Disclosure—
The Key to Financial Statements

(DKFS4)

KAPLAN

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DISCLOSURE—THE KEY TO FINANCIAL STATEMENTS (DKFS4)

Published in 2022 by Kaplan Financial Education.

ISBN: 978-1-0788-2452-1

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Unit 1

Introduction

LEARNING OBJECTIVE

When you have completed this unit, you will be able to accomplish the following.

- Identify and describe current developments in accounting that will impact financial statement disclosures.

TOPICS

1. Introduction
2. General Disclosure Requirements
3. Balance Sheet and Related Disclosures
4. Income Statement Disclosures
5. Statement of Cash Flow Disclosures

PRIMARY FOCUS IS GAAP

The primary focus of this seminar is U.S. financial reporting disclosures as described in the FASB Codification. These disclosures are required for general purpose financial statement presentations for reporting entities that are a going concern. Included will be disclosures required for public and non-public entities with discussion of GAAP disclosure alternatives available for non-public entities.

This course manual contains the following information:

- A brief discussion of the accounting topics requiring financial statement disclosures as well as the actual disclosure requirements. Although the text does discuss selected accounting requirements, it is not intended to be an all-inclusive discussion of the topics covered. A best practice is to always review an accounting topic in the FASB Codification before preparing the financial statements.

- Sample disclosures. Each section includes illustrative disclosures presented in the notes or presentation requirements in the financial statements.

- Many of the sample disclosures are actual financial statement disclosures published by public and private companies in order to demonstrate best practices in applying the disclosure requirements.

Preparers of financial statements usually rely on certain practice aids that serve as "memory joggers" and provide illustrative examples that reflect "best practices" and ensure compliance with the extensive and complex GAAP disclosure requirements. These include:

1. **Disclosure checklists** – These checklists are designed to include virtually every disclosure that may be required under the circumstances. They are often set up to include a comprehensive checklist of issues that are likely to apply to most entities, along with supplements to be used if special situations apply – such as business combinations, going concern, stock-based compensation, etc. If the reporting entity operates in a specialized industry, a specialized disclosure checklist might be necessary.

   It is important to use these checklists in a meaningful way. Unfortunately, a careful review of many completed checklists will reveal incorrect answers, including "not applicable" when an item is present. Or, the prior period footnotes may be copied onto the current year statements, and a disclosure checklist completed without careful comparison with the notes to see if all required disclosures are actually included. (This is how errors that occur once are repeated year after year.)

   Ideally, checklists should include authoritative references to simplify further research. They should also be comprehensive enough to guide the preparer. For example, if a disclosure checklist asks "Are related party transactions adequately disclosed?" There is not enough information to know *what* should be disclosed.

2. **Publications with sample financial statements and footnotes** – Publishers such as the AICPA and PPC offer resources that provide illustrative examples arranged by topic.

3. **Annual reports of public companies** – Internet searches of public company reports can provide useful examples of presentation and disclosure. This is especially useful when new standards are implemented earlier by public entities; the delay for non-public entities means that examples will be available when a private company must apply a new standard for the first time.

Special Purpose Frameworks

There is no authoritative guidance on financial statements prepared under special purpose frameworks (SPFs). The AICPA has issued many memorandums and practice aids on how to prepare SPF financial statements. Regarding disclosures, they say that disclosures are divided into three categories depending on if they are related to elements that are.

- **Equivalent** to GAAP,

- Those that are **similar** but not equivalent to GAAP, and

- Those that **do not have a GAAP equivalency**

For elements that are calculated equivalent to GAAP, disclosures should include the same information as GAAP requires. They don't need to follow GAAP formats. For example, GAAP requires for long term debt that the principal payments for the next five years be presented in tabular format. In a SPF disclosure, the information must be given but is not required to be in tabular format

For elements that are similar but computed differently than GAAP, the disclosure must **communicate the substance** of GAAP disclosures. In cases where the SPF does not include a GAAP equivalency, no disclosure is required. For example, since tax basis financial statements do not use fair value accounting, accounting for income taxes, and variable interest entities, no disclosure in those areas are necessary.

CURRENT DEVELOPMENTS IN ACCOUNTING AND DISCLOSURE

Status of Recent FASB Projects

Revenue from Contracts with Customers

ASU 2014-09, as amended (Topic 606), was effective for public companies for the period beginning after December 15, 2017, and for non-public entities for the period beginning after December 15, 2019. In general, this new revenue guidance applies to a reporting entity that enters into contracts with customers, excluding contracts that are within the scope of other FASB topics.

Topic 606 provides the following guidance to companies as to when revenue is recognized:

> "[A]n entity shall recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled to in exchange for those goods or services"

Topic 606 introduces a 5-step model for revenue recognition, replacing the four-step model in legacy GAAP which emphasized the earning process being substantially complete:

1. Identify the contract(s) with customers

2. Identify the performance obligation(s) in the contract

3. Determine the transaction price

4. Allocation the transaction price to the performance obligations in the contract

5. Recognize revenue when (or as) the entity satisfies a performance obligation – transfer of control

The standard is principals based and requires professional judgement in nearly every step. As such, disclosures should include the policies adopted and judgements made. In general, the following revenue disclosures are required:

- Revenue recognized from contracts with customers, including the disaggregation of revenue into relevant categories

- Contract balances, including the opening and closing balances of receivables, contract assets, and contract liabilities

- Performance obligations, including when the reporting entity typically satisfies its performance obligations and the transaction price that is allocated to the remaining performance obligations in a contract

- Significant judgments, and changes in judgments, made in applying the requirements to those contracts

Leases

ASU 2016-02, as amended (Topic 842) was effective for public companies for periods beginning after December 15, 2018, and is effective for non-public entities for periods beginning after December 15, 2021 (per ASU 2020-05).

When a reporting entity first applies Topic 842, the entity should recognize and measure leases within the scope of Topic 842 as determined by the transition method that the entity elects. A reporting entity should apply Topic 842 using one of the following two methods:

1. Retrospectively to each prior reporting period presented in the financial statements with the cumulative effect of initially applying Topic 842 recognized at the beginning of the earliest comparative period presented. Under this transition method, the application date should be the later of the beginning of the earliest period presented in the financial statements and the commencement date of the lease.

2. Modified retrospective at the beginning of the period of adoption through a cumulative-effect adjustment. In the period of adoption, the entity does not apply Topic 842 to prior-period financial statements that are presented on a comparative basis in conjunction with the current-period financial statements. Under this transition method, the application date should be the beginning of the reporting period in which the entity first applies Topic 842. Note, most SEC registrants in 2019 used the modified retrospective approach when applying Topic 842.

In this guidance, a lease is defined as a contract or part of a contract that conveys the right to control the use of an identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.

For lessees, following the guidance in Topic 842, all long-term leases (lease term for more than 12 months) are recorded on the statement of financial position at the present value of the remaining lease payments by making the following journal entry:

Dr: Right-of-Use Asset (RoU)

Cr: Lease Payment Liability

Long-term leases are classified as either finance or operating. A lessee will classify a lease as a finance lease when the lease contract meets any of the following criteria at the lease commencement date:

- Transfer of ownership
- Option to purchase the underlying asset (reasonably certain)
- Lease term is for a major part of the remaining economic life of the underlying asset
- Present value of the sum of the lease payments and any residual value guaranteed by the lessee equals or exceeds the total fair value of the underlying asset
- Underlying asset is of such a specialized nature only the lessee can benefit from the asset

If none of the criteria above are met, then the lease is classified as an operating lease. The only difference in the accounting for finance leases and operating leases is the **pattern of expense** recognition. Finance leases amortize the RoU asset on a straight line basis and amortize the lease payment liability of an effective interest basis. Operating leases recognize a single lease cost on a straight line basis throughout the lease period.

Lessee disclosures are similar to the lease disclosures in legacy GAAP.

Financial Instruments

FASB's financial instrument project has resulted in three financial instrument ASUs:

1. ASU 2016-01, *Financial Instruments – Overall* (Subtopic 825-10): *Recognition and Measurement of Financial Assets and Financial Liabilities*, effective for public companies for periods beginning after December 15, 2017, and for all other entities for periods beginning after December 15, 2018.

2. ASU 2016-13, *Financial Instruments – Credit Losses* (Topic 326): *Measurement of Credit Losses on Financial Instruments*, effective for public companies for periods beginning after December 15, 2019, and for all other entities for periods beginning after December 15, 2022.

3. ASU 2017-12, *Derivatives and Hedging* (Topic 815): *Targeted Improvements to Accounting for Hedging Activities*, effective for public companies for periods beginning after December 15, 2018, and for all other entities for periods beginning after December 15, 2019.

The primary changes to GAAP resulting from these three financial instrument ASUs include the following:

1. ASU 2016-01 creates new codified guidance, Topic 321, *Investments-Equity Securities,* requiring reporting entities to measure and recognize all equity investments at fair value. Trading and available for sale classifications are no longer available for equity investments.

2. ASU 2016-13 provides financial statement users with more decision-useful information about a reporting entity's expected credit losses. Reporting entities are now required to measure credit losses on financial instruments (including trade receivables) by developing credit losses by evaluating past events, current conditions, and future cash flow expectations. The addition of future cash flow expectations is expected to result in more-timely reporting of credit losses.

3. ASU 2017-12 requires a reporting entity to increase their risk management economic activity disclosures and it simplifies and improves hedging transparency and understandability. ASU

2017-12 recognizes that hedging can be an effective risk minimization strategy for companies and creates a less burdensome approach to developing hedging relationships.

Consolidation

FASB has proposed rewriting and reorganizing Topic 810, *Consolidation.* The Board has issued a proposed Update (Topic 812) in response to stakeholders' concerns that the consolidation guidance in Topic 810 as currently organized is difficult to understand and navigate. To address those concerns, the amendments in the proposed Update would reorganize and clarify certain items within the consolidation guidance.

The amendments would affect the organization of the consolidation guidance and would clarify certain items within that guidance. Specifically, the consolidation guidance currently in Topic 810 would be reorganized into a new Topic (Topic 812), with separate Subtopics for variable interest entities (VIEs) and voting interest entities (Subtopics 812-20, *Consolidation—Variable Interest Entities*, and 812-30, *Consolidation—Voting Interest Entities*, respectively). Certain areas of the guidance would also be clarified to make the consolidation guidance easier to understand without the intent of (a) changing analyses performed or (b) outcomes currently reached by stakeholders.

As of this writing, FASB expects to issue this consolidation guidance in 2021.

FASB's Simplification Initiative

In 2014, The FASB launched the Simplification Initiative. The purpose of FASB's Simplification Initiative is to make narrow-scope simplifications and improvements to issued accounting topics through a series of short-term projects. These projects are intended to improve or maintain the usefulness of the information reported to users while reducing costs and complexity in financial reporting. To date, these Simplification Initiatives have resulted in the following ASUs issued:

- ASU 2014-08 – *Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity*

- ASU 2014-10 – *Development Stage Entities: Elimination of Certain Financial Reporting Requirements, Including an Amendment to Variable Interest Entity Guidance*

- ASU 2015-01 – *Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items*

- ASU 2015-03 – *Simplifying the Presentation of Debt Issuance Costs*

- ASU 2015-04 – *Practical Expedient for the Measurement Date of an Employer's Defined Benefit Obligation and Plan Assets*

- ASU 2015-05 – *Customer's Accounting for Fees Paid in a Cloud Computing Arrangement*

- ASU 2015-11 – *Simplifying the Measurement of Inventory*

- ASU 2015-12 – *Measurement Date of Defined Benefit Pension Plans*

- ASU 2015-16 – *Simplifying the Accounting for Measurement Period Adjustments*

- ASU 2015-17 – *Balance Sheet Classification of Deferred Taxes*
- ASU 2016-07 – *Simplifying the Transition to the Equity Method of Accounting*
- ASU 2016-09 – *Improvements to Employee Share-Based Payment Accounting*
- ASU 2016-16 – *Intra-Entity Transfers of Assets Other Than Inventory*
- ASU 2017-11 – *Liabilities and Equity – Targeted Improvements*
- ASU 2018-07 – *Improvements to Non-Employee Share-Based Payment Accounting*
- ASU 2018-15 – *Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That is a Service Contract*
- ASU 2018-17 – *Targeted Improvements to Related Party Guidance for Variable Interest Entities*
- ASU 2018-18 – *Collaborative Arrangements*
- ASU 2018-20 – *Leases (Topic 842): Narrow-Scope Improvements for Lessors*
- ASU 2019-12 – *Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes*
- ASU 2020-06 – *Accounting for Convertible Instruments (Topic 470) and Contracts in an Entity's Own Equity (Topic 815)*

FASB CODIFICATION

When it is necessary to consult the GAAP literature to prepare financial statements and disclosures, the Codification is now the sole authoritative source for such research. Its contents may be accessed through a subscription to the FASB portal directly, or through various other vendors as part of their research "packages."

Codification content is arranged by topic, subtopic, and section. Topics are organized under the following areas:

- Section 100 – General Principles
- Section 200 – Presentation
- Section 300 – Assets
- Section 400 – Liabilities
- Section 500 – Equity
- Section 600 – Revenue
- Section 700 – Expenses
- Section 800 – Broad Transactions

- Section 900 – Specialized Industries

The numbering scheme is XXX-YY-ZZ, where XXX is topic, YY is subtopic (unique numbering for each topic, except that subtopic number 10 is always "overall"), and ZZ is section. *Section numbers are standardized. The most relevant sections when researching disclosures are number 50 – Disclosure, and number 55 – Implementation Guidance, but number 45 – Presentation – is also relevant.*

ASC Topic List

100	General Principles	800	Broad Transactions
105	Generally Accepted Accounting Principles	805	Business Combinations
		808	Collaborative Arrangements
200	Presentation	810	Consolidation
205	Presentation of Financial Statements	815	Derivatives and Hedging
210	Balance Sheet	820	Fair Value Measurements and Disclosures
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225	Income Statement	835	Interest
230	Statement of Cash Flows	840	Leases
235	Notes to Financial Statements	842	Leases
250	Accounting Changes and Error Corrections	845	Nonmonetary Transactions
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260	Earnings Per Share	852	Reorganizations
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		908	Airlines
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310	Receivables	920	Entertainment – Broadcasters
320	Investments – Debt and Equity Securities	922	Entertainment – Cable Television
321	Investments – Equity Securities	924	Entertainment – Casinos
323	Investments – Equity Method and Joint Ventures	926	Entertainment – Films

325	Investments – Other	928	Entertainment – Music
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330	Inventory	932	Extractive Activities – Oil and Gas
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350	Intangibles – Goodwill and Other	942	Financial Services – Depository and Lending
360	Property, Plant, and Equipment	944	Financial Services – Insurance
		946	Financial Services – Investment Companies
400	Liabilities	948	Financial Services – Mortgage Banking
405	Liabilities	950	Financial Services – Title Plant
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420	Exit or Disposal Cost Obligations	954	Health Care Entities
430	Deferred Revenue	958	Not-for-Profit Entities
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450	Contingencies	962	Plan Accounting – Defined Contribution Pension Plans
460	Guarantees	965	Plan Accounting – Health and Welfare Benefit Plans
470	Debt	970	Real Estate – General
480	Distinguishing Liabilities from Equity	972	Real Estate – Common Interest Realty Associations
		974	Real Estate – Real Estate Investment Trusts
500	Equity	976	Real Estate – Retail Land
505	Equity	978	Real Estate – Time-Sharing Activities
		980	Regulated Operations
600	Revenue	985	Software
605	Revenue Recognition – extant	995	U.S. Steamship Entities
606	Revenue from Contracts with Customers		
700	Expenses		
705	Cost of Sales and Services		
710	Compensation – General		

712	Compensation – Nonretirement Postemployment Benefits		
715	Compensation – Retirement Benefits		
718	Compensation – Stock Compensation		
720	Other Expenses		
730	Research and Development		
740	Income Taxes		

ASC Section List

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10	Objectives	50	Disclosure
15	Scope and Scope Exceptions	55	Implementation Guidance and Illustrations
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30	Initial Measurement	70	Grandfathered Guidance
35	Subsequent Measurement	75	XBRL Definitions
40	De-recognition		

Unit

2

General Disclosure Requirements

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- Identify and describe the general presentation and disclosure requirements required by the FASB Codification for general purpose financial statements.
- Review "live" financial statement disclosures to demonstrate disclosure best practices.

DISCLOSURE METHODS

Disclosures necessary for financial statements to be presented in accordance with GAAP include:

- Disclosures required by specific authoritative pronouncements
- Disclosures that are "generally accepted"
- Additional disclosures necessary to prevent the financial statements from being misleading

Basic Financial Statements

1. Body of Financial Statements
   - Titles and Classifications
   - Parenthetical Disclosures
2. Notes to Financial Statements

Information Presented in Supplemental Data

1. Supporting Schedules

   (e.g., schedule of operating expenses; 5-year summary information)

2. Supplementary Statements

   (e.g., consolidating statements for a parent and subsidiaries)

Supplemental data is, by definition, *not* required, and therefore does not count in terms of meeting GAAP disclosure requirements, but may be informative and useful. (There are isolated cases where certain supplemental data **is** required by industry standards or regulators.) CAUTION: If GAAP-required disclosures are presented only in supplementary schedules, this is a disclosure deficiency (i.e., the data must be in the notes to the financial statements).

SIGNIFICANT ACCOUNTING POLICIES

Subtopic 235-10, *Notes to Financial Statements*

The Topic indicates that the accounting policies of a reporting entity are the specific accounting principles and the methods of applying those principles that are judged by the management of the entity to be the most appropriate to present fairly the financial position, cash flows, and results of operations in accordance with GAAP.

Topic 235 requires a company's significant accounting policies to be disclosed. This disclosure should be labeled "Summary of Significant Accounting Policies" and should either precede the notes or be the first note. This disclosure should include important judgments made by management concerning principles relating to recognition of revenue and allocation of asset costs to current and future periods, specifically:

- A selection from existing acceptable alternatives (e.g., FIFO, LIFO)
- Principles and methods peculiar to the industry the entity operates, even if such principles and methods are predominantly followed in that industry
- Unusual or innovative applications of GAAP

Examples of disclosures by a reporting entity that are commonly included in accounting policies notes include:

- Basis of consolidation
- Depreciation methods
- Amortization of intangibles
- Inventory pricing
- Recognition of revenue from contracts with customers

- Recognition of revenue from leasing operations

Practical Considerations

Level of Detail: Information included in the policies note should not be detailed and should not repeat information disclosed elsewhere in the financial statements and notes. As a result, a general policy may be described in this note, with more detailed information for the same financial statement item presented in another, separate footnote.

A "rule of thumb" for the policy note is to avoid dollar amounts. But as a practical matter, dollar amounts are sometimes included to avoid having a separate note that would include only one sentence with the amount. An example would be advertising, where the only required disclosure beyond the accounting policy is to disclose the amount of expense for the period; many companies simply include this with the policy note.

Descriptions of GAAP Rules: It is increasingly common to see a lengthy description of GAAP requirements in the policy notes of public companies; so it is natural to ask whether this is required for private companies. The short answer is "no."

A sample policy footnote is presented below.

EXAMPLE

Note 1: Summary of Significant Accounting Policies

Revenue from Contracts with Customers – The Company is in the business of providing consumer products, transportation and energy services to customers located in North America, Europe, and Asia. The business is broken down into seven major goods and service lines. Goods are generally transferred at a point in time whereas services may be transferred to customers both at a point in time or over time. Revenue from contracts with customers in the current fiscal year totaled $120,000,000.

Consolidation – The consolidated financial statements include the accounts of the Company and its majority-owned subsidiary. All material intercompany accounts and transactions have been eliminated.

Investment in Affiliate – The Company's investment in an unconsolidated affiliate is accounted for under the equity method.

Use of Estimates – The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Accounts Receivable – The Company carries its accounts receivable at cost less an allowance for doubtful accounts. Periodically, the Company evaluates its accounts receivable and establishes an allowance for doubtful accounts based on historical experience with bad debts and collections, as well as current credit conditions.

Interest is accrued on receivables considered past due at the rate of 1% per month, starting 30 days after the payment due date. Accounts on which payments have not been received by the company for 90 days are turned over for collection. Accounts are written off as uncollectible if no payments are received 90 days after they have been turned over for collection.

Property and Equipment – Property and equipment are carried at cost. Depreciation is determined using accelerated and straight-line methods over the estimated useful lives of the property. Maintenance and repairs that do not materially improve or extend the lives of the respective assets are expensed as incurred.

Intangibles and Other Assets – The acquisition cost of customer lists is amortized over five years on a straight-line basis. Deferred financing costs are amortized using the interest method over the terms of the related debt.

Inventories – Inventories are valued at the lower of cost or market, with cost determined on the first-in, first-out method.

Income Taxes – Deferred taxes are provided for temporary differences in the bases of assets and liabilities for financial and tax purposes, and arise principally from methods used for depreciation, capitalization of costs in inventory, and certain accrued expenses.

The Company classifies interest accrued on unrecognized tax benefits with interest expense and penalties thereon with operating expenses. The Company's tax returns since 201X generally remain open to possible examination.

Cash Equivalents – The Company considers all highly-liquid debt instruments with an original maturity of three months or less to be cash equivalents.

Advertising – The Company expenses advertising costs when the advertising first takes place, except for direct-response advertising.

Direct-response advertising consists primarily of print advertisements with coupons for the company's products. The cost of these ads is capitalized and amortized over a six-month period following publication, based on expiration of the coupons.

Shipping and Handling Costs – Shipping costs billed to customers are included in sales. Shipping and handling costs are included in cost of goods sold.

Sales Tax – Sales tax collected from customers is recorded as a liability, pending remittance to the taxing jurisdiction. Consequently, sales taxes have been excluded from revenues and costs ("net method").

Subsequent Events – The Company has evaluated subsequent events through March 11, 20X5, the date the financial statements were available to be issued.

Reclassifications – Certain reclassifications have been made to 20X3 amounts in the accompanying financial statements to conform to the 20X4 presentation.

Summary of Significant Accounting Policies

Ford Motor Company

Annual Report

December 31, 2019

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

For each accounting topic that is addressed in its own note, the description of the accounting policy may be found in the related note. Other significant accounting policies are described below.

Use of Estimates

The preparation of financial statements requires us to make estimates and assumptions that affect our results. Estimates are used to account for certain items such as marketing accruals, warranty costs, employee benefit programs, etc. Estimates are based on assumptions that we believe are reasonable under the circumstances. Due to the inherent uncertainty involved with estimates, actual results may differ.

Foreign Currency

We remeasure monetary assets and liabilities denominated in a currency that is different than a reporting entity's functional currency from the transactional currency to the legal entity's functional currency. The effect of this remeasurement process and the results of our foreign currency hedging activities are reported in *Cost of sales* and *Other income/(loss), net* and were $307 million, $(121) million, and $108 million, for the years ended 2017, 2018, and 2019, respectively.

Generally, our foreign subsidiaries use the local currency as their functional currency. We translate the assets and liabilities of our foreign subsidiaries from their respective functional currencies to U.S. dollars using end-of-period exchange rates. Changes in the carrying value of these assets and liabilities attributable to fluctuations in exchange rates are recognized in *Foreign currency translation*, a component of *Other comprehensive income/(loss), net of tax*. Upon sale or upon complete or substantially complete liquidation of an investment in a foreign subsidiary, the amount of accumulated foreign currency translation related to the entity is reclassified to income and recognized as part of the gain or loss on the investment.

Cash Equivalents

Cash and cash equivalents are highly liquid investments that are readily convertible to known amounts of cash and are subject to an insignificant risk of change in value due to interest rate, quoted price, or penalty on withdrawal. A debt security is classified as a cash equivalent if it meets these criteria and if it has a remaining time to maturity of three months or less from the date of acquisition. Amounts on deposit and available upon demand, or negotiated to provide for daily liquidity without penalty, are classified as *Cash and cash equivalents*. Time deposits, certificates of deposit, and money market accounts that meet the above criteria are reported at par value on our consolidated balance sheet.

Restricted Cash

Cash and cash equivalents that are restricted as to withdrawal or use under the terms of certain contractual agreements are recorded in *Other assets* in the non-current assets section of our consolidated balance sheet. Our Automotive segment restricted cash balances primarily include various escrow agreements related to legal, insurance, customs, and environmental matters. Our Ford Credit segment restricted cash balances primarily include cash held to meet certain local governmental and regulatory reserve requirements and cash held under the terms of certain contractual agreements. Mobility segment restricted cash balances primarily include cash held under the terms of certain contractual agreements. Restricted cash does not include required minimum balances or cash securing debt issued through securitization transactions.

Marketable Securities

Investments in securities with a maturity date greater than three months at the date of purchase and other securities for which there is more than an insignificant risk of change in value due to interest rate, quoted price, or penalty on withdrawal are classified as *Marketable securities*.

Realized gains and losses and interest income on all of our marketable securities and unrealized gains and losses on securities not classified as available for sale are recorded in *Other income/(loss), net*. Unrealized gains and losses on available for sale securities are recognized in *Unrealized gains and losses on securities*, a component of *Other comprehensive income/(loss), net of tax*. Realized gains and losses and reclassifications of accumulated other comprehensive income into net income are measured using the specific identification method.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(Continued)*

On a quarterly basis, we review our available-for-sale securities for impairment. If we conclude that any of these investments are impaired, we determine whether such impairment is other-than-temporary. Factors we consider to make such determination include the duration and severity of the impairment, the reason for the decline in value, and the potential recovery period and our intent to sell. If any impairment is considered other-than-temporary, we will write down the asset to its fair value and record the corresponding charge in *Other income/(loss), net.*

Trade Receivables

Trade and other receivables consists primarily of Automotive segment receivables from contracts with customers for the sale of vehicles, parts, and accessories. Trade receivables initially are recorded at the transaction amount and are typically outstanding for less than 30 days. Each reporting period, we evaluate the collectibility of the receivables and record an allowance for doubtful accounts representing our estimate of the probable losses. Additions to the allowance for doubtful accounts are made by recording charges to bad debt expense reported in *Selling, administrative, and other expenses.*

Net Intangible Assets and Goodwill

Indefinite-lived intangible assets and goodwill are not amortized but are tested for impairment annually or more frequently if events or circumstances indicate the assets may be impaired. Goodwill impairment testing is also performed following an allocation of goodwill to a business to be disposed or a change in reporting units. We test for impairment by assessing qualitative factors to determine whether it is more likely than not that the fair value of the indefinite-lived intangible asset or the reporting unit allocated the goodwill is less than its carrying amount. If the qualitative assessment indicates a possible impairment, the carrying value of the asset or reporting unit is compared with its fair value. Fair value is measured relying primarily on the income approach by applying a discounted cash flow method, the market approach using market values or multiples, and/or third-party valuations. We capitalize and amortize our finite-lived intangible assets over their estimated useful lives.

Intangible assets are comprised primarily of licensing and advertising agreements, land rights, patents, customer contracts, and technology. The net carrying amount of our intangible assets was $178 million and $188 million at December 31, 2018 and 2019, respectively.

The net carrying amount of goodwill was $264 million and $278 million at December 31, 2018 and 2019, respectively.

For the periods presented, we have not recorded any material impairments for indefinite-lived intangibles or goodwill.

The carrying amount of intangible assets and goodwill is reported in *Other assets* in the non-current assets section of our consolidated balance sheet.

Held-and-Used Long-Lived Asset Impairment

We test long-lived asset groups for recoverability when changes in circumstances indicate the carrying value may not be recoverable. Events that trigger a test for recoverability include material adverse changes in projected revenues and expenses, present cash flow losses combined with a history of cash flow losses and a forecast that demonstrates significant continuing losses, significant negative industry or economic trends, a current expectation that a long-lived asset group will be disposed of significantly before the end of its useful life, a significant adverse change in the manner in which an asset group is used or in its physical condition, or when there is a change in the asset grouping. When a triggering event occurs, a test for recoverability is performed, comparing projected undiscounted future cash flows to the carrying value of the asset group. If the test for recoverability identifies a possible impairment, the asset group's fair value is measured relying primarily on a discounted cash flow method. To the extent available, we will also consider third-party valuations of our long-lived assets that were prepared for other business purposes. An impairment charge is recognized for the amount by which the carrying value of the asset group exceeds its estimated fair value. When an impairment loss is recognized for assets to be held and used, the adjusted carrying amount of those assets is depreciated over their remaining useful life. For the periods presented, we have not recorded any impairments.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(Continued)*

Held-for-Sale Asset Impairment

We perform an impairment test on a disposal group to be discontinued, held for sale, or otherwise disposed when we have committed to an action and the action is expected to be completed within twelve months. We estimate fair value to approximate the expected proceeds to be received, less cost to sell, and compare it to the carrying value of the disposal group. An impairment charge is recognized when the carrying value exceeds the estimated fair value (see Note 24).

Fair Value Measurements

We measure fair value of our financial instruments, including those held within our pension plans, using various valuation methods and prioritize the use of observable inputs. The use of observable and unobservable inputs and their significance in measuring fair value are reflected in our fair value hierarchy.

- Level 1 - inputs include quoted prices for identical instruments and are the most observable
- Level 2 - inputs include quoted prices for similar instruments and observable inputs such as interest rates, currency exchange rates, and yield curves
- Level 3 - inputs include data not observable in the market and reflect management judgment about the assumptions market participants would use in pricing the instruments

Fixed income securities, equities, commingled funds, derivative financial instruments, and alternative assets are remeasured and presented within our consolidated financial statements at fair value on a recurring basis. Finance receivables and debt are measured at fair value for the purpose of disclosure. Other assets and liabilities are measured at fair value on a nonrecurring basis.

Transfers into and transfers out of the hierarchy levels are recognized as if they had taken place at the end of the reporting period.

Valuation Method

Fixed Income Securities. Fixed income securities primarily include government securities, government agency securities, corporate bonds, and asset-backed securities. We generally measure the fair value using prices obtained from pricing services or quotes from dealers that make markets in such securities. Pricing methods and inputs to valuation models used by the pricing services depend on the security type (i.e., asset class). Where possible, fair values are generated using market inputs including quoted prices (the closing price in an exchange market), bid prices (the price at which a buyer stands ready to purchase), and other market information. For fixed income securities that are not actively traded, the pricing services use alternative methods to determine fair value for the securities, including quotes for similar fixed income securities, matrix pricing, discounted cash flow using benchmark curves, or other factors. In certain cases, when market data are not available, we may use broker quotes or pricing services that use proprietary pricing models to determine fair value. The proprietary models incorporate unobservable inputs primarily consisting of prepayment curves, discount rates, default assumptions, recovery rates, yield assumptions, and credit spread assumptions.

An annual review is performed on the security prices received from our pricing services, which includes discussion and analysis of the inputs used by the pricing services to value our securities. The price of certain securities sold close to the quarter end are also compared to the price of the same security at the balance sheet date to ensure the reported fair value is reasonable.

Equities. Equity securities are primarily exchange-traded and are valued based on the closing bid, official close, or last trade pricing on an active exchange. If closing prices are not available, securities are valued at the last quoted bid price or may be valued using the last available price. Securities that are thinly traded or delisted are valued using unobservable pricing data.

Commingled Funds. Fixed income and public equity securities may each be combined into commingled fund investments. Most commingled funds are valued to reflect our interest in the fund based on the reported year-end net asset value ("NAV").

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(Continued)*

Derivative Financial Instruments. Exchange-traded derivatives for which market quotations are readily available are valued at the last reported sale price or official closing price as reported by an independent pricing service on the primary market or exchange on which they are traded. Over-the-counter derivatives are not exchange traded and are valued using independent pricing services or industry-standard valuation models such as a discounted cash flow. When discounted cash flow models are used, projected future cash flows are discounted to a present value using market-based expectations for interest rates, foreign exchange rates, commodity prices, and the contractual terms of the derivative instruments. The discount rate used is the relevant benchmark interest rate (e.g., LIBOR, SONIA) plus an adjustment for non-performance risk. The adjustment reflects the full credit default swap ("CDS") spread applied to a net exposure, by counterparty, considering the master netting agreements and any posted collateral. We use our counterparty's CDS spread when we are in a net asset position and our own CDS spread when we are in a net liability position. In cases where market data is not available we use broker quotes and models (e.g., Black-Scholes) to determine fair value. This includes situations where there is lack of liquidity for a particular currency or commodity, or when the instrument is longer dated.

Alternative Assets. Hedge funds generally hold liquid and readily-priced securities, such as public equities, exchange-traded derivatives, and corporate bonds. Private equity and real estate investments are less liquid. External investment managers typically report valuations reflecting initial cost or updated appraisals, which are adjusted for cash flows, and realized and unrealized gains/losses. All alternative assets are valued at the NAV provided by the investment sponsor or third party administrator, as they do not have readily-available market quotations. Valuations may be lagged up to six months. The NAV will be adjusted for cash flows (additional investments or contributions, and distributions) through year end. We may make further adjustments for any known substantive valuation changes not reflected in the NAV.

The Ford-Werke GmbH ("Ford-Werke") defined benefit plan is primarily funded through a group insurance contract (see Note 18). We measure the fair value of the insurance asset by projecting expected future cash flows from the contract and discounting them to present value based on current market rates including an assessment for non-performance risk of the insurance company. The assumptions used to project expected future cash flows are based on actuarial estimates and are unobservable; therefore, the contract is categorized within Level 3 of the hierarchy.

Finance Receivables. We measure finance receivables at fair value using internal valuation models (see Note 10). These models project future cash flows of financing contracts based on scheduled contract payments (including principal and interest). The projected cash flows are discounted to present value based on assumptions regarding credit losses, pre-payment speed, and applicable spreads to approximate current rates. Our assumptions regarding pre-payment speed and credit losses are based on historical performance. The fair value of finance receivables is categorized within Level 3 of the hierarchy.

On a nonrecurring basis, we also measure at fair value retail contracts greater than 120 days past due or deemed to be uncollectible, and individual dealer loans probable of foreclosure. We use the fair value of collateral, adjusted for estimated costs to sell, to determine the fair value of our receivables. The collateral for a retail financing or wholesale receivable is the vehicle financed, and for dealer loans is real estate or other property.

The fair value of collateral for retail receivables is calculated as the outstanding receivable balances multiplied by the average recovery value percentage. The fair value of collateral for wholesale receivables is based on the wholesale market value or liquidation value for new and used vehicles. The fair value of collateral for dealer loans is determined by reviewing various appraisals, which include total adjusted appraised value of land and improvements, alternate use appraised value, broker's opinion of value, and purchase offers.

Debt. We measure debt at fair value using quoted prices for our own debt with approximately the same remaining maturities (see Note 20). Where quoted prices are not available, we estimate fair value using discounted cash flows and market-based expectations for interest rates, credit risk, and the contractual terms of the debt instruments. For certain short-term debt with an original maturity date of one year or less, we assume that book value is a reasonable approximation of the debt's fair value. The fair value of debt is categorized within Level 2 of the hierarchy.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(Continued)*

Finance and Lease Incentives

We routinely sponsor special retail financing and lease incentives to dealers' customers who choose to finance or lease Ford or Lincoln vehicles with Ford Credit. The cost for these incentives is included in our estimate of variable consideration when the vehicle is sold to the dealer. Ford Credit records a reduction to the finance receivable or reduces the cost of the vehicle operating lease when it records the underlying finance contract and we transfer to Ford Credit the amount of the incentive on behalf of the dealer's customer. See Note 1 for additional information regarding transactions between Automotive and Ford Credit. The Ford Credit segment recognized interest revenue of $2 billion, $2.4 billion, and $2.5 billion in 2017, 2018, and 2019, respectively, and lower depreciation of $2.1 billion, $2.4 billion, and $2.6 billion in 2017, 2018, and 2019, respectively, associated with these incentives.

Supplier Price Adjustments

We frequently negotiate price adjustments with our suppliers throughout a production cycle, even after receiving production material. These price adjustments relate to changes in design specification or other commercial terms such as economics, productivity, and competitive pricing. We recognize price adjustments when we reach final agreement with our suppliers. In general, we avoid direct price changes in consideration of future business; however, when these occur, our policy is to defer the recognition of any such price change given explicitly in consideration of future business where guaranteed volumes are specified.

Government Incentives

We receive incentives from U.S. and non-U.S. governmental entities in the form of tax rebates or credits, grants, and loans. Government incentives are recorded in our consolidated financial statements in accordance with their purpose as a reduction of expense, a reduction of the cost of the capital investment, or other income. The benefit is generally recorded when all conditions attached to the incentive have been met and there is reasonable assurance of receipt.

Employee Bonus and Lump-Sum Payments

Effective November 15, 2019, we signed a new agreement with the International Union, United Automobile, Aerospace, and Agricultural Implement Workers of America ("UAW") covering approximately 56,000 employees in the United States. The agreement established wages, benefits, and a variety of bonus payments for covered employees over a four-year period.

Performance-based and inflation-protection employee bonuses are accrued throughout the period in which services are provided and the bonuses are earned. Lump-sum cash bonuses paid in connection with signing a union contract are recognized in the period that the contract negotiations are finalized and ratified. These amounts are reported in *Cost of sales.*

Selected Other Costs

Engineering, research, and development expenses are reported in *Cost of sales* and primarily consist of salaries, materials, and associated costs. Engineering, research, and development costs are expensed as incurred when performed internally or when performed by a supplier if we guarantee reimbursement. Advertising costs are reported in *Selling, administrative, and other expenses* and are expensed as incurred. Engineering, research, development, and advertising expenses for the years ended December 31 were as follows (in billions):

	2017	2018	2019
Engineering, research, and development	$ 8.0	$ 8.2	$ 7.4
Advertising	4.1	4.0	3.6

NOTE: Topic 235-10-50-3 states that disclosure of accounting policies should identify and describe the accounting principles followed by the reporting entity and the methods of applying those principles that materially affect the determination of financial position, cash flows, or results of operations.

In general, the disclosure should encompass important judgments as to appropriateness of principles relating to recognition of revenue and allocation of asset costs to current and future periods. Given the COVID-19 pandemic, this disclosure should include the impacts on the reporting entity due to the coronavirus.

EXAMPLE – DISCLOSURE – BASIS OF PRESENTATION

FORD MOTOR 10Q – 6/30/2020 (IN PART):

Global Pandemic

Our results include adjustments to our assets and liabilities made due to the impact of COVID-19, the most significant of which were a valuation allowance on certain deferred tax assets of $228 million and $1.1 billion for the second quarter and first half of 2020, respectively, and a charge to the provision for credit losses on Ford Credit's finance receivables of $46 million and $532 million during the second quarter and first half of 2020, respectively.

Our assessment of the effect of COVID-19 on our financial statements, including estimates, are based on a variety of factors and are subject to many uncertainties.

EXAMPLE – DISCLOSURE – BASIS OF PRESENTATION

MACY'S 10Q – 5/2/2020 (IN PART):

Impact of COVID-19

As a result of store closures, the Company recognized an approximate $300 million inventory write-down, primarily in fashion merchandise, during the 13 weeks ended May 2, 2020.

In an effort to increase liquidity, the Company fully drew on its $1,500 million credit facility, announced the suspension of quarterly dividends beginning in the second quarter of 2020 and took additional steps to reduce discretionary spending. In the first quarter of 2020, the Company deferred rent payments for a significant number of stores. The Company has elected to treat COVID-19 pandemic-related rent deferrals as accrued liabilities. The Company will continue to recognize expense during the deferral period.

RISKS AND UNCERTAINTIES

The purpose of Topic 275, *Risks and Uncertainties,* is to provide financial statement users with information that will assist them in evaluating an entity's risks and uncertainties in the **near term**, defined as a period of time not to exceed one year from the financial statement date. In comparative financial statements, disclosures are only required for the most recent period.

Topic 275 does not apply to risks and uncertainties related to acts of God, war or catastrophes, management or key personnel, proposed changes in governmental regulations or accounting principles, or deficiencies in internal control.

There are four specific disclosures discussed in this topic. **The first two are general disclosures that apply to virtually all reporting entities, and are usually included in the Summary of Significant Accounting Policies**. The third and fourth are required only when specific criteria are met. The Codification states that these disclosures may overlap, and may be combined or placed anywhere in the financial statements and notes.

1. **Nature of operations** – Always required – This disclosure includes a description of an entity's major products or services sold and its principal markets, including their locations. If there is more than one line of business, the relative importance of each should be disclosed. The basis used to derive relative importance should be disclosed (although it is often implicit when based on sales). Quantification is not required; relative terms such as "principally", "equally", etc., are sufficient. This note describes the what, who, where, and how much of revenues, and may also serve to disclose concentrations in sources of revenue.

EXAMPLE

Note 1: Significant Accounting Policies (in part)

Nature of Operations – The Company is engaged primarily in the production and sale of medical device components sold to manufactures of imaging equipment. Approximately 15% of revenues are derived from contract design services performed under long-term contracts.

Many companies are combining their nature of operations note with the note for revenue from contracts with customers.

NOTE: Although not prohibited, it is not necessary in this or any other disclosure to provide a history of a company's date or state of incorporation, when it elected S or LLC status, etc.

2. **Use of estimates** – Always required – Topic 275 states that disclosures should include a note explaining that the preparation of financial statements requires the use of management estimates. The related implementation guidance adds that this disclosure "is intended to inform users of inherent uncertainties in measuring assets and liabilities and related revenues and expenses and contingent assets and liabilities, and that subsequent resolution of some matters could differ significantly from the resolution that is currently expected."

   Consequently, all of these financial statement components should be mentioned in this boilerplate footnote (as illustrated in the preceding Sears Use of estimate note sample), rather than a general statement that GAAP financial statements include estimates.

3. **Certain significant estimates** – Additional disclosures are required for estimates when, based on information known when the financial statements are issued, it is **reasonably possible** that an estimate will change by a **material amount** in the **near term**. In such cases, the notes must describe the nature of the uncertainty and include a statement that it is at least reasonably possible that a material change in estimate will occur in the near term. Describing the factors that cause the estimate to be sensitive to change is encouraged but not required, and the exact term "reasonably possible" need not be used.

   If the uncertainty is a loss contingency covered by Topic 450, the amount of possible loss (or a statement saying an estimate cannot be made) should also be included.

As a practical matter, all financial statements contain estimates that could change. However, most estimates that could change by material amounts tend to be long term in nature, and it may not be likely that a significant change would occur in the near term. For example, if the realization of deferred tax benefits is dependent on utilization of NOL carryforwards before they expire, conclusions about future taxable income could certainly change more than 20 years – but the likelihood this assessment would change within one year may be remote.

Note also that the issue here is not the materiality of the estimate itself, but rather the potential change in the estimate. For example, an inventory write down may have been considered but not processed because management's best estimate was that the goods could still be sold at prices above cost. This conclusion results in an inventory reserve of $-0- that could change materially in the near term if it turns out that the goods do, in fact, have to be sold at prices significantly below cost.

Topic 275 includes a list of estimates that may trigger this disclosure requirement. Some of the more common ones are:

- High tech inventory subject to technological obsolescence
- Valuation allowance for deferred tax assets or loans
- Litigation losses
- Long-term contract revenue
- Significant change in market value of assets
- Significant change in utilization of asset
- Significant adverse legal changes
- Actual or projected losses related to an asset

Example disclosures for significant estimates follow:

EXAMPLE

Note 4: Income Taxes (in part)

The Company has recorded a deferred tax asset of $200,000 to reflect the benefit of $600,000 in loss carryforwards expiring during the period 20X7 through 20Y8. Realization is dependent on sufficient taxable income prior to expiration of the loss carryforwards. Although realization is not assured, management believes it is more likely than not that all of the deferred tax benefits will be realized. The amount of the deferred tax asset considered realizable, however, could be reduced by a material amount if estimates of future taxable income change in the near term.

EXAMPLE

Note 3: Inventory (in part)

At December 31, 20X7, the Company wrote off approximately $275,000 of inventory to reduce the balance to the lower of cost or market. Although management believes it has established adequate allowances, it is at least reasonably possible that additional material losses on actual inventory sales would occur in the near term.

Note: These disclosures could also be presented in a separate footnote for Significant Estimates.

4. Current vulnerability due to certain concentrations – If a company does not diversify its operations, it is exposing itself to risk. Therefore, the following concentrations must be disclosed, if based on information known to management prior to the issuance of the financial statements, all of the following criteria are met:

    a. The concentration existed at the balance sheet date.

    b. The concentration makes the company vulnerable to a near term severe impact; (i.e., a significant financially disruptive effect on normal operations of the entity.) *Keep in mind severe impact is a higher threshold than material.*

    c. It is at least reasonably possible that the events causing the severe impact will occur in the near term.

These concentrations include:

1. Volume of business with a specific:
    - Customer
    - Supplier
    - Lender
    - Grantor or contributor
2. Revenue from particular products, services, or fundraising events
3. Available sources of materials, labor, services or licenses:
    - Disclosure under this topic is always required for labor subject to collective bargaining agreements, and should include both the percentage of labor covered by all collective bargaining agreements and the percentage working under agreements that expire within one year.
4. Market or geographic area – For operations outside the home country, identification of the geographic area and the carrying amounts of net assets involved must be disclosed.

There are a number of important considerations in applying this disclosure requirement:

- The general rule is that events that would cause disruption must be considered reasonably possible. However, under this standard, the loss of a major customer or contributor is *assumed* to be reasonably possible. Therefore, if the loss of a customer would result in a severe impact, disclosure is required—even if there is no reason to believe the relationship is threatened.

  Many companies have addressed this requirement by "substituting" disclosure of major customers, based on a threshold of 10% of revenues. This is an oversimplification of the issue, because it assumes that the loss of an individual 10%-or-more customer would result in severe impact, while the loss of a 9.9%-of-sales customer would not. Neither is necessarily true. (Consider, for example, how very large customers may demand such favorable pricing that they add little to the bottom line.)

  The disclosure of customers representing 10% or more of sales is only required under segment reporting by *public* companies.

  Certain concentrations have additional disclosure requirements in other standards, most notably "Concentrations of Credit Risk", included in GAAP for financial instruments and discussed in Unit 3. This is frequently the case when a company's customers are concentrated in a particular industry or geographic area likely to move in tandem during economic ups and downs, or when cash on deposit at financial institutions exceeds FDIC-insured limits.

- Accountants, both internal and external, may not be aware that concentrations exist, for materials, service providers, etc. Consider the following scenario:

  > A bakery goods company gets all of its flour from one supplier. Certainly, this vendor could be readily replaced if necessary. However, there is a reason why the company is using only one supplier, most likely a pricing issue. Therefore, if the supplier had to be replaced, could competitors' higher prices have a severe impact? Or could there be an interruption in production before adequate quantities could be delivered? If so, the only issue would be whether it is reasonably possible that this source of supply could be lost in the near term.

- In determining whether the conditions for this disclosure are met, it may be that the loss of a supplier, source of financing, source of labor, etc., would have a severe impact. So the issue often boils down to whether the loss is "reasonably possible."

  Examples of this disclosure follow; they could be included in a separate note for concentrations, or within other notes dealing with the accounts involved.

EXAMPLE

Note 6: Concentrations (in part)

At December 31, 20X7, all of the Company's construction employees work under collective bargaining agreements. Unions whose current agreements expire within one year represent approximately 35% of these employees.

EXAMPLE

Note 6: Concentrations (in part)

Sales to two customers comprise approximately 30% of revenues; loss of either or both of these customers would have a negative impact on the Company.

EXAMPLE

Note 5: Concentrations (in part)

The Company currently purchases all of its adhesives from one supplier. Although there are a limited number of manufacturers of the specific adhesives required by the Company, management believes that other suppliers could provide these materials on comparable terms. A change in suppliers could cause a delay in production and a possible loss of revenue, which would adversely affect the results of operations.

NOTE: With regard to COVID-19 and the need to make significant estimates concerning the financial statement impact of the coronavirus, the related disclosure requires the nature of any uncertainty and should include a statement that it is at least reasonably possible that a material change in estimate will occur in the near term and a description of the factors that cause the estimate to be sensitive to change.

EXAMPLE – DISCLOSURE – SIGNIFICANT ESTIMATES

ALPHABET INC. 10Q - 6/30/2020 (IN PART):

Use of Estimates

As of June 30, 2020, the impact of COVID-19 continues to unfold and the extent of the impact will depend on a number of factors, including the duration and severity of the pandemic; the uneven impact to certain industries; advances in testing, treatment, and prevention; and the macroeconomic impact of government measures to contain the spread of the virus and related government stimulus measures.

As a result, certain of our estimates and assumptions, including the allowance for credit losses for accounts receivable, the credit worthiness of customers entering into revenue arrangements, the valuation of non-marketable equity securities, including our impairment assessment, the fair values of our financial instruments, and income taxes, require increased judgment and carry a higher degree of variability and volatility that could result in material changes to its estimates in future periods.

COMMITMENTS, CONTINGENCIES, AND GUARANTEES

Commitments

Subtopic 440-10, *Commitments,* provide guidance for the accounting and disclosures required for general commitments and unconditional purchase obligations.

General

The scope of this section includes:

- Unused letters of credit
- Preferred stock dividends in arrears
- Commitments for plant acquisitions
- Obligations to reduce debts
- Obligations to maintain working capital
- Obligations to restrict dividends

Disclosures required for situations when general commitments exist include the following:

- Unused letters of credit
- Leases (Topic 842)
- Assets pledged as security for loans
- Pension plans (Topic 715)
- The existence of cumulative preferred stock dividends in arrears
- Commitments, including the following:
  - A commitment for plant acquisition
  - An obligation to reduce debts
  - An obligation to maintain working capital
  - An obligation to restrict dividends

Unconditional Purchase Obligations

An **unconditional purchase obligation** is defined as an obligation to transfer funds in the future for fixed or minimum amounts or quantities of goods or services at fixed or minimum prices—for example, as in take-or-pay contracts or throughput contracts.

A **take-or-pay contract** is an agreement between a purchaser and a seller that provides for the purchaser to pay specified amounts periodically in return for products or services. The purchaser must make specified minimum payments even if it does not take delivery of the contracted products or services.

A **throughput contract** is an agreement between a shipper (processor) and the owner of a transportation facility (such as an oil or natural gas pipeline or a ship) or a manufacturing facility that provides for the shipper (processor) to pay specified amounts periodically in return for the transportation (processing) of a product. The shipper (processor) is obligated to provide specified minimum quantities to be transported (processed) in each period and is required to make cash payments even if it does not provide the contractual quantities.

An unconditional purchase obligation that has all of the following characteristics should be disclosed following the requirements for unrecognized commitments or recognized commitments:

1. It is non-cancelable, or cancelable only in any of the following circumstances:
   - Upon the occurrence of some remote contingency
   - With the permission of the other party
   - If a replacement agreement is signed between the same parties
   - Upon payment of a penalty in an amount such that continuation of the agreement appears reasonably certain
2. It was negotiated as part of arranging financing for facilities that will provide the contracted goods or services or for costs related to those goods or services
3. It has a remaining term in excess of one year

Disclosures for unrecognized commitments should include all of the following:

- The nature and term of the obligation(s)
- The amount of the fixed and determinable portion of the obligation(s) as of the date of the latest balance sheet presented, in the aggregate and, if determinable, for each of the five succeeding fiscal years
- The nature of any variable components of the obligation(s)
- The amount purchased under the obligation(s) for each period an income statement is presented

EXAMPLE

Note 6: Unconditional Purchase Obligation

To secure access to process product A, the Company has signed a processing agreement with a supplier allowing the Company to submit 50,000 tons for processing annually for the next 10 years. Under the terms of the agreement, the Company may be required to advance funds against future processing charges if the supplier is unable to meet its financial obligations. The aggregate amount of required payments as of December 31, 20X2, is as follows (in thousands):

20X3	$10,000
20X4	10,000
20X5	10,000

20X6	8,000
20X7	8,000
Later years	44,000
Total	$90,000
Less interest imputed	(27,000)
Total at present value	$63,000

Disclosures for recognized commitments should include all of the following:

- A purchaser should disclose for each of the five years following the date of the latest balance sheet presented the aggregate amount of payments for unconditional purchase obligations that have been recognized on the purchaser's balance sheet.

- If an unconditional purchase obligation is subject to the requirements of this Topic as well as the requirement of Topic 815, *Derivatives and Hedging,* the reporting entity should comply with the disclosure requirements for each Topic.

Contingencies

Topic 450's, *Contingencies,* guidance related to accounting and disclosure for loss contingencies is based on whether a loss is considered probable, possible, or remote.

1. **Accrued losses** – Topic 450 establishes the following criteria for *accruing* a loss contingency:

   - The future confirming event is probable.

   - The amount of the loss can be reasonably estimated. If the estimate is a range, accrue the "best" estimate; if all amounts in the range are equally likely, accrue the minimum amount of the range and disclose the range.

   If a loss contingency is recorded, the nature and amount of the accrual are disclosed.

EXAMPLE

Note 7: Loss Contingency

During 20X8, notification was received that the state of Washington was asserting that gross receipts taxes were owed by the Company for the years 20X4 through 20X7. The resulting examination is nearing completion, and the ultimate amount of taxes (including interest and penalties) to be assessed is currently estimated at between $40,000 and $75,000. Accordingly, the Company has accrued $40,000 for this loss at December 31, 20X9.

2. **Disclosed losses** – Loss contingencies are disclosed but not accrued when:

   - A loss is probable but cannot be estimated. The nature of the loss and the fact that an estimate could not be made are disclosed.

- A loss is considered to be reasonably possible. The nature of the loss is disclosed, as is an estimate (amount or range) of the loss. Again, if an estimate could not be made, that fact is disclosed.

EXAMPLE

Note 8: Loss Contingency

The Company is a defendant in two separate lawsuits for damages aggregating at least $1,500,000. An action filed by a former officer alleges damages from breach of contract and fraud in excess of $1,000,000 and an action filed by a former customer alleges lost profits from breach of contract in the amount of $500,000. The Company is vigorously defending both actions and, based on the advice of counsel, management does not believe that the outcome of these proceedings will have a material effect on the financial statements.

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3. **Gain contingencies** – Gain contingencies are normally not recorded. Rarely, if collection is assured soon after year end, a receivable may be recorded. Disclosure should be made of contingencies that may result in gains. However, the disclosure should *not* imply that realization will occur.

EXAMPLE

Note 9: Gain Contingency

During the year, the Company discovered an embezzlement perpetuated by the Company controller. An investigation determined that the embezzlement dated back to 20X2 and approximated $900,000 over a 3-year period.

Although the controller has confessed the embezzlement to authorities and has agreed to make restitution, the amount that may ultimately be collected is uncertain and no receivable from the controller has been recorded.

The Company maintained a $500,000 fidelity insurance policy throughout the embezzlement period; however, recovery from the insurance carrier is dependent on approval of the loss claim.

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4. **Insurance recoveries** – Insurance recoveries from involuntary conversions of assets such as fire or theft are usually netted against the related loss in the income statement, as long as there is no problem or dispute about coverage. However, a receivable for amounts due from the carrier may not be offset against any recorded liability for the loss, because Topic 210 requires that the asset and liability be with the same counterparty in order to present them net.

   For recoveries relating to business interruption policies, Topic 225 states that a company may choose how to classify the recovery, as long as the classification does not violate GAAP. In this case, the following disclosures are required:

   - Nature of the event triggering the loss

   - Total amount of recognized recoveries in the period and the line item where they are reflected in the Income Statement

EXAMPLE

Other Income (Expense):

Fire and business interruption loss – net of insurance recoveries ($50,000)

Note 7: Fire Loss and Business Interruption

In January, the Company's office building was vandalized and a resulting fire destroyed a substantial portion of the facility. As a result, the company temporarily moved operations to a leased facility. The total loss is estimated to be $600,000, including the cost of rebuilding the office building, additional expenses incurred to operate out of another facility, and lost profit during the suspension of operations. The company has received $375,000 and $100,000 in commercial and business interruption claims, respectively, and expects to receive an additional $75,000 when the rebuilt facility is completed.

ASU 2016-15, *Classification of Certain Cash Receipts and Cash Payments,* stipulates that insurance proceeds on property claims should be included as investing cash flows; proceeds on business interruption insurance is classified with operating activities.

5. **Unasserted claims** – Unasserted claims are generally not accrued or mentioned in the notes unless:

   - A claim is probable

     and

   - There is a reasonable possibility that the outcome will be unfavorable

   If these criteria are met, the rules for loss contingencies are followed.

6. **Self-insurance** – Self-insurance is an increasingly frequent strategy used by companies to control costs. Usually, coverage is purchased to protect the self-insured company from claims over a certain significant amount ("stop gap" coverage). The mere fact that a company is self-insured is not a required disclosure, but accruals for actual claims made should be disclosed. In addition, significant estimate disclosure is often included due to the degree of judgment needed in measuring the accrual.

EXAMPLE

Note 10: Self-Insurance Accruals

The Company is self-insured up to certain limits for benefits paid under employee healthcare programs. At December 31, 20X4 and 20X3, self-insurance accruals of approximately $400,000 and $350,000, respectively, were recorded for incurred claims.

The measurement of these costs requires the consideration of historical cost experience and judgments about the present and expected levels of cost per claim. The Company accounts for these costs through measurement of claims outstanding and projected payments.

The Company believes the use of this method provides a consistent and effective way to measure this accrual. However, the use of any estimation technique is inherently sensitive given the claims involved and the length of time until the ultimate cost is known. Changes in healthcare costs and other factors can materially affect the estimates for this liability.

NOTE: One specific loss contingency issue being felt by many companies that self-insure all or a portion of their employee medical claims is estimating these costs in light of COVID-19. Historical medical claim patterns may not be accurate and estimating these costs will result in a loss contingency that may be difficult to estimate but the nature of the loss will have to be disclosed.

EXAMPLE

Note X: Loss Contingencies – Self-Insurance Reserves

We are self-insured for certain costs related to environmental, automobile warranty, product liability claims and medical claims up to $10,000 per employee, per year. Our liability reflected in our Consolidated Balance Sheet, classified within other liabilities, represents an estimate of the ultimate cost of claims incurred at the balance sheet date. In estimating this liability, we utilize loss development factors based on Company-specific data to project the future development of incurred losses. Loss estimates are adjusted based upon actual claims settlements and reported claims.

With respect to self-insurance for medical claims, we have increased our estimated liability for future employee medical claims due to COVID-19 by $5,000,000 in the current fiscal year. The future results of employee medical claims though is uncertain at this time and our estimate is based on the best available information available to management. This self-insurance liability will be adjusted as better information becomes available.

Guarantees

Topic 460, *Guarantees,* requires that, even though performance may be a remote possibility, guarantees should be disclosed. Further, Topic 460 states that the obligation to stand ready to perform is not contingent and therefore meets the definition of a liability. Topic 460 goes beyond mere contingency disclosure in two important ways:

1. It requires certain guarantees to be booked at inception at fair value. Since this course deals with disclosure and not the accounting for transactions, this provision will not be discussed in this program. Note, however, there are many exclusions from this provision; most notably, guarantees of debt among entities under common control.

2. It requires expanded disclosures for *all* guarantees, including those with related parties, as well as for product warranties, contingent consideration in a business combination, performance bonds, etc. Disclosure is required of the following:

    a. **Nature of the guarantee** – This includes the approximate term of the guarantee, the reason the guarantee arose, and when the guarantor would be required to perform

    b. **Maximum potential amount of undiscounted future payments** – This amount should not be reduced by any collateral or recourse provisions. If there is no maximum or it cannot be quantified, those facts should be disclosed. This disclosure is not required for product warranties (see "e" below).

c. **Current carrying amount of the liability that the reporting entity guaranteed**

d. **Nature of any recourse provision or the amount of any collateral, as well as the amount of the liability that would be covered from the proceeds of the assets**

e. **For product warranties:**

1) Accounting policy and method used to determine the liability. This would also include revenue recognition policies for sales of extended warranties.

2) A tabular reconciliation of the changes in the aggregate liability for warranties for each period, as follows:

Beginning balance	$ xx
Additional accruals for newly issued warranties	xx
Payments made for warranties	(xx)
Adjustments	xx
Ending balance	$ xx

Note that the above disclosures are in addition to those required by Topic 850, *Related Party Disclosures,* and Topic 825, *Financial Instruments*.

EXAMPLE

Note 6: Commitments and Contingencies (in part)

The Company has guaranteed a mortgage loan of Bran More Inc. The guarantee arose under the original terms of the loan agreement. In the event that Bran More defaults on the loan, the Company would be liable for the outstanding balance on the debt. At December 31, 20X2, the current outstanding balance is $3,500,000, and the remaining scheduled payments, including interest at 5.5%, total $5,800,000. However, the loan is also secured by assets of Bran More, which currently have a net book value of $8,000,000 and fair values estimated to exceed the loan balance by a significant amount. In addition, the stockholders of Bran More have personally guaranteed the debt.

Note that many guarantees encountered in practice are for debt of companies affiliated through common ownership. The existence of guarantees and other aspects of the related party relationship frequently result in a requirement to consolidate the affiliate as a variable interest entity. Disclosures required under those conditions are discussed later in this unit.

In addition, guarantees can relate to situations other than debt and the knowledge of a company's operations may need to be expanded to discern the existence of such arrangements, which are often obscured in the accounting records.

EXAMPLE

Guarantee Disclosure

We have issued a construction completion guarantee related to the third-party project financing secured by APLNG. Our maximum potential amount of future payments under the guarantee is estimated to be $3.2 billion, which could be payable if the full debt financing capacity is utilized and completion of the project is not achieved. Our guarantee of the project financing will be released upon meeting certain completion tests with milestones, which we estimate should occur beginning later in 20x6. Our maximum exposure at March 31, 20x6, is $3.2 billion based upon our pro-rata share of the facility used at that date. At March 31, 20x6, the carrying value of this guarantee is approximately $114 million.

Maximum potential future payments

Current Carrying Value of Liability

Note 12. Guarantees

Guarantees that have been entered into by Valley include standby letters of credit of $205.2 million as of March 31, 20x6. Standby letters of credit represent the guarantee by Valley of the obligations or performance of a customer in the event the customer is unable to meet or perform its obligations to a third party. Of the total standby letters of credit, $134.0 million, or 6.3 percent, are secured and, in the event of non-performance by the customer, Valley has rights to the underlying collateral, which include commercial real estate, business assets (physical plant or property, inventory or receivables), marketable securities and cash in the form of bank savings accounts and certificates of deposit. As of March 31, 20x6, Valley had a $735 thousand liability related to the standby letters of credit.

Maximum potential payment & percentage covered by collateral

EXAMPLE

Unrecorded Guarantee Disclosure

Note F: Guarantees

We do not have guarantees that we believe are reasonably likely to have a material current or future effect on our consolidated financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources. However, as of February 29, 20x6, we were party to an operating lease for an aircraft in which we have guaranteed a residual value at the termination of the lease. The maximum obligation under the terms of this guarantee was approximately $10,820,000 at February 29, 20x6. We have also guaranteed the repayment of a term loan entered into by our unconsolidated affiliate, ArtiFlex, which had $417,000 outstanding at February 29, 20x6. Based on current facts and circumstances, we have estimated the likelihood of payment pursuant to these guarantees, and determined that the fair value of our obligation under each guarantee based on those likely outcomes is not material and, therefore, no amounts have been recognized in our consolidated financial statements.

Note 4. Warranty Liability

The Company provides a lifetime warranty on its products to the prescribed patient for sales within the U.S. and a three-year warranty for all institutional sales and sales to individuals outside the U.S. The Company estimates the costs that may be incurred under its warranty and records a liability in the amount of such costs at the time the product is shipped. Factors that affect the Company's warranty liability include the number of units shipped, historical and anticipated rates of warranty claims, the product's useful life, and cost per claim. The Company periodically assesses the adequacy of its recorded warranty liability and adjusts the amounts as necessary.

Changes in the Company's warranty liability were approximately as follows:

	Nine Months Ended March 31, 20x6	**Fiscal Year Ended June 30, 20x5**
Beginning warranty reserve	$ 660,000	$ 700,000
Accrual for products sold	130,000	139,000
Expenditures and costs incurred for warranty claims	(120,000)	(179,000)
Ending warranty reserve	$ 670,000	$ 660,000

GOING CONCERN

Presentation of Financial Statements (Topic 205): *Disclosure of Uncertainties about an Entity's Going Concern Presumption*

In August 2014, FASB issued ASU 2014-15 – *Presentation of Financial Statements – Going Concern: Disclosure of Uncertainties about an Entity's Going Concern Presumption.* The ASU requires management of public and private companies to evaluate and disclose whether there is substantial doubt about a company's ability to continue as a going concern. Management's assessment would be similar to the one auditors are required to make today. Topic 205 defines "substantial doubt" by incorporating a likelihood component and using the term "probable."

Topic 205 requires management of every entity to:

- Evaluate uncertainties about the entity's going concern presumption at each annual and interim reporting period, and
- Include specific, relevant disclosures if certain conditions are met.

To determine whether disclosures are required, management should consider relevant conditions or events that are known or reasonably knowable on the date the financial statements are issued (or for private companies, are available for issuance). In addition, the reporting entity's ability to meet its obligations would be assessed for a period of one year from that date.

The required note disclosures – when management determines that there is a substantial doubt about an entity's ability to continue as a going concern – are:

- The substantial doubt about the entity's ability to continue as a going concern
- The principal conditions and events giving rise to the substantial doubt
- Management's evaluation of the significance of those conditions and events
- Any mitigating conditions and events, including management's plans

Under a new requirement, when and if substantial doubt is mitigated by management's plans, the entity must disclose this fact and also disclose:

- The principal conditions and events that initially raised the substantial doubt
- A description of management's plans that alleviated the substantial doubt

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EXAMPLE

Note X: Going Concern

The Company has sustained repeated operating losses in recent years, resulting in a net stockholder's deficiency. In addition, the Company is currently in default on certain of its loan agreements. These conditions lead management to believe that there is substantial doubt about the Company's ability to continue as a going concern.

Management is currently negotiating with its bank to restructure outstanding loans. In addition, the Company's owners have agreed to defer any salary during 20X5 and 20X6 and to contribute existing stockholder loans to the equity of the Company (see Note L). While management believes the expected success of these actions will allow the Company to continue operations for the foreseeable future, there is no assurance that these actions will permit the Company to continue as a going concern in the long-term. The financial statements do not include any adjustments that might result if the Company cannot continue as a going concern.

EXAMPLE

Note 4: Financing Arrangements

The Company has sustained repeated operating losses in recent years, resulting in a stockholders' deficiency. In addition, the Company is currently in default on certain of its loan agreements at December 31, 20X7.

In March 20X8, the Company finalized a royalty agreement with a third party manufacturer to produce and sell its new robotic orthopedic surgery components. The revenue from this contract is expected to achieve a return to profitable operations and cure violations of debt covenants.

NOTE: The impact of the COVID-19 pandemic with mandatory shutdowns of businesses, may cause substantial doubt to the reporting entity's ability to continue as a going concern or may generate operational and/or financial risks requiring additional related disclosure.

EXAMPLE

Note X: Going Concern

The Company has sustained operating losses in 2020 due to the COVID-19 pandemic, resulting in a net stockholder's deficiency. In addition, the Company is currently in default on certain of its loan agreements. These conditions lead management to believe that there is substantial doubt about the Company's ability to continue as a going concern.

Management is currently negotiating with its bank to restructure outstanding loans. In addition, the Company's owners have agreed to defer any salary during 2020 and 2021 and to contribute existing stockholder loans to the equity of the Company (see Note L). While management believes the expected success of these actions will allow the Company to continue operations for the foreseeable future, there is no assurance that these actions will permit the Company to continue as a going concern in the long-term. The financial statements do not include any adjustments that might result if the Company cannot continue as a going concern.

RELATED PARTIES

Topic 850, *Related Party Disclosures* is devoted entirely to related party disclosures. Additional disclosures for related parties that are variable interest entities fall under Topic 810, *Consolidations* and proposed Topic 812.

1. <u>Who is a Related Party?</u>

Topic 850 defines related parties as:

a. A parent and its subsidiaries

b. Subsidiaries of a common parent

c. Investments accounted for by the equity method

d. A business or trust for the benefit of its employees; for example, a pension fund

e. A company and its principal owners or management, including their immediate families. A principal owner holds a more-than-10% voting interest in the company. Family members of a principal owner or management are "immediate" family if they might control or influence—or be controlled or influenced by—a principal owner or member of management.

f. Affiliates – An affiliate is a party that directly or indirectly controls, is controlled by or is under common control with the reporting entity. Control gives the party the power to direct or cause to direct the management or policies of the company.

g. Any party that controls or can significantly influence the management or operating policies to the extent that one party might be prevented from fully pursuing its own separate interests.

2. **<u>Required Disclosures for Related Party Transactions</u>** – Whenever material transactions between related parties occur, the following disclosures are required.

   a. Nature of the Relationships – The related party need not be identified by name, but the nature of the relationship should be clear. Terms such as officer, stockholder, affiliate, parent company, or subsidiary fulfill this requirement.

   b. Description of the Transactions – For each period presented, disclosures should describe the nature of all related party transactions and any information needed to understand their effects on the financial statements. For example, it should be clear whether transactions involved loans, guarantees, leases, sales of goods or services, chargebacks for expense allocations, etc. This is required even if no dollar amounts are involved, such as providing free services.

   c. If there is a pervasive relationship between related parties, the nature of the relationship should be disclosed even if there were no transactions between them. This is because the control relationship may still impact results of operations. For example, the author worked with two affiliated companies that had overlapping product lines; the owners decided which company would fill customer orders. Although this involved no intercompany transactions, the relationship could impact results of operations depending on how orders were assigned.

   d. Dollar Amounts of Transactions – For each period presented, the dollar amount of transactions during each period must be disclosed—not just year-end balances. For example, if a company makes numerous sales totaling $500,000 to an affiliate, and the balance receivable at year end is $200,000; both the total sales and the balance must be disclosed. Groups of similar transactions with one type of related party may be combined and disclosed in total

   e. Effect of Any Changes in the Terms of the Transactions – If the terms of any related party transactions have changed from the prior period, the change should be disclosed to clarify the effect on comparability. This would apply, for instance, if the stated rate of interest were changed or eliminated on a loan due from a stockholder.

   f. Balances, Terms, and Settlement of Related Party Receivables and Payables – For each balance sheet presented, amounts due to and from related parties must be disclosed. Topic 310, Receivables, requires that notes or accounts receivable due from officers, employees or affiliated companies be shown separately. This is typically done on the face of the balance sheet. In addition, if the terms and settlement provisions are not obvious, these, too, must be disclosed.

   The following notes illustrate a variety of disclosures for related party transactions:

EXAMPLES

Note 5: Related Party Transactions

During 20X9 and 20X8, the Company made unsecured, non-interest bearing demand loans to the President of the Company totaling $55,000 and $125,000, respectively.

Note 6: Related Party Transactions

The Company provides administrative support at no charge to a company affiliated through common ownership.

Note 7: Related Parties

The major stockholders of the Company also own an affiliate that produces similar products. Customer orders may be assigned to either company, without regard to their impact on earnings.

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3. **Practical Considerations** – There are a number of special GAAP issues and frequent disclosure deficiencies for related party disclosures.

   a. Topic 850 applies to all "material" related party transactions; however, the materiality threshold is quite different for related parties. Even if no or nominal dollar amounts are involved, disclosure is still required unless a transaction is considered isolated and insignificant.

   b. There are special exclusions from the requirement to disclose related party transactions for compensation and expense accounts. Therefore, there is no requirement to disclose officer compensation or benefits, expense account payments, etc.

   c. Unless it can be clearly supported and substantiated, related party disclosures should not include statements that imply the transactions were made on arm's length terms. Therefore, care should be taken before stating that interest rates, rents, or selling prices charged to or by related parties are "at market."

      On the other hand, there is no requirement to state that related party transactions are *not* equivalent to arm's-length. As long as the actual terms are described, the disclosure requirements are met. Nothing precludes you, however, from providing information for purposes of clarification. For example, the author once suggested to a client with numerous intercompany charges that this disclosure include a statement that "such charges were at amounts agreed to by management." (Public companies are required to discuss the basis used to value related party transactions in Management's Discussion and Analysis.)

   d. Even if a transaction is not given accounting recognition because there is no charge for the transaction, it is considered a related party transaction; for example, free services.

   e. Stockholder loans can present various substance over form issues that arise when repayment is not made according to their stated terms, or when due on demand loans remain on the books for a prolonged period.

      For notes payable, if there is no formal note or if the loan is due on demand, the loan should be classified as a current liability, unless the stockholder has waived the right to demand payment. This is true whether there is a formal due on demand note, or just an informal "understanding." If the lack of intent to demand payment is relied upon to classify the loan as long-term, it is better to avoid "due on demand" terminology and instead disclose that the loan has no stated maturity and there is no intention by the lender to call the loan within the next 12 months.

If a stockholder has formally subordinated loans to long-term debt with a bank, the stockholder loans should still be classified as short-term, and the subordination disclosed. Although this seems counter intuitive, the AICPA has taken this position because the bank loan could be prepaid and the stockholder loan could then be paid currently.

For loans receivable from stockholders, the issue is usually that the amounts are considered due on demand, but sit on the books for years—usually until they are treated as distributions (S-Corporations) or "bonused out." As a receivable, these loans are *not* exempt from the requirement to consider collectability and the need for an allowance. At a minimum, if a due on demand receivable has no specific repayment terms and is likely to remain on the books for some time, classification as a non-current asset should be strongly considered. This might be disclosed as follows:

EXAMPLE

Note 8: Related Party Transactions

Loans receivable from stockholder relate to $80,000 in cash advances made to a stockholder during 20X9. The loans are non-interest bearing and have been classified as noncurrent at December 31, 20Y1 due to the absence of stipulated repayment terms.

f. There is often confusion over whether interest should be imputed on related party receivables that do not provide for a stated rate of interest. This is because (1) interest must be imputed for tax purposes and (2) everyone remembers learning that "there is no such thing as an interest-free loan." However, if a loan is issued solely for cash (rather than property, goods, or services), with no exchange of other rights or privileges, then the loan is presumed to earn the stated rate of interest (Topic 835-30-25). In short, if a loan for cash is non-interest bearing, the GAAP rate of interest is 0%.

EXAMPLE

Note 5: Note Receivable (in part)

During 20X0, the Company loaned $200,000 to a company affiliated through common ownership. The loan provided for payments of interest at the rate of 8% per year, with the outstanding balance to be paid on April 30, 20X2. The affiliated company has not paid the outstanding balance and the company has ceased accruing interest. The loan is not considered impaired because the Company purchases goods and services from the affiliate and can, if necessary, offset amounts owed on these transactions with the note receivable.

Additionally, the SEC's Regulation S-K, Item 404, *Transactions with Related Persons, Promoters and Certain Control Persons,* provides guidance for public companies in the related party area. The registrant is required to describe any transaction since the beginning of the registrant's last fiscal year or any currently proposed transaction, which the registrant was or is to be a participant and the amount involved exceeds $120,000 and if any related person had or will have a direct or indirect material interest.

Further, the registrant must disclose its policies and procedures for the review, approval, or ratification of any related persons transaction required to be reported.

Specifically, these disclosures include:

- The person's (entity's) name and relationship to the company
- The person's (entity's) interest in the transaction with the company
- The approximate dollar value of the amount involved in the transaction and of the related person's (entity's) interest in the transaction
- Any other information regarding the transaction or the related person (entity) in the context of the transaction that is material to investors in light of the circumstances of the particular transaction
- A description of the material features of the registrant's policies and procedures for the review, approval, or ratification of transactions with related parties, including:
  - Types of transaction covered by the policies and procedures
  - Persons or groups on the board or otherwise who are responsible for applying such policies and procedures
  - Whether such policies or procedures are in writing, and, if not, how such policies and procedures are communicated

Related Party Disclosure

Community Bank of Texas

December 31, 2019

NOTE 13: RELATED PARTY TRANSACTIONS

In the ordinary course of business, the Company, through the Bank, has and expects to continue to conduct routine banking business with related parties, including its executive officers and directors. Related parties also include shareholders and their affiliates who directly or indirectly have 5% or more beneficial ownership in the Company.

Loans—In the opinion of management, loans to related parties were on substantially the same terms, including interest rates and collateral, as those prevailing at the time of comparable transactions with other persons and did not involve more than a normal risk of collectability or present any other unfavorable features to the Company. The Company had approximately $158.7 million and $168.9 million in loans to related parties at December 31, 2019 and 2018, respectively. At December 31, 2019 and 2018, there were no loans made to related parties deemed nonaccrual, past due, restructured, or classified as potential problem loans.

Activity in loans to related parties as of the periods shown below was as follows:

	Years Ended December 31,	
(Dollars in thousands)	**2019**	**2018**
Beginning balance	$ 168,851	$ 205,768
New loans	15,934	107,303
Repayments	(26,058)	(144,220)
Ending balance	$ 158,727	$ 168,851

Unfunded Commitments—At December 31, 2019 and 2018, the Company had approximately $48.7 million and $55.7 million in unfunded loan commitments to related parties, respectively.

Deposits—The Company held related party deposits of approximately $233.9 million and $311.2 million at December 31, 2019 and 2018, respectively.

Advertising—The Company incurred advertising expenses of approximately $97,000 and $94,000 for the years ended December 31, 2019 and 2018, respectively, to a vendor that is solely owned by a director of the Company.

SUBSEQUENT EVENTS

Type 1 and Type 2 Subsequent Events

Topic 855, *Subsequent Events,* discusses the two types of subsequent events that can impact financial statements and disclosures:

1. An event or transaction occurring after the balance sheet date but before financial statements are issued (or available to be issued) that confirms a fact that existed at the balance sheet date. These events are called **recognized subsequent events** because they are recorded in the accounts. The key is that the event must be the culmination of conditions that existed on or before the balance sheet date. For example:

   - An employee is injured on the job in October and sues the company. The lawsuit is settled in March, prior to the issuance of the financial statements. Since the event (injury and lawsuit) took place prior to year-end, the settlement should be accrued as of the balance sheet date.

   - An OSHA inspection conducted before year-end resulted in penalties. Management recorded an estimate of the penalty at the balance sheet date. Subsequent to year-end, but before the date the financial statements were available to be issued, the amount of the penalty was finalized, and the estimated accrual adjusted to actual.

2. An event or transaction occurring after the balance sheet date but before the financial statements are issued (or available to be issued) that relates to events occurring after the balance sheet date. These events are called **non-recognized subsequent events**. Such events would not cause a change in the accounts but, if material, are disclosed in the notes. For example:

   - Stock issuances, new financing, or business acquisitions occurring after the balance sheet date.

   - Loss of assets due to a catastrophic loss such as a fire or flood.

   - A significant change in the value of marketable securities or other investments after the balance sheet date.

   - A loss on a receivable as a result of customer conditions that did not exist on the balance sheet date.

   - Losses due to claims that became probable of assertion after the balance sheet date.

   - Significant commitments or contingent liabilities arising after the balance sheet date.

AICPA Auditing Interpretation 9410.13-1A, *The Impact on an Auditor's Report of a FASB Statement Prior to the Statement's Effective Date*, discusses the need to disclose the anticipated impact of a forthcoming accounting pronouncement on the financial statements. This is an example of a needed disclosure to prevent the financial statements from being misleading. In practice, this is often included in the Summary of Significant Accounting Policies.

EXAMPLE

New Accounting Standards and Accounting Standards Not Yet Adopted

In 2016, the FASB issued a new lease accounting standard which requires lessees to put most leases on their balance sheets, but recognize the expenses in their income statements in a manner similar to current practice. The new standard states that a lessee will recognize a lease liability for the obligation to make lease payments and a right-of-use asset for the right to use the underlying asset for the lease term. Expenses related to leases determined to be operating leases will be recognized on a straight-line basis, while those determined to be financing leases will be recognized following a front-loaded expense profile in which interest and amortization are presented separately in the income statement. The new standard will also require disclosures to help investors and other financial statement users better understand the amount, timing and uncertainty of cash flows arising from leases. These disclosures include qualitative and quantitative requirements, as well as additional information about the amounts recorded in the financial statements.

We are adopting the new leasing standard using a modified retrospective transition method as of the beginning of the period of adoption; therefore, we will not adjust the comparative periods presented but will record a cumulative effect adjustment to retained earnings effective as of June 1, 2019. We will elect the package of practical expedients permitted under the transition guidance within the new standard, which among other things, allows us to carry forward the historical accounting relating to lease identification and classification for existing leases upon adoption and to not separate lease and non-lease components for certain classes of assets. We will make an accounting policy election not to recognize leases with an initial term of 12 months or less on the consolidated balance sheets.

Based on our lease portfolio, we anticipate recognizing a lease liability and related right-of-use asset on our balance sheet of approximately $14 billion, with an immaterial impact on our income statement compared to the current lease accounting model. In addition, we expect to de-recognize existing deferred gains on sale leasebacks of aircraft of approximately $56 million as a cumulative-effect adjustment to retained earnings effective as of June 1, 2019. The majority of our existing lease arrangements are classified as operating leases, which will continue to be classified as operating under the new standard. In connection with the adoption of these new rules, we implemented changes to our policies, processes, information systems, and internal controls to ensure we meet the standard's reporting and disclosure requirements.

In June 2016, the FASB issued an Accounting Standards Update (ASU 2016-13) that changes how entities will measure credit losses for most financial assets and certain other instruments that are not measured at fair value through net income. These changes will be effective June 1, 2020 (fiscal 2021). We are assessing the impact of this new standard on our consolidated financial statements and related disclosures.

In February 2018, the FASB issued an Accounting Standards Update (ASU 2018-02) that will permit companies to reclassify the income tax effect of the Tax Cuts and Jobs Act ("TCJA") on items within AOCI to retained earnings. We are adopting this standard as of June 1, 2019 (fiscal 2020) and are electing to reclassify these tax effects, which are immaterial to our financial statements.

In August 2018, the FASB issued an Accounting Standards Update (ASU 2018-15) that reduces the complexity for accounting for costs of implementing a cloud computing service arrangement and aligns the accounting for capitalizing implementation costs of hosting arrangements, regardless of whether they convey a license to the hosted software. These changes will be effective June 1, 2020 (fiscal 2021). We are assessing the impact of this new standard on our consolidated financial statements and related disclosures.

General Disclosure of Date Through Which Subsequent Events Were Considered

Topic 855 introduced the concept of the date financial statements are **"*issued or available to be issued*."** The date through which subsequent events must be considered is either:

1. For cases where the financial statements are expected to be widely distributed (e.g., a public company) the date the financial statements are issued.

2. For all others, the date the financial statements are available to be issued. Financial statements are considered available to be issued when they are complete in form and content and all necessary approvals needed for release have been obtained.

Topic 855 also:

- Requires disclosure of the date through which subsequent events have been considered and also whether that date is the date the financial statements were issued or were available to be issued. If there is a separate subsequent events footnote, this disclosure can be included in that note. Otherwise, it is often included in the Summary of Significant Accounting Policies. This is an area frequently noted as a deficiency by peer review. Practitioners should take care not to overlook this disclosure requirement.

- It does not affect requirements of other GAAP pronouncements that differ from Topic 855. For example, existing GAAP allows debt to be classified as noncurrent if an event of default exists at the balance sheet date but is cured within a prescribed grace period. Topic 855 would not change that treatment.

- If financial statements have to be reissued, subsequent events occurring after the original issuance should not be recognized, unless required by other existing GAAP. However, disclosure of the event may be necessary to prevent the financial statements from being misleading. Also, Topic 855 requires disclosure of the date through which subsequent events have been evaluated in both the originally issued financial statements and the reissued financial statements.

EXAMPLE

Type 1 – Litigation

Note 10: Subsequent Event

In 20X2, a suit was filed against the Company that alleged employment practice violations. On March 31, 20X9, the jury, on appeal, found in favor of the plaintiff and a judgment was entered against the Company in the amount of $900,000. The financial statements reflect an expense of $400,000, the amount of the judgment that exceeds liability insurance recoveries.

The Company has evaluated all subsequent events through May 31, 20X9, the date the financial statements were available to be issued.

NOTE: The above example assumes that the insurance recovery is probable. However, because there is no right of offset, the Company would record the full liability of $900,000 and a receivable of $500,000, with a net expense of $400,000.

EXAMPLE

Type 2 – Buy Out

Note 12: Subsequent Event

On January 31, 20X7, the Company repurchased shares owned by a minority stockholder for $80,000. The purchase price consisted of cash in the amount of $20,000 and a non-interest bearing note that requires monthly payments of $5,000. In connection with this transaction, the Company entered into a consulting and non-compete agreement with the stockholder. Under the terms of the agreement, the Company will pay the former stockholder $120,000 over a 1-year period.

The Company evaluated all subsequent events through April 20, 20X7, the date the financial statements were available to be issued.

CHANGES IN ACCOUNTING PRINCIPLE

Changes in Accounting Principle (Topic 250) are accomplished by retrospective adjustment of all periods presented. In effect, Topic 250 accounts for these changes as if the new accounting treatment was always in effect, which is mechanically equivalent to restatement.

Topic 250 applies to voluntary accounting changes; it does not apply to transition rules in new standards. Each new accounting pronouncement includes specific guidance on transition, often involving a simplification of retrospective treatment and/or disclosures that would otherwise apply to changes in accounting principle.

In practice, voluntary changes from one acceptable method to another are rare, as examples where GAAP allows such latitude are dwindling. In the past, the most common example was a change from one acceptable depreciation method to another (for assets placed in service in prior years). However, a change in depreciation method is now treated as a change in estimate, with the effects handled prospectively.

Topic 250 requires:

- The "cumulative effect" on all periods prior to those presented adjusts the book value of assets and liabilities as of the beginning of the earliest period presented. For example, if the entity changes its method of valuing inventory in 20X1 but also presents 20X0 comparative statements. The cumulative effect would restate inventory as of the beginning of 20X0.
- Beginning retained earnings is adjusted for the change made to assets and liabilities as of the beginning of the earliest period presented.

- Statements for each prior period presented are "restated" to show the effect of the change on that specific period.

For the retrospective application, only the **direct effects** of the accounting change should be included in the adjustment. Direct effects are only those recognized changes that are necessary in order to change the accounting principle. This would include the deferred tax or impairment changes that might result from a change in an asset.

Indirect effects, those that change current or future cash flows because of the change, are reported in the year of the change. For example, if a change in interest capitalization causes an increase in net income and that increase resulted in a larger bonus to the owner, then that bonus is reflected in the year that the change in interest capitalization took place, rather than prior periods presented.

Topic 250 requires the following disclosures:

- The nature and reason for the change
- A description of why the change was preferable
- The method of applying the change
- A description of any prior-period information that has been retrospectively adjusted
- The effect of the change on the current period and any prior periods presented on:
  - Income from continuing operations
  - Net Income or equivalent
  - Other line items affected
  - Per-share amounts (public companies only)
  - The cumulative effect on Retained Earnings, other components of equity or net assets as of the beginning of the earliest period presented
  - The reasons and the alternative method used for the change (only if retrospective application is impracticable)
- If there are any **indirect effects**:
  - A description of the indirect effects
  - The amount recognized in the current period
  - Per-share amounts (public companies only)
  - The total effects recognized on each prior period (unless impractical)

- If the change is not material in the current period but is reasonably certain to have a material effect in the future, the nature and reason for the change and why the new accounting principle is preferable. This disclosure should be included for all periods when the change is presented.

EXAMPLE

Note 6: Change in Inventory Valuation Methods

Inventories are stated at the lower of cost or market. Cost, which includes material, labor, and factory overhead, is determined on a FIFO basis.

Prior to January 1, 20X9, we valued certain inventories under the LIFO cost method. As of January 1, 20X9, we changed our method of accounting for these inventories from the LIFO method to the FIFO method. As of December 31, 20X8, the inventories for which the LIFO method of accounting was applied represented approximately 85% of total net inventories. We believe that this change is to a preferable method which better reflects the current cost of inventory on our consolidated balance sheets. Additionally, this change conforms all of our worldwide inventories to a consistent inventory costing method and provides better comparability to our peers.

We applied this change in accounting principle retrospectively to all prior periods presented herein in accordance with Topic 250 “Accounting Changes and Error Corrections.” As a result of this accounting change, our retained earnings as of December 31, 20X6 decreased to $621.2 million using the FIFO method from $638.6 million as originally reported using the LIFO method. The following tables summarize the effect of the accounting change on our consolidated financial statements.

	Year Ended December 31, 20X9		
	Computed Under Prior Method	Effect of Change	As Computed Under FIFO
	(Thousands, Except per share data)		
Statement of Operations:			
Cost of sales	$ 807,275	$ (3,739)	$ 803,536
Income taxes	55,436	1,226	56,662
Net income	113,391	2,513	115,904
Earnings per common share:			
Basic	1.41	0.03	1.44
Diluted	1.40	0.03	1.43
Statement of Cash Flows:			
Net income	113,391	2,513	115,904
Deferred income taxes	1,081	1,226	2,307
Changes in inventories	23,149	(3,739)	19,410
Net cash provided by operating activities	212,532	–	212,532

	Year Ended December 31, 20X8		
	Computed Under Prior Method	**Effect of Change**	**As Computed Under FIFO**
	(Thousands, Except per share data)		
Statement of Operations:			
Cost of sales	$ 892,038	($ 6,476)	$ 885,562
Income taxes	65,201	2,142	67,343
Net income	127,026	4,334	131,360
Earnings per common share:			
Basic	1.55	0.05	1.60
Diluted	1.53	0.06	1.59
Statement of Cash Flows:			
Net income	127,026	4,334	131,360
Accrued Expenses	1,215	(614)	601
Deferred income taxes	(10,817)	2,621	(8,196)
Changes in inventories	(4,389)	(5,270)	(9,659)
Net cash provided by operating activities	223,060	1,071	224,131

	Year Ended December 31, 20X7		
	Computed Under Prior Method	**Effect of Change**	**As Computed Under FIFO**
	(Thousands, Except per share data)		
Statement of Operations:			
Cost of sales	$ 792,470	($ 2,288)	$ 790,182
Income taxes	78,457	843	79,300
Net income	153,700	1,445	155,145
Earnings per common share:			
Basic	1.89	0.02	1.91
Diluted	1.87	0.02	1.89
Statement of Cash Flows:			
Net income	153,700	1,445	155,145
Deferred income taxes	1,470	979	2,449
Changes in inventories	(191)	(3,311)	(3,502)
Net cash provided by operating activities	198,994	(887)	198,107

	As of December 31, 20X9			As of December 31, 20X8		
	Computed Under Prior Method	**Effect of Change**	**As Computed Under FIFO**	**Computed Under Prior Method**	**Effect of Change**	**As Computed Under FIFO**
Balance Sheet:						
Inventories						
Other current assets (prepaid taxes)	$ 159,463	$ 36,699	$ 196,162	$ 181,200	$ 32,960	$ 214,160
Accrued expenses (income tax payable)	35,545	(9,669)	25,876	32,866	(8,443)	24,423
Deferred income tax liability	98,730	(614)	98,116	117,186	(614)	116,572
Cumulative translation adjustment	148,806	2,352	151,158	141,984	2,352	144,336
Retained earnings	59,399	(262)	59,137	40,204	(331)	39,873

Following is AT&T Revenue Recognition note disclosure for the period of initial adoption of Topic 606, *Revenue from Contracts with Customers.*

Revenue Recognition

AT&T Corporation

Quarterly Report

March 31, 2018

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) - Continued
Dollars in millions except per share amounts

The following table is a reconciliation of Segment Contribution to "Income Before Income Taxes" reported on our consolidated statements of income.

	First Quarter	
	2018	2017
Consumer Mobility	$ 4,655	$ 4,530
Business Solutions	2,084	2,187
Entertainment Group	1,335	1,570
International	(111)	(100)
Segment Contribution	7,963	8,187
Reconciling Items:		
Corporate and Other	(445)	(526)
Amortization of intangibles acquired	(1,062)	(1,202)
Merger and integration charges	(67)	(207)
Venezuela devaluation	(25)	-
Employee separation costs	(51)	-
Natural disaster charges	(104)	-
Gain on wireless spectrum transactions	-	118
Segment equity in net (income) loss of affiliates	(8)	(14)
AT&T Operating Income	6,201	6,356
Interest expense	1,771	1,293
Equity in net income (loss) of affiliates	9	(173)
Other income (expense) - net	1,702	488
Income Before Income Taxes	$ 6,141	$ 5,378

NOTE 5. REVENUE RECOGNITION

As of January 1, 2018, we adopted FASB ASU 2014-09, "Revenue from Contracts with Customers (Topic 606)," as modified (ASC 606). With our adoption of ASC 606, we made a policy election to record certain regulatory fees, primarily Universal Service Fund (USF) fees, on a net basis. See the Notes to the Consolidated Financial Statements of our 2017 Annual Report on Form 10-K for additional information regarding our policies prior to adoption of ASC 606.

When implementing ASC 606, we utilized the practical expedient allowing us to reflect the aggregate effect of all contract modifications occurring before the beginning of the earliest period presented when allocating the transaction price to performance obligations.

Contracts with Customers
Our products and services are offered to customers in service-only contracts and in contracts that bundle equipment used to access the services and/or with other service offerings. Service revenue is recognized when services are provided, based upon either usage (e.g., minutes of traffic/bytes of data processed) or period of time (e.g., monthly service fees). We record the sale of equipment when title has passed and the products are accepted by the customer. Some contracts have fixed terms and others are cancellable on a short-term basis (i.e., month-to-month arrangements).

Revenues from transactions between us and our customers are recorded net of regulatory fees and taxes. Cash incentives given to customers are recorded as a reduction of revenue. Nonrefundable, upfront service activation and setup fees associated with service arrangements are deferred and recognized over the associated service contract period or customer life. We record the sale of equipment and services to customers as gross revenue when we are the principal in the arrangement and net of the associated costs incurred when we act as an agent in the arrangement.

Our contracts allow for customers to frequently modify their arrangement, without incurring penalties in many cases. When a contract is modified, we evaluate the change in scope or price of the contract to determine if the modification should be treated as a new contract or if it should be considered a change of the existing contract. We generally do not have significant impacts from contract modifications.

Dollars in millions except per share amounts

Service-Only Contracts and Standalone Equipment Sales
Revenue is recognized as service is provided or when control has transferred. For devices sold through indirect channels (e.g., national dealers), revenue is recognized when the dealer accepts the device, not upon activation.

Arrangements with Multiple Performance Obligations
Revenue recognized from fixed term contracts that bundle services and/or equipment are allocated based on the standalone selling price of all required performance obligations of the contract (i.e., each item included in the bundle). Promotional discounts are attributed to each required component of the arrangement, resulting in recognition over the contract term. Standalone selling prices are determined by assessing prices paid for service-only contracts (e.g., arrangements where customers bring their own devices) and standalone device pricing.

We offer the majority of our customers the option to purchase certain wireless devices in installments over a specified period of time, and, in many cases, they may be eligible to trade in the original equipment for a new device and have the remaining unpaid balance paid or settled. For customers that elect these equipment installment payment programs, at the point of sale, we recognize revenue for the entire amount of revenue allocated to the customer receivable net of fair value of the trade-in right guarantee. The difference between the revenue recognized and the consideration received is recorded as a note receivable when the devices are not discounted and our right to consideration is unconditional. When installment sales include promotional discounts (e.g., "buy one get one free"), the difference between revenue recognized and consideration received is recorded as a contract asset to be amortized over the contract term.

Less commonly, we offer certain customers highly discounted devices when they enter into a minimum service agreement term. For these contracts, we recognize equipment revenue at the point of sale based on a standalone selling price allocation. The difference between the revenue recognized and the cash received is recorded as a contract asset that will amortize over the contract term.

For contracts that require the use of certain equipment in order to receive service (e.g., AT&T U-verse® and DIRECTV linear video services), we allocate the total transaction price to service if the equipment does not meet the criteria to be a distinct performance obligation.

Disaggregation of Revenue
The following table sets forth disaggregated reported revenue by category:

For the three months ended March 31, 2018

	Consumer Mobility	Business Solutions	Entertainment Group	International	Other	AT&T Inc.
Wireless service	$ 11,612	$ 1,791	$ -	$ 404	$ -	$ 13,807
Video entertainment	-	-	8,359	1,354	-	9,713
Strategic services	-	3,138	-	-	-	3,138
High-speed internet	-	-	1,878	-	-	1,878
Legacy voice and data	-	2,839	819	-	-	3,658
Other service	-	669	519	-	264	1,452
Wireless equipment	3,374	578	-	267	-	4,219
Other equipment	-	170	2	-	1	173
	$ 14,986	$ 9,185	$ 11,577	$ 2,025	$ 265	$ 38,038

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) - Continued
Dollars in millions except per share amounts

Deferred Customer Contract Acquisition and Fulfillment Costs
Costs to fulfill customer contracts are deferred and amortized over periods ranging generally from four to five years, reflecting the estimated economic lives of the respective customer relationships, subject to an assessment of the recoverability of such costs. Costs to acquire customer contracts, including commissions on service activations, for our wireless and video entertainment services, are deferred and amortized over the contract period or expected customer life, which typically ranges from two to five years. For contracts with an estimated amortization period of less than one year, we expense incremental costs immediately.

Our deferred customer contract acquisition costs and deferred customer contract fulfillment costs balances were $2,117 and $10,763 as of March 31, 2018, respectively, of which $782 and $4,062 were included in Other current assets on our consolidated balance sheets. For the three months ended March 31, 2018, we amortized $263 and $1,047 of these costs, respectively.

Contract Assets and Liabilities
A contract asset is recorded when revenue is recognized in advance of our right to bill and receive consideration (i.e., we must perform additional services or satisfy another performance obligation in order to bill and receive additional consideration). The contract asset will decrease as services are provided and billed. When consideration is received in advance of the delivery of goods or services, a contract liability is recorded. Reductions in the contract liability will be recorded as we satisfy the performance obligations.

The following table presents contract assets and liabilities and revenue recorded at or for the period ended March 31, 2018:

	March 31, 2018
Contract asset	$ 1,757
Contract liability	5,510
Beginning of period contract liability recorded as customer contract revenue during period	3,625

Our consolidated balance sheet included approximately $1,252 for the current portion of our contract asset in "Other current assets" and $4,882 for the current portion of our contract liability in "Advanced billings and customer deposits."

Transaction Price Allocated to Remaining Performance Obligations
Our remaining performance obligations represent services we are required to provide to customers under bundled or discounted arrangements, which are satisfied as services are provided over the contract term. In determining the transaction price allocated, we do not include non-recurring charges and estimates for usage, nor do we consider arrangements with an original expected duration of less than one-year, which are primarily prepaid wireless, video and residential internet agreements.

Remaining performance obligations associated with business contracts reflect recurring charges billed, adjusted to reflect estimates for sales incentives and revenue adjustments. Performance obligations associated with wireless contracts are estimated using a portfolio approach in which we review all relevant promotional activities, calculating the remaining performance obligation using the average device price and average service component for the portfolio. As of March 31, 2018, the aggregate amount of the transaction price allocated to remaining performance obligations was $27,836, of which we expect to recognize approximately 50% over the remainder of 2018, with the balance recognized thereafter.

Comparative Results

Prior to 2018, revenue recognized from contracts that bundle services and equipment was limited to the lesser of the amount allocated based on the relative selling price of the equipment and service already delivered or the consideration received from the customer for the equipment and service already delivered. Our prior accounting also separately recognized regulatory fees as operating revenue when received and as an expense when incurred. Sales commissions were expensed as incurred.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) - Continued
Dollars in millions except per share amounts

The following table presents our reported results under ASC 606 and our pro forma results using the historical accounting method:

At or for the three months ended March 31, 2018	As Reported	Historical Accounting Method
Consolidated Statements of Income:		
Service Revenues	$ 33,646	$ 35,069
Equipment Revenues	4,392	3,861
Total Operating Revenues	38,038	38,930
Other cost of services	7,932	8,861
Selling, general and administrative expenses	7,897	8,497
Total Operating Expenses	31,837	33,366
Operating income	6,201	5,564
Income before income taxes	6,141	5,504
Income tax expense	1,382	1,226
Net income	4,759	4,278
Net income attributable to AT&T	4,662	4,187
Basic Earnings per Share Attributable to AT&T	$ 0.75	$ 0.68
Diluted Earnings per Share Attributable to AT&T	$ 0.75	$ 0.68
Consolidated Balance Sheets:		
Other current assets	12,008	10,124
Other Assets	20,974	19,164
Accounts payable and accrued liabilities	31,569	31,748
Advanced billings and customer deposits	5,081	5,140
Deferred income taxes	45,730	44,787
Other noncurrent liabilities	19,117	18,990
Retained earnings	55,067	52,250
Accumulated other comprehensive income	7,386	7,375
Noncontrolling interest	1,156	1,115

NOTE 6. PENSION AND POSTRETIREMENT BENEFITS

Many of our employees are covered by one of our noncontributory pension plans. We also provide certain medical, dental, life insurance and death benefits to certain retired employees under various plans and accrue actuarially determined postretirement benefit costs. Our objective in funding these plans, in combination with the standards of the Employee Retirement Income Security Act of 1974, as amended (ERISA), is to accumulate assets sufficient to provide benefits described in the plans to employees upon their retirement.

In 2013, we made a voluntary contribution of a preferred equity interest in AT&T Mobility II LLC, the primary holding company for our domestic wireless business, to the trust used to pay pension benefits under our qualified pension plans. The preferred equity interest had a value of $8,944 at March 31, 2018. The trust is entitled to receive cumulative cash distributions of $560 per annum, which are distributed quarterly by AT&T Mobility II LLC to the trust, in equal amounts and accounted for as contributions. We distributed $140 to the trust during the three months ended March 31, 2018. So long as we make the distributions, we will have no limitations on our ability to declare a dividend or repurchase shares. This preferred equity interest is a plan asset under ERISA and is recognized as such in the plan's separate financial statements. However, because the preferred equity interest is not unconditionally transferable to an unrelated party, it is not reflected in plan assets in our consolidated financial statements and instead has been eliminated in consolidation.

NOTES

Unit 3

Balance Sheet and Related Disclosures

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- Identify and describe the presentation and disclosure requirements for the balance sheet.
- Review live financial statement disclosures to demonstrate disclosure best practices.

CASH AND CASH EQUIVALENTS

Cash includes currency, checking accounts, and other accounts at financial institutions that permit the customer to deposit or withdraw funds at any time without prior notice or penalty. For example, a money market account at a bank or broker-dealer that pays interest and places no restrictions on deposits or withdrawals would be considered cash (so long as the brokerage account is not actually a form of mutual fund). Cash accounts include both interest and non-interest bearing accounts.

NOTE: Disclosures are also required when cash balances at FDIC-insured institutions exceed $250,000, because they represent a concentration of credit risk.

Cash Equivalents are defined in Topic 230, *Statement of Cash Flows*, as short-term, highly liquid instruments that:

- Are readily convertible into cash, AND
- Present insignificant risk of changes in value due to interest rate changes because of their short maturity, generally three months or less.

Topic 230 considers only investments with *original* maturities *to the entity* of three months or less to meet this definition.

Not all investments that qualify as cash equivalents need to be treated as cash equivalents. For example, if a company has certificates of deposit with maturities both shorter and longer than three months, management could decide to treat all of the certificates the same by excluding all CDs from cash equivalents and presenting them separately as short-term investments. However, if the items included as cash equivalents changes from one period to the next, it results in a change in accounting policy.

EXAMPLE

Apple Inc.

CONSOLIDATED BALANCE SHEETS
(In millions, except number of shares which are reflected in thousands and par value)

	September 28, 2019	September 29, 2018
ASSETS:		
Current assets:		
Cash and cash equivalents	$ 48,844	$ 25,913
Marketable securities	51,713	40,388
Accounts receivable, net	22,926	23,186
Inventories	4,106	3,956
Vendor non-trade receivables	22,878	25,809
Other current assets	12,352	12,087
Total current assets	162,819	131,339

Restricted Cash – There is a general presumption that the account "cash" on the balance sheet represents funds on deposit, usually at banks, that can be withdrawn at management's discretion for any legitimate purpose. Topic 210, *Balance Sheet,* requires that any cash "which is restricted as to withdrawal or use for other than current operations..." be excluded from current assets. Therefore, restricted cash must be included with non-current assets.

If "restricted cash" is held in an account that is not cash or cash equivalents (such as a CD with a greater-than-three-month term), it should be classified as an investment.

ASU 2016-18*, Restricted Cash* requires that the statement of cash flows be prepared by combining all cash and cash equivalents, including amounts classified as restricted on the balance sheet. As a result, the beginning and ending cash amounts on the statement of cash flows will include the sum of restricted and unrestricted cash, and transfers between the two will not appear separately.

ASU 2016-18 also requires that a reporting entity should **disclose** information about the nature of restrictions on its cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. Further, if these items are presented in more than one line item within the statement of financial position, a reporting entity should, for each period that the statement of financial position is presented, present on the face of the statement of cash flows or disclose in the notes, the line items and amounts of cash and cash equivalents reported within the statement of financial position.

Compensating balances are required by some loan agreements with banks; by requiring non-interest bearing funds on deposit, the bank is actually realizing a higher effective rate of interest. Classification of these balances as current or long-term should follow the classification of the related debt. For example, if a compensating balance is required on a line of credit (current liability), it should be included with cash and cash equivalents in current assets. The requirement to maintain such balances would be disclosed along with other terms describing the debt, usually within the debt footnote.

EXAMPLE

Note X: Debt (in part)

Terms of the Company's revolving line of credit with a bank require maintaining compensating balances of at least 10% of available borrowing; which was $100,000 at December 31, 20XX. This amount is included in cash and cash equivalents.

INVESTMENTS

Investments in Debt and Equity securities have experienced some changes in the FASB guidance in recent years. FASB, in reaction to some of the financial reporting abuse that took place during the recession of 2007 through 2011, issued the following two accounting standard updates to address issues associated with accounting and disclosing transactions with debt and equity securities:

- ASU 2016-01 – *Recognition and Measurement of Financial Assets and Financial Liabilities (Topic 320)*
- ASU 2016-13 – *Measurement of Credit Losses on Financial Instruments (Topic 321)*

The following briefly summarizes the guidance from these two ASUs and then identifies the disclosure requirements.

Investments in Debt Securities

The guidance in Topic 320 establishes standards of financial accounting and disclosures for all investments in debt securities including those resulting from securitization of other financial instruments. The Topic does not apply to derivative instruments that are subject to the requirements of Topic 815, *Derivatives and Hedging*.

At acquisition, a reporting entity should recognize debt securities at their acquisition price and classify them into one of the following three categories:

1. **Trading securities** – if a security is acquired with the intent of selling it within hours or days, the security is classified as trading. Trading securities are subsequently valued at fair value with any unrealized gain or loss recognized in earnings.

2. **Held to maturity securities** – Investments in debt securities when the reporting entity has the positive intent and ability to hold those securities to maturity.

   Permanent impairments of held to maturity securities are determined by applying the guidance in ASU 2016-13 (Topic 326) where a current expected credit loss (CECL) model is applied to estimate credit losses over the debt security's life. If historical experience and future expectations suggests amounts will not be collected as previously planned, an allowance for credit losses will be recorded in these amounts. The allowance for credit losses is adjusted each period with any change recognized in earnings. The net carrying value should equal the mount expected to be collected over the contractual term of the investment.

3. **Available for sale securities** – Investments in debt securities not classified as trading securities or held to maturity securities. Management's intent is to hold these securities for purposes other than trading. Available for sale securities are subsequently measured at fair value with any unrealized gain or loss recognized in other comprehensive income.

   Permanent impairments of available for sale securities are determined by also applying the guidance in ASU 2016-13 (Topic 326) where a current expected credit loss (CECL) model is applied to estimate credit losses over the debt security's life. As with held to maturity debt securities, an allowance for credit losses will be recorded for these amounts and the allowance will be adjusted each period with any changes to earnings. However, since these securities could be sold, the allowance should not reduce net carrying value below the security's fair value. In fact, so long as the security's fair value exceeds carrying value, expected credit losses need not be estimated.

Debt Security Disclosures

Debt security disclosures are required for debt held to maturity and available for sale debt securities.

Held to Maturity by Major Security Type:

- Amortized cost basis
- Aggregate fair value
- Total allowance for credit losses
- Gross unrecognized holding gains
- Gross unrecognized holding losses
- Net carrying amount
- Gross gains or losses in accumulated other comprehensive income for any derivatives that hedged the forecasted acquisition of the held to maturity security
- Information about the contractual maturities of those securities as of the date of the most recent statement of financial position is presented:
  - Within 1 year
  - After 1 year through 5 years
  - After 5 years through 10 years
  - After 10 years

Available for Sale Securities by Major Security Type:

- Amortized cost basis
- Aggregate fair value
- Total allowance for credit losses
- Total unrealized gains for securities with net gains in accumulated other comprehensive income
- Total unrealized losses for securities with net losses in accumulated other comprehensive income
- Information about the contractual maturities of those securities as of the date of the most recent statement of financial position is presented:
  - Within 1 year
  - After 1 year through 5 years
  - After 5 years through 10 years
  - After 10 years

Additional disclosures are required for all impaired debt securities concerning the nature, scope, and amount of any impairments.

Investments in Equity Securities

The guidance in Topic 321 establishes standards of financial accounting and disclosure for all investments in equity securities and other ownership interests in an entity, including investments in partnerships, unincorporated joint ventures, and limited liability companies as if those other ownership interests are equity securities. The guidance in Topic 321 does not apply to the following:

- Derivative instruments that are subject to the requirements of Topic 815, *Derivatives and Hedging*
- Investments accounted for following the equity method
- Investments in consolidated subsidiaries
- Stock exchange memberships
- Federal Home Bank and Federal Reserve Bank Stock

At acquisition, a reporting entity should recognize and classify investments in equity securities as an investment at the security's acquisition price. For equity securities **with readily determinable fair values**, reporting entities subsequently measure these equity investments at fair value with any fair value changes recognized directly in earnings.

For equity investments **without readily determinable fair values**, reporting entities may elect to measure these investments at cost, less any impairment, plus/minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer.

Note: Recently issued ASU 2020-01, *Investments-Equity Securities (Topic 321), Investments-Equity Method and Joint Ventures (Topic 323), and Derivatives and Hedging (Topic 815) – Clarifying the Interactions between Topic 321, Topic 323, and Topic 815,* clarifies the interaction accounting standards related to equity securities, equity method investments, and certain derivatives due to the issuance of ASU 2016-01, Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities.

Specifically, ASU 2020-01 clarifies that a reporting entity **should consider observable transactions** that require the reporting entity to either apply or discontinue the equity method of accounting under Topic 323, *Investments-Equity Method and Joint Ventures,* for the purposes of applying the measurement alternative in accordance with Topic 321, *Investments-Equity Securities,* immediately before applying or upon discontinuing the equity method.

The ASU notes the following: The current basis of the investor's previously held interest in the investee should be re-measured in accordance with Topic 321 immediately before adopting the equity method. For an investor's previously held interest, if the investor identifies observable price changes in orderly transactions for an identical or similar investment of the same issuer that results in it applying Topic 323, the reporting entity should remeasure its previously held interest at fair value immediately before applying Topic 323.

Equity Security Disclosures

For equity investments **with readily determinable fair values** the reporting entity should make the related fair value disclosures as established in Topic 820, *Fair Value Measurements.*

A reporting entity that applies the guidance for equity securities **without readily determinable fair values** should also disclose the following:

- The carrying amount of investments without readily determinable fair values
- The amount of any impairments and downward adjustments both annual and cumulative
- The amount of any upward adjustments both annual and cumulative
- As of the date of the most recent statement of financial position, additional information in narrative form, that is sufficient to permit users to understand the quantitative disclosures and the information that the entity considered in reaching the carrying amounts and upward or downward adjustments resulting from observable price changes

In addition, for each period when the results of operations are presented, a reporting entity should disclose the portion of any unrealized gains or losses for the period that relates to equity securities still held at the reporting date. The portion of unrealized gains and losses for the period related to equity securities still held at the reporting date is calculated as follows:

EXAMPLE

Net gains and losses recognized during the period	$140,000
Less: Net gains and losses realized (sold) during the period	(90,000)
Unrealized gains and losses recognized during the period for securities still held at the reporting date	$50,000

Investments in Debt and Equity

Wells Fargo Bank

December 31, 2019

Note 4: Trading Activities

Table 4.1 presents a summary of our trading assets and liabilities measured at fair value through earnings.

Table 4.1: Trading Assets and Liabilities

(in millions)		Dec 31, 2019	Dec 31, 2018
Trading assets:			
Debt securities	$	79,733	69,989
Equity securities		27,440	19,449
Loans held for sale		972	1,469
Gross trading derivative assets		34,825	29,216
Netting (1)		(21,463)	(19,807)
Total trading derivative assets		13,362	9,409
Total trading assets		121,507	100,316
Trading liabilities:			
Short sale		17,430	19,720
Gross trading derivative liabilities		33,861	28,717
Netting (1)		(26,074)	(21,178)
Total trading derivative liabilities		7,787	7,539
Total trading liabilities	$	25,217	27,259

(1) Represents balance sheet netting for trading derivative asset and liability balances, and trading portfolio level counterparty valuation adjustments.

Table 4.2 provides a summary of the net interest income earned from trading securities, and net gains and losses due to the realized and unrealized gains and losses from trading activities. Net interest income also includes dividend income on trading securities and dividend expense on trading securities we have sold, but not yet purchased.

Table 4.2: Net Interest Income and Net Gains (Losses) on Trading Activities

			Year ended December 31,	
(in millions)		2019	2018	2017
Interest income:				
Debt securities	$	3,130	2,831	2,313
Equity securities		579	587	515
Loans held for sale		78	62	38
Total interest income		3,787	3,480	2,866
Less: Interest expense		525	587	416
Net interest income		3,262	2,893	2,450
Net gains (losses) from trading activities (1):				
Debt securities		1,053	(824)	125
Equity securities		4,795	(4,240)	3,394
Loans held for sale		12	(1)	45
Derivatives (2)		(4,867)	5,667	(3,022)
Total net gains from trading activities		993	602	542
Total trading-related net interest and noninterest income	$	4,255	3,495	2,992

(1) Represents realized gains (losses) from our trading activities and unrealized gains (losses) due to changes in fair value of our trading positions.
(2) Excludes economic hedging of mortgage banking and asset/liability management activities, for which hedge results (realized and unrealized) are reported with the respective hedged activities.

Note 5: Available-for-Sale and Held-to-Maturity Debt Securities

Table 5.1 provides the amortized cost and fair value by major categories of available-for-sale debt securities, which are carried at fair value, and held-to-maturity debt securities, which are carried at amortized cost. The net unrealized gains (losses) for available-for-sale debt securities are reported on an after-tax basis as a component of cumulative OCI. Information on debt securities held for trading is included in Note 4 (Trading Activities).

Table 5.1: Amortized Cost and Fair Value

(in millions)	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
December 31, 2019				
Available-for-sale debt securities:				
Securities of U.S. Treasury and federal agencies	**$ 14,948**	**13**	**(1)**	**14,960**
Securities of U.S. states and political subdivisions (1)	**39,381**	**992**	**(36)**	**40,337**
Mortgage-backed securities:				
Federal agencies	**160,318**	**2,299**	**(164)**	**162,453**
Residential	**814**	**14**	**(1)**	**827**
Commercial	**3,899**	**41**	**(6)**	**3,934**
Total mortgage-backed securities	**165,031**	**2,354**	**(171)**	**167,214**
Corporate debt securities	**6,343**	**252**	**(32)**	**6,563**
Collateralized loan and other debt obligations	**29,693**	**125**	**(123)**	**29,695**
Other (2)	**4,664**	**50**	**(24)**	**4,690**
Total available-for-sale debt securities	**260,060**	**3,786**	**(387)**	**263,459**
Held-to-maturity debt securities:				
Securities of U.S. Treasury and federal agencies	**45,541**	**617**	**(19)**	**46,139**
Securities of U.S. states and political subdivisions	**13,486**	**286**	**(13)**	**13,759**
Federal agency and other mortgage-backed securities (3)	**94,869**	**2,093**	**(37)**	**96,925**
Other debt securities	**37**	**—**	**—**	**37**
Total held-to-maturity debt securities	**153,933**	**2,996**	**(69)**	**156,860**
Total (4)	**$ 413,993**	**6,782**	**(456)**	**420,319**
December 31, 2018				
Available-for-sale debt securities:				
Securities of U.S. Treasury and federal agencies	$ 13,451	3	(106)	13,348
Securities of U.S. states and political subdivisions (1)	48,994	716	(446)	49,264
Mortgage-backed securities:				
Federal agencies	155,974	369	(3,140)	153,203
Residential	2,638	142	(5)	2,775
Commercial	4,207	40	(22)	4,225
Total mortgage-backed securities	162,819	551	(3,167)	160,203
Corporate debt securities	6,230	131	(90)	6,271
Collateralized loan and other debt obligations	35,581	158	(396)	35,343
Other (2)	5,396	100	(13)	5,483
Total available-for-sale debt securities	272,471	1,659	(4,218)	269,912
Held-to-maturity debt securities:				
Securities of U.S. Treasury and federal agencies	44,751	4	(415)	44,340
Securities of U.S. states and political subdivisions	6,286	30	(116)	6,200
Federal agency and other mortgage-backed securities (3)	93,685	112	(2,288)	91,509
Other debt securities	66	—	—	66
Total held-to-maturity debt securities	144,788	146	(2,819)	142,115
Total (4)	$ 417,259	1,805	(7,037)	412,027

(1) Includes investments in tax-exempt preferred debt securities issued by investment funds or trusts that predominantly invest in tax-exempt municipal securities. The amortized cost and fair value of these types of securities was $5.8 billion each at December 31, 2019, and $6.3 billion each at December 31, 2018.
(2) Largely includes asset-backed securities collateralized by student loans.
(3) Predominantly consists of federal agency mortgage-backed securities at both December 31, 2019, and December 31, 2018.
(4) We held debt securities from Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC) that each exceeded 10% of shareholders' equity, with an amortized cost of $112.1 billion and $89.9 billion and a fair value of $114.0 billion and $91.4 billion at December 31, 2019, and an amortized cost of $99.0 billion and $95.0 billion and a fair value of $97.6 billion and $93.0 billion at December 31, 2018, respectively.

Gross Unrealized Losses and Fair Value

Table 5.2 shows the gross unrealized losses and fair value of available-for-sale and held-to-maturity debt securities by length of time those individual securities in each category have been in a continuous loss position. Debt securities on which we have taken credit-related OTTI write-downs are categorized as being "less than 12 months" or "12 months or more" in a continuous loss position based on the point in time that the fair value declined to below the cost basis and not the period of time since the credit-related OTTI write-down.

Table 5.2: Gross Unrealized Losses and Fair Value

		Less than 12 months		12 months or more		Total	
(in millions)		Gross unrealized losses	Fair value	Gross unrealized losses	Fair value	Gross unrealized losses	Fair value
December 31, 2019							
Available-for-sale debt securities:							
Securities of U.S. Treasury and federal agencies	**$**	**—**	**—**	**(1)**	**2,423**	**(1)**	**2,423**
Securities of U.S. states and political subdivisions		**(10)**	**2,776**	**(26)**	**2,418**	**(36)**	**5,194**
Mortgage-backed securities:							
Federal agencies		**(50)**	**16,807**	**(114)**	**10,641**	**(164)**	**27,448**
Residential		**(1)**	**149**	**—**	**—**	**(1)**	**149**
Commercial		**(3)**	**998**	**(3)**	**244**	**(6)**	**1,242**
Total mortgage-backed securities		**(54)**	**17,954**	**(117)**	**10,885**	**(171)**	**28,839**
Corporate debt securities		**(9)**	**303**	**(23)**	**216**	**(32)**	**519**
Collateralized loan and other debt obligations		**(13)**	**5,070**	**(110)**	**16,789**	**(123)**	**21,859**
Other		**(12)**	**1,587**	**(12)**	**492**	**(24)**	**2,079**
Total available-for-sale debt securities		**(98)**	**27,690**	**(289)**	**33,223**	**(387)**	**60,913**
Held-to-maturity debt securities:							
Securities of U.S. Treasury and federal agencies		**(19)**	**989**	**—**	**—**	**(19)**	**989**
Securities of U.S. states and political subdivisions		**(9)**	**613**	**(4)**	**57**	**(13)**	**670**
Federal agency and other mortgage-backed securities		**(35)**	**5,825**	**(2)**	**31**	**(37)**	**5,856**
Total held-to-maturity debt securities		**(63)**	**7,427**	**(6)**	**88**	**(69)**	**7,515**
Total	**$**	**(161)**	**35,117**	**(295)**	**33,311**	**(456)**	**68,428**
December 31, 2018							
Available-for-sale debt securities:							
Securities of U.S. Treasury and federal agencies	$	(1)	498	(105)	6,204	(106)	6,702
Securities of U.S. states and political subdivisions		(73)	9,746	(373)	9,017	(446)	18,763
Mortgage-backed securities:							
Federal agencies		(42)	10,979	(3,098)	112,252	(3,140)	123,231
Residential		(3)	398	(2)	69	(5)	467
Commercial		(20)	1,972	(2)	79	(22)	2,051
Total mortgage-backed securities		(65)	13,349	(3,102)	112,400	(3,167)	125,749
Corporate debt securities		(64)	1,965	(26)	298	(90)	2,263
Collateralized loan and other debt obligations		(388)	28,306	(8)	553	(396)	28,859
Other		(7)	819	(6)	159	(13)	978
Total available-for-sale debt securities		(598)	54,683	(3,620)	128,631	(4,218)	183,314
Held-to-maturity debt securities:							
Securities of U.S. Treasury and federal agencies		(3)	895	(412)	41,083	(415)	41,978
Securities of U.S. states and political subdivisions		(4)	598	(112)	3,992	(116)	4,590
Federal agency and other mortgage-backed securities		(5)	4,635	(2,283)	77,741	(2,288)	82,376
Total held-to-maturity debt securities		(12)	6,128	(2,807)	122,816	(2,819)	128,944
Total	$	(610)	60,811	(6,427)	251,447	(7,037)	312,258

We have assessed each debt security with gross unrealized losses included in the previous table for credit impairment. As part of that assessment we evaluated and concluded that we do not intend to sell any of the debt securities, and that it is more likely than not that we will not be required to sell, prior to recovery of the amortized cost basis. We evaluate, where necessary, whether credit impairment exists by comparing the present value of the expected cash flows to the debt securities' amortized cost basis.

For descriptions of the factors we consider when analyzing debt securities for impairment, see Note 1 (Summary of Significant Accounting Policies) and below.

SECURITIES OF U.S. TREASURY AND FEDERAL AGENCIES AND FEDERAL AGENCY MORTGAGE-BACKED SECURITIES (MBS) The unrealized losses associated with U.S. Treasury and federal agency securities and federal agency MBS are generally driven by changes in interest rates and not due to credit losses given the explicit or implicit guarantees provided by the U.S. government.

SECURITIES OF U.S. STATES AND POLITICAL SUBDIVISIONS The unrealized losses associated with securities of U.S. states and political subdivisions are usually driven by changes in the relationship between municipal and term funding credit curves rather than by changes to the credit quality of the underlying securities. Substantially all of these investments with unrealized losses are investment grade. The securities were generally underwritten in accordance with our own investment standards prior to the decision to purchase. Some of these securities are guaranteed by a bond insurer, but we did not rely on this guarantee when making our investment decision. These investments will continue to be monitored as part of our ongoing impairment analysis but are expected to perform, even if the rating agencies reduce the credit rating of the bond insurers. As a result, we expect to recover the entire amortized cost basis of these securities.

RESIDENTIAL AND COMMERCIAL MBS The unrealized losses associated with private residential MBS and commercial MBS are generally driven by changes in projected collateral losses, credit spreads and interest rates. We assess for credit impairment by estimating the present value of expected cash flows. The key assumptions for determining expected cash flows include default rates, loss severities and/or prepayment rates. We estimate security losses by forecasting the underlying mortgage loans in each transaction. We use forecasted loan performance to project cash flows to the various tranches in the structure. We also consider cash flow forecasts and, as applicable, independent industry analyst reports and forecasts, sector credit ratings, and other independent market data. Based upon our assessment of the expected credit losses and the credit enhancement level of the securities, we expect to recover the entire amortized cost basis of these securities.

CORPORATE DEBT SECURITIES The unrealized losses associated with corporate debt securities are predominantly related to unsecured debt obligations issued by various corporations. We evaluate the financial performance of each issuer on a quarterly basis to determine if the issuer can make all contractual principal and interest payments. Based upon this assessment, we expect to recover the entire amortized cost basis of these securities.

COLLATERALIZED LOAN AND OTHER DEBT OBLIGATIONS The unrealized losses associated with collateralized loan and other debt obligations relate to securities predominantly backed by commercial collateral. The unrealized losses are typically driven by changes in projected collateral losses, credit spreads and interest rates. We assess for credit impairment by estimating the present value of expected cash flows. The key assumptions for determining expected cash flows include default rates, loss severities and prepayment rates. We also consider cash flow forecasts and, as applicable, independent industry analyst reports and forecasts, sector credit ratings, and other independent market data. Based upon our assessment of the expected credit losses and the credit enhancement level of the securities, we expect to recover the entire amortized cost basis of these securities.

OTHER DEBT SECURITIES The unrealized losses associated with other debt securities predominantly relate to other asset-backed securities. The losses are usually driven by changes in projected collateral losses, credit spreads and interest rates. We assess for credit impairment by estimating the present value of expected cash flows. The key assumptions for determining expected cash flows include default rates, loss severities and prepayment rates. Based upon our assessment of the expected credit losses and the credit enhancement level of the securities, we expect to recover the entire amortized cost basis of these securities.

OTHER DEBT SECURITIES MATTERS The fair values of our debt securities could decline in the future if the underlying performance of the collateral for the residential and commercial MBS or other securities deteriorate, and our credit enhancement levels do not provide sufficient protection to our contractual principal and interest. As a result, there is a risk that significant OTTI may occur in the future.

Table 5.3 shows the gross unrealized losses and fair value of the available-for-sale and held-to-maturity debt securities by those rated investment grade and those rated less than investment grade, according to their lowest credit rating by Standard & Poor's Rating Services (S&P) or Moody's Investors Service (Moody's). Credit ratings express opinions about the credit quality of a debt security. Debt securities rated investment grade, that is those rated BBB- or higher by S&P or Baa3 or higher by Moody's, are generally considered by the rating agencies and market participants to be low credit risk. Conversely, debt securities rated below investment grade, labeled as "speculative grade" by the rating agencies, are considered to be distinctively higher credit risk than investment grade debt securities. We have also included debt securities not rated by S&P or Moody's in the table below based on our internal credit grade of the debt securities (used for credit risk management purposes) equivalent to the credit rating assigned by major credit agencies. The unrealized losses and fair value of unrated debt securities categorized as investment grade based on internal credit grades were $7 million and $2.2 billion, respectively, at December 31, 2019, and $20 million and $5.2 billion, respectively, at December 31, 2018. If an internal credit grade was not assigned, we categorized the debt security as non-investment grade.

Table 5.3: Gross Unrealized Losses and Fair Value by Investment Grade

	Investment grade		Non-investment grade	
(in millions)	Gross unrealized losses	Fair value	Gross unrealized losses	Fair value
December 31, 2019				
Available-for-sale debt securities:				
Securities of U.S. Treasury and federal agencies	$ (1)	2,423	—	—
Securities of U.S. states and political subdivisions	(32)	5,019	(4)	175
Mortgage-backed securities:				
Federal agencies	(164)	27,448	—	—
Residential	(1)	149	—	—
Commercial	(3)	1,158	(3)	84
Total mortgage-backed securities	(168)	28,755	(3)	84
Corporate debt securities	(3)	155	(29)	364
Collateralized loan and other debt obligations	(123)	21,859	—	—
Other	(13)	1,499	(11)	580
Total available-for-sale debt securities	(340)	59,710	(47)	1,203
Held-to-maturity debt securities:				
Securities of U.S. Treasury and federal agencies	(19)	989	—	—
Securities of U.S. states and political subdivisions	(13)	670	—	—
Federal agency and other mortgage-backed securities	(25)	5,428	(12)	428
Total held-to-maturity debt securities	(57)	7,087	(12)	428
Total	$ (397)	66,797	(59)	1,631
December 31, 2018				
Available-for-sale debt securities:				
Securities of U.S. Treasury and federal agencies	$ (106)	6,702	—	—
Securities of U.S. states and political subdivisions	(425)	18,447	(21)	316
Mortgage-backed securities:				
Federal agencies	(3,140)	123,231	—	—
Residential	(2)	295	(3)	172
Commercial	(20)	1,999	(2)	52
Total mortgage-backed securities	(3,162)	125,525	(5)	224
Corporate debt securities	(17)	791	(73)	1,472
Collateralized loan and other debt obligations	(396)	28,859	—	—
Other	(7)	726	(6)	252
Total available-for-sale debt securities	(4,113)	181,050	(105)	2,264
Held-to-maturity debt securities:				
Securities of U.S. Treasury and federal agencies	(415)	41,978	—	—
Securities of U.S. states and political subdivisions	(116)	4,590	—	—
Federal agency and other mortgage-backed securities	(2,278)	81,977	(10)	399
Total held-to-maturity debt securities	(2,809)	128,545	(10)	399
Total	$ (6,922)	309,595	(115)	2,663

Contractual Maturities

Table 5.4 shows the remaining contractual maturities and contractual weighted-average yields (taxable-equivalent basis) of available-for-sale debt securities. The remaining contractual principal maturities for MBS do not consider prepayments. Remaining expected maturities will differ from contractual maturities because borrowers may have the right to prepay obligations before the underlying mortgages mature.

Table 5.4: Available-for-Sale Debt Securities – Fair Value by Contractual Maturity

			Remaining contractual maturity							
	Total		Within one year		After one year through five years		After five years through ten years		After ten years	
(in millions)	amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
December 31, 2019										
Available-for-sale debt securities (1):										
Fair value:										
Securities of U.S. Treasury and federal agencies	$ 14,960	1.96%	$ 9,980	1.88%	$ 4,674	2.12%	$ 46	1.83%	$ 260	2.25%
Securities of U.S. states and political subdivisions	40,337	4.82	2,687	2.91	3,208	3.31	4,245	3.21	30,197	5.38
Mortgage-backed securities:										
Federal agencies	162,453	3.43	—	—	152	3.40	1,326	2.52	160,975	3.44
Residential	827	2.78	—	—	—	—	—	—	827	2.78
Commercial	3,934	3.44	—	—	31	4.03	235	3.22	3,668	3.45
Total mortgage-backed securities	167,214	3.43	—	—	183	3.51	1,561	2.62	165,470	3.43
Corporate debt securities	6,563	4.83	460	5.37	2,251	4.93	3,070	4.64	782	4.98
Collateralized loan and other debt obligations	29,695	3.33	—	—	—	—	12,137	3.43	17,558	3.27
Other	4,690	2.57	35	4.16	687	3.15	1,408	1.80	2,560	2.81
Total available-for-sale debt securities at fair value	$ 263,459	3.57%	$ 13,162	2.22%	$ 11,003	3.12%	$ 22,467	3.39%	$ 216,827	3.69%

(1) Weighted-average yields displayed by maturity bucket are weighted based on fair value and predominantly represent contractual coupon rates without effect for any related hedging derivatives.

Table 5.5 shows the amortized cost and weighted-average yields of held-to-maturity debt securities by contractual maturity.

Table 5.5: Held-to-Maturity Debt Securities – Amortized Cost by Contractual Maturity

			Remaining contractual maturity							
	Total		Within one year		After one year through five years		After five years through ten years		After ten years	
(in millions)	amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
December 31, 2019										
Held-to-maturity debt securities (1):										
Amortized cost:										
Securities of U.S. Treasury and federal agencies	$ 45,541	2.12%	$ 1,296	1.75%	$ 42,242	2.13%	$ 1,244	2.00%	$ 759	2.33%
Securities of U.S. states and political subdivisions	13,486	4.89	—	—	87	5.95	1,866	4.80	11,533	4.90
Federal agency and other mortgage-backed securities	94,869	3.08	—	—	15	3.10	—	—	94,854	3.08
Other debt securities	37	3.18	—	—	—	—	37	3.18	—	—
Total held-to-maturity debt securities at amortized cost	$ 153,933	2.95%	$ 1,296	1.75%	$ 42,344	2.14%	$ 3,147	3.68%	$ 107,146	3.27%

(1) Weighted-average yields displayed by maturity bucket are weighted based on amortized cost and predominantly represent contractual coupon rates.

Table 5.6 shows the fair value of held-to-maturity debt securities by contractual maturity.

Table 5.6: Held-to-Maturity Debt Securities – Fair Value by Contractual Maturity

			Remaining contractual maturity			
		Total	Within one year	After one year through five years	After five years through ten years	After ten years
(in millions)		amount	Amount	Amount	Amount	Amount
December 31, 2019						
Held-to-maturity debt securities:						
Fair value:						
Securities of U.S. Treasury and federal agencies	$	46,139	1,301	42,830	1,268	740
Securities of U.S. states and political subdivisions		13,759	—	87	1,940	11,732
Federal agency and other mortgage-backed securities		96,925	—	15	—	96,910
Other debt securities		37	—	—	37	—
Total held-to-maturity debt securities at fair value	$	156,860	1,301	42,932	3,245	109,382

Realized Gains and Losses

Table 5.7 shows the gross realized gains and losses on sales and OTTI write-downs related to available-for-sale debt securities.

Table 5.7: Realized Gains and Losses

		Year ended December 31,		
(in millions)		2019	2018	2017
Gross realized gains	$	227	155	948
Gross realized losses		(24)	(19)	(207)
OTTI write-downs		(63)	(28)	(262)
Net realized gains from available-for-sale debt securities	$	140	108	479

Other-Than-Temporary Impaired Debt Securities

Table 5.8 shows the detail of total OTTI write-downs included in earnings for available-for-sale debt securities. There were no OTTI write-downs on held-to-maturity debt securities during the years ended December 31, 2019, 2018 or 2017.

Table 5.8: Detail of OTTI Write-downs

		Year ended December 31,		
(in millions)		2019	2018	2017
Debt securities OTTI write-downs included in earnings:				
Securities of U.S. states and political subdivisions	$	33	2	150
Mortgage-backed securities:				
Residential		—	4	11
Commercial		17	18	80
Corporate debt securities		13	—	21
Other debt securities		—	4	—
Total debt securities OTTI write-downs included in earnings	$	63	28	262

Table 5.9 shows the detail of OTTI write-downs on available-for-sale debt securities included in earnings and the related changes in OCI for the same securities.

Table 5.9: OTTI Write-downs Included in Earnings and the Related Changes in OCI

		Year ended December 31,	
(in millions)	2019	2018	2017
OTTI on debt securities			
Recorded as part of gross realized losses:			
Credit-related OTTI	$ 27	27	119
Intent-to-sell OTTI	36	1	143
Total recorded as part of gross realized losses	63	28	262
Changes to OCI for losses (reversal of losses) in non-credit-related OTTI (1):			
Securities of U.S. states and political subdivisions	(1)	(2)	(5)
Residential mortgage-backed securities	(1)	2	(1)
Commercial mortgage-backed securities	2	(11)	(51)
Other debt securities	1	—	—
Total changes to OCI for non-credit-related OTTI	1	(11)	(57)
Total OTTI losses recorded on debt securities	$ 64	17	205

(1) Represents amounts recorded to OCI for impairment of debt securities, due to factors other than credit that have also had credit-related OTTI write-downs during the period. Increases represent initial or subsequent non-credit-related OTTI on debt securities. Decreases represent partial to full reversal of impairment due to recoveries in the fair value of debt securities due to non-credit factors.

Table 5.10 presents a rollforward of the OTTI credit loss that has been recognized in earnings as a write-down of available-for-sale debt securities we still own (referred to as "credit-impaired" debt securities) and do not intend to sell. We have not recognized OTTI on held-to-maturity debt securities we still own. Recognized credit loss represents the difference between the present value of expected future cash flows discounted using the security's current effective interest rate and the amortized cost basis of the security prior to considering credit loss.

Table 5.10: Rollforward of OTTI Credit Loss

		Year ended December 31,	
(in millions)	2019	2018	2017
Credit loss recognized, beginning of year	$ 562	742	1,043
Additions:			
For securities with initial credit impairments	6	1	9
For securities with previous credit impairments	21	26	110
Total additions	27	27	119
Reductions:			
For securities sold, matured, or intended/required to be sold	(390)	(204)	(414)
For recoveries of previous credit impairments (1)	—	(3)	(6)
Total reductions	(390)	(207)	(420)
Credit loss recognized, end of year	$ 199	562	742

(1) Recoveries of previous credit impairments result from increases in expected cash flows subsequent to credit loss recognition. Such recoveries are reflected prospectively as interest yield adjustments using the effective interest method.

RECEIVABLES

Topic 310, *Receivables,* addresses measurement, presentation, and disclosure requirements for financing receivables, including trade receivables, and loans receivable. Although much of the guidance under this topic is obviously geared toward financial institutions, its provisions apply to trade receivables and "incidental" loans receivable of any commercial business.

Recognition and Measurement

1. Loans and trade receivables not held for sale should be presented on the balance sheet as outstanding principal adjusted for:

   - Charge-offs
   - Allowance for doubtful accounts (loan losses)
   - Deferred fees
   - Unamortized premiums or discounts on purchased loans

2. Write-offs of receivables should be deducted from the allowance account. If these accounts are later recovered, they should be recorded when received. This topic does not specify how recoveries are recorded; many commercial companies record them directly through earnings.

3. If a decision is made to sell loans, they are reclassified as "held for sale" (either mortgages or non-mortgage loans) at the lower of cost or fair value, with any excess of cost over fair value shown as a valuation allowance.

4. Non-mortgage loans held for sale are carried at the lower of cost or fair value.

   The topic also discusses how to account for delinquency fees, prepayment fees, rebates of finance charges, and factoring commissions. Since these are not commonly applicable to normal trade receivables, they will not be discussed.

The following **disclosures** are required for trade receivables in the Summary of Significant Accounting Policies note:

- The basis of accounting used
- The method for recognizing interest income
- The methodology used to estimate the allowance for doubtful accounts
- The allowance for doubtful accounts (usually on the balance sheet), and, as applicable, any unearned income, unamortized premiums or discounts, and any net unamortized deferred fees and costs
- Except for credit card receivables, an entity shall disclose its policy for charging off uncollectible trade accounts receivable that arose from the sale of goods or services and have contractual maturities of one year or less.

In addition to this accounting policy disclosure, Topic 310 requires the following disclosures for trade receivables:

Presentation and Disclosure

Separate presentation of:

a. Receivables from officers, employees, or affiliates

b. Receivables held for sale – on face of balance sheet

c. Major categories – either on balance sheet or in notes

d. Foreclosed or repossessed assets – either on balance sheet or in notes

e. Aggregate gains/losses on sales of receivables – in Income Statement or in notes

Disclosure of:

a. Allowance for doubtful accounts (credit losses)

b. Unearned income

c. Unamortized premiums or discounts

d. Unamortized deferred fees and costs

e. Carrying amount of receivables pledged as collateral

EXAMPLE

Balance Sheet (excerpt)

December 31, 20X2

Assets:

Cash	$140,000
Receivables:	
Trade – Net of allowance for doubtful accounts of $100,000	$800,000
Note receivable – Net of allowance for loan loss of $50,000	$150,000

Note 1: Summary of Significant Policies (In Part)

Accounts Receivable - The Company carries its accounts receivable at cost less an allowance for doubtful accounts. Periodically, the Company evaluates its accounts receivable and establishes an allowance for doubtful accounts based on historical experience with bad debts and collections, as well as current credit conditions.

Interest is accrued on receivables considered past due at the rate of 1% per month, starting 30 days after the payment due date. Accounts on which payments have not been received by the company for 90 days are turned over for collection; balances are written off as uncollectible if no payments are received 90 days after they have been turned over for collection.

Note 8: Notes Payable (In Part)

The Company's notes payable are collateralized by all receivables and property.

[This discloses the amounts pledged by inference (i.e., all the amounts on the balance sheet). If only some of the assets were pledged, the amounts would need to be provided].

Topic 310 – Impaired Loans

Topic 310 requires loss recognition whenever a loan receivable is impaired. A loan is impaired when it is probable that principal or interest will not be collected according to a loan's contractual terms.

When a loan receivable is impaired, the creditor must calculate the present value of expected collections using the effective interest rate of the original loan. If this present value amount is less than the net carrying amount of the loan, the following entry is recorded:

	Dr	Cr
Dr: Bad debt expense	XX	
Cr: Valuation allowance		XX

Topic 310 permits recording impaired loans at the lower of this impaired amount or another more conservative amount (such as value of collateral, if less).

The following **disclosures** are required when a company has impaired loans:

1. As of the date of each balance sheet:
   - Total recorded investment in impaired loans
   - The amount of recorded investment for which there is an allowance and the amount of the allowance
   - The amount of recorded investment for which there is no allowance
2. The company's policy for recognizing interest income on impaired loans, including how cash receipts are recorded
3. For each Income Statement:
   - The average recorded investment in impaired loans during the period
   - The amount of interest income recognized within the period that the loans were impaired
   - The amount of interest income recognized using the cash method of accounting during the period that the loans were impaired, if practical

- The activity in the total allowance for credit losses related to loans including:
  - Beginning balance in allowance account
  - Ending balance in allowance account
  - Additions charged to operations
  - Direct write-downs charged against the allowance accounts
  - Recoveries of previous amounts charged off

EXAMPLE

The following example is for a single impaired loan receivable.

Note 8: Note Receivable

The Company carries its note receivable at the principal amount due reduced by a loan loss allowance. The Company evaluated this loan based on the past payment history and credit worthiness of the borrower and established a loan loss allowance during 20X2, when it determined that contractual payments of interest and principal on the loan will not be collected in accordance with terms of the loan agreement. The recorded investment is based on management's best estimate of the present value of future cash flows, discounted using the loan's contractual interest rate of 6.5%. Amounts receivable will be charged off against the allowance only if all reasonable attempts at collection fail.

Interest is accrued monthly; the loan has not been placed on nonaccrual status at December 31, 20X2. Information on this loan is as follows:

Recorded investment	$470,000
Unpaid principal balance	$650,000
Related allowance	$180,000
Average recorded investment	$605,000
Interest income recognized	$ 38,000

Activity in the allowance for loan losses for the year ended December 31, 20X2 was:

Beginning balance	$ -0-
Provision	180,000
Ending balance	$180,000

Note: The example does not include any fair value disclosures that may be required under other standards.

EXAMPLE – DISCLOSURE – RECEIVABLE IMPAIRMENTS

ALPHABET INC. 10Q - 6/30/2020 (IN PART):

Accounts Receivable

For the six months ended June 30, 2020, our assessment of the allowance for credit losses considered the impact of COVID-19 and estimates of expected credit and collectability trends. Volatility in market conditions and evolving credit trends are difficult to predict and may cause variability and volatility that may have a material impact on our allowance for credit losses in future periods. The allowance for credit losses was $275 million and $788 million as of December 31, 2019, and June 30, 2020, respectively.

INVENTORIES

Topic 330, *Inventory,* inventory disclosures are in three general areas:

1. **Major Categories of Inventory** – The financial statements should separately present or disclose the amount of inventory in:

   - Raw Materials
   - Work in Process
   - Finished Goods

In some cases, it is sufficient to disclose this breakdown in qualitative terms, such as "substantially all of the Company's inventory is comprised of raw materials."

2. **Basis of Carrying Inventory** – Inventory is required to be carried on the balance sheet at the lower of cost or net realizable value (NRV) for inventory costed using the FIFO and average cost methods. This evaluation may be done on an individual or aggregate basis. In addition to disclosing valuation at the lower of cost or NRV, the method for determining cost (FIFO, average, etc.) must also be disclosed, usually in the policy note. When a reporting entity uses the LIFO costing method, inventory is valued at lower of cost or market. Again, the method for determining LIFO cost must be disclosed.

3. **Inventory Pledged as Collateral** – Topic 450, *Contingencies,* requires disclosure of the nature and amount of any asset, including inventory, pledged as collateral.

PROPERTY, PLANT, AND EQUIPMENT

Basic Property, Plant, and Equipment Disclosures

Property, plant, and equipment is a major portion of assets for many companies. Not only is its cost significant, but this cost flows through operations over the longest period of time. Topic 360, *Property, Plant, and Equipment,* requires the following disclosures for property, plant, and equipment:

1. Balances of major classes of depreciable assets. This can be shown on the face of the balance sheet or in the notes. Assets that are held for sale (discussed below) or idle should be segregated from operating assets and not depreciated.

2. Depreciation expense for each period presented. This expense is often disclosed in a separate line on the Income Statement or as an adjustment within operating cash flows on the Statement of Cash Flows.

Recent tax legislation has increased Section 179 and bonus depreciation limits to the extent that it is usually not appropriate to take the position that tax methods are not materially different from methods allowable for GAAP.

3. Accumulated depreciation by major classes or in total

4. A general description of the methods used in calculating depreciation (normally in the Summary of Significant Accounting Policies). It is not necessary to specify the number of years in describing the assets' useful lives.

5. Description of property pledged as collateral

6. Amount of interest capitalized under Topic 835 (discussed in the following)

The following financial statement presentation and note illustrate these disclosure requirements (assumes depreciation expense shown on face of the Income Statement or Statement of Cash Flows):

EXAMPLE

Balance Sheet	20X9	20X8
Property, Plant, and Equipment:		
Land	$ 668,000	$ 668,000
Buildings	2,445,000	2,325,000
Machinery and equipment	1,380,000	1,242,000
Construction in progress	1,420,000	822,000
	5,913,000	5,057,000
Less: Accumulated depreciation	1,703,000	1,557,000
	$4,210,000	$3,500,000

Note 1: Summary of Significant Accounting Policies (In Part)

Property, plant, and equipment – Property, plant, and equipment is recorded at cost. Depreciation is computed using accelerated and straight-line methods over the estimated useful lives of the related assets.

Topic 360-10 – Impairment of Long-Lived Assets

Impairment rules for property are included in Topic 360-10-35. The guidance therein also applies to amortizable intangibles.

Long-lived assets held and used should be tested for impairment when events or circumstances indicate that their carrying values are not recoverable. These "triggering events" include:

- A significant decrease in the market price of the asset (group)

- A significant adverse change in the extent or manner in which the asset (group) is used or its physical condition
- A significant adverse change in legal factors or the business climate, such as a recession
- Costs that significantly exceed the original amount to acquire or construct the asset
- A current period operating or cash flow loss combined with a history of operating or cash flow losses, or a projection or forecast demonstrating continuing losses associated with the use of the asset (group)
- A current expectation that, more likely than not, the asset will be sold or disposed of significantly before the end of its previously expected useful life

These events and circumstances trigger a 2-step impairment test. First, the asset's carrying value is compared to the related undiscounted cash flows it is expected to generate. If the cash flows are lower, the asset is impaired. Then, the loss to recognize equals the difference between the carrying amount and the fair value of the asset.

Often, the impairment test is applied to a group of assets that generate cash as a group; in such cases, any impairment loss should be allocated on a pro rata basis, except that the carrying amount of any individual asset cannot be reduced below its fair value.

Any impairment loss is permanent, and the fair value becomes the asset's new depreciable basis going forward. Recoveries in value cannot be recognized.

Often, the fair value of long-lived assets is based on either an entity-specific appraisal or the present value of a probability-weighted range of possible cash flows. The result is a nonrecurring, Level 3 fair value subject to all the related fair value disclosures.

EXAMPLE

In 20X1, Snappy, Inc. built a manufacturing plant for $10,000,000 with an expected useful life of twenty years. After several years, the company suffered operating losses because of intense competition and weakened demand for its products. At the end of 20X6, management concluded that the property's value may be impaired.

Management estimated undiscounted net cash flows from both the use and sale of the plant, excluding interest, during the remaining 14 years at $5,500,000. The plant's carrying value at December 31, 20X6 is $7,000,000 and its fair value based on an appraisal is $4,000,000.

The impairment test would be performed as follows:

Step 1 – Compare estimated cash flows to carrying amount to determine if there is impairment

Estimated undiscounted net cash flows	$ 5,500,000
Carrying amount	(7,000,000)
Asset is deemed to be impaired	$(1,500,000)

Step 2 – Compare carrying amount to fair value to determine the impairment loss

Carrying amount	$ 7,000,000
Fair value	(4,000,000)
Impairment loss	$ 3,000,000

The following **disclosures**, in addition to Topic 820 fair value disclosures, are required for assets held for use that are impaired:

1. A description of the assets impaired and the facts and circumstances leading to the impairment

2. The amount of the impairment loss and the caption in the Income Statement or Statement of Activities that includes the impairment loss, if the loss is not separately disclosed. The impairment loss should be part of income from continuing operations and if the reporting entity presents a measure of operations or performance indicator, such as income from operations, the impairment loss is to be included in that amount.

3. The method used to determine fair value

4. The business segment(s) affected, if applicable

EXAMPLE

Note 5: Impairment of Long-Lived Assets

The Company reviews long-lived assets for impairment when circumstances indicate the carrying amount of an asset may not be recoverable based on the undiscounted expected future cash flows from the use and eventual disposition of the asset. If the carrying amount of the asset is determined not to be recoverable, a write-down to fair value is recorded. The Company reviews long-lived assets for impairment at the individual asset or the asset group level for which the lowest level of independent cash flows can be identified.

In 20X6, due to operating losses and declining market demand, the Company determined that the value of its manufacturing plant was impaired. Based on an independent appraisal of the property, the Company recorded an impairment loss of $3,000,000 in income from continuing operations.

NOTE: Previous example does not include the related Topic 820 fair value disclosures for non-recurring fair value measurements.

EXAMPLE – DISCLOSURE – IMPAIRMENT COSTS

MACY'S 10-Q – 5/2/2020 (IN PART)

Impact of COVID-19

During the 13 weeks ended May 2, 2020, primarily as a result of the COVID-19 pandemic, the Company incurred non-cash impairment charges totaling $3,150 million consisting of:

- $3,070 million of goodwill impairments
- $80 million of impairments on long-lived tangible assets and right of use assets to adjust the carrying value of certain store locations to their estimated fair value

Goodwill and Indefinite Lived Intangible Assets

As a result of the sustained decline in the Company's market capitalization and changes in the Company's long-term projections driven largely by the impacts of the COVID-19 pandemic, the Company determined a triggering event had occurred that required an interim impairment assessment for all reporting units using a market approach, and income approach, or a combination of both, where appropriate.

EXAMPLE – DISCLOSURE – IMPAIRMENTS

ROYAL DUTCH SHELL'S 10-Q – 6/30/2020 (IN PART):

Impairments

The impairment loss in the second quarter 2020 was mainly triggered by revision of Shell's mid-and long-term commodity price and refining margin outlook reflecting the expected effects of COVID-19 pandemic and related macroeconomic as well as energy market demand and supply fundamentals.

Impairment losses of $16,842 million post-tax are recognized.

For impairment testing purposes, the respective carrying amounts of property, plant and equipment, and intangible assets were compared with their value in use. Cash flow projections used in the determination of value in use were made using management's forecasts of commodity prices, market supply and demand, potential cost associated with operational GHG emissions, product margins including forecast refining margins, and expected production volumes.

Impairments of Long-Lived Assets and Costs Associated with Exit Activities

Sears Holdings Corporation

February 2, 2019

Annual Report

Impairment of Long-Lived Assets and Costs Associated with Exit Activities

In accordance with accounting standards governing the impairment or disposal of long-lived assets, the carrying value of long-lived assets, including property and equipment, is evaluated whenever events or changes in circumstances indicate that a potential impairment has occurred. Factors that could result in an impairment review include, but are not limited to, a current period cash flow loss combined with a history of cash flow losses, current cash flows that may be insufficient to recover the investment in the property over the remaining useful life, or a projection that demonstrates continuing losses associated with the use of a long-lived asset, significant changes in the manner of use of the assets, or significant changes in business strategies. An impairment loss is recognized when the estimated undiscounted cash flows expected to result from the use of the asset plus net proceeds expected from disposition of the asset (if any) are less than the carrying value of the asset. When an impairment loss is recognized, the carrying amount of the asset is reduced to its estimated fair value as determined based on quoted market prices or through the use of other valuation techniques. We recorded impairment charges with respect to long-lived assets of $2.1 million and $3.4 million

in fiscal years 2018 and 2017, respectively, included in Impairment of property and equipment in the accompanying Consolidated Statements of Operations.

We account for costs associated with location closings in accordance with accounting standards pertaining to accounting for costs associated with exit or disposal activities and compensation. When management makes a decision to close a location we record a reserve as of that date for the expected inventory markdowns associated with the closing. We also record a liability for future lease costs (net of estimated sublease income) when we cease to use the location. As of February 2, 2019 and February 3, 2018, this liability was approximately $2.6 million and $4.7 million, respectively. See Note 15.

ASSETS HELD FOR SALE

Subtopic 360-45-10 addresses assets held for sale which are:

- Segregated from other long-lived assets on the balance sheet
- Carried at the lower of carrying value or fair value less costs to sell
- Not depreciated

Because abuse of this classification would permit manipulation of income (less asset depreciation), the following **conditions** must *all* be met as of the balance sheet date in order to apply the above provisions:

1. Management has committed to a plan to sell the asset.
2. The asset is immediately available for sale in its present condition, subject only to "normal customary" sales terms.
3. The company has begun an active program to locate a buyer.
4. The sale is probable and the asset transfer is expected to qualify as a completed sale within one year. There is one exception when there is a firm purchase commitment that may take longer to consummate. In addition, the pronouncement includes a list of circumstances beyond the seller's control that may expand the time to sell beyond one year. In those cases, the company can still classify the asset as held for sale.
5. The asset is being actively marketed at a reasonable price.
6. Significant changes to the sale plan are unlikely.

If these conditions are met after the balance sheet date but before the financial statements are issued (or available to be issued), that fact is disclosed in a subsequent events footnote.

The following **disclosures**, in addition to Topic 820 fair value disclosures, are required for assets either held for sale or assets that have been sold. Note that they are equally applicable to situations where assets held for sale relate to discontinued operations.

1. The facts and circumstances leading to the expected disposal, the expected manner and disposal date, and the carrying amount of the major classes of assets and liabilities

2. The gain or loss, if any, resulting from changes in the carrying amount of the assets and if not shown separately, the caption in the Income Statement or Statement of Activities that includes the gain or loss

3. The amount of revenue and pre-tax profit or loss in discontinued operations

4. The business segment(s) in which assets to be disposed of are held (if applicable)

EXAMPLE

Note X: Property, Plant, and Equipment (In Part)

In 20X1, the Company decided to sell its Mid-Atlantic warehouse due to poor product sales in that region. The Company expects to sell the warehouse within the next six months. Accordingly, in 20X1, the carrying value of this asset was reduced by $300,000 to reflect its fair value less costs to sell of $2,000,000.

(Assumes $300,000 loss shown separately in the Income Statement).

NOTE: Previous example does not reflect Topic 820 fair value disclosures.

LEASES

The FASB issued ASU 2016-02, *Leases,* as amended (Topic 842), to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements.

The **core principle** of Topic 842 is that a reporting entity should recognize assets and liabilities arising from a lease. A lessee will recognize a liability to make lease payments and a right-of-use (RoU) asset representing its right to use the leased asset for the lease term.

A lease is a contract or part of a contract that conveys the right to control the use of an identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.

From the lessee's perspective, a lessee will **classify** a lease as a **finance lease** when the lease contract meets any of the following criteria at the lease commencement date. This criterion classifies a lease based on whether the lease contract effectively reflects a purchase of the underlying asset:

- The lease **transfers ownership** of the underlying asset to the lessee by the end of the lease term

- The lease grants the lessee an **option to purchase the underlying asset** that the lessee is reasonably certain (probable) to exercise

- The lease term is for the **major part** (previously 75%) of the remaining economic life of the underlying asset – note that if the commencement date falls at or near the end of the economic life of the underlying asset, this specific criterion should not be used for purposes of classifying the lease

  - If a single lease component contains the right to use more than one underlying asset, the reporting entity should consider the remaining economic life of the predominant asset in the lease component for the purpose of applying this criterion

- The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments, **equals or exceeds substantially all of the fair value** (previously 90%) 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

When none of the criteria for a finance lease are met, a lessee classifies the lease as an operating lease.

The objective of the **disclosure requirements** in Topic 842, *Leases*, is to enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. These disclosures will be both **qualitative and quantitative**. The following are the lease disclosure requirements for lessees:

1. Information about the nature of the entity's leases, including:

   - A general description of its leases

   - The basis, terms, and conditions on which variable lease payments are determined

   - The existence and terms of any options to extend or terminate the leases

   - Narrative disclosure about options that are recognized as part of its RoU assets and lease payment liabilities and those that are not

   - The existence, terms, and conditions any residual value guarantees provided by the lessee

   - Any restrictions or covenants imposed by leases (e.g., dividends, additional financial obligations, etc.)

   - If the entity has subleases, the entity should identify the information relating to subleases as indicated above

2. Information about leases that have not yet commenced but that create significant rights and obligations for the lessee, including the nature of any involvement with the construction of the underlying asset.

3. Information about significant assumptions and judgments made in applying Topic 842, which may include the following:

   - The determination of whether a contract contains a lease
   - The allocation of the consideration in a contract between lease and non-lease components
   - The determination of the discount rate for the lease

4. In addition, for each period in the financial statements, a lessee must disclose the following amounts relating to a **lessee's total lease cost**. These amounts include both amounts recognized in profit or loss during the period and any amounts capitalized as part of the cost of another asset in accordance with other GAAP, and the cash flows arising from lease transactions:

   - **Finance lease cost** segregated between the amortization of the RoU assets and the interest on the lease liabilities
   - **Operating lease cost** including its amortization allocation, variable lease payments, and impairments (if any)
   - **Short-term lease cost** excluding expenses relating to leases of one month or less
   - **Variable lease cost** not included in the lease liability in the period in which those obligations are incurred
   - **Sublease income** disclosed on a gross basis, separate from the finance or operating lease expense
   - **Net gain or loss** recognized from any sale and leaseback transactions
   - **Amounts segregated** between those for finance and operating leases for the following items:
     - Cash paid for amounts included in the measurement of lease liabilities, segregated between operating and financing cash flows
     - Supplemental non-cash information on lease liabilities arising from RoU assets
     - Weighted-average remaining lease terms
     - Weighted-average discount rates

5. A **maturity analysis** of the lessee's finance lease liabilities and its operating lease liabilities, separately, presenting the undiscounted cash flows on an annual basis for a minimum of five years and a total of the amounts for the remaining years. The lessee should present a

reconciliation of the undiscounted cash flows to the financial lease and operating lease liabilities recognized in the statement of financial position.

6. Other lessee disclosures, not shown in sample disclosure below, include:

   - Lease transactions between related parties
   - If the lessee elects the accounting policy option for short-term leases, the lessee must disclose that fact
   - If the short-term lease expense for the period does not reasonably reflect the lessee's short-term lease commitments, the lessee must disclose that fact and the amount of its short-term lease commitments
   - A lessee that elects the practical expedient on not separating lease components from non-lease components must disclose its accounting policy election and which class or classes of the underlying assets it has elected to apply the practical expedient
   - Main terms and conditions of any sales-leaseback transactions

EXAMPLE – LESSEE DISCLOSURE

Note 7 – Leases

We lease retail stores in shopping centers, office facilities, warehouses, computers, and transportation equipment. Variable lease payments are included in most retail store leases based on the achievement of certain sales targets. These variable lease payments are recognized as lease expense when and if the targets are achieved. Most retail store, office facilities, and warehouse leases have options to extend the lease terms as well as options to terminate the leases. Lease termination clauses include penalties for early termination.

40% of the retail store, office facilities, and warehouse leases include options to extend the lease terms and these amounts are included in the Company's right of use assets and lease payment liabilities. 60% of the retail store, office facilities, and warehouse leases do not have options to extend the lease terms. As a matter of Company policy, we do not provide any residual value guarantees to lessors' assets that we lease. Any restrictions or performance covenants imposed by lessors are limited to certain debt and income metrics and the Company is in full compliance with these restrictions and performance covenants. Subleases entered into by the Company are immaterial to operations.

We are a party to the construction of two shopping malls, one in Phoenix, Arizona, and one in Atlanta, Georgia. These shopping malls are expected to be completed and open for business in 201Z. We will be the lead tenant in both malls and have signed long-term leases for 20 years each to occupy 110,000 square feet in the Phoenix location and 125,000 square feet in the Atlanta location. Once these leases commence, we will have significant rights and financial obligations throughout the 20 years of these leases.

Based on Topic 842, Leases, we have established policies and procedures to assist the Company in determining whether a contract contains a lease, we separate non-lease components from lease components in our lease contracts and account for non-lease components based on other U.S. GAAP. Lease components in our lease contracts are accounted for following the guidance in Topic 842 for the capitalization of long-term leases. Discount rates used in our capitalization policies are the discount rates implicit in our lease contracts as established through negotiation with our lessors. Based on the length of a lease contract, as well as any variable lease payments, these discount rates currently range from 6% to 10%.

		20x9		20x8
Lease cost:				
Finance lease cost:				
Amortization of right-of-use assets	$	XXX	$	XXX
Interest on lease		XXX		XXX
Total finance lease cost		XXX		XXX
Operating lease cost		XXX		XXX
Short-term lease cost		XXX		XXX
Variable lease cost		XXX		XXX
Sublease income		(XXX)		(XXX)
Total lease cost	$	XXX	$	XXX
Other information:				
Gain/(Loss) on sale-leaseback transactions, net	$	XXX	$	XXX
Cash paid for amounts included in lease liabilities:				
Operating cash flows from finance leases		XXX		XXX
Operating cash flows from operating leases		XXX		XXX
Financing cash flows from finance leases		XXX		XXX
Total cash paid		XXX		XXX
Right-of-use assets obtained in exchange for new finance lease liabilities		XXX		XXX
Right-of-use assets obtained in exchange for new operating lease liabilities		XXX		XXX
Weighted-average remaining lease term - finance leases		XXyears		XXyears
Weighted-average remaining lease term - operating leases		XXyears		XXyears

Weighted-average discount rate - finance leases	XX %	XX %
Weighted-average discount rate - operating leases	XX %	XX %

Maturity Analysis

201X	$XX	$XXX
201Y	XX	XXX
201Z	X	XX
201A	X	XX
201B	XX	XXX
Total Undiscounted Cash Flows	$XXX	$X,XXX
Interest at a Weighted Average Rate of 7.4%	(XX)	(XXX)
Lease Payment Labilities	$XXX	$X,XXX

Leasing Arrangements

McDonald's

December 31, 2019

Annual Report

Leasing Arrangements

The Company is the lessee in a significant real estate portfolio, primarily through ground leases (the Company leases the land and generally owns the building) and through improved leases (the Company leases the land and buildings). The Company determines whether an arrangement is a lease at inception. Lease terms for most restaurants, where market conditions allow, are generally for 20 years and, in many cases, provide for rent escalations and renewal options. Renewal options are typically solely at the Company's discretion. Escalation terms vary by market with examples including fixed-rent escalations, escalations based on an inflation index and fair-value market adjustments. The timing of these escalations generally range from annually to every five years.

The following table provides detail of rent expense:

In millions	*2019*	*2018*	*2017*
Restaurants	**$1,530.4**	$1,433.9	$1,562.5
Other	**76.4**	87.9	82.0
Total rent expense	**$1,606.8**	$1,521.8	$1,644.5

Rent expense included percent rents in excess of minimum rents (in millions) as follows–Company-operated restaurants: 2019–$74.4; 2018–$82.1; 2017–$115.6. Franchised restaurants: 2019–$200.7; 2018–$200.8; 2017–$204.9.

The amount of the Right of Use Asset and Lease Liability recorded at transition included known escalations and renewal option periods reasonably assured of being exercised. Typically, renewal options are considered reasonably assured of being exercised if the associated asset lives of the building or leasehold improvements exceed that of the initial lease term, and the sales performance of the restaurant remains strong. Therefore, the Right of Use Asset and Lease Liability include an assumption on renewal options that have not yet been exercised by the Company, and are not currently a future obligation.

The Company has elected not to separate non-lease components from lease components in our lessee portfolio. To the extent that occupancy costs, such as site maintenance, are included in the Asset and Liability, the impact is immaterial and is generally limited to Company-owned restaurant locations. For franchised locations, which represent the majority of the restaurant portfolio, the related occupancy costs including property taxes, insurance and site maintenance are generally required to be paid by the franchisees as part of the franchise arrangement.

In addition, the Company is the lessee under non-restaurant related leases such as office buildings, vehicles and office equipment. These leases are not a material subset of the Company's lease portfolio.

As the rate implicit in each lease is not readily determinable, the Company uses an incremental borrowing rate to calculate the lease liability that represents an estimate of the interest rate the Company would incur to borrow on a collateralized basis over the term of a lease within a particular currency environment. The weighted average discount rate used for operating leases was 4.0% as of December 31, 2019.

As of December 31, 2019, maturities of lease liabilities for our operating leases were as follows:

In millions		*Total **
2020	$	1,161.9
2021		1,132.8
2022		1,091.4
2023		1,052.6
2024		1,010.3
Thereafter		13,573.6
Total lease payments		19,022.6
Less: imputed interest		(5,643.8)
Present value of lease liability	$	13,378.8

* Total lease payments include option periods that are reasonably assured of being exercised. See contractual cash outflows for operating leases within the Contractual Obligations and Commitments section on page 19.

The increase in the present value of the lease liability since adoption of ASC 842 is approximately $0.9 billion. The lease liability will continue to be impacted by new leases, lease modifications, lease terminations, reevaluation of likely-term due to new facts and circumstances, and foreign currency.

As of December 31, 2019, the Weighted Average Lease Term remaining that is included in the maturities of lease liabilities was 20 years.

As of December 31, 2018, prior to the adoption of ASC 842, future minimum payments required under existing operating leases with initial terms of one year or more were:

In millions		*Restaurant*		*Other*		*Total **
2019	$	1,093.4	$	51.3	$	1,144.7
2020		1,032.1		51.0		1,083.1
2021		955.5		45.7		1,001.2
2022		873.8		35.7		909.5
2023		806.0		24.6		830.6
Thereafter		7,132.3		164.9		7,297.2
Total minimum payments	$	11,893.1	$	373.2	$	12,266.3

* Future minimum payments exclude option periods that have not yet been exercised.

FINANCIAL INSTRUMENTS (TOPIC 825)

Topic 825, *Financial Instruments,* defines financial instruments and primarily deals with three disclosure areas:

1. Fair value disclosures for both on- and off-balance-sheet financial instruments where it is practicable to estimate fair values.

2. Concentrations of credit risk

3. Market risk of all financial instruments (encouraged, not required)

Financial instruments are defined as cash, evidence of an ownership interest in an entity, or a contractual right or obligation to receive or pay cash, or exchange another financial instrument (receivable or payable).

Fair Value of Financial Instruments

This disclosure requirement is a holdover from standards issued before comprehensive new guidance was developed for measuring and disclosing fair values. Companies are entirely exempt from making this disclosure if:

- They are non-public
- They have less than $100 million in assets at the balance sheet date
- They have not held or issued any derivative instruments during the reporting period

This exemption was defined some years ago, and most private companies were found to fit the requirements. However, since that time, many more companies have used derivatives such as interest rate swaps. As a result, they must provide these disclosures. (Note: If ASU 2014-03 is elected for "plain vanilla" swaps, the exemption still applies so long as no other types of derivatives are held.)

Topic 825 requires disclosure of:

1. The fair value of financial instruments, whether on- or off-balance sheet, where it is practicable to estimate that value – on the face of the balance sheet or in the notes.

2. The method(s) and significant assumptions used to estimate the fair values.

3. A description of any changes in the method(s) and significant assumptions used to estimate fair values.

4. The level of the fair value hierarchy within the fair value measurements categorized in their entirety (Level 1, 2, or 3).

Note: For financial instruments recognized at fair value in the statement of financial position, the disclosure requirements of Topic 820, *Fair Value Measurement*, applies.

This information must be disclosed only in annual statements of private companies; it is required in interim and annual statements for public companies.

In practice, this requirement provides information primarily for financial instruments not carried at fair value on the balance sheet or not recognized at all ("off-balance sheet"), because assets and liabilities that *are* recorded at fair value are subject to copious disclosures that incorporate these items.

Notably, *trade receivables and trade payables are exempt* from this disclosure if their carrying amounts approximate fair value. In addition, leases, benefit plans, warranty obligations, equity method investments, non-controlling interests in consolidated statements, and an entity's own equity instruments are excluded.

Therefore, if a private company is not exempt from this disclosure, the assets and liabilities likely to fall within the guidelines might include:

- Cash and cash equivalents (carrying value approximates fair value)
- Investments on the cost method (often, this will be an investment in a private company, with estimate of fair value not practicable)
- Notes payable and long-term debt (carrying value approximates fair value so long as interest rates reflect current market conditions and creditworthiness)
- Off-balance sheet guarantees (not practicable)

If this information is disclosed in the notes, it must be presented together with related carrying amounts, in a format that makes it clear how the amounts tie into the balance sheet, and whether the instruments are assets or liabilities (if not obvious). Netting is generally not allowed unless the instruments qualify for right of setoff.

If the fair value of financial instruments is disclosed in more than one note, one of the notes must include a summary table containing the fair values and carrying values, as well as cross references to the notes where the remaining disclosures are included.

If it is not practicable to estimate the fair value of a financial instrument, the notes must explain the reasons why and provide information that would be relevant to assessing fair value, such as carrying amounts, maturities, etc. "Practicable" means that an estimate of fair value can be made without incurring excessive costs.

In comparative statements, a company that was exempt from this disclosure in prior periods need not provide comparative information. If a company became exempt in the current period, the information from the prior year need not be repeated.

EXAMPLE

Note 6: Financial Instruments

The carrying values of the Company's cash, cash equivalents and notes payable approximate their fair values. The fair value of the Company's long-term debt is calculated by discounting the contractual payments using current market rates of interest and was approximately $482,000 at December 31, 20X0, as compared to its carrying value of $543,000. It is not practicable to estimate the fair value of the Company's 5% ownership interest in Cowhill Corporation, carried at its cost of $100,000, because the investee is a privately held company. This investment has not been reviewed for impairment, and there were no events or changes in circumstances that may have had a negative impact on its fair value.

The following sample disclosure assumes that a company's long-term debt carries a fixed rate of interest that is lower than current rates.

Concentrations of Credit Risk

Entities must disclose the following for significant concentrations of credit risk for all financial instruments:

- Information about the **activity, region, or economic** characteristics that identifies the concentration
- The maximum amount of loss, based on the gross fair value of the financial instruments, that would be incurred if the parties failed to perform according to the terms of the contract and the collateral or security had no value
- The collateral or security policy of the entity, the entity's access to such collateral or security, and the nature and a description of the collateral or security supporting the financial instruments
- Disclosure of credit risk applies to all financial instruments, not just those with off balance sheet risk
- The entity's policy of entering into master netting arrangements (i.e., hedging) that mitigate credit risk
- The description of master netting arrangements, including the extent of reduction of loss due to credit risk

Note that the above disclosures require not only a description of the type of concentration, but also the maximum potential loss at year-end. For example, if a company has a significant amount of receivables concentrated in a specific industry, the amount of accounts receivable at the balance sheet date from customers in this industry should be disclosed.

As previously noted, ASU 2016-13, *Financial Instruments—Credit Losses* (Topic 326), was issued in June 2016. The Update makes significant changes to accounting, reporting, and disclosing credit losses. It will be effective for public companies with years beginning after December 15, 2019, with early adoption a year earlier permissible. For all other reporting entities, this ASU is effective for fiscal years beginning after December 15, 2022. Those rules are not discussed here.

EXAMPLE

Note 1: Summary of Significant Accounting Policies (In Part)

Nature of Operations – The Company develops and licenses software products. Approximately 40% of sales are to banks and credit unions. At the balance sheet date, $380,000 of trade receivables was due from financial institutions.

(Note that the term "trade receivables" discloses by inference that there are no collateral arrangements.)

AICPA Technical Information Service (TIS) 2110.06 states that bank balances in excess of FDIC insured amounts represent a concentration of credit risk; therefore, material uninsured cash balances in a single bank must be disclosed as a concentration of credit risk. Proper note disclosure should disclose both the fact that cash may exceed the FDIC limit during the year, as well as the dollar amount of the risk at the balance sheet date.

Legislation has permanently set the maximum FDIC insurance coverage at $250,000 for each financial institution.

EXAMPLE

Note 1: Summary of Significant Accounting Policies (In Part)

Cash and Cash Equivalents – The Company considers all highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents.

Note 5: Concentration of Credit Risk

The Company's cash balances fluctuate during the year and at times exceed the $250,000 federally insured limit. At December 31, 20X5, cash and cash equivalents at one financial institution exceeded the federally insured limit by $26,500.

(Many companies include the concentration disclosure with the policy note on cash and cash equivalents.)

TIS 2110.06 also goes on to say that immaterial uninsured cash balances at several banks may not require disclosure, depending on the circumstances. The TIS does give an example of a disclosure that might be appropriate when immaterial uninsured balances exist, as follows:

EXAMPLE

The Company maintains its cash in bank deposit accounts, which, at times, may exceed federally insured limits. The Company has not experienced any losses in such accounts. The Company believes it is not exposed to any significant credit risk on cash and cash equivalents.

There are also several disclosures that may be necessary due to concentrations related to investments:

a. **<u>Concentration</u>** – If a company has an investment portfolio that is concentrated in a specific company or industry, then that concentration should be disclosed (similar to the accounts receivable issue discussed above).

b. **<u>Uninsured risk</u>** – If a company has cash and investments at a broker-dealer in excess of SIPC (Securities Investor Protection Corporation) insurance limits, this concentration of credit risk must be disclosed. All broker-dealers registered with the SEC must be SIPC members except for:

   - Broker-dealers handling exclusively open-end investment companies or unit trusts
   - Broker-dealers handling exclusively insurance or annuities
   - Investment advisers

As members, broker-dealers pay an assessment that is used to cover claims in the event a broker-dealer fails. The general SIPC coverage for cash and securities held in street name is $500,000, of which cash claims cannot exceed $100,000. Keep in mind that if securities are held in <u>the customer's name</u>, the securities are returned to the customer without any dollar limit and therefore, there is no off-balance sheet risk. However, customer names are generally not used in practice.

Market Risk of All Financial Instruments

Reporting entities are encouraged, but not required, to disclose quantitative information about the market risks of financial instruments that is consistent with the way it manages or adjusts those risks. Examples disclosures can include:

- More details about current positions and activity during the period
- The hypothetical effects on comprehensive income (or net assets), or annual income, of several possible changes in market prices
- A gap analysis of interest rate repricing or maturity dates
- The duration of financial instruments
- The reporting entity's value at risk (measure of risk of loss from investments) from derivatives and from other positions at the end of the reporting period and the average value at risk during the year.

Financial Instruments

General Electric

December 31, 2018

Annual Report

NOTE 20. FINANCIAL INSTRUMENTS

The following table provides information about assets and liabilities not carried at fair value. The table excludes finance leases, equity securities without readily determinable fair value and non-financial assets and liabilities. Substantially all of the assets discussed below are considered to be Level 3. The vast majority of our liabilities' fair values can be determined based on significant observable inputs and thus considered Level 2. Few of the instruments are actively traded and their fair values must often be determined using financial models. Realization of the fair value of these instruments depends upon market forces beyond our control, including marketplace liquidity.

	2018		2017	
December 31 (In millions)	Carrying amount (net)	Estimated fair value	Carrying amount (net)	Estimated fair value
GE				
Assets				
Notes receivable	$ 798	$ 787	$ 700	$ 700
Liabilities				
Borrowings(a)(b)	32,309	29,586	34,473	35,416
Borrowings (assumed by GE)(a)(c)	36,262	36,298	47,114	53,502
GE Capital				
Assets				
Loans	10,820	10,807	17,363	17,331
Other commercial mortgages	1,747	1,792	1,489	1,566
Loans held for sale	404	405	3,274	3,274
Liabilities				
Borrowings(a)(d)(e)(f)	43,028	42,006	55,353	60,415
Investment contracts	2,388	2,630	2,569	2,996

(a) See Note 11 for further information.
(b) Included $210 million and $217 million of accrued interest in estimated fair value at December 31, 2018 and December 31, 2017, respectively.
(c) Included $568 million and $696 million of accrued interest in estimated fair value at December 31, 2018 and December 31, 2017, respectively.
(d) Fair values exclude interest rate and currency derivatives designated as hedges of borrowings. Had they been included, the fair value of borrowings at December 31, 2018 and December 31, 2017 would have been reduced by $1,300 million and $1,754 million, respectively.
(e) Included $583 million and $731 million of accrued interest in estimated fair value at December 31, 2018 and December 31, 2017, respectively.
(f) Excluded $22,513 million and $39,844 million of net intercompany payable to GE at December 31, 2018 and December 31, 2017, respectively.

A description of how we estimate fair values follows:

Loans. Based on a discounted future cash flows methodology, using current market interest rate data adjusted for inherent credit risk or quoted market prices and recent transactions, if available.

Borrowings. Based on valuation methodologies using current market interest rate data that are comparable to market quotes adjusted for our non-performance risk or quoted market prices and recent transactions, if available.

Investment contracts. Based on expected future cash flows, discounted at currently offered rates for immediate annuity contracts or the income approach for single premium deferred annuities.

Assets and liabilities that are reflected in the accompanying financial statements at fair value are not included in the above disclosures; such items include cash and equivalents, investment securities and derivative financial instruments.

NOTIONAL AMOUNTS OF LOAN COMMITMENTS *December 31 (In millions)*	2018	2017
Ordinary course of business lending commitments(a)	$ 767	$ 1,105
Unused revolving credit lines	34	198

(a) Excluded investment commitments of $1,373 million and $677 million at December 31, 2018 and December 31, 2017, respectively.

FAIR VALUE MEASUREMENT

This unit has been updated to include the issuance of ASU 2018-13, *Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement,* in August 2018. This ASU is effective for all reporting entities for fiscal years and interim periods within those fiscal years beginning after December 15, 2019.

Topic 820, *Fair Value Measurement,* sets forth the fair value framework that applies to various accounting topics, both old and new. Recent fair value standards did not change *when* fair value measurements are required; rather they affect *how* fair value must be measured and disclosed.

Fair value is defined as:

> "The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced or distressed sale) between market participants at the measurement date."

- **The price** reflects the amount that would be received upon the sale of an asset, or paid to transfer a liability – often referred to as the **exit price**.

  Consequently, fair value is determined from the point of view of the transferor, not the transferee. It is similar to the difference between realizable value upon sale and replacement cost.

- There is a presumption that the transfer takes place in the **principal (or most advantageous) market** for the asset or liability. A principal market is the one with the greatest volume or level of activity for similar transactions. The price in the principal (or most advantageous) market is *not* adjusted for transaction costs that arise from the transaction event.

- **Market participants** are willing parties who are independent of the reporting entity and knowledgeable about the transactions and the assets and liabilities involved.

- Fair values of non-financial assets should reflect their **highest and best use**, so long as such use is possible, legal, and financially feasible.

The intuitive conclusion that "cost" is the same as fair value on the acquisition date will not always be correct. For example, an acquisition price may not equal the fair value of an asset or liability if:

- The transaction was between related parties.

- The transaction was "forced" or entered into under duress; for example, if an asset is acquired from a seller in financial difficulty.

- The "unit of account" inherent in the transaction is different from that used in measuring fair value. This can occur, for example, in a "basket" purchase of assets and liabilities, or if the transaction includes rights and privileges (or obligations) that must be measured separately.

- The market in which the transaction occurred is not the principal or most advantageous market.

Fair value measurements for liabilities assume that the risk of nonperformance by the primary obligor will be the same before and after the transfer; in other words, the reporting entity should consider the effect of its credit standing on the fair value of the liability, assuming a market participant would similarly perform or similarly bear the consequences of not performing in the same way as the reporting entity.

Applying an exit price approach to measuring the fair value of liabilities assumes that they can be exchanged in orderly transactions between market participants. However, liabilities (e.g., long-term debt) are rarely traded in a marketplace due to creditor imposed restrictions. To address this concern, ASU 2009-05 (Subtopic 820-10-35), *Measuring Liabilities at Fair Value,* provides the following guidance:

1. If a quoted price exists in an active market for an identical liability, it should be used and would be a Level 1 Input. (This would apply, for example, to publicly traded bonds payable.)

2. If a quoted price is not available, one or more of the following techniques should be used:

   - The quoted price of an identical liability when traded as an asset. (Level 1)

   - The quoted price of a similar liability when traded as an asset. (Level 2)

3. Another valuation technique reflecting a market or income approach, such as the amount the entity would have to pay to transfer the liability or the amount it would receive to enter the same liability. (Level 2 or 3)

Valuation Techniques

Topic 820 recognizes three valuation techniques:

1. **Market Approach** – This approach uses observable prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities. It includes observable market prices, as well as business valuation models such as earnings multiples.

2. **Income Approach** – This method is based on present valuing a future stream of cash flows or income. It incorporates expectations about future amounts, and includes methods such as:

   – Present value techniques

   – Option-pricing models such as the Black-Scholes or lattice models

   – Multi-period excess earnings models – typically used to determine the fair value of intangible assets

   Topic 820 clarifies that fair value measurements using present value should include an adjustment for risk, if market participants would include one in pricing the related asset or liability. The adjustment for risk is generally factored into the discount rate rather than the future cash flow stream.

3. **Replacement Cost Approach** – The amount that currently would be required to replace the service capability of an asset.

Valuation techniques used to measure the fair value of assets or liabilities should be applied consistently. If subsequent changes in circumstances suggest that a different weighting or different range of inputs is more representative of fair value, a change in valuation approach would be appropriate. Changes in valuation techniques are accounted for as a change in estimate, with appropriate disclosure of the change.

Fair Value Hierarchy

Topic 820 establishes a hierarchy of inputs based on whether they are observable (external and verifiable) or unobservable (internally generated). Observable inputs are always preferable when they are available.

The fair value hierarchy consists of:

- **Level 1 Inputs** – Observable market inputs that reflect quoted prices for identical assets or liabilities in active markets to which the reporting entity has access. Topic 820 requires the use of quoted prices in active markets whenever available.

  Any necessary adjustments to quoted prices cause the resulting fair value measurement to be a Level 2 or Level 3 value.

- **Level 2 Inputs** – Market inputs, other than Level 1 quoted prices, for identical or similar assets or liabilities that are *observable* either directly or indirectly.

  Level 2 inputs include:

  – Quoted prices for similar assets or liabilities in active markets

  – Quoted prices for identical or similar assets or liabilities in markets that are not active

  – Inputs other than quoted prices that are observable for the asset or liability such as interest rates, prepayment speeds, credit risks, or default rates

  – Market-corroborated inputs that are derived principally from or corroborated by observable market data by correlation or other means

If these observable inputs are adjusted for factors such as location or condition of an asset, they become Level 3 inputs.

- **Level 3 Inputs** – Topic 820 recognizes that fair values may be required when there is no observable market for the asset or liability at the measurement date (measuring the fair value of goodwill in testing it for impairment is a good example). The use of unobservable inputs may also be necessary when the market for an asset or liability has become inactive or disorderly, making observed transactions an unreliable basis for fair value.

  Level 3 inputs are **unobservable inputs** that are derived from predictive assumptions that cannot be corroborated by observable market data – normally internally-generated management assumptions developed from the perspective of market participants.

The initial adoption of current fair value standards coincided to a large degree with the start of the recent economic downturn. As a result, practice problems arose because instruments that had previously been actively traded—in particular those relating to mortgages—underwent a market collapse that effectively eliminated observable active and orderly markets for those instruments.

In April 2009, FASB responded to this development by amending its fair value guidance to address situations where the volume and level of activity in a market have decreased, or where the transactions in that market could not be considered orderly. Topic 820 now lists relevant factors to consider in determining when these circumstances are present and, if they are, permits the reporting entity to adjust observed prices or use other techniques to derive fair value. This provision in effect "trumps" the normal hierarchy by allowing unobservable inputs to be used. (This provision is not explained in detail herein because it generally applies to financial institutions or market segments that are specialized.)

Such judgments and changing market conditions can cause the same asset or liability to be valued with different level inputs from period to period. Consequently, ASU 2011-04 added requirements to disclose information about "transfers" among levels in the fair value hierarchy.

Topic 820 recognizes that, in some cases, inputs from different levels in the hierarchy may need to be combined to measure fair value. Identification of the resulting fair value measurement as Level 1, 2, or 3 will be based on the lowest level input that is significant to the fair value measurement in its entirety. FASB does not define "significance" for this purpose.

Disclosure Requirements

The objective of the fair value disclosure requirements are to provide users of financial statements with information about assets and liabilities measured at fair value in the statement of financial position or disclosed in the notes to the financial statements including:

- The valuation techniques and inputs that a reporting entity uses to arrive at its measures of fair value, including judgments and assumptions that the entity makes
- The measurement uncertainty in the fair value measurements as of the reporting date
- How changes in fair value measurements affect an entity's performance and cash flows

Expanded disclosures are required for Level 3 fair values, because they involve unobservable inputs and subjective judgments. Further, all quantitative disclosures are required to be presented in tabular format.

The breakdown of fair value disclosures is now required for each *class* of assets and liabilities, rather than each *major category*. Classes may be characterized by shared activity or business sector, vintage, geographic concentration, credit quality, or other economic characteristics. (In contrast, major categories are limited to stocks, corporate debt, government obligations, etc.)

Topic 820 requirements are broken down between disclosures for items measured at fair value on a *recurring* basis—generally certain financial instruments—and items measured at fair value on a *non-recurring* basis, usually impairments of non-financial assets, such as property or goodwill, or assets and liabilities acquired in a business combination.

The following disclosures are required for each annual and interim period, separately for each *class* of assets and liabilities measured at fair value on a **recurring** basis:

1. The fair value measurement at the end of the reporting period

2. The level of the fair value hierarchy where the fair value measurements are categorized in their entirety (Level 1, 2, or 3)

3. For fair value measurements categorized within level 2 and level 3 of the fair value hierarchy, a description of the valuation technique(s) and the inputs used in the fair value measurement

4. When a change in either or both a valuation approach and a valuation technique, the reporting entity must disclose that change and the reasons for making it

5. For fair value measurements categorized in Level 3 of the fair value hierarchy, a reporting entity must provide quantitative information about the significant unobservable inputs used in the fair value measurement. This quantitative information must include the range and weighted average (or median or arithmetic average) of significant unobservable inputs used to develop Level 3 fair value measurements. (Note: range and weighted average not required for non-public entities)

6. For fair value measurements categorized in Level 3 of the fair value hierarchy, a reconciliation from the opening balances to the closing balances, disclosing separately the following:

   - Total gains or losses for the period recognized in earnings and or other comprehensive income and the line item(s) in the statement of income or other comprehensive income which these gains or losses are recognized

   - Purchases, sales, issues, and settlements each disclosed separately

   - The amount of any transfers into or out of Level 3 of the fair value hierarchy and the reasons for those transfers. Transfers into Level 3 must be disclosed and discussed separately from transfers out of Level 3

7. For fair value measurements categorized in Level 3 of the fair value hierarchy, the amount of the total gains or losses for the period included in earnings and included in other comprehensive income that is attributable to the change in unrealized gains or losses relating to those assets and liabilities held at the end of the reporting period, and the line item(s) in the statement of comprehensive income which those unrealized gains or losses are recognized. (Note: not required by non-public entities)

8. For fair value measurements categorized in Level 3 of the fair value hierarchy, a narrative description of the measurement uncertainty of the fair value measurement from the use of significant unobservable inputs if those inputs reasonably could have been different at the reporting date. (Note: not required by non-public entities)

9. If the highest and best use of a non-financial asset differs from its current use, a reporting entity must disclose that fact and why the non-financial asset is being used in a manner that differs from its highest and best use

10. For each class of assets and liabilities not measured at fair value in the statement of financial position but fair value is disclosed, a reporting entity must disclose the information required by 2, 3, and 9 above

EXAMPLE

Note X: Assets and Liabilities – Fair Value Information:

Assets measured at fair value on a recurring basis at December 31, 20XX, were as follows:

	Fair Value at Reporting Date (in 000s)			
Description	12/31/XX	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Trading securities:				
Equity securities – retail industry	$ 75	$ 75		
Equity securities – other	30	30		
Total trading securities	105	105		
Available-for-sale securities:				
Residential mortgage-backed securities	90			$90
Collateralized debt obligations	20			20
Corporate bonds	85	85		--
Total available-for-sale debt securities	195	85		110
Available-for-sale equity securities:				
Construction industry	110	110		
Distribution industry	45	45		
Other	50	50		
Total available-for-sale equity securities	205	205		
Total available-for-sale securities	400	290		
Private equity funds	70		$70	
Futures contracts	35		--	35
Total	$610	$395	$70	$145

In addition to quoted market prices in active markets, valuation techniques used were:

Level 2 – Private equity funds are valued based on net asset values provided by the fund managers.

Level 3 – Residential mortgage-backed securities and collateralized debt obligations were valued based on trading prices of comparable debt. Futures contracts held as hedges of commodity prices (see Note X) are valued based on the net present value of expected cash flows based on externally provided inputs.

There were no changes in valuation techniques used to measure fair values during the period.

Note: The above example includes only assets. Liabilities would be shown the same way, but separately from assets.

The following example illustrates the expanded disclosures required within the Level 3 fair value roll forward table.

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)		
	Available-for-Sale Securities		
	Residential Mortgage-Backed Securities	Collateralized Debt Obligations	Futures Contracts
Beginning balance	$100	-	($10)
Transfers into Level 3		$30	
Transfers out of Level 3	-	-	-
Total gains or losses			
Included in earnings (or changes in net assets)	(30)	5	
Included in other comprehensive income	(10)	-	20
Purchases, issuances, sales, and settlements			
Purchases	50	-	(40)
Issuances	-	-	-
Sales	(20)	-	-
Settlements	-	(15)	65
Ending balance	$90	$20	$35

The amount of total gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets still held at the reporting date. $9

Changes in unrealized gains or losses for the period included in other comprehensive income for assets held at the end of the reporting period $14

Valuation Techniques and Inputs (In part):

	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted Average)
Residential Mortgage Backed Security	$90	DCF	Prepayment Rates Probability of Default Loss severity	4% - 5% (4.5%) 5% - 20% (12%) 60% - 100% (75%)
Collateralized Debt Obligation	$20	Consensus Pricing	Offered Quotes Comparability AJEs	20% - 40% (30%) 4% - 9%) (7%)
Futures Contracts	$35	Option Model	Changes in the Underlying Assets/Liabilities	- 20% (15%)

For assets and liabilities measured at fair value on a **non-recurring** basis, annual and interim disclosures must include by class of asset and liability, the following information:

1. The fair value measurement at the relevant measurement date and the reasons for the measurement

2. The level of the fair value hierarchy where the fair value measurements are categorized in their entirety (Level 1, 2, or 3)

3. For fair value measurements categorized within level 2 and level 3 of the fair value hierarchy, a description of the valuation technique(s) and the inputs used in the fair value measurement

4. When a change in either or both a valuation approach and a valuation technique, the reporting entity must disclose that change and the reasons for making it

5. For fair value measurements categorized in Level 3 of the fair value hierarchy, a reporting entity must provide quantitative information about the significant unobservable inputs used in the fair value measurement. This quantitative information must include the range and weighted average (or median or arithmetic average) of significant unobservable inputs used to develop Level 3 fair value measurements. (Note: range and weighted average not required for non-public entities)

6. If the highest and best use of a non-financial asset differs from its current use, a reporting entity must disclose that fact and why the non-financial asset is being used in a manner that differs from its highest and best use

7. For each class of assets and liabilities not measured at fair value in the statement of financial position but fair value is disclosed, a reporting entity must disclose the information required by 2, 3, and 6 above

The Topic also encourages combining these disclosures with the fair value disclosures for Topic 825 and providing comparable information for other similar measurements, such as how "market" was derived for inventories that have been written down.

EXAMPLE

Note 4: Asset Impairments:

During 20XX, the following impairment losses were recorded on assets of the Company and included in income from continuing operations:

As a result of decreased utilization of certain distribution facilities, long-lived assets held and used with a carrying amount of $525,000 were written down to their fair value of $375,000, resulting in an impairment loss of $150,000. The estimate of fair value is based on having the facilities fully utilized as a distribution center, which is their highest and best use.

Due to increased competition and decreased demand for the products of Subsidiary X, goodwill with a carrying amount of $300,000 was written down to its implied fair value of $200,000, resulting in an impairment loss of $100,000.

In connection with its restructuring plan, the Company's operations in Bangor, Maine were moved to a facility in Worcester, Massachusetts. The vacated facility is currently held for sale, and has been written down from its carrying value of $600,000 to its fair value of $400,000 less estimated costs to sell of $50,000, resulting in a loss of $250,000.

These non-recurring fair value measurements were based on inputs as follows:

$(000)s

Description	Year Ended 12/31/XX	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Gains (Losses)
Long-Lived assets held and used			$375		
Goodwill				$200	
Long-lived assets held for sale			350		

Valuation techniques for impaired assets were based on:

- Assets held and used and held for sale – appraisal values based on sales of similar assets.
- Goodwill – management's estimate based on the present value of forecasted earnings for the reporting unit.

Note: Valuation techniques and inputs as noted above, are also required.

Fair Value

General Electric

December 31, 2018

Annual Report

NOTE 19. FAIR VALUE MEASUREMENTS

RECURRING FAIR VALUE MEASUREMENTS

Our assets and liabilities measured at fair value on a recurring basis include investment securities mainly supporting obligations to annuitants and policyholders in our run-off insurance operations and derivatives.

ASSETS AND LIABILITIES MEASURED AT FAIR VALUE ON A RECURRING BASIS *(In millions)*	Level 1	Level 2	Level 3(a)	Netting adjustment(d)	Net balance(b)
December 31, 2018					
Assets					
Investment securities	$ 126	$ 29,408	$ 4,301	$ —	$ 33,835
Derivatives	—	2,294	8	(2,001)	301
Total	$ 126	$ 31,701	$ 4,309	$ (2,001)	$ 34,136
Liabilities					
Derivatives	$ —	$ 1,913	$ 6	$ (1,234)	$ 686
Other(c)	—	722	—	—	722
Total	$ —	$ 2,635	$ 6	$ (1,234)	$ 1,408
December 31, 2017					
Assets					
Investment securities	$ 158	$ 34,126	$ 4,413	$ —	$ 38,696
Derivatives	—	3,343	21	(2,986)	378
Total	$ 158	$ 37,469	$ 4,433	$ (2,986)	$ 39,074
Liabilities					
Derivatives	$ —	$ 2,354	$ 7	$ (2,034)	$ 327
Other(c)	—	999	—	—	999
Total	$ —	$ 3,353	$ 7	$ (2,034)	$ 1,325

(a) Included debt securities classified within Level 3 of $3,498 million of U.S. corporate and $580 million of Government and agencies securities at December 31, 2018, and $3,629 million of U.S. corporate and $614 million of Government and agencies securities at December 31, 2017.

(b) See Notes 3 and 20 for further information on the composition of our investment securities and derivative portfolios.

(c) Primarily represents the liabilities associated with certain of our deferred incentive compensation plans.

(d) The netting of derivative receivables and payables is permitted when a legally enforceable master netting agreement exists. Amounts include fair value adjustments related to our own and counterparty non-performance risk.

LEVEL 3 INSTRUMENTS

The vast majority of our Level 3 balances consist of debt securities classified as available-for-sale with changes in fair value recorded in shareowners' equity.

(In millions)	Balance at January 1	Net realized/ unrealized gains (losses) included in earnings(a)	Net realized/ unrealized gains (losses) included in AOCI(b)	Purchases(c)	Sales	Settlements	Transfers into Level 3	Transfers out of Level 3	Balance at December 31
2018									
Debt securities	$ 4,413	$ 2	$ (234)	$ 804	$ (65)	$ (358)	$ 2	$ (262)	$ 4,301
2017									
Debt securities	$ 4,406	$ 54	66	$ 1,108	$ (38)	$ (641)	$ 32	$ (575)	$ 4,413

(a) Earnings effects are primarily included in the "GE Capital revenues from services" and "Interest and other financial charges" captions in our consolidated Statement of Earnings (Loss).

(b) Includes unrealized net gains and losses of $(233) million and $97 million and realized net gains and losses of $(1) million and $(32) million in other comprehensive income for the years ended December 31, 2018 and December 31, 2017, respectively.

(c) Included $615 million and $675 million of U.S. corporate debt securities for the years ended December 31, 2018 and 2017.

NONRECURRING FAIR VALUE MEASUREMENTS

The following table represents nonrecurring fair value amounts (as measured at the time of the adjustment) for those assets remeasured to fair value on a nonrecurring basis during the fiscal year and still held at December 31, 2018 and 2017.

ASSETS MEASURED AT FAIR VALUE ON A NONRECURRING BASIS *(In millions)*	Remeasured during the years ended December 31 2018 Level 2	2018 Level 3	2017 Level 2	2017 Level 3
Financing receivables and financing receivables held for sale	$ —	$ 47	$ 32	$ 1,649
Equity securities without readily determinable fair value and equity method investments	479	874	—	2,076
Long-lived assets	152	422	177	591
Goodwill	—	2,440	—	—
Total	$ 631	$ 3,783	$ 209	$ 4,316

The following table represents the fair value adjustments to assets measured at fair value on a nonrecurring basis and still held at December 31, 2018 and 2017.

December 31 (In millions)	2018	2017
Financing receivables and financing receivables held for sale	$ (23)	$ (310)
Equity securities without readily determinable fair value and equity method investments	(535)	(891)
Long-lived assets	(1,152)	(819)
Goodwill	(22,136)	(2,550)
Total	$ (23,845)	$ (4,571)

LEVEL 3 MEASUREMENTS - SIGNIFICANT UNOBSERVABLE INPUTS

(Dollars in millions)	Fair value	Valuation technique	Unobservable inputs	Range (weighted-average)
December 31, 2018				
Recurring fair value measurements				
Investment securities(b)	$ 402	Income approach	Discount rate(a)	2.8%-7.6% (6.8)%
Nonrecurring fair value measurements				
Financing receivables	$ 22	Income approach	Discount rate(a)	10%
Equity securities without readily determinable fair value and equity method investments	579	Income approach, market comparables	Discount rate(a)	6.5%-35% (8.7%)
Long-lived assets	159	Income approach	Discount rate(a)	2.9%-11.1% (8.2%)
December 31, 2017				
Recurring fair value measurements				
Investment securities(b)	$ 903	Income approach	Discount rate(a)	3.0%-12.6% (6.2%)
Nonrecurring fair value measurements				
Financing receivables	$ 1,639	Income approach	Discount rate(a)	3.2%-16.5% (10.0%)
Equity securities without readily determinable fair value and equity method investments	2,037	Income approach	Discount rate(a)	5.0%-50.0% (7.7%)
Long-lived assets	554	Income approach	Discount rate(a)	2.7%-18.0% (7.3%)

(a) Discount rates are determined based on inputs that market participants would use when pricing investments, including credit and liquidity risk. An increase in the discount rate would result in a decrease in the fair value.

(b) Comprises substantially all of U.S. corporate and government Non-U.S. securities

At December 31, 2018 and December 31, 2017, other Level 3 recurring fair value measurements of $3,893 million and $3,517 million, respectively, and nonrecurring measurements of $483 million and $83 million, respectively, are valued using non-binding broker quotes or other third-party sources. Other nonrecurring fair value measurements were $100 million and $3 million and other recurring fair value measurements were insignificant at December 31, 2018 and December 31, 2017, respectively. These fair value measurements utilize a number of different unobservable inputs not subject to meaningful aggregation.

INTANGIBLE ASSETS

Intangibles are addressed in Topic 350, *Intangibles – Goodwill and Others*. Topic 805, *Business Combinations,* contains related guidance to properly measure the "cost" of intangibles acquired in a business combination.

The authoritative guidance for intangible assets is organized into two main categories:

1. Intangibles (goodwill and other) that are considered to have an indefinite life – these assets are *not* amortized but they must be reviewed for impairment at least annually.

2. Intangibles that have a definite life – these assets *are* amortized and are tested for impairment only if a triggering event occurs (similar to impairment of tangible property).

Many GAAP disclosures are also organized this way, including separate identification of intangibles in each category.

Goodwill

Goodwill is defined as "an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized". It results from paying more than the fair value of the identifiable assets and liabilities when acquiring a business.

Under Topic 805, if less than 100% of a business is acquired, the non-controlling interest is recorded at its fair value, and the goodwill recorded is not reduced for the less-than-100% ownership.

If the amount paid is *less than* the fair value of assets and liabilities acquired, the resulting "negative goodwill" is reported as a gain that flows through earnings in the period of the acquisition.

The accounting for goodwill has been an evolving process going back many years. We have gone from amortizing goodwill over a 40-year period, to testing goodwill for impairment using a two part test, to providing a private company alternative to (ASU 2014-02 – see Unit 1 of this program) and most recently with the issuance of ASU 2017-04, *Simplifying the Test for Goodwill Impairment,* changed the previous two part test to now a one part test.

The previous two part impairment test consisted of:

1. Comparing the fair value of the reporting unit with material goodwill with the carrying value of the reporting unit. If the carrying value exceeds the fair value, then

2. Calculate the implied fair value of goodwill by based on the reporting unit's current fair value

ASU 2017-04 eliminated part two of the goodwill impairment test above. Today, goodwill impairment analysis is accounted for as follows:

- Evaluate qualitative factors existing at the time of the impairment test that may suggest that it is more-likely-than-not that the goodwill recorded amount on the balance sheet is impaired. If these qualitative factors suggest that the goodwill amount is impaired, then the quantitative impairment test must be performed.

- Quantitative impairment test consist of calculating the implied fair value of goodwill by comparing the fair value of the reporting unit to its carrying value and if the carrying value is greater than its fair value, write down goodwill by the difference – goodwill cannot be reduced below zero.

This impairment analysis is not an alternative that may be elected; it is the only way to perform the impairment analysis once the ASU is adopted. The required frequency for performing the impairment test on goodwill is unaffected by this ASU (generally, annually unless negative factors necessitate an interim test)

Note: Goodwill is tested for impairment after other assets.

The effective date of ASU 2017-04 for public entities is for annual or interim goodwill impairment tests performed during fiscal years beginning after December 15, 2019. All other entities must adopt the ASU for annual or interim goodwill impairment tests performed during fiscal years beginning after December 15, 2021. Early adoption is permitted.

Goodwill Disclosures

Goodwill must be presented as a **separate line item** on the balance sheet. Likewise, any goodwill impairment loss, other than for discontinued operations, must be a separate line item before the subtotal "Income from Continuing Operations" on the Income Statement.

The following disclosures, in addition to Topic 820 fair value disclosures, are also required:

1. For each period a balance sheet is presented, changes in the carrying amount of goodwill. Topic 350 requires the aggregate amount acquired, the aggregate impairment losses recorded, and any goodwill amounts included in the gain or loss on disposal of all or a portion of a reporting unit (discontinued operations).

   Topic 350 includes the following disclosures regarding **changes in goodwill**:

   - The gross amount and accumulated impairment losses at the beginning of the period
   - Additional goodwill recognized during the period, except goodwill included in a disposal group, that on acquisition, meets the criteria to be classified as held for sale
   - Adjustments during the period resulting from the recognition of subsequent deferred tax adjustments resulting from an acquisition
   - Goodwill included in a disposal group classified as held for sale in accordance discontinued operations guidance ad goodwill derecognized during the period without having previously reported in a disposal group classified as held for sale
   - Impairment losses recognized during the period
   - Net foreign exchange differences arising during the period
   - Any other changes in the carrying amounts during the period
   - The gross amount and accumulated impairment losses at the end of the period

2. Reporting entities that have one or more reporting units with zero or negative carrying amounts of net assets must disclose those reporting units with allocated goodwill and the amount of goodwill allocated to each ad in which reporting segment (if public) the reporting unit is included.

3. For each goodwill impairment loss recognized:

   - A description of the facts and circumstances leading to the impairment

   - The amount of the impairment loss and the method of determining the fair value of the associated reporting unit

   - If the recognized impairment loss is an estimate that has not yet been finalized, that fact and the reasons therefor and, in subsequent periods, the nature and amount of any significant adjustments made to the initial estimate of the impairment loss.

Disclosures – Intangibles Other Than Goodwill

Note that ASU 2014-18 offers private entities and not-for-profits the opportunity to reduce the number of intangible assets a reporting entity will recognize in a business combination. This will result in more of the purchase price ending up in goodwill. Accordingly, a reporting entity desiring to use this alternative must also elect to follow ASU 2014-02. None of this affects the presentation and disclosure requirements for the remaining intangible assets.

The following summarizes the presentation and disclosure requirements of Subtopic 350-30-50 for intangibles other than goodwill:

a. Intangible assets should be presented **separately** on the balance sheet, as either a single line item or several line items

b. Amortization expense and impairment losses should be presented within income from continuing operations and, if there is a measure of operations or performance indicator, as a part of that amount

c. In the year of acquisition:

   - For each major intangible asset class that is amortized, the amount assigned, the amount of any significant residual values, and the weighted average amortization period used for those assets that are amortized, both by major intangible asset class and in total.

   - For intangible assets **not** amortized, the amount assigned, in total and by major intangible asset class.

   - Amount of research and development assets acquired in a transaction other than a business combination and written off and the line item in the income statement that includes the write-off.

   - For intangible assets with renewal or extension terms, the weighted-average period before the next renewal or extension by major intangible asset class.

Topic 805 requires the above information to be disclosed separately for each material business combination or in the aggregate if there are immaterial combinations that are material in the aggregate.

d. For each period for which a statement of financial position is presented:

   For intangible assets subject to amortization, all of the following:

   - Gross carrying amounts, in total and by major class.
   - Accumulated amortization expense for the period, in total and by major class
   - Aggregate amortization expense for each period presented and aggregate amortization expense for each of the succeeding five years

   For intangible assets not subject to amortization, the total carrying amount and the carrying amount for each major intangible asset class

   In addition, the reporting entity's accounting policy on the treatment of costs incurred to renew or extend the term of a recognized intangible asset

e. For intangible assets that have been renewed or extended in the reporting period, both of the following:

   - For reporting entities that capitalize renewal or extension costs, the total amount of costs incurred in the period to renew or extend the term of a recognized intangible asset, by major intangible asset class
   - The weighted-average period before the next renewal or extension, by major intangible asset class

f. For each intangible asset impairment loss recognized:

   - A description of the impaired intangible asset and the facts and circumstances leading to the impairment
   - The amount of the impairment loss and the method for determining fair value
   - The caption in the Income Statement or the Statement of Activities in which the impairment loss is aggregated
   - If applicable, the segment in which the impaired intangible asset is reported

Topic 820 fair value disclosures, which may also be required, are not illustrated in the following example.

EXAMPLE

Balance Sheet Excerpt

	20X2	20X1
<u>Intangible Assets:</u>		
Goodwill	$920,000	$400,000
Trademarks	807,500	
Customer lists, less accumulated amortization of $50,000	150,000	
Covenant not to complete, less accumulated amortization of $95,000	380,000	
	$2,257,500	$400,000

Note 5: Goodwill and Intangible Assets

The changes in carrying amount of goodwill for the year ended December 31, 20X2 are as follows:

Balance - January, 20X2	$400,000
Acquired goodwill	550,000
Impairment losses - 20X2	(30,000)
Balance - December 31, 20X2	$920,000

Due to increased competition, operating profits, and cash flows of the ABC division were lower than expected. Since the carrying value of the reporting unit exceeded its fair value based on the expected present value of future cash flows, a good will impairment loss of $30,000 was recognized in the current year.

At December 31, 20X2, intangible assets other than goodwill consisted of:

	Gross Carrying Amount	Accumulated Amortization
Amortized intangible assets:		
Customer lists	$200,000	$50,000
Covenant not-to-compete	475,000	95,000
Unamortized intangible assets:		
Trademarks	$807,500	

Amortization expense for the period ended December 31, 20X2, was $145,000.

The aggregate amortization expense for the next 5 years is:

20X3	145,000
20X4	145,000
20X5	145,000
20X6	95,000
20X7	

Goodwill and Intangible Asset Disclosure

Kellogg

December 31, 2019

Annual Report

NOTE 4
GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill and Intangible Assets

Changes in the carrying amount of goodwill, intangible assets subject to amortization, consisting primarily of customer relationships, and indefinite-lived intangible assets, consisting of brands and distribution agreements, are presented in the following tables:

Carrying amount of goodwill

(millions)	North America	Europe	Latin America	AMEA	Consoli-dated
December 30, 2017	$ 4,617	$ 368	$ 244	$ 275	$ 5,504
Additions	—	—	—	616	616
Purchase price allocation adjustment	(2)	—	—	—	(2)
Purchase price adjustment	—	—	—	—	—
Currency translation adjustment	(4)	(22)	(26)	(16)	(68)
December 29, 2018	$ 4,611	$ 346	$ 218	$ 875	$ 6,050
Divestiture	(191)	—	—	—	(191)
Currency translation adjustment	2	1	(5)	4	2
December 28, 2019	**$ 4,422**	**$ 347**	**$ 213**	**$ 879**	**$ 5,861**

Intangible assets subject to amortization

Gross carrying amount					
(millions)	North America	Europe	Latin America	AMEA	Consoli-dated
December 30, 2017	$ 72	$ 45	$ 74	$ 10	$ 201
Additions	—	—	—	425	425
Purchase price allocation adjustment	2	—	—	—	2
Currency translation adjustment	—	(2)	(11)	(7)	(20)
December 29, 2018	$ 74	$ 43	$ 63	$ 428	$ 608
Additions	2	—	—	—	2
Divestiture	(12)	—	—	—	(12)
Currency translation adjustment	—	(2)	(3)	1	(4)
December 28, 2019	**$ 64**	**$ 41**	**$ 60**	**$ 429**	**$ 594**

Accumulated Amortization					
December 30, 2017	$ 35	$ 18	$ 10	$ 4	$ 67
Amortization	4	3	4	12	23
Currency translation adjustment	—	(1)	(2)	—	(3)
December 29, 2018	$ 39	$ 20	$ 12	$ 16	$ 87
Amortization (a)	4	2	3	18	27
Divestiture	(12)	—	—	—	(12)
Currency translation adjustment	—	(1)	—	—	(1)
December 28, 2019	**$ 31**	**$ 21**	**$ 15**	**$ 34**	**$ 101**

Intangible assets subject to amortization, net					
December 30, 2017	$ 37	$ 27	$ 64	$ 6	$ 134
Additions	—	—	—	425	425
Amortization	(4)	(3)	(4)	(12)	(23)
Purchase price allocation adjustment	2	—	—	—	2
Currency translation adjustment	—	(1)	(9)	(7)	(17)
December 29, 2018	$ 35	$ 23	$ 51	$ 412	$ 521
Additions	2	—	—	—	2
Amortization	(4)	(2)	(3)	(18)	(27)
Divestiture	—	—	—	—	—
Currency translation adjustment	—	(1)	(3)	1	(3)
December 28, 2019	**$ 33**	**$ 20**	**$ 45**	**$ 395**	**$ 493**

(a) The currently estimated aggregate amortization expense for each of the next five succeeding fiscal periods is approximately $28 million per year through 2024.

Intangible assets not subject to amortization

(millions)	North America	Europe	Latin America	AMEA	Consoli-dated
December 30, 2017	$ 1,985	$ 420	$ 86	$ 14	$ 2,505
Additions	—	—	—	373	373
Purchase price allocation adjustment	—	—	—	—	—
Currency translation adjustment	—	(19)	(13)	(6)	(38)
December 29, 2018	$ 1,985	$ 401	$ 73	$ 381	$ 2,840
Additions	18	—	—	—	18
Divestiture	(765)	—	—	—	(765)
Currency translation adjustment	—	(9)	(3)	2	(10)
December 28, 2019	$ 1,238	$ 392	$ 70	$ 383	$ 2,083

Annual Impairment Testing

On December 30, 2018 the Company reorganized our North American business. The reorganization eliminated the legacy business unit structure and internal reporting. In addition, the Company changed the internal reporting provided to the chief operating decision maker (CODM) and segment manager. As a result, the Company reevaluated its operating segments and reporting units.

In addition, we transferred the management of our Middle East, North Africa, and Turkey businesses from Europe to AMEA, effective December 30, 2018.

Refer to Note 17 Reportable Segments for further details on these changes. As a result of these changes in operating segments and related reporting units, the Company re-allocated goodwill between reporting units where necessary and compared the carrying value to the fair value of each impacted reporting unit on a before and after basis. This evaluation was only required to be performed on reporting units impacted by the changes noted above.

Effective December 30, 2018 in North America, the previous U.S. Snacks, U.S. Morning Foods, U.S. Specialty Channels, U.S. Frozen Foods, Kashi, Canada and RX operating segments are now a single operating segment (Kellogg North America). At the beginning of 2019, the Company evaluated the related impacted reporting units for impairment on a before and after basis and concluded that the fair values of each reporting unit exceeded their carrying values.

Approximately $46 million of goodwill was re-allocated between the impacted reporting units within Europe and AMEA related to the transfer of businesses between these operating segments. The Company performed a goodwill evaluation of the impacted reporting units on a before and after basis and concluded that the fair value of the impacted reporting units exceeded their carrying values.

Additionally, during the first quarter of 2019, the Company determined that it was more likely than not that the Company would be selling selected cookies, fruit and fruit-flavored snacks, pie crusts, and ice cream cones businesses within the North America reporting unit. As a result, the Company performed a goodwill impairment evaluation on the North America reporting unit in the first quarter of 2019 and concluded that the fair value exceeded the carrying value of the reporting unit. During the second quarter of 2019, the Company entered into a definitive agreement to sell the businesses to Ferrero. The sale was completed during the third quarter of 2019 and resulted in the divestiture of the net assets and liabilities of these businesses, included in the North America reporting unit, including $191 million of Goodwill and $765 million of Net Intangibles. In addition to the cash consideration received, the Company entered into a perpetual royalty-free licensing agreement with Ferrero, allowing Kellogg the use of certain brand names for cracker products. The license agreement was fair valued at $18 million and recorded as an indefinite-lived intangible asset.

At December 28, 2019, goodwill and other intangible assets amounted to $8.4 billion, consisting primarily of goodwill and brands originally associated with the 2001 acquisition of Keebler Foods Company and the 2012 acquisition of Pringles. Within this total, approximately $2.1 billion of non-goodwill intangible assets were classified as indefinite-lived, including $1.7 billion related to trademarks, comprised principally of Pringles and cracker-related trademarks. The majority of these intangible assets are recorded in our North America reporting unit. The Company currently believes the fair value of goodwill and other intangible assets exceeds their carrying value and that those intangibles so classified will contribute indefinitely to cash flows. Through impairment testing performed during the fourth quarter of 2019, no heightened risk of impairment of individual intangible assets or reporting units was identified.

Additionally, the Company has goodwill of $606 million and $373 million at December 28, 2019 related to the Multipro and RX reporting units, respectively. The Company performed goodwill impairment testing for Multipro using both an EBITDA market multiple and discounted cash flow (DCF) method. The Company performed goodwill impairment testing for RX using both a sales market multiple and discounted cash flow method. Significant assumptions utilized within the Multipro DCF model include forecasted net sales growth and gross margin. The significant assumption utilized within the RX DCF model is forecasted net sales growth. The Company determined the fair value of Multipro and RX exceed the carrying value and no heightened risk of impairment exists for the reporting units.

TOPIC 470 – LIABILITIES

Current vs. Long-Term Classification

Classification of assets and liabilities as current or long-term provides important information to users in assessing liquidity and compliance with loan covenants, and is actually one form of disclosure. While the general rule for classification as current liabilities is straight-forward (due within one year or operating cycle, whichever is longer), certain situations can complicate this assessment.

Nevertheless, peer reviewers are finding that in many cases, debt continues to be classified as long-term even though the debt's maturity date is less than 12 months or a debt covenant violation has occurred causing the debt to be due on demand. This is an area that requires increased attention by practitioners.

Topic 470, *Debt*, requires current classification for liabilities that are:

a. Due on demand.

b. Due on demand within one year, even if liquidation is not expected within the year.

c. Long-term debt that is callable by the creditor because of a violation of the debt agreement, unless the creditor has waived or subsequently lost the right to demand payment.

   Under Topic 470, long-term debt should be classified as noncurrent unless both of the following two conditions exist:

   - There is a loan violation at the balance sheet date or a violation would have occurred if the loan was not modified, and

   - It is probable that the default would not be cured or a covenant would not be complied with at measurement dates within the next twelve months (or the operating cycle).

   Topic 470 does not distinguish between substantive versus non-substantive violations. Therefore, "tripping" a minor covenant (such as a deadline for submitting financial statements or other documents) triggers the due-on-demand clause in a loan agreement just as major violations do.

   If a violation is cured after the balance sheet date and the debt is not callable at the time the financial statements are issued, then the debt can be classified as noncurrent, provided the debt instrument doesn't give the bank a call privilege after the violation has been cured.

d. Long-term debt that will be callable by the creditor if a violation is not cured within a specified grace period. Here, the debt should be classified as current unless it is probable that the violation will be cured during the grace period. If the debt is classified as noncurrent, then the circumstances of the classification should be disclosed.

If a loan agreement has a "lock-box" provision, the terms must be understood to determine if the arrangement has an effect on classification. A lock-box arrangement that automatically applies a company's cash collections against borrowings will result in the debt being classified as current.

However, if the arrangement is a "springing" lock-box agreement, the debt is long-term. A springing lock-box arrangement is one where remittances are deposited in the borrower's bank account and are not used to pay down debt unless the creditor exercises its subjective acceleration clause or another triggering event takes place.

Note: If the loan agreement just includes a subjective acceleration clause, then Topic 470 requires the company to assess the likelihood of the clause being used. If there is a remote chance that the bank will use this clause to call the loan, then there is no classification or disclosure issue.

EXAMPLE

Note to Participants: FASB has issued a proposed ASU on Simplifying the Balance Sheet Classification of Debt (Topic 470, Debt).

This standard would simplify and replace the current "fact-specific guidance" on determining whether debt is current or long-term with a more comprehensive approach. The standard is expected to be finalized in 2021.

Currently, there are numerous special rules on classification of debt when there are covenant violations, acceleration clauses, an intent to refinance short-term debt, etc. This proposal would simplify these rules and is likely to affect the classification of debt in some cases.

Liabilities will be classified as non-current if:

- The debt is contractually due more than one year (or one operating cycle, if longer) after the balance sheet date, or
- The entity has a contractual right to defer payment for at least one year (or one operating cycle, if longer) after the balance sheet date.

The exposure draft retains the long-term classification if the entity receives a waiver for a covenant violation, so long as the waiver (a) does not result in a troubled debt restructuring or (b) is not treated as a debt extinguishment. However, debt classified as noncurrent under such a waiver must be presented separate from other noncurrent debt on the balance sheet.

The proposal mentions two situations where the GAAP changes are likely to change the classification of debt:

- For short-term debt refinanced after the balance sheet date, current GAAP permits classification as long-term so long as the refinancing occurs before the financial statements are issued. The new standard would not permit consideration of refinancing after the balance sheet date in determining classification at year end, so the debt would be current under this scenario. (In essence, the refinancing is treated like a Type 2 subsequent event.)
- For debt with subjective acceleration clauses or material adverse change clauses, current GAAP requires an assessment of the probability that the lender will accelerate the due date. The new standard would remove this probability assessment and consider the effects of such clauses only if they are actually triggered.

The effective date will be determined when the standard is finalized. Transition will use the prospective method.

Disclosures

The required disclosures for debt have been around for a long time and should be well known to practitioners. Nevertheless, this is an area where peer review is continuing to note the omission of required disclosures.

Required disclosures for debt include:

1. **Interest rate, term, and maturity** – Care should be taken to ensure that the description of these terms can be "tied in" to the amount of debt. For example, many loan agreements base payments on an amortization schedule covering a period longer than the term of the debt; a balloon payment is then due on the maturity date. If a note explains that a $500,000 loan has 30 payments of $2,500 remaining, the "math" doesn't work because the description fails to mention the balloon payment of $425,000!

2. **Collateral or significant restrictions and covenants** – Restrictions and covenants can be described qualitatively. For example, the disclosure can state that a loan contains current ratio or liquidity requirements; it need not say that the company must maintain a current ratio of 1.5:1. It is also acceptable to state that "substantially all" assets have been pledged as collateral, without listing them.

3. **The total amount of maturities and sinking fund requirements for all long-term debt for each of the five years following the latest balance sheet date** (Topic 440, *Commitments*)

	Long-Term Debt
20X1	$ 30,000
20X2	40,000
20X3	50,000
20X4	10,000
20X5	10,000
Through 20X9	35,000 **
	175,000
Less current portion	(38,500) **
Less debt issue costs	(1,500) **
Total Long-term Debt	$145,000

**Although these items are not required by GAAP, this type of presentation is useful since it ties into the balance sheet. ASU 2015-03 requires debt issue cost to be reported as a contra-liability.

4. Imputed interest – To the extent that notes exchanged for assets other than cash bear no interest or interest above or below current market rates, Topic 835-30 requires that they be valued using an appropriate imputed interest rate. If the stated interest is less than the market rate, a discount is recorded; if the stated interest is greater than the market rate, a premium is recorded.

Subtopic 835-30 does not apply to:

- Normal trade receivables and payables due in less than one year
- Notes that are issued for cash
- Deposits against the purchase price of goods
- Security deposits
- Normal lending transactions of banks, savings and loans, and other financial institutions
- Transactions when interest rates are affected by tax or legal restrictions
- Parent-subsidiary and brother-sister transactions

All notes for which interest has been imputed require the following disclosure:

a. The discount or premium should be presented in the balance sheet as a deduction or addition to the face amount of the note. This discount or premium should be amortized as interest expense or income over the life of the note, using the interest method of amortization.

b. A description of the note

c. The effective interest rate of the note

d. The full amount of the note

Below is a sample note for a discounted liability:

EXAMPLE

During 20X2, Alpha Company purchased property for $100,000 with the seller taking back a 3-year, 2% note. The note payable has been recorded using an imputed interest rate of 8%.

For tax purposes, imputed interest must be calculated following the OID rates. This is another example of a temporary difference.

Disclosure requirements for debt are illustrated in the following example:

EXAMPLE

Note 5: Notes Payable and Long-Term Debt

The Company maintains a $500,000 line of credit with interest at the bank's prime rate plus 2% (5.25% and 5.0% at December 31, 20X9, and 20X8, respectively). Borrowings are secured by qualifying accounts receivable and finished goods inventory. The amount outstanding under this line at December 31, 20X9, and 20X8, was $100,000 and $150,000, respectively.

Long-term debt at December 31, 20X9, and 20X8, consisted of the following:

	20X9	20X8
Term loan payable with interest at prime plus 2% due March 31, 20Y3, secured by equipment	$1,000,000	$1,000,000
Note payable in monthly installments of $2,800 plus interest at prime plus 1½% through December 20Y2, collateralized by equipment	100,800	134,400
Note payable in monthly installments of $500, plus interest at 10% through December 20Y2, collateralized by a vehicle	18,000	--
	$1,118,800	$1,134,400
Less current portion	(38,100)	(32,000)
Less debt issue costs	(1,500)	(1,600)
Long-term debt	$1,079,200	$1,100,800

The $1,000,000 term loan payable requires the Company to meet stipulated working capital, net worth, and debt-to-equity requirements. At December 31, 20X9, the working capital ratio fell below the required ratio. This note has been classified as long-term since the Company expects to cure this violation within the 90-day grace period granted by the bank.

Maturities of long-term debt as of December 31, 20X9, are:

Year ended December 31	Amount
20Y0	$39,600
20Y1	39,600
20Y2	39,600
20Y3	1,000,000
20Y4	--
	$1,118,800

NOTE: Financial reporting issues associated with long-term debt due to COVID-19 include:

- Reclassification of the debt as current (on demand) due to a violation (breach) of the debt covenant agreements and related disclosures
- Potential modifications or extinguishment of debt necessary to address debt covenant violations

- A conclusion must be reached as to whether any debt restructuring is a troubled debt restructuring
  - Both debtors and creditors

EXAMPLE

Note X: Breach of Loan Covenants

Some of the Company's loan agreements that were classified as long-term during the year are subject to debt covenant clauses that the Company is required to achieve for certain financial statement performance and liquidity ratios. Due to the financial impact of the COVID-19 pandemic, the Company was not able to comply with a number of these ratios as of December 31, 2020. Due to this breach of our debt covenants, ABC Bank is contractually entitled to request immediate payment of the outstanding loan amount of $10,000,000. The loan is now classified as current (due on demand) as of December 31, 2020.

ABC Bank has not requested early payment of the loan as of March 25, 2021. Management is in the process of renegotiating the terms of the loan agreement with ABC Bank and expects that a revised loan agreement will be in place by June 30, 2021.

Debt

Air Products

September 30, 2019

Annual Report

During the third quarter ended 30 June 2017, we recognized a goodwill impairment charge of $145.3 and an intangible asset impairment charge of $16.8 associated with our LASA reporting unit. Refer to Note 11, *Goodwill*, and Note 12, *Intangible Assets*, for more information related to these charges and the associated fair value measurement methods and significant inputs/assumptions, which were classified as Level 3 since unobservable inputs were utilized in the fair value measurements.

16. DEBT

The tables below summarize our outstanding debt at 30 September 2019 and 2018:

Total Debt

30 September	**2019**	2018
Short-term borrowings	**$58.2**	$54.3
Current portion of long-term debt[(A)(B)]	**40.4**	406.6
Long-term debt	**2,907.3**	2,967.4
Long-term debt – related party[(B)]	**320.1**	384.3
Total Debt	**$3,326.0**	$3,812.6

(A) Fiscal year 2019 includes the current portion of long-term debt owed to a related party of $37.8.
(B) Refer to Note 7, *Acquisitions*, for additional information regarding related party debt.

Short-term Borrowings

Short-term borrowings consisted of bank obligations of $58.2 and $54.3 at 30 September 2019 and 2018, respectively. The weighted average interest rate of short-term borrowings outstanding at 30 September 2019 and 2018 was 3.7% and 5.0%, respectively.

Long-term Debt

30 September	Fiscal Year Maturities	2019	2018
Payable in U.S. Dollars			
Debentures			
8.75%	2021	**$18.4**	$18.4
Medium-term Notes (weighted average rate)			
Series E 7.6%	2026	**17.2**	17.2
Senior Notes			
Note 4.375%	2019	**—**	400.0
Note 3.0%	2022	**400.0**	400.0
Note 2.75%	2023	**400.0**	400.0
Note 3.35%	2024	**400.0**	400.0
Other (weighted average rate)			
Variable-rate industrial revenue bonds 1.44%	2035 to 2050	**631.9**	631.9
Other .25%(A)		**—**	.9
Payable in Other Currencies			
Eurobonds 2.0%	2020	**327.0**	348.1
Eurobonds .375%	2021	**381.5**	406.2
Eurobonds 1.0%	2025	**327.0**	348.1
Other 2.9%	2020 to 2023	**3.8**	8.0
Related Party(B)			
Chinese Renminbi 5.5%	2020 to 2026	**357.9**	384.3
Capital Lease Obligations			
Foreign 10.3%	2020 to 2036	**10.1**	10.5
Total Principal Amount		**3,274.8**	3,773.6
Less: Unamortized discount and debt issuance costs		**(12.2)**	(15.3)
Less: Fair value hedge accounting adjustments(A)		**5.2**	—
Total Long-term Debt		**3,267.8**	3,758.3
Less: Current portion of long-term debt		**(40.4)**	(406.6)
Less: Long-term debt – related party		**(320.1)**	(384.3)
Long-term Debt		**$2,907.3**	$2,967.4

(A) The Company has entered into LIBOR-based interest rate swap arrangements with various counterparty financial institutions on certain of our outstanding fixed-rate senior notes, which have maturity dates between 2019 and 2022. These interest rate swaps have been designated as fair value hedges of the notes. Refer to Note 14, *Financial Instruments*, for additional information. The fiscal year 2018 fair value hedge accounting adjustment is reflected as "Other" senior notes in the table above.

(B) Refer to Note 7, *Acquisitions*, for additional information regarding related party debt.

Maturities of long-term debt, including related party, in each of the next five years and beyond are as follows:

2020	$367.4
2021	440.2
2022	439.3
2023	453.7
2024	453.4
Thereafter	1,120.8
Total	$3,274.8

Various debt agreements to which we are a party include financial covenants and other restrictions, including restrictions pertaining to the ability to create property liens and enter into certain sale and leaseback transactions. As of 30 September 2019, we are in compliance with all the financial and other covenants under our debt agreements.

As of 30 September 2019, we classified our 2.0% Eurobond of €300.0 million ($327.0) maturing in August 2020 as long-term debt because we have the ability to refinance the debt under the 2017 Credit Agreement. Our current intent is to refinance this debt via the U.S. or European public or private placement markets.

Additional commitments totaling $2.3 are maintained by our foreign subsidiaries, all of which were borrowed and outstanding at 30 September 2019.

Cash paid for interest, net of amounts capitalized, was $155.9, $123.1, and $125.9 in fiscal years 2019, 2018, and 2017, respectively.

2017 Credit Agreement

On 31 March 2017, we entered into a five-year $2,500 revolving credit agreement maturing 31 March 2022 with a syndicate of banks (the "2017 Credit Agreement"), under which senior unsecured debt is available to both the Company and certain of its subsidiaries. On 28 September 2018, we amended the 2017 Credit Agreement to reduce the maximum borrowing capacity to $2,300. No other terms were impacted by the amendment.

The 2017 Credit Agreement provides a source of liquidity for the Company and supports our commercial paper program. The Company's only financial covenant under the 2017 Credit Agreement is a maximum ratio of total debt to total capitalization (total debt plus total equity) no greater than 70%. No borrowings were outstanding under the 2017 Credit Agreement as of 30 September 2019.

17. RETIREMENT BENEFITS

The Company and certain of its subsidiaries sponsor defined benefit pension plans and defined contribution plans that cover a substantial portion of its worldwide employees. The principal defined benefit pension plans are the U.S. salaried pension plan and the U.K. pension plan. These plans were closed to new participants in 2005, after which defined contribution plans were offered to new employees. The principal defined contribution plan is the Retirement Savings Plan, in which a substantial portion of the U.S. employees participate. A similar plan is offered to U.K. employees. We also provide other postretirement benefits consisting primarily of healthcare benefits to U.S. retirees who meet age and service requirements.

Refinancing Short-Term Obligations

When large amounts of debt are due within one year, the borrower's intent is usually to refinance with the existing lender or issue new long-term debt. Topic 470 permits long-term classification of debt expected to be refinanced only when management has both the **intent and the ability** to refinance, meeting all of the following conditions:

1. The company intends to refinance on a long-term basis

   AND

2. The company has the ability to refinance, as evidenced by:

   a. Actual post-balance sheet issuance of debt or equity securities – issuance must be prior to the date the statements are issued or available to be issued.

      OR

   b. Having entered into a financing agreement that allows financing on a long-term basis and that:

      - Does not expire within one year from the balance sheet date
      - Is not cancelable except for a violation of a provision that can be objectively determined; for example, working capital ratios, debt to equity ratios, etc.
      - Has not been violated prior to the issuance of the statements. However, if a waiver has been obtained, this criterion is met.
      - Can be honored based on the financial capability of the lender

The amount that can be reclassified as long-term cannot exceed the actual amount refinanced or the amount specified in the agreement. If the amount in the agreement fluctuates, then an estimate of the minimum amount to be available should be made. If an estimate can't be made, then none of the debt should be reclassified. Note that if the debt on the balance sheet is paid and then replaced with new long-term debt, the debt may *not* be reclassified as long-term.

The required disclosures for short-term debt expected to be refinanced are:

1. A general description of the financing agreement
2. The terms of the new financing agreement or equity securities to be issued

Following is a sample note that discloses short-term liabilities that were reclassified as long-term.

EXAMPLE

At December 31, 20X1, $250,000 of debt due within one year has been classified as long-term because the Company intends to refinance such debt under an unused long-term bank line of credit exercisable through February 28, 20X3. These notes will bear interest at the prime rate and will be due in twenty equal quarterly installments, commencing approximately one year after the date of such borrowings.

Debt Extinguishments

Topic 860, *Transfers and Servicing*, states that a liability is extinguished if:

- The debtor pays the creditor

  or

- The debtor is legally released from the debt, either by the creditor or legally

When this happens, any difference between the amounts paid to extinguish the debt and the net carrying amount of the debt is booked as a gain or loss in current year earnings and disclosed separately.

ASU 2014-11

In June 2014, the FASB issued ASU 2014-11, Transfers and Servicing (Topic 860), Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures. This update:

- Eliminates existing guidance for repurchase financings. Instead it requires that entities consider the initial transfer and the related repurchase agreement separately when applying the de-recognition requirements.

- Requires repurchase-to-maturity transactions to be accounted for as secured borrowings as if the transferor retains effective control, even though the transferred financial assets are not returned to the transferor at settlement.

New disclosures are required for:

- Certain transactions accounted for as secured borrowings.

- Transfers accounted for as sales when the transferor also retains substantially all of the exposure to the economic return on the transferred financial assets throughout the term of the transaction.

Subtopic 470-60 – Troubled Debt Restructuring

Troubled debt restructurings may involve just **a modification of loan terms, or may also involve foreclosure or repossession of assets, or granting an equity interest to a creditor**. Troubled debt restructurings always involve **concessions** made by a creditor in response to financial difficulties of the debtor, and are designed to help the creditor protect its investment. Restructurings can result from an agreement between the creditor and the debtor, or because they are imposed by law or by a court.

Modifications of debt that reflect **general economic conditions**, or refunding debt with new debt at rates that are comparable to rates for non-troubled borrowers are not troubled debt restructurings.

Individual renegotiations of debt by companies in bankruptcy are within the scope of this topic; but the impact of **Chapter 11 proceedings** where an approval of creditors and the court reduces *all* liabilities by some proportional percentage is not.

Modifications may involve:

- Reduction in the interest rate
- Reduction or forgiveness of accrued interest
- Extended maturities
- Reduction of principal

Designation of such modifications as a troubled debt restructuring hinges on whether the resulting cash flows associated with the debt are substantially changed.

If a loan is "paid off" in full by transferring non-financial assets (such as surrendering collateral in full satisfaction of amounts due), the gain or loss on the extinguishment is the difference between the carrying value of the debt and the *fair values* of the assets transferred. Consequently, the assets transferred must first be "marked to market", with a resulting "gain or loss on transfer."

If terms of a loan are modified, the accounting treatment is prospective. The liability is reduced (and a corresponding gain recorded) *only* if the *total* future cash payments (including interest) are less than the carrying amount of the debt. So long as the total future cash payments exceed the carrying value of the debt, the interest rate is simply changed to a rate that equates the present value of the new payments with the balance on the debt, and no gain is recorded. (For example, if the total of future payments is the same as the principal balance, the interest rate going forward is 0%.)

If future payments are *uncertain* under the terms of the restructuring, no gain should be recognized so long as the maximum possible payments exceed the carrying value of the debt. If the restructuring provides for *contingent* payments (such as higher payments if conditions improve), use a "probable and estimable" contingency threshold to include them in measuring the restructured debt.

Required disclosures in the period of the troubled debt restructuring are:

- A description of the changes in terms, and any major settlements (assets transferred)
- The aggregate gain recognized on restructuring (public companies must also disclose the effect on earnings per share)
- The aggregate gain or loss recognized on asset transfers (resulting from marking such assets to market)
- If the disclosure criteria under Topic 450, *Contingencies,* are met, the total amounts that are contingently payable on restructured payables are disclosed, including the conditions under which such amounts would become payable. In subsequent periods, the entity must disclose the extent to which the carrying value of restructured payables includes amounts that were contingently payable under terms of the original restructuring.

Note that a troubled debt restructuring can also affect the current vs. long-term classification of the debt.

EXAMPLE

Note 8: Troubled Debt Restructuring

During 20X2, due to the Company's financial difficulties, the Company and XYZ Bank negotiated a troubled debt restructuring. Under the terms of this agreement, the principal balance of the Company's debt was reduced from $120,000 to $97,000, accrued interest of $10,000 was forgiven, and the interest rate reduced from 5% to 4%; the 5-year term to maturity was retained. The Company recorded a gain on restructuring of $13,600, which amount is the excess of previous amounts due over the total of restructured payments including interest.

Should the Company achieve certain performance measurements as of the third year of the 5-year agreement, a contingent payment of $15,000 will be due, and the interest rate for the remaining term of the loan will be increased to 5%.

NOTE: The last paragraph is required only if the payment of these additional amounts is considered at least possible.

INCOME TAXES

Topic 740, Income Taxes

ASU 2015-17, *Balance Sheet Classification of Deferred Taxes*, simplified the classification of deferred taxes by eliminating the need to present current and non-current portions. Upon the effective date (years beginning after December 15, 2016, for public companies and one year later for private companies), all deferred taxes are reported as non-current.

Deferred Taxes

GAAP requires the liability method to be used for measuring deferred taxes. This method accrues the future tax effect of all temporary differences, using the applicable tax rates expected to be in effect at that time.

Deferred tax assets are recognized for future deductible amounts, as well as operating loss and tax credit carryforwards. These assets are reduced by a valuation allowance **if it is more likely than not** that all, or a portion of the future tax benefits will not be realized.

In calculating **deferred taxes, the following methodology** is used:

1. Identify future taxable items (deferred tax liability)

2. Identify future deductible items (deferred tax asset)

3. Tax effect all future taxable/deductible items

4. Compare the beginning balances of deferred tax asset to the ending balance

5. Compare the beginning and ending balances of deferred tax assets and liabilities to derive the deferred tax provision

6. Determine the need for a valuation allowance against deferred tax assets

7. Derive income tax expense

Uncertain Tax Positions

Topic 740, *Income Taxes*, requires financial statement recognition of the possibility that certain tax positions that avoid or defer income taxes may not be sustainable upon examination of returns by taxing authorities. In applying this provision, an entity must *presume* that any and all tax positions on its returns will be examined, regardless of the likelihood that this will occur.

"Tax positions" can relate to previous returns filed or taxes for the current period. They can involve a permanent reduction of taxes or a deferral of tax, and also include matters such as:

- The entity's tax status (e.g., pass-through entity or not-for-profit)
- A decision not to file returns in certain jurisdictions
- Allocations of income and tax among jurisdictions (including issues such as transfer pricing)
- Characterization or exclusion of certain taxable income on returns
- Classification of income as exempt from tax

Topic 740 applies to all entities that are potentially subject to income taxes, including not-for-profits, pass-through entities, and entities whose tax liability is subject to 100% credit for dividends, such as REITs and registered investment companies, but the disclosure requirements are more onerous for public companies.

Note: Topic 740 only applies to taxes based on income. Therefore, it is not applicable to payroll taxes, sales and use tax, or taxes based on gross receipts, revenue, capital, or property. Topic 450 guidance for contingent losses applies to these taxes.

A 2-step process is used to determine the liability for uncertain tax positions:

1. **Recognition** – A tax benefit is recognized only if it is deemed **more likely than not** that the position will be sustained upon *assumed* examination. This greater-than-50% assessment is a facts-and-circumstances process based on all evidence available at the balance sheet date.

   All relevant laws, regulations, case law, prior experience of management and its tax advisors, as well as "widely held and understood" practices and precedents, etc., would be considered.

   Further, *each* tax position must be evaluated on a standalone basis in applying the more-likely-than-not threshold, rather than aggregating it with other positions.

2. **Measurement** – Once a tax position item passes the more-than-likely criterion for recognition, it is then measured at an amount equal to the largest possible benefit considered to be more likely than not, assuming a taxing authority having full knowledge of all relevant

information will examine the item. The calculation of related amounts and probabilities of realization are based on facts and circumstances known at the balance sheet date.

The resulting liability corresponds to the income tax on that portion of a position that would most likely be disallowed upon examination, *plus* interest and penalties thereon. The interest and penalties may be included with the tax provided or classified separately; the treatment chosen must be applied consistently and disclosed as an accounting policy.

The liability for unrecognized tax benefits is normally classified as noncurrent unless it is expected to be paid in cash within 12 months. (It is still non-current if it will reverse or expire within 12 months.)

Generally, the liability for unrecognized tax benefits cannot be combined or netted with other income tax accounts on the balance sheet. However, ASU 2013-11 permits netting this liability against deferred tax assets relating to net operating loss or credit carryforwards.

EXAMPLE

Randolph Company deducted $40,000 of auto expense on its tax return. This amount reflects a somewhat aggressive allocation to business rather than personal use.

Management estimates that the largest amount that more-likely-than-not would “survive” an assumed examination of the return is $30,000.

Result: The current tax provision will reflect the entire $40,000, as that amount will be deducted on the return. But a liability for “unrecognized tax benefits” will also be recorded for the amount of tax on $10,000, along with any related interest and penalties that would be expected from the disallowance. The benefit recognized in earnings for this deduction is therefore only the tax on $30,000.

Except for tax positions that never expire (such as the decision not to file in some jurisdictions), the liability for uncertain tax positions will ultimately reverse when:

- The statute of limitations expires, or
- The position is examined (no longer uncertain, even if disallowed)

Disclosures for Income Taxes

Topic 740 requires the following disclosure for income taxes:

a. Grossed-up amounts of deferred tax assets and liabilities netted on the balance sheet:

   - Total of all deferred tax liabilities.
   - Total of all deferred tax assets. This includes deductible temporary differences and tax credit carryforwards.
   - Total valuation allowance.

One net noncurrent deferred tax amount is presented on the balance sheet for each tax jurisdiction and tax-paying component of the entity. Offsetting deferred tax assets and liabilities for different tax-paying components or different tax jurisdictions is prohibited.

b. The components of income tax expense related to continuing operations each year:

- Current tax expense (benefit)
- Deferred tax expense (benefit)
- Investment tax credits
- Government grants
- Operating loss carryforward benefits
- Adjustments required for changes in tax laws, rates, or tax status. For example, if a company changes from a C corp. to a LLC, this requires elimination of any deferred tax assets or liabilities as of the date the entity ceases to be a taxable entity.
- Any change in valuation allowance due to a change in judgment

  Any net change during the year in the total valuation allowance must be disclosed. As an example, assume a company did not set up a valuation allowance because future taxable income was expected to be sufficient to cover future deduction. If conditions change so that the company now forecasts losses that indicate a valuation allowance is needed, this change would flow through income tax expense.
- Tax expense resulting from allocating certain tax benefits directly to contributed capital or to reduce goodwill or other noncurrent tangible assets of an acquired entity

c. The types of temporary differences and carryforwards resulting in significant deferred tax assets and liabilities; this is usually disclosed in the policy footnote. For public companies, the tax effect would also be required.

d. Reconciliation of taxes provided on continuing operations to taxes based on regular statutory rates applied to pre-tax income from continuing operations. Public companies must disclose both the amount and nature of major reconciling items either in percentages or dollar amounts. **Non-public companies need only disclose the nature of these items**.

e. The amounts and expiration dates for loss carryforwards for tax purposes (they are often already recognized for book purposes as deferred tax assets).

f. Any portion of the valuation allowance for deferred tax assets for which subsequently recognized tax benefits will be allocated to reduce goodwill or other noncurrent intangible assets of an acquired company or directly to contributed capital.

g. Intra-period tax allocation – Income taxes are presented separately for:

1. Continuing operations – note that the benefit of an NOL carryback or carryforward should be reported based on the source of income or loss in the current year.

There are some exceptions to the intra-period tax allocation rules for NOL carryforwards when dealing with business combinations or equity adjustments.

2. Discontinued operations.

3. Taxes within Stockholders' Equity accounts – this includes:

    - Adjustments to beginning Retained Earnings for certain changes in accounting principles or a correction of an error

    - Gains and losses included in comprehensive income

    - Increase/decrease in contributed capital (e.g., deductible expenses reported as a reduction in the proceeds from issuing stock)

    - Expenses for employee stock options recognized differently for book and tax purposes

    - Dividends paid on unallocated shares held by an ESOP and charged to Retained Earnings

    - Deductible temporary differences and carryforwards that existed at the date of a quasi-reorganization

h. Specialized disclosures – Topic 740 also requires certain disclosures for specialized situations, such as consolidated tax returns, REITS, and undistributed earnings of foreign and certain domestic subsidiaries.

Additional disclosures required for uncertain tax positions include:

1. Classification policy for interest and penalties as a component of the liability for unrecognized tax benefits, or separately with interest and administrative costs.

2. At the end of each annual reporting period:

    a. The amount of interest and penalties recognized on the income statement (expense) and the balance sheet (liability).

    b. Significant estimate disclosures when related amounts meet the related criteria in Topic 275, *Risks and Uncertainties*, namely that it is reasonably possible that amounts will change by a material amount in the next 12 months.

    c. A description of tax years remaining open for examination, by major tax jurisdictions. (For pass-through entities that have no liabilities for uncertain tax positions, this is often the only disclosure that applies to them.)

Lastly, entities such as pass-throughs and not-for-profits that are not subject to income taxes will include a policy footnote explaining their tax status, such as:

EXAMPLE

Note 1: Summary of Significant Accounting Policies (In Part)

Tax Status: The Company is an S Corporation as defined in the Internal Revenue Code. Accordingly, the Company is exempt for federal and state income taxes, and the income of the Company is taxed at the shareholder level directly.

Applicable disclosures for uncertain tax positions and open years would also be provided.

EXAMPLE

Note 1: Summary of Significant Accounting Policies (In Part)

Income Taxes – Deferred taxes are provided on temporary differences arising from assets and liabilities whose bases are different for financial reporting and income tax purposes, primarily capitalized costs in inventory, accrued vacation, and depreciable assets.

The Company classifies interest accrued on unrecognized tax benefits with interest expense and penalties thereon with operating expenses. The Company's tax returns since 201X generally remain open to possible examination.

Note 5: Income Taxes

The Company's net deferred tax asset consists of:

Deferred tax asset	$82,000
Deferred tax liability	(30,000)
Valuation allowance	(12,000)
	$40,000

The Company's effective tax rate differs from statutory income tax rates primarily due to jobs credits, an increase in the valuation allowance, and exempt investment income.

During 201Z, the Company recognized approximately $8,000 in interest and penalties, of which $3,800 is accrued at December 31, 201Z.

NOTE: Based on the issuance of ASU 2009-06, which eliminated most uncertain tax liability disclosures for non-public entities, the surviving disclosures are in 740-10-50-15 and relate to policies and presentation of interest and penalties and tax positions likely to significantly increase or decrease over the next 12 months, as well as tax years remaining open for examination.

NOTE: Due to the economic and financial impact of COVID-19, reporting entities may have to evaluate whether recorded deferred tax assets will be realizable in the future if the reporting entity has net operating loss carryforwards expiring in the next few years or if future taxable income in the next few years is expected to be zero or in a loss position.

EXAMPLE - DISCLOSURE – IMPAIRMENTS

FORD MOTOR'S 10-Q – 6/30/2020 (IN PART):

Income Taxes

Based on available evidence, we established a valuation allowance against certain net operating losses and tax credits of $228 million and $1.1 billion during the second quarter and the first half of 2020, respectively, as it is more likely than not that these deferred tax assets will not be realized. In assessing the realizability of deferred tax assets, we have changed our priorities due to the effects of COVID-19 on our operations. We continue to balance preservation of cash against long-term tax planning actions that could have resulted in cash outlays to preserve some of our tax credits.

Income Taxes

Kellogg

December 31, 2019

Annual Report

NOTE 13
INCOME TAXES

The components of income before income taxes and the provision for income taxes were as follows:

(millions)	2019	2018	2017
Income before income taxes			
United States	$ 938	$ 851	$ 1,097
Foreign	367	478	560
	1,305	1,329	1,657
Income taxes			
Currently payable			
Federal	345	7	358
State	52	28	31
Foreign	77	99	79
	474	134	468
Deferred			
Federal	(124)	109	(41)
State	(29)	(59)	8
Foreign	—	(3)	(25)
	(153)	47	(58)
Total income taxes	$ 321	$ 181	$ 410

The difference between the U.S. federal statutory tax rate and the Company's effective income tax rate was:

	2019	2018	2017
U.S. statutory income tax rate	21.0%	21.0%	35.0%
Foreign rates varying from U.S. statutory rate	(2.5)	(3.0)	(6.7)
Excess tax benefits on share-based compensation	—	(0.3)	(0.3)
State income taxes, net of federal benefit	1.3	1.5	1.4
Cost (benefit) of remitted and unremitted foreign earnings	0.8	0.7	0.1
Legal entity restructuring, deferred tax impact	—	(3.3)	—
Discretionary pension contributions	—	(2.3)	—
Revaluation of investment in foreign subsidiary	2.5	—	—
Net change in valuation allowance	(1.6)	2.0	(0.4)
U.S. deduction for qualified production activities	—	—	(1.4)
Statutory rate changes, deferred tax impact	0.3	—	(9.0)
U.S. deemed repatriation tax	—	(1.2)	10.4
Intangible property transfer	—	—	(2.4)
Divestiture	2.9	—	—
Out-of-period adjustment	3.0	—	—
Other	(3.1)	(1.5)	(1.9)
Effective income tax rate	24.6%	13.6%	24.8%

As presented in the preceding table, the Company's 2019 consolidated effective tax rate was 24.6%, as compared to 13.6% in 2018 and 24.8% in 2017.

The 2019 effective income tax rate was unfavorably impacted by a permanent basis difference in the assets sold to Ferrero as well as an out-of-period correction. During the fourth quarter of 2019, the Company recorded an out-of-period adjustment to correct an error in the tax rate applied to a deferred tax asset arising from an intangible property transfer in a prior year. The adjustment increased income tax expense and decreased deferred tax assets by $39 million, respectively. We determined the adjustment to be immaterial to our Consolidated Financial Statements for the year ended December 28, 2019 and related prior annual and quarterly periods.

The 2018 effective income tax rate benefited from the reduction of the U.S. corporate tax rate as well as a $11 million reduction of income tax expense due to changes in estimates related to the Tax Cuts and Jobs Act, the impact of discretionary pension contributions totaling $250 million in 2018, which were designated as 2017 tax year contributions, and a $44 million discrete tax benefit as a result of the remeasurement of deferred taxes following a legal entity restructuring.

NOTES

Unit

4

Income Statement Disclosures

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- Identify and describe the presentation and disclosure requirements for the income statement.
- Review "live" financial statement disclosures to demonstrate disclosure best practices.

INTRODUCTION

The Income Statement should present all significant items of revenues and expenses. For example, the following items should be presented separately on the face of the Income Statement:

1. Sales or Revenues
2. Cost of Sales
3. Selling and Administrative Expenses
4. Unrealized Gains or Losses on Trading Securities and Gross Realized Gains or Losses on Available-for-Sale Securities
5. Equity in Net Income (Loss) of Investments Accounted for by the Equity Method
6. Unusual or Infrequent Gains or Losses
7. Discontinued Operations (below-the-line, net of tax)
8. Income Taxes

In addition, there are specific disclosure requirements for certain categories of earnings, as well as for certain expenses.

Note the absence of extraordinary items on the list. ASU 2015-01 eliminated the concept for fiscal years beginning after December 15, 2015. Previously, the cumulative effect of changes in accounting principles that appeared in the same section with extraordinary items was also eliminated as an income statement item. The notion of unusual or infrequently occurring items presented as separate line items in the income statement, or alternatively disclosed in the notes to the financial statements remains (Subtopic 225-20).

CATEGORIES OF EARNINGS

Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of a Business Enterprise*, develops the concept of categories of earnings. Special categories of earnings include:

1. **Unusual and/or Infrequent Gains and Losses** – They should be presented as separate line items within income from continuing operations, and may also be included in disclosures required for sales of investments, contingencies, etc., covered in previous sections. Note that this category now includes items that were classified as extraordinary items in the past.

2. **Discontinued Operations** – Topic 205, *Presentation of Financial Statements*, is the standard governing the accounting for discontinued operations. ASU 2014-08, *Discontinued Operations*, significantly changed previous guidance by redefining what constitutes a discontinued operation (making it more difficult for transactions to qualify for treatment as discontinued operations), and revised the disclosures required for discontinued operations.

   a. Assets held for sale, whether or not they are part of discontinued operations, are carried at the lower of net carrying amounts or fair value less costs to sell (rather than net realizable value). Assets (and related liabilities) held for sale must be separately disclosed on the face of the balance sheet or in the notes. Depreciation ceases for assets held for sale.

   b. Estimated future operating losses from discontinued operations are not recognized before they occur. Rather, the discontinued operations section of the Income Statement only reflects the results of operations for the period and realized losses on disposal.

   c. A significant change with ASU 2014-08 is that entities with discontinued operations may now have (i) significant continuing involvement and (ii) continuing cash flows with the discontinued operation.

   Topic 205, Presentation of Financial Statements, requires:

   a. Discontinued operations, net of applicable income taxes, shown separately from continuing operations.

   b. Discontinued operation are generally shown as a single amount that includes:

      - Income/(loss) from operations, net of tax, including changes in carrying amounts.

      - Gain or loss on disposals – This amount must be disclosed on the face of the statements or in the notes.

   c. Any adjustments to amounts previously reported in discontinued operations (due to changes in estimates) must be shown separately in current period discontinued operations.

   d. The following are the disclosures in a period in which a discontinued operation either has been disposed of or is classified as held for sale:

- A description of:

  1. The facts and circumstances leading to the disposal or expected disposal.

  2. The expected manner and timing of that disposal.

- If not separately presented on the face of the statement where net income is reported (or statement of activities for a not-for-profit entity) as part of discontinued operations, the gain or loss recognized on the disposal.

- If applicable, the segment(s) in which the discontinued operation is reported.

EXAMPLE

Income Statement (In Part)
Discontinued Operations

Income from continuing operations before income taxes	$2,000,000
Income taxes	500,000
Net income from continuing operations	1,500,000
Discontinued operations (Note X)	
Loss from operations of discontinued division (including loss on disposal of $400,000)	(1,300,000)
Income tax benefit	300,000
Loss on discontinued operations	(1,000,000)
Net income	$ 500,000

Note X: Discontinued Operations

In 20X1, the Company closed its Virginia operations due to reduced sales and continued operating losses. In 20X1, the Virginia operations generated gross revenue of $1,000,000 and pre-tax losses of $900,000. All assets have been sold for a loss of $400,000.

PRIOR PERIOD ADJUSTMENTS

Topic 250, *Accounting Changes and Error Corrections,* is designed to limit the ability to "bury" the effects of various items in Retained Earnings, without affecting current earnings. As a result, prior period adjustments are limited to **corrections of errors** such as:

- A mathematical error
- Improper application of an accounting principle
- An oversight or misuse of facts that existed at the balance sheet date
- Change from an accounting principle that is not GAAP to one that is GAAP

Note: An error does not mean a change in judgment.

For example, if a company neglected to depreciate certain property in past years, it misapplied GAAP and needs to correct an error. But if it decided that estimates used for useful lives of property in the past should have been different, this is a change in judgment and will be handled prospectively as a change in estimate.

Adjustments resulting from IRS audits are generally **not** prior period adjustments. Because the provision for taxes is always subject to change, it represents an estimate. Any adjustment to that estimate, including RAR adjustments, should flow through current operations, unless the adjustment clearly resulted from an *accounting* error; for example:

- Incorrect tax rate
- A mathematical error
- Inadvertent omission of an item of income or expense

Prior period adjustments (i.e., corrections of errors) are accomplished in the same manner as changes in accounting principle, but are considered to be "restatements" rather than "retrospective adjustments."

Prior period adjustments require restatement of all periods presented, as follows:

1. Restate the carrying amounts of affected assets and liabilities as of the beginning of the first period presented.
2. Opening retained earnings for the first period presented is adjusted for the effect of 1 above.
3. Financial statements for each prior period presented are restated for the correction.

The **disclosure requirements** for prior period adjustments are:

1. A description of the nature of the error and the fact that previously issued financial statements have been restated.
2. The *effect of the correction on each financial statement line item* and any per-share amounts for each prior period presented.
3. The cumulative effect of the change on retained earnings, as of the beginning of the earliest period presented.
4. In the year the correction is made, the effect on income and net income of prior periods presented, both gross and net of taxes. If only single period statements are presented, the effect on beginning retained earnings and on net income of the immediately preceding period must be disclosed. With comparative statements, the effect on all periods presented should be disclosed. No disclosure is required in subsequent financial statements.

EXAMPLE

Excerpt of Single Period Statement of Income and Retained Earnings

	20X8
Net Income	$ 170,000
Reatined Earnings - January 1, 201X8 as previously reported	838,000
Prior Period Adjustment (Note 8)	(100,000)
Retained Earnings - As restated	738,000
Retained Earnings - December 31, 20X8	$ 908,000

Note 8: Prior Period Adjustment

Management has determined that certain equipment had not been depreciated in the financial statements for the past four years. As a result, the 2007 previously issued financial statements have been restated from amounts previously reported. Depreciation expense has been increased and the net book value of property, plant and equipment has been reduced by $75,000. The effect of the restatement on retained earnings as of January 1, 20X7 and 20X7 net income was $75,000 and $25,000, respectively.

Comparative Statements of Income and Retained Earnings

	20X8	20X7 As Restated (Note 8)
Revenue	$1,150,000	$1,000,000
Expenses:		
Salaries	300,000	225,000
Rent	100,000	80,000
Interest	130,000	100,000
Depreciation (Note 8)	175,000	150,000
Telephone	13,000	10,000
Utilities	7,000	5,000
Promotion and entertainment	20,000	15,000
Other expenses	90,000	65,000
Total expenses	$ 835,000	$ 650,000
Income from Operations	$ 315,000	$ 350,000
Provision for Taxes	$ 145,000	$ 150,000
Net Income	$ 170,000	$ 200,000
Retained Earnings - beginning		
As Previously Reported	613,000	
Prior Period Adjustment (Note 8)	(75,000)	
Retained Earnings - beginning, as restated	738,000	538,000
Retained Earnings - ending	$ 908,000	$ 738,000

EXAMPLE

Note X: Restatement of Prior Periods

In the course of the review of the 20X8 financial statements, it was determined that certain equipment had not been depreciated for the past four years. As a result, the 2007 previously issued financial statements have been restated from amounts previously reported. Depreciation expense has been increased by $75,000, and the net book value of property, plant and equipment and retained earnings as of January 1, 20X7, has been reduced by $75,000. The effect of the restatement on 20X8 and 20X7 income before taxes and net income was a decrease of $46,000 and $25,000 respectively, with a corresponding tax benefit of $11,000 and $7,000.

REVENUE FROM CONTRACTS WITH CUSTOMERS

The following disclosure requirements are based on ASU 2014-09, (Topic 606), *Revenue from Contracts with Customers,* was effective in 2018 for public companies and 2019 for non-public companies. **NOTE:** ASU 2020-05 defers, for one year, the required effective date of Topic 606 for certain reporting entities who have not yet issued their financial statements reflecting the adoption of Topic 606. These reporting entities may elect to adopt Topic 606 for annual reporting periods beginning after December 15, 2019, and for interim reporting periods within annual reporting periods beginning after December 15, 2020.

The objective of the new disclosure requirements is to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.

To achieve that objective, a reporting entity will be required to disclose qualitative and quantitative information about all of the following:

- Its contracts with customers
- The significant judgments, and changes in the judgments, made in applying the new guidance to those contracts
- Any assets recognized from the costs to obtain or fulfill a contract with a customer

An entity will be required to consider:

- The level of detail necessary to satisfy the disclosure objective; and
- How much emphasis to place on each of the various requirements.

A reporting entity will be required to aggregate or disaggregate disclosures so that useful information is not obscured by either:

- The inclusion of a large amount of insignificant detail; or
- The aggregation of items that have substantially different characteristics.

In general, amounts to be disclosed are:

- For each period for which an income statement is presented; or
- As of each period for which a balance sheet is presented.

Redundant disclosures (i.e., the entity has provided the information in accordance with another ASC topic) will not be required.

NOTE: Certain disclosures discussed and illustrated below are not required for non-public entities. A non-public entity may elect non-disclosure practical expedients for selected items. A non-public company disclosure illustration, assuming the reporting entity elected all of the practical expedients, is presented at the end of this unit.

CONTRACTS WITH CUSTOMERS

A reporting entity must disclose all of the following amounts for the reporting period unless they are presented separately in the statement of comprehensive income:

- Revenue recognized from contracts with customers, disclosed separately from other sources of revenue

- Any impairment losses recognized on any receivables or current assets arising from the contracts with customers, separately from impairment losses from other contracts

Each of these items will be explained further on the following pages.

Disaggregation of Revenue

Revenue recognized from contracts with customers must be disaggregated into categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors.

In addition, disclosure must be sufficient to enable users of the financial statements to understand the relationship between the disclosure of disaggregated revenue and revenue information that is disclosed for each reportable segment, if applicable.

Non-public entities may elect not to (public entities, certain not-for-profits and employee benefit plans will be required to) disaggregate revenue into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. If this election is made, the entity must disclose, at minimum, revenue disaggregated according to the timing of transfer.

Examples of **types of categories** that might be appropriate include:

- Type of good or service (e.g., major product lines)

- Geography (e.g., country or region)

- Market or type of customer (e.g., government and nongovernment customers)

- Type of contract (e.g., fixed-price and time-and-materials contracts)

- Contract duration (e.g., short-term and long-term contracts)

- Timing of transfer of goods or services (e.g., revenue from goods or services transferred to customers at a point in time and revenue from goods or services transferred over time)

- Sales channels (e.g., goods sold directly to consumers and goods sold through intermediaries)

EXAMPLE – DISAGGREGATION OF REVENUE

3. Revenue

(a) Disaggregation of Revenue

We disaggregate our revenue into groups of similar products and services that depict the nature, amount, and timing of revenue and cash flows for our various offerings. The sales cycle, contractual obligations, customer requirements, and go-to-market strategies differ for each of our product categories, resulting in different economic risk profiles for each category.

The following table presents this disaggregation of revenue (in millions):

Years Ended	July 27, 2019	July 28, 2018	July 29, 2017
Revenue:			
Infrastructure Platforms	**$ 30,191**	$ 28,322	$ 27,817
Applications	**5,803**	5,036	4,568
Security	**2,730**	2,352	2,152
Other Products	**281**	999	1,168
Total Product	**39,005**	36,709	35,705
Services	**12,899**	12,621	12,300
Total [(1)]	**$ 51,904**	$ 49,330	$ 48,005

Amounts may not sum due to rounding.

[(1)] During the second quarter of fiscal 2019, we completed the divestiture of the Service Provider Video Software Solutions (SPVSS) business. Total revenue includes SPVSS business revenue of $168 million and $903 million for fiscal 2019 and 2018, respectively.

Infrastructure Platforms consist of our core networking technologies of switching, routing, wireless, and data center products that are designed to work together to deliver networking capabilities and transport and/or store data. These technologies consist of both hardware and software offerings, including software licenses and software-as-a-service (SaaS), that help our customers build networks, automate, orchestrate, integrate, and digitize data. We are shifting and expanding more of our business to software and subscriptions across our core networking portfolio. Our hardware and perpetual software in this category are distinct performance obligations where revenue is recognized upfront upon transfer of control. Term software licenses are multiple performance obligations where the term license is recognized upfront upon transfer of control with the associated software maintenance revenue recognized ratably over the contract term. SaaS arrangements in this category have one distinct performance obligation which is satisfied over time with revenue recognized ratably over the contract term.

Applications consists of offerings that utilize the core networking and data center platforms to provide their functions. The products consist primarily of software offerings, including software licenses and SaaS, as well as hardware. Our perpetual software and hardware in this category are distinct performance obligations where revenue is recognized upfront upon transfer of control. Term software licenses are multiple performance obligations where the term license is recognized upfront upon transfer of control with the associated software maintenance revenue recognized ratably over the contract term. SaaS arrangements in this category have one distinct performance obligation which is satisfied over time with revenue recognized ratably over the contract term.

Security primarily includes our network security, cloud and email security, identity and access management, advanced threat protection, and unified threat management products. These products consist of both hardware and software offerings, including software licenses and SaaS. Updates and upgrades for the term software licenses are critical for our software to perform its intended commercial purpose because of the continuous need for our software to secure our customers' network environments against frequent threats. Therefore, security software licenses are generally represented by a single distinct performance obligation with revenue recognized ratably over the contract term. Our hardware and perpetual software in this category are distinct performance obligations where revenue is recognized upfront upon transfer of control. SaaS arrangements in this category have one distinct performance obligation which is satisfied over time with revenue recognized ratably over the contract term.

Other Products primarily include our Service Provider Video Software Solutions and cloud and system management products. On October 28, 2018, we completed the sale of the SPVSS. These products include both hardware and software licenses. Our offerings in this category are distinct performance obligations where revenue is recognized upfront upon transfer of control.

In addition to our product offerings, we provide a broad range of service and support options for our customers, including technical support services and advanced services. Technical support services represent the majority of these offerings which are distinct performance obligations that are satisfied over time with revenue recognized ratably over the contract term. Advanced services are distinct performance obligations that are satisfied over time with revenue recognized as services are delivered.

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CONTRACT BALANCES

A reporting entity must disclose all of the following:

- The opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers, if not otherwise separately presented or disclosed
- Revenue recognized in the reporting period that was included in the contract liability balance at the beginning of the period
- Revenue recognized in the reporting period from performance obligations satisfied (wholly or partially) in previous periods (i.e., a change in transaction price)

In addition, an explanation of how the timing of the satisfaction of performance obligations relates to the typical timing of payments and the effect that those factors have on the contract asset and the contract liability balances is required. Explanations can use qualitative information if necessary.

Included in the disclosures would be an explanation of the significant changes in the contract asset and the contract liability balances during the reporting period. The explanation must include qualitative and quantitative information. Examples could be:

a. Changes due to business combinations

b. Cumulative catch-up adjustments to revenue that affect the corresponding contract asset or contract liability, including adjustments arising from a change in the measure of progress, a change in an estimate of the transaction price or a contract modification

c. Impairment of a contract asset

d. A change in the time frame for a right to consideration to become unconditional

e. A change in the time frame for a performance obligation to be satisfied.

Non-public companies may elect not to provide any or all of the above disclosures with the exception of disclosure of opening and closing balances of receivables, contract assets and contract liabilities from contracts with customers.

EXAMPLE

Contract Balances

Accounts receivable, net was $5.5 billion as of July 27, 2019, compared to $5.6 billion as of July 28, 2018.

Contract assets consist of unbilled receivables and are recorded when revenue is recognized in advance of scheduled billings to our customers. These amounts are primarily related to software and service arrangements where transfer of control has occurred but we have not yet invoiced. As of July 27, 2019, and July 29, 2018, our contract assets for these unbilled receivables were $860 million and $122 million, respectively, and were included in other current assets and other assets.

Contract liabilities consist of deferred revenue. Deferred revenue was $18.5 billion as of July 27, 2019, compared to $19.7 billion as of July 28, 2018. In connection with the adoption of Topic 606, we recorded an adjustment to retained earnings to reduce deferred revenue by $2.8 billion. We recognized approximately $9.6 billion of revenue during fiscal 2019 that was included in the deferred revenue balance at July 29, 2018.

PERFORMANCE OBLIGATIONS

Performance Obligations in General

Based on the guidance in Topic 606, a reporting entity will be required to disclose information about its performance obligations in contracts with customers, including a description of all of the following:

a. When the entity typically satisfies its performance obligations (for example, upon shipment, upon delivery, as services are rendered, or upon completion of service)

b. Significant payment terms

   – For example, when payment typically is due, whether the contract has a significant financing component, whether the consideration amount is variable, and whether the estimate of variable consideration is typically constrained

c. The nature of the goods or services that the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (that is, if the entity is acting as an agent)

d. Obligations for returns, refunds, and other similar obligations

e. Types of warranties and related obligations

EXAMPLE

Performance Obligations: Timing of Satisfaction

The Company typically satisfies its performance obligations as goods are delivered and as services are rendered. Goods that are shipped to customers are typically shipped "FOB Destination." As such, ownership of goods in transit remains with the Company and the Company bears the associated risks (e.g., loss, damage, delay). In some cases, a customer will take delivery directly from the Company's inventory, at which point ownership and the associated risks pass to the customer.

The Company's services are typically performed over time. Customers obtain the benefits of such services as the services are performed. Therefore, the Company satisfies its performance obligations as services are rendered. In some cases, the time required to render a service is trivially short; in those cases, the Company satisfies its performance obligation upon completion of the service.

Performance Obligations: Significant Payment Terms

Payment for goods and services sold by the Company is typically due within 30 days after an invoice is sent to the customer. Invoices for goods are typically sent to customers within three calendar days of delivery. Invoices for services performed over time are typically sent to customers on the last business day of each calendar month. Invoices for services performed at a point in time are typically sent to customers within three calendar days of performance. The Company does not offer discounts if the customer pays some or all of an invoiced amount prior to the due date.

In some cases (primarily contracts for services to be delivered over a period longer than six months), a contract will require the customer to pay 15%-25% of the total contract price in advance.

For some contracts, the amount of consideration to which the Company will be entitled is variable. Under those contracts, some or all of the consideration for satisfied performance obligations is contingent on events over which the Company has no direct influence. For example, with regard to sales of equipment, a contract may stipulate that the Company will be entitled to “bonus” consideration if and only if the equipment’s uptime-to-elapsed-time ratio exceeds a specified minimum over a specified assessment period. The Company excludes amounts of variable consideration from a contract’s transaction price (and from the Company’s disclosure of the amounts of contract transaction prices allocated to remaining performance obligations) to the extent that the amounts would be subject to significant reversals (that is, downward adjustments to the contract’s transaction price and revenue recognized for satisfied performance obligations) if the Company were to include such amounts in the contract’s transaction price and the consideration contingencies are ultimately resolved in a manner that does not favor the Company. When a consideration contingency is resolved in the Company’s favor such that the Company obtains an unconditional entitlement to a specific amount of consideration, an invoice is typically sent to the customer within three calendar days.

None of the Company’s contracts have a significant financing component.

Performance Obligations: Nature

In most cases, goods that the Company contracts to transfer to customers are purchased by the Company for resale. Also, in most cases, services that the Company contracts to transfer to customers are performed by the Company. In no case does the Company act as an agent, i.e., the Company does not provide a service of arranging for another party to transfer goods or services to the customer.

Performance Obligations: Returns, Refunds, etc.

In most cases, goods that customers purchase from the Company may be returned within 30 days of delivery. Any consideration paid for those goods, whether before or after delivery, is refundable in full to customers until the return period expires. At the time revenue is recognized, the Company estimates expected returns and excludes those amounts from revenue. The Company also maintains appropriate accounts to reflect the effects of expected returns on the Company’s financial position and periodically adjusts those accounts to reflect its actual return experience.

In most cases, consideration paid for services that customers purchase from the Company is nonrefundable. Therefore, at the time revenue is recognized, the Company does not estimate expected refunds for services nor does the Company exclude any such amounts from revenue.

Performance Obligations: Warranties

In most cases, goods that customers purchase from the Company are covered by manufacturers’ warranties for periods that exceed one year from the date of delivery. In cases where a manufacturer’s warranty period is less than one year from the date of delivery, the Company provides a warranty for the period not covered by the manufacturer’s warranty up to one year from the date of delivery. The Company does not sell warranties separately.

The Company’s warranties provide customers with assurance that purchased goods comply with published specifications. At the time revenue is recognized, the Company estimates the cost of expected future warranty claims but does not exclude any amounts from revenue. The Company maintains appropriate accounts to reflect the effects of expected future warranty claims on the Company's financial position and periodically adjusts those accounts to reflect its actual warranty claim experience.

Transaction Price Allocated to the Remaining Performance Obligations

A reporting entity must disclose the following information about its remaining performance obligations (nonpublic entities may elect not to include any of the following):

- The aggregate amount of the transaction price allocated to remaining performance obligations that are unsatisfied (wholly or partially) as of the end of the reporting period
- An explanation of when the entity expects to recognize as revenue the amount disclosed in (a), which the entity shall disclose in either of the following ways:
  - On a quantitative basis using the time bands that would be most appropriate for the duration of the remaining performance obligations; or
  - By using qualitative information.

As a practical expedient, an entity need not disclose the above information for a performance obligation if either of the following exists:

1. The performance obligation is part of a contract that has an original expected duration of one year or less
2. The entity recognizes revenue from the satisfaction of the performance obligation when the entity has the right to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date (i.e., a service contract that bills a fixed amount for each hour of service)

The entity should provide an explanation quantitatively as to whether it is applying the practical expedient and whether any consideration from contracts with customers is not included in the transaction price and, as such, not included in the information disclosed (i.e., variable consideration which is constrained).

EXAMPLE

The following table presents the aggregate amounts of revenue that the Company expects to recognize in future years as a result of satisfying performance obligations associated with long-term contracts having unsatisfied performance obligations at the end of the current year (December 31, 20Y3). A long-term contract is one that had an expected duration of more than one year at its inception.

Year	Amount
20Y4	$X,XXX

20Y5	X,XXX
20Y6	XXX
20Y7 and beyond	XXX
Total	$XX,XXX

The following table presents the aggregate amounts of revenue that the Company expected to recognize in future years as a result of satisfying performance obligations associated with long-term contracts having unsatisfied performance obligations at the end (December 31) of years 20Y3, 20Y2, and 20Y1. A long-term contract is one that had an expected duration of more than one year at its inception.

	Amounts as of December 31		
From performance obligations expected to be satisfied in:	20Y3	20Y2	20Y1
1 year or less	$X,XXX	$X,XXX	$X,XXX
More than 1 year but less than 2 years	X,XXX	X,XXX	X,XXX
More than 2 years but less than 3 years	X,XXX	X,XXX	X,XXX
More than 3 years	X,XXX	X,XXX	X,XXX
TOTAL	$XX,XXX	XX,XXX	$XX,XXX

SIGNIFICANT JUDGMENTS

A reporting entity will be required to disclose information about the judgments, and changes in the judgments, made in applying this new guidance that significantly affect the determination of the amount and timing of revenue from contracts with customers.

At a minimum (with certain exceptions), an entity will be required to explain the judgments, and changes in the judgments, used in determining each of the following:

- The timing of satisfaction of performance obligations

- The transaction price and the amounts allocated to performance obligations

Determining the Timing of Satisfaction of Performance Obligations

For performance obligations that an entity satisfies *over time*, all entities will be required to:

a. Disclose the methods used to recognize revenue (for example, a description of the output method or input method). An explanation of why the methods used provide a faithful depiction of the transfer of goods or services. *****

b. For performance obligations satisfied *at a point in time*, an entity should disclose the significant judgments made in evaluating when the customer obtains control of promised goods or services. *****

* (Non-public companies may elect not to include marked disclosure.)

EXAMPLE

Most of the Company's contracts with customers obligate the Company to perform services. The Company typically satisfies its performance obligations for services over time. For service performance obligations that are satisfied over time, the Company typically uses input methods to measure progress. The use of input methods results in the recognition of revenue on the basis of the Company's efforts toward the satisfaction of the performance obligations. The most common input method that the Company uses is labor hours expended relative to the total labor hours expected to be expended in satisfying each performance obligation. This method is a faithful depiction of the transfer of services to customers because customers obtain the benefits from the services as the services are performed to an extent that strongly correlates with labor hours expended.

In some cases, the Company's performance obligations for services are satisfied at a point in time. Management exercises judgment in determining when such performance obligations have been satisfied. In making such judgments, management typically relies on information obtained from the Company employees who have rendered services to evaluate when the customer has obtained control of the services.

The Company typically satisfies its performance obligations for goods at a point in time. In most cases, goods are shipped by common carrier to customers under "FOB Destination" terms. As such, customers typically obtain control of the goods upon delivery. The Company's management exercises judgment in determining when performance obligations for goods have been satisfied. In making such judgments, management typically relies on delivery information obtained from common carriers to evaluate when the customer has obtained control of the goods.

Determining the Transaction Price and the Amounts Allocated to Performance Obligations

A reporting entity should disclose the methods, inputs, and assumptions used for all of the following:

- Determining the transaction price, including but not limited to, estimating variable consideration, adjusting the consideration for the effects of time, value of money, and measuring non-cash consideration

- Assessing whether an estimate of variable consideration is constrained *****

- Allocating the transaction price, including estimating standalone selling prices of promised goods or services and allocating discounts and variable consideration to a specific part of the contract, if applicable

- Measuring obligations for returns, refunds, and other similar obligations

* (Non-public companies may elect not to include marked disclosure.)

EXAMPLE

Satisfaction of Performance Obligation

A performance obligation is a promise in a contract to transfer a distinct good or service to the customer, and is the basis of revenue recognition in accordance with U.S. generally accepted accounting principles (GAAP). To determine the proper revenue recognition method for contracts, we evaluate whether two or more contracts should be combined and accounted for as one single contract and whether the combined or single contract should be accounted for as more than one performance obligation. For most of our contracts, the customer contracts with us to provide distinct services within a single contract, such as transportation services. The majority of our contracts with customers for transportation services include only one performance obligation, the transportation services themselves. However, if a contract is separated into more than one performance obligation, we allocate the total transaction price to each performance obligation in an amount based on the estimated relative standalone selling prices of the promised goods or services underlying each performance obligation. We frequently sell standard transportation services with observable standalone sales prices.

In these instances, the observable standalone sales are used to determine the standalone selling price.

For transportation services, revenue is recognized over time as we perform the services in the contract because of the continuous transfer of control to the customer. Our customers receive the benefit of our services as the goods are transported from one location to another. If we were unable to complete delivery to the final location, another entity would not need to re-perform the transportation service already performed. As control transfers over time, revenue is recognized based on the extent of progress towards completion of the performance obligation. The selection of the method to measure progress towards completion requires judgment and is based on the nature of the products or services to be provided. We use the cost-to-cost measure of progress for our package delivery contracts because it best depicts the transfer of control to the customer which occurs as we incur costs on our contracts. Under the cost-to-cost measure of progress, the extent of progress towards completion is measured based on the ratio of costs incurred to date to the total estimated costs at completion of the performance obligation. Revenues, including ancillary or accessorial fees and reductions for estimated customer incentives, are recorded proportionally as costs are incurred. Costs to fulfill include labor and other direct costs and an allocation of indirect costs. For our freight and freight forwarding contracts, an output method of progress based on time-in-transit is utilized as the timing of costs incurred does not best depict the transfer of control to the customer.

We also provide customized customer-specific solutions, such as supply chain management solutions and inventory and service parts logistics, through which we provide the service of integrating a complex set of tasks and components into a single capability. For these arrangements, the entire contract is accounted for as one performance obligation. For these performance obligations, we typically have a right to consideration from customers in an amount that corresponds directly with the value to the customers of our performance completed to date, and as such we recognize revenue in the amount to which we have a right to invoice the customer.

Assets Recognized from the Costs to Obtain or Fulfill a Contract with a Customer

Consistent with the overall disclosure objective in Topic 606, and guidance contained in subtopic 340-40-50, a reporting entity shall provide (non-public may elect not to) the following disclosures of assets recognized from the costs to obtain or fulfill a contract with a customer:

Describe both of the following:

1. Judgments made in determining the amount of the costs incurred to obtain or fulfill a contract with a customer

2. The methods used to determine the amortization for each reporting period

Disclose all of the following:

- The closing balances of assets recognized from costs incurred to obtain or fulfill a contract with a customer, by main category, of assets

- The amount of amortization and any impairment losses recognized in the period

EXAMPLE

In general, the Company recognizes costs incurred to obtain or fulfill contracts with customers as assets. The Company capitalizes costs that, in management's judgment: (1) are incurred in the Company's efforts to obtain contracts with customers; (2) the Company would not have incurred if the contracts had not been obtained; and (3) are expected to be recovered. Additionally, the Company capitalizes costs that, in management's judgment: (1) relate directly to a contract (or a specific anticipated contract); (2) generate or enhance resources of the Company that will be used in satisfying performance obligations in the future; and (3) are expected to be recovered.

The following table presents the balances of assets recognized from the costs incurred to obtain or fulfill contracts with customers as of the end (December 31) of years 20Y3, 20Y2, and 20Y1.

	As of December 31		
Balance of:	20Y3	20Y2	20Y1
Acquisition costs	$X,XXX	$X,XXX	$X,XXX
Pre-contract costs	X,XXX	X,XXX	X,XXX
Setup costs	X,XXX	X,XXX	X,XXX
Other fulfillment costs	X,XXX	X,XXX	X,XXX

In 20Y3, 20Y2, and 20Y1, the Company amortized assets recognized from the costs incurred to obtain or fulfill contracts with customers in proportion to the amount of revenue recognized from the associated contracts. The following table presents the amounts of such amortization recognized in 20Y3, 20Y2, and 20Y1.

	Amortization Recognized in		
For:	20Y3	20Y2	20Y1
Acquisition costs	XXX	XXX	XXX
Pre-contract costs	XXX	XXX	XXX
Setup costs	XXX	XXX	XXX
Other fulfillment costs	XXX	XXX	XXX

In 20Y3, 20Y2, and 20Y1, as a practical expedient, the Company recognized the incremental costs of obtaining contracts as expenses when incurred if the amortization period of the assets that the Company otherwise would have recognized would have been one year or less. The amounts so expensed, which are not included in the table above, were $YYY, $YYY, and $YYY in 20Y3, 20Y2, and 20Y1 respectively.

Revenue Recognition

Apple Inc.

December 31, 2020

Annual Report

Note 2 – Revenue Recognition

Net sales consist of revenue from the sale of iPhone, Mac, iPad, Services and other products. The Company recognizes revenue at the amount to which it expects to be entitled when control of the products or services is transferred to its customers. Control is generally transferred when the Company has a present right to payment and title and the significant risks and rewards of ownership of products or services are transferred to its customers. For most of the Company's Products net sales, control transfers when products are shipped. For the Company's Services net sales, control transfers over time as services are delivered. Payment for Products and Services net sales is collected within a short period following transfer of control or commencement of delivery of services, as applicable.

The Company records reductions to Products net sales related to future product returns, price protection and other customer incentive programs based on the Company's expectations and historical experience.

For arrangements with multiple performance obligations, which represent promises within an arrangement that are distinct, the Company allocates revenue to all distinct performance obligations based on their relative stand-alone selling prices ("SSPs"). When available, the Company uses observable prices to determine SSPs. When observable prices are not available, SSPs are established that reflect the Company's best estimates of what the selling prices of the performance obligations would be if they were sold regularly on a stand-alone basis. The Company's process for estimating SSPs without observable prices considers multiple factors that may vary depending upon the unique facts and circumstances related to each performance obligation including, where applicable, prices charged by the Company for similar offerings, market trends in the pricing for similar offerings, product-specific business objectives and the estimated cost to provide the performance obligation.

The Company has identified up to three performance obligations regularly included in arrangements involving the sale of iPhone, Mac, iPad and certain other products. The first performance obligation, which represents the substantial portion of the allocated sales price, is the hardware and bundled software delivered at the time of sale. The second performance obligation is the right to receive certain product-related bundled services, which include iCloud, Siri and Maps. The third performance obligation is the right to receive, on a when-and-if-available basis, future unspecified software upgrades relating to the software bundled with each device. The Company allocates revenue and any related discounts to these performance obligations based on their relative SSPs. Because the Company lacks observable prices for the undelivered performance obligations, the allocation of revenue is based on the Company's estimated SSPs. Revenue allocated to the delivered hardware and bundled software is recognized when control has transferred to the customer, which generally occurs when the product is shipped. Revenue allocated to the product-related bundled services and unspecified software upgrade rights is deferred and recognized on a straight-line basis over the estimated period they are expected to be provided. Cost of sales related to delivered hardware and bundled software, including estimated warranty costs, are recognized at the time of sale. Costs incurred to provide product-related bundled services and unspecified software upgrade rights are recognized as cost of sales as incurred.

For certain long-term service arrangements, the Company has performance obligations for services it has not yet delivered. For these arrangements, the Company does not have a right to bill for the undelivered services. The Company has determined that any unbilled consideration relates entirely to the value of the undelivered services. Accordingly, the Company has not recognized revenue, and has elected not to disclose amounts, related to these undelivered services.

For the sale of third-party products where the Company obtains control of the product before transferring it to the customer, the Company recognizes revenue based on the gross amount billed to customers. The Company considers multiple factors when determining whether it obtains control of third-party products including, but not limited to, evaluating if it can establish the price of the product, retains inventory risk for tangible products or has the responsibility for ensuring acceptability of the product. For third-party applications sold through the App Store and certain digital content sold through the Company's other digital content stores, the Company does not obtain control of the product before transferring it to the customer. Therefore, the Company accounts for such sales on a net basis by recognizing in Services net sales only the commission it retains.

The Company has elected to record revenue net of taxes collected from customers that are remitted to governmental authorities, with the collected taxes recorded within other current liabilities until remitted to the relevant government authority.

Deferred Revenue

As of September 26, 2020 and September 28, 2019, the Company had total deferred revenue of $10.2 billion and $8.1 billion, respectively. As of September 26, 2020, the Company expects 65% of total deferred revenue to be realized in less than a year, 25% within one-to-two years, 8% within two-to-three years and 2% in greater than three years.

Disaggregated Revenue

Net sales disaggregated by significant products and services for 2020, 2019 and 2018 were as follows (in millions):

	2020	2019	2018
iPhone (1)	$ 137,781	$ 142,381	$ 164,888
Mac (1)	28,622	25,740	25,198
iPad (1)	23,724	21,280	18,380
Wearables, Home and Accessories (1)(2)	30,620	24,482	17,381
Services (3)	53,768	46,291	39,748
Total net sales (4)	$ 274,515	$ 260,174	$ 265,595

(1) Products net sales include amortization of the deferred value of unspecified software upgrade rights, which are bundled in the sales price of the respective product.

(2) Wearables, Home and Accessories net sales include sales of AirPods, Apple TV, Apple Watch, Beats products, HomePod, iPod touch and Apple-branded and third-party accessories.

(3) Services net sales include sales from the Company's advertising, AppleCare, digital content and other services. Services net sales also include amortization of the deferred value of Maps, Siri, and free iCloud storage and Apple TV+ services, which are bundled in the sales price of certain products.

(4) Includes $5.0 billion of revenue recognized in 2020 that was included in deferred revenue as of September 28, 2019, $5.9 billion of revenue recognized in 2019 that was included in deferred revenue as of September 29, 2018, and $5.8 billion of revenue recognized in 2018 that was included in deferred revenue as of September 30, 2017.

The Company's proportion of net sales by disaggregated revenue source was generally consistent for each reportable segment in Note 11, "Segment Information and Geographic Data" for 2020, 2019 and 2018.

Non-Public Entity Revenue Disclosure Illustration

The revenue disclosures required to be made by non-public reporting entities are as follows:

1. Revenue recognized from contracts with customers, which the reporting entity should disclose separately from its other sources of revenue (Subtopic 606-10-50-4a)

2. Credit losses recorded in accordance with Subtopic 326-20, *Financial Instruments Measured at Amortized Cost,* on any receivables or contract assets arising from a reporting entity's contracts with customers, which the reporting entity should disclose separately from credit losses from other contracts (Subtopic 606-10-50-4b)

3. Revenue disaggregated according to the timing of the transfer of goods or services (point in time or over time) (Subtopic 606-10-50-7)

4. Qualitative information about how economic factors affect the nature, amount, timing, and uncertainty of revenue and cash flows (Subtopic 606-10-50-7)

5. The opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers (Subtopic 606-10-50-8a)

6. A reporting entity should disclose information about its performance obligations in contracts with customers, including a description of all of the following (Subtopic 606-10-50-12):

   - When a reporting entity typically satisfies its performance obligations (shipment, delivery, when rendered, completion of service, bill and hold)

   - The significant payment terms in the contract including any variable consideration

   - The nature of the goods or services that the reporting entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services if the reporting entity is acting as an agent

   - Obligations for returns, refunds, and other similar obligations

   - Types of warranties and related obligations

7. A reporting entity should disclose the judgments, and changes in judgments, made in applying Topic 606 that significantly affect the determination of the amount and timing of revenue from contracts with customers. In particular, a reporting entity should explain the judgments, and changes, in judgments, used in determining both of the following (Subtopic 606-10-50-17):

   - The timing of satisfaction of performance obligations (point in time or over time)

   - The transaction price and the amounts allocated to performance obligations

8. For performance obligations that the reporting entity satisfies over time, the reporting entity should disclose the methods used to recognize revenue (output or input) and how these methods are applied (Subtopic 606-10-50-18a)

9. A reporting entity should disclose information about the methods, inputs, and assumptions used for assessing whether an estimate of variable consideration is constrained (Subtopic 606-10-50-20b)

EXAMPLE

Note 7 – Revenue from Contracts with Customers

1. Alabaster Inc. is in the business of providing consumer products, transportation and energy services to customers primarily located in North America, Europe and Asia. The business is broken down into 7 major goods/service lines. Goods are generally transferred at a point in time whereas services may be transferred to customers both at a point in time or over time. Revenue from contracts with customers in the current fiscal year totaled $ 11,500,000.
2. The Company estimates credit losses on accounts receivable by estimating expected credit losses over the contractual term of the receivable using a discounted cash flow method. When developing this estimate of expected credit losses, the Company considers all available information (past, current, and future) relevant to assessing the collectability of cash flows. The expected credit losses on accounts receivable of $1,600,000 for the current fiscal year are estimated to be $75,000.
3. Revenue is recognized in three major product segments – Consumer Products, Transportation, and Energy. The timing of revenue recognition for these three product segments are:

	Consumer	Transportation	Energy	Total
Timing of revenue recognition				
Goods transferred at a point in time	$1,990	$3,260	$1,000	$6,250
Services transferred over time	0	0	5,250	5,250
	$1,990	$3,260	$6,250	$11,500

4. The following economic factors affect the nature, amount, timing, and uncertainty of the Company's revenue and cash flows as indicated:
   - Type of customer: Based on dollar amounts of revenue, almost all of the goods sold by the company are sold to corporate customers whereas services sold by the company are almost evenly distributed between corporate customers and individual customers. Furthermore, sales to individual customers are highly seasonal, whereas sales to corporate customers lack seasonality. Additionally, sales to corporate customers correlate strongly with economic cycles, whereas sales to individual customers are slightly counter-cyclical.
   - Geographical location of customers: Sales to customers located outside of the United States represent a small but significant portion of the Company's sales. Prices realized for international sales tend to be significantly lower than prices realized for U.S. sales.
   - Type of contract: Sales contracts that include goods almost always include services. However, most sales contracts that include services don't include goods. Goods-and-services contracts tend to be short term (i.e., less than or equal to one year in duration) whereas services-only contracts tend to be long-term (i.e., more than one year in duration).
5. The opening and closing balances of trade receivables, contract assets, and contract liabilities from contracts with customers are as follows:

	Trade Receivables	Contract Assets	Contract Liabilities
Balance 1/1	$1,450,000	$140,000	$86,000
Balance 12/31	$1,600,000	$125,000	$122,000

6. Description of the Company's performance obligations with customers:

   Performance Obligations

   The Company typically satisfies its performance obligations as goods are delivered and as services are rendered.

   The Company's services are typically performed over time. Customers obtain the benefits of such services as the services are performed. Therefore, the Company satisfies its performance obligations as services are rendered. In some cases, the time required to render a service is trivially short; in those cases, the Company satisfies its performance obligation upon completion of the service.

   Payment for goods and services sold by the Company is typically due within 30 days after an invoice is sent to the customer. Invoices for goods are typically sent to customers within three calendar days of delivery. Invoices for services performed over time are typically sent to customers on the last business day of each calendar month. Invoices for services performed at a point in time are typically sent to customers within three calendar days of performance. The Company does not offer discounts if the customer pays some or all of an invoiced amount prior to the due date.

   None of the Company's contracts have a significant financing component.

   In most cases, goods that customers purchase from the Company may be returned within 30 days of delivery. In most cases, consideration paid for services that customers purchase from the Company is non-refundable. Therefore, at the time revenue is recognized, the Company does not estimate expected refunds for services nor does the Company exclude any such amounts from revenue.

   In most cases, goods that customers purchase from the Company are covered by manufacturers' warranties for periods that exceed one year from the date of delivery. In cases where a manufacturer's warranty period is less than one year from the date of delivery, the Company provides a warranty for the period not covered by the manufacturer's warranty up to one year from the date of delivery. The Company does not sell warranties separately.

7. Most of the Company's contracts with customers obligate the Company to perform services. The Company typically satisfies its performance obligations for services over time by relying on information obtained from the Company employees who have rendered services to evaluate when the customer has obtained control of the services. The Company typically satisfies its performance obligations for goods at a point in time by relying on delivery information obtained from common carriers to evaluate when the customer has obtained control of the goods.

8. For each contract that involves variable consideration, the Company estimates the contract's transaction price as the single most likely amount in a range of possible consideration amounts (i.e., the single most likely outcome of the contract). The information that the Company uses to determine the transaction price is similar to the information that the Company's management uses in establishing the prices of goods and services.

GOVERNMENT GRANTS

When the pandemic hit, many entities obtained loans under the Government's Paycheck Protection Program (PPP). Under the program, entities received low interest loans from the U.S. Government that would be forgiven if certain criteria were met. It was quickly realized that there were no direct standards in the ASC to account for these loans. The accounting choices that were available were:

- **Debt Model (Topic 470)** – Under this model, the PPP loan is treated as any other loan and recorded as a liability. The liability is written off to revenue when it is legally discharged and recorded as a gain on extinguishment.

- **Government Grant Model (Subtopic 958-605)** – Under this model, even though Topic 958 does not apply, the entity will adopt the topic by analogy (a term not previously used often) and treating the money in the same way it would be treated if it was a grant given to a non-for-profit entity. ASC 958 states the grant will be treated as revenue once all the conditions of the loan have been met and is treated as a contribution received.

- **Gain Contingency Model (Subtopic 450-30)** – Under this model, the loan would be recorded as a liability and written off to revenue once all the conditions have been met and the gain is realized or realizable and is treated as a gain.

- **Government Assistance Model (IAS 20)** – Under this model, the loan is recorded as a liability and written off to revenue when there is reasonable assurance that conditions will be met. This international standard differs from Topic 958 in that it specifically applies to for-profit entities. Like the Government Grand Model, this standard can be adopted by analogy. In this model the forgiveness is recorded as other income or reduction of related expenses.

In each of the above cases, disclosures were treated in accordance with the related topic. In November 2021, the FASB issued **ASU 2021-10, *Disclosures by Business Entities about Government Assistance,*** which provides guidance in situations such as PPP loans. The update does not provide any new guidance on how to treat the loan but does directly reference Topic 105-10-05-2 which allows for accounting by analogy. The standard creates new Topic 832, *Government Assistance*, which provides guidance disclosures with the following requirements:

- Information about the nature of the transactions and the related accounting policy used to account for the transactions

- The line items on the balance sheet and income statement that are affected by the transactions, and the amounts applicable to each financial statement line item

- Significant terms and conditions of the transactions, including commitments and contingencies

The ASU becomes effective for periods beginning after December 15, 2021; however, it is expected that most entities will adopt it early.

EXAMPLE

Note X: Government Grants

In August 2020, the company received a loan under the Paycheck Protection Program (PPP). The loan accrues interest at 1% with payments beginning six months after the loan date. Under the terms of the loan balance, along with accrued interest is forgiven if the proceeds are spent for specified expenses. In January 2021, the company fulfilled the loan conditions by incurring expenses that qualified for the debt relief. The company elected to account for the loan under the government assistance model which adopts IAS 20 by analogy. Under this model, the loan was recorded as a liability upon receipt and was reclassified as other income in 2021 when the conditions of the loan were met.

OPERATING EXPENSES

There are specific disclosure requirements for expenses within the related Codification topics where they are covered. For some expenses, the only requirement is to disclose amounts. For others, disclosure is more extensive, requiring a description of items such as the reporting entity's policies and where on the Income Statement the expense is classified.

If required expense disclosures only appear in schedules or information labeled "supplemental", it is not in accordance with GAAP. This is because supplemental data is identified as information not required by GAAP and, unlike the notes, is not an integral part of the financial statements.

- The amounts of **Depreciation Expense, Pension Expense, Rent Expense and, Interest Expense** must be disclosed if they are not listed separately on the face of the income statement.

  If the amount of depreciation appears on the face of the Statement of Cash Flows, it need not be disclosed again in the notes. Parenthetical disclosure is required for amounts of interest capitalized.

- **Advertising Expense** – This expense not only includes traditional advertising (such as print and media ads), but also catalogs, point-of-sale materials, sponsorship of special events, etc. Subtopic 720-35 permits advertising costs to be expensed either as incurred, or the first time the advertising takes place.

  This distinction may appear trivial, but can be significant if prolonged production predates the publication or dissemination of advertising, or costs are incurred near year end. For example, assume a calendar year company produces a costly annual January catalog; as a result, the timing of expenses incurred near year end could fall in December in some years and January in others. If the Company's accounting policy is to expense costs as incurred, there is a potential doubling up in some years, with no expense in others. (Arbitrary deferral to avoid doubling up would smooth out expenses, but violate the policy.) Choosing instead to expense the costs when the advertising first appears would ensure that the related costs are expensed each January, when the catalog is distributed. Any costs incurred before year end would be deferred.

  Therefore, in addition to disclosing the amount of advertising expense, the accounting policy must also be disclosed.

EXAMPLE

Note 1: Summary of Significant Accounting Policies (In Part)

Advertising expense includes costs for production and distribution of catalogs, print ads, and internet advertising. The Company expenses these costs when the advertising first appears. Advertising expense was approximately $215,000 and $205,000 for the years ended December 31, 20X2 and 20X1, respectively.

(This disclosure could also be presented in a separate note for advertising.)

There are four special situations that can impact the accounting policy for advertising:

1. **Executory contracts** – The cost of executory contracts, such as product endorsements and sponsorship of events, is generally expensed as performance under the contract is performed. Topic 720 states that such contracts should be evaluated to determine whether the costs recognized are advertising costs; to the extent they are, they must be expensed as incurred or when the advertising first appears (the general rule).

2. **Direct response advertising** (Topic 340) – GAAP permits (but does not require) deferring costs that qualify as direct response advertising. In such cases, the specific sales resulting from the advertising can be identified, and the deferred costs are expensed proportionately with those sales. The accounting policy disclosure should describe this treatment when it is used. This might be the case where a company advertises on television with a special "800" phone number; orders placed can then be matched against the cost of the ad. In many cases, however, the duration of the ad campaign and related sales does not span more than one accounting period, making this option irrelevant.

3. **Tangible assets** – Occasionally, companies may acquire tangible assets for promotional purposes, such as a blimp or owned billboards. These assets are accounted for like property; neither the cost nor the depreciation is classified as advertising costs.

4. **Brochures and Catalogs** – Brochures and catalogs may be designed and printed once, and then used for an extended period of time. Subtopic 720-35-25 permits accounting for them as prepaid supplies (i.e., amortized as used) until they are no longer owned or expected to be used, at which time the remaining cost would be expensed.

STOCK-BASED COMPENSATION – TOPIC 718

Introduction

In summary, the accounting for stock-based compensation is as follows. Stock options may be provided by a company to its employees or to non-employees for goods or services. Stock options provided to employees are recorded as compensation expense at their fair values calculated on the grant date of the options. Non-employee stock options are recognized in exchange for the receipt of goods or services and are recorded at the fair value of the consideration received or the fair value of the equity instruments issued, whichever can be more reliably measured.

Stock options can be classified as either equity or a liability. Options or similar instruments are classified as liabilities if either of the following conditions are met:

- The underlying shares are classified as liabilities.

- The reporting entity can be required under any circumstances to settle the option or similar instrument by transferring cash or other assets. Note: A cash settlement feature that can be exercised only upon the occurrence of a contingent event that is outside the company's control (IPO, for example) would not meet the condition until it becomes probable that the event will occur.

The measurement objective for equity instruments awarded to grantees is to estimate the **fair value at the grant date** of the equity instruments that the entity is obligated to issue when grantees have delivered the good or rendered the service and satisfied any other conditions necessary to earn the right to benefit from the instruments (e.g., to exercise share options). That estimate is based on the share price and other pertinent factors, such as expected volatility at the grant date.

Grant date is the date at which a grantor and a grantee reach a mutual understanding of the key terms and conditions of a share-based payment award. The grantor becomes contingently obligated on the grant date to issue equity instruments or transfer assets to a grantee who delivers the goods or renders the service.

A share-based payment award becomes **vested** at the date that the grantee's right to receive or retain shares, other instruments, or cash under the award is no longer contingent on satisfaction of either a service condition or a performance condition. Market conditions are not vesting conditions.

Reporting entities use valuation models to estimate the fair value of stock options. Two of those models are:

1. Black-Scholes-Merton Model

2. Lattice Model

The **Black-Scholes-Merton Model** consist of five inputs designed to estimate the fair value of stock options. Those five inputs include:

1. Exercise price

2. Price of the underlying common stock security

3. Term of the option

4. Volatility of the price of the underlying common stock security

5. Risk-free interest rate

Note: Volatility is a measure of the amount by which a financial variable, such as a share price has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. The higher the volatility, the more the returns on the shares can be expected to vary—up or down. Volatility is typically expressed in annualized terms.

The **Lattice Model** produces an estimated fair value based on the assumed changes in prices of a financial instrument over successive periods of time. The binomial model is an example of a lattice model. In each time period, the model assumes that at least two price movements are possible. The lattice represents the evolution of the value of either a financial instrument or a market variable for the purpose of valuing a financial instrument.

Disclosure Objectives

A reporting entity with one or more share-based payment arrangements must disclose information that enables users of the financial statements to understand all of the following:

- The nature and terms of such arrangements that existed during the period and the potential effects of those arrangements on shareholders.
- The effect of compensation cost arising from share-based payment arrangements on the income statement.
- The method of estimating the fair value of the equity instruments granted, or offered to grant, during the period.
- The cash flow effects resulting from share-based payment arrangements.

Required Disclosures

- A description of the share-based payment arrangement(s), including the general terms of awards under the arrangement(s) including:
    1. The employee's requisite service period(s) and, if applicable, the non-employee's vesting period and any other substantive conditions.
    2. The maximum contractual term of equity (or liability) share options or similar instruments.
    3. The number of shares authorized for awards of equity share options or other equity instruments.
- The method the company uses for measuring compensation cost from share-based payment arrangements.
- For the most recent year an income statement is presented, both of the following:
    1. The number and weighted-average exercise price (or conversation ratios) for each of the following share options:
        - Outstanding at the beginning of the year
        - Outstanding at the end of the year
        - Exercisable or convertible at the end of the year
        - Granted, exercised/converted, forfeited and expired during the year
    2. The number and weighted-average grant date fair value (or calculated/intrinsic value for a non-public entity) for all of the following groups:

- Non-vested at the beginning of the year
- Non-vested at the end of the year
- Granted, vested and forfeited

- For fully vested share options and share options expected to vest, both of the following:

  1. The number, weighted-average exercise price (or conversion ratio), aggregate intrinsic value (except for non-public entities), and weighted-average remaining contractual term of options outstanding.

  2. The number, weighted-average exercise price (or conversion ratio), aggregate intrinsic value (except for non-public entities), and weighted-average remaining contractual term of options currently exercisable.

- For each year an income statement is presented, both of the following:

  1. A description of the method used during the year to estimate the fair or calculated value of awards under share-based payment arrangements.

  2. A description of the significant assumptions used during the year to estimate the fair value or calculated value of share-based compensation awards.

- For each year an income statement is presented, both of the following:

  1. Total compensation cost for share-based payment arrangements

  2. A description of any significant modifications made to the option plan

- As of the latest statement of financial condition presented, the total compensation cost related to non-vested awards not yet recognized and the weighted-average period they are expected to be recognized.

- If not disclosed elsewhere, the amount of cash used to settle equity instruments granted under share-based payment arrangements.

- A description of the reporting entity's policy, if any, for issuing shares upon the exercise of share options including the sources of those shares.

- If as a result of the reporting entity's policy, the reporting entity expects to repurchase shares in the following annual period, the reporting entity must disclose an estimate of the amount (or a range, if more appropriate of shares to be repurchased during the period).

- If not disclosed elsewhere, the reporting entity's policy for estimating expected forfeitures or recognizing forfeitures as they occur.

- If not disclosed elsewhere, the amount of cash received from exercise of share options and similar instruments granted under share-based payment arrangements and the tax benefit from stock options during the annual period.

Stock-Based Compensation Disclosure

Procter & Gamble Company

June 30, 2019

Annual Report

Net earnings per share were calculated as follows:

Years ended June 30	2019	2018	2017		
CONSOLIDATED AMOUNTS	Total	Total	Continuing Operations	Discontinued Operations	Total
Net earnings	$ 3,966	$ 9,861	$ 10,194	$ 5,217	$ 15,411
Less: Net earnings attributable to noncontrolling interests	69	111	85	—	85
Net earnings attributable to P&G	3,897	9,750	10,109	5,217	15,326
Less: Preferred dividends, net of tax	263	265	247	—	247
Net earnings attributable to P&G available to common shareholders (Basic)	$ 3,634	$ 9,485	$ 9,862	$ 5,217	$ 15,079
Net earnings attributable to P&G available to common shareholders (Diluted)	$ 3,634	$ 9,750	$ 10,109	$ 5,217	$ 15,326
SHARES IN MILLIONS					
Basic weighted average common shares outstanding	2,503.6	2,529.3	2,598.1	2,598.1	2,598.1
Add: Effect of dilutive securities					
Impact of stock options and other unvested equity awards [(1)]	35.9	32.5	43.0	43.0	43.0
Conversion of preferred shares [(2)]	—	94.9	99.3	99.3	99.3
Diluted weighted average common shares outstanding	2,539.5	2,656.7	2,740.4	2,740.4	2,740.4
NET EARNINGS PER SHARE [(3)]					
Basic	$ 1.45	$ 3.75	$ 3.79	$ 2.01	$ 5.80
Diluted	$ 1.43	$ 3.67	$ 3.69	$ 1.90	$ 5.59

(1) Weighted average outstanding stock options of approximately 13 million in 2019, 48 million in 2018 and 20 million in 2017 were not included in the Diluted net earnings per share calculation because the options were out of the money or to do so would have been antidilutive (i.e., the assumed proceeds upon exercise would have exceeded the market value of the underlying common shares).

(2) Despite being included in Diluted net earnings per common share, the actual conversion to common stock occurs when the preferred shares are sold. Shares may only be sold after being allocated to the ESOP participants pursuant to the repayment of the ESOP's obligations through 2035. In fiscal year 2019, weighted average outstanding preferred shares of 90 million were not included in the Diluted net earnings per share calculation because to do so would have been antidilutive, due to lower Net earnings driven by the Shave Care impairment charges (see Note 4).

(3) Net earnings per share are calculated on Net earnings attributable to Procter & Gamble.

NOTE 7

STOCK-BASED COMPENSATION

We have two primary stock-based compensation programs under which we annually grant stock option, restricted stock unit (RSU) and performance stock unit (PSU) awards to key managers and directors.

In our main long-term incentive program, key managers can elect to receive options or RSUs. All options vest after three years and have a 10-year life. Exercise prices on options are set equal to the market price of the underlying shares on the date of the grant. Effective in fiscal year 2017, RSUs vest and settle in shares of common stock three years from the grant date. RSUs granted prior to fiscal year 2017 vest and settle in shares of common stock five years from the grant date.

Senior-level executives participate in an additional long-term incentive program that awards PSUs, which are paid in shares after the end of a three-year performance period subject to pre-established performance goals. Effective in fiscal year 2019, we added a Relative Total Shareholder Return (R-TSR) modifier to the PSU, under which the number of shares ultimately granted is also impacted by the Company's actual shareholder return relative to our consumer products competitive peer set.

In addition to these long-term incentive programs, we award RSUs to the Company's non-employee directors and make other minor stock option and RSU grants to employees for which the terms are not substantially different from our long-term incentive awards.

A total of 185 million shares of common stock were authorized for issuance under the stock-based compensation plan approved by shareholders in 2014, of which 41 million shares remain available for grant.

The Company recognizes stock-based compensation expense based on the fair value of the awards at the date of grant. The fair value is amortized on a straight-line basis over the requisite service period. Awards to employees eligible for retirement prior to the award becoming fully vested are recognized as compensation expense from the grant date through the date the employee first becomes eligible to retire and is no longer required to provide services to earn the award. Stock-based compensation expense is included as part of Cost of products sold and SG&A in the Consolidated Statement of Earnings and includes an estimate of forfeitures, which is based on historical data. Total expense and related tax benefit were as follows:

Years ended June 30	2019	2018	2017 (1)
Stock options	$ 246	$ 220	$ 216
RSUs and PSUs	269	175	150
Total stock-based expense	$ 515	$ 395	$ 366
Income tax benefit	$ 101	$ 87	$ 111

(1) Includes amounts related to discontinued operations, which are not material.

We utilize an industry standard lattice-based valuation model to calculate the fair value for stock options granted. Assumptions utilized in the model, which are evaluated and revised to reflect market conditions and experience, were as follows:

Years ended June 30	2019	2018	2017
Interest rate	2.5 - 2.7%	1.9 - 2.9%	0.8 - 2.6%
Weighted average interest rate	2.6%	2.8%	2.6%
Dividend yield	3.0%	3.1%	3.2%
Expected volatility	17%	18%	15%
Expected life in years	9.2	9.2	9.6

Lattice-based option valuation models incorporate ranges of assumptions for inputs and those ranges are disclosed in the preceding table. Expected volatilities are based on a combination of historical volatility of our stock and implied volatilities of call options on our stock. We use historical data to estimate option exercise and employee termination patterns within the valuation model. The expected life of options granted is derived from the output of the option valuation model and represents the average period of time that options granted are expected to be outstanding. The interest rate for periods within the contractual life of the options is based on the U.S. Treasury yield curve in effect at the time of grant.

A summary of options outstanding under the plans as of June 30, 2019 and activity during the year then ended is presented below:

Options	Options (in thousands)	Weighted Average Exercise Price	Weighted Average Contract-ual Life in Years	Aggregate Intrinsic Value
Outstanding, beginning of year	205,654	$ 74.21		
Granted	13,451	95.78		
Exercised	(53,670)	62.99		
Forfeited/ expired	(694)	81.58		
OUTSTANDING, END OF YEAR	164,741	$ 79.59	5.6	$ 4,951
EXERCISABLE	110,504	$ 75.07	4.2	$ 3,822

The following table provides additional information on stock options:

Years ended June 30	2019	2018	2017
Weighted average grant-date fair value of options granted	$13.60	$11.89	$10.45
Intrinsic value of options exercised	1,770	500	1,334
Grant-date fair value of options that vested	180	209	246
Cash received from options exercised	3,381	1,245	2,630
Actual tax benefit from options exercised	221	127	421

At June 30, 2019, there was $174 of compensation cost that has not yet been recognized related to stock option grants. That cost is expected to be recognized over a remaining weighted average period of 1.9 years.

A summary of non-vested RSUs and PSUs outstanding under the plans as of June 30, 2019 and activity during the year then ended is presented below:

	RSUs		PSUs	
RSU and PSU awards	Units (in thousands)	Weighted Average Grant Date Fair Value	Units (in thousands)	Weighted Average Grant Date Fair Value
Non-vested at July 1, 2018	5,376	$ 77.17	1,385	$ 84.08
Granted	1,970	96.74	555	112.83
Vested	(1,685)	78.40	(642)	91.40
Forfeited	(168)	79.67	(3)	92.72
Non-vested at June 30, 2019	5,493	$ 84.00	1,295	$ 92.98

At June 30, 2019, there was $261 of compensation cost that has not yet been recognized related to RSUs and PSUs. That cost is expected to be recognized over a remaining weighted average period of 2.0 years. The total grant date fair value of shares vested was $205, $175 and $163 in 2019, 2018 and 2017, respectively.

The Company settles equity issuances with treasury shares. We have no specific policy to repurchase common shares to mitigate the dilutive impact of options, RSUs and PSUs. However, we have historically made adequate discretionary purchases, based on cash availability, market trends and other factors, to offset the impacts of such activity.

NOTE 8

POSTRETIREMENT BENEFITS AND EMPLOYEE STOCK OWNERSHIP PLAN

We offer various postretirement benefits to our employees.

Defined Contribution Retirement Plans

We have defined contribution plans, which cover the majority of our U.S. employees, as well as employees in certain other countries. These plans are fully funded. We generally make contributions to participants' accounts based on individual base salaries and years of service. Total global defined contribution

Unit

5

Statement of Cash Flow Disclosures

LEARNING OBJECTIVE

When you have completed this unit, you will be able to accomplish the following.

- Identify and describe presentation and disclosure requirements for the statement of cash flows.

GENERAL

Topic 230, *Statement of Cash Flows,* requires that whenever a business entity or not-for-profit organization reports financial position and results of operations, a cash flow statement is to be presented for each period for which results of operations is presented. However, Topic 230 exempts most pension plans from presenting a Statement of Cash Flows.

The primary objective of a statement of cash flows is to provide relevant information about the cash receipts and cash payments of a reporting entity during a period of time. The information provided in a statement of cash flows, if used with related disclosures and other information in the financial statements, should help users to do all of the following:

- Assess the reporting entity's ability to generate positive future net cash flows
- Assess the reporting entity's ability to meet its obligations, its ability to pay dividends, and its needs for external financing
- Assess the reasons for differences between net income and associated cash receipts and payments (quality of earnings)
- Assess the effects on a reporting entity's financial position of both its cash and non-cash investing and financing transactions during the reporting period

A statement of cash flows is organized into three classifications:

1. **Operating Activities** – Operating activities include all transactions and other events that are not defined as investing or financing activities. Operating activities generally involve producing and delivering goods and providing services. Cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income.

2. **Investing Activities** – Investing activities include making and collecting loans and acquiring and disposing of debt or equity instruments and property, plant, and equipment and other productive assets other than materials that are part of the reporting entity's inventory.

3. **Financing Activities** – Financing activities include obtaining resources from owners and providing them with a return on, and return of, their investment; receiving restricted resources, that by donor stipulation must be used for long-term purposes; borrowing money and repaying amounts borrowed, or otherwise settling the obligation; and obtaining and paying for other resources obtained from creditors on long-term credit.

The following includes examples of these activities:

1. **Operating** activities include all activities other than financing or investing, such as:

   - Receipts from the sale of goods and services and the collection of accounts and notes receivable.
   - Receipts and payments of interest, even for a not-for-profit.
   - Receipts of dividends, even for a not-for-profit.
   - Distributions to equity method investors.
   - Receipts or payments from the sale or purchase of trading securities. Note: Topic 825 (fair value option) requires these cash transactions to be classified based on the nature and purpose for which the securities were purchased.
   - Payments to acquire goods for resale or materials for the manufacture of goods and principal payments on accounts or notes payable.
   - Payments to suppliers and employees for other goods and services.
   - Payments to governmental units for taxes, fines, duties, penalties, and other fees.
   - Payments to settle an asset retirement obligation (Topic 410).

2. **Investing** activities, such as:

   - Making and collecting loans, including related party loans
   - Acquiring and disposing of debt and equity securities which are held to maturity or available for sale

- Acquiring and disposing of property, plant, and equipment and other productive assets
- Deposits or deferred costs that relate to investing assets or liabilities
- Cash paid to increase the cash surrender value of life insurance

3. **Financing** activities, such as:
   - Borrowing money and repaying amounts borrowed, including related party loans
   - Issuing and reacquiring the entity's own equity instruments
   - Dividends or other distributions to owners

   Payments for debt issuance costs are financing activities. Fees and other costs deducted from the proceeds of borrowing should be offset against the face amount of the debt so that only the net proceeds are reflected on the cash flows statement.

The effect of **fluctuations in exchange rates** on foreign cash balances is reported as a separate item.

Indirect Method

Tyler Products Company
Statement of Cash Flows
For the Year Ended December 31, 20X7

Operating Activities:	
Net Income	$ 1,762,400
Adjustments to reconcile net income to net cash	
Provided by operating activities:	
Depreciation	197,420
Provision for Deferred Income Taxes	37,111
Provision for Bad Debts	6,200
Gain on Sale of Machinery	(26,200)
Changes in operating assets and liabilities:	
Accounts Receivable	(87,400)
Inventories	89,174
Prepaid Assets	42,819
Accounts Payable	174,899
Net Cash Provided by Operating Activities	2,196,423
Investing Activities:	
Purchase of Machinery	(375,472)
Proceeds from Sale of Machinery	51,674
Net Cash Used in Investing Activities	(323,798)
Financing Activities:	
Proceeds from Long-Term Borrowings	1,500,000
Principal Payments on Debt	(2,651,900)
Dividends Paid	(40,000)
Net Cash Used in Financing Activities	(1,191,900)
Increase (Decrease) in Cash	680,725
Cash and Cash Equivalents at Beginning of Year	14,271
Cash and Cash Equivalents at End of Year	$ 694,996
Supplemental Disclosures:	
Interest Paid	$ 165,000
Income Taxes Paid	$ 515,000

Direct Method

Taylor Products Company
Statement of Cash Flows
For the Year Ended December 31, 20X7

Cash flows from operating activities:	
Cash received from customers	$7,680,912
Cash paid to suppliers and employees	(4,777,715)
Interest paid	(165,000)
Income taxes paid	(515,000)
Other operating cash receipts (payments)	(26,774)
Net Cash Provided by Operating Activities	2,196,423
Cash flows from investing activities:	
Purchase of Machinery	(375,472)
Proceeds from Sale of Machinery	51,674
Net Cash Used in Investing Activities	(323,798)
Cash flows from financing activities:	
Proceeds from Long-Term Borrowings	1,500,000
Principal Payments on Debt	(2,651,900)
Dividends Paid	(40,000)
Net Cash Used in Financing Activities	(1,191,900)
Increase (Decrease) in Cash	680,725
Cash and Cash Equivalents at Beginning of Year	14,271
Cash and Cash Equivalents at the End of Year	$ 694,996
Reconciliation of net income to net cash provided by operating activities:	
Net Income	$1,762,400
Adjustments to reconcile net income to cash provided by operating activities:	
Depreciation	197,420
Provision for Deferred Income Taxes	37,111
Provision for Bad Debts	6,200
Gain on Sale of Machinery	(26,200)
Change in operating assets and Liabilities:	
Accounts Receivable	(87,400)
Inventories	89,174
Prepaid Assets	42,819
Accounts Payable	174,899
Net Cash Provided by Operating Activities	$2,196,423

NOTE: ASU 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities,* removes the reconciliation of net income to net cash provided by operating activities for not-for-profit organizations that prepare their cash flow statements using the direct method.

CASH FLOW STATEMENT DISCLOSURES

In addition to presenting the three categories of cash flows, the following additional **cash flow disclosures** are required (Subtopic 230-10-50):

- **The entity's accounting policy for determining which items are treated as cash equivalents**. Cash equivalents are defined as highly liquid investments that are (a) readily convertible to cash and (b) so near maturity that the risk of changes in value due to changes in interest rates is insignificant. Generally, this is interpreted to mean **original** maturities of three months or less.

  Note that, because the definition includes the concept of "maturities", only debt securities can possibly qualify as cash equivalents. Consequently, any temporary investment that represents *shares* on which the holder receives *dividends* should not be classified as a cash equivalent. This occurs with some brokerage money market accounts, even though they are structured to allow check-writing privileges and other "cash-like" transactions.

  Prevalent practice is to have an accounting policy that considers *all* highly liquid debt securities with original maturities of three months or less to be cash equivalents. However, the standard provides for a policy that may include only some of these investments as cash equivalents, with others classified separately as temporary investments. If this approach is used, any changes in the items included as cash equivalents from one period to the next triggers a change in accounting principle requiring retrospective adjustment of prior periods presented.

- **Income taxes paid and interest paid** (net of amounts capitalized), when the indirect method is used.

- **Non-cash investing and financing activities** – This disclosure may be presented as a schedule or in narrative form. Although it has become common practice to include this disclosure on the face of the statement of cash flows, this is not required. Subtopic 230-10-50 actually states that, if there are only a few non-cash transactions to disclose, it may be convenient to include the disclosure on the same page. If the information is disclosed in the notes, it should be clearly referenced to the Statement.

  If a transaction is partly cash and partly non-cash, it must be split, with the cash portion in the statement of cash flows and the non-cash portion as a required disclosure.

  Because the statement of cash flows still "foots" if noncash transactions are not identified and excluded from the body of the Statement, care must be taken to exclude noncash amounts within changes in the comparative balance sheet when deriving cash flows.

- **Restrictions on Cash and Cash Equivalents** – A reporting entity is required to disclose information about the nature of restrictions on its cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents.

EXAMPLE

Note 1: Summary of Significant Accounting Policies (In Part):

<u>Cash Equivalents</u> – The Company considers Treasury Bills and Notes, and commercial paper with original maturities of 90 days or less to be cash equivalents.

OR

<u>Cash Equivalents</u> – The Company considers all highly liquid debt securities with maturities of three months or less to be cash equivalents.

EXAMPLE

Statement of Cash Flows
(disclosure excerpt)

Supplemental Disclosures of Cash Flow Information

Cash paid for:

Interest	$ 6,716
Income taxes	$ 12,421

Supplemental Schedule of Non-Cash Financing Activities

Reduction of long-term debt by additional stock issuance (Note X)	$400,000
Property acquired with installment note payable	$280,000

PRACTICE ISSUES – CASH FLOWS

There are a number of **common practice issues** that arise in preparing the statement of cash flows.

1. The requirement to include a statement of cash flows is limited to GAAP presentations. Therefore, an entity presenting financial statements prepared on the income tax basis of accounting, or other SPF, is not required to include a statement of cash flows, although it is not prohibited and may be useful.

2. If an entity has no cash equivalents (such as a company that only has bank deposits,) a policy note on cash equivalents would be unnecessary.

3. The approach toward cash flows in Topic 230 is very literal. Therefore, if a building is bought with a mortgage, it is a noncash transaction. But if the check for the mortgage loan is made out to the buyer, who then endorses it over to the seller, the proceeds and purchase *are* cash flows (TPA 1300.21).

4. When there is a prior period adjustment, the *restated* prior year amounts on the balance sheet should be used to calculate cash flows. The impact on each line of the financial statements is then included as part of the required footnote disclosure for the prior period adjustment.

5. A change from the indirect to the direct method or vice versa is not considered an accounting change. However, if comparative statements are presented, the prior period statement of cash flows should be restated to conform to the new method, with disclosure of the restatement in the notes.

6. The circumstances when cash flows may be netted are limited to adjustments in the operating section (indirect method) and activity in other accounts only when the turnover is quick, amounts are large, and maturities are short. Because the preparation of the statement of cash flows is usually based on net changes in the balance sheet; care must be taken to analyze these changes to see if they should be "grossed up."

7. Under the indirect method, noncash revenues or expenses are deducted or added back to net income as an adjustment in deriving Cash Flows from Operating Activities. Often, noncash components of net income are "missed" or mishandled. While depreciation and amortization are obvious examples, others include bad debt expense (in its entirety), non-cash compensation, deferred taxes, unrealized gains or losses included in income, impairment losses, income from an equity-method investee, revenue from the change in CSV life insurance, etc. Errors escape detection during review because the correct treatment causes amounts in the Statement of Cash Flows to differ from net balance sheet changes.

8. The adjustment in the operating section for the change in Accounts Payable should not include amounts for capital additions that happen to be in payables at year end. In the year purchased, the acquisition is a noncash investing activity. In the following year when paid, the payment is a financing activity.

9. The classification of cash transactions with related parties should be the same as those with third parties. Therefore, if activity is for rent, labor, or other operating items, the cash flows should be included in the operating section. But if the amounts are for cash advances or loans, they should be investing or financing activities, presented net only if the requirements of item 6 are met.

10. Deficiencies noted by Peer Review:

    <u>Improper Netting of Cash Inflows and Outflows</u>

    Generally, Topic 230 requires separate presentation of gross cash inflows and outflows. This is true for both direct and indirect methods. Exceptions are permitted for:

    - Exchanges between cash and cash equivalents

    - Financial instruments with quick turnover, short maturities, and large amounts of cash inflows and outflows (line of credit borrowings, notes receivable, certain short-term investments)

    - Changes of assets and liabilities associated with operating activities (operating cash flows on indirect method, reconciliation on direct method)

    <u>Incorrect Presentation of Non-Cash Transactions</u>

    Topic 230 requires non-cash financing and investing activities to be **excluded** from cash flows and **disclosed** as supplemental information on the face of the statement or in the footnotes. This is relevant for both the direct and indirect methods.

    Two points should be emphasized to clarify this requirement:

    a. Treatment of these transactions differs from the "all-inclusive" approach used years ago in the statement of changes in financial position, which showed such transactions as both a source and use of working capital or cash.

b. The required presentation for non-cash activities is an example of "required supplemental disclosure," and while common practice is to include it on the face of the statement, inclusion in the notes is also acceptable.

In practice, this disclosure is often missing or the amounts are erroneously included in cash flows.

NOTES

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	Tax

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—Debbie Y.