In this publication, we address a variety of topics that companies should consider as they begin the process of year-end financial reporting. Some relate to current events or types of transactions and arrangements that have become more common due to economic trends or other factors. We also discuss financial reporting matters that companies often find challenging or that the Securities and Exchange Commission (SEC) staff focuses on when reviewing financial reports. While our list of topics isn't all-inclusive, we hope it will help you plan your year-end reporting process. For each topic, we list EY publications that provide more information.

Internal controls

2013 COSO framework
Most companies subject to internal control reporting are in the process of adopting, or have adopted, the Committee of Sponsoring Organizations of the Treadway Commission’s (COSO) 2013 Internal Control – Integrated Framework (the 2013 framework) for their annual assessments. While the 2013 framework does not require a company to redesign a system of internal controls that is currently effective, a company that adopts the new framework may identify gaps in its system of internal controls where controls and/or documentation need to be added or improved. The transition\(^1\) to the 2013 framework also presents opportunities for companies to review their current internal control system and make enhancements and/or rationalize approaches.

Many companies haven’t reconsidered the mapping of their system of internal control to the COSO framework since their first annual assessment required by Section 404 of the Sarbanes-Oxley Act of 2002 (SOX). This also may have been the last time a company performed a complete review of the documentation of its systems, procedures and controls and how it aligns with the requirements of the original framework. While the fundamental
elements of the framework remain the same, companies should use the 2013 framework to consider whether any changes are needed in their internal controls and/or documentation. The extent of these efforts will vary depending on how extensive a company’s periodic assessments have been and the condition of its existing documentation.

If companies have not already done so, they also may want to challenge and possibly enhance their documentation in the following areas:

- The precision of internal controls, especially management review controls
- Controls that ensure the completeness and accuracy of information in system-generated data or reports used in the execution of management review and other controls
- Controls over revenue recognition such as controls over contractual arrangements, presentation (e.g., gross versus net revenue), period of recognition and required disclosures
- Controls over important estimates, accounting for significant or unusual transactions and transactions with related parties

In addition to evaluating whether individual deficiencies indicate that a material weakness in a relevant principle exists, companies that adopt the 2013 framework are also required to evaluate whether deficiencies in the aggregate indicate that:

- A relevant principle or one of the five components of internal control is not present and functioning.
- The components of internal control are not operating together in an integrated manner.

**Deficiencies in information technology general controls**

Questions often arise as to whether deficiencies in information technology general controls (ITGCs) can result in a material weakness. We believe that the significance of any deficiencies in ITGCs will largely be based on the significance of the application or IT-dependent manual controls for which the deficient ITGCs provide support.

We believe that deficiencies in ITGCs could result in a material weakness if (1) ITGCs have not been effectively designed or are not operating effectively, (2) a company cannot conclude that application and IT-dependent manual controls affected by the ITGC deficiencies are operating effectively and (3) there are not sufficient compensating controls within the affected significant classes of transactions to address the unmitigated risks associated with the deficiencies in ITGCs.

**Financial statement errors**

When companies identify errors in their financial statements, they should consider the ramifications on their internal controls assessments. Additionally, we believe that companies can benefit from understanding the themes that gave rise to recent restatements.

**Control considerations**

Companies that identify an error in their annual or interim financial statements should assess whether and how such an error affects their current and previous conclusions about the effectiveness of the related internal controls. This evaluation is necessary even when the error does not require restatement of the financial statements because the error may indicate that some aspect of the internal control design or execution did not function properly in the current or prior period(s).
When the evaluation reveals a control deficiency, the company should evaluate the severity of the deficiency, including whether it is a significant deficiency or a material weakness. The evaluation of the severity should not be limited to the magnitude of the discovered error but also should consider whether there is a reasonable possibility that the company’s controls will fail to prevent or detect a material misstatement. Therefore, a company’s assessment of the severity of a deficiency should consider any mitigating controls and whether such controls could have prevented or detected an error and the available evidence that the mitigating controls were operating effectively.

**Restatement themes**

Accounting for income taxes, revenue recognition and the statement of cash flows were the leading topics of restatements in 2013. While there were various types of errors for each of those topics, the following general themes were observed:

**Key contractual terms** – Many restatements were caused by the misapplication of accounting guidance due to an incomplete understanding of contractual terms. Companies should have robust processes and controls for identifying key contract terms and assessing the accounting implications.

**Changes in estimates** – Determining whether an adjustment is a change in accounting estimate or an error requires judgment. We often receive questions about whether using “new information” is a change in estimate or an error correction. Our response often depends on when the information was reasonably available, when the estimate was updated and how the information was interpreted. For example, not changing an underlying assumption in a timely fashion when new information becomes available or circumstances change could result in an error. Misinterpreting information used to develop or support an estimate also may lead to an error.

Controls for estimation processes should be designed to ensure that estimates are changed timely as new information becomes available. A company that uses its reviews of accounts receivable aging as a control to identify potentially uncollectible balances, for example, would need to make sure that such reviews are performed timely and with sufficient detail so that estimates of uncollectible accounts receivable are updated appropriately as of the end of each reporting period.

**Income tax accounting** – Tax errors leading to restatements may occur even if a full valuation allowance has been recorded (i.e., the tax provision is zero). A company still must consider the intraperiod tax allocation requirements and whether the tax effect of non-routine transactions that are accounted for outside of the income statement (e.g., in other comprehensive income) are appropriately recognized. Further, companies should consider the recognition and measurement of deferred tax balances, as errors can build on the balance sheet and in the footnotes, regardless of minimal annual income statement effects.

Restatements also result from errors in calculating the tax basis of assets and liabilities, which often result in the inappropriate measurement of deferred tax assets and liabilities. An accurate computation of the tax basis requires a technical understanding of tax law, often for multiple jurisdictions.
Revenue recognition

Vendor payments and incentives provided to customers

Companies may be surprised to learn that the guidance on vendors’ accounting for payments and incentives made to customers applies to their transactions, especially when the transactions between the parties are not linked. If companies do not properly evaluate transactions with their customers, amounts paid or incentives granted may not be appropriately recorded in the income statement.

When assessing vendor payments or incentives provided to customers, companies should broadly consider customers to include any purchasers of their products, regardless of whether the purchases are direct or indirect. In addition, companies need to think broadly about what is consideration paid, which includes anything that the customer can apply against trade amounts owed to the vendor (e.g., cash payments, credits to the customer’s account, equity instruments of the vendor). Further, companies are required to evaluate all transactions between a vendor and a customer, and the timing of or type of transaction doesn’t exempt a company from considering the guidance. For example, if a company makes contributions to a charitable organization and the charity is also a customer of the company, the contributions are likely within the scope of the guidance.

Consideration given by a vendor to a customer is presumed to be a reduction of its selling prices that should be characterized as a reduction of revenue when recognized in the income statement. However, this presumption is overcome if the vendor receives, or will receive, an identifiable benefit (goods or services) in exchange for the consideration and the vendor can reasonably estimate the fair value of the identifiable benefit.

Gross versus net presentation

Because existing revenue guidance on principal and agent considerations was written largely in the context of tangible goods, applying it to service transactions often requires the use of significant judgment when determining whether revenues should be reported on a gross or net basis in the financial statements. This evaluation can be especially challenging for companies in industries (e.g., service, technology) that do not carry inventory.

In many arrangements, a company may help a supplier fulfill its obligations to deliver goods or services to a customer. In these circumstances, the company must determine whether it should report revenue based on (1) the total amount billed to the customer (i.e., gross) because it has earned revenue from the sale of the goods or services or (2) the net amount the company retains (i.e., the amount billed to a customer less the amount paid to the supplier) because it has earned a commission or fee. The objective is to determine whether the company is in substance acting as the principal that holds substantially all of the risks and rewards related to the sale of a product or service or as an agent on behalf of another party (e.g., the supplier).

The revenue guidance on principal and agent considerations applies to transactions in all industries unless specific guidance is provided in other authoritative literature. The guidance does not provide any bright lines to determine whether gross or net presentation is appropriate. Rather, it provides indicators suggesting gross or net reporting that often require companies to apply considerable judgment based on their specific facts and circumstances. While certain indicators are weighted (i.e., strong or weak), no single indicator is presumptive or determinative, and all of the indicators should be analyzed in their totality to determine whether the preponderance of evidence supports gross or net revenue reporting.
It is important for companies to maintain thorough, contemporaneous documentation to support their judgments. It is not uncommon for a company to act as a principal in one arrangement and to present gross revenue, while acting as an agent in another arrangement and report net revenue. It is also important for a company to routinely update its analyses to ensure that its documentation reflects the terms and conditions of its current arrangements.

**Impairment of long-lived and intangible assets**

In evaluating assets for impairment, companies should consider economic conditions and political factors (e.g., the effects of sanctions and government intervention in certain industries) in the regions in which they operate. Companies should note that the economic recovery has been uneven in different industries and regions.

**Long-lived assets**

Long-lived assets are evaluated for impairment when events or changes in circumstances indicate that their carrying amounts may not be recoverable. Management should consider whether economic or political developments directly affect the business and whether they are indicators of impairment. In addition, management should consider how these developments may affect their capital and operating strategies and whether changes to those strategies will affect the recoverability of assets.

When a company performs a recoverability test, long-lived assets are grouped (i.e., the asset group) at the lowest level for which there are identifiable cash flows that are largely independent of the cash flows of other assets and liabilities. Determining the asset group requires a significant amount of judgment. Furthermore, when performing a recoverability test, management should consider the current economic environment when developing estimates of future cash flows. Companies should also consider the disclosure requirements for significant estimates used in the preparation of the financial statements.

**Indefinite-lived intangible assets and goodwill**

Indefinite-lived intangible assets and goodwill are subject to annual impairment tests as well as interim impairment tests if impairment indicators are present. As with long-lived assets, management should consider whether economic or political developments would trigger an interim impairment test.

When testing an indefinite-lived intangible asset or goodwill for impairment, companies may qualitatively assess whether the fair value of an indefinite-lived asset or a reporting unit, for goodwill, is below its carrying amount. If a company fails or elects to skip the qualitative assessment, it would need to quantitatively assess these assets for impairment. For an indefinite-lived intangible asset, if the fair value is less than the carrying amount, a company would recognize the difference as an impairment loss. For goodwill, if the fair value of the reporting unit is below its carrying amount, the company would perform another step to determine whether there is an impairment loss. In this step, a company must determine the implied fair value of goodwill in the same manner as the amount of goodwill recognized in a business combination (i.e., the excess of the fair value of a reporting unit over the amounts assigned to its identifiable net assets).
Useful lives of intangible assets

With global merger and acquisition (M&A) activity on the rise, we are seeing more transactions that involve the acquisition of intangible assets. In some cases, an intangible asset is the most significant asset acquired. Companies need to carefully determine the useful lives of acquired intangible assets.

The useful life of an intangible asset is the period over which the asset is expected to contribute directly or indirectly to the future cash flows of the company. It is based on numerous factors including the expected use of the asset; legal, regulatory or contractual provisions that may limit the asset’s useful life; and a company’s experience. If the company concludes there is no limit on the useful life of an intangible asset, that asset is considered to have an indefinite life. An intangible asset with a finite life is amortized over the asset’s useful life and is subject to an impairment test as a long-lived asset, while an intangible asset with an indefinite life is subject to an annual impairment test and interim impairment tests as indicated in the prior topic.

The useful life of an intangible asset should be evaluated each reporting period to determine whether events and circumstances warrant a revision to the remaining useful life, including a change to a previous conclusion that an intangible asset has an indefinite life. Companies should understand that a reduction in the useful life of a finite-lived intangible asset may be an indicator of impairment. Additionally, an indefinite-lived intangible asset that is subsequently determined to have a finite life must be tested for impairment. Any change in the estimated remaining useful life would be reflected prospectively as the intangible asset is amortized over the revised remaining useful life.

Income taxes

Realizability of deferred tax assets

Companies that reported losses during the recession are returning to profitability and challenging whether to reverse valuation allowances related to deferred tax assets.

A valuation allowance is required if, based on the weight of available evidence (both positive and negative), it is more likely than not (i.e., a likelihood of more than 50%) that some portion or all of a company’s deferred tax assets will not be realized. The analysis is the same, regardless of whether a company is evaluating whether to initially recognize, maintain or reverse a valuation allowance.

Entities must consider four sources of taxable income when determining whether a valuation allowance is required. Ultimately, the realizability of deferred tax assets depends on the existence of sufficient taxable income of the appropriate character in either the carryback or carryforward period.

When determining the weight to place on each piece of positive and negative evidence, a company should consider how objectively verifiable the evidence is. Estimates of future taxable income obviously require judgments about future events. A company should carefully assess the realizability of its deferred tax assets and make complete, transparent disclosures in its financial statements and management’s discussion and analysis (MD&A).

A company that decides that an existing valuation allowance is still needed should continue to account for and measure gross deferred tax assets and deferred tax liabilities so the effects of any future reversal of the allowance are appropriately stated (see the financial statement errors topic above for additional information).
Indefinite reinvestment assertions and related disclosures

Earnings of a foreign subsidiary are generally taxed in the US upon repatriation. Under the income tax accounting guidance it is presumed all earnings of a foreign subsidiary will be repatriated. Companies can overcome the presumption that all undistributed earnings of a foreign subsidiary will be repatriated to the US parent if they have sufficient evidence that the subsidiary has invested or will invest the undistributed earnings indefinitely or that the earnings will be remitted in a tax-free liquidation. Companies that overcome the presumption record no US tax liability for undistributed earnings. However, we have seen an increase in acquisitions, divestitures (e.g., sales, spinoffs), internal reorganizations and other transactions that have resulted in companies paying taxes on previously undistributed earnings of a foreign subsidiary.

A company’s assertion that earnings from foreign subsidiaries will be indefinitely reinvested should be supported by evidence of specific plans for reinvestment of foreign earnings (e.g., past experience, working capital forecasts, long-term liquidity plans, capital improvement programs, merger and acquisition plans, investment plans) in the locations where the earnings are generated, as well as an analysis of why those funds are not needed upstream.

As companies contemplate acquisitions, divestitures, reorganizations and other transactions, questions may arise about their ability to continue to indefinitely reinvest foreign earnings. For example, a company may need foreign earnings to fund an acquisition, or an anticipated sale of a foreign subsidiary may trigger a tax on previously undistributed earnings. In these cases, because such plans are inconsistent with an indefinite reinvestment assertion, a company may no longer be able to assert indefinite reinvestment of foreign earnings.

A company that changes its indefinite reinvestment assertion must record deferred taxes on the earnings that are no longer indefinitely reinvested as a component of income tax expense in the period it changes its assertion.

Companies that assert that foreign earnings are indefinitely reinvested and don’t recognize deferred tax liabilities are required to disclose taxable temporary differences (i.e., outside basis differences when the book basis of an investment exceeds its tax basis) for the related foreign subsidiaries and foreign corporate joint ventures. They also are required to disclose the amount of the related unrecognized deferred tax liability if determining the amount is practicable. If such a determination is not practicable, a statement to that effect is required. Notably, there is no practicability exception for disclosing the temporary difference. Companies also should disclose the types of events or circumstances that would cause unrecognized deferred tax liabilities to be recorded (e.g., repatriation of foreign earnings).

Business combinations

Questions sometimes arise about whether the income tax effects of an intercompany transaction that occurs after a business combination but was contemplated at the time of the business combination should be included in the accounting for the business combination. An example might be the transfer of acquired intellectual property from an acquired entity to an existing consolidated subsidiary.

Post-combination intercompany transactions are typically entered into at the sole discretion of the acquirer, and the tax effects are accounted for outside of the business combination in accordance with the guidance on income taxes.

Companies should carefully consider the exception to recognition of income taxes on intercompany transactions. Under that exception, the income tax effects of the sale or transfer of assets among members of a consolidated group that remain in the consolidated group are eliminated from earnings.
Tax legislation and other initiatives

Tax extenders
Companies that are affected by any of the more than 50 income tax provisions known as “tax extenders,” which expired on 31 December 2013, will need to closely monitor developments in this area to determine whether they are reinstated. The provisions include the research and development (R&D) tax credit, the active financing exception for financial services businesses, a host of renewable energy incentives and bonus depreciation. In the current environment, however, tax legislation faces significant challenges, adding to the uncertainty about whether or when the provisions will be reinstated.

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Companies are required to recognize the income tax accounting effects of tax law changes in the period in which a new law is enacted. The reinstatement of an expired provision, even if retroactive, would require companies to wait until the date of enactment (i.e., the date the President signs any legislation into law) before factoring the effects of the law into their income tax provision. For example, if a law reinstating the extenders is enacted in January 2015 and the provisions are retroactively effective to 1 January 2014, a calendar year-end company would not be able to account for the effects of R&D credits until the period of enactment (i.e., the first quarter of 2015 in this example). Additionally, if an expired provision is reinstated in the fourth quarter of the calendar year, non-calendar year-end companies would factor the effects of the reinstatement into their estimated annual effective tax rate calculation.

Inversion transactions
The Internal Revenue Service (IRS) and the Treasury Department announced in September that they plan to issue regulations to modify the tax rules to limit the US tax benefits of transactions called inversions. In recent transactions, US companies have re-domiciled in foreign jurisdictions that have lower tax rates than the US federal tax rates in conjunction with merger transactions with foreign entities. Additionally, the IRS and Treasury Department have stated they are considering further guidance addressing shifting or stripping US-source earnings, including intercompany debt. The regulations generally are expected to apply to inversion transactions occurring on or after 22 September 2014.

Companies are required to evaluate uncertain tax positions using a two-step approach. Recognition (Step 1) occurs when a company concludes that a tax position, based solely on its technical merits, is more likely than not to be sustained upon examination. Measurement (Step 2) is only addressed if Step 1 has been satisfied. Under Step 2, the tax benefit is measured as the largest amount of benefit, determined on a cumulative probability basis, that is more likely than not to be realized upon ultimate settlement. Changes related to recognition and measurement of an uncertain tax position are expected to be supported by triggering events in the form of new information.

Companies that are considering or have completed an inversion or similar transaction should consider the IRS and Treasury Department’s notification that regulations are forthcoming as well as regulations that are expected to be issued and those that are ultimately issued when assessing the accounting for any affected transactions.
Debt and equity classification

Debt – current versus noncurrent

In a classified balance sheet, liabilities must be classified as current and noncurrent. Making this determination can be challenging for debt that is callable by the creditor or is convertible or when the company has violated (or is at risk of violating) debt covenants.

Current liabilities generally include those that are expected to be liquidated within one year or those that are due on demand or will be due on demand within one year. Certain short-term obligations that are expected to be refinanced on a long-term basis may not require the use of current assets and therefore may not require current liability classification. In contrast, current liabilities may include long-term obligations that become callable by the creditor (i.e., the creditor can require the debtor to repay the debt) within one year or upon contingent events such as the debtor's covenant violations or change of control events and those events have occurred by the balance sheet date.

Debt that is callable at the balance sheet date because of a covenant violation at that date should be classified as a current liability unless the creditor has waived or lost the right to demand repayment for more than one year (or operating cycle, if longer) from the balance sheet date. For long-term debt that contains a contractual grace period during which the debtor may cure a covenant violation, the debt should be classified as a current liability, unless it is probable that the violation will be cured during that period, thus preventing the debt from becoming callable.

The terms of a waiver obtained for a violated covenant should be carefully evaluated, considering the nature of the violation and the financial circumstances of the borrower.

In addition, debt that becomes callable after the balance sheet date but before the financial statements are issued (or before the financial statements are available to be issued for private companies) also requires careful consideration.

Certain convertible or contingently convertible debt instruments require the debtor to settle the accreted value in cash upon conversion. Because of this requirement, the debt should be classified as part of current liabilities when the debt (including contingently convertible debt if the contingency has been met) is currently convertible at the balance sheet date.

Equity

Companies raise capital by issuing debt and equity instruments, which can take many forms. Frequently, companies offer several debt and equity instruments in a single transaction, which may include additional elements, such as freestanding warrants or embedded conversion features, to meet investors' demands. The accounting for a freestanding equity-linked financial instrument or an embedded feature in a hybrid financial instrument should be reassessed at each balance sheet date. Events during the period may require a change to the classification (i.e., equity or asset/liability) or the conclusion on bifurcation. Any new accounting for the instrument or feature should be performed as of the date of the triggering event.

The accounting model for equity classification is generally based on the premise that freestanding equity-linked instruments or embedded features in hybrid financial instruments that could require net cash settlement are classified (or bifurcated) as assets or liabilities, while those that allow the issuer to settle in shares are classified as equity. Settlement in shares includes both net share settlement and gross physical settlement. The equity classification guidance provides several sometimes onerous criteria beyond those in the basic settlement
guidance that must be met for a contract to be classified in equity. If an instrument that initially met the equity classification criteria fails to meet one or more of the criteria after issuance because of new facts or circumstances, reclassification of the instrument (or bifurcation of an embedded feature) may be required as of the date the criteria are no longer met.

For example, due to the issuance of another equity-linked instrument, an issuer may no longer have sufficient authorized and unissued shares to cover its share-settlement obligation pursuant to a previously issued freestanding, equity-classified instrument. As such, the instrument may no longer be classified in equity. Conversely, a previously issued freestanding, liability-classified instrument may subsequently meet the criteria for equity classification (e.g., if the issuer increased its authorized shares to cover the share-settlement obligation) and, as such, the instrument should be reclassified to equity.

**Temporary equity**

The SEC staff requires certain redeemable equity instruments to be classified as temporary (or mezzanine) equity between liabilities and stockholders’ equity to distinguish these instruments from permanent equity. Companies must determine the appropriate classification of a redeemable equity instrument when it is issued and reevaluate the appropriateness of the classification at each subsequent balance sheet date.

This requirement applies to all redeemable equity securities, including common stock, preferred stock, noncontrolling interests, securities held by employee stock ownership plans, employee share-based payment arrangements and equity components of certain financial instruments (such as convertible debt).

Equity instruments for which redemption for cash or other assets could be required at the option of the holder or upon the occurrence of events that are not solely within the control of the issuer are required to be classified in temporary equity. If there is any possibility that a contingent event that would require redemption could occur, classification as temporary equity is required.

Over the life of an instrument, there may be changes in circumstances that require a change in its classification between temporary and permanent equity. Such a change in classification may also affect future earnings per share.

Companies should consider events that could require a change in an instrument’s classification including:

- Holders of preferred stock that is callable by the issuer gaining control of the issuer’s board of directors, thus obtaining the ability to force redemption of the preferred stock by voting for the exercise of the call feature, or losing control of the board and their ability to force redemption

- The expiration of a redemption option in an equity instrument

- The issuance of new stock, granting of stock options or issuance of convertible debt instruments that reduces the number of authorized but unissued shares available to satisfy a previously issued redeemable instrument that is to be share-settled, resulting in a presumption that settlement will be in cash

- A convertible debt instrument with an equity-classified component that is not redeemable or convertible at inception becoming redeemable or convertible by the holder as a result of the passage of time or the occurrence of a contingent event.
Leases

Leases or contracts that contain a lease may have unique terms and may require judgments that can affect the accounting. For example, to meet their changing strategic objectives and/or to minimize risks, companies may negotiate more complex contract terms such as variable payments (e.g., rent holidays, escalating lease payments) or lessor-provided incentives (e.g., tenant improvement allowances). Companies may enter into sale-leaseback transactions as an alternative source of financing. In addition, lessees seeking a new location may enter into pre-construction lease arrangements that could subject them to certain construction-period risks.

Operating leases

Minimum lease payments in operating leases are generally recognized as rent expense by lessees and rental income by lessors on a straight-line basis over the lease term. Lessees and lessors should review their lease contracts to identify all elements that are minimum lease payments and adjustments to the minimum lease payments (e.g., lessor incentives) to determine the appropriate lease expense (or income) to be recognized.

Asset construction

Lessees entering into leases of assets under construction should consider their activities and responsibilities related to the construction. Certain activities and responsibilities may cause the lessee to be deemed, for accounting purposes, the owner of the asset during the construction period. This deemed ownership would subject the lessee to reporting the asset on its balance sheet during the construction period and to sale-leaseback accounting post-construction.

Sale-leasebacks

Asset owners may sell an asset and lease the same asset back from the buyer (i.e., a sale-leaseback transaction) for a variety of reasons (e.g., to monetize an existing capital asset). In a sale-leaseback transaction, the amount of profit or loss (other than an indicated loss) recognized by the seller-lessee depends on the level of use that is retained through the leaseback. A seller-lessee should only recognize a profit or a loss (other than an indicated loss) on a sale-leaseback transaction when one of the following conditions exists:

- The leaseback is minor compared to the remaining use of the asset.
- The leaseback is more than minor but less than substantially all of the remaining use of the asset and the profit recognized is limited to that in excess of the present value of the minimum lease payments (operating lease) or the recorded amount of the leased asset (capital lease).

Additional considerations are required when the asset subject to the sale-leaseback is real estate.

Noncontrolling interests and equity method investments

A parent is required to allocate net income or loss and comprehensive income or loss to controlling and noncontrolling interests when it consolidates an entity it doesn't wholly own. Similarly, an equity method investor is required to record its share of the equity method investee's income or losses. The allocation of income and losses can be challenging when investors agree to share income and losses in proportions that differ from their ownership interests. Substantive profit-sharing agreements that lay out these terms are becoming more common. If a substantive profit-sharing agreement exists, the allocation is based on the terms of such agreement. Similarly, an equity method investor also records its proportionate share of income or losses based on any substantive profit-sharing agreement.
To be substantive, the economic outcome of a profit-sharing arrangement shouldn’t change over time, and subsequent events should not have the potential to retroactively affect or “unwind” prior attributions. When a substantive profit-sharing arrangement exists, the company should carefully analyze its terms. In some circumstances, an arrangement may attribute losses to the shareholders in a different manner than it attributes income, and therefore all elements and conditions should be evaluated.

We believe that it would be appropriate to disclose the terms and effects of any material substantive profit-sharing arrangement.

**Cash flow hedges**

Given current economic indicators and the Federal Reserve’s recent decision to end its monthly bond purchase program, many companies are concerned that their financing costs could rise along with US interest rates. In this type of environment, companies planning to issue new debt or refinance existing debt may decide to “lock in” current interest rates by entering into a forward-starting swap or a Treasury lock.

When using a cash flow hedge to hedge fixed or variable rate debt a company plans to issue in the future, the company must perform ongoing assessments to determine whether the hedge is highly effective and to record any ineffectiveness in current earnings. The shortcut method cannot be used because it only applies to hedges of recognized interest-bearing assets or liabilities.

At the inception of the hedge, the terms of the derivative will generally match the forecasted transaction; however, it is rare for these hedges to remain perfectly effective because companies usually cannot forecast the exact date that they will issue the new debt. As forecasts change, the company must quantify any ineffectiveness that results from differences between the terms of the derivative and the new forecasts and record that ineffectiveness in current earnings.

When the debt is issued and the derivative (e.g., the forward-starting swap) is terminated, companies may overlook the requirement to perform a final assessment of effectiveness and measurement of ineffectiveness. If the forecasted issuance date has not changed, the hedge will be perfectly effective. However, when the final issuance date is not the same as originally forecast, companies must perform a final analysis to determine whether the hedge was highly effective and record any ineffectiveness in current earnings. Only the changes in fair value of the derivative that correspond with the effective portion of the hedge should remain in other comprehensive income to be recycled as the hedged item affects earnings (i.e., when interest payments are accrued on the debt).

**Defined benefit plans**

The Society of Actuaries (SOA) has issued new mortality tables and a new improvement scale that reflect today’s longer life expectancies. Companies that use the SOA mortality tables (or use them as a starting point) for developing their assumptions may see an increase in their benefit obligation. Companies that do not use the SOA mortality tables should challenge their life expectancy assumptions and remember that they need credible evidence to support their assumptions. A sponsor of a defined benefit or other post-employment benefit plan will need to disclose any significant changes in benefit obligations in MD&A and disclose the general approach used to estimate mortality rates in the retirement benefits footnote.

Defined benefit plan sponsors are required to measure costs and obligations using their best estimate for the plan. Such estimates should consider all available information as of the measurement date. Selecting appropriate assumptions is critical to measuring the components of...
a benefit plan and can significantly affect a plan sponsor’s financial statements. The mortality rate is a key assumption used to value many retirement plans because it reflects the probability of future benefit payments that are contingent upon plan participants’ life expectancies.

The SOA mortality tables and improvement scale represent an important new point of reference that plan sponsors should consider when determining their best estimate of the mortality assumption for year-end financial reporting. Plan sponsors that use the SOA mortality tables (or use them as a starting point or basis for their assumptions) should determine which of the 11 new tables or combination of tables are appropriate for their plan. Plan sponsors may choose not to use the SOA mortality tables but should have sufficient data and mortality experience to support their estimate.

### Foreign currency matters

In early 2014, the Venezuelan government significantly expanded the use of its Supplementary Foreign Currency Administration System (SICAD 1) auction rate and created a third currency mechanism called SICAD 2 that it said could be used by all companies for all transactions. These mechanisms (SICAD 1 and 2) offer less favorable rates than the official government exchange rate of 6.3 bolivars per US dollar.

In November 2014, the Venezuelan government passed a new currency exchange law that acknowledged the existence of an alternative market for the purchase and sale of foreign currencies and gave the Venezuelan Central Bank (VCB) the option to legalize that market. Companies should monitor actions by the VCB to better understand the effects of the new law, if any, on their accounting.

Because multiple exchange rates are available in certain circumstances, companies have had to determine which exchange rate to use to remeasure their Venezuelan bolivar-denominated monetary assets and liabilities and related revenues and expenses.

The foreign currency accounting guidance requires each foreign currency transaction to be recorded in the functional currency of the reporting entity at the date it is recognized, using the exchange rate in effect at that date. The functional currency of a Venezuelan foreign subsidiary of a US dollar functional currency parent is the US dollar because Venezuela has a highly inflationary economy. Consequently, all bolivar-denominated assets, liabilities, revenues, expenses, gains and losses are considered foreign currency transactions of that Venezuelan foreign subsidiary. As a result, monetary assets and liabilities are remeasured at each balance sheet date using the rate at which the item could be settled at that date.

If more than one exchange mechanism is legally available, a company should generally base its decision on its intent to use a particular mechanism to settle the specified transaction and whether the rate available through that mechanism is published or readily determinable at the balance sheet date. The probability of transacting through a particular mechanism should also be considered (i.e., whether the volume and frequency of exchange activity through a particular mechanism will support the company’s currency needs). If exchangeability is lacking across all exchange mechanisms, a company should use the published rate for the legally available exchange mechanism that most faithfully reflects the economics of the company’s business activity.

Determining the appropriate exchange rate for financial reporting purposes depends on a company’s individual facts and circumstances. The assistance of legal counsel or Venezuelan regulatory authorities may be required to determine which exchange rates a company has access to.
Pharma fee

The IRS issued final regulations on 28 July 2014 that will affect how the annual branded prescription drug fee imposed by the Affordable Care Act is recognized. As a result, affected companies will have to accrue for the obligation to pay the annual branded prescription drug fee as each sale occurs, even though they won’t receive initial bills from the IRS or adjusted bills until subsequent periods.

The final regulations clarify that a company is a “covered entity” in the first year it has branded prescription drug sales to the specified US government programs and that a company doesn’t need to make a qualifying sale in the following year to owe the fee. The final regulations further clarify that a company incurs a liability for the fee as each sale occurs, regardless of when a bill or a final adjustment is presented. As a result, a company will incur an obligation and will recognize a related expense to pay the annual fee as each sale occurs.

As a result of this change, companies will have to adjust their annual fee liability to include fees payable for 2014 sales. A calendar year-end company that previously recorded a liability in the first quarter of 2014 for 2013 sales based on the accounting guidance should have recorded an additional liability and related expense as a cumulative catch-up adjustment in the period the final regulations were issued (i.e., the third quarter in 2014). Further, the remaining deferred cost should have been expensed in the period that includes the date the final regulations were issued.

We believe a company should accrue its best estimate of the fee, including adjustments, it expects to pay based on the current year’s sales, regardless of the timing of billing or adjustment. That's because while the billing of the fee is cumbersome, a company incurs the legal obligation to pay the fee, including any subsequent adjustment, in the year of sales to specified US government programs. For purposes of accounting for the fee, it’s irrelevant that the IRS sends initial bills the year after sales are incurred and makes final adjustments the following year (i.e., companies received bills for 2013 sales in 2014, and the IRS will make final adjustments in 2015).

Statement of cash flows

The statement of cash flows provides unique challenges to preparers of financial statements because the guidance in the Accounting Standards Codification (ASC) is contained in one high-level standard. This is in stark contrast to the guidance on balance sheet or income statement classification, which is generally discussed in detail in a related ASC topic. Moreover, the guidance on classifying cash flows in the statement of cash flows isn’t always clear, meaning companies must apply judgment in determining the appropriate classification of cash flows for many transactions.

To determine whether to classify cash flows as operating, investing or financing cash flows when the guidance is not explicit, a company must analyze the nature of the activity and the predominant source of the cash flows. Companies can't just pick a classification. They also should:

- Document their rationale for the classification they deem most appropriate
- Provide transparent disclosure of the classification either on the face of the statement of cash flows or in the notes to the financial statements
Disclosure of pending adoption of new accounting standards

Public companies are required to disclose certain information in registration statements and periodic reports filed with the SEC about the anticipated effects, if known, of new accounting standards that have been issued but not yet adopted (e.g., the new standards on revenue recognition and discontinued operations).

Registrants should consider the following disclosures within the financial statements:

- A brief description of the new standard and the date that adoption is required
- A discussion of the methods of adoption allowed by the standard and the method the registrant expects to use, if determined
- A discussion of the effect the standard is expected to have on the financial statements or, if the effect isn't known or reasonably estimable, a statement to that effect
- Disclosure of other significant matters that the registrant believes might result from adopting the standard (e.g., planned or intended changes in business practices)

For example, many companies may not know or be able to make a reasonable estimate of the effect the new revenue recognition standard will have on their financial statements and will make a statement to that effect. However, we note that the SEC staff expects a registrant’s disclosures to evolve in each reporting period up until adoption as more information about the effects of the new standard becomes available. Registrants should disclose their expected transition method once they select it.

Also, registrants that have not yet adopted the new discontinued operations guidance and have frequent disposal (or held for sale) transactions should consider disclosing whether they expect future disposals to qualify for presentation as discontinued operations under the new standard.

Fair value disclosures

The fair value hierarchy in US GAAP is intended to provide users with information about the nature of inputs used to determine the fair values of assets and liabilities. Companies are required to disclose the fair value hierarchy level of each asset or liability measured at fair value so that financial statement users can assess the relative subjectivity of the various measurements made by a company at a balance sheet date.

The hierarchy consists of the following three levels:

- Level 1: Quoted prices (unadjusted) in active markets for identical assets and liabilities that the reporting entity can access at the measurement date
- Level 2: Inputs other than quoted prices in active markets for identical assets and liabilities that are observable either directly or indirectly
- Level 3: Unobservable inputs

Classification of an asset or liability is based on the observability of the lowest level input that is significant to the fair value measurement in its entirety. Although the hierarchy disclosure is presented by class of asset or liability, it is important to understand that the determination of the hierarchy level in which a fair value measurement falls (and therefore the category in which it should be disclosed) is based on the fair value measurement for the specific item being measured. It is therefore driven by the unit of account for the asset or liability and the actual manner in which the fair value of the specific asset or liability is determined by the company.
as of the balance sheet date. Companies should reassess where they categorize assets and liabilities in the fair value hierarchy each reporting period based on the observability of inputs.

As a reminder, classification is based on the observability of inputs to the fair value measurement, not the perceived riskiness of the item being measured. For example, a company may hold listed equity securities and publicly traded debt of the same issuer. From a risk perspective, the uncertainty inherent in the cash flows would likely be higher for the equity security than the debt instrument. But the equity security would be categorized in Level 1 if its fair value is based on quoted prices in an active market. The debt security would likely be categorized in Level 2 (e.g., if the fair value is based on observable trades for similar instruments) or Level 3 (e.g., if the fair value is based solely on non-binding broker quotes).

Segment reporting

Segment reporting continues to be an important element of financial reporting for public companies. While the requirements of the segment reporting guidance have been effective for a number of years, segment disclosures continue to be challenging particularly as it relates to:

- Identifying operating segments
- Aggregating operating segments into reportable segments
- Providing appropriate entity-wide disclosures with respect to products and services, revenues attributable to individual foreign countries and revenues from major customers

Companies should reassess whether changes in segment reporting are warranted as a result of acquisitions, disposals, reorganizations or restructurings that change internal management reporting. In such instances, management should carefully evaluate its identification of operating and reportable segments and should contemporaneously document its assessment and any changes to segment reporting.

The segment reporting guidance is conceptually based on a “management approach.” That is, segment disclosures should be consistent with a company’s internal management reporting structure to enable investors to view the company as management does. By highlighting the risks and opportunities that management views as important, the idea is that financial statement users will be able to understand the company’s performance, to assess its prospects for future net cash flows and to make more informed judgments about the company as a whole.

Identifying a company’s operating segments is the first step in determining what segment information needs to be reported in the company’s financial statements. Once operating segments are identified, the guidance allows, but does not require, them to be aggregated for reporting purposes. Specific criteria must be met to aggregate operating segments. To be consistent with the objective and basic principles of the standard, any aggregation should help users make better-informed judgments about the company by improving their understanding of the company’s performance and assessment of the prospects for future net cash flows.

Additional entity-wide disclosures also are required in the annual financial statements even if the information is not used by the chief operating decision maker (CODM) to manage the company. Entity-wide disclosures are based on the financial information that is used in the consolidated financial statements, rather than the amounts reported to the CODM in the management reports.
Endnotes:

1 COSO has said that after 15 December 2014, it will consider its original 1992 framework to have been superseded by the 2013 framework. The staff of the SEC has indicated that the longer issuers continue to use the 1992 framework after 15 December 2014, the more likely they are to receive questions about whether their use of the 1992 framework satisfies the SEC’s requirement to use a suitable, recognized framework to assess internal control over financial reporting.

2 Data obtained from a review of restated financial information presented in a Form 10-K or Form 10-K/A for companies audited by one of the four largest accounting firms.

3 Undistributed foreign earnings often form a significant portion of a company’s outside basis difference related to an investment in another entity. An outside basis difference refers to the difference between the financial reporting basis and the tax basis of a company’s investment in another entity.

4 The new mortality tables (RP-2014) and the new mortality improvement scale (MP-2014) are available on the Society of Actuaries’ website.
Appendix – Effective date highlights

**Note:** Early adoption generally is permitted unless otherwise noted.

### Effective in 2014 for public\(^{(1)}\) calendar year-end entities\(^{(2)}\)

| ASU 2014-17 | Business Combinations (Topic 805), Pushdown Accounting | Effective immediately (18 November 2014). After the effective date, an acquired entity may elect to apply the guidance to future change-in-control events or to its most recent change-in-control event. |
| ASU 2014-06 | Technical Corrections and Improvements Related to Glossary Terms | Effective upon issuance (14 March 2014). |
| ASU 2013-12 | Definition of a Public Business Entity – An Addition to the Master Glossary | The term “public business entity” is being used to consider the scope of new guidance beginning in 2014. |
| ASU 2013-11 | Income Taxes (Topic 740), Presentation of an Unrecognized Tax Benefit When a Net Loss Operating Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists | Effective for fiscal years, and interim periods within those years, beginning after 15 December 2013. |
| ASU 2013-08 | Financial Services – Investment Companies (Topic 946), Amendments to the Scope, Measurement, and Disclosure Requirements | Effective for an entity's interim and annual reporting periods in fiscal years that begin after 15 December 2013. Earlier application is prohibited. |
| ASU 2013-07 | Presentation of Financial Statements (Topic 205), Liquidation Basis of Accounting | Effective for an entity that determines liquidation is imminent during annual reporting periods beginning after 15 December 2013, and interim reporting periods therein. |
| ASU 2013-05 | Foreign Currency Matters (Topic 830), Parent’s Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity | Effective for fiscal years, and interim periods within those years, beginning after 15 December 2013. |
| ASU 2013-04 | Liabilities (Topic 405), Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation is Fixed at the Reporting Date | Effective for fiscal years, and interim periods within those years, beginning after 15 December 2013. |
| ASU 2011-06 | Other Expenses (Topic 720), Fees Paid to the Federal Government by Health Insurers | Effective for calendar years beginning after 31 December 2013. |

### Effective after 2014 for public\(^{(1)}\) calendar year-end entities\(^{(2)}\)

| ASU 2014-16 | Derivatives and Hedging (Topic B15) – Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity | Effective for fiscal years, and interim periods within those fiscal years, beginning after 15 December 2015. |
| ASU 2014-15 | Presentation of Financial Statements – Going Concern (Subtopic 205-40), Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern | Effective for annual periods ending after 15 December 2016, and interim periods within annual periods beginning after 15 December 2016. |
| ASU 2014-12 | Compensation – Stock Compensation (Topic 718), Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period | Effective for annual periods and interim periods within those annual periods, beginning after 15 December 2015. |
| ASU 2014-11 | Transfers and Servicing (Topic 860), Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures | Effective for the first interim or annual period beginning after 15 December 2014. Disclosures for transactions accounted for as secured borrowings: Effective for annual periods beginning after 15 December 2014, and for interim periods beginning after 15 March 2015. |
| ASU 2014-09 | Revenue from Contracts with Customers (Topic 606) | Effective for annual reporting periods beginning after 15 December 2016, including interim reporting periods within that reporting period. |
| ASU 2014-08 | Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360), Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity | Effective for all disposals (or classifications as held for sale) of components of an entity, and all businesses or nonprofit activities that, on acquisition, are classified as held for sale, that occur within annual periods beginning on or after 15 December 2014, and interim periods within those years. |
| ASU 2014-05 | Service Concession Arrangements (Topic 853) | Effective for annual periods, and interim periods within those annual periods, beginning after 15 December 2014. |
| ASU 2014-04 | Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40), Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure | Effective for annual periods, and interim periods within those annual periods, beginning after 15 December 2014. |
| ASU 2014-01 | Investments – Equity Method and Joint Ventures (Topic 323), Accounting for Investments in Qualified Affordable Housing Projects | Effective for annual periods, and interim reporting periods within those annual periods, beginning after 15 December 2014. |
| ASU 2013-06 | Not-for-Profit Entities (Topic 956), Services Received from Personnel of an Affiliate | Effective for fiscal years beginning after 15 June 2014, and interim and annual periods thereafter. |

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1. Refer to each ASU to determine which types of entities (e.g., public business entities, not-for-profits, employee benefit plans) are subject to these effective dates.
2. The JOBS Act allows emerging growth companies to follow private company effective dates for new or revised accounting standards issued after 5 April 2012. However, an emerging growth company must follow public company effective dates for all such standards if it has disclosed an election to do so.
Effective in 2014 for nonpublic<sup>3</sup> calendar year-end entities

| ASU 2014-17 | Business Combinations (Topic 805), Pushdown Accounting | Effective immediately (18 November 2014). After the effective date, an acquired entity may elect to apply the guidance to future change-in-control events or to its most recent change-in-control event. |
| ASU 2014-06 | Technical Corrections and Improvements Related to Glossary Terms | Effective upon issuance (14 March 2014). |
| ASU 2013-12 | Definition of a Public Business Entity – An Addition to the Master Glossary | The term “public business entity” is being used to consider the scope of new guidance beginning in 2014. |
| ASU 2013-08 | Financial Services – Investment Companies (Topic 946), Amendments to the Scope, Measurement, and Disclosure Requirements | Effective for an entity’s interim and annual reporting periods in fiscal years that begin after 15 December 2013. Earlier application is prohibited. |
| ASU 2013-07 | Presentation of Financial Statements (Topic 205), Liquidation Basis of Accounting | Effective for an entity that determines liquidation is imminent during annual reporting periods beginning after 15 December 2013, and interim reporting periods therein. |
| ASU 2013-04 | Liabilities (Topic 405), Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation is Fixed at the Reporting Date | Effective for fiscal years ending after 15 December 2014, and interim and annual periods thereafter. |
| ASU 2013-02 | Comprehensive Income (Topic 220), Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income | Effective for fiscal years beginning after 15 December 2013, and interim and annual periods thereafter. |
| ASU 2012-04 | Technical Corrections and Improvements | Effective upon issuance (1 October 2012) for amendments that do not have transition guidance. Amendments that are subject to transition guidance: effective for fiscal periods beginning after 15 December 2013. |
| ASU 2012-01 | Health Care Entities (Topic 954), Continuing Care Retirement Communities – Refundable Advance Fees | Effective for fiscal periods beginning after 15 December 2013. |
| ASU 2011-06 | Other Expenses (Topic 720), Fees Paid to the Federal Government by Health Insurers | Effective for calendar years beginning after 31 December 2013. |

Effective after 2014 for nonpublic<sup>3</sup> calendar year-end entities

| ASU 2014-16 | Derivatives and Hedging (Topic 815) – Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity | Effective for fiscal years beginning after 15 December 2015, and interim periods within fiscal years beginning after 15 December 2016. |
| ASU 2014-15 | Presentation of Financial Statements – Going Concern (Subtopic 205-40), Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern | Effective for annual periods ending after 15 December 2016, and interim periods within annual periods beginning after 15 December 2016. |
| ASU 2014-12 | Compensation – Stock Compensation (Topic 718), Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period | Effective for annual periods and interim periods within those annual periods, beginning after 15 December 2015. |
| ASU 2014-11 | Transfers and Servicing (Topic 860), Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures | Effective for annual periods beginning after 15 December 2014, and interim periods beginning after 15 December 2015. |
| ASU 2014-09 | Revenue from Contracts with Customers (Topic 606) | Effective for annual reporting periods beginning after 15 December 2017, and interim reporting periods within annual reporting periods beginning after 15 December 2018. |
| ASU 2014-08 | Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360), Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity | Effective for all disposals (or classifications as held for sale) of components of an entity and all businesses or nonprofit activities that, on acquisition, are classified as held for sale that occur within annual periods beginning on or after 15 December 2014, and interim periods within annual periods beginning on or after 15 December 2015. |
| ASU 2014-02 | Intangibles – Goodwill and Other (Topic 350), Accounting for Goodwill | Effective for goodwill existing as of the beginning of the period of adoption and new goodwill recognized in annual periods beginning on or after 15 December 2014, and interim periods within annual periods beginning after 15 December 2015. |
| ASU 2014-01 | Investments – Equity Method and Joint Ventures (Topic 323), Accounting for Investments in Qualified Affordable Housing Projects | Effective for annual periods beginning after 15 December 2014, and interim periods within annual periods beginning after 15 December 2015. |
| ASU 2013-11 | Income Taxes (Topic 740), Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists | Effective for fiscal years, and interim periods within those years, beginning after 15 December 2014. |
| ASU 2013-06 | Not-for-Profit Entities (Topic 958), Services Received from Personnel of an Affiliate | Effective for fiscal years beginning after 15 June 2014, and interim and annual periods thereafter. |
| ASU 2013-05 | Foreign Currency Matters (Topic 830), Parent’s Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity | Effective for fiscal years beginning after 15 December 2014, and interim and annual periods thereafter. |

<sup>3</sup> Refer to each ASU to determine which types of entities (e.g., private companies, not-for-profits, employee benefit plans) are subject to these effective dates.