TEACHING INTERMEDIATE ACCOUNTING: FASB'S SIMPLIFICATION INITIATIVE

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SIMPLIFICATION INITIATIVE

In June 2014, the Financial Accounting Standards Board (FASB) announced a Simplification Initiative with two related goals: reduce unnecessary complexity of financial reporting and improve (or at least maintain) its decision usefulness. Unlike many accounting pronouncements, most of these simplification projects are limited in scope and relatively short in duration (FASB 2014). Due to publishing cycles, Intermediate Accounting textbooks may not include these changes, although accounting professors should include them in their course materials. The purpose of this article is to highlight Simplification Initiative updates which are relevant to Intermediate Accounting I and/or II, as well as provide a brief perspective on other accounting changes which impact the courses.

ELIMINATION OF EXTRAORDINARY ITEMS

For over a half century, the accounting profession has been debating whether the income statement should focus on the results of current operations or should take an all-inclusive approach. The concept of extraordinary items was a compromise solution. It allowed the income statement to present current operating results first, followed by other items that would not be considered part of current operations.

Prior to Accounting Standards Update 2015-01, an event or transaction was presumed to be an ordinary and usual activity of the reporting entity unless evidence clearly supported its classification as an extraordinary item. Paragraph 225-20-45-2 of the Codification specified that extraordinary items must be both unusual in nature and infrequently occurring.

While stakeholders indicated they found information about unusual or infrequent events and transactions useful, they did not need the extraordinary item presentation to identify those events and transactions. Moreover, it is extremely rare in current practice for a transaction or event to meet the requirements to be presented as an extraordinary item.

For these reasons, Accounting Standards Update 2015-01 eliminates the concept of extraordinary items. These gains and losses will simply be included in the already existing categories of Other Gains and Revenues, or Other Losses and Expenses of the Income Statement on a before-tax basis. This Update will result in a further convergence of GAAP and IFRS.

The elimination of extraordinary items is effective for fiscal years beginning after December 15, 2015. An entity may apply this amendment retrospectively or prospectively, and early adoption is allowed. (FASB 2015)

Impact on Intermediate Accounting

- Income Statement: removal of extraordinary items as a “below the income tax line” item and inclusion as an “Other Gain” or “Other Loss” before Income Tax Expense
- Earnings per Share: no need to calculate extraordinary items on a per share basis
- IFRS: Extraordinary items no longer create a difference between US GAAP and IFRS

DEBT ISSUANCE COSTS

To simplify the presentation of debt issuance costs, Accounting Standards Update No. 2015 – 03 requires that costs related to a recognized debt liability be presented on the balance sheet as a direct deduction from the carrying amount of the debt liability. “This is consistent with the guidance in Concepts Statement 6, which states that debt issuance costs are similar to a debt discount and in effect reduce the proceeds of borrowing, thereby increasing the effective interest rate. Concepts Statement 6 further states that debt issuance costs are not assets because they provide no future economic benefit." Thus, the new approach prohibits debt issue costs from being presented on the balance sheet as an asset or a deferred charge.

Because the debt issuance costs will now be deducted to obtain the net proceeds of the debt, the effective rate of interest must be recalculated. For instance, assume a reporting entity issued $2,000,000 of 6%, 10 year bonds when the market interest rate was 6.5%. Interest is paid semiannually. The bonds would sell for $1,927,303, resulting in a discount on the bond issue. If there are $39,963 of bond issue costs incurred, the net proceeds would be further reduced to $1,887,340. The effective interest rate for the bond issue would now be 6.785%. The result on the income statement is that the bond issue costs are amortized using the effective interest method. Prohibiting debt issuance costs from being recorded as an asset and requiring it to be included in the effective interest on the debt increases the convergence of GAAP with IFRS.

For all business entities, these reporting requirements are effective for financial statements issued for fiscal years beginning after December 15, 2015. An entity should apply the new guidance on a retrospective basis, and early adoption is permitted. (FASB 2015)

<u>Impact on Intermediate Accounting</u>

- Long-term Liabilities: Debt issuance costs will be netted from the proceeds of the issuance and a new effective interest rate computed, rather than being recorded as a deferred charge on the balance sheet.
- IFRS: Debt issuance costs no longer create a difference between US GAAP and IFRS

CLASSIFICATION OF DEFERRED TAX ASSETS AND LIABILITIES

GAAP currently requires that firms classify deferred tax assets and liabilities as current or noncurrent, based on how the related assets or liabilities are classified. If a deferred tax asset or liability is not related to an asset or liability for financial reporting purposes (e.g., a deferred tax asset related to a net operating loss carryforward), the deferred tax asset or liability is classified as current or noncurrent based on the expected reversal date of the associated temporary difference.

However, stakeholders indicated that the requirement to divide deferred income tax assets and liabilities into current and non-current portions resulted in little or no benefit to users of financial statements since this classification does not generally align with the time period in which the recognized deferred tax amounts are expected to be recovered or settled. If there is any cost involved, the classification of deferred tax assets and liabilities into current and non-current portions would not meet the cost-benefit test. Thus, FASB issued Accounting Standards Update 2015-17 Income Taxes (Topic 740), *Balance Sheet Classification of Deferred Taxes*. This new standard requires all deferred tax assets and liabilities to be classified as noncurrent on the balance sheet, as well as any related valuation allowances. The new classification of deferred tax assets and liabilities converges with IFRS.

This requirement is effective for annual periods beginning after December 15, 2016. Earlier application is permitted. This standard may be applied either prospectively to all deferred tax liabilities and assets or retrospectively to all periods presented. (FASB 2015).

Impact on Intermediate Accounting

- Deferred Income Taxes: all deferred tax assets and liabilities as well as their valuation allowances will be classified as long-term on the balance sheet.
- IFRS: Classification of deferred tax assets and liabilities no longer creates a difference between US GAAP and IFRS.

DEBT CLASSIFICATION

The Board received input from stakeholders that guidance on balance sheet classification of debt is unnecessarily complex. FASB tentatively decided to simplify the existing debt classification guidance in Accounting Standards Codification (ASC) 470-10-451 by replacing it with a cohesive principle for determining whether debt should be classified as current or noncurrent on the balance sheet. The Board directed the staff to draft guidance in a proposed Accounting Standards Update for vote by written ballot, with a comment period of 60 days.

Work on the proposal to date stipulates that an entity should classify a debt as noncurrent if one or both of the following criteria are met as of the balance sheet date:

- The liability is contractually due to be settled more than 12 months (or operating cycle, if longer) after the balance sheet date
- The entity has a contractual right to defer settlement of the liability for at least 12 months (or operating cycle, if longer) after the balance sheet date.

Thus, decisions about the classification of debt will be made based on facts and circumstances that exist as of the reporting date (that is, as of the balance sheet date). The guidance would apply to all debt arrangements, including convertible debt and mandatorily redeemable financial instruments that are accounted for as liabilities. This treatment would eliminate the reclassification from current to noncurrent of current liabilities expected to be refinanced in the upcoming accounting period. Since IFRS has no provision for current liabilities expected to be refinanced, this change would increase convergence with IFRS.

An effective date has not been specified, but will be forthcoming when the Board votes on the final proposal. In the first interim and annual financial statements following the effective date, an entity would apply the proposed amendments on a prospective basis to all debt that exists as of that date (FASB 2015).

Impact on Intermediate Accounting

- Balance Sheet: simplifies classification of liabilities based on facts in existence at the balance sheet date
- Current Liabilities: opportunity to reclassify short-term debt expected to be refinanced no longer exists

INVENTORY VALUATION

A long-standing accounting requirement is that inventories be valued at the lower of cost or market as of balance sheet date. Currently, market is defined as the median value among replacement cost, net realizable value (ceiling), or net realizable value less a normal profit margin (floor). In Accounting Standards Update 2015-11, FASB simplifies the lower of cost or market analysis by requiring that inventory should be measured at the lower of cost or net realizable value. Thus, reporting entities would no longer consider replacement cost or net realizable value less a normal profit margin when applying the lower of cost or market rule. Inventory measured using the last-in, first-out (LIFO) and retail inventory methods would be exempt from this requirement. This change increases the convergence of GAAP and IFRS with respect to the measurement of inventory.

Business entities will be required to apply the amendments in annual reporting periods beginning after December 15, 2016. Prospective application of this standard is required, and early application is permitted (FASB 2015).

Impact on Intermediate Accounting

- Inventory: valuation of inventory at balance sheet date is now the lower of cost or net realizable value. There is no need to compute three measures of the market value and then choose the median to compare to cost.
- IFRS: Inventory valuation no longer creates a difference between US GAAP and IFRS.

ADDITIONAL IMPORTANT FASB UPDATES

Although they are beyond the scope of this paper to discuss fully, there are other recent FASB Updates professors teaching Intermediate Accounting should keep in mind as they prepare for their classes. These Updates are not part of the Simplification Initiative due to their broad scope and complexity.

Investments

The FASB and the IFSB have been involved in a joint project for nearly ten years to improve accounting for financial instruments. Accounting Standards Update 2016-01 includes targeted improvements regarding both financial assets and financial liabilities. One such financial asset is equity investments accounted for at fair value (rather than those accounted for under the equity method).

Briefly stated, the guidance in Accounting Standards Update 2016-01 will eliminate categorizing investments as either trading or available for sale. Classification as current or long-term will remain appropriate. In addition, holding gains and losses will all be reflected in earnings, rather than certain holding gains and losses being a component of other comprehensive income. These changes directly impact teaching accounting for investments, as well as the classified balance sheet, income statement, statement of comprehensive income, and stockholders equity. For example, the typical example given in Intermediate I as an item in other comprehensive income is holding gains/losses on available-for-sale securities.

Accounting Standards Update 2016-01 is effective for fiscal years beginning after December 15, 2017 and early adoption is permitted only under limited circumstances. The amendment will be applied through a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The amendments in Accounting Standards Update 2016-01 provide some convergence with IFRS, but not full convergence due to cost-benefit considerations (FASB 2016).

Leases

Changes to lease accounting have been excected for several years, and the new standards have been issued in Accounting Standards Update 2016-02. The most sweeping changes are concerned with lessee accounting. For all leases, the lessee will recognize a lease asset and lease liability. However, for leases whose term is 12 months or less, the lessee can make an accounting policy election not to record the asset and liability for all such leases (rather than on a case-by-case basis). Lessor accounting is largely unchanged from prior standards, other than conforming lease accounting to new revenue recognition standards. The amendments in this Update are effective for fiscal years beginning after December 15, 2018, and early adoption is permitted. Accounting Standards Update 2016-02 increases convergence with IFRS, but there are still some material differences (FASB 2016). Intermediate Accounting professors will need to make a detailed study of the new standard.

Revenue Recognition

On May 28, 2014, the FASB and the IASB issued a converged standard on recognition of revenue from contracts with customers. Since that time, the FASB has continued to issue more detailed guidance on various implementation issues related to revenue recognition. For instance, during 2016 Accounting Updates have been issued regarding collectibility, transition guidance, licensing, agent vs. principal considerations, and others. Most Intermediate Accounting textbooks will include the new revenue recognition standard, Update No. 2014-09-Revenue from Contracts with Customers, but professors should be at least somewhat conversant with these further nuances which have been issued recently.

CONCLUSION

The FASB's Simplification Initiative intends to provide financial reporting that is more understandable and transparent, as well as less costly to prepare. The specific projects presented above will streamline reporting for these various topics, often based on input from financial statement users. Although convergence with IFRS is not a stated goal of the Simplification Initiative, each Update from the Simplification Initiative has increased convergence with IFRS. Internationally uniform financial reporting standards is yet another type of simplicity that is desirable. While somewhat modest in scope, these financial reporting changes are evidence of a responsive, proactive standard-setting body. Accounting professors in Intermediate I and II will need to keep these changes and their effective dates in mind as they go forward into the 2016-17 academic year.

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