions of the SASB, GRI, IIRC, and UN, result in growing executive and investor, as well as other stakeholders, awareness of the value of nonfinancial reporting and increased prominence of sustainability and integrated reporting. The SEC's *Concept Release* indicates the growing importance of sustainability reporting and suggests the possibility of it becoming mandatory in U.S. filings.

As stated by HRH Prince Charles of Wales, in his address on sustainability to AICPA Governing Council in 2009, "Who better to take the lead and set an example than the Accountancy Profession which is the engine room of the corporate world and government" (Prince Charles, 2009). Accountants will continue to play a key role in sustainability and integrated reporting.

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An Analysis of the FASB's New Going-Concern Standard and Its Relation to Liquidation Basis Accounting Requirements

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Abstract

Whether a company expects to remain in existence for a reasonable time into the future is a fundamental consideration for investors and creditors when evaluating investment alternatives. Investors and creditors are understandably concerned about management's ability to enhance the capital-providers' investment, and any doubts about an entity's future demise or liquidation is decision-useful information for these capital-market participants. To provide investors and creditors with some assurance about a company's future survival, the accounting standards establish the *going-concern* assumption.

While the going-concern assumption is a foundational underpinning of the financial reporting process, until recently, an entity's management has had no formal responsibility for evaluating or disclosing conditions about an entity's ability to continue as a going concern. The burden of assessing the going-concern assumption has historically resided with the entity's independent auditor, and disclosure of going-concern issues was not required if management was able to satisfy the auditor that the conditions raising uncertainty would be alleviated.

This process changed significantly with a recent Financial Accounting Standards Board (FASB) Accounting Standards Update (ASU). The accounting standards now charge an entity's management with the responsibility to evaluate the going-concern assumption, stipulate stricter requirements for disclosure of going-concern uncertainties, and address financial reporting requirements if an entity's liquidation becomes imminent.

Our manuscript discusses the major provisions of the new going-concern standard and how it relates to the liquidation basis of accounting standard.

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We provide important information for investors, creditors, managers, preparers, auditors, and other capital market participants about how this new standard may affect the interpretation of financial statements. Our manuscript also provides an analysis of the FASB exposure draft comment letters, poses unanswered questions about the new going-concern standard, and discusses the effects the standard has on auditors.

INTRODUCTION

Transparency in financial reporting significantly influences capital-market efficiency as decision makers use the information presented in financial statements to make investment decisions. Hence, the importance of reliable financial reports, that fairly reflect the financial condition of an entity, cannot be overstated. One of the most fundamental accounting assumptions underlying the preparation of financial statements is the *going-concern* assumption.

The going-concern assumption presumes that an entity will be able to realize its assets and meet its financial obligations when they become due for a reasonable time into the future. Accordingly, general-purpose financial statements are prepared using the going-concern basis of accounting (traditional accrual accounting). Investors, creditors, and analysts use this financial information to evaluate current performance and make predictions about the future performance of an entity.

If, however, an entity is not expected to continue operating as a going concern and its liquidation is imminent, use of the liquidation basis of accounting is required for the preparation of financial statements to provide relevant information to investors about the expected resources available after liquidation.

Given the critical importance of an entity's ability to continue as a going concern for capital-investment decisions, when and how should this information be communicated to interested parties to make it most decision useful? For example, even before an entity's liquidation is imminent, uncertainties may exist about the entity's ability to continue as a going concern that would be relevant to investors.

The question is, how much of this information should be publicly disclosed? In the past, if auditors expressed uncertainty about the validity of the going-concern assumption, but the entity's management implemented a plan to alleviate the problem, this information was not communicated to the investing public.

U.S. accounting standards have not, until recently, adequately addressed these important issues regarding the going-concern assumption. To close this gap in the standards, the FASB recently completed a two-phase project that resulted in the issuance of two Accounting Standards Updates: ASU No. 2014-15, *Presentation of Financial Statements (Topic 205): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*, issued on August 27, 2014; and ASU No. 2013-07, *Presentation of Financial Statements (Topic 205): Liquidation Basis of Accounting,* issued on April 22, 2013.

The purpose of this paper is to analyze the major provisions of the going-concern standard update and its relationship to the liquidation basis of accounting. We also present results of an analysis of the feedback from various constituents who commented on the FASB Exposure Draft and present important unanswered questions related to the cost-benefit of the new standard, the effect on the capital markets of implementation of the amendments, and the impact of the new disclosure requirements on U.S. auditing standards.

GOING-CONCERN STANDARD UPDATE

Background

The issuance of financial statements prepared using the going-concern basis of accounting signals to users of the information that an entity expects to continue its operations into the foreseeable future. To assure investors that the going-concern assumption is valid, recent updates have been made to generally accepted accounting principles (GAAP).

The revised standard provides guidance on going-concern issues, including management's responsibility to assess going-concern uncertainties, when and how such uncertainties should be disclosed in the financial statement footnotes, and when to use the liquidation basis of accounting to prepare financial reports.

Prior to issuance of the standards update, responsibility for evaluating the going-concern assumption resided solely with an entity's independent auditor, in accordance with U.S. auditing standards and federal securities law, and was conducted as part of the annual financial statement audit. Independent auditors are also charged with responsibility for evaluating the adequacy of disclosures relative to going-concern uncertainties and for assessing the viability of management's plans to alleviate any substantial doubt about the entity's ability to continue as a going concern.

Varying interpretations of the substantial-doubt threshold on the part of independent auditors, combined with the considerable professional judgment involved in the going-concern assessment, and the absence of GAAP guidance, has resulted in considerable diversity in practice with respect to the timing, content, and overall extent of footnote disclosures related to going-concern conditions. ASU 2014-15 was issued to reduce this diversity in an effort to improve the timeliness and quality of footnote disclosures, thereby increasing the usefulness of financial statements.

Key Provisions of ASU 2014-15

Incorporating and expanding on certain principles that are currently in the U.S. auditing standards, the FASB amended GAAP with the issuance of ASU 2014-15. The new going-concern standard applies to all entities (SEC filers and non-filers) covered by FASB rules and became effective for the annual reporting period ending after December 15, 2016, and for annual and interim periods thereafter. Key provisions of the going-concern standard update include:

a. Management Responsibility: A provision has been added to GAAP that charges management with the responsibility to evaluate whether *substantial doubt* exists as to an entity's ability to continue as a going concern. In its evaluation, management must consider relevant conditions and events that are known and *reasonably knowable*[1] at the financial statement issuance date.

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[1]*Reasonably knowable* means that a company should make a reasonable effort to identify conditions that it may not readily know, but that could be identified without undue cost and effort (PwC, 2014, p. 3).

The new FASB guidance includes indicators to be considered in management's evaluation of the entity's ability to meet its obligations, such as financial conditions, liquidity sources, financial obligations, and cash flow.

b. Look-Forward Period: Auditors have historically assessed the going-concern assumption based on a timeframe of one year after the balance sheet date (as required by auditing standards). The revised accounting standard extends the look-forward period to one year after the date financial statements are issued (or available to be issued for non-SEC filers). See Figure 1.

   By extending the look-forward period to begin at issuance date, the going-concern assessment must consider all relevant subsequent events[2] after the balance sheet date. This provision will benefit financial statement users by providing more current and relevant information, potentially earlier disclosures about going-concern uncertainties, and a look-forward period that is still one year, even if issuance of financial statements is delayed (Deloitte, 2014).

c. Frequency of Assessment: The frequency of going-concern evaluations has been increased to include each annual and interim[3] reporting period, whereas past practice was limited to an annual evaluation. This change results in the most current information being made available to users of the financial statements.

d. *Substantial Doubt* Defined: A definition of *substantial doubt* is now provided in the going-concern standard, using a likelihood threshold of *probable* ("likely to occur"). A *more-likely-than-not* threshold was initially proposed in the exposure draft; however, the higher-likelihood "probable" threshold was ultimately selected. Auditing standards do not specifically define "substantial doubt."

e. Plans to Alleviate Substantial Doubt: When it is probable that an entity will be unable to meet its current obligations, management must determine whether or not its plans will mitigate the conditions that create substantial doubt. The FASB guidance has been expanded to include examples of plans to mitigate going-concern uncertainties, information to consider in evaluating the feasibility of each plan, and principles for considering the mitigating effect of management's plans.

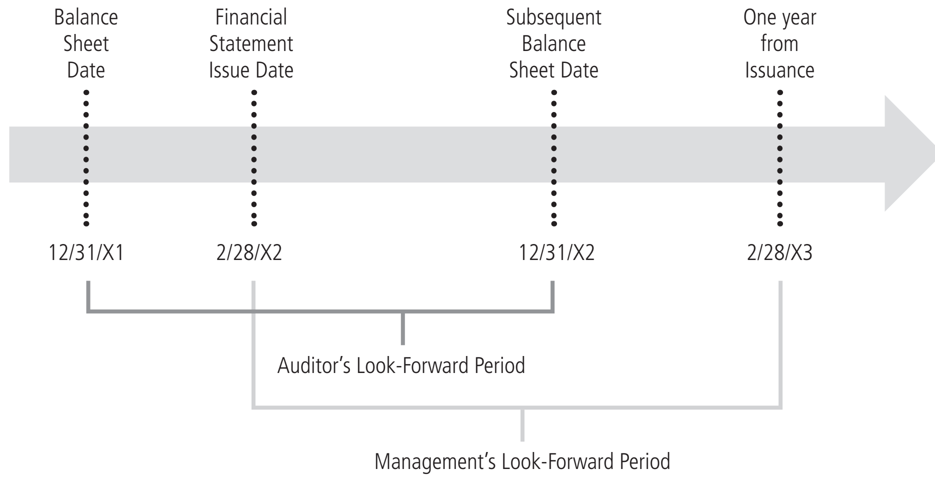
f. Footnote Disclosures: In the past, footnote disclosures were not required if the auditors determined that management's plans would alleviate going-concern uncertainties. The revised standard, however, requires disclosure if substantial doubt was identified from management's going-concern assessment, even if management's plans are expected to alleviate the doubt.

   Specific requirements are provided in the standard for the timing of initial footnote disclosures, how long subsequent disclosures should continue, and what information must be provided in the footnotes. The nature

[2]Subsequent events are events that occur between the balance sheet date and the financial statement issuance date that have a material effect on the financial statements and therefore require adjustment or disclosure in the financial statements.

[3]SEC registrants meeting certain size criteria have interim reporting requirements that require the issuance of quarterly financial statements. However, interim financial statements are not generally audited.

FIGURE 1. Look-Forward Periods



Assessment Date: The date financial statements are issued. Management must assess conditions known, or reasonably knowable, at this date.

Management's Look-Forward Period: The period of time, extending one year from the assessment date, in which management must "look-forward" to assess the ability of the entity to continue as a going concern.

Auditor's Look-Forward Period: The period of time under the auditing standards, in which auditors evaluate an entity's ability to continue as a going concern.

of the disclosures will differ depending on whether or not management's plans are expected to alleviate substantial doubt. Disclosures are discussed in more detail below.

It is interesting to note that even if significant going-concern uncertainties exist, financial statements would continue to be prepared using the going-concern basis of accounting (PwC, 2014). Imminent liquidation is the trigger for using the liquidation basis of accounting. The FASB provides a flowchart to support the decision-making process relative to going-concern issues, a copy of which is provided in Appendix A.

Required Disclosures

The revised standard specifies requirements for when going-concern disclosures must be reported, what information must be disclosed, and when it is acceptable to consider the mitigating effect of management's plans on going-concern uncertainties. The emergence of substantial doubt about a company's ability to continue as a going-concern is the trigger for providing footnote disclosure (PwC, 2014).

If substantial doubt exists, the entity must disclose the relevant information about the conditions that are causing substantial doubt, along with management's plans to alleviate that doubt. Prior to the update, GAAP provided minimal guidance as to the timing and content of going-concern disclosures, and the auditing standards indicate only that the adequacy of disclosures be considered, but put forth no specific disclosure requirements (PwC, 2014).

If management's plans *will* alleviate substantial doubt, disclosures must address the principal conditions that raised substantial doubt *before* consideration of management's plans, management's evaluation of the significance of those conditions in relation to the entity's ability to meet its obligations, and management's plans that alleviate substantial doubt.

If management's plans will *not* alleviate substantial doubt, the footnotes must include an explicit statement that there is substantial doubt about the entity's ability to continue as a going concern, in addition to disclosing information about the principal conditions that raised substantial doubt, management's evaluation of the significance of those conditions in relation to the entity's ability to meet its obligations, and management's plans that are intended to mitigate the conditions that raise substantial doubt.

Although the nature of going-concern disclosures will differ depending on whether management's plans will or will not alleviate substantial doubt, the new requirement for disclosure—even if management's plans will alleviate substantial doubt—is a significant change from past practice. The authors believe that this amendment may cause confusion as a result of differing interpretations of the disclosures by capital-market participants.

Disclosures must be updated to reflect current and relevant information, and are required to continue in subsequent annual or interim reports for as long as conditions continue to raise substantial doubt. For the period in which substantial doubt no longer exists, information about how the relevant conditions that raised substantial doubt were resolved must be disclosed.

Alignment with Auditing Standards

In light of the revised accounting standards, the auditing standards board (ASB) of the American Institute of Certified Public Accountants (AICPA) responded with the issuance of interpretations to Statement on Auditing Standards (SAS) No. 126, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,* followed by the issuance of SAS 132, which carries the same title, to supersede SAS 126.

In January 2015, the ASB issued four auditing interpretations to SAS 126 as a short-term initiative to address some of the effects of ASU 2014-15. The interpretations clarify the independent auditor's role in light of the provisions relative to:

1. The definition of substantial doubt
2. The definition of reasonable period of time
3. Interim financial information
4. Consideration of financial statement effects

The interpretations essentially emphasize that since auditors are required to form an opinion on whether an entity's financial statements are presented fairly, in accordance with the applicable financial reporting framework, and the applicable financial reporting framework defines substantial doubt, then this definition must be used by the auditor.

Similarly, if the applicable financial reporting framework specifies that management's going-concern assessment extends beyond one year from the date of the financial statements, the auditor's assessment of management's going-concern evaluation would be for the same period of time as required by the applicable financial reporting framework (AICPA AU-C Section 9570). This provision seems to add to the confusion as it does not clarify the time period for the auditors' required separate conclusion (explained below) regarding the existence of substantial doubt.

The new going-concern disclosure requirements promulgated by ASU 2014-15 result in the need for independent auditors to perform interim review procedures related to both management's going-concern assessment and the adequacy of the related disclosures (AICPA AU-C Section 9570).

On February 22, 2017, the FASB issued SAS 132 to further address the provisions in FASB ASU 2014-15. SAS 132 is effective for audits of financial statements for periods ending on or after December 15, 2017, and reviews of interim financial information for interim periods beginning after fiscal years ending on or after December 15, 2017.

The new auditing guidance clarifies the auditor's objectives to render separate conclusions regarding the existence of substantial doubt about an entity's ability to continue as a going concern, and the use of the going-concern basis of accounting to prepare financial statements. Requiring both auditors and management to separately evaluate the going-concern assumption may cause confusion in the early stages of implementation as each group works to understand its role and responsibilities.

The new auditing standard also addresses the use of *emphasis of matter paragraphs* to highlight liquidity issues related to management disclosures when the auditor concludes that substantial doubt has been alleviated by management's plans.

Alignment with International Financial Reporting Standards (IFRS)

Revision of the going-concern standard aligns U.S. GAAP with International Financial Reporting Standards (IFRS) in that both sets of standards emphasize management's responsibility for evaluating and disclosing going-concern uncertainties. However, differences between GAAP and IFRS still remain and are summarized in Table 1.

TABLE 1. IFRS Versus GAAP Going-Concern Standards

Going-Concern Standard	IFRS	U.S. GAAP
Assessment period	At least one year from balance sheet date with no upper limit provided.	Within one year after the date financial statements are issued.
Basis of accounting used to prepare financial statements	Use going-concern basis unless management either intends to liquidate or cease trading (operations) or has no realistic alternative but to do so. If going-concern basis is not used to prepare financial statements, entity must disclose basis used. No guidance provided on liquidation basis of accounting.	Use going-concern basis of accounting unless and until liquidation becomes imminent at which time apply liquidation basis of accounting.
Disclosures	Required when management is aware of material uncertainties that cast significant doubt about entity's ability to continue as a going concern.	Required when there is substantial doubt about entity's ability to continue as a going concern or when substantial doubt is alleviated as a result of consideration of management's plans.

Liquidation Basis of Accounting

With the issuance of ASU 2013-07, FASB updated its guidance by establishing criteria for when to apply the liquidation basis of accounting, how to measure assets, liabilities, and other items under the liquidation basis, and what information to disclose in the footnotes. The purpose of the updates is to enable users to understand how much will be available for distribution to investors after liquidation is complete. The expectation is that the revised guidance will improve consistency and comparability in financial reporting by reducing diversity in practice.

As mentioned in an earlier footnote, *liquidation* is the process by which an entity converts its assets to cash or other assets and settles its obligations with creditors in anticipation of the entity ceasing all of its activities. Liquidation is imminent when the likelihood is *remote* that an entity will return from liquidation and either: (a) a plan for liquidation is approved by the appropriate authorities and not likely to be blocked by other parties; or (b) a plan for liquidation is being imposed by other forces (such as involuntary bankruptcy).

GAAP requires that financial statements be prepared using the going-concern basis of accounting unless and until a determination is made that the entity's liquidation becomes imminent, at which time financial statements must be prepared using the liquidation basis of accounting.

Preparation of financial statements using the liquidation basis of accounting requires the presentation of relevant information about an entity's expected resources in liquidation. Assets are measured and presented at the amount of expected cash proceeds from liquidation, and liabilities are measured and presented using the amount of the obligations.

Footnote disclosures must include a statement that the financial statements are presented using the liquidation basis of accounting, along with relevant facts and circumstances surrounding adoption of liquidation basis accounting and the entity's determination that liquidation is imminent.

Also required is a description of the entity's plan of liquidation that includes information regarding the manner in which assets will be disposed and liabilities settled, expected date that the liquidation will be completed, and methods and significant assumptions used to measure assets and liabilities.

CONTENT ANALYSIS

Data for the content analysis consists of publicly available comment letters provided to the FASB in response to its exposure draft on the proposed going-concern standard. The standard-setting model adopted by the FASB is a transparent and deliberative process that seeks to solicit broad participation from a variety of stakeholders.

The process begins with the identification of topics, conducting pre-agenda research, deciding whether to place the matter on FASB's agenda, deliberation at public meetings, and then the issuance of a document for public comment.

These "exposure drafts" provide interested stakeholders with details of the proposed accounting standards update and solicit the response to pertinent and specific questions regarding the proposed accounting standard. Respondents generally have a specific window of time to respond to the FASB.

The exposure draft for the proposed going-concern standards update was issued on June 26, 2013 with comments due by September 24, 2013. FASB solicited the response to 19 questions related to the exposure draft. These 19 questions are reproduced in Appendix C. Forty-seven comment letters were received.

Not all comment letters addressed all questions, since respondents may have specific comments or suggestions and are not required to address FASB's questions. We obtained all of the comment letters and analyzed them by source, coded closed-ended questions as to whether the respondent agreed or disagreed with elements of the exposure draft, and analyzed the final standard with respect to the comments received by the FASB.

FINDINGS

Not surprisingly, the accounting community, accounting firms, and boards of accountancy, comprise the majority (64%) of comment letters. Industry professionals engage in the process, but most academics do not.

The 47 comment letters received by the FASB comprise approximately 293 pages of comments written in response to FASB's exposure draft on the going-concern presumption. The average number of pages for each comment letter was approximately 6 pages, with a range of responses between 1 and 17 pages.

The longest response of 17 pages was written by the Center for Audit Quality, a non-profit public policy advocacy organization based in Washington, DC, which is affiliated with the American Institute of Certified Public Accountants (AICPA). The average length of the responses is not unexpected, given the fact that the FASB asked responders to answer 19 questions about the proposed accounting standard.

During 2013, the responses to 11 exposure documents were due to the FASB, of which a total of 224 responses were received. The responses to the going-concern exposure draft represent 21% of all responses received by the FASB for 2013, and the going-concern exposure draft received the most responses of any proposed accounting standards change, except for the exposure draft on accounting for goodwill, which received 52 comment letters. The average number of responses per exposure draft is approximately 20, which suggests that the going-concern standard was one of the most important issues FASB considered in 2013.

Appendix B provides a list of the 47 responses received by the FASB, listed in order by the date the response was received. The first comment letter, sent by Simon Hu, was dated July 1, 2013, and the final comment letter, sent by the AICPA, was dated November 10, 2013.

The official due date for comment letters was September 24, 2013 and, as such, responses 43 through 47 were submitted after the official due date. Approximately 60% of respondents (28) dated their response as of September 24, 2013, the last date of the comment period.

Table 2 summarizes the industry affiliation of the respondents to the going-concern exposure draft as well as the summary of affiliations provided by the Yen, Hirst, and Hopkins (2007) examination of responses to the exposure draft on changes to the comprehensive income accounting standards.

The latter exposure draft solicited significantly more responses—278 as compared to 47 for the going-concern exposure draft. This fact is not surprising

TABLE 2. Reponses to *Going Concerns Disclosures Exposure Draft* in Order of Comments Received

	Frequency (%)	
	Going Concern Exposure Draft	**Comprehensive Income Exposure Draft**[a]
Academics	1 (2)	6 (2)
Financial Institutions	1 (2)	117 (42)
Industry (Non-financial)	10 (21)	114 (41)
Public Accountants	30 (64)	29 (11)
Other	5 (11)	12 (4)
Total	47 (100)	278 (100)

[a] Yen, Hirst, and Hopkins (2007)

given the nature of the proposed changes. Items that are included or disregarded in the determination of net income and comprehensive income have significant implications for various types of entities, especially financial institutions.

Overall, respondents agreed that the guidance provided in the *Going Concern Exposure Draft* should be included in U.S. GAAP, and there was widespread agreement that management should be primarily responsible for assessing its entity's ability to continue as a going concern. Appendix C, Panel A provides a list of questions posed in the *Exposure Draft*; Appendix C, Panel B provides a summary of responses to the *Exposure Draft* questions.

The main areas of concern expressed by respondents relate to:

a. The 24-month assessment period to consider going-concern assumption
b. Exempting non-SEC filers from the requirements
c. Probability thresholds (i.e., more-likely-than-not or probable)
d. Distinguishing management plans between ordinary-course of business plans versus other plans

The 24-month assessment period suggested by the FASB was particularly concerning to respondents. Practitioners noted the 24-month period assessment period would not be operable, auditable, or cost-effective (FASB, 2013).

Exempting non-SEC filers from the disclosure requirements as suggested by FASB also resulted in much disagreement from the respondents, with approximately 87 percent disagreeing with the statement that non-SEC filer should be exempt from the reporting requirements.

Most respondents agreed with using the *more-likely-than-not* threshold to trigger disclosure of information about going-concern uncertainties in the financial statement footnotes. However, many respondents expressed concern about applying such a quantitative measure in this setting, fearing that the guidance would be interpreted at 50.1% and would become a bright line.

Finally, one of the most challenging aspects of the proposed standard, as cited by respondents, is the distinction between management's plan *within* and *outside* the ordinary course of business. Table 3 provides selected qualitative responses to the main areas where commenters expressed concern or objections to FASB's proposal.

TABLE 3. Selected Qualitative Responses

Matter	Qualitative Comments
Measurement of substantial doubt	Deloitte strongly encouraged the Board to provide meaningful examples of distinguishing between the varying thresholds established in the proposal to ensure consistency of application.
	BDO believed the term *known* should be deleted from the phrase "it is known or probable that the entity will be unable to meet its obligations within 24 months after the financial statement date without taking actions outside the ordinary course of business," since this term is subsumed within the term *probable*.
	The Ohio Society of CPA's state that the assessment of the overall entity will include contradicting assessment of specific transactions. Accordingly, more guidance is necessary to determine how to evaluate these subjective contradictions.
	Cohn Reznick was concerned that the current "more-likely-than-not" threshold for the 12-month period could be interpreted by preparers as a point estimate, which would require precise measurement. Due to the inherent uncertainties in developing estimates around future events, they suggest placing additional emphasis in the exposure draft on qualitative factors such that preparers are not solely focused on the quantitative aspects of the thresholds.
Frequency of evaluation	Deloitte does not believe that the same level of effort should be used each interim period as it is for the annual assessment, and suggested that the Board consider requiring the going-concern assessment to be performed as of each fiscal year end and between the year-end assessments only as warranted.
	KPMG agreed with a going-concern evaluation necessary for each reporting period. However, they disagreed with the proposal that would require entities to adopt the ASU for the first time in the interim period in the year of adoption.
	Cohn Reznick suggests that although performing an interim assessment will create additional effort and work on behalf of preparers, this additional interim work will be beneficial not only to investors and other stakeholders in providing timely information, but also to management in preparing the annual year-end assessment.
24-month assessment period/ early warning disclosures	The AICPA's Technical Issues Committee recommended requiring an assessment period of 12 months from the date the financial statements are available to be issued. Under such a proposal, most nonpublic entities would have an assessment period of 15 to 18 months from the financial statement date, instead of 24 months, for a reasonable compromise.
	The American Accounting Association found that management's disclosure of uncertainty about going-concern is informative in predicting bankruptcy two and three years out, which supports the 24-month consideration period. They believe the proposed guidance will represent a reasonable approach because it focuses on both the 12-month and 24-month period, with varying probability thresholds triggering disclosure in the two periods.
	Cohen Resnick believed that the 24 months would be appropriate as long as the definitions are modified to prevent unnecessary quantitative projections. The firm stated that the considerations which should be made in connection with the first 12 months and the second 12 months should not be differentiated.
	KPMG added that the proposed 24-month assessment period will improve the timeliness and usefulness of disclosures. However, additional guidance will be needed on when and how management should consider its mitigation.
	McGladrey expressed that the "known and probable" threshold should be revised to consider only whether it is probable that an entity will be unable to meet its obligations within 24 months after the financial statement date.
Ordinary business plans versus other plans	The majority answered yes to this question, as it would be appropriate for management to use actions in and outside the ordinary course of business as distinguishing factors when evaluating whether going-concern disclosures are needed.
	Calloway, along with a few others, did not agree that this distinction is relevant to determine if and when disclosures should be made. Calloway expressed that disclosure should be required when there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.
	Marcum suggested the proposed amendments present an unworkable standard, as "in the ordinary course of business" and "outside the ordinary course of business" is inherently too subjective. Attempts to make a distinction between the two add unnecessary complexity to what should be a broad principles-based approach to an entity's determination of its ability to continue as a going concern. The degree of certainty with which these plans can be accomplished should be disclosed to provide the reader of the financial statements with all relevant information.
	The Louisiana Society of CPA's stated that the distinction is relevant, as the mitigating effects of plans inside the ordinary course of business may be viewed by financial statement users as more likely to occur, as opposed to plans outside the course of business which may be read as a last-ditch effort by management to stave off bankruptcy.

(continued)

TABLE 3. Selected Qualitative Responses *(continued)*

Matter	Qualitative Comments
Public versus non-public entities	The majority did not agree with the provision that a non-SEC filer should be exempted from the requirements to evaluate and disclose substantial doubt about its ability to continue as a going concern. Management should have the responsibility to make a substantial doubt assessment and to disclose, if necessary, that condition in the financial statements. This should not be any different/more difficult for management of a private entity. McGladrey was one of the respondents that did not agree with the decision to exclude non-SEC filers from the requirement to evaluate whether or not to provide disclosure when there is substantial doubt about an entity's going-concern presumption. They do not agree that the auditor should be the source of original information in the auditing standards to assess whether there is substantial doubt. PwC also disagreed with the FASB proposal to exempt non-SEC filers from disclosure of substantial doubt about a company's going-concern presumption, since this assumption is of fundamental interest to users of all financial statements and not just those of an SEC filer. The Louisiana Society of CPAs did not agree with the Board's decision. They believed investors in private entities would benefit from having an assessment of the entity's ability to continue as a going concern to be included within the financial statements. Marcum believed there ought to be no distinction in the development of U.S. GAAP between a privately held entity and a publicly held registrant with respect to the going-concern assessment, as there is a consistent need to provide meaningful disclosure to financial statement users.

Table 4 summarizes the major components of the exposure draft that were ultimately changed by the FASB after feedback from the comment letters. For example, in the original exposure draft, the FASB considered expanding the consideration period for evaluating the going-concern assumption up to 24 months after the financial statement issue date. This extended period was commonly referred to as the "early warning" disclosures.

Due to concerns about implementation, FASB limited the assessment period to one-year forward from financial statement issue date. Likewise, FASB's original proposal considered evaluating management's plans that arise in the ordinary course of business versus other plans to alleviate substantial doubt.

Due to concerns expressed by respondents over the difficulties in preparers' ability to determine which plans were in the ordinary course of business versus other plans, FASB's final standard eliminated the distinction between these two categories of plans.

The FASB also asked respondents to address the applicability of the standard to both publicly-traded as well as non-public entities, suggesting that the standard should apply primarily to entities regulated by the SEC. Respondents

TABLE 4. Issues Identified in the Comment Letters and FASB Issued Standard

Matter	Resolution
Definition of substantial doubt	Board added the word probable to the definition
Frequency of evaluation	FASB decided on evaluation each reporting period
24-month assessment period (early warning disclosures)	FASB limited assessment to 1-year forward from the issue date of the financial statements
Ordinary business plans versus other plans	FASB eliminated need to make a distinction between ordinary business plans and other plans to mitigate going-concern issues
Public versus non-public entities	FASB decided to make the standard applicable to all entities

overwhelming suggested that the standard be applied to all entities and FASB's final standard applies to all firms.

The final vote of the FASB was five members in favor and two against adoption of ASU 2014-15. One reason for the negative votes relates to the future-oriented nature of the required going-concern disclosures. The dissenting member suggested that such forward-looking information is not appropriate for footnote disclosures but rather should be part of the management discussion and analysis (MD&A) in the SEC filing, which are subject to a safe harbor for forward-looking information.

Another issue relates to use of the "probable" threshold regarding substantial doubt disclosures. The dissenting member believes that the trigger of disclosure based on a probable threshold is too late to be of significant benefit to users because little or no predictive value is provided by the financial statements and suggests that a *more-likely-than-not* or earlier threshold would be more helpful to users.

SUMMARY AND CONCLUSION

Results of the content analysis suggest that feedback from the comment letter process influenced key elements of the final going-concern standard adopted by the FASB and that stakeholder feedback can have significant influence on the accounting standard-setting process.

FASB made significant changes from the original exposure draft to the final standard on areas such as the assessment period, application of the accounting standard to public and non-public entities, and the frequency of management's assessments.

While the revised standards may succeed in achieving some increased level of consistency in financial reporting across companies, many questions remain unanswered. For example:

- How will management and auditors reconcile their individual responsibilities relative to the going-concern assessment, and how will this affect their relationships?
- Will auditing standards evolve such that auditors will assess management's going-concern assessment, similar to internal controls, or will auditors continue to have a responsibility to perform their own separate going-concern assessment?

Other concerns raised by stakeholders in the comment letters include possible economic consequences of implementation:

- What will be the true cost-benefit of the new standard?
- Are there legal ramifications and consequences for going-concern disclosures?
- Will the revised standard, with more timely and detailed disclosures even when substantial doubt is alleviated, create confusion in the market as firms implement the new guidance?
- How will analysts' forecasts be affected by early-warning disclosures?

How companies will implement the new standard remains to be seen. Although the revised standard does not require modifications to internal control systems in relation to management's newly defined responsibility for going-concern assessment, companies will likely need to modify and document processes and controls to assess risk, determine the level of analysis necessary, and perform the going-concern assessment (PwC, 2014).

Our research provides the background for future research in areas such as the effectiveness of the new standard to provide improved consistency and comparability between firms, the frequency of going-concern disclosures in light of the new standards, and whether going-concern disclosures will more accurately predict the eventual liquidation of entities.

And finally, will the changes to the going-concern responsibilities for management result in greater frequency of reporting financial information using the liquidation basis of accounting?

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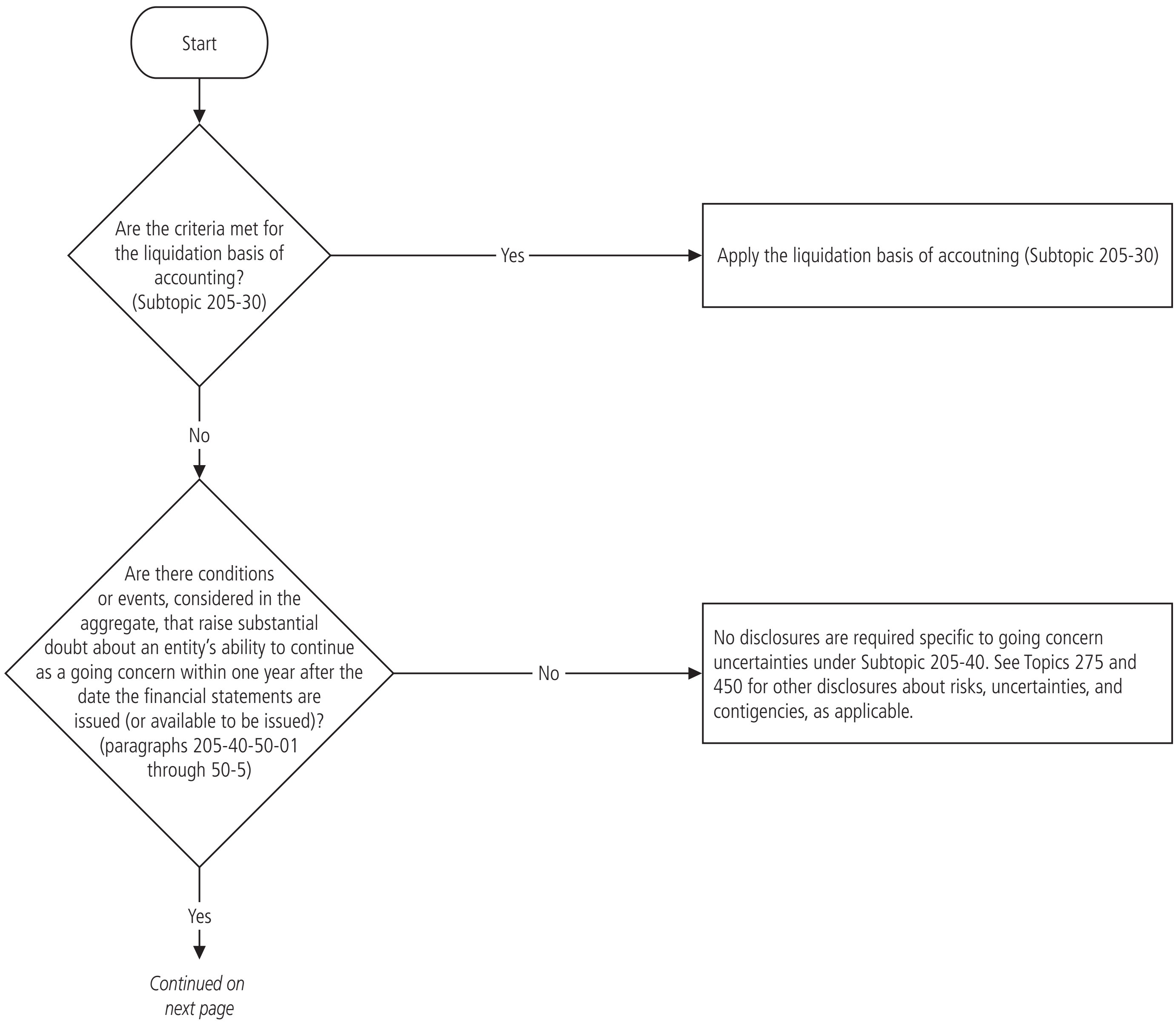
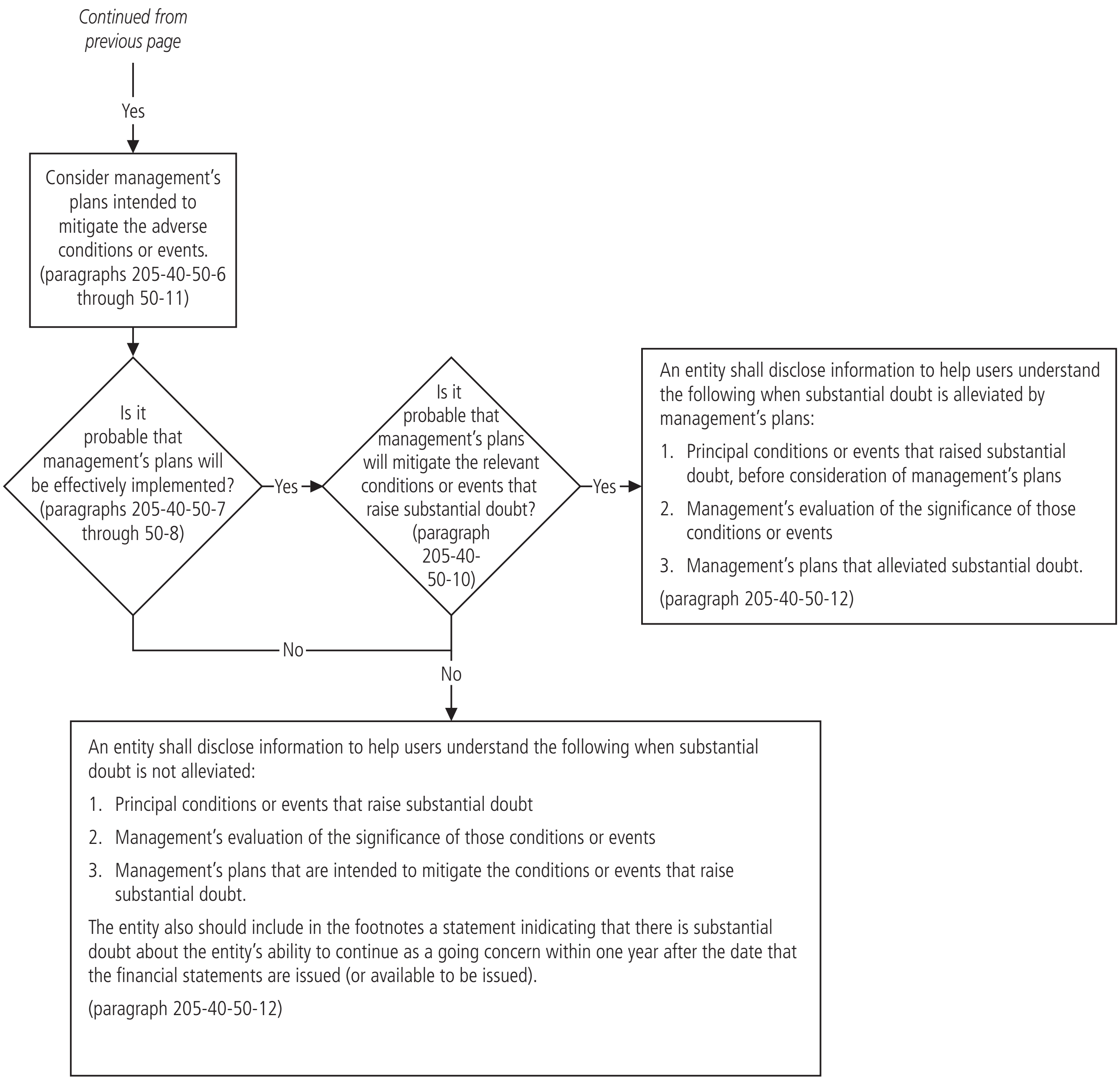
Appendix A *FASB Flow Chart*




Continued from previous page
Yes
Consider management's plans intended to mitigate the adverse conditions or events. (paragraphs 205-40-50-6 through 50-11)
Is it probable that management's plans will be effectively implemented? (paragraphs 205-40-50-7 through 50-8)
Yes
Is it probable that management's plans will mitigate the relevant conditions or events that raise substantial doubt? (paragraph 205-40-50-10)
Yes
An entity shall disclose information to help users understand the following when substantial doubt is alleviated by management's plans:
1. Principal conditions or events that raised substantial doubt, before consideration of management's plans
2. Management's evaluation of the significance of those conditions or events
3. Management's plans that alleviated substantial doubt.
(paragraph 205-40-50-12)
No
No
An entity shall disclose information to help users understand the following when substantial doubt is not alleviated:
1. Principal conditions or events that raise substantial doubt
2. Management's evaluation of the significance of those conditions or events
3. Management's plans that are intended to mitigate the conditions or events that raise substantial doubt.
The entity also should include in the footnotes a statement inidicating that there is substantial doubt about the entity's ability to continue as a going concern within one year after the date that the financial statements are issued (or available to be issued).
(paragraph 205-40-50-12)

Appendix B *Reponses to Going-Concerns Disclosures Exposure Draft*

(In Order of Date Received by the FASB)

Appendix C *Panel A: ASU 2014-15 Going-Concern Questions for Respondents*

1. The proposed amendments would define going-concern presumption as the inherent presumption in preparing financial statements under U.S. GAAP that an entity will continue to operate such that it will be able to realize its assets and meet its obligations in the ordinary course of business. Do you agree with this definition? If not, what definition should be used and why?
2. Currently, auditors are responsible under the auditing standards for assessing going-concern uncertainties and for assessing the adequacy of related disclosures. However, there is no guidance in the United States. GAAP for preparers as it relates to management's responsibilities. Should management be responsible for assessing and providing footnote disclosures about going-concern uncertainties for SEC registrants and other entities? Why or why not?
3. Would the proposed amendments reduce diversity in the timing, nature, and extent of footnote disclosures and provide relevant information to financial statement users? If so, would the proposed disclosures for SEC registrants provide users with incremental benefits relative to the information currently provided under other sections of U.S. GAAP and under the SEC's disclosure requirements?
4. The proposed amendments would require management to evaluate going-concern uncertainties and additionally, for SEC filers, to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern. An alternative view is that such evaluations should not be required because management would inherently be biased, and thus the resulting disclosures would provide little incremental benefit to investors.

   Do you believe that an entity's management has the objectivity to assess and provide disclosures of uncertainties about the entity's ability to continue as a going concern? Why or why not? If not, please also explain how this assessment differs from other assessments that management is required to make in the preparation of an entity's financial statements.
5. At each reporting period, including interim periods, the proposed amendments would require management to evaluate an entity's going-concern uncertainties. Do you agree with the proposed frequency of the assessment? If not, how often should the assessment be performed?
6. For SEC registrants, the proposed footnote disclosures would include aspects of reporting that overlap with certain SEC disclosure requirements (including those related to risk factors and MD&A, among others). The Board believes that the proposed footnote disclosures would have a narrower focus on going-concern uncertainties compared with the SEC's disclosure requirements.

   Do you agree? Why or why not? What differences, if any, will exist between the information provided in the proposed footnote disclosures and the disclosures required by the SEC? Is the redundancy that would result from this proposal appropriate? Why or why not?

7. For SEC registrants, would the proposed footnote disclosure requirements about going-concern uncertainties have an effect on the timing, content, or communicative value of related disclosures about matters affecting an entity's going-concern assessment in other parts of its public filings with the SEC (such as risk factors and MD&A)?
8. The proposed footnote disclosures about going-concern uncertainties would result in disclosure of some forward-looking information in the footnotes. What challenges or consequences, if any, including changes in legal liability for management and its auditors, do you anticipate entities may encounter in complying with the proposed disclosure guidance? Do you foresee any limitations on the type of information that preparers would disclose in the footnotes about going-concern uncertainties? Would a higher threshold for disclosures address those concerns?
9. What challenges, if any, could auditors face if the proposed amendments are adopted?
10. Do the expected benefits of the proposed amendments outweigh the incremental costs of applying them?
11. Under the proposed amendments, disclosures would start at the more-likely-than-not or at the known or probable threshold as described in paragraph 205-40-50-3.
12. The proposed amendments would require an entity to assess its potential inability to meet its obligations as they become due for a period of 24 months after the financial statement date. Is this consideration period appropriate? Is it appropriate to distinguish the first 12 months from the second 12 months as proposed in the amendments? Why or why not?
13. Under the proposed amendments, management would be required to distinguish between the mitigating effect of management's plans in and outside the ordinary course of business when evaluating the need for disclosures. Is this distinction relevant to determining if and when disclosures should be made? If so, explain how management's plans should be considered when defining the two different disclosure thresholds.
14. Do you agree with the definition of management's plans that are outside the ordinary course of business as outlined in paragraph 205-40-50-5 and the related implementation guidance?
15. Do you agree with the nature and extent of disclosures outlined in paragraph 205-40-50-7?
16. The proposed amendments define substantial doubt as existing when information about existing conditions and events after considering the mitigating effect of management's plans (including those outside the ordinary course of business), indicates that it is known or probable that an entity will be unable to meet its obligations within a period of 24 months after the financial statement date.

    Do you agree with this likelihood-based definition for substantial doubt? Do you agree with the 24-month consideration period? Why or why not? Do you anticipate any challenges with this assessment? If so, what are those challenges?

17. Do you agree that an SEC filer's management, in addition to disclosing going-concern uncertainties, should be required to evaluate and determine whether there is substantial doubt about an entity's ability to continue as a going concern (going-concern presumption) and, if there is substantial doubt, disclose that determination in the footnotes?
18. Do you agree with the Board's decision not to require an entity that is not an SEC filer to evaluate or disclose when there is substantial doubt about its going-concern presumption? If not, explain how users of non-SEC filers' financial statements would benefit from a requirement for management to evaluate and disclose substantial doubt.
19. The Board notes, in paragraph BC36, that its definition of substantial doubt most closely approximates the upper range in the present interpretation of substantial doubt by auditors. Do you agree? Why or why not?

    Assuming it does represent the upper end of the range of current practice, how many fewer substantial doubt determinations would result from the proposed amendments?

    If the proposed amendments were finalized by the Board and similar changes were made to auditing standards, would the occurrence of audit opinions with an emphasis-of-matter paragraph discussing going-concern uncertainties likewise decrease and be different from what is currently observed? If so, by how much? Is such a decrease an improvement over current practice? Why or why not?

Appendix C *Panel B: Summary of Responses to Questions Asked by FASB*

Response	Q #1	Q #2	Q #3	Q #4	Q #5	Q #6	Q #7	Q #8	Q #9	Q #10	Q #11	Q #12	Q #13	Q #14	Q #15	Q #16	Q #17	Q #18	Q #19
Support	24	28	21	22	23	20	10	1	0	17	23	20	18	13	24	18	22	6	13
Oppose	5	0	3	6	2	1	8	3	1	5	1	7	4	5	1	4	3	19	7
Unsure/unclear	3	5	7	3	4	5	4	1	5	6	6	5	5	8	2	3	1	2	6
No response	15	14	16	16	18	21	25	40	39	19	17	15	20	21	20	22	21	20	21

Review of Business: Interdisciplinary Journal on Risk and Society, 38(1), 36–46.

FASB Issues New Guidance to Improve Financial Reporting for Not-for-Profit Organizations

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Abstract

This work examines the August 2016 guidance in ASC 2016-14, *Not-for-Profit Entities (Topic 958)* issued by the Financial Accounting Standards Board. Through examples and discussion, this work concludes that given the diversity of reporting practices around contributions, this proposed Update is necessary to add clarity to and strengthen not-for-profit financial reporting.

The Financial Accounting Standards Board (FASB) recently issued new guidance in ASC 2016-14, *Not-for-Profit Entities (Topic 958)*. This Update is the first significant change to financial statement reporting for not-for-profit (NFP) entities. This new guidance improves requirements for net asset classifications. In particular, the new standard will examine the absence or presence of donor-imposed restrictions, and whether such restrictions are temporary or permanent.

In addition, the guidance will improve transparency in assessing an NFP's liquidity through the use of the term *unrestricted net asset*. The new standard also examines the inconsistencies between natural and functional expense classifications. This article will examine these issues, as well as present the new financial statement reporting format.

In August 2016, the FASB issued Accounting Standards Update (ASU) No. 2016-14, *Not-for-Profit Entities (Topic 958) Presentation of Financial Statements for Not-for-Profit Entities*. When the Exposure Draft, proposed Update, was issued in April 2015, the Financial Accounting Standards Board ("Board") intended to address four issues about the current financial reporting model of not-for-profit (NFP) entities:

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1. Complexities about the use of the currently required three classes of net assets that focus on the absence or presence of donor-imposed restrictions, and whether those restrictions are temporary or permanent. Deficiencies in the utility of information provided to donors, creditors, and others in assessing an entity's liquidity caused by potential misunderstandings and confusion about how restrictions or limits imposed by donors, laws, contracts, and governing boards affect an entity's liquidity, classes of net assets, performance, and related terminology, particularly the term *unrestricted net assets*.
2. Inconsistencies in the reporting (or lack of reporting) of intermediate measures of operations in the statement of activities, including inconsistencies between that reporting and the reporting of operating cash flows in the statement of cash flows. Those inconsistencies cause difficulties in communicating and assessing an entity's financial performances.
3. Inconsistencies in the type of information provided about expenses of the period—for example, some, but not all, NFPs provide information about operating expenses by both function and nature.
4. Misunderstandings about and opportunities to enhance the utility of the statement of cash flows, particularly about the reporting of operating cash flows. (FASB Exposure Draft, Proposed Accounting Standards Update, *Not-for-Profit Entities (Topic 958) and Health Care Entities (Topic 954)*, April 22, 2015, p. 1)

The Update affects NFPs and the users of their general-purpose financial statements, which typically include non-governmental entities such as charities, foundations, colleges and universities, health care providers, cultural institutions, religious organizations, and trade associations.

The amendments in the Update are effective for annual financial statements issued for fiscal years beginning after December 15, 2017, and for interim periods within fiscal years beginning after December 15, 2018. Additional applications of the Update will be discussed later in the article.

MAIN PROVISIONS OF THE UPDATE

Net Asset Classifications

On the Statement of Financial Position, the existing three-classification net asset reporting is replaced with two classes of net assets at the end of the period. NFPs will now have to report *net assets with donor restrictions* and *net assets without donor restrictions*, as well as presenting total net assets.

On the Statement of Activities, the amount of change in each of the two classes of net assets will be presented, replacing the currently required three-classes of net assets; in addition, the NFP would continue to report the current change in total net assets of the period.

The existing classifications, unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets will be removed from the FASB Accounting Standards Codification Master Glossary once the amendments are implemented. The Board indicates that the distinction between permanent restrictions and temporary restrictions "has become blurred by changes in state

FIGURE 1. Statement of Financial Position Required Under ASU 2016-14

Not-for-Profit Entity A
Statement of Financial Position
June 30, 20X1 and 20X0
(in thousands)

	20X1	20X0
Assets:		
Cash and cash equivalents	$4,575	$4,960
Accounts and interest receivable	2,130	1,670
Inventories and prepaid expenses	610	1,000
Contributions receivable	3,025	2,700
Short-term investments	1,400	1,000
Assets restricted to investment in land, buildings, and equipment	5,210	4,560
Land, buildings, and equipment	61,700	63,590
Long-term investments	218,070	203,500
Total assets	$296,720	$282,980
Liabilities and net assets:		
Accounts payable	$2,570	$1,050
Refundable advance		650
Grants payable	875	1,300
Notes payable		1,140
Annuity trust obligations	1,685	1,700
Long-term debt	5,500	6,500
Total Liabilities	10,630	12,340
Net assets:		
Without donor restrictions	92,600	84,570
With donor restrictions	193,490	186,070
Total net assets	286,090	270,640
Total liabilities and net assets	$296,720	$282,980

Source: ASC 958-205-55-9, p. 92. The *FASB Accounting Standards Codification*® material is copyrighted by the Financial Accounting Foundation, 401 Merritt 7, Norwalk, CT 06856, and is used with permission.

laws that diminished its relevance, and rendered that distinction less useful on the face of financial statements" (ASU 2016-14, p. 4).

The two classes of net asset reporting will reduce complexity, increase understandability, and bring greater comparability of financial statements that can provide donors, grantors, creditors, and other stakeholders with information useful in identifying and assessing key trends. Later in the article, we shall address some additional reporting components of the amended net asset classification model, as well as financial reporting illustrations. Figure 1 is an example of what the Statement of Financial Position looks like with the amendments.

In addition to the amended net asset section, this model presents assets and liabilities sequenced based on their relative liquidity. The Update does require that the statement of financial position, as well as the statements of activities and cash flows, report comparative financial information. As a result, in Figure 1, the difference in the total net assets between 20X0 and 20X1 is $15,450, which is the increase in net assets that is determined on the Statement of Activities (Figure 2).

Statement of Activities

Three formats of statement of activities are presented in the Update. In each of the formats allowed, revenues and gains are reported first, then expenses, then losses. Reclassification of net assets must be reported separately.

FIGURE 2. Statement of Activities (Single-Column Format) Under ASU 2016-14

Not-for-Profit Entity A
Statement of Activities
Year Ended June 30, 20X1
(in thousands)

Changes in net assets *without* donor restrictions:	
Revenues and gains:	
Contributions	$8,640
Fees	5,200
Investment return, net	6,650
Gain on sale of equipment	200
Other	150
Total revenues and gains without donor restrictions	20,840
Net assets released from restrictions	
Satisfaction of program restrictions	8,990
Satisfaction of equipment acquisition restrictions	1,500
Expiration of time restrictions	1,250
Appropriation from donor endowment and subsequent satisfaction of any related donor restrictions	7,500
Total net assets released from restrictions	19,240
Total revenues, gains, and other support without donor restrictions	40,080
Expenses and losses:	
Salaries and benefits	15,115
Grants to other organizations	4,750
Supplies and travel	3,155
Services and professional fees	2,840
Office and occupancy	2,528
Depreciation	3,200
Interest	382
Total expenses	31,970
Fire loss on building	80
Total expenses and losses	32,050
Increase in net assets without donor restrictions	8,030
Changes in net assets *with* donor restrictions:	
Contributions	8,390
Investment return, net	18,300
Actuarial loss on annuity trust obligations	(30)
Net assets released from restrictions	(19,240)
Increase in net assets with donor restrictions	7,420
Increase in total net assets	15,450
Net assets at beginning of year	270,640
Net assets at end of year	$286,090

Source: ASC 958-205-55-13, p. 47. The *FASB Accounting Standards Codification®* material is copyrighted by the Financial Accounting Foundation, 401 Merritt 7, Norwalk, CT 06856, and is used with permission.

The first format is provided in Figure 2, which is a single-column format. In this format, comparative year data may be provided. This model reports those activities without donor restrictions first, reporting those activities with donor restrictions separately. The net increase or decrease in net assets is reported as a subtotal ($15,540 in Figure 2), as well as beginning and ending net assets.

Figure 3 presents the same information as Figure 2, but in a multicolumn format; a column is provided for each class of net assets. A total column is optional, but the change in total net assets is presented in accordance with ASC

958-210-45-1. Each figure presents aggregated information regarding contributions and investment returns of the entity as a whole.

The third format option can be found in Figure 4. This figure is presented in a columnar format, but the Update also allows a single-column approach, which requires a two-statement presentation.

According to the Update, the two-statement format may be preferred by membership organizations and NFPs where management believes that "certain transactions and events, including receipts of donor-restricted revenues and gains from contributions and investment return[s], as incidental or insignificant to their daily operations" (ASC 958-205-55-10, par. c). For ease of presentation, we are illustrating the columnar format (Figure 3), as well as a more condensed alternative approach (Figure 4).

FIGURE 3. Statement of Activities (Multicolumn Format) Under ASU 2016-14

Not-for-Profit Entity A
Statement of Activities
Year Ended June 30, 20X1
(in thousands)

	Without Donor Restrictions	With Donor Restrictions	Total
Revenues, gains, and other support:			
Contributions	$8,640	$8,390	$17,030
Fees	5,200		5,200
Investment return, net	6,650	18,300	24,950
Gain on sale of equipment	200		200
Other	150		150
Net assets released from restrictions			
Satisfaction of program restrictions	8,990	(8,990)	–
Satisfaction of equipment acquisition restrictions	1,500	(1,500)	–
Expiration of time restrictions	1,250	(1,250)	–
Appropriation from donor endowment and subsequent satisfaction of any restrictions	7,500	(7,500)	–
Total net assets released from restrictions	19,240	(19,240)	–
Total revenues, gains, and other support	40,080	7,450	47,530
Expenses and losses:			
Program A	13,296		13,296
Program B	8,649		8,649
Program C	5,837		5,837
Management and general	2,038		2,038
Fundraising	2,150		2,150
Total expenses	31,970		31,970
Fire loss on building	80		80
Actuarial loss on annuity trust obligation		30	30
Total expenses and losses	32,050	30	32,080
Change in net assets	8,030	7,420	15,450
Net assets at beginning of year	84,570	186,070	270,640
Net assets at end of year	$92,600	$193,490	$286,090

Source: ASC 958-205-55-13, p. 49. The *FASB Accounting Standards Codification*® material is copyrighted by the Financial Accounting Foundation, 401 Merritt 7, Norwalk, CT 06856, and is used with permission.

FIGURE 4. Statement of Activities (Alternative Format) Under ASU 2016-14

Not-for-Profit Entity A
Statement of Activities
Year Ended June 30, 20X1
(in thousands)

	Without Donor Restrictions	With Donor Restrictions	Total
Revenues, gains, and other support:			
Revenues and gains without donor restrictions	$20,840		$20,840
Revenues and gains with donor restrictions:			
Contributions		8,390	8,390
Investment return, net		18,300	18,300
Net assets released from restrictions (Note D)	19,240	(19,240)	–
Total revenues, gains, and other support	40,080	7,450	47,530
Expenses and losses:			
Expenses and losses	32,050		32,050
Actuarial loss on annuity trust obligation		30	30
Total expenses and losses	32,050	30	32,080
Change in net assets	8,030	7,420	15,450
Net assets at beginning of year	84,570	186,070	270,640
Net assets at end of year	$92,600	$193,490	$286,090

Source: ASC 958-205-55-17, p. 55. The *FASB Accounting Standards Codification*® material is copyrighted by the Financial Accounting Foundation, 401 Merritt 7, Norwalk, CT 06856, and is used with permission.

Statement of Cash Flows

The Update continues to require the net amount for operating cash flows (either *net cash provided* or *net cash used* for operating activities) using either the direct or indirect method of reporting. However, the Update no longer requires presentation or disclosure of the indirect method for reporting operating activities if the direct method is used.

Figure 5 presents only the direct method; no reconciliation from change in net assets for the operating activities section is presented. Please note that the authors consolidated some of the activities in the Update for brevity.

Functional Classification of Expenses

The Update made a significant change to NFP reporting by now requiring all not-for-profit entities to report an analysis of expenses by their nature and function. The prior standard required only that voluntary health and welfare entities report the natural classification of expenses on a statement of functional expenses. However, "all NFPs shall report information about all expenses in one location on the face of the statement of activities, as a schedule in the notes to the financial statements, or in a separate financial statement, as discussed in paragraph 958-205-45-6."

The Update allows NFPs flexibility in how they report the analysis of the expenses by their nature and function. The relationship between functional classification and natural classification for all expenses shall be presented in an analysis that disaggregates functional expense classifications, such as major classes

FIGURE 5. **Statement of Cash Flows (Direct Method)**

Not-for-Profit Entity A
Statement of Cash Flows
Year Ended June 30, 20X1
(in thousands)

Cash flows from operating activities:	
Cash received from service recipients	$5,020
Cash received from contributions	8,030
Cash collected on promises to give	2,615
Interest and dividends received	8,570
Cash paid to employees and retirees	(13,400)
Cash paid to suppliers	(5,658)
Interest paid	(382)
Grants paid	(5,025)
Net cash used by operating activities	(230)
Cash flows from investing activities:	
Purchase of equipment	(1,500)
Proceeds on the sale of equipment	200
Insurance proceeds from fire loss on building	250
Proceeds from sale of investments	76,100
Purchase of investments	(74,900)
Net cash provided by investing activities	150
Cash flows from financing activities:	
Proceeds from contributions restricted for:	
Investment in perpetual endowment	270
Investment in land, buildings, and equipment	1,410
	1,680
Other financing activities:	
Payments on notes payable	(1,985)
	(1,985)
Net cash used by financing activities	(305)
Net decrease in cash and cash equivalents	(385)
Cash and cash equivalents at beginning of year	4,960
Cash and cash equivalents at end of year	$4,575
Supplemental data for noncash investing and financing activities:	
Gift of equipment	$140
Gift of paid-up life insurance, cash surrender value	80

Source: Adapted from ASC 958-205-55-19. The *FASB Accounting Standards Codification®* material is copyrighted by the Financial Accounting Foundation, 401 Merritt 7, Norwalk, CT 06856, and is used with permission.

of program services and supporting activities, by the natural expense classifications.

Note F of 958-720-45-15 provides an example of how to report expenses by nature and by function (this is located under Notes to the Financial Statements at ASC 958-205-55-21). This is provided in Figure 6.

According to Note F of the Update, the financial statement will report certain categories of expenses that are attributable to more than one program or supporting function. Therefore, these expenses require allocation on a reasonable basis that is consistently applied. The expenses that are allocated include office and occupancy, depreciation, and interest, which are allocated on a square-footage basis, as well as salaries and benefits, which are allocated on the basis of estimates of time and effort (ASC 958-720-45-15).

FIGURE 6. Functional Expenses Presentation Under ASU 1016-14

	Program Activities				Supporting Activities			
	A	B	C	Program Subtotal	Management and General	Fund-Raising	Supporting Subtotal	Total Expenses
Salaries and benefits	$7,400	$3,900	$1,725	$13,025	$1,130	$960	$2,090	$15,115
Grants to other organizations	2,075	750	1,925	4,750				4,750
Supplies and travel	890	1,013	499	2,402	213	540	753	3,155
Services and professional fees	160	1,490	600	2,250	200	390	590	2,840
Office and occupancy	1,160	600	450	2,210	218	100	318	2,528
Depreciation	1,440	800	570	2,810	250	140	390	3,200
Interest	171	96	68	335	27	20	47	382
Total expenses	$13,296	$8,649	$5,837	$27,782	$2,038	$2,150	$4,188	$31,970

Source: ASC 958-720-45-15 p. 66. The *FASB Accounting Standards Codification*® material is copyrighted by the Financial Accounting Foundation, 401 Merritt 7, Norwalk, CT 06856, and is used with permission.

OTHER PROVISIONS IN THE UPDATE

Reporting Endowment Funds

According to ASC 958-205-45-13, endowment funds are established by either a donor or by a governing board and can be with donor restrictions or without restrictions. Funds with donor restrictions are referred to as *donor-restricted endowment funds*, which result from a gift with a stipulation that the resources be invested either for a long, specified period of time, or held in perpetuity.

Any endowment funds without donor restrictions are referred to as *board-designated endowment funds*. Such funds are created when a governing board designates for earmarks a portion of its net assets without donor restrictions to be invested, "generally for a long but possibly unspecified period of time" (ASC 958-205-45-13).

On the statement of financial position, as indicated earlier, endowment funds are reported in the net asset section within the following two classes of net assets on the basis of the existence or absence of donor-imposed restrictions:

Net assets with donor restrictions. A donor-restricted endowment would be classified as net assets with donor restrictions.

Net assets without donor restrictions. A board-designated endowment fund, which generally results from an internal designation of net assets without donor restrictions, would generally be classified as net assets without donor restrictions (ASC 958-205-45-13A).

According to ASC 958-205-45-13B, when classifying a donor-restricted endowment fund, consideration must be given to both the donor's explicit stipulations and the applicable laws that extend donor restrictions. Investment return is generally considered free of donor restrictions unless it is limited by a donor-imposed restriction or by a law.

Conversely, for an endowment fund that is created by a governing board (board-designated endowment fund), assuming no other purpose-type restrictions exist on the use of those types of funds, the original fund and all investment returns are free of donor restrictions, and are reported as net assets without donor restrictions.

Underwater Endowment Funds

In the Amendments to the Master Glossary, the Update defines an underwater endowment fund as "a donor-restricted endowment fund for which the fair value of the fund at the reporting date is less than either the original gift amount or the amount required to be maintained by the donor or by law that extends donor restrictions" (ASC 958-10-65-1).

The Update no longer allows underwater endowments to be offset against unrestricted net assets, but now requires those amounts be reported within net assets with donor restrictions. NFPs will be required to disclose their policy for spending from underwater endowments, as well as reporting the aggregate original gift amounts and the fair value of those funds. ASC 958-205-50-1B requires, at a minimum, that an NFP disclose the following regarding underwater endowments:

a. A description of the governing board's interpretation of the law or laws that underlie the NFPs net asset classification of donor-restricted endowment funds, including its interpretation of the ability to spend from underwater endowment funds.
b. A description of the NFPs policy or policies for the appropriation of endowment assets for expenditure (its endowment spending policy or policies), including its policy, and any new actions taken during the period, concerning appropriation from underwater endowment funds.

Disclosures on Liquidity and Availability

The Update requires in ASC 958-210-50-1 that a NFP disclose in the notes to the financial statements relevant information about the liquidity or maturity of assets and liabilities, including restrictions and self-imposed limits on the use of particular items, in addition to information provided on the statement of financial position. Specifically, an NFP must disclose the following, according to ASC 958-210-50-1A:

a. Qualitative information in the notes to the financial statement that is useful in assessing an entity's liquidity and communicates how an NFP manages its liquid resources available to meet cash needs for general expenditures within one year of the date of the statement of financial position.
b. Quantitative information either on the face of the statement of financial position or in the notes, and additional qualitative information in the notes as necessary, that communicate the availability of an NFPs financial assets at the date of the statement of financial position to meet cash needs for general expenditures within one year of the date of the statement of financial position (see paragraph 958-210-45-7(c)).

Availability of a financial asset may be affected by:

1. Its nature.
2. External limits imposed by donors, laws, and contracts with others.
3. Internal limits imposed by governing board decisions.

Figure 7 presents a sample of a liquidity disclosure.

FIGURE 7. Liquidity Availability Disclosure Presentation Under ASU 1016-14

Financial Assets, at year-end	$234,410
Less those unavailable for general expenditures within one year, due to:	
Contractual or donor-imposed restrictions:	
Restricted by donor with time or purpose restrictions	(11,940)
Subject to appropriation and satisfaction of donor restrictions	(174,700)
Investments held in annuity trust	(4,500)
Board designations:	
Quasi-endowment fund, primarily for long-term investing	(36,600)
Amounts set aside for liquidity reserve	(1,300)
Financial assets available to meet cash needs for general expenditures within one year	$5,370

Source: ASC 958-205-55-21, Note G, p. 67. The *FASB Accounting Standards Codification*® material is copyrighted by the Financial Accounting Foundation, 401 Merritt 7, Norwalk, CT 06856, and is used with permission.

One of the reporting challenges of NFPs is the ability for financial statement readers to determine the financial asset availability (liquidity availability) from the face of the statement of financial position, given that NFPs have many donor-imposed restrictions, as well as board-designations.

Figure 7 highlights how organizations need to disclose, at minimum, such cash availability in the notes to the financial statements. The liquidity disclosures are some of the more significant reporting changes required in this Update.

OBJECTIVES REACHED IN THE UPDATE

The Update aimed to address four areas of the current financial reporting model of NFPs, including:

- The complexities in the formal reporting of net assets
- The inconsistencies in the reporting of intermediate measures of operations on the statement of activities necessary in assessing an entity's financial performance
- The problems in information reported about operating expenses by both function and nature
- Misunderstandings about how to improve the utility of reporting operating cash flows

It is the authors' views that this Update is a very productive effort by the FASB to address these issues in improving the financial reporting for not-for-profit entities. The new format of the financial statements will be initially costly to NFPs to implement, but this Update does satisfy its objectives of providing users greater clarity and transparency into the operations and financial position of NFP entities.

TRANSITION AND EFFECTIVE DATE OF UPDATE

Accounting Standards Update (ASU) No. 2016-14, *Not-for-Profit Entities (Topic 958) Presentation of Financial Statements for Not-for-Profit Entities*, is effective for annual financial statements issued for fiscal years beginning after December 15, 2017, and for interim periods within fiscal years beginning after December 15, 2018. The Update permits early adoption. The Update provides guidance for the years of transition when the new standard is adopted, including specific disclosures that must be made at ASC 958-10-65-1.

FASB ISSUES PROPOSED GUIDANCE FOR CONTRIBUTIONS RECEIVED AND CONTRIBUTIONS MADE

As of this writing, on August 3, 2017, the FASB issued an Exposure Draft, Proposed Update to Topic 958, to clarify and improve the scope and guidance for contributions received and contributions made.

According to the Exposure Draft, the amendments "would assist entities in (1) evaluating where transactions should be accounted for as contributions (nonreciprocal transactions) within the scope of *Topic 958, Not-for-Profit Entities*, or as exchange (reciprocal) transactions subject to other guidance, and (2) distinguishing between conditional contributions and unconditional contributions."

Given the diversity of reporting practices around contributions, this proposed Update is necessary to add clarity to and strengthen not-for-profit financial reporting.

References

Accounting Standards Update (ASU) No. 2016-14, *Not-for-Profit Entities (Topic 958) Presentation of Financial Statements for Not-for-Profit Entities*. Norwalk, CT: Financial Accounting Standards Board.

Proposed Accounting Standards Update, FASB Exposure Draft, *Not-for-Profit Entities (Topic 958) and Health Care Entities (Topic 954)*. April 22, 2015. Norwalk, CT: Financial Accounting Standards Board.

Proposed Accounting Standards Update, FASB Exposure Draft, *Not-for-Profit Entities (Topic 958), Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made*. August 3, 2017. Norwalk, CT: Financial Accounting Standards Board.

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The Conceptual Framework: Past, Present, and Future

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Yeong C. Choi

Abstract

In a broad sense, a conceptual framework can be seen as a structured theory of accounting. A conceptual framework is intended to set forth objectives and fundamental concepts that will be the basis for the development of accounting standards.

A complete, internally consistent, and logical conceptual framework assists the standard setters in developing new and improving existing standards based on underlying concepts. It also assists preparers in applying financial reporting standards, auditors in providing an opinion on whether the financial statements are in accordance with a given set of standards, and users in interpreting the information presented in the financial statements.

Moreover, such a well developed conceptual framework facilitates communication between national and international standard setting bodies.

In 2004, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) began a joint project to revise and converge their respective conceptual frameworks. The six-year long cooperation on that project resulted in convergence regarding the objective of general purpose financial reporting and the qualitative characteristics of useful financial information.

However, in late 2010 the Boards, preoccupied with other joint convergence projects, agreed to discontinue the joint efforts in order to work on their respective frameworks.

As the convergence process pursued by FASB and IASB moved the accounting standards into a less rule-based and more principles-based direction, the creation of a well-structured accounting theory has become of paramount importance.

No wonder that when questioned about the IASB agenda in 2011, many stakeholders identified the conceptual framework as a priority project.

Consequently, the IASB restarted its conceptual framework project in 2012, and independently developed an Exposure Draft of the *Conceptual Framework for Financial Reporting* in 2015. The final version of the revised conceptual framework was issued on March 29, 2018.

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Meanwhile, in January 2014, the FASB reactivated its conceptual framework project, focusing on concepts for presentation and measurement. The measurement portion of the project is still at the initial deliberations stage, but a limited Exposure Draft addressing issues of presentation, which would become Chapter 7 of Concepts Statement 8, was issued in 2016.

More recently the FASB expanded the conceptual framework project by starting initial deliberations of issues related to the elements of financial statements.

The recommendations to continue independent work on the respective conceptual framework projects received by both Boards, and the engagement of constituencies in the due process, indicate how important conceptual framework is not only to standard setters, but also to users of financial statements and other stakeholders.

The increasing use of framework-based teaching of accounting standards adds further urgency to this need.

INTRODUCTION

A conceptual framework is a logical system of interrelated objectives and basic concepts that prescribe the nature, function, and limits of financial reporting, which is expected to lead to development of consistent guidance, whether rules-based or principles-based. In the absence of such a framework, guidance would often be promulgated on an ad hoc basis, the result of which process would likely be inconsistent and incoherent, with obvious negative ramifications.

Furthermore, without a framework, standard-setting would be subject to the possibly divergent individual concepts held by the members of the standard-setting body. Agreement on issues would be more difficult to reach, as it would require the convergence of personal perspectives on financial reporting or that other compromises be made on a case-by-case basis.

As a result, different conclusions might be reached on similar or even identical issues addressed on different dates, making the standard setting very ineffective. For the users, this would mean inconsistent, more difficult to understand and, consequently, less useful financial reports.

Accounting standard setting by the Financial Accounting Standard Board (FASB) in the United States and by the International Accounting Standards Board (IASB) (collectively, the Boards) is guided by their respective conceptual frameworks.

The FASB's original conceptual framework was issued in a series of seven Statements of Financial Accounting Concepts (SFACs or Concept Statements) between 1978 and 2000.

The IASB inherited the International Accounting Standards Committee's (IASC's) *Framework for the Preparation and Presentation of Financial Statements* (the *Framework*) issued in 1989, which was partially derived from the FASB's Concept Statements.

The existing FASB and IASB frameworks differ in their authoritative status. Managers of entities preparing financial statements in accordance with International Financial Reporting Standards (IFRS) may be required to consider the IASB's *Framework* if no standard or interpretation specifically applies to a transaction, other event, or condition.

In a situation such as that, management should use its judgment in developing and applying accounting policy. In making the judgment, management should refer to, and consider the applicability of, first, the requirements in IFRS dealing with similar and related issues, and, second, the definitions, recognition criteria, and measurement concepts for assets, liabilities, income, and expenses in the *Framework* (IASB, IAS 8.10-11).

The FASB's Concepts Statements had a lower standing in the Generally Accepted Accounting Principles (GAAP) hierarchy, and entities were not required to consider those concepts in preparing financial statements, even in the absence of fact-specific guidance in the standards themselves.

In April 2005, when FASB issued and Exposure Draft of a Proposed Statement of Financial Accounting Standards entitled *The Hierarchy of Generally Accepted Accounting Principles*, the Board acknowledged that it had considered elevating the ranking of Concepts Statements, but decided not to make such an improvement to the existing GAAP hierarchy, as set forth in AICPA's Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles* (SAS-69), at that time.

When FASB codified the accounting standards, only pronouncements from levels A-D of the GAAP hierarchy were included in the FASB Accounting Standards Codification®, the source of authoritative GAAP recognized by the FASB to be applied to nongovernmental entities, effective September 2009. The conceptual framework has not been codified and remains among the non-authoritative literature items.

Both the FASB and IASB frameworks have been criticized for various reasons. A few aspects of the frameworks are internally inconsistent and some others are unclear. Also, the two frameworks differ on some concepts.

Furthermore, some aspects of the frameworks are outdated and do not fully reflect accounting thought of the past three decades. Still other aspects of the FASB's framework that were originally planned were not ultimately completed (Bullen and Crook, 2005).

Because of the shortcomings mentioned above, the development of a better conceptual framework was considered one of the most critical aspects in the effort to converge U.S. GAAP and IFRS. Starting with the Norwalk Agreement in 2002, FASB and IASB in their joint effort tried to develop standards which would be more principles-based and less prescriptive in nature.

To provide the best foundation for developing principles-based and internationally converged accounting standards, the Boards undertook a joint project to develop a common conceptual framework that would be both complete and internally consistent.

The goals for this project, added to FASB and IASB agenda in 2004, included:

1. Updating and refining the existing concepts to reflect changes in markets, business practices, and the economic environment
2. Improving some parts of the existing frameworks, such as recognition and measurement
3. Filling gaps in the existing frameworks

This paper reflects on the importance of the conceptual framework for financial reporting, compares the FASB's Concepts Statements with the IASB's *Framework,* discusses the joint conceptual framework project and its accomplishments, and highlights the most recent independently proposed advances in FASB and IASB respective conceptual frameworks. Arguments for a more prominent role of the conceptual framework as a meta-theoretical structure for financial reporting are made.

THE PRE-CONVERGENCE FASB CONCEPTUAL FRAMEWORK

The FASB was the first accounting-standard setting body in the world that successfully developed a comprehensive conceptual framework. It presented its concepts in a series of separate Concept Statements. Seven pre-convergence FASB Concepts Statements are listed in Table 1.

The FASB *Conceptual Framework* is an evolutionary document based on many earlier attempts at the promulgation of concepts. For example, the objectives were rooted in the AICPA's 1973 Trueblood Committee Report and the qualitative characteristics and definitions of elements stem from *A Statement of Basic Accounting Theory* published by the American Accounting Association in 1966; and/or APB's Statement 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises* (Wolk, Dodd, and Rozycki, 2013, pp. 255–256).

The goal of this framework is to rationalize a basis for the development of financial reporting standards. It relies on three central features (Christensen and Demski, 2002):

- Information is being provided
- This information is conveyed using the language and algebra of valuation
- This information perspective can be well articulated with or by "qualitative characteristics" of that information

The FASB stressed the overriding importance of providing useful information, and viewed *relevance* and *reliability* as the characteristics that are essential for *usefulness*.

TABLE 1. Concept Statements Constituting Pre-Convergence FASB Conceptual Framework

Date Issued	Concept Number	Concept Statement Title
November 1978	SFAC No. 1	*Objectives of Financial Reporting by Business Enterprises*
May 1980	SFAC No. 2	*Qualitative Characteristics of Accounting Information*
December 1980	SFAC No. 3	*Elements of Financial Statements of Business Enterprises*
December 1980	SFAC No. 4	*Objectives of Financial Reporting by Nonbusiness Organizations*
December 1984	SFAC No. 5	*Recognition and Measurement in Financial Statements of Business Enterprises*
December 1985	SFAC No. 6	*Elements of Financial Statements—A Replacement of FASB Concepts Statement*
February 2000	SFAC No. 7	*Using Cash Flow Information and Present Value in Accounting Measurements*

THE PRE-CONVERGENCE IASB FRAMEWORK

The IASB also had a conceptual framework underlying its financial reporting standards and interpretations. The IASB *Framework* set out the concepts that underlie the preparation and presentation of financial statements for external users.

This *Framework*, derived from the FASB's Concept Statements, was approved by the International Accounting Standards Committee (IASC) in April 1989, and adopted by the IASB in April 2001. It was less developed than the FASB's Concepts Statements, often alluding in few words to fundamental concepts that need further explanation to provide a principles-based guidance for resolving financial reporting issues.

THE CONCEPTUAL FRAMEWORK CONVERGENCE PROJECT 2004–2010

A conceptual framework project was added to the FASB and IASB agendas in October 2004. This project was later described in the Memorandum of Understanding published in February 2006, which set forth a joint program of work for the Boards.

The objective of this joint project was to develop a common superior conceptual framework that both converges and improves upon the existing frameworks of the two Boards. It was determined that the common FASB-IASB framework was needed because:

1. The existing FASB and IASB frameworks are two or more decades old and in need of refinement, updating, completion, and convergence to guide both standard-setters to similar conclusions on accounting issues
2. It would help to eliminate existing differences between U.S. GAAP and IFRS and serve to develop principles-based standards

The Boards gave priority to issues that were believed likely to yield standard-setting benefits in the near term. The goal was the common framework, a single document (like the IASB's *Framework* rather than a series of Concepts Statements) and would include a summary and basis for conclusion.

The Boards decided to focus initially on business entities in the private sector. They intended to later consider the applicability of those concepts to financial reporting by not-for-profit entities in the private sector and business entities in the public sector.

The conceptual framework project was divided into phases A-H. Table 2 lists the phases with their status and outcomes.

THE SUCCESS STORY: PHASE A OF THE CONCEPTUAL FRAMEWORK PROJECT

In September 2010, both the FASB and the IASB issued converged chapters dealing with the objectives of financial reporting and with the qualitative characteristics of useful financial information.

More specifically, FASB issued Concept Statement No. 8 (SFAC 8), *Conceptual Framework for Financial Reporting:* Chapter 1, "The Objective of General

TABLE 2. Conceptual Framework Project Phases, Status, and Outcomes

Phase	Topic	Status	Outcome
A	Objectives and qualitative characteristics	Completed	Converged Chapters 1 and 3 of the FASB's SFAC No. 8 and Chapters 1 and 3 of the IASB's Conceptual Framework for Financial Reporting (2010)
B	Elements and recognition	Initiated	The Boards reconsidered definitions of the elements of the financial statements
C	Measurement	Initiated	Few tentative decisions reached by the Boards
D	Reporting entity	Worked on	Discussion Paper (2008) and Exposure Draft (2010)
E	Presentation and disclosure, including financial reporting boundaries	Never started	None
F	Framework purpose and status in GAAP hierarchy	Never started	None
G	Applicability to the not-for-profit sector	Never started	None
H	Remaining Issues	Never started	None

Purpose Financial Reporting," and Chapter 3, "Qualitative Characteristics of Useful Financial Information," which replaced SFAC 1 and SFAC 2, respectively.

At the same time the IASB issued Chapter 1, "The Objective of General Purpose Financial Reporting" and Chapter 3, "Qualitative Characteristics of Useful Financial Information," which replaced the Preface and Introduction as well as paragraphs 1 through 22 and 24 through 46 in the IASB's *Framework*. Chapters 1 and 3 are identical in FASB SFAC No. 8 and in the IASB's *Framework*.

According to Chapter 1, "The Objective of General Purpose Financial Reporting," "the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and creditors ["primary users"] in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments, and providing or settling loans and other forms of credit" (FASB, 2010). Consequently, primary users need information to help them assess the prospects of future net cash inflows to an entity.

To assess an entity's prospects for future cash inflows, primary users need information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity's management and governing board have discharged the responsibilities to use the entity's resources.

Many primary users cannot require that reporting entities provide information directly to them, and thus primary users must rely on general purpose financial statements for much of the financial information they need.

The Boards emphasized that general purpose financial statements are not designed to show the value of the reporting entity, are not designed for the sole use of management, and are not directed toward regulators or other parties that are not primary users.

Although the word *stewardship* does not appear in the statement on objectives, the Boards indicated that one purpose of financial reporting is to provide information that allows users to assess how efficiently and effectively management has been in using the reporting entity's resources.

Relevance remains as one of the two fundamental qualitative characteristics of useful information. *Reliability*, however, was replaced with *faithful representation* as the second fundamental quality.

Relevance influences user decisions, and is determined by predictive and confirmatory values. Furthermore, relevant information is constrained by entity-specific materiality and cost considerations. Information that is *faithfully represented* is complete, neutral, and free from error.

The FASB recommends this three-step process for applying the fundamental qualitative characteristics when reporting financial information:

1. Identification of an economic phenomenon that has the potential to be useful to users of the reporting entity's financial information
2. Identification of the type of information about the phenomenon that would be the most relevant if it is available and can be faithfully represented
3. Determination of whether that information is available and can be faithfully represented (if not, the process is repeated with the next most relevant type of information) (FASB, 2010, QC18, p. 19)

The converged framework groups comparability, verifiability, timeliness, and understandability as enhanced qualitative characteristics. This approach simplifies the framework and clarifies that these attributes serve to enhance the usefulness of financial information that is relevant and faithfully represented.

The Boards considered other concepts for inclusion in the framework, such as transparency and the true and fair view, but in the final analysis determined that they were not qualitative characteristics (Kaminski and Carpenter, 2011).

Other Work Completed Under the Joint Project Agenda

The FASB and the IASB also worked jointly on the reporting entity concept. Their effort resulted in publication of both, a Discussion Paper in 2008, and an Exposure Draft in 2010.

Some work on the definitions of the elements of the financial statements and on measurement was also completed. The pressure of the other projects, however, resulted in the Boards suspending further work on the joint *Conceptual Framework* project in November 2010.

POST-CONVERGENCE REVISIONS TO THE FASB AND IASB CONCEPTUAL FRAMEWORKS

Developments at FASB

FASB reactivated its conceptual framework project in January 2014. At the June 18, 2014 meeting, the FASB discussed how to proceed with the conceptual framework project. Discussion focused on Concept Statement No. 5, dealing with recognition, measurement, and certain aspects of presentation of information on the face of financial statements.

Consistent with the objective of financial reporting, the FASB concluded that the discussion of presentation could be developed further to enhance ability of investors and creditors to determine future cash flows.

The deliberations over the next several months regarding the presentation issues resulted in the Exposure Draft entitled *Conceptual Framework for Financial Reporting: Chapter 7: Presentation*. This proposed chapter of Concept Statement 8, issued August 11, 2016, deals with items that have been recognized in financial statements, and addresses issues such as the display of line items, totals, and subtotals.

The proposal is designed to provide the FASB with a framework for developing standards concerning summarization and communication of information in the financial statements in ways consistent with the objective of financial reporting.

Specifically, the FASB intended to provide a foundation for future standards that enhance financial statement users' ability to assess prospects for future cash flows by addressing the grouping of items and clarifying the relationships among an entity's assets, liabilities, and equity, and the effects of related changes of those assets and liabilities on comprehensive income and cash flows (FASB, 2016).

The FASB has discussed the feedback received from constituencies and will redeliberate the proposed chapter at a future meeting.

The FASB members have also discussed how to proceed with developing concepts related to measurement, including identifying appropriate types of measurements and determining which measurements to use in specific circumstances. The *Conceptual Framework: Measurement* project is still in the initial deliberations stage.

On September 24, 2015, the FASB issued two exposure drafts as part of its ongoing Disclosure Framework project. One proposal was issued to amend the FASB's discussion of materiality in the conceptual framework; the other was intended to update the codification to explain the application of materiality to the preparation of footnote disclosures.

The proposed amendment to Chapter 3 of FASB Concepts Statement No. 8 intended to clarify that materiality is fundamentally a legal concept. It acknowledged that different legal frameworks may have different definitions of materiality and that the FASB cannot prescribe a specific universal threshold.

The proposed clarification of the definition was intended to resolve a longstanding inconsistency between the conceptual framework and the Security and Exchange Commission's guidance relating to materiality. The proposal was criticized for applying the Supreme Court's definition of materiality, because the decision regarding what constitutes a material disclosure would shift from preparers and auditors to lawyers. Consequently, the definition of materiality has not been amended in Chapter 3 of the Concept Statement No. 8.

At the meeting on May 3, 2017, the FASB decided to add to its technical agenda a project on elements of financial statements defined in FASB Concepts Statement No. 6, *Elements of Financial Statements*.

Developments at IASB

The international stakeholders, during a public consultation of the IASB agenda in 2011, encouraged the Board to independently complete revisions to the existing *Conceptual Framework*.

The deficiencies of the existing framework were perceived to include limited guidance on measurement and on presentation and disclosure, as well as an unclear role for uncertainty in recognition and measurement decisions. It was also noted that existing guidance on when assets and liabilities should be recognized was outdated.

In response, the IASB restarted its conceptual framework project in 2012 and decided to execute it in a single phase.

The first step in the due process was publication of a Discussion Paper entitled *A Review of the Conceptual Framework for Financial Reporting*, published in July 2013 (IASB, 2013). As the title suggests, the IASB decided to build on the existing conceptual framework rather than reconsider all the fundamental concepts.

This decision was met with support from stakeholders, as expressed in 221 comment letters. The IASB members and staff conducted over 150 outreach meetings to further gauge the response to the changes proposed in the Discussion Paper.

The IASB received support for revised definitions of an asset and of a liability focusing more on the resource or obligation than on the flows that might result from them. The mixed measurement approach was supported as well, but was criticized for including too much standard-level details.

The sections discussing the distinction between liabilities and equity, and presentation of profit or loss and other comprehensive income (OCI) were also perceived as being areas of concern.

Finally, although the IASB made the conscious decision to not reconsider chapters of the existing conceptual framework issued jointly with the FASB in 2010, some respondents who expressed unhappiness with the outcome of the joint project urged the IASB to reconsider such notions as stewardship, prudence, reliability, and substance over form.

After the extensive due process, including ten public meetings in 2014 and 2015, the IASB published the Exposure Draft *Conceptual Framework for Financial Reporting* accompanied by the Exposure Draft *Conceptual Framework for Financial Reporting: Basis for Conclusions,* in May 2015.[1]

The customary 150-day comment period for this Exposure Draft was extended, at the request of stakeholders, by another month, to the end of November 2015.

The new document covered the whole conceptual framework, including chapters on objectives of financial reporting and qualitative characteristics of useful information based on the chapters issued in 2010, but with proposed changes to some of the aspects of those chapters.

It also included a chapter on the reporting entity that was developed, based on the Discussion Paper and Exposure Draft developed jointly with the FASB, after taking into consideration the feedback received on those documents.

The IASB received 233 comment letters and conducted more than 80 outreach meetings in the wake of the Exposure Draft. The revisions to the conceptual framework have been enthusiastically received, and the Exposure Draft has been praised as a significant improvement over the Discussion Paper.

It received a strong support for reintroducing an explicit reference to the notion of prudence, for giving more prominence to the role of the financial in-

[1]The third document published by IASB on the same day, May 28, 2015 was Exposure Draft Updating References to the Conceptual Framework, Proposed Amendments to IFRS 2, IFRS 3, IFRS 4, IFRS 6, IAS 1, IAS 8, IAS 34, SIC-27 and SIC-32. All three Exposure Drafts on the Conceptual Framework had the same original due date for comment letters; that is, October 26, 2015.

formation in assessing management's stewardship of the entity's resources, and for the new definitions of an asset and liability, including additional guidance on uncertain liabilities.

Some respondents were still unhappy with the way measurement and the distinction between profit or loss and OCI were handled in the Exposure Draft. Despite the IASB removing a significant number of paragraphs containing a detailed standard-level discussion, a few respondents still perceived the Exposure Draft as an inappropriate mixture of concepts and rules. Some criticized its approach as a justification of existing practice rather than development of fundamental concepts.

Key changes to the conceptual framework since the proposals in the Discussion Paper and the up-to-date tentative decisions about the revised conceptual framework are summarized in Table 3, based on the information from the IASB website.

The IASB finalized an update to the *Conceptual Framework for Financial Reporting* to provide a more complete, clear, and updated set of concepts to use when it develops or revises IFRS standards. The revised *Conceptual Framework* was published on March 29, 2018 (IASB, 2018).

TABLE 3. Exposure Draft *Conceptual Framework for Financial Reporting:* Proposed Key Changes and Tentative Decisions on the Proposals

Section	Proposed Key Changes in the Exposure Draft	Tentative Decisions Since the Exposure Draft
The objective of financial reporting	Give more prominence, within the overall objective of financial reporting, to the importance of providing information needed to assess management's stewardship of the entity's resources.	The IASB will clarify further the link between the objective of financial reporting and management's stewardship of the entity's resources.
The qualitative characteristics of useful financial information	Reintroduce an explicit reference to prudence—the exercise of caution when making judgments under conditions of uncertainty. State explicitly that a faithful representation means the substance of an economic phenomenon instead of merely its legal form.	The IASB will clarify that prudence does not imply the need for asymmetry; the explicit reference to the notion of prudence is introduced to acknowledge the possibility that assets (income) might be treated differently from liabilities (expenses) if that provides useful information.
Measurement	Focus on describing the different measurement bases and a discussion on the factors to consider when selecting a measurement basis. Remove a detailed discussion of the implications of the measurement decisions for particular types of assets and liabilities.	The IASB will explain more clearly how various factors, such as the characteristic of an asset or a liability, affect the selection of a measurement basis.
Presentation and disclosure	Focus on the communication role of the financial statements. Remove a discussion of the distinction between primary financial statements and notes and remove standard-level details.	
Presentation in profit or loss and OCI	Emphasize the role of profit or loss as the primary source of information about an entity's performance for the period. Propose a high-level guidance to the board on the use of OCI and on recycling of OCI items into profit or loss. Remove discussion of the categories of items that can be included in OCI.	The IASB will replace the rebuttable presumption about the use of the statement of profit or loss with a principle that income and expenses should be included in the statement of profit or loss, unless the relevance or faithful representation of the information would be enhanced by including in OCI the income or expenses arising from a change in the current value of an asset or a liability. Also, the IASB will replace recycling with a principle that income and expenses included in OCI and recognized previously in the equity should be reclassified to profit or loss when doing so would enhance the relevance or faithful representation of the information in the statement of profit or loss for that period.

CONCLUDING REMARKS

Standards, to be principles-based, must be rooted in fundamental concepts. The conceptual framework is an attempt to provide a meta-theoretical structure for financial reporting (Wolk, Dodd, and Rozycki, 2013, p. 225).

The two most important financial reporting standard-setting bodies in the world, the FASB and the IASB, have concluded that they need a framework to provide direction and structure to their work in developing requirements for financial reporting. Many other national standard setters that have also developed conceptual frameworks to help guide their decisions on financial reporting issues share that conclusion.

Standard setters cannot fulfill their missions without a sound and unified conceptual underpinning that serves to guide and provide discipline to principles-based standard setting. Both the FASB and the IASB use their respective conceptual frameworks to establish the standards on which U.S. GAAP or IFRS financial reporting is based.

Although the FASB's and the IASB's respective original conceptual frameworks were not dramatically different, the Boards achieved only limited success in converging them. After a six-year-long process, only the objective of financial reporting and qualitative characteristics of useful information were fully converged.

Some work on reporting entity, measurement, and elements of financial statements had also been conducted and is now carried forward to the independent conceptual framework projects.

The IASB has just issued a revised version of its conceptual framework, while FASB has only begun the more substantive and impactful deliberations. Success of both projects is extremely important for the future of not only accounting standard setting, but also accounting education.

Teaching U.S. GAAP and IFRS should be grounded in the conceptual framework, with explicit delineation of how the concepts in the framework are related to individual standards being taught. Such framework-based teaching provides students with an enduring base for using judgment in addressing financial reporting issues.

Under this pedagogical approach, students would gain not only better understanding of accounting standards, but also an opportunity to exercise judgment consistent with the conceptual framework, necessary in applying principles-based accounting standards in practice (Burton and Jermakowicz, 2015, pp. 17–19).

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FASB's New Accounting Standard on Leases: Overview of Some Key Requirements for Lessees and Implementation Considerations

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Abstract

The Financial Accounting Standards Board (FASB) issued its long-awaited new standard on the accounting for leases in Accounting Standards Update (ASU) 2016-02, on February 25, 2016. Since ASU 2016-02 focuses primarily on lessee accounting, this article will emphasize new key requirements for lessees and provide information about the ASU 2016-02's effective date and transition provisions, as well as implementation considerations.

In the interest of brevity, this article has been written for the benefit of professionals and students who already understand the previous U.S. GAAP for lease contracts.

The reader will learn that the central point of ASU 2016-02 is that lessees need to recognize the assets and liabilities that arise from their leases. This is its primary improvement over the previous GAAP, which did not require lease assets and lease liabilities to be recognized for many leases. Now, the sole exception will be for leases with a term of 12 months or less. This article will also explain the core similarity with previous GAAP, that operating leases are allowed to recognize the expense of the lease on a straight-line basis over the term of the lease.

INTRODUCTION

The Financial Accounting Standards Board (FASB) issued its long-awaited new standard on the accounting for leases in Accounting Standards Update (ASU) 2016-02, Leases (Topic 842), on February 25, 2016. The new standard replaces the generally accepted accounting principles (GAAP) in Topic 840, Leases, in the FASB's Accounting Standards Codification (ASC).

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The FASB issued this guidance after joint deliberations with the International Accounting Standards Board (IASB), which issued a similar standard (IFRS 16, Leases, http://eifrs.ifrs.org/eifrs/bnstandards/en/2016/ifrs16.pdf), on January 13, 2016. Significant differences between the FASB and IASB standards will, however, remain.

Despite those differences, both standards satisfied the key objective of both Boards, in how leases should be reported in financial statements, especially with respect to the recognition of lease-related assets and liabilities of lessees on their balance sheets, as well as enhancing the transparency of disclosures for these transactions (Ernst & Young, 2017, January 16, p. 2).

This is seen as a great improvement over the existing U.S. GAAP, because it has allowed lessees to structure lease transactions to achieve off-balance sheet financing. This lease accounting guidance being replaced, codified in FASB Accounting Standards Codification (ASC) 840, Leases (hereafter ASC 840), has been criticized for failing to meet the needs of users of the financial statements, particularly because it doesn't require lessees to recognize assets and liabilities in financial statements arising from operating leases.

The new guidance in ASU 2016-02, which is codified in FASB ASC 842, Leases (hereafter ASC 842), addresses those criticisms by requiring lessees to recognize most leases on their balance sheets as assets and liabilities and providing enhanced disclosures. The FASB believes this will result in a more faithful representation of lessees' assets and liabilities and greater transparency about the lessees' obligations and leasing activities (Ernst & Young, 2017, January 16, p. 3).

Under ASC 842, leases are accounted for based on the FASB's right-of-use (ROU) model, which reflects the fact that a lessee has a financial obligation to make lease payments to the lessor for its right to use a specific asset, during the lease term, beginning at the commencement date of the lease contract. The lessor provides that right to use the asset at the lease commencement date.

The new guidance in ASC 842 will affect lease accounting significantly more for lessees than for lessors, the latter of which will experience only a few significant changes. Lessees will now be required to recognize and record a right-of-use (ROU) asset and a lease liability for almost all of their leases, except those that satisfy the new standard's definition of a short-term lease, which are essentially leases for 12 months or less, to be expanded upon later.

The lease liability to be recorded will be equal to the present value of lease payments as before under ASC 840, Leases, and the leased asset recorded will be determined on the basis of the liability recorded, subject to certain adjustments, such as lessee incentives and initial direct costs associated with the lease.

Each lease will be classified by the lessee as either operating or financing based on criteria similar to those used before, amended to avoid explicit numerical bright lines. *Operating leases* will generally result in a straight-line expense reported on the income statement, which is again similar to previous guidance for operating leases.

Financing leases will generally result in larger related expenses being reported in the income statement in earlier years and lower expenses in later years of the lease term, similar to how they were recorded for capital leases, under the prior accounting guidance in ASC 840.

Accounting requirements for lessors, on the other hand, will be mostly similar to that under ASC 840, with some modifications for consistency, with certain changes from other new accounting requirements (e.g., certain definitions, such as initial direct costs, which have been changed) and the recent revenue recognition standard codified in ASC 606, Revenue from Contracts with Customers, https://asc.fasb.org.

Since ASC 842 focuses primarily on lessee accounting, this paper will emphasize new key requirements in this lease guidance for lessees and provide information about the ASC 842's effective date and transition provisions, as well as implementation considerations.

The scope of ASC 842 applies to all 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, but not equipment used to explore for the natural resources
- Leases of biological assets, including timber
- Leases of inventory
- Leases of assets under construction

DEFINITION OF A LEASE

A *lease* is defined as: a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time or another amount of usage, in exchange for consideration (ASC 842-10-20).

An entity must determine whether a contract is or contains a lease at the inception of that contract, by applying the guidance in (ASC 842-10-15-2 through 15-8). For a contract (or part of a contract) to meet the definition of a lease, both of the following must be true:

- The contract depends on the use of a specifically identified asset
- The contract conveys the right to control the identified asset

In order for the contract to depend on an identified asset, there must be a specified asset, such as one that is explicitly specified in a contract (such as a VIN number for a car, a serial number for certain types of machinery and equipment, etc.).

Implicit identification of an asset may occur when there is only one asset that can realistically be used by the supplier (owner) to fulfill a contract. For the contract to convey the right to control the identified asset, both of the following two conditions mentioned below must be true:

1. The customer has the right to obtain substantially all of the economic benefits from using the identified asset over the period of use in the contract (ASC 842-10-15-17).

   For example, a customer can obtain economic benefits from the use of an asset directly or indirectly in several ways, such as exclusively using or holding the asset, or subleasing the asset.

2. The customer must have the right to direct the use of the identified asset over the period of use in the contract, as discussed in (ASC 842-10-15-20).

A contract may include terms and conditions designed to protect the supplier's interest in the asset or to ensure the supplier's compliance with laws or regulations, without impeding the customer's right to control the use of a specific asset. These protective rights typically define the scope of the customer's right of use but do not, in isolation, prevent the customer from having the right to direct the use of an asset (ASC 842-10-15-23).

After determining that a contract contains a lease, an entity should identify the separate lease components, if any, within the contract. The standard requires that an entity consider whether the contract contains multiple components and whether they are considered to be lease or non-lease components.

For contracts that contain the rights to use multiple assets other than land (as discussed in ASC 842-10-15-29), the right to use each asset is considered a separate lease component if both of the criteria in ASC 842-10-15-28 are satisfied. Otherwise the right to use multiple assets is considered a single component.

A contract may also have lease and non-lease components that may have to be separated. A non-lease component includes only those items or activities that transfer a good or service to the lessee that is separate from the right to use the underlying asset. For example, a non-lease component that often arises in a contract with a lease component is maintenance services related to the underlying asset, such as providing scheduled and as-needed cleaning and repairs.

According to ASC 842-10-15-31, an entity should account for each lease component separately from the non-lease components of the contract, unless a lessee makes the accounting policy election described in ASC 842-10-15-37. Also note that non-lease components are not within the scope of ASC 842, and therefore should be accounted for in accordance with other accounting guidance.

Both lessees and lessors would be required to separate lease components and non-lease components in an arrangement and allocate the total lease transaction consideration to the individual components.

KEY FACTORS AND DEFINITIONS TO CONSIDER WHEN CLASSIFYING AND ACCOUNTING FOR A LEASE

Terms are defined in the Master Glossary of ASC 842, which is available without cost at https://asc.fasb.org/glossary. If at any time a reader wants to verify their understanding of terms used in this article, they can avail themselves of that resource.

A *short-term lease* is defined in ASC 842 as one in which: (a) the lease term is 12 months or less, and (b) there is not an option to purchase the underlying asset that the lessee is reasonably certain to exercise.

CLASSIFYING A LEASE UNDER ASC 842 AT THE COMMENCEMENT DATE

According to ASC 842-10-25-1, an entity should classify each separate lease component at the commencement date, unless the lease is accounted for using the short-term lease scope exception discussed in ASC 842. An entity should not subsequently reassess the lease classification unless the contract is modified and the modification is not accounted for as a separate contract in accordance with paragraph ASC 842-10-25.

However, a lessee should reassess the lease classification after the commencement date if there is a change in the lease term or the assessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset.

According to ASC 842-10-25-2, a lessee should classify a lease as a financing lease when the lease meets any one of the following five criteria at lease commencement:

a. The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
b. The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
c. The lease term is for the major part of the remaining economic life of the underlying asset.
d. However, if the commencement date falls at or near the end of the economic life of the underlying asset, as discussed in ASC 842-10-55-2, this criterion should not be used to classify a lease.
e. The present value of the sum of the lease payments and any residual value guaranteed by the lessee 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.

Those familiar with the existing US GAAP will recognize the first four of these criteria as nearly exact matches, except here criteria (c) and (d) avoid specifying specific quantitative thresholds, 75% and 90% as exists now.

Criteria (e) above, most would admit, is arguably unnecessary, in that no rational lessor would lease an asset of this "specialized nature" without insisting that at least criteria (d) and probably criteria (c) also are already met. Leases that do not meet any of these criteria would be classified as operating leases by the lessee.

ASC 842-10-55-2 provides guidance for implementing two of the above lease classification criteria. For example, one reasonable approach to assessing the criteria in ASC 842-10-25-2(c) would be to conclude that 75 percent or more of the remaining economic life of the underlying asset is a major part of the remaining economic life of that asset.

However, a commencement date that falls in the last 25 percent of the total economic life of the underlying asset also falls at or near the end of the economic life of the underlying asset, and hence, the criteria in ASC 842-10-25-2(c) should not be used to classify a lease.

In addition, when applying criteria ASC 842-10-25-2(d) above, if the present value of the lease payments plus the present value of any residual value guaranteed by the lessee amounts to ninety percent or more of the fair value of the underlying asset, this represents substantially all the fair value of the underlying asset.

Note, however, ASC 842-10-55-3 states that if it is not practicable for an entity to determine the fair value of an underlying asset (without incurring undue cost or effort), the lease classification should be determined without consideration of the criteria in paragraph ASC 842-10-25-2(d).

According to ASC 842, a lessee is not required to reassess its classification of a lease unless:

1. The lease is subsequently modified and the modification is not accounted for as a separate contract, or
2. There is a change in the lease term (e.g., there is a change in the assessment of whether the lessee is reasonably certain to exercise a renewal option) or a change in the assessment of the exercise of a purchase option.

LESSEE'S INITIAL MEASUREMENTS AT THE COMMENCEMENT DATE

On the commencement date, lessees should recognize ROU assets and lease liabilities for all leases not considered short-term leases (as per ASC 842-20-30-1). A lessee should measure and recognize a lease liability, regardless of the lease's classification, as the present value of the lease payments not yet paid, discounted using the discount rate for the lease as of the commencement date (as described above and in paragraphs ASC 842-20-30-2 through 30-4).

The lessee should also recognize a corresponding lease asset as discussed in ASC842-20-30-5. According to ASC842-20-30-5, the initial measurement of the ROU asset, regardless of the lease's classification, includes: the lease liability, as discussed above, plus initial direct costs, plus any lease payments already paid to the lessor before or at the commencement of the lease.

ACCOUNTING SUBSEQUENT TO THE COMMENCEMENT DATE—MEASUREMENT AND REMEASUREMENT OF LEASE PAYMENTS

Lease payments are used in the lease classification criteria and in the measurement of the assets and liabilities recognized by lessees when accounting for their leases. A lessee is required to remeasure the lease payments, as explained in ASC 842-10-35-4, if any of the following items occur:

- The lease is modified, and that modification is not accounted for as a separate contract in accordance with paragraph ASC 842-10-25-8.
- A contingency upon which some or all of the variable lease payments are based is resolved so that those payments now meet the definition of lease payments. For example, an event occurs that results in variable lease payments that were linked to the performance or use of the underlying asset becomes fixed payments for the remainder of the lease term.
- Any of the following three changes occur:
    1. There is a change in the lease term, as described in ASC 842-10-35-1, such that the lessee should determine the revised lease payments on the basis of the revised lease term.

2. There is a change in the assessment of whether the lessee is reasonably certain to exercise or not to exercise an option to purchase the lease's underlying asset, as described in paragraph ASC 842-10-35-1, in which case the lessee should determine the revised lease payments to reflect the change in this assessment.
3. There is a change in the amount that was probable of being owed by the lessee under a residual value guarantee, in which case the lessee must determine the revised amount probable of being owed by the lessee under that residual value guarantee.

According to ASC 842-10-35-5, when a lessee remeasures the lease payments in accordance with the above guidance, variable lease payments that depend on an index or a rate should be measured using the index or rate at the remeasurement date.

In addition, the lease liability should be remeasured using an updated discount rate as of the remeasurement date to reflect the remaining lease term and remaining lease payments, unless remeasurement of the liability was triggered by one or more of the following:

- A change in the lease term or a change in whether the lessee is reasonably certain to exercise a purchase option, and the discount rate already takes into consideration the effects of any lessee options to extend the lease, terminate the lease, or purchase the underlying asset.
- A change in the amount of a residual value guarantee that is probable of being owed.
- A change in the variable lease payments that did not previously meet the definition of lease payments such that they subsequently meet the definition of lease payments for the remainder of the lease term.

ILLUSTRATIONS OF LESSEE RECOGNITION, MEASUREMENT, AND REASSESSMENT OF THE LEASE TERM

As adapted from FASB's Lessee Illustration covered in ASC 842-20-55-21 through ASC 842-20-55-39, this example illustrates how a lessee would initially and subsequently measure right-of-use assets and lease liabilities and how a lessee would account for a subsequent change in the lease term.

Day 1 The lessee enters into a 10-year lease of an asset, with an option to extend for an additional 5 years. Lease payments are $40,000 per year during the initial term and $45,000 per year during the optional period, all payable at the beginning of each year. Lessee incurs initial direct costs of $10,000. Other important considerations are:

- At the commencement date, lessee concludes that it is not reasonably certain to exercise the option to extend the lease and, therefore, determines the lease term to be 10 years.
- The rate implicit in the lease is not readily determinable.
- Lessee's incremental borrowing rate is 6.0 percent, which reflects the fixed rate at which lessee could borrow a similar amount in the same currency,

for the same term, and with similar collateral as in the lease at the commencement date.

- At the commencement date, lessee makes the lease payment for the first year, incurs initial direct costs, and measures the lease liability at the present value of the remaining nine payments of $40,000, discounted at the rate of 6.0 percent, which is $272,067.69. Lessee also measures a right-of-use asset of $322,067.69 (the initial measurement of the lease liability plus the initial direct costs and the lease payment for the first year).
- During the first year of the lease, lessee recognizes lease expense based on how the lease is classified, i.e., either as a financing lease, or as an operating lease. For both classifications an effective-interest amortization schedule is useful and would be the same, as shown in Figure 1.

First, let's review the entries if the lease is classified as a financing lease, as this is closest to previous GAAP. Here because the lessee depreciates its owned assets on a straight-line basis, for consistency the right-of-use asset would be amortized on a straight-line basis over the 10-year lease term.

The lease liability is increased to reflect the Year 1 interest on the lease liability in accordance with the effective interest method. As a result, in Year 1 of the lease, lessee recognizes the amortization expense of $32,206.77 ($322,067.69 ÷ 10) and the interest expense of $16,324.06 (6.0% × $272,067.69).

Therefore, at the end of the first year of the lease, the lessee's lease-related liabilities total $288,391.75 consisting of $272,067.69 of lease payable and $16,324.06 of interest payable, and the carrying amount of the right-of-use asset is $289,860.92 ($322,067.69 – $32,206.77). See Figure 2.

Now let's review the entries, if the lease is classified as an operating lease. Here the lessee determines the cost of the lease to be $410,000 (sum of the lease payments for the lease term and initial direct costs incurred by lessee). The annual lease expense to be recognized is therefore $41,000 ($410,000 ÷ 10 years).

Here the lease liability is, once again, increased to reflect the Year 1 interest on the lease liability in accordance with the effective interest method. Therefore

FIGURE 1.

	Payment	6.00% Interest	Principal	Carrying Value
Day 1				$312,067.69
Day 1	$40,000.00		$40,000.00	$272,067.69
Beginning Year 2	$40,000.00	$16,324.06	$23,675.94	$248,391.75
Beginning Year 3	$40,000.00	$14,903.51	$25,096.49	$223,295.26
Beginning Year 4	$40,000.00	$13,397.72	$26,602.28	$196,692.97
Beginning Year 5	$40,000.00	$11,801.58	$28,198.42	$168,494.55
Beginning Year 6	$40,000.00	$10,109.67	$29,890.33	$138,604.22
Beginning Year 7	$40,000.00	$8,316.25	$31,683.75	$106,920.48
Beginning Year 8	$40,000.00	$6,415.23	$33,584.77	$73,335.71
Beginning Year 9	$40,000.00	$4,400.14	$35,599.86	$37,735.85
Beginning Year 10	$40,000.00	$2,264.15	$37,735.85	$0.00

FIGURE 2.

		Net CV of R-o-U Asset**		$286,891.75	
		Total Liability		$288,391.75	
Beginning Year 2	Dr.	Lease Liability		$50,000.00	
		Cr. Cash			$50,000.00
842-20-55-22			5.87%		
		Payment	Interest	Principal	CV*
	Day 1				$392,017.10
	Day 1	$50,000.00		$50,000.00	$342,017.10
	Beginning Year 2	$50,000.00	$20,521.03	$29,478.97	$312,538.13
	Beginning Year 3	$50,000.00	$18,752.29	$31,247.71	$281,290.41
	Beginning Year 4	$50,000.00	$16,877.42	$33,122.58	$248,167.84
	Beginning Year 5	$50,000.00	$14,890.07	$35,109.93	$213,057.91
	Beginning Year 6	$50,000.00	$12,783.47	$37,216.53	$175,841.38
	Beginning Year 7	$50,000.00	$10,550.48	$39,449.52	$136,391.87

* CV = carrying value

** R-o-U Asset = right-of-use asset, as discussed in ASU 2016-02.

at the end of the first year of the lease, the carrying amount of the lessee's lease liability is again $288,391.75 ($272,067.69 + $16,324.06).

What is unique under this operating lease classification, is that the amortization of the right-of-use asset is calculated as the amount required to bring the total lease expense for the period up to the previously determined straight-line amount, in this case $41,000, after the amount contributed by the growth in the liability for this period, $16,324.06, with resulting amortization in this first year of $24,675.94 and a year-end carrying amount of the right-of-use asset is $297,391.75. See Figure 3.

For this author, the carrying value (CV) of the right-of-use asset is not an intuitively obvious relationship. What is logical is that the amortization of the right-of-use asset, each period, is the amount required as an incremental addition to interest, for the period, in order to book the target straight-line lease expense amount. From there, knowing that the carrying value of the right-of-use asset equals its initial cost less its accumulated amortization, to date, seems much more straightforward.

Now we consider accounting for a change in the lease term. At the end of Year 6 of the lease, lessee makes significant leasehold improvements. Those improvements are expected to have significant economic value for the lessee at the end of the original lease term of 10 years. The improvements result in the underlying asset having greater utility to the lessee than alternative assets that could be leased for a similar amount and that are expected to have significant economic life beyond the original lease term.

Consequently, construction of the leasehold improvements is deemed a significant event or significant change in circumstances that directly affects whether a lessee is reasonably certain to exercise the option to extend the lease, and triggers an assessment of the lease term.

Upon reassessing the lease term, at the end of Year 6, lessee concludes that it is reasonably certain to exercise the option to extend the lease for 5 years. Tak-

FIGURE 3.

Day 1	Dr.*	Right-of-use Asset	$322,067.69	
		Cr* Lease Payable		$272,067.69
		Cr. Cash		$40,000.00
		Cr. Deferred initial direct costs		$10,000.00
End Year 1	Dr.	Lease Expense	$41,000.00	
		Cr. Lease Payable		$16,324.06
		Cr. Accumulated Amortization R-o-U Asset		$24,675.94
	Balance Sheet Has:			
		Net CV of R-o-U Asset**	$297,391.75	***
		Total Liability	$288,391.75	
Beginning Year 2	Dr.	Lease Payable	$40,000.00	
		Cr. Cash		$40,000.00

* Dr. = debit, Cr. = credit, as used to record accounting journal entries.

** CV of R-o-U Asset = carry value of right-of-use asset, as discussed in ASU 2016-02.

***Note that the carrying value (CV) of the right-of-use asset equals the liability balance plus the amount of initial direct costs that would yet to have been amortized to expense on a straight-line basis, if we were amortizing them separately. FASB in 842-20-55-30 expresses this as, "the carrying amount of the right-of-use asset is [$amt.] (the carrying amount of the lease liability plus the remaining initial direct costs)."

ing into consideration the extended remaining lease term, lessee's incremental borrowing rate at the end of Year 6 is 8.0 percent.

As a result of the lessee's remeasuring the remaining lease term to 9 years, lessee also would remeasure any variable lease payments that depend on an index or a rate; however, in this example, there are no variable lease payments that depend on an index or a rate. In accordance with paragraph 842-10-25-1, lessee reassesses the lease classification as a result of the change in the lease term.

Assume for purposes of this example that the reassessment does not change the classification of the lease from that determined at the commencement date. The Year 6 expense accrual entries are still based on the lease term considered reasonably assured throughout the year, up until this point. They are shown in Figure 4.

At the end of Year 6, before accounting for the change in the lease term, the lease liability is $146,920.48 (the beginning of the year balance in the effective-interest amortization schedule above of $138,604.22 plus 1 year's accrued interest at the initial 6.0% rate or $8,316.25).

Lessee's right-of-use asset has a carrying value of $128,827.08 if the lease is classified as a finance lease ($322,067.69 – ($32,206.77 × 6) or $150,920.48 if the lease is classified as an operating lease ($322,067.69 – ($41,000 × 6) – the sum of the interest accruals in the effective-interest amortization schedule above for those same six periods.)

Note here, again, under the operating lease methodology, the carrying value of the right-of-use asset is also equal to the lease liability balance $146,920.48 plus the amount of initial direct costs that would yet to have been amortized to expense on a straight-line basis, if we were amortizing them separately, $4,000.

Lessee remeasures the lease liability, which is now equal to the present value of four payments of $40,000 followed by five payments of $45,000, all

FIGURE 4.

As a financing lease:				
End Year 6	Dr. *	Amortization Expense	$32,206.77	
		Cr* Accumulated Amortization R-o-U Asset		$32,206.77
	Dr.	Interest Expense	$8,316.25	
		Cr. Interest Payable		$8,316.25
End Year 6	Balance Sheet Has:			
		Net CV of R-o-U Asset**	$128,827.08	
		Total Liability	$146,920.48	
As an operating lease:				
End Year 6	Dr.	Lease Expense	$41,000.00	
		Cr. Lease Liability		$8,316.25
		Cr. Accumulated Amortization R-o-U Asset		$32,683.75
End Year 6	Balance Sheet Has:			
		Net CV of R-o-U Asset	$150,920.48	
		Total Liability	$146,920.48	

* Dr. = debit, Cr. = credit, as used to record accounting journal entries.
** CV of R-o-U Asset = carry value of right-of-use asset, as discussed in ASU 2016-02.

discounted at the new rate of 8.0 percent, which is $285,713.27. This sets up a new effective-interest amortization schedule, such as shown in Figure 5.

Lessee increases the lease liability by $138,792.79, representing the difference between the remeasured liability and its current carrying amount ($285,713.27 – $146,920.48). The corresponding adjustment is made to the right-of-use asset to reflect the cost of the additional rights.

Following this adjustment, the carrying amount of lessee's right-of-use asset is $267,619.87 if the lease is a finance lease (that is, $128,827.08 + $138,792.79), or $289,713.27 if the lease is an operating lease (that is, $150,920.48 + $138,792.79).

Lessee then makes the $50,000 lease payment for Year 7, reducing the lease liability to $245,713.27 ($285,713.27 – $40,000.00), regardless of how the lease is classified.

Lessee recognizes lease expense in Year 7 as follows, depending on how the lease had been classified at the commencement date.

If classified as a finance lease, and given as before the lessee depreciates its owned assets on a straight-line basis, the right-of-use asset will be amortized on a straight-line basis over the remaining lease term, shown in Figure 6.

If the lease is classified as an operating lease, the lessee determines the remaining cost of the lease as the sum of the following:

a. The total lease payments, as adjusted for the remeasurement, which is the sum of $400,000 (ten payments of $40,000 during the initial lease term) and $225,000 (five payments of $45,000 during the term of the lease extension); plus
b. the total initial direct costs attributable to the lease of $10,000; minus
c. the periodic lease cost recognized in prior periods of $246,000 ($41,000 × 6).

The resulting remaining cost of the lease is therefore $379,000 ($625,000 + $10,000 – $246,000). Consequently, lessee determines that the annual expense to be recognized throughout the remainder of the lease term is $42,111.11 ($379,000 ÷ the remaining lease term of 9 years).

The lease liability itself is increased using the interest method, and the amortization of the right-of-use asset is again based on the difference between the period's liability increase and the total annual expense. In this case, that is $22,454.05 ($42,111.11 – $19,657.06), for a resulting entry shown in Figure 7.

Figure 7 demonstrates the goal of the operating lease accounting model, which essentially is to achieve a straight-line cost (expense) pattern over the term of the lease in the income statement.

> To achieve this, the lessee first calculates the interest on the lease liability by using the discount rate for the lease, and then deducts this amount from the straight-line cost (expense) amount for the period. This difference is simply "plugged" as amortization of the ROU asset to result in a straight-line expense for the period. By using this method, the lessee recognizes a single operating lease expense rather than separate interest and amortization charges in the income statement, although the effect on the lease liability and ROU asset in the balance sheet reflects a bifurcated view of the expense. (Barker, et al., 2016, p. 15)

IMPLEMENTATION CONSIDERATIONS

As can be seen from the examples provided previously in this article, anyone already comfortable with accounting for a lessee's leases under previous GAAP should have little difficulty making the switch to the new GAAP in ASU 2016-02, at least in terms of recording their annual expenses and related balance sheet values.

What may challenge reporting entities more are the various new presentation and disclosure requirements. These topics are well addressed by FASB in ASC 842-20-50-1 through 842-20-50-9, with their stated goal of "enabling us-

FIGURE 5.

	Payment	8.00% Interest	Principal	Carrying Value
End Year 6				$285,713.27
Beginning Year 7	$40,000.00		$40,000.00	$245,713.27
Beginning Year 8	$40,000.00	$19,657.06	$20,342.94	$225,370.33
Beginning Year 9	$40,000.00	$18,029.63	$21,970.37	$203,399.96
Beginning Year 10	$40,000.00	$16,272.00	$23,728.00	$179,671.95
Beginning Year 11	$45,000.00	$14,373.76	$30,626.24	$149,045.71
Beginning Year 12	$45,000.00	$11,923.66	$33,076.34	$115,969.36
Beginning Year 13	$45,000.00	$9,277.55	$35,722.45	$80,246.91
Beginning Year 14	$45,000.00	$6,419.75	$38,580.25	$41,666.67
Beginning Year 15	$45,000.00	$3,333.33	$41,666.67	$0.00

FIGURE 6.

As a financing lease:				
End Year 7	Dr. *	Amortization Expense	$29,735.54	
		Cr* Accumulated Amortization R-o-U Asset		$29,735.54
		($267,619.87 ÷ the remaining lease term of 9 years)		
End Year 7	Dr.	Interest Expense	$19,657.06	
		Cr. Interest Payable		$19,657.06
		(See interest amortization schedule above)		
End Year 7	Balance Sheet Has:			
		Net CV of R-o-U Asset**	$237,884.33	
		Total Liability	$265,370.33	

* Dr. = debit, Cr. = credit, as used to record accounting journal entries.
** CV of R-o-U Asset = carry value of right-of-use asset, as discussed in ASU 2016-02.

ers of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases."

To meet that objective, the Board decided to require qualitative disclosures along with specific quantitative disclosures (ASU 2016-02 section A, p. 6). They also provide a useful example of how a lessee may meet the new quantitative disclosure requirements in ASC 842-20-55-53.

The guidance in ASC 842 is effective for public business entities for annual periods beginning after December 15, 2018 (i.e., calendar periods beginning on January 1, 2019), and interim periods therein. For all other entities, ASC 842 is effective for annual periods beginning after December 15, 2019 (i.e., calendar periods beginning on January 1, 2020), and interim periods thereafter. Early adoption is permitted for all entities.

For the transition, FASB provides guidance ASC 842-10-65-1. As the Board summarizes this guidance, "In transition, lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach." A full retrospective approach is not allowed.

FIGURE 7.

As an operating lease:				
End Year 7	Dr.*	Lease Expense	$42,111.11	
		Cr* Lease Payable		$19,657.06
		Cr. Accumulated Amortization R-o-U Asset		$22,454.05
End Year 7	Balance Sheet Has:			
		Net CV of R-o-U Asset**	$267,259.22	***
		Total Liability	$265,370.33	

* Dr. = debit, Cr. = credit, as used to record accounting journal entries.
** CV of R-o-U Asset = carry value of right-of-use asset, as discussed in ASU 2016-02.
***Note at this point, after remeasurement the relationship between the carrying value of the right-of-use asset and the lease liability balance is no longer equal to the amount of initial direct costs that would yet to have been amortized to expense on a straight-line basis, if we were amortizing them separately.

The modified retrospective approach includes a number of optional practical expedients that entities may elect to apply. These practical expedients relate to the identification and classification of leases that commenced before the effective date, initial direct costs for leases that commenced before the effective date, and the ability to use hindsight in evaluating lessee options to extend or terminate a lease or to purchase the underlying asset.

"An entity that elects to apply the practical expedients will, in effect, continue to account for leases that commence before the effective date in accordance with previous GAAP unless the lease is modified, except that lessees are required to recognize a right-of-use asset and a lease liability for all operating leases at each reporting date based on the present value of the remaining minimum rental payments that were tracked and disclosed under previous GAAP" (ASU 2016-02, section A, p. 6). Ernst & Young (2017, January 16) provides some addition insights for the transition on its pages 282 and 283.

Given the availability of relatively clear guidance on presentation, disclosures and transition, along with the only incremental change to understanding how to record a lessee's lease contracts, reporting entities should move forward with confidence. Previous GAAP had already required lessees to know their full population of lease contracts, to determine for each lease whether they were to be categorized as a capital (now finance) or an operating lease and to provide disclosure for all their leases about their future cash flows.

In this light, the new GAAP could be looked at as moving operating lease information onto the balance sheet, while only slightly expanding the disclosures about them in the footnotes. This being the case, the new standard should not impose significantly higher costs on reporting entities.

Successful adoption will involve training up relevant staff and ensuring they are able to use existing systems and processes to deliver on the new reporting and disclosure requirements. Where necessary, information technology (IT) support may be enlisted.

It would be prudent to form cross-functional transition teams, including controllers, financial reporting, treasury and legal, and investor relations departments to assess the implications from increased asset and debt levels. Such a transition team could analyze issues such as:

- Whether any existing debt covenants would be violated, and how the organization can adapt to maintain compliance
- Whether the impact on financial statement balances and related metrics, such as return-on-assets (ROA), will be poorly received by the markets

Executive management and the board could use this transition team's findings to communicate with and decide the business's response to the impacts identified with relevant internal stakeholders, such as segment managers. The existence of issues, or lack thereof, may well shape a reporting entity's decision regarding its target transition date. Does it early adopt, as is allowed, or doesn't it?

As mentioned, on page 20 of the Ernst & Young and the Financial Executives Research Foundation (2016, June 16) publication, it would make a great deal of sense to have "dry runs" with "parallel reports," before going live. Ultimately, reporting entities need to be prepared to comply with the new GAAP and to communicate with and respond to feedback from relevant stakeholders.

CONCLUSION

As we have said, the central point of ASC 842 is that lessees need to recognize the assets and liabilities that arise from their leases. This is its primary improvement over previous GAAP, which did not require lease assets and lease liabilities to be recognized for many leases, despite the fact that lease contracts do create the equivalent of an asset and a liability, as they are defined in FASB Concepts Statement No. 6, Elements of Financial Statements.

For leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election, by class of underlying asset, not to recognize lease assets and lease liabilities.

The recognition, measurement, and presentation of expenses and cash flows arising from a lease by a lessee have not changed significantly from previous GAAP. Reporting entities will continue to make a distinction between a finance lease, formerly known as a capitalized lease and an operating lease.

The core difference from previous GAAP is that the lease assets and lease liabilities arising from operating leases get recognized on their balance sheet. A core similarity with previous GAAP is that operating leases are allowed to recognize the expense of the lease on a straight-line basis over the term of the lease.

It will be interesting to see how reporting entities and the capital markets respond to this new guidance, given its clear potential to impact the statement of financial position.

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CORRECTION

In the Winter 2016–2017 issue, Vol. 37, No. 2, we neglected to include the name of an author, Dr. Hui Di. She co-authored **A Practical Guide to Deferring Taxes When Replacing Business Property** with Dr. Steven Hanke. Both are on the faculty of the Department of Accounting and Finance, Indiana University-Purdue University Fort Wayne, Indiana.

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