

Chapter 5 — Other Accounting and Financial Reporting Topics

5.1 Acquisitions and Divestitures

The technology industry has undergone significant changes throughout the years, and technology entities must continually innovate to stay competitive. Specifically, technology entities must find new ways to improve the effectiveness and efficiency of their operations, increase their R&D capabilities, access new markets and data, expand their pipeline of products in development, increase their talent pool, and tap into alternative sources of innovation. As a result of these challenges and opportunities, technology entities frequently engage in M&A activity. In addition, technology entities may divest some of their noncore assets to focus on their main business lines and access the capital they need to remain competitive.

It is important for entities to correctly apply the guidance on accounting for M&A transactions because of the significantly different accounting outcomes that exist in this area of financial reporting. For example, the application of the guidance in ASC 805 on accounting for business combinations can differ significantly depending on whether the acquired entity is considered a “business” or an “asset.” Similarly, application of the guidance in ASC 205 on the presentation and disclosure of discontinued operations related to divestiture transactions fundamentally affects financial statement presentation.

5.1.1 Definition of a Business

An entity must use significant judgment in (1) evaluating whether a transaction represents the acquisition of a “business” as defined in ASC 805-10 and (2) accounting for transactions after that determination has been made. Entities apply the definition of a business in ASC 805 in many areas of accounting, including acquisitions, disposals, reporting-unit determinations, and consolidation.

The distinction between businesses and assets is important because the accounting for a business combination significantly differs from the accounting for an asset acquisition. For example, an entity may acquire a mature technology entity that has substantive processes, employees, and revenue-generating products. If the acquiree meets the definition of a business, the acquirer may end up recognizing substantial goodwill. On the other hand, an entity may acquire IP that represents the sole asset purchased and does not meet the definition of a business. In that circumstance, the acquirer would not recognize any goodwill. For more information, see [Section 2.4](#) of Deloitte’s Roadmap *Business Combinations*.

5.1.2 Asset Acquisitions

In applying the framework in ASC 805, entities must account for transactions that do not meet the definition of a business as asset acquisitions. For such transactions, the accounting requirements related to transaction costs, measurement of assets acquired and liabilities assumed, and recognition of intangible assets may differ from those for business combinations.

The table below summarizes some of the key differences between the accounting for a business combination and the accounting for an acquisition of an asset group determined not to be a business.

Issue	Accounting in a Business Combination	Accounting in an Asset Acquisition
General principle	Fair value model: assets and liabilities are recognized at fair value, with certain exceptions.	Cost accumulation model: the cost of the acquisition, including certain transaction costs, is allocated to the assets acquired on the basis of relative fair values, with some exceptions. This allocation results in the recognition of those assets at other than their fair values.
Scope	Acquisition of a business as defined in ASC 805-10.	Acquisition of an asset or a group of assets (and liabilities) that does not meet the definition of a business in ASC 805-10 or qualify as a VIE under ASC 810-10.
Acquisition-related costs or transaction costs	Acquisition-related costs are expensed as incurred, except for costs of issuing debt and equity securities, which are accounted for under other GAAP.	Direct and incremental costs are included in the cost of the acquisition, except for costs of issuing debt and equity securities, which are accounted for under other GAAP. Indirect costs are expensed as incurred.
Contingent consideration	Recognized at fair value and classified as a liability, equity, or an asset on the acquisition date on the basis of the terms of the arrangement. Subsequently, any changes in the fair value of contingent consideration classified as a liability or as an asset are recognized in earnings until settled.	Contingent consideration that is accounted for as a derivative is recognized at fair value under ASC 815. Otherwise, such consideration generally is recognized under ASC 450 when it becomes probable and reasonably estimable or when the contingency is resolved by analogy to FASB Statement 141.
Goodwill	If the sum of the consideration transferred, the fair value of any noncontrolling interests, and the fair value of any previously held interests exceeds the sum of the identifiable assets acquired and liabilities assumed, goodwill is recognized as the amount of the excess.	Goodwill is not recognized. Instead, any excess of the cost of the acquisition over the fair value of the net assets acquired is allocated to certain assets on the basis of relative fair values.
Gain from bargain purchase	Recognized in earnings on the acquisition date.	Generally not recognized in earnings. Instead, any excess of the fair value of the net assets acquired over the cost of the acquisition is typically allocated to certain assets on the basis of relative fair values.
Contingencies	Measured at fair value, if determinable; otherwise, measured at their estimated amounts if probable and reasonably estimable. If such assets or liabilities cannot be measured during the measurement period, they are accounted for separately from the business combination in accordance with ASC 450.	Accounted for in accordance with ASC 450 on the acquisition date and subsequently. Loss contingencies are recognized when they are probable and reasonably estimable. Gain contingencies are recognized on the earlier of when they are realized or are realizable and are thus not recognizable in an asset acquisition.

(Table continued)

Issue	Accounting in a Business Combination	Accounting in an Asset Acquisition
Intangible assets	Recognized at fair value if they are identifiable (i.e., if they are separable or arise from contractual rights).	Finite-lived intangible assets recognized on the basis of relative fair value under ASC 350-10 if they meet the asset recognition criteria in FASB Concepts Statement 5 . Indefinite-lived intangible assets are recognized at amounts that do not exceed fair value.
Assembled workforce	Not recognized because it is presumed not to be identifiable.	Recognized because it is presumed to meet the asset recognition criteria in FASB Concepts Statement 5.
In-process research and development (IPR&D)	Measured at fair value and recognized as an indefinite-lived intangible asset until completion or abandonment of the related project, then reclassified as a finite-lived intangible asset and amortized.	Expensed under ASC 730 unless the IPR&D has an alternative future use.
Deferred taxes	Generally recognized for most temporary book/tax differences related to assets acquired and liabilities assumed under ASC 740.	Generally recognized for temporary book/tax differences in an asset acquisition by using the simultaneous equations method in accordance with ASC 740.
Lease classification	Under ASC 840-10-25-27, the acquirer retains the acquiree's previous lease classification "unless the provisions of the lease are modified as indicated in paragraph 840-10-35-5." Under ASC 842-10-55-11, the acquirer retains the acquiree's previous lease classification "unless there is a lease modification and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8."	ASC 805-50 does not provide guidance on an entity's classification of a lease acquired in an asset acquisition.
Measurement period	In accordance with ASC 805-10-25-13, the acquirer reports provisional amounts for the items for which the accounting "is incomplete by the end of the reporting period in which the combination occurs" and is allowed up to one year to adjust those provisional amounts. This time frame is referred to as the measurement period.	ASC 805-50 does not address a measurement period in the context of an asset acquisition.

For more information, see [Appendix C](#) of Deloitte's Roadmap *Business Combinations*.

5.1.3 Business Combinations

5.1.3.1 *Acquired Revenue Contracts*

In October 2021, the FASB issued [ASU 2021-08](#), which requires entities to recognize and measure contract assets and contract liabilities from contracts acquired in a business combination that are within the scope of ASC 606 or ASC 610-20 by applying the guidance in ASC 606. The ASU also provides for practical expedients that allow entities to account for the aggregate effect of all modifications, and determine stand-alone selling prices, as of the acquisition date. However, the ASU does not change the accounting for customer-related intangibles, such as customer relationships, which entities are required to measure at fair value. The ASU's stated purpose is "to improve the accounting for acquired revenue contracts with customers in a business combination by addressing diversity in practice and inconsistency related to the following:

1. Recognition of an acquired contract liability
2. Payment terms and their effect on subsequent revenue recognized by the acquirer."

5.1.3.2 *Acquired Technology and IPR&D*

Technology entities often contemplate opportunities for expanding their current portfolio of products by making strategic acquisitions. As a result, an entity may acquire substantively complete technology-based IP in a business combination (i.e., technology-based intangible assets that are not IPR&D). If those assets represent identifiable intangible assets (i.e., they arise from contractual or other legal rights or are separable), they would generally be recognized at their fair value.

Entities may also acquire technology-based IP that is still being developed. The accounting for costs associated with the purchase of such IP currently in development as part of a business combination may vary significantly from the typical accounting treatment of R&D costs incurred by technology entities as part of their normal operations.

For example, before being acquired in a business combination, an entity may incur R&D expenditures related to the entity's continued development of software to be sold on an on-premise basis that would be expensed as incurred in accordance with ASC 985-20 and ASC 730-10. That is, before consummation of the business combination, the acquiree would not have recorded any asset related to R&D costs incurred before technological feasibility was established. To the extent that the acquiree was using or planning to use the unrecognized asset for R&D activities to further the development of the software, the asset would represent acquired IPR&D to the acquirer.

If, instead, the acquiree incurred development costs for software that will solely be sold on a cloud basis, such development costs would be subject to the requirements of ASC 350-40, and some of those costs may have been capitalized before the business combination. In that circumstance, the capitalized development costs would not be R&D expenses and would not represent IPR&D acquired in a business combination. Rather, the acquirer would generally recognize the internal-use software, as acquired during the business combination, at its fair value if it represents an identifiable intangible asset. For more information, see [Section 4.10](#) of Deloitte's Roadmap [Business Combinations](#).

5.1.3.3 *Reacquired Rights*

Technology entities frequently acquire businesses in a vertical merger. As part of a business combination, an acquirer may reacquire a right that it had previously granted to the acquiree under a contractual arrangement. For example, the acquiree may have been granted a right to use the acquirer's technology under an exclusive IP licensing arrangement before the business combination. That reacquired right would be considered an identifiable intangible asset but would be measured on the basis of the related contract's remaining term regardless of whether a fair value measurement would reflect potential contract renewals. In addition, if the terms of the preexisting contractual relationship giving rise to a reacquired right are favorable or unfavorable relative to the terms of current market transactions for the same or similar items, the acquirer must recognize a settlement gain or loss separately from the accounting for the business combination. For more information, see [Sections 4.3.7 and 6.2.2.6](#) of Deloitte's Roadmap *Business Combinations*.

5.1.3.4 *Compensation Arrangements*

Technology entities frequently acquire businesses in which significant value is attributed to the workforce. Therefore, it is important for an acquirer to evaluate the acquiree's preexisting compensation arrangements and any new or modified compensation arrangements to determine the appropriate accounting. For example, the acquiree may have arrangements in place to provide specified employees with additional compensation (e.g., stock-based compensation) or accelerated compensation (i.e., acceleration of vesting) that is predicated on a change in control. The ultimate accounting conclusion could vary depending on whether such arrangements were established before or after the negotiations for the business combination began. In addition, the acquirer may agree to provide contingent payments to selling shareholders who are also employees. Further, selling shareholders may decide to share some of the proceeds that they are entitled to receive with nonshareholder employees. When determining whether the acquirer should account for these arrangements as part of the business combination or separately as compensation, entities must frequently use judgment and consider the specific facts and circumstances. For more information, see [Sections 6.2.3 and 6.2.5](#) of Deloitte's Roadmap *Business Combinations*.

Stock-based compensation awards held by grantees of the acquiree are often exchanged for stock-based compensation awards of the acquirer. In this circumstance, the acquirer must analyze the terms of both the preexisting and the replacement awards to determine what portion of the replacement awards is related to precombination vesting (i.e., past goods or services) and therefore part of the consideration transferred in the business combination. The portion of replacement awards that is related to postcombination vesting (i.e., future goods or services) should be recognized as compensation cost in the postcombination period. For more information on this topic and other stock-based compensation arrangements associated with business combinations, see [Chapter 10](#) of Deloitte's Roadmap *Share-Based Payment Awards*.

5.1.3.5 *SEC Reporting Requirements*

A technology entity that is an SEC registrant must also consider certain SEC reporting requirements when it acquires a business, an asset, or a group of assets. For instance, the registrant must separately evaluate whether the acquired business or assets meet the definition of a business for SEC reporting purposes under SEC Regulation S-X, Rule 11-01(d), since this definition differs from the U.S. GAAP definition of a business under ASC 805-10. For more information about the SEC's reporting requirements, see [Section C.5](#) of Deloitte's Roadmap *Business Combinations* and Deloitte's Roadmap *SEC Reporting Considerations for Business Acquisitions*.

5.1.4 Divestitures

Technology entities frequently divest businesses and product lines to focus on their core or more profitable businesses. The determination of whether a group of assets represents a business is important not only in acquisitions but also in divestitures. Generally, ASC 810 addresses the deconsolidation and derecognition of divestitures of subsidiaries or groups of assets that meet the definition of a business. ASC 810 also applies to divestitures of subsidiaries that do not meet the definition of a business unless such divestitures are specifically addressed by other U.S. GAAP, such as ASC 606 (revenue transactions) and ASC 610-20 (derecognition of nonfinancial assets and in-substance nonfinancial assets). For more information, including SEC reporting requirements, see [Appendix F](#) of Deloitte's Roadmap *Consolidation — Identifying a Controlling Financial Interest*. For considerations related to revenue transactions and the derecognition of nonfinancial assets, see Deloitte's Roadmap *Revenue Recognition*.

5.1.4.1 Disposals of Long-Lived Assets and Discontinued Operations

Additional considerations are required when long-lived assets (e.g., IP) are classified as held for sale or may be disposed of in ways other than by sale (e.g., abandonment). In addition, discontinued operations are reported separately from continuing operations. To be reported as a discontinued operation, the disposal must be “a strategic shift that has (or will have) a major effect on an entity's operations and financial results”¹ (e.g., major geographic area, major line of business). Therefore, the determination of whether a disposal qualifies for discontinued-operations reporting requires (1) an assessment of both qualitative and quantitative factors and (2) the use of judgment. For more information, including SEC reporting requirements, see Deloitte's Roadmap *Impairments and Disposals of Long-Lived Assets and Discontinued Operations*.

5.1.4.2 Carve-Out Financial Statements

Carve-out financial statements are commonly prepared for divestitures of businesses and product lines. A carve-out occurs when a parent entity segregates a portion of its operations and prepares a distinct set of financial information in anticipation of a sale, spin-off, or divestiture of the “carve-out entity.” The carve-out entity may consist of all or part of an individual subsidiary, multiple subsidiaries (or portions of such subsidiaries), an individual segment, multiple segments, or a specific group of products.

The form and content of carve-out financial statements may vary depending on the situation. For example, if the acquisition is small, a strategic buyer of a carve-out entity may be satisfied with an unaudited balance sheet and income statement for the most recent fiscal year. Another public buyer, however, may require a full set of SEC-compliant audited financial statements, including footnotes. Further, another buyer may require that the periods be audited but may not be concerned with SEC reporting considerations. The existence of a foreign buyer could present different requirements and challenges in addition to those noted above, such as working closely with the foreign buyer on IFRS conversion of certain financial statement line items.

For more information, see Deloitte's Roadmap *Carve-Out Financial Statements*.

¹ Quoted from ASC 205-20-45-1B.

5.1.5 Common-Control Transactions

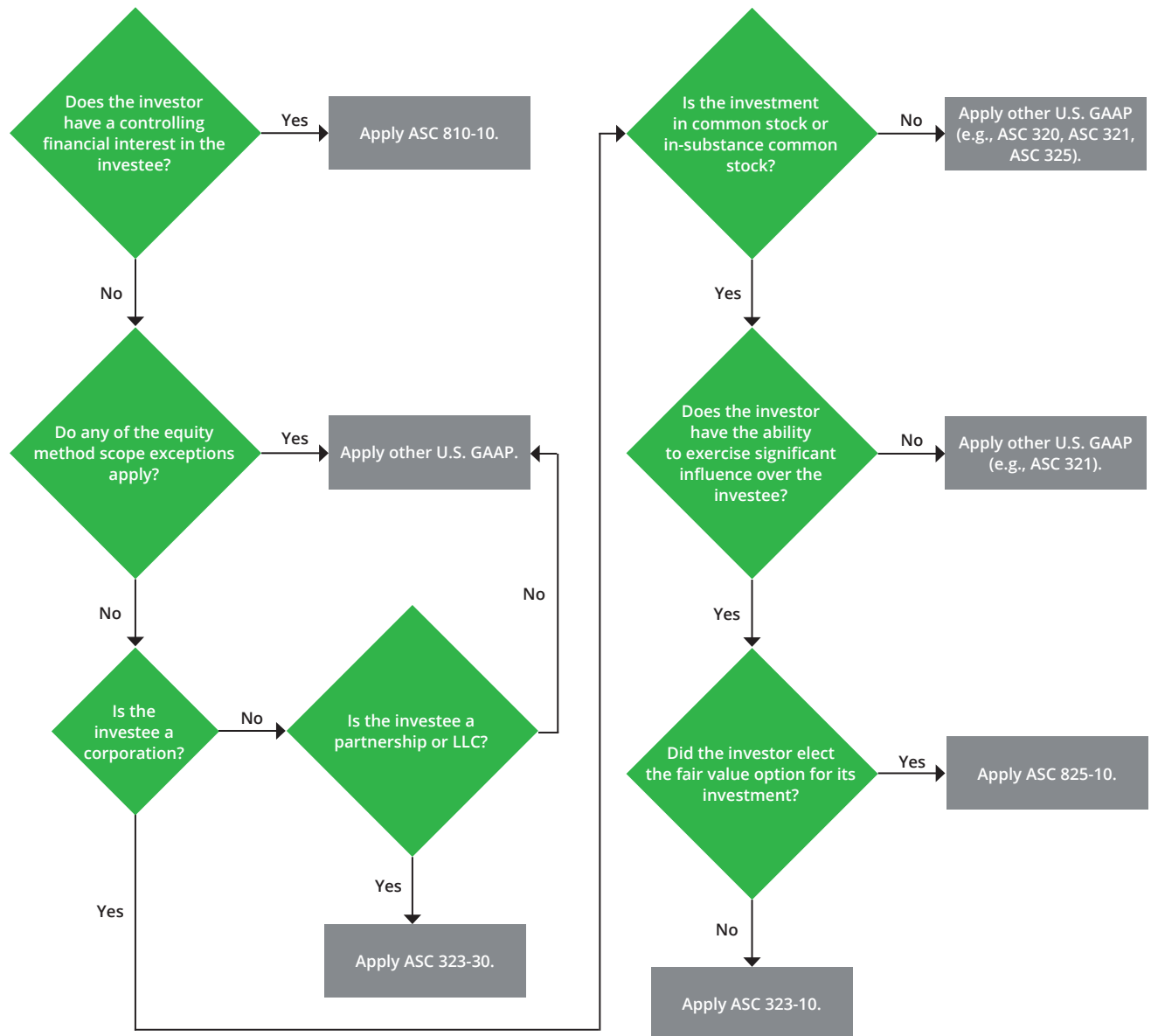
As technology entities seek to rebalance their portfolios and potentially prepare for public offerings, they may engage in common-control transactions. A common-control transaction is typically a transfer of net assets or an exchange of equity interests between entities under the control of the same parent. While a common-control transaction is similar to a business combination for the entity that receives the net assets or equity interests, such a transaction does not meet the definition of a business combination because there is no change in control over the net assets. Therefore, the accounting and reporting for a transaction between entities under common control is outside the scope of the business combinations guidance in ASC 805-10, ASC 805-20, ASC 805-30, and ASC 805-40 and is instead addressed in ASC 805-50. Since there is no change in control over the net assets from the parent's perspective, there is no change in basis in the net assets. ASC 805-50 requires the receiving entity to recognize the net assets received at their historical carrying amounts, as reflected in the ultimate parent's financial statements.

For more information, see [Appendix B](#) of Deloitte's Roadmap *Business Combinations*.

5.1.6 Equity Method Investments and Joint Ventures

5.1.6.1 Equity Method Investments

Technology entities frequently enter into strategic partner or alliance arrangements with other entities. In many of those circumstances, the technology entity becomes an investor by purchasing an interest in the other entity. That interest should be carefully evaluated to determine whether the investor should apply ASC 810, ASC 323, or other U.S. GAAP (e.g., ASC 321). The flowchart below illustrates the relevant questions to be considered in the determination of whether an investment should be accounted for under the equity method of accounting or other U.S. GAAP.



There are presumed levels of ownership (depending on the legal form of the investee) that generally provide an investor with the ability to exercise significant influence over the investee. For example, an investment of less than 20 percent leads to a presumption that, in the absence of evidence to the contrary, an investor does not have the ability to exercise significant influence over a corporate investee.

However, the determination of whether the investor has the ability to exercise significant influence over the investee's reporting and financial policies should not be limited to the evaluation of voting rights (which can be conferred by instruments other than common stock) given that significant influence may be exhibited through other means. For example, an investor may provide technology to an investee that is critical to the investee's operational ability. Such a situation may cause the investee to be technologically dependent on the investor and, as a result, allow the investor to exert some level of influence over the investee. When determining the level of influence it can exercise, the investor should consider the terms of the licensed technology. For example, the technology granted to the investee for a period that would give the investor an option not to renew such a license would be more indicative of significant influence than if the investee had already obtained a perpetual license to such technology. When evaluating whether the investee's technological dependency provides the investor with significant influence, the investor should also consider the technology alternatives available to the investee and the costs that the investee might reasonably be expected to incur were it to license alternative technology. For example, if the investee could license similar technology from other companies without incurring significant costs, such a licensing agreement would usually not provide the investor with the ability to exercise significant influence over the operating and financial policies of the investee.

5.1.6.2 *Joint Ventures*

Technology entities may also enter into a joint venture with other entities in which the venturers have joint control (e.g., to jointly develop and commercialize IP). Generally, a venturer accounts for its investment in a joint venture the same way it would account for any other equity method investment. However, it is necessary to assess whether a legal entity is in fact a joint venture because this determination may affect the financial statements of the joint venture upon the venture's initial formation and thereafter.



Changing Lanes

In August 2023, the FASB issued [ASU 2023-05](#) to address the accounting by a joint venture for the initial contribution of nonmonetary and monetary assets to the venture. Adoption of the ASU is required for joint ventures with a formation date on or after January 1, 2025, with early adoption permitted. The FASB issued the ASU because of the absence of guidance on the recognition and measurement of the contribution of nonmonetary and monetary assets in a joint venture's stand-alone financial statements. While the ASU does not change the definition of a joint venture, a new basis of accounting is established upon the venture's formation. The ASU requires a joint venture, upon formation, to (1) recognize and measure the initial contributions of monetary and nonmonetary assets by the venturers at fair value and (2) measure its net assets (including goodwill) at fair value by using the fair value of the joint venture as a whole. Therefore, upon adoption of ASU 2023-05, a joint venture will measure its total net assets upon formation as the fair value of 100 percent of the joint venture's equity immediately after formation. For more information about the ASU, see Deloitte's Roadmap [Equity Method Investments and Joint Ventures](#).

5.1.6.3 SEC Reporting Requirements

A technology entity that is an SEC registrant must also consider certain SEC reporting requirements for equity method investments. If an equity method investee is considered significant to a registrant, the registrant may be required to provide the investee's separate financial statements or summarized financial information in the financial statement footnotes (or both). The amount of information a registrant must present depends on the level of significance, which is determined on the basis of the results of various tests outlined in SEC Regulation S-X.

For more information, see Deloitte's Roadmaps [Equity Method Investments and Joint Ventures](#) and [SEC Reporting Considerations for Equity Method Investees](#).

5.1.7 SEC Comment Letter Trends

The SEC staff's comments about business combinations frequently focus on (1) the evaluation of whether a transaction should be accounted for as a business combination or an asset acquisition, (2) the identification of the accounting acquirer, (3) the allocation of the consideration transferred to identified assets acquired and liabilities assumed, (4) accounting for any contingent consideration, and (5) required disclosures.

For divestitures, the SEC staff frequently issues comments on whether certain dispositions should be presented as discontinued operations and whether all of the required disclosures under ASC 205 have been provided for dispositions presented as discontinued operations. The SEC staff may also question whether assets meet the held-for-sale criteria in ASC 360 and may inquire about items such as (1) the timeline of events leading to the sale; (2) consideration of the factors used to determine whether assets qualify for classification as held for sale, especially when assets have been classified as held for sale for an extended period or when assets are not classified as held for sale at the end of a reporting period but are sold shortly thereafter; (3) the timing of impairment testing when assets are expected to be sold or disposed of; and (4) consideration of the required disclosures for assets held for sale. In addition, for carve-out financial statements, the SEC staff may ask whether the financial statements have been appropriately prepared in accordance with [SAB Topic 1.B](#), which indicates that the registrant's historical income statements should present all of the costs of doing business, including expenses incurred by the parent on behalf of the registrant.

For goodwill, the SEC staff frequently issues comments related to (1) disclosures in MD&A, including the critical accounting estimates section and any known uncertainties related to the potential for a material impairment charge; (2) identification of reporting units, especially when changes appear to have been made to an entity's reporting structure; and (3) interim impairment tests, including (a) whether negative trends could trigger the requirement to test goodwill for impairment between annual tests, (b) the events leading up to any impairment charge, and (c) whether an impairment should have been identified in a prior period.

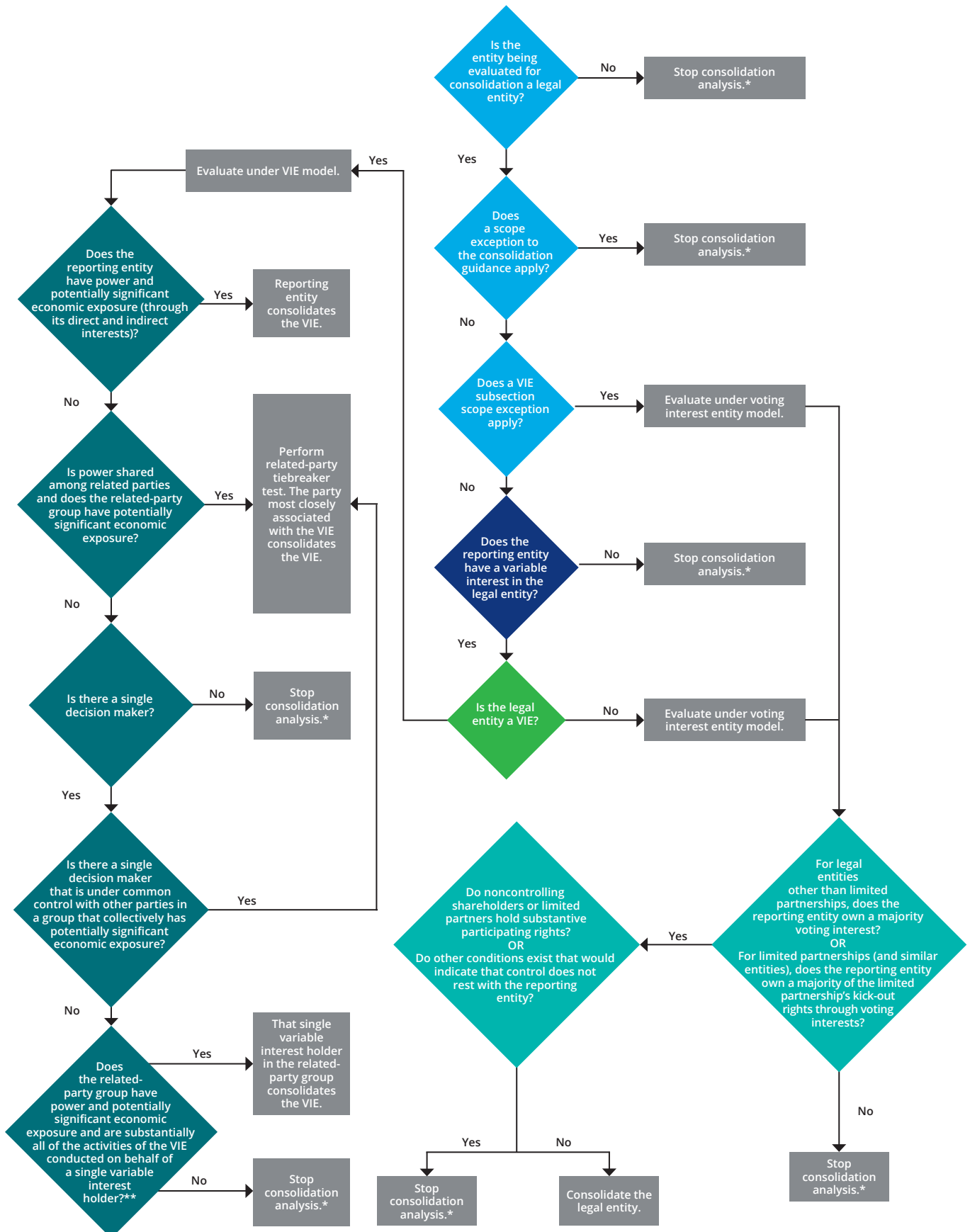
For more information, see [Sections 2.1, 2.5, 2.11.1, and 4.2.4](#) of Deloitte's Roadmap [SEC Comment Letter Considerations, Including Industry Insights](#).

5.2 Consolidation

Technology entities enter into a variety of arrangements with other parties to facilitate the research, development, or sale of their IP or products. Because technology entities may absorb the risks and rewards of other parties through interests other than those based on traditional voting equity, they must carefully analyze their arrangements with those parties to determine whether to consolidate them. However, it is important to note that the consolidation guidance is only applicable to arrangements that are structured in a separate legal entity and is not applicable to collaborative arrangements because those arrangements are not primarily conducted through a separate legal entity. The dual consolidation model under U.S. GAAP, which comprises the variable interest entity (VIE) model and the voting interest entity model, is designed to ensure that the reporting entity that consolidates another legal entity has a controlling financial interest in that legal entity. Under the voting interest entity model, a reporting entity with ownership of a majority of the voting interests of a legal entity is generally considered to have a controlling financial interest in the legal entity. Under the VIE model, the evaluation of whether the reporting entity has a controlling financial interest in a VIE focuses on (1) the obligation to absorb losses of, or the right to receive benefits from, the legal entity that could potentially be significant to the legal entity and (2) the power to direct the activities that most significantly affect the legal entity's economic performance.

5.2.1 Consolidation Decision Trees

ASC 810-10-05-6 contains a flowchart that consists of a series of decision trees to help reporting entities identify (1) which consolidation model to apply, if any; (2) whether a reporting entity should consolidate a VIE; and (3) whether a reporting entity should consolidate a voting interest entity. The flowchart below incorporates the concepts in the FASB's flowchart and serves as a guide to the consolidation accounting literature.



* Consolidation is not required; however, other GAAP may be relevant to the determination of recognition, measurement, or disclosure.

** Interests in low-income housing tax partnerships within the scope of ASU 2014-01 would not be subject to this requirement.

5.2.2 Voting Interest Entity Model Versus VIE Model

The table below summarizes the most significant differences between the voting interest entity model and the VIE model.

Concept	Voting Interest Entity Model	VIE Model	Explanation
Definition of a controlling financial interest	The usual condition for consolidation is ownership of a majority voting interest or majority of the limited partnership's kick-out rights.	A reporting entity has a controlling financial interest if it has both of the following characteristics: (1) the power to direct the activities of the entity that most significantly affect the entity's economic performance and (2) the obligation to absorb losses of — or the right to receive benefits from — the entity that could potentially be significant to the entity.	Under either model, control may not rest with the majority owner if certain conditions exist. Under the VIE model (unlike the voting interest entity model), a broader list of activities is typically considered in the determination of which party, if any, should consolidate.
Definition of participating rights	Rights that allow the limited partners or noncontrolling shareholders to block or participate in certain significant financial and operating decisions that are made in the ordinary course of business. A majority voting interest holder is precluded from consolidating if a participating right that is held by a noncontrolling shareholder is related to any significant financial and operating decision that occurs as a part of the ordinary course of the investee's business.	Rights that provide the ability to block or participate in the actions through which an entity exercises the power to direct the activities of a VIE that most significantly affect the VIE's economic performance. Participating rights only preclude another party from controlling and consolidating if they are held by a single reporting entity and unilaterally exercisable relative to all of the activities that most significantly affect the economic performance of the VIE.	While the definition of participating rights differs under the two models (i.e., under the VIE model, it encompasses a broader set of activities), the most significant difference is that the voting interest entity model precludes consolidation if a noncontrolling interest holder has a substantive participating right over certain significant financial and operating decisions. The VIE model precludes consolidation only if another party has substantive participating rights over all activities that most significantly affect the economic performance of the VIE.

(Table continued)

Concept	Voting Interest Entity Model	VIE Model	Explanation
Impact of related parties	Related parties and de facto agents are not considered.	Related parties, including de facto agents, must be considered. The identification of related parties can have a significant impact on the consolidation analysis, including potentially requiring one of the related parties to consolidate even though the reporting entity, on its own, does not have a controlling financial interest.	Related-party and de facto agency relationships may have an impact on the consolidation conclusion under the VIE model, whereas they have no impact under the voting interest entity model.
Disclosures	The required disclosures for consolidated subsidiaries are limited, including those about such subsidiaries that are not wholly owned.	In addition to the general disclosures required for consolidated voting interest entities, specific VIE disclosures about consolidated and unconsolidated VIEs must be provided.	Consolidating (or having a variable interest in) a VIE results in additional disclosure requirements.

5.2.3 VIE Consolidation Issues

Technology entities may encounter the issues discussed below when determining whether a legal entity is a VIE and should be consolidated.

5.2.3.1 Scope Exceptions

Determining whether a legal entity is subject to the VIE model includes an evaluation of whether any of the scope exceptions in ASC 810 apply. For technology entities, the scope exception for businesses may be the most relevant.

In accordance with ASC 810-10-15-17(d), a legal entity would qualify for the business scope exception to the VIE model if (1) it is a business and (2) none of the following conditions exist:

- The reporting entity, the reporting entity's related parties, or both were significantly involved in the legal entity's design or redesign — unless “the legal entity is an operating joint venture under joint control of the reporting entity and one or more independent parties or a franchisee” (e.g., a technology entity may be an investor in a joint venture that (1) constitutes a business and (2) is formed to develop a new product or technology).
- “The legal entity is designed so that substantially all of its activities either involve or are conducted on behalf of the reporting entity and its related parties.” For example, a situation in which the legal entity is dedicated to developing software or other in-process technology and the reporting entity has rights to the resulting product may indicate (depending on the relative significance of those factors) that substantially all of the legal entity's activities are conducted on behalf of the reporting entity.

- “The reporting entity and its related parties provide more than half of the total of the equity, subordinated debt, and other forms of subordinated financial support to the legal entity based on an analysis of the fair values of the interests in the legal entity.”
- “The activities of the legal entity are primarily related to securitizations or other forms of asset-backed financings or single-lessee leasing arrangements.”

For more information, see [Section 3.4.4](#) of Deloitte’s Roadmap *Consolidation — Identifying a Controlling Financial Interest*.

5.2.3.2 Identifying Variable Interests

While there are many forms of variable interests, all variable interests will absorb portions of a VIE’s variability (changes in the fair value of the VIE’s net assets exclusive of variable interests) that the legal entity was designed to create. Sometimes, it is easy to identify a variable interest (e.g., equity and debt). However, the analysis is much more challenging in the evaluation of other arrangements (e.g., derivatives, leases, and decision-maker and other service-provider contracts). For example, a technology entity may have licenses, royalties, or other similar arrangements that represent variable interests in the legal entity because the contractual terms require payments from the legal entity on the basis of the legal entity’s revenues or other performance indicators. Therefore, such arrangements absorb, in part, the variability associated with changes in the legal entity’s performance (i.e., changes in the fair value of the legal entity’s net assets). For more information, see [Section 4.3](#) of Deloitte’s Roadmap *Consolidation — Identifying a Controlling Financial Interest*.

5.2.3.3 Determining Whether a Legal Entity Is a VIE

To qualify as a VIE, a legal entity needs to satisfy only one of the following characteristics:

- The legal entity does not have sufficient equity investment at risk.
- The equity investors at risk, as a group, lack the characteristics of a controlling financial interest.
- The legal entity is structured with disproportionate voting rights, and substantially all of the activities are conducted on behalf of an investor with disproportionately few voting rights.

Technology entities may invest in development-stage entities. In determining whether the first characteristic is met, a reporting entity should consider the design of the development-stage entity and the development-stage entity’s current stage of development. When the development-stage entity is still in the development stage and there is substantial uncertainty about whether the development-stage entity will proceed to the next stage, it may be appropriate to consider only the current stage in the equity sufficiency assessment. For example, a technology entity may invest in a development-stage entity that is currently in the product development stage. If a product is successfully developed, the development-stage entity plans to commence test marketing by selling the products in selected areas. If there is substantial uncertainty about whether a product will be successfully developed, only the current phase of the development-stage entity’s development needs to be considered. Therefore, if the equity capital is deemed sufficient to finance the initial product development phase, the development-stage entity would be considered to have sufficient equity investment at risk. However, this determination may need to be reassessed in a subsequent period (e.g., if the development-stage entity successfully develops a product and commences test marketing in the next phase). For more information, see [Section 5.2.4](#) of Deloitte’s Roadmap *Consolidation — Identifying a Controlling Financial Interest*.

5.2.3.4 Determining the Primary Beneficiary

The primary beneficiary of a VIE is the party required to consolidate the VIE because it has a controlling financial interest in the VIE. Specifically, the reporting entity is the primary beneficiary if it has (1) the power to direct the activities that most significantly affect the VIE's economic performance and (2) the obligation to absorb losses or the right to receive benefits of the VIE that could potentially be significant to the VIE.

Identifying which entity has the power necessitates (1) evaluating the purpose and design of the VIE and the risks the VIE was designed to create and pass along to its variable interest holders, (2) identifying the activities related to the risks that most significantly affect the economic performance of the VIE, and (3) identifying the party that makes the significant decisions or controls the activity or activities that most significantly affect the VIE's economic performance. For more information, see [Chapter 7](#) of Deloitte's Roadmap *Consolidation — Identifying a Controlling Financial Interest*.

Sometimes, forward starting rights or contingencies may shift power from one investor to another, as illustrated in the example below.

Example 5-1

Investor A, a technology entity, invests with Investor B, an unrelated party, in Entity C, a VIE that is designed to develop a particular IP and manufacture and market the resulting product. Whereas A has the power over the development of the IP, B has the power over the manufacturing and marketing of the resulting product. The activities and decisions related to both the development of the IP and the manufacturing and marketing of the resulting product are significant to C's economic performance.

Entity C is designed in such a way that there are two distinct stages during its life, and the manufacturing and marketing stage will not begin until the development stage is complete. In addition, there is substantial uncertainty about whether the IP can be successfully developed.

Under these circumstances, successful completion of development may be considered a substantive contingent event that results in a change in power from A to B. Therefore, the primary-beneficiary determination would focus on the first stage (i.e., development of the IP) until the development is complete, and A would initially have the power to direct the most significant activities of C. If the IP is successfully developed into a product, the primary-beneficiary determination would focus on the second stage (i.e., the manufacturing and marketing of the product), and B would have the power at that time to direct the most significant activities of C.

For more information, see [Section 7.2.10](#) of Deloitte's Roadmap *Consolidation — Identifying a Controlling Financial Interest*.

5.2.4 SEC Comment Letter Trends

The SEC staff's comments about consolidation frequently focus on the VIE model, including (1) an explanation of the reporting entity's involvement with, and the structure of, VIEs; (2) the determination of whether an entity is a VIE; (3) the determination of whether the reporting entity is the primary beneficiary of a VIE (including reassessment of whether the reporting entity continues to be the primary beneficiary); and (4) required disclosures related to the reporting entity's interests in VIEs.

For more information, see [Section 2.2](#) of Deloitte's Roadmap *SEC Comment Letter Considerations, Including Industry Insights*.

SEC staff comments related to noncontrolling interests have focused on the allocation of net income (loss) to the noncontrolling interest holder and the parent. Accordingly, a registrant may be asked to provide the SEC staff with detailed information about how the registrant determined the allocation, particularly when the allocation is disproportionate to the noncontrolling interest holder's investment. The SEC staff has also commented on registrants' accounting for redeemable noncontrolling interests since SEC rules still prohibit registrants from including redeemable equity in any caption titled "total equity." For more information, see [Chapters 6 and 9](#) of Deloitte's Roadmap *Noncontrolling Interests* and [Section 2.16](#) of Deloitte's Roadmap *SEC Comment Letter Considerations, Including Industry Insights*.

5.3 Inventory

Many technology entities manufacture (or outsource the manufacture of) various hardware and components, including semiconductor chips, servers, personal computers, and smart devices. Under ASC 330, inventory is defined as tangible personal property that is (1) "[h]eld for sale in the ordinary course of business," (2) "[i]n process of production for such sale," or (3) "[t]o be currently consumed in the production of goods or services to be available for sale." For manufacturers, inventory is characterized as finished goods, work in process, or raw materials and supplies.

5.3.1 Hardware and Components

All inventory is accounted for on the basis of its cost (i.e., "expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location," as stated in ASC 330-10-30-1). However, there are various methods for determining such cost, including FIFO; last in, first out (LIFO); and the retail inventory method. In addition to direct costs, inventoriable costs include overhead costs, such as repairs and maintenance of production equipment, utilities and rents related to the production area, production supervisory wages and compensation, costs of quality control and inspection, certain warehousing or distribution costs, and depreciation on production-related assets.

Technology entities must also consider whether inventory has become impaired, especially since the risks of impairment have increased as a result of supply-chain issues, inflationary pressures, and reduced demand. Inventory is recorded at either (1) the lower of cost or market (for inventory measured by using LIFO or the retail inventory method) or (2) the lower of cost or net realizable value (for inventory measured by using a method other than LIFO or the retail inventory method, such as FIFO). In addition, a technology entity that has entered into noncancelable long-term purchase commitments may need to consider whether it should recognize losses on the purchase commitments if it cannot recover such losses by increasing its selling prices.

5.3.1.1 Hardware and Services — Combined Performance Obligation

In some arrangements, costs (other than set-up costs) are incurred at or around the time an entity begins to satisfy a performance obligation. For example, an entity may physically deliver hardware used as part of a combined performance obligation to provide services (e.g., an integrated cybersecurity solution) to a customer over time. That is, the hardware is not distinct; rather, it forms part of a combined performance obligation that is satisfied over time. The hardware may be recorded by the entity as inventory before it is physically transferred to the customer and would typically be derecognized by the entity once it is physically delivered to the customer since it would most likely be a fulfillment cost.

Depending on the facts and circumstances, it may or may not be acceptable under ASC 340-40 for an entity to capitalize initial fulfillment costs incurred when the costs are related to part of a combined performance obligation that will be satisfied over time. Generally, before delivery, the asset to which the fulfillment costs are related (e.g., hardware) is held in the entity's inventory and is therefore within the scope of the inventory accounting guidance of ASC 330. However, once the asset is physically transferred to the customer, the asset may no longer be within the scope of ASC 330.

Under ASC 330, the cost of inventory should be recognized with the related revenue. However, the asset may no longer be within the scope of ASC 330 once it is deployed in a specific customer contract (i.e., once it is shipped to a customer). At this point, the costs related to the asset could be evaluated as contract fulfillment costs in accordance with ASC 340-40. If ASC 340-40 is applicable, an entity should consider the three criteria in ASC 340-40-25-5 to determine whether capitalization of the costs is appropriate:

- a. The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify
- b. The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future.
- c. The costs are expected to be recovered.

Generally, the asset to which the costs are related is physically delivered to the customer as part of a specific contract with that customer; therefore, criterion (a) is met. Further, if the entity expects to recover the costs of the delivered asset through the transaction price, the entity would conclude that criterion (c) is met.

Unlike the evaluations of criteria (a) and (c), respectively, which are relatively straightforward, the evaluation of whether criterion (b) is met (i.e., whether the costs generate or enhance a resource of the entity that the entity will use to satisfy its performance obligation in the future) generally requires more judgment. If the entity determines that capitalization of the related costs is appropriate in accordance with ASC 340-40, it should subsequently amortize the costs related to the asset as it transfers the related services. For more information, see [Section 13.3.3.4](#) of Deloitte's Roadmap *Revenue Recognition*.

5.3.1.2 Leased Hardware

There are additional considerations when a technology entity leases hardware instead of selling it. In these situations, the entity's arrangement would be subject to the guidance in ASC 842 (or ASC 840 before the adoption of ASC 842), provided that the arrangement meets the definition of a lease. If the hardware is subject to an operating lease (as opposed to a direct financing lease or sales-type lease, in which case the hardware would be accounted for under ASC 330), the entity would account for the hardware under ASC 360 rather than ASC 330. For more information about leases, see [Section 5.5](#).

5.3.2 Software

Costs of software to be sold, leased, or marketed are subject to the guidance in ASC 985-20 and ASC 985-330. Under ASC 985-330, any costs incurred to duplicate software, produce documentation and training, and physically package the software are capitalized as inventory. However, those costs are typically not material for software entities, and under ASC 985-20, costs incurred before technological feasibility is established are expensed as R&D costs. Further, costs of developing software for internal use are subject to the guidance in ASC 350-40. For more information about whether software costs should be accounted for under ASC 985-20 or ASC 350-40, see [Chapter 4](#).

5.3.3 SEC Comment Letter Trends

The SEC staff may ask registrants to clarify their accounting policy disclosures regarding inventory valuation, particularly the policies and estimates related to the measurement of inventory. ASC 275-10-50 requires disclosures of significant estimates applicable to inventory.

5.4 Stock-Based Compensation

To incentivize employee and nonemployee performance and align the interests of grantees and shareholders, technology entities often grant stock-based compensation awards such as stock options, restricted stock, restricted stock units, stock appreciation rights, and other equity-based instruments in exchange for goods or services or consideration paid to a customer. Such awards are accounted for under ASC 718. The amount of compensation cost to recognize is generally based on the fair value of the stock-based compensation arrangement, and ASC 718 requires entities to apply a “fair-value-based measurement method” when accounting for such arrangements.

For more information about accounting for stock-based compensation, see Deloitte’s Roadmap [Share-Based Payment Awards](#).

5.4.1 Valuation Considerations

Technology entities that are publicly traded typically use the observable market price in an active market to value the equity shares underlying a stock-based compensation award. However, observable market prices for a nonpublic entity’s equity shares may not exist. In such an instance, a nonpublic entity could apply many of the principles of ASC 820 to determine the fair value of its common stock, often by using either a market approach or an income approach (or both). A nonpublic entity may apply a “top-down method,” which involves first valuing the entity, then subtracting the fair value of debt, and then using the resulting equity valuation as a basis for allocating the equity value among the entity’s different classes of equity securities. A nonpublic entity may also look to recent sales of its equity shares directly to investors or other transactions in secondary markets.

While not authoritative, the AICPA Accounting and Valuation Guide [Valuation of Privately-Held-Company Equity Securities Issued as Compensation](#) (the “AICPA Valuation Guide”) provides useful interpretive and best-practice guidance for valuing the equity securities of nonpublic entities. It discusses, among other topics, possible methods of allocating enterprise value to underlying securities, enterprise- and industry-specific attributes that should be considered in the determination of fair value, best practices for supporting fair value, and recommended disclosures for a registration statement. The AICPA Valuation Guide also emphasizes the importance of contemporaneous valuations from independent valuation specialists to determine the fair value of equity securities. Further, the AICPA Valuation Guide highlights differences between pre-IPO and post-IPO valuations. One significant difference is that the valuation of nonpublic entity securities often includes a discount for lack of marketability (DLOM). The DLOM can be determined by using several valuation techniques and is significantly affected by the underlying volatility of the stock and the period the stock is illiquid.

For more information, see [Section 4.12](#) of Deloitte’s Roadmap [Share-Based Payment Awards](#).



Changing Lanes

On June 23, 2024, the AICPA's Financial Reporting Executive Committee ("FinREC") announced the release of a **working draft** of two revised chapters that are ultimately expected to be included in the next edition of the AICPA Valuation Guide:

- Chapter 8, "Inferring Value From Transactions in a Private Company's Securities."
- Chapter 9, "Selected Accounting and Disclosure Matters."

FinREC established the Equity Securities Task Force to develop the revisions, which are primarily intended to expand the interpretive guidance on the comprehensive framework for evaluating and assessing the impact of secondary transactions and to better align the AICPA Valuation Guide with the accounting literature issued after the publication of the guide's current edition in 2013.

The purpose of the proposed guidance in Chapter 8 of the AICPA Valuation Guide is to give entities a "framework for calibrating to [primary and secondary] transactions in the company securities for evaluating and assessing their impact on estimating fair value of the equity securities underlying awards of stock-based compensation." The updates would expand the interpretive guidance and the framework for applying the measurement principles in ASC 820 as well as for assessing the relevance of primary and secondary transactions associated with such estimations.

The proposed updates to Chapter 9 of the AICPA Valuation Guide would provide (1) a framework based on ASC 718 for assessing whether a secondary transaction is compensatory and (2) certain disclosure considerations related to share-based payment awards.

For more information about the working draft of the two revised chapters, see Deloitte's June 27, 2024, [Heads Up](#) and March 28, 2025, [Technology Spotlight](#).

5.4.1.1 Cheap Stock

The SEC often focuses on "cheap stock"² issues in connection with a nonpublic entity's preparation for an IPO. The SEC staff is interested in the rationale for any difference between the fair value measurements of the underlying common stock of stock-based compensation awards and the anticipated IPO price. In addition, the SEC staff will challenge valuations that are significantly lower than prices paid by investors to acquire similar stock. If the differences cannot be reconciled, a nonpublic entity may be required to record a cheap-stock charge. Since stock-based compensation awards are often a compensation tool to attract and retain employees or nonemployees, a cheap-stock charge could be material and, in some cases, lead to a restatement of the financial statements.

An entity preparing for an IPO should refer to [paragraph 7520.1](#) of the SEC Division of Corporation Finance's (the "Division's") Financial Reporting Manual (FRM), which outlines considerations for registrants when the "estimated fair value of the stock is substantially below the IPO price." In such situations, registrants should be able to reconcile the change in the estimated fair value of the underlying equity between the award grant date and the IPO by taking into account, among other things, intervening events and changes in assumptions that support the change in fair value.

For more information, see [Section 4.12.1](#) of Deloitte's Roadmap [Share-Based Payment Awards](#).

² Cheap stock refers to issuances of equity securities before an IPO in which the value of the shares is below the IPO price.

5.4.1.2 Internal Revenue Code Section 409A

When granting stock-based compensation awards, a nonpublic entity should be mindful of the tax treatment of such awards and the related implications. Section 409A of the Internal Revenue Code (IRC) contains requirements related to nonqualified deferred compensation plans that can affect the taxability of holders of stock-based compensation awards. If a nonqualified deferred compensation plan (e.g., one issued in the form of stock-based compensation) fails to comply with certain IRC rules, the tax implications and penalties at the federal level (and potentially the state level) can be significant. Accordingly, it is imperative to establish a supportable fair market value of the stock to avoid unintended tax consequences for the issuer and holder. For more information, see [Section 4.12.2](#) of Deloitte's Roadmap *Share-Based Payment Awards*.

5.4.2 Common-Stock Repurchase Transactions

Certain stock transactions with employees, former employees, nonemployee providers of goods or services, and customers of a nonpublic entity (collectively referred to as "grantees") involve significant judgment and complexities that may have a material impact on the nonpublic entity's financial statements. In addition, such transactions often have certain tax implications for both the nonpublic entity and its employees. These stock transactions can be between (1) the nonpublic entity and its grantees or (2) investors and the nonpublic entity's grantees.

5.4.2.1 Nonpublic-Entity Purchases of Shares From Grantees

To give their grantees liquidity (or for other reasons), nonpublic entities may sometimes repurchase vested common stock from them. In some cases, the price paid for the shares exceeds their fair value at the time of the transaction. When a nonpublic entity repurchases common shares from its grantees at an amount greater than the estimated fair value of the shares at the time of the transaction, the excess of the purchase price over the fair value of the common shares generally represents compensation cost. In addition, an entity's past practice of repurchasing shares, or an arrangement that permits repurchase, could affect the classification of stock-based compensation awards. For more information, see [Section 4.12.3.1](#) of Deloitte's Roadmap *Share-Based Payment Awards*.

5.4.2.2 Investor Purchases of Shares From Grantees

On occasion, existing investors (such as private equity, hedge fund, or venture capital investors) intending to increase their stake in a nonpublic entity may undertake transactions with other shareholders in connection with or separately from a recent financing round (e.g., a recent issuance of preferred stock). Often called "secondary market transactions," these arrangements may include the purchase of shares of common or preferred stock (typically common stock) by investors from the founders of the nonpublic entity or other individuals who are also considered grantees. Because the secondary transactions are between grantees of the nonpublic entity and existing shareholders and are related to the transfer of outstanding shares, the nonpublic entity may not be directly involved in them (though it may be indirectly involved by facilitating the exchange or not exercising a right of first refusal). In other circumstances, the nonpublic entity may be actively involved in effecting a tender offer through activities such as determining or negotiating the purchase price, determining which grantees and investors can participate, or determining how many shares can be sold in the secondary transaction.

A secondary transaction may be an arm's-length fair value transaction or may otherwise provide an indication of the fair value of the entity's common stock. Such a transaction is likely to be relevant in the nonpublic entity's common stock valuation, which is typically performed by a third-party valuation firm to ensure compliance with IRC Section 409A and determine the fair-value-based measure of the nonpublic entity's stock-based compensation arrangements.

If the price paid for the shares exceeds their fair value at the time of the secondary transaction, the nonpublic entity will typically recognize the excess as compensation cost. The presumption in such a transaction is that the excess is compensation paid to grantees, and we believe that it would be difficult for an entity to demonstrate that the non-fair value transaction with grantees is clearly for purposes other than compensation. It is important for a nonpublic entity to recognize that this type of transaction may be subject to the guidance in ASC 718 because the investors are considered to be holders of an economic interest in the entity. In addition, when new investors participate in a secondary transaction with a compensatory element, they may not be dissimilar to parties that already hold economic interests in the nonpublic entity and may have similar motivations to compensate employees even though they may not hold economic interests in the entity before entering into the transaction.

Investors purchasing common stock in a secondary transaction may pay a price that is the same as, or at a small discount from, the price paid for convertible preferred stock concurrently or recently issued. In these and other circumstances in which common stock is purchased from grantees, nonpublic entities will need to carefully consider whether the price paid is an indication of the fair value of the common stock or is compensatory. While there may be indicators that the transaction is compensatory (e.g., the entity actively facilitated the transaction by determining or negotiating the purchase price and the sellers were limited to grantees), significant judgment is required in making this assessment, and all facts and circumstances related to the transaction should be considered. If the facts and circumstances reflect mixed indicators that the transaction is both an indication of the fair value of the common stock and compensatory, an entity should consider whether it should both (1) provide some weighting of the observable price in its fair value estimation in conjunction with other valuation approaches and (2) recognize compensation cost for any difference between the price paid and the ultimate fair value determination.

A reporting entity's past practice of repurchasing a grantee's awards in cash before the risks and rewards of share ownership are borne by grantees (generally six months from the date on which options are exercised or shares are vested [i.e., immature shares]) may indicate that the awards are in-substance liabilities. However, we do not believe that a reporting entity would generally consider a history of investor purchases of immature shares from grantees (regardless of whether such purchases are conducted at fair value or at an amount that exceeds fair value) when assessing whether it has established a past practice of settling immature shares that results in an in-substance liability. Generally, if the reporting entity otherwise classifies the shares as equity, purchases of immature shares by an investor (i.e., a related party, an existing economic interest holder, or a new investor) cannot be used to pay off a liability on the reporting entity's behalf. Rather, the purchaser (often through a tender offer to grantees that is, in part, organized by the reporting entity) is making an investment decision to establish or increase its ownership interest in the reporting entity and thereby is the party making a payment as the principal in the purchase transaction with grantees. Accordingly, an investor that directly makes such a purchase from grantees would not change the substantive terms of the stock-based compensation arrangement under which the shares must be reclassified from equity to a liability.

For more information, see [Section 4.12.3.2](#) of Deloitte's Roadmap *Share-Based Payment Awards*.

5.4.2.3 Tax Considerations

For tax purposes, stock repurchases are generally treated either as capital (e.g., capital gain) or as dividend-equivalent redemptions (e.g., ordinary dividend income to the extent that the entity has earnings and profits). Repurchases from grantees (e.g., current or former employees or independent contractors) give rise to questions about whether any of the proceeds should be treated as compensation for tax purposes. For more information, see [Section 4.12.3.2.2](#) of Deloitte's Roadmap *Share-Based Payment Awards*.

5.4.3 SEC Comment Letter Trends

The SEC staff's comments about stock-based compensation frequently focus on (1) compliance with the required disclosures in ASC 718-10-50-2, (2) cheap stock considerations, (3) secondary transactions (including entity repurchases of shares from grantees), (4) significant valuation assumptions for options such as volatility and expected term, (5) accounting for profits interests, and (6) presentation of stock-based compensation expense. Many of these areas of focus are particularly relevant for financial reporting periods preceding the date on which an entity goes public.

For more information, see [Section 2.21](#) of Deloitte's Roadmap *SEC Comment Letter Considerations, Including Industry Insights*.

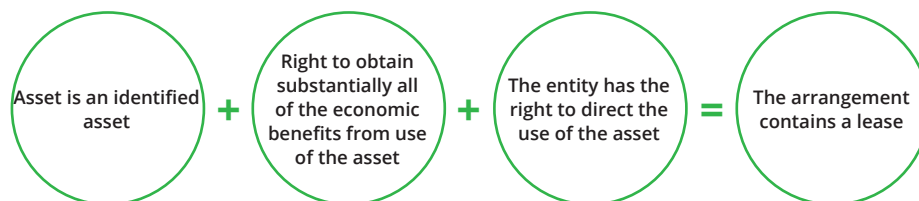
5.5 Leases

All entities, both public and nonpublic, have now adopted ASC 842. The most significant change under ASC 842 is its lessee model, which brings most leases onto the balance sheet. Accordingly, except for those leases that qualify for the short-term lease exemption (i.e., certain leases with a lease term of 12 months or less), the standard's lessee model requires lessees to adopt a right-of-use (ROU) asset approach that brings substantially all leases onto the balance sheet. Under this approach, a lessee records an ROU asset representing its right to use the underlying asset during the lease term and a corresponding lease liability in a manner similar to the current approach for capital leases.

For lessors, while much of the accounting in ASC 842 is largely unchanged relative to legacy GAAP (e.g., ASC 842 retains the approach for operating and capital/finance leases), a common misconception is that lessor accounting has not changed much under ASC 842. One key change is to align certain underlying principles of ASC 842 with those of the revenue standard (i.e., ASC 606).

5.5.1 Scope

One of the most significant challenges technology entities encounter in applying the leasing standard is to determine which arrangements contain leases subject to ASC 842, particularly when there are embedded leases in nonlease arrangements. ASC 842 defines a lease as "a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration." Identifying whether an arrangement contains a lease requires judgment and often requires an entity to understand the nuances of the contractual provisions and delivery. The graphic below summarizes the three criteria that must be met for a contract to contain a lease.



An entity is required at inception to identify whether a contract is or contains a lease. The entity will reassess whether the contract is or contains a lease only in the event of a modification to the terms and conditions of the contract.

The table below further discusses key concepts related to the definition of a lease.

Concept	Requirement	Observation
Use of an identified asset	An asset is typically considered to be an identified asset if it is explicitly specified in a contract or implicitly specified at the time the asset is made available for use by the customer. However, if the supplier has substantive rights to substitute the asset throughout the period of use and would benefit economically from substituting that asset, the asset is not considered “identified,” and there is no lease for accounting purposes (see below).	<p>This requirement is similar to the guidance in ASC 840-10-15 (formerly EITF Issue 01-8). An entity does not need to be able to identify the particular asset (e.g., by serial number) but must instead determine whether an identified asset is needed to fulfill the contract.</p> <p>Distinguishing between a lease and a capacity contract requires significant judgment. The standard clarifies that a capacity portion of an asset is an identified asset if it is physically distinct (e.g., a specific floor of a building). On the other hand, a capacity portion of a larger asset that is not physically distinct (e.g., a percentage of a pipeline) is not an identified asset unless that portion represents substantially all of the asset’s capacity.</p>
Substantive substitution rights	<p>A supplier’s right to substitute an asset is substantive only if both of the following conditions exist:</p> <ul style="list-style-type: none"> • The supplier has the practical ability to substitute alternative assets throughout the period of use. • The supplier would benefit economically from the exercise of its right to substitute the asset. 	<p>The FASB established this requirement because it reasoned that if a supplier has a substantive right to substitute the asset throughout the period of use, the supplier — not the customer — controls the use of the asset.</p> <p>It is often difficult for a customer to determine whether a supplier’s substitution right is substantive. A customer should presume that a substitution right is not substantive if it is impractical to prove otherwise.</p>
Right to obtain economic benefits from use of the identified asset	To control the use of an identified asset, a customer must have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use. The term “substantially all” is generally 90 percent of the economic benefits of the asset.	The economic benefits from use of an asset include the primary output and by-products of the asset as well as other economic benefits from using the asset that could be realized from a commercial transaction with a third party.

(Table continued)

Concept	Requirement	Observation
Right to direct the use of the identified asset	<p>A customer has the right to direct the use of an identified asset throughout the period of use if either of the following conditions exists:</p> <ul style="list-style-type: none"> The customer has the right to direct “how and for what purpose” the asset is used throughout the period of use. The relevant decisions about how and for what purpose the asset is used are predetermined and (1) the customer has the right to operate (or direct others to operate) the asset throughout the period of use and the supplier does not have the right to change the operating instructions or (2) the customer designed the asset in a way that predetermines how and for what purpose the asset will be used. 	<p>The relevant rights to be considered are those that affect the economic benefits derived from the use of the asset. Customers’ rights to direct the use of the identified asset include the rights to change:</p> <ul style="list-style-type: none"> The type of output produced by the asset. When the output is produced. Where the output is produced. <p>On the other hand, rights that are limited to maintaining or operating the asset do not grant a right to direct how and for what purpose the asset is used.</p>

Often, the assessment of whether a contract is or contains a lease will be straightforward. However, the evaluation will be more complicated when an arrangement involves both a service component and a leasing component or when both the customer and the supplier make decisions about the use of the underlying asset. An asset typically is identified by being explicitly specified in a contract. However, an asset also can be identified by being implicitly specified at the time the asset is made available for the customer’s use.

For more information about identifying a lease, see [Chapter 3](#) of Deloitte’s Roadmap *Leases*.

5.5.1.1 Cloud Computing Arrangements

Cloud computing arrangements (CCAs) require the use of certain equipment (e.g., servers). While a benefit of cloud-based technologies is that an entity does not need to own and maintain servers in its facility, saving valuable space and minimizing certain costs, the equipment being used to provide the cloud-based technology could represent a lease to the entity if the lease criteria are met. Under the leasing guidance in ASC 842, if a CCA contains a lease of the equipment used to provide the related service, the lessee would be required to recognize on its balance sheet an asset (related to the right to use the equipment) and a liability (related to the payments owed by the lessee).

The table below provides indicators of whether a CCA contains a lease.

Criteria	Indicators That the CCA Contains a Lease	Indicators That the CCA Does Not Contain a Lease
Equipment is an identified asset	<ul style="list-style-type: none"> Because of specific security and encryption requirements, only certain servers or locations can be used by the entity (i.e., the customer). The server is explicitly specified (e.g., through a serial number) in the contract. The server is dedicated to the entity. The supplier does not have the contractual right to substitute the server being used by the entity (other than for maintenance or upgrade purposes). 	<ul style="list-style-type: none"> The entity shares the server with other customers (i.e., only a portion of server space provided). The contract states that the entity will receive access to applications in the cloud but does not specify the server being used, and the server is not dedicated to the entity. The supplier has the practical ability and contractual right to substitute the server being used without the entity's permission, and the supplier would not incur significant costs to switch the entity to a different server.
The entity has the right to obtain substantially all of the economic benefits from use of the equipment	<ul style="list-style-type: none"> The server is dedicated to the entity. Even if the entity does not fully use the server, the supplier does not have the right to store another customer's data on the server. 	<ul style="list-style-type: none"> The supplier has the right to sell unused server capacity to other customers. The entity is limited from using all of the server's capacity.
The entity has the right to direct the use of the equipment	<ul style="list-style-type: none"> The entity determines what type of data and how much data will be stored on the server as well as when the data will be transferred to and from the server. The entity is not limited to when it can use the cloud-based technology. 	<ul style="list-style-type: none"> The supplier specifies what type of data and how much data will be stored on the server (excluding protective rights). The supplier specifies when the entity can access the cloud-based technology.

The determination of whether a CCA contains a lease and the resulting accounting can significantly affect an entity's balance sheet and target metrics through the recognition of an additional asset and liability. In addition, certain policy elections related to lease costs (e.g., the election of a practical expedient to treat lease and nonlease components as a single component) may cause the nature and extent of the costs to be capitalized as part of the lease asset to vary. Further, the presentation and subsequent accounting and expense profile for the arrangement will vary depending on whether the lease is classified as a finance or operating lease. Because of the size of many cloud implementation projects, an entity's move to the cloud may have impacts on key performance indicators (KPIs) and the financial statements overall; for example, EBITDA, working capital, the debt-to-equity ratio, and the return on assets may be affected by the structure of these arrangements. With these factors in mind, entities should carefully evaluate their CCAs to determine whether the equipment being used in the arrangements represents a lease.

For an illustration of CCAs and the related financial impacts, see [Section 5.5.3.3](#).




5.5.1.2 Intangible Assets

Technology entities commonly enter into arrangements that convey rights to use intangible assets (e.g., on-premise software licenses). Customer rights to use intangible assets are outside the scope of ASC 842. As specified in ASC 842-10-15-1, entities should consider the guidance in ASC 350 when accounting for such arrangements.

5.5.2 Components of a Contract

A contract can contain both lease and nonlease components. Generally, the nonlease components are services that the supplier is also performing for the customer. For example, a technology entity may decide to (1) lease hardware and (2) sell its subscription service to the same customer. In these situations, the entity's hardware would be subject to the provisions in ASC 842, and consideration would generally be allocated to the separate lease component (i.e., the hardware) and the nonlease component (i.e., the subscription service). However, practical expedients exist for both lessees and lessors if certain conditions are met. For lessee considerations related to lease and nonlease components and lessor considerations related to those components, see [Sections 5.5.3.2 and 5.5.4.2](#), respectively.

The table below highlights the differences between lease components, nonlease components, and “noncomponents” (i.e., activities paid for by the customer that do not transfer a good or service to the customer).

<div>Lease Component</div> <div></div>	The right to use an underlying asset is considered a separate lease component if (1) a lessee can benefit from the use of the underlying asset either on its own or with other resources that are readily available and (2) the underlying asset is not highly dependent on or highly interrelated with other assets in the arrangement.
<div>Nonlease Component</div> <div></div>	An activity that transfers a separate good or service to the customer is a nonlease component. For example, maintenance services consumed by the customer and bundled with the lease component in the contract would be a separate nonlease component because the performance of the maintenance transfers a service to the customer that is separate from the right to use the asset.
<div>Noncomponent</div> <div></div>	Any activity in a contract that does not transfer a separate good or service to the lessee is neither a lease component nor a nonlease component; therefore, consideration in the contract would not be allocated to such an activity. For example, payments made by the customer for property taxes or insurance that covers the supplier’s interests would not represent a component in the contract.

For more information about components of a contract, see [Chapter 4](#) of Deloitte’s Roadmap [Leases](#).

5.5.3 Lessee Considerations

5.5.3.1 Lease Classification

Under ASC 842, at lease commencement, a lease is classified as a finance lease if any of the following criteria are met:

- “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 to exercise.”

- “The lease term is for the major part of the remaining economic life of the underlying asset.”
- “The present value of the sum of the lease payments and any residual value guaranteed by the lessee . . . equals or exceeds substantially all of the fair value of the underlying asset.”
- “The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.”

If none of the above criteria are met, the lease will be classified as an operating lease.

Finance leases are accounted for in a manner similar to how entities account for a financed purchase arrangement. The lessee recognizes interest expense and amortization of the ROU asset, which result in a greater expense in the early years of the lease than in the later years of the lease. The single lease cost related to an operating lease is recognized on a straight-line basis over the lease term unless another systematic and rational basis is more representative of the pattern in which benefit is expected to be derived from the right to use the underlying asset. Thus, the amortization of an ROU asset related to an operating lease takes into account the interest on the liability so that the expense amount remains constant. That is, the amortization of the ROU asset will increase or decrease proportionally to the change in interest expense on the liability to maintain a straight-line expense throughout the term of the lease. For both types of leases, the lessee recognizes an ROU asset for its interest in the underlying asset and a corresponding lease liability. For more information about lessee accounting, see [Chapter 8](#) of Deloitte’s Roadmap [Leases](#).

5.5.3.2 Practical Expedient

ASC 842 affords lessees a practical expedient related to separating (and allocating consideration to) lease and nonlease components. That is, lessees may elect to account for the nonlease components in a contract as part of the single lease component to which they are related. The practical expedient is an accounting policy election that must be made by class of underlying asset. Accordingly, when a lessee elects the practical expedient, any portion of consideration in the contract that would otherwise be allocated to the nonlease components will instead be accounted for as part of the related lease component for classification, recognition, and measurement purposes. In addition, any payments related to noncomponents would be accounted for as part of the related lease component (i.e., the associated payments would not be allocated between the lease and nonlease components).

5.5.3.3 Cloud Computing Arrangements

Differences, even if minor, in how a cloud computing contract is structured can result in differing expense recognition patterns, including:

- Operating expense being recognized immediately as incurred.
- Costs being capitalized and recognized as interest and amortization (e.g., finance lease or internal-use software development).
- Costs being deferred over the life of the contract (e.g., cloud computing service arrangement or operating lease).

The guidance in ASC 350-40 provides for the deferral of certain costs incurred in CCAs that are service agreements. Although an entity may find it beneficial to recognize certain costs incurred in the development phase over the life of the contract, such deferred recognition may not achieve its desired effect when all financial measures and budgetary objectives are taken into account.

The example below illustrates some of the considerations related to an entity's cloud adoption efforts and how different paths can result in significantly different financial statement and budgetary outcomes while obtaining effectively the same operational end state.

Example 5-2

Entity X is a large multilocation organization that relies heavily on its on-premise technology. Recently, X determined that it should migrate its data and applications to the cloud to provide (1) the additional flexibility it needs to support its decentralized employee base and (2) the scalability it needs to accommodate its growth.

Entity X now plans to enter into a three-year cloud contract with Vendor Y under which all of its data and applications will be migrated to the cloud. It is looking to acquire access equivalent to 1,000 terabytes of space on Y's servers. To determine the best structure for the arrangement, X considers three scenarios, which are outlined in the table below.

Scenario 1 — Operating Expense Treatment (Service)	Scenario 2 — Capitalization (Finance Lease)	Scenario 3 — Capitalization (Operating Lease)
<ul style="list-style-type: none"> Contract provides X with 1,000 terabytes of space. Space in the cloud is within a domestically located server farm. Space provided is part of a larger server. Although X's data and applications are segregated from those of other entities through logical partitioning, X cannot specifically identify the server or servers on which its information resides because the license does not specifically identify the server or servers that hold X's information. Vendor Y has ability to move data to another server and perform upgrades without an explicit request from X to do so. Autoscaling is included with the contract. The cloud hosting fee is \$720,000 (paid annually in advance). 	<ul style="list-style-type: none"> Contract provides X with 1,000 terabytes of space. Space in the cloud is within a domestically located server farm. Entity X's data and applications are segregated from other entities' data and applications by being part of dedicated servers that are specifically configured to meet X's requirements and can be identified by serial number. Entity X has direct say in any upgrades to its servers, and Y cannot make changes unless X directly requests them. Autoscaling is included with the contract. The cloud hosting fee is \$790,000 (paid annually in advance). The servers' estimated fair market value is \$825,000. The servers' estimated economic life is four years. 	<ul style="list-style-type: none"> Contract provides X with 1,000 terabytes of space. Space in the cloud is within a domestically located server farm. Entity X's data and applications are segregated from other organizations' data and application by being part of dedicated servers that are specifically configured to meet X's requirements and can be identified by serial number. Entity X has direct say in any upgrades to its servers, and Y cannot make changes unless X directly requests them. Autoscaling is included with the contract. The cloud hosting fee is \$790,000 (paid annually in advance). The servers' estimated fair market value is \$880,000. The servers' estimated economic life is five years.

Example 5-2 (continued)

Entity X cannot take possession of the software under any of the scenarios. Up-front configuration costs, data migration costs, and application development costs are the same under each scenario since those costs are not the focus of this example. Service level agreements and all technical aspects are also considered to be comparable. In addition, the technology options explored all provide the necessary level of security. Because the operational benefits, challenges, and risks are consistent across the technology options, the deciding factor for choosing the structure of the arrangement will be the accounting treatment.

On the basis of its analysis, X determines that Scenario 1 falls under the guidance in ASC 350-40 on the implementation costs of a hosting arrangement that is a service contract.

The contract in scenario 2 is a lease (for a specified asset) that should be accounted for under ASC 842. Since (1) that contract is for three years, (2) the servers' estimated economic life is four years, and (3) the servers' estimated fair market value is \$825,000, X will be using 75 percent of the useful life of the asset (major part of remaining economic life), and the net present value of payments is more than 90 percent of the fair value (substantially all of the fair value). Therefore, the lease should be classified as a finance lease.

Like the contract in Scenario 2, the contract in Scenario 3 is a lease (for a specified asset) that should be accounted for under ASC 842. However, unlike in Scenario 2, neither the test for the major part of the remaining economic life nor the test for substantially all of the fair value is met because the servers in Scenario 3 have a higher estimated fair market value and a longer estimated economic life than those in Scenario 2. Therefore, the lease is an operating lease.

These differences in the structure of the contract result in significantly different accounting treatments, as shown in the tables below.

Overview and Financial Metric Impact			
	Scenario 1	Scenario 2	Scenario 3
Type of arrangement	Service contract	Finance lease	Operating lease
Balance sheet impact	No impact	ROU asset and liability	ROU asset and liability
Type of expense	Operating expense	Amortization expense and interest expense	Operating expense
Impact on EBITDA	EBITDA = net income	EBITDA > net income	EBITDA = net income

Fiscal Year-End 1			
	Scenario 1	Scenario 2	Scenario 3
Cash paid	\$ 720,000	\$ 790,000	\$ 790,000
ROU asset	—	1,527,172	1,553,285
Liability	—	1,500,758	1,500,758
Operating expense	720,000	—	790,000
Interest expense	—	52,527	—
Amortization expense	—	\$ 763,586	—

Example 5-2 (continued)

	Fiscal Year-End 2		
	Scenario 1	Scenario 2	Scenario 3
Cash paid	\$ 720,000	\$ 790,000	\$ 790,000
ROU asset	—	763,586	790,000
Liability	—	763,285	763,285
Operating expense	720,000	—	790,000
Interest expense	—	26,715	—
Amortization expense	—	\$ 763,586	—

	Fiscal Year-End 3		
	Scenario 1	Scenario 2	Scenario 3
Cash paid	\$ 720,000	\$ 790,000	\$ 790,000
ROU asset	—	—	—
Liability	—	—	—
Operating expense	720,000	—	790,000
Interest expense	—	—	—
Amortization expense	—	\$ 763,586	—

For contracts that contain leases (i.e., those in Scenarios 2 and 3), X would generally be required to account for nonlease components (e.g., maintenance and other ongoing service costs) separately from the lease components. However, as noted in [Section 5.5.3.2](#), ASC 842 offers lessees a practical expedient under which they may elect to combine lease and nonlease components and account for the combined component as a lease. Entities should carefully consider whether electing this practical expedient would achieve their desired accounting outcomes.

5.5.4 Lessor Considerations

ASC 842's most significant changes to lessor accounting (1) align the profit recognition requirements under the lessor model with those of ASC 606 and (2) amend the lease classification criteria for a lessor to make them consistent with those for a lessee. Accordingly, ASC 842 requires a lessor to use the same classification criteria discussed in [Section 5.5.3.1](#) to classify a lease as a sales-type lease. If none of those criteria are met, the lessor evaluates whether the lease meets the two criteria it must satisfy to be considered a direct financing lease. If neither the sales-type lease criteria nor the direct financing lease criteria are met, the lease is an operating lease.

For more information about lessor accounting, see [Chapter 9](#) of Deloitte's Roadmap [Leases](#).

5.5.4.1 Variable Payments

While much of the guidance on lessor accounting is aligned with the revenue guidance in ASC 606, an important distinction between the two may affect lessors in the technology industry. Under ASC 606, variable payments are generally estimated and included in the transaction price subject to a constraint. By contrast, under ASC 842, variable lease payments not linked to an index or rate are generally excluded from the determination of a lessor's lease payments.

For example, a technology entity may sell or lease hardware for which the consideration is based entirely on the usage of the hardware. If a hardware sale is accounted for under ASC 606, the customer's variable payments to the entity may need to be estimated up front and included in the transaction price. However, if the hardware is leased and accounted for under ASC 842, the lessee's variable payments to the entity would not be included in the entity's lease payments.

5.5.4.2 Practical Expedient

Lessors can elect not to separate lease and nonlease components. This election is made by each class of underlying asset and can only be made if certain criteria are met in accordance with ASC 842-10-15-42A through 15-42C, which state the following:

ASC 842-10

15-42A As a practical expedient, a lessor may, as an accounting policy election, by class of underlying asset, choose to not separate nonlease components from lease components and, instead, to account for each separate lease component and the nonlease components associated with that lease component as a single component if the nonlease components otherwise would be accounted for under Topic 606 on revenue from contracts with customers and both of the following are met:

- a. The timing and pattern of transfer for the lease component and nonlease components associated with that lease component are the same.
- b. The lease component, if accounted for separately, would be classified as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3A.

15-42B A lessor that elects the practical expedient in paragraph 842-10-15-42A shall account for the combined component:

- a. As a single performance obligation entirely in accordance with Topic 606 if the nonlease component or components are the predominant component(s) of the combined component. In applying Topic 606, the entity shall do both of the following:
 1. Use the same measure of progress as used for applying paragraph 842-10-15-42A(a)
 2. Account for all variable payments related to any good or service, including the lease, that is part of the combined component in accordance with the guidance on variable consideration in Topic 606.
- b. Otherwise, as an operating lease entirely in accordance with this Topic. In applying this Topic, the entity shall account for all variable payments related to any good or service that is part of the combined component as variable lease payments.

In determining whether a nonlease component or components are the predominant component(s) of a combined component, a lessor shall consider whether the lessee would be reasonably expected to ascribe more value to the nonlease component(s) than to the lease component.

15-42C A lessor that elects the practical expedient in paragraph 842-10-15-42A shall combine all nonlease components that qualify for the practical expedient with the associated lease component and shall account for the combined component in accordance with paragraph 842-10-15-42B. A lessor shall separately account for nonlease components that do not qualify for the practical expedient. Accordingly, a lessor shall apply paragraphs 842-10-15-38 through 15-42 to account for nonlease components that do not qualify for the practical expedient.

5.5.4.2.1 Lease of Smart Device and Related Subscription Services

Many technology entities offer solutions in which a customer purchases (1) a smart device with an embedded software component (e.g., firmware), (2) maintenance and support (i.e., PCS), and (3) a cloud-based service. In these offerings, the firmware allows the smart device to connect to the cloud-based application, which is physically hosted on the technology entity's systems (or hosted by the entity's cloud-computing vendor) and accessed by the customer over the Internet. Because PCS and a cloud-based service typically are sold together, are coterminous, and have the same pattern of transfer (i.e., ratably over time as stand-ready obligations), they will be referred to collectively as "subscription services."³

Instead of selling its smart device, an entity may decide to lease the device and sell its subscription service to the same customer. In these situations, the entity's device would be subject to the provisions in ASC 842,⁴ and consideration would generally be allocated to the separate lease component (i.e., the smart device⁵) and the nonlease component (i.e., the subscription service) in accordance with the guidance in ASC 606 on allocating the transaction price to performance obligations. Because the device would be subject to the leasing guidance, the entity would not evaluate whether the leased device represents a distinct promise in accordance with ASC 606.

5.5.4.2.1.1 Practical Expedient Criteria

If the entity elects to use the practical expedient, it may combine the device (i.e., the lease component) and the subscription service (i.e., the nonlease component) if the subscription service would otherwise be accounted for under ASC 606 and both of the conditions in ASC 842-10-15-42A(a) and (b) are met.

As explained in [ASU 2018-11](#), the criterion in ASC 842-10-15-42A(a) focuses on the timing and pattern of transfer (i.e., a "straight-line pattern of transfer . . . to the customer over the same time period") rather than on the timing and pattern of revenue recognition. Therefore, an entity may qualify for the practical expedient if it (1) leases a device that is classified as an operating lease and (2) sells subscription services constituting a stand-ready obligation that has a straight-line pattern of transfer over the same period as the operating lease.

Example 5-3

Entity Z leases a hardware device over a one-year period and sells a cloud-based service for the device over the same period. The cloud-based service would be subject to ASC 606 if accounted for separately from the leased device. The service is a stand-ready obligation that has a straight-line pattern of transfer over the one-year period. In addition, the leased device would be classified as an operating lease under ASC 842 if accounted for separately from the cloud-based service. The leased device similarly has a straight-line pattern of transfer over the one-year period.

Entity Z can elect the practical expedient to account for the leased device and the cloud-based service as a single combined component because (1) the cloud-based service otherwise would be accounted for under ASC 606, (2) the timing and pattern of transfer for the leased device and the cloud-based service are the same, and (3) the leased device, if accounted for separately, would be classified as an operating lease under ASC 842.

³ When control of two or more goods or services is transferred at exactly the same time, or on the same basis over the same period, and if those items do not need to be segregated for presentation or disclosure purposes, it will not be necessary to unbundle each of those concurrently delivered items because the amount and timing of revenue recognized and disclosed would not differ if the items were unbundled. The FASB acknowledges this in paragraph BC116 of [ASU 2014-09](#) and paragraph BC47 of [ASU 2016-10](#).

⁴ While it is assumed that the lease of the smart device would be subject to ASC 842, entities should carefully evaluate the scope provisions of the leasing guidance in making that determination.

⁵ While the smart device may have embedded software, such software would not need to be treated as a separate nonlease component if it is essential to the functionality of the device. If the software is not essential to the functionality of the device (i.e., it is distinct from the device), the software would not be within the scope of ASC 842.

Example 5-4

Assume the same facts as in Example 5-3 above, except that the cloud-based service only has a one-month term. The customer has the option to renew the service over the one-year lease term but is not contractually obligated to do so. Therefore, the lease term for the device and the contractual service period for the cloud-based service are not coterminous.

Entity Z can elect the practical expedient to account for the leased device and the cloud-based service as a single combined component if certain conditions are met. We believe that, in some circumstances, the practical expedient can be applied even if the nonlease component is not coterminous with the lease component. Specifically, we think that if the separation of the lease component from the nonlease component would only affect presentation and disclosure (i.e., the pattern and timing of revenue recognition would not differ if the nonlease component were accounted for separately), the lessor can elect the practical expedient to combine the lease component and the nonlease component even if the timing of transfer of the nonlease component is not coterminous with the lease component. This would generally be the case when (1) the lease component and the optional nonlease component are each priced at their stand-alone selling price and an allocation between components would therefore not be necessary (i.e., they are not priced at a significant discount in such a way that a material right within the scope of ASC 606 might need to be identified) and (2) the timing and pattern of transfer of the nonlease component are the same as those of the lease component for the period over which the nonlease component will be transferred to the lessee.

This view is supported by paragraph BC31 of ASU 2018-11, which states, in part, “The Board noted that its objective in providing the practical expedient was to align the accounting by lessors under the new leases standard more closely with the revenue guidance.” Further, paragraph BC116 of ASU 2014-09 notes that “Topic 606 would not need to specify the accounting for concurrently delivered distinct goods or services that have the same pattern of transfer. This is because, in those cases, an entity is not precluded from accounting for the goods or services as if they were a single performance obligation, if the outcome is the same as accounting for the goods and services as individual performance obligations.”

On the basis of the Board’s stated objective, we believe that the practical expedient in ASC 842-10-15-42A can be applied when the only impact is on presentation and disclosure of amounts recognized as part of the arrangement (i.e., the pattern and timing of recognition are the same), provided that the lease component, if accounted for separately, would be classified as an operating lease. Therefore, if the leased device and the cloud-based service are each priced at their stand-alone selling price and renewals of the cloud-based service are not priced at a discount, Z may elect to apply the practical expedient.

The presence of a nonlease component that is ineligible for the practical expedient does not preclude the entity from electing the expedient for the lease and nonlease components that meet the criteria. Rather, the entity would account for the nonlease components that do not qualify for the practical expedient separately from the combined lease and nonlease components that do qualify. For example, if the entity also provides professional services that do not qualify for the practical expedient, it would not necessarily be precluded from electing the practical expedient.

Example 5-5

Assume the same facts as in [Example 5-3](#), except that Entity Z also sells implementation services that are transferred over a three-month period. The implementation services are distinct from the cloud-based service, and Z recognizes revenue for the implementation services over time by using a cost-based measure of progress under ASC 606.

Entity Z can elect the practical expedient to account for the leased device and the cloud-based service as a single combined component for the reasons stated in [Example 5-3](#). However, because Z recognizes revenue for the implementation services by using a cost-based measure of progress over a three-month period, those services do not have the same timing and pattern of transfer as the leased device (which is transferred ratably over a one-year period). Therefore, the implementation services do not qualify for the practical expedient and should be accounted for separately under ASC 606.

This conclusion is supported by the guidance in ASC 842-10-15-42C, which states that those components that qualify for the practical expedient are combined while those components that do not qualify are accounted for separately.

5.5.4.2.1.2 Determining Which Component Is Predominant

If the entity elects to apply the practical expedient to its leased device and cloud-based service, it should determine whether the cloud-based service associated with the leased device is the predominant component of the combined component. If so, the entity is required to account for the combined component in accordance with ASC 606. Otherwise, the entity must account for the combined component as an operating lease in accordance with ASC 842.

As indicated in the Background Information and Basis for Conclusions of ASU 2018-11, the FASB decided not to include a separate definition or threshold for determining whether “the nonlease component is the *predominant* component of the combined component.” Rather, the Board noted that a lessor should consider whether the lessee would “ascribe more value to the nonlease component(s) than to the lease component.” Further, the Board acknowledged that the term “predominant” is used elsewhere in U.S. GAAP, including ASC 842 and ASC 606.

The Board also explained that it does not expect that an entity will need to perform a detailed quantitative analysis or allocation to determine whether the nonlease component is predominant. Rather, it is sufficient if an entity can reasonably determine, on a qualitative basis, whether to apply ASC 842 or ASC 606. Therefore, entities will need to use judgment in making this determination.

At its March 28, 2018, meeting, the FASB discussed a scenario in which the components were evenly split (e.g., a 50/50 split of value) and suggested that, in such circumstances, the combined component should be accounted for under ASC 842 because the nonlease component is not predominant. That is, the entity would need to demonstrate that the predominant element is the nonlease component; otherwise, the combined unit of account would be accounted for as a lease under ASC 842. We believe that the final language in ASU 2018-11 is intended to indicate that an entity would need to determine whether the lease or nonlease component (or components) is larger (i.e., has more value); only when the nonlease component is larger should the combined component be accounted for under ASC 606.

In discussions with the FASB staff, we confirmed that an entity needs to look at which component has more value, not *significantly* more value. In a quantitative analysis, “more value” would constitute more than 50 percent. For example, when the value of the nonlease component is 51 percent and the value of the lease component is 49 percent, the nonlease component would be the predominant component. However, the FASB staff indicated that it generally expects that entities will be able to make this determination qualitatively. We also confirmed that the language “ascribe more value to the nonlease component(s) than to the lease component” intentionally excludes the wording “ascribe significantly more value to the license” from ASC 606-10-55-65A. Accordingly, we believe that to be predominant, the nonlease component only needs to be larger (not *significantly* larger) than the lease component.

5.5.4.2.1.3 Variable Payments

The accounting for variable payments should be consistent with that for the combined component. That is, when the combined component is accounted for as a lease under ASC 842, there are no longer any nonlease (revenue) variable payments; rather, there are only variable payments related to the combined lease component, and that variability should be accounted for in accordance with ASC 842. Conversely, if the combined component is accounted for as a service under ASC 606, all variable payments related to the combined component should be accounted for in accordance with the guidance in ASC 606 on variable consideration. That is, the entity would be required to estimate the variable consideration and constrain such estimates in accordance with the guidance in ASC 606-10-32-11. The entity would also be required to consider the variable consideration guidance in ASC 606-10-32-40 to determine whether a variable amount should be allocated to a distinct good or service.

For example, if the entity elects the practical expedient and the cloud-based service is the predominant component, the single combined component (consisting of the leased device and the cloud-based service) would be accounted for under ASC 606. If the entity also charges usage-based fees for the cloud-based service, it would need to consider the variable consideration guidance in ASC 606.

5.5.5 Discount Rate

Entities will need to recognize ROU assets and lease obligations by using an appropriate discount rate at transition and on an ongoing basis. Compliance with this requirement may be difficult for entities with a significant number of leases since they will need to identify the appropriate incremental borrowing rate for each lease on the basis of factors associated with the underlying lease terms (e.g., lease tenor, asset type, residual value guarantees). That is, entities would not be permitted to use the same discount rate for all of their leases unless the leased assets and related terms are similar. See [Chapter 7](#) of Deloitte’s Roadmap [Leases](#) for further details on the related guidance and illustrative examples.

5.5.6 Additional Considerations Related to ASC 842

Technology entities may enter into various lease arrangements such as subleases, sale-and-leaseback arrangements, and build-to-suit arrangements. See [Chapters 10 through 12](#) of Deloitte’s Roadmap [Leases](#) for further details on the related guidance and illustrative examples.

In addition, ASC 842 offers a variety of practical expedients (including those discussed in [Sections 5.5.3.2](#) and [5.5.4.2](#)) that may be of relevance to technology entities. See [Chapters 15 through 17](#) of Deloitte’s Roadmap [Leases](#) for further details on the various practical expedients.

5.5.7 SEC Comment Letter Trends

The focus of the SEC staff's comments on leasing transactions has shifted from registrants' accounting under the legacy leasing guidance (codified in ASC 840) to their application of the guidance in ASC 842. Although relatively few SEC staff comments on the application of ASC 842 have been issued thus far, some observations in comments related to its application have emerged. For example, registrants have received comments on (1) how ASC 842 applies or does not apply in certain arrangements and (2) the discount rate used to calculate the amount of the lease liability and corresponding ROU asset. Other topics addressed in SEC staff comments on ASC 842 include, but are not limited to, the nature of expenses treated as initial direct costs; the determination of lease classification; accounting for leasehold improvements, including amortization; impairment considerations related to ROU assets; and the application of the sale-and-leaseback accounting requirements in ASC 842-40.

Given the relatively low volume of SEC staff comments related to ASC 842 that have been issued thus far, registrants in the technology industry should continue monitoring staff comments to identify any new comments or trends related to the leasing standard that may emerge in the future.

For more information, see [Section 2.14](#) of Deloitte's Roadmap *SEC Comment Letter Considerations, Including Industry Insights*.

5.6 Financial Instruments

To fund the cost of operations and the development of new IP and products, technology entities frequently seek external financing. Many of their financing transactions include complex terms and conditions that require a careful accounting analysis. Consequently, technology entities must apply the highly complex, rules-based guidance in U.S. GAAP to determine whether the securities they issue are classified as liabilities, permanent equity, or temporary equity (temporary equity considerations apply to SEC registrants and non-SEC registrants that choose to apply the SEC's rules and guidance). Early-stage and smaller growth technology entities are often financed with preferred stock and warrants with complex and unusual features, whereas larger, more mature entities often have a mix of debt and equity securities with more plain-vanilla common stock capitalization.

An instrument's classification on the balance sheet will affect how returns on the instrument are reflected in an entity's income statement. Returns on liability-classified instruments are reflected in net income (e.g., interest expense or mark-to-market adjustments), whereas returns on equity-classified instruments are generally reflected in equity, without affecting net income. However, dividends and remeasurement adjustments on equity securities that are classified as temporary equity may reduce an entity's reported earnings per share (EPS).

The SEC staff historically has focused on the classification of liabilities and equity on the balance sheet when equity instruments have redemption provisions or financial instruments possess characteristics of both liabilities and equity. For example, classification of convertible debt instruments and freestanding warrants is often scrutinized since they may contain both liability and equity components under U.S. GAAP.

In addition, prospective SEC registrants in the technology industry may have previously outstanding instruments with characteristics of both liabilities and equity at the time they are approaching a potential IPO, or technology entities may issue new instruments in connection with a potential IPO. Even if certain instruments are already outstanding before an IPO, it may be appropriate for an instrument to be classified outside of permanent equity in accordance with SEC rules when public financial statements are initially filed. Further, for a technology entity that becomes a public company, there can be other accounting consequences that did not exist while the entity was private.

The discussion below highlights guidance on the accounting for financial instruments that frequently affects technology entities. The guidance cited is not intended to be all-inclusive or comprehensive; rather, the discussion focuses on targeted considerations related to the application of the guidance most relevant to the industry. To complete an analysis of the accounting for financial instruments, entities must consider all facts and circumstances and use significant judgment.

5.6.1 Liability Classification

Upon the issuance of an equity instrument, a technology entity should first evaluate whether the instrument meets the definition of a liability in accordance with ASC 480. ASC 480 provides guidance on determining whether (1) certain financial instruments with both debt-like and equity-like characteristics should be accounted for “outside of equity” (i.e., as liabilities or, in some cases, assets) by the issuer and (2) SEC registrants should present certain redeemable equity instruments as temporary equity.

Securities issued in the legal form of debt must be classified as liabilities. In addition, ASC 480 requires liability classification for three types of freestanding financial instruments that are not debt in legal form:

- Mandatorily redeemable financial instruments (e.g., mandatorily redeemable preferred stock or mandatorily redeemable noncontrolling interests).
- Obligations to repurchase the entity's equity (e.g., written put options and warrants to issue redeemable equity securities).
- Obligations to issue a variable number of equity shares (e.g., preferred stock that must be settled with a variable number of common shares that have a fixed monetary amount).

For more information, see Deloitte's Roadmap [Distinguishing Liabilities From Equity](#).

5.6.2 Redeemable Equity Securities

Technology entities frequently issue redeemable equity securities, such as redeemable preferred stock or redeemable noncontrolling interests. Technology entities may also issue redeemable preferred stock that have substantive conversion options at issuance that would not be considered liabilities under ASC 480 because redemption is not certain, even though such securities are called mandatorily redeemable convertible securities.⁶ Further, if redemption is required only upon the liquidation of the entity, the securities are not considered redeemable.

The SEC staff believes that redeemable equity securities are significantly different from conventional equity capital because such securities possess characteristics similar to debt as a result of the redemption obligation attached to the securities. If the instruments are not classified as liabilities, the guidance in ASC 480-10-S99-3A requires instruments to be classified outside of permanent equity in “temporary equity” if they are redeemable (1) at a fixed or determinable price on a fixed or determinable date, (2) at the option of the holder, or (3) upon the occurrence of an event that is not solely within the issuer's control. To determine the appropriate classification, SEC registrants must evaluate all facts and circumstances related to events that could trigger redemption of the securities. Issuers should evaluate whether equity instruments that do not meet the definition of a liability under ASC 480 nevertheless must be presented outside of permanent equity because of any of these provisions. Because only public entities are required to present certain equity instruments as temporary equity (sometimes referred to as mezzanine equity) instead of permanent equity, the SEC staff frequently comments on this topic during the IPO process.

⁶ A conversion feature that results in settlement of the instrument through the issuance of a variable number of shares of common stock equal to a fixed monetary amount is equivalent to “share-settled” debt and would not represent a substantive conversion option.

Start-up and other technology entities financed by private equity or venture capital firms often have one or more series of convertible preferred stock issued and outstanding. When holders of convertible preferred stock have control over the entity, the following convertible preferred stock instruments must be classified as temporary equity:

- Convertible preferred stock that contains a stated redemption feature that allows the issuer to call the security on one or more specified dates.
- Convertible preferred stock that contains a stated redemption feature that allows the holder to put the security to the issuer upon the occurrence of a specified event that can be controlled by a vote of the entity's stockholders or by actions of the entity's board of directors.

Even if a convertible preferred stock instrument does not contain a stated redemption feature (i.e., a stated call option or a stated put option), an entity must evaluate the instrument's liquidation provisions, including whether those provisions are considered "ordinary liquidation" or "deemed liquidation" provisions, to determine whether the instrument should be classified as temporary equity. Whereas an ordinary liquidation provision does not trigger the requirement to classify the convertible preferred equity in temporary equity, a deemed liquidation provision will typically trigger the requirement to classify the convertible preferred equity in temporary equity. For example, a deemed liquidation clause that includes the sale or exclusive license of substantially all of a technology entity's IP could require the convertible preferred equity to be classified in temporary equity.

If an instrument classified in temporary equity is currently redeemable, it should be adjusted to its maximum redemption amount as of the balance sheet date. However, if an instrument classified in temporary equity is not currently redeemable and a determination is made that the instrument's redeemability is not probable, subsequent adjustment of the carrying amount is not necessary until it is probable that the security will become redeemable.

For more information, see [Chapter 9](#) of Deloitte's Roadmap *Distinguishing Liabilities From Equity*.

5.6.3 Conversion Features of Preferred Stock and Debt

A technology entity that issues convertible preferred stock or convertible debt should perform an evaluation under ASC 815 to determine whether its contracts contain embedded equity derivatives that may need to be bifurcated and accounted for separately from the host contract under ASC 815's bifurcation requirements. On the basis of the entity's bifurcation conclusion, the entity will account for a convertible debt instrument wholly as debt, and for convertible preferred stock wholly as preferred stock (i.e., as a single unit of account), unless (1) a convertible instrument contains features that require bifurcation as a derivative under ASC 815 or (2) a convertible debt instrument was issued at a substantial premium.

For more information, see [Section 7.6](#) of Deloitte's Roadmap *Issuer's Accounting for Debt*.

5.6.4 Warrants and Debt

A technology entity may also issue both a debt instrument and a warrant on the entity's shares. The entity should consider the definition of a freestanding financial instrument in the ASC master glossary to determine whether the debt instrument and warrant represent freestanding financial instruments. A freestanding financial instrument is one that is entered into either "separately and apart from any of the entity's other financial instruments or equity transactions" or "in conjunction with some other transaction and is legally detachable and separately exercisable." When an entity issues debt together with a detachable warrant, and the debt and detachable warrant represent separate freestanding financial instruments, the proceeds received must be allocated between the debt and the warrant. The following

table provides an overview of the appropriate allocation of proceeds between debt and detachable warrants at initial recognition:

	Warrant Accounted for at Fair Value, With Fair Value Changes Recognized in Earnings	Warrant Classified as Equity
Debt accounted for at amortized cost	With-and-without method (i.e., warrant is measured initially at fair value and debt is measured as the residual).	Relative fair value method.
Debt accounted for at fair value, with changes in fair value recognized in earnings	Debt is measured initially at fair value. If the initial fair values of the debt and warrants, in the aggregate, exceed the proceeds received, special considerations are necessary.	With-and-without method (i.e., debt is measured initially at fair value and warrant is measured as the residual).

For more information, see [Sections 3.3.2.1](#) and [3.4.3.2](#) of Deloitte's Roadmap *Issuer's Accounting for Debt*.

5.6.5 Accelerated Share Repurchase Programs

Some technology companies have executed accelerated share repurchase (ASR) programs. As described in ASC 505-30-25-5, an ASR program is "a combination of transactions that permits an entity to repurchase a targeted number of shares immediately with the final repurchase price of those shares determined by an average market price over a fixed period of time. An accelerated share repurchase program is intended to combine the immediate share retirement benefits of a tender offer with the market impact and pricing benefits of a disciplined daily open market stock repurchase program."

ASC 505-30 contains unit-of-account guidance for ASR programs. Under ASC 505-30, an entity accounts for an ASR as two separate units of account: a treasury stock repurchase and a separate forward contract on the entity's shares. An entity should analyze the treasury stock repurchase and forward contract separately to determine whether ASC 480 or ASC 815 applies.

For more information, see [Section 3.2.5](#) of Deloitte's Roadmap *Contracts on an Entity's Own Equity*.

5.6.6 Derivatives

Common financing arrangements issued by technology entities in the form of debt or equity capital may be considered to be or may contain equity derivatives (i.e., equity derivatives may be freestanding or embedded). Examples of common equity derivatives are stock warrants, stock options, and forward contracts to buy or sell an entity's shares. Equity derivatives may be classified as liabilities (or, in some cases, as assets) and measured at fair value on the balance sheet, with changes in fair value recognized in earnings. It is important to be aware of these instruments, how they are accounted for, and subsequent events that could affect such accounting. Sometimes, the measurement attribute for such instruments could be fair value as a result of an IPO or subsequent financing.



Changing Lanes

At the FASB's December 6, 2023, [meeting](#), the Board discussed preagenda work on challenges associated with applying the definition of a derivative and the derivative scope exceptions to arrangements with contingent features. Such challenges had been identified in stakeholders' responses to the FASB staff's June 2021 [invitation to comment](#). During the meeting, the Board decided to add a project to its technical agenda to address these challenges. Subsequently, at the FASB's April 10, 2024, [meeting](#), the Board further discussed the scope of its guidance on derivatives and decided to issue an exposure draft for public comment.

In July 2024, the FASB issued a [proposed ASU](#) that would refine the scope of the guidance on derivatives in ASC 815 (as well as clarify the scope of the guidance on share-based payments from a customer in ASC 606, as discussed in [Section 2.5.4](#)). The proposed ASU is intended, in part, to address concerns about the application of derivative accounting to a contract that has features based on the operations or activities of one of the parties to the contract.

For more information, see Deloitte's August 2, 2024, [Heads Up](#).

5.6.6.1 Embedded Derivatives

In addition to the considerations related to freestanding instruments (e.g., warrants or stock options) under ASC 815, an entity should evaluate whether other contracts, such as those involving preferred stock or convertible debt, contain embedded equity derivatives that may need to be bifurcated and accounted for separately from the host contract under ASC 815's bifurcation requirements. An entity identifies the terms of each embedded feature on the basis of the feature's economic payoff profile (underlying) rather than on the basis of how the feature has been formally documented. In identifying the embedded features, the entity should consider all terms of the convertible instrument. Common examples of embedded features include conversion options and redemption provisions. For more information, see [Chapter 8](#) of Deloitte's Roadmap [Issuer's Accounting for Debt](#).

5.6.6.2 Contracts on an Entity's Own Equity

ASC 815-40 provides guidance on the accounting for contracts (and features embedded in contracts) that are indexed to, and potentially settled in, an entity's own equity (also known as contracts on own equity or equity-linked financial instruments). The analysis under ASC 815-40 can be complex; in performing this analysis, an entity often must consult with its legal counsel regarding the various terms associated with the contract. In general, a contract on an entity's own equity can be classified in equity (and not remeasured while it is classified in equity) as long as it is considered to be indexed to the entity's own stock and the issuer has the ability to settle the contract by issuing its own shares under all scenarios. This determination requires an evaluation of all events that could change the settlement value (e.g., adjustments to strike price) and all events that would affect the form of settlement. For more information, see Deloitte's Roadmap [Contracts on an Entity's Own Equity](#).

Many special-purpose acquisition companies (SPACs) issue warrants that must be classified as liabilities because their terms could change depending on the holder. For more information about warrants issued by SPACs and other accounting issues related to SPACs, see [Appendix D](#) of Deloitte's Roadmap [Initial Public Offerings](#).

Technology entities frequently issue financial instruments that include a provision to adjust the conversion price (other than a standard antidilution provision that applies to all shareholders). For example, an entity may provide certain investors with price protection by adjusting the strike price if there is a subsequent round of equity or convertible instrument financing at a strike price that is lower than theirs. Under a provision that triggers such price protection (a “down-round provision”), the strike price would usually be adjusted to the strike price of the subsequent transaction. Special recognition and measurement requirements apply each time a down-round feature in a freestanding equity-classified instrument is triggered. For more information, see [Section 6.1.5](#) of Deloitte’s Roadmap *Contracts on an Entity’s Own Equity*.

5.6.7 Fair Value

Many Codification topics require or permit the subsequent measurement of assets or liabilities at fair value. ASC 820-10-35 provides guidance on the subsequent measurement of items at fair value and applies to both recurring and nonrecurring measurements.

The definition of fair value is based on an exit price notion. An asset, liability, or equity instrument is measured at fair value on the basis of market-participant assumptions; such measurement is not entity-specific. Entities must consider all characteristics of the asset, liability, or equity instrument that a market participant would consider in determining an exit price in the principal or most advantageous market.

Technology entities frequently issue securities with restrictions on their sale. In some cases, it is appropriate to consider a restriction on the sale or use of an asset as a characteristic of the asset that affects its fair value. Only a legal or contractual restriction on the sale or use of an asset that is specific to the asset (an instrument-specific restriction) and that would be transferred to market participants should be incorporated into the asset’s fair value measurement. Thus, an entity should consider the effect of a restriction on the sale or use of an asset that it owns only if market participants would consider such a restriction in pricing the asset because they would also be subject to the restriction if they acquired the asset. Entity-specific restrictions that would not be transferred to market participants should not be considered in the determination of the asset’s fair value, since doing so would be inconsistent with the exit price notion underlying the definition of fair value.

For more information, see [Sections 10.1](#) and [10.2](#) of Deloitte’s Roadmap *Fair Value Measurements and Disclosures (Including the Fair Value Option)*.

5.6.8 Sales of Future Revenue

Technology entities may securitize certain financial assets, such as trade receivables. In those circumstances, entities would apply ASC 860 to determine whether the transfer of financial assets should be accounted for as a sale. However, if an entity cannot recognize accounts receivable because, for example, it does not have an unconditional right to cash, the entity may instead enter into an arrangement that represents a sale of future revenue (i.e., ASC 860 applies only to transfers of recognized financial assets). For more information, see [Section 2.2.2](#) of Deloitte’s Roadmap *Transfers and Servicing of Financial Assets*.

In a sale of future revenue (such as a profit-sharing agreement, a securitization of a participation in a future revenue stream, a celebrity bond, or other contingent payment obligation that varies on the basis of future revenue or income), an entity receives an up-front lump sum payment from an investor and, in return, agrees to pass on a specified percentage or amount of its future revenue or income to that investor for a specified period. The share of revenue or income owed to the investor may be graduated (e.g., 50 percent of the first \$1 million of revenue and then 25 percent of the amount in excess of \$1 million) or may be different from year to year. Further, the entity might guarantee a minimum amount

to be paid to the investor or there may be a maximum total amount payable. The underlying cash flows that the entity will pass on might originate from its contractual arrangements with third parties (e.g., fees and royalties that it will receive from the licensing of IP) or its operations (e.g., a specified interest in revenue, gross margin, or income of the entity or one of its subsidiaries, business segments, or product lines).

Typically, sales of future revenue are within the scope of ASC 470-10. ASC 470-10 requires a seller of future revenue to evaluate whether the offsetting entry to the proceeds received should be classified as debt or deferred income. It is generally inappropriate to record the proceeds immediately as income, because the seller maintains some continuing involvement and the earnings process is not completed when the cash is received.

ASC 470-10-25-2 requires an entity to consider six factors in determining the appropriate classification of the proceeds:

Factors That Create Rebuttable Presumption of Debt	Factors That Could Help Overcome the Debt Presumption
The “form of the transaction is debt”	The transaction purports to be a sale
“The entity has significant continuing involvement in the generation of the cash flows due the investor”	The entity is not significantly involved in the generation of the cash flows owed to the investors
“The transaction is cancelable by either the entity or the investor through payment of a lump sum or other transfer of assets by the entity”	The agreement is not cancelable
“The investor’s rate of return is implicitly or explicitly limited by the terms of the transaction”	There is no cap on payments to the investor
“Variations in the entity’s revenue or income underlying the transaction have only a trifling impact on the investor’s rate of return”	Variations in the level of revenue or income can produce at least moderate variations in the investor’s return
“The investor has any recourse to the entity relating to the payments due the investor”	The agreement includes no guarantees, recourse, or collateral provisions

For more information, see [Section 7.2](#) of Deloitte’s Roadmap *Issuer’s Accounting for Debt*.

5.6.9 Current Expected Credit Losses

In June 2016, the FASB issued [ASU 2016-13](#) (codified in ASC 326 and subsequently amended), which amends guidance on the impairment of financial instruments. The ASU adds to U.S. GAAP an impairment model (known as the current expected credit loss [CECL] model) that is based on expected losses rather than incurred losses. Under the new guidance, an entity recognizes as an allowance its estimate of expected credit losses, which is presented as either (1) an offset to the amortized cost basis of the related asset (for on-balance-sheet exposures) or (2) a separate liability (for off-balance-sheet exposures). That is, the expected credit losses estimated over the lifetime of a financial instrument are recognized at inception (i.e., on day 1). While the ASU has not affected technology entities’ financial statements as significantly as those of banks, most entities have financial instruments or other assets that are subject to the CECL model under ASU 326. For example, technology entities typically have trade receivables and contract assets. In applying the guidance, entities should (1) focus on identifying which financial instruments and other assets are subject to the CECL model and (2) evaluate whether they need to make changes to existing credit impairment models to comply with the standard. For more information, see Deloitte’s Roadmap [Current Expected Credit Losses](#).

5.6.10 Reference Rate Reform

In response to the market-wide migration away from the London Interbank Offered Rate (LIBOR) and other interbank offered rates, the FASB issued [ASU 2020-04](#) (with subsequent amendments). The relief provided by the ASU, which is codified in ASC 848, is elective and applies “to all entities, subject to meeting certain criteria, that have contracts, hedging relationships, and other transactions that reference LIBOR or another reference rate expected to be discontinued because of reference rate reform.” The ASU establishes a general contract modification principle that entities can apply in areas of the Codification that may be affected by reference rate reform, as well as (1) elective contract modification expedients for specific areas of the Codification, (2) certain elective hedge accounting expedients, and (3) held-to-maturity debt security classification relief. In December 2022, the FASB issued [ASU 2022-06](#), which defers ASC 848’s original sunset date of December 31, 2022, to December 31, 2024. For more information, see [Chapter 8](#) of Deloitte’s Roadmap [Hedge Accounting](#). The FASB is not acting alone in its efforts to address issues related to reference rate reform. In July 2019, the SEC staff issued a statement that provides additional guidance related to reference rate reform. For more information about the staff’s statement, see Deloitte’s August 6, 2019, [Heads Up](#).

5.6.11 Modification or Exchange of a Freestanding Equity-Classified Written Call Option

In May 2021, the FASB issued [ASU 2021-04](#), which addresses an issuer’s accounting for a modification or exchange of a freestanding equity-classified written call option (e.g., warrants) that remains equity classified after the modification or exchange. The guidance clarifies the accounting for the modification or exchange, which is treated in the same manner as if cash had been paid as consideration. The effect of the modification or exchange is measured as the difference between the option’s fair value immediately before and immediately after the modification or exchange. For more information, see [Section 6.1.4.2](#) of Deloitte’s Roadmap [Contracts on an Entity’s Own Equity](#).

5.6.12 SEC Comment Letter Trends

5.6.12.1 Debt and Equity

The SEC staff may comment on debt restrictions, including those that limit a registrant’s ability to pay dividends or transfer funds within a consolidated group. It is also important for a registrant to consider providing disclosures about debt covenant compliance in MD&A to illustrate its financial condition and liquidity.

The SEC staff has asked registrants to explain the basis for their determination of how financial instruments should be classified and their application of relevant accounting literature (e.g., ASC 480, ASC 815), particularly for financial instruments that have both debt- and equity-like characteristics. In addition, the SEC staff frequently asks registrants with redeemable securities — including registrants undertaking IPO transactions — to support the basis for their classification of such securities as debt, temporary (mezzanine) equity, or permanent equity. Further, the staff often asks registrants about the accounting for conversion features in convertible instruments, including convertible preferred securities.

For more information, see [Sections 2.4](#) and [2.8](#) of Deloitte’s Roadmap [SEC Comment Letter Considerations, Including Industry Insights](#).

5.6.12.2 Earnings per Share

When a filing indicates that the registrant has two classes of common stock (or one class of common stock and participating securities) that have been treated as a single class in the calculation of EPS, the SEC staff often asks whether application of the two-class method in the computation of EPS under ASC

260-10-45-59A through 45-70 is required. The SEC staff may ask a registrant to substantiate the method used to calculate EPS (e.g., the two-class method or the if-converted method), and it may request additional information or disclosures about each of the registrant's classes of common stock, preferred stock, and common-stock equivalents (such as convertible securities, warrants, or options). Further, the SEC staff expects that a registrant with two classes of common stock will present both basic and diluted EPS for each class regardless of whether either class has conversion rights.

In assessing registrants' conclusions related to the two-class method, the SEC staff has focused on understanding the terms of arrangements, including (1) classes and types of common (or preferred) stock, (2) such stock's dividend rates, and (3) the rights and privileges associated with each class (or type) of stock. When a registrant has preferred shares, the SEC staff may seek to determine whether the preferred stockholders have contractual rights to share in profits and losses of the registrant beyond the stated dividend rate. Similarly, the SEC staff may ask registrants about the dividend rights of restricted stock unit awards or other share-based payment awards and how those rights are considered in the calculation of EPS.

For more information, see [Section 2.6](#) of Deloitte's Roadmap *SEC Comment Letter Considerations, Including Industry Insights*.

5.6.12.3 Fair Value

The SEC staff has requested more specific information from registrants related to valuation techniques and inputs used in fair value measurements. Registrants should consider how the fair value disclosure requirements of ASC 820-10-50 apply to their recurring and nonrecurring fair value measurements. More specifically, registrants should provide information about (1) the methods and techniques used to determine fair value and (2) the inputs to those models. In addition, entities are required to disclose quantitative information about the significant unobservable inputs used in Level 3 fair value measurements.

The SEC staff continues to ask registrants to describe the procedures they perform to validate fair value measurements obtained from third-party pricing services. The staff has also asked registrants to clarify when and how often they use adjusted rather than unadjusted quoted market prices and to disclose why prices obtained from pricing services and securities dealers were adjusted. If multiple quotes were obtained, the SEC staff may request information about how the registrant determined the ultimate value used in the financial statements.

For more information, see [Section 2.7](#) of Deloitte's Roadmap *SEC Comment Letter Considerations, Including Industry Insights*.

5.6.12.4 Embedded Derivatives

The SEC staff may ask whether registrants have reached appropriate accounting conclusions regarding whether embedded features in hybrid instruments should be bifurcated from the host contract. Given the complexity involved in determining whether a host contract is debt-like or equity-like, registrants can expect the SEC staff to continue asking about the terms and features of convertible instruments to determine whether the registrant has (1) properly determined the nature of the host contract and (2) accounted for embedded features as stand-alone financial instruments when necessary. Registrants should consider the disclosure requirements of ASC 815-15 when making disclosures about the nature of the host contract.

For more information, see [Section 2.8.1](#) of Deloitte's Roadmap *SEC Comment Letter Considerations, Including Industry Insights*.

5.7 Income Taxes

The accounting for income taxes under ASC 740 is sometimes very specific and can be complex. The overall objective of accounting for income taxes is to reflect (1) the amount an entity currently owes to tax authorities and (2) deferred tax assets (DTAs) and deferred tax liabilities (DTLs) for the tax effects of transactions or events that have occurred but that have not yet been reflected in a tax return or vice versa (also referred to as “basis differences” or “temporary differences”). A DTA will be recorded for items that will result in future tax deductions (sometimes referred to as a benefit or a deductible temporary difference), and DTLs are recorded for items that will result in the inclusion of future taxable income in an entity's tax return (taxable temporary difference). This balance sheet approach is used to calculate temporary differences and, in effect, takes into account the total tax that would be payable (or receivable) if all of an entity's assets and liabilities were realized at their carrying value at a specific time (the reporting date).

In accordance with ASC 740, the critical event for recognition of a DTA is the event that gives rise to the deductible temporary difference, tax credit, or net operating loss (NOL) carryforward. Once that event occurs, those tax benefits should be recognized, subject to a realizability assessment. In effect, earning taxable income in future years is treated as a confirmation of realizability and not as a prerequisite to asset recognition. At the same time, management should consider future events to record those DTAs at amounts that are more likely than not to be realized in future tax returns. In the case of DTLs, ASC 740 requires an entity to include in its balance sheet an obligation for the tax consequences of taxable temporary differences, even when losses are expected in future years.

For more information, see Deloitte's Roadmap [Income Taxes](#).

5.7.1 Scope Considerations

The scope of ASC 740 is limited to “taxes based on income” when income is determined after revenues and gains are reduced by some amount of expenses and losses allowed by the jurisdiction. Therefore, a tax based on gross receipts, revenue, or capital should be accounted for under other applicable literature (e.g., ASC 405, ASC 450). In contrast, a tax whose base takes into account both income and expense is within the scope of ASC 740.

A common question for technology entities to consider is whether certain investment tax credits and R&D credits are within the scope of ASC 740. Credits whose realization ultimately depends on taxable income are generally recognized as a reduction of income tax expense under ASC 740. However, tax credits whose realization does not depend on the entity's generation of taxable income or the entity's ongoing tax status or tax position (e.g., refundable credits) are not considered an element of income tax accounting under ASC 740 regardless of whether the credit claims are filed in connection with a tax return. When determining the classification of these credits, an entity may consider them to be a form of government grant or assistance. If so, the entity may consider the guidance in IAS 20 by analogy.

For more information, see [Section 2.7](#) of Deloitte's Roadmap [Income Taxes](#).

5.7.2 Intra-Entity Transfers of IP

Technology entities often develop IP such as software, know-how, and other proprietary information. This IP may be developed in one jurisdiction but subsequently transferred to a subsidiary in another jurisdiction. Such transfers are often tax-motivated, and both the initial and subsequent accounting for them has historically been complex. An entity should record the current and deferred tax effects of intra-entity transfers of assets other than inventory, including the tax consequences of intra-entity asset transfers involving IP. For more information, see [Section 3.3](#) of Deloitte's Roadmap [Income Taxes](#).

5.7.3 Transfer Pricing

Many technology entities are global and operate legal entities in multiple countries. The global nature of these entities gives rise to income tax accounting issues regarding the use of transfer pricing for intra-entity and related-party transactions. Generally, transfer pricing is the pricing used for transfers of tangible property, intangible property, services, or financing between affiliated entities in different tax jurisdictions. The general transfer pricing principle is that the pricing of a related-party transaction should be consistent with the pricing of similar transactions between independent entities under similar circumstances (i.e., an arm's-length transaction).

An entity's exposure to transfer pricing primarily occurs when the entity includes in its tax return the benefit received from a related-party transaction that was not conducted as though it was at arm's length. An unrecognized tax benefit results when one of the related parties reports either lower revenue or higher costs than it can sustain (depending on the type of transaction). While a benefit is generally more likely than not to result from such a transaction (e.g., some amount will be allowed as an interest deduction, royalty expense, or cost of goods sold), the amount of benefit is often uncertain because of the subjectivity of valuing the related-party transaction.

For more information, see [Section 4.6.3](#) of Deloitte's Roadmap *Income Taxes*.

5.7.4 Research and Development

For many technology entities, R&D activities represent a significant focus and expenditure. Beyond the above-mentioned scope considerations related to refundable R&D tax credits, these activities may result in various income tax accounting impacts that should be accounted for in accordance with ASC 740. For example, R&D cost-sharing agreements may affect an entity's accounting for the income tax effects of stock-based compensation. In addition, an entity may acquire R&D assets in a business combination that result in the creation of temporary differences. For more information, see the next section and [Section 11.3.4.3](#) of Deloitte's Roadmap *Income Taxes*.

5.7.5 Cost-Sharing Arrangements

Related entities that operate in different tax jurisdictions may enter into cost-sharing (or recharge) agreements under which one party is reimbursed for a portion of certain costs it incurred in undertaking shared development activities associated with intangible property. A jurisdiction may permit or require the resident entity to include stock-based compensation cost in the joint cost pool that is reimbursed (commonly referred to as the "all costs rule").

Under U.S. tax regulations, entities may generally use one of two methods in determining the appropriate amount and timing of stock-based compensation cost that is included in the joint cost pool: (1) the exercise method, under which the amount and timing are based on the award's intrinsic value as of the exercise date; or (2) the grant method, under which entities determine the amount and timing by using the award's grant-date fair-value-based measure (which, in turn, is based on U.S. GAAP compensation costs).

A technology entity should consider the impact of cost-sharing arrangements when measuring, on the basis of the tax election it has made or plans to make, the initial and subsequent deferred tax effects associated with its stock-based compensation costs. If regulations in a particular jurisdiction vary significantly from those in the U.S. federal tax jurisdiction, the entity should consult with its accounting advisers regarding the appropriate accounting treatment. For more information, see [Section 10.5](#) of Deloitte's Roadmap *Income Taxes*.

When a parent company grants stock-based compensation awards to its subsidiary's employees and the subsidiary reimburses the parent company for the awards, the subsidiary will need to account for its intercompany recharge agreement if it files stand-alone financial statements. Depending on the facts and circumstances, the subsidiary's financial statements may reflect the reimbursement as a reduction in contributed capital or a distribution, either of which could result in an intercompany payable depending on the timing.

5.7.6 Valuation Allowances

Technology entities, particularly emerging growth entities, frequently incur losses over an extended period to invest in R&D and marketing as well as reward employees with stock-based compensation. A technology entity that has recurring losses or other negative evidence must consider all available evidence, both positive and negative, to determine whether a valuation allowance against its DTAs is needed. This analysis can be quite complex depending on the entity's facts and circumstances. Significant judgment is often required, and it is difficult to assert that the entity will have future taxable income exclusive of reversing taxable temporary differences when it has cumulative losses in recent years. Further, tax-planning strategies must meet certain criteria to be treated as a source of taxable income, and evaluation of those criteria is often not straightforward. For more information, see [Chapter 5](#) of Deloitte's Roadmap *Income Taxes*.

5.7.7 IRC Section 382 Limitations on NOL Carryforwards

Because of the significant up-front costs required for entities to bring new technologies to market, it is common for entities in the technology industry to generate losses in the early stage of development. Entities can generally benefit from these losses in the form of NOL carryforwards that offset future taxable income.

However, IRC Section 382 provides that loss corporations may be subject to a limitation on the amount of the NOL carryforward that can be realized in periods after a change in ownership (the "Section 382 limitation"). While ownership changes can result from a business combination or an IPO transaction, they can also be driven by a new round of equity financing that affects the company's ownership structure when certain thresholds are met.

The determination of a Section 382 limitation involves a high degree of complexity and requires careful evaluation. An assessment of potential limitations on NOL carryforwards should be included as part of an entity's ongoing tax-planning and tax-forecasting strategies, and the impacts of such limitations on potential funding, exit plans, or acquisition portfolio strategies should also be considered.

5.7.8 SEC Comment Letter Trends

SEC staff comments frequently focus on (1) valuation allowances, (2) disclosures related to the income tax rate, (3) tax effects of significant or unusual transactions that occurred during the period, and (4) noncompliance with disclosure requirements (e.g., omission of required disclosures).

The SEC staff may ask a registrant to provide early-warning disclosures to help financial statement users understand key estimates and assumptions that the registrant made in recording items related to income taxes and how changes to those estimates and assumptions could potentially affect the financial statements in the future. The SEC staff also may issue comments on non-GAAP measures with a particular focus on the income tax impact of the adjustments made to the GAAP measures.

Historically, the SEC staff has stated that boilerplate language should be avoided with respect to income tax disclosures within MD&A and that approaches more conducive to effective disclosure would include:

- Using the income tax rate reconciliation as a starting point and describing the details of the material items.
- Discussing significant foreign jurisdictions, including statutory rates, effective rates, and the current and future impact of reconciling items and uncertain tax positions.
- Providing meaningful disclosures about known trends and uncertainties, including expectations regarding the countries where registrants operate.

For more information, see [Section 2.12](#) of Deloitte's Roadmap *SEC Comment Letter Considerations, Including Industry Insights*.

5.8 Contingencies and Loss Recoveries

ASC 450 defines a contingency as an “existing condition, situation, or set of circumstances involving uncertainty as to possible gain (gain contingency) or loss (loss contingency) to an entity that will ultimately be resolved when one or more future events occur or fail to occur.” In the technology industry, contingencies often arise as a result of patent litigation cases, such as lawsuits filed against an entity for patent infringement. Technology entities also are facing increased risks associated with antitrust lawsuits and compliance with various regulatory requirements in different regimes, particularly risks related to consumer privacy, prevention of anticompetitive practices, cybersecurity incidents, discrimination, and classification of workers as employees rather than independent contractors. Technology entities should monitor the tightening regulatory environment in the United States and globally, especially as the regulatory environment continues to evolve quickly.

5.8.1 Loss Contingencies

Contingent liabilities are liabilities for which the possible loss outcome is unknown or uncertain, such as those associated with pending litigation or product warranties. The likelihood that a liability has been incurred ranges from “remote”⁷ to “reasonably possible”⁸ to “probable.”⁹ The ASC master glossary's definitions of these terms provide no quantitative thresholds; accordingly, entities need to exercise judgment when applying the terms. While there is diversity in practice related to the likelihood percentage that entities consider “probable” to represent, the threshold for “probable” would need to be at least 70 percent. Although “remote” is not discussed quantitatively in any guidance issued by the FASB, in practice, this term is used to indicate a likelihood of 10 percent or less.

⁷ As defined in the ASC master glossary, “remote” means that the “chance of the future event or events occurring is slight.”

⁸ As defined in the ASC master glossary, “reasonably possible” means that the “chance of the future event or events occurring is more than remote but less than likely.”

⁹ As defined in the ASC master glossary, “probable” means that the “future event or events are likely to occur.”

Accrual of a loss contingency is required when (1) it is probable that a loss has been incurred and (2) the amount can be reasonably estimated. An entity must determine the probability of the uncertain event and demonstrate its ability to reasonably estimate the loss from it to accrue a loss contingency. Loss contingencies that do not meet both of these criteria for recognition may need to be disclosed in the financial statements. Various disclosure considerations are required under ASC 450-20 and ASC 275; and SEC Regulation S-K, Item 303, requires discussion of items that might affect an entity's liquidity or financial position in the future, including contingent liabilities.

For more information, see [Chapter 2](#) of Deloitte's Roadmap *Contingencies, Loss Recoveries, and Guarantees*.

5.8.1.1 Incurrence of a Future Cost of Doing Business

Technology entities sometimes settle litigation by altering the terms of future business arrangements. However, it is not always clear how to distinguish between the settlement of a past liability and the incurrence of a future cost of doing business. For technology entities, the incurrence of a future cost of doing business is often indicated by a payment stream that is contingent on the future sale of products or services in the ordinary course of business (e.g., royalties due to a licensor for the license and use of IP).

A technology entity may sometimes agree to settle a claim by agreeing to offer the claimant(s) a price concession on future purchases of the entity's goods or services by the claimant(s). In such a scenario, the claimant(s) will be required to make an independent future purchasing decision to realize the benefit of the settlement. An entity that is obligated to provide such price concessions in connection with a settlement will need to assess whether the settlement (1) represents a liability that should be currently recognized for the estimated settlement amount or (2) should be accounted for as a sales incentive in accordance with ASC 606, which generally results in the entity's accounting for the sales incentive at the time the claimant or claimants use the price concession in connection with the purchase of the entity's goods or services.

Irrespective of when the future price concession is accounted for, any settlement with a customer or a vendor would need to be evaluated in accordance with ASC 606 or ASC 705-20, respectively, regarding the income statement presentation of the settlement. That is, the settlement may need to be characterized as a reduction of revenue from a customer under ASC 606 or a reduction of the purchase price of goods or services acquired from a vendor under ASC 705-20.

For more information, see [Section 2.2.6](#) of Deloitte's Roadmap *Contingencies, Loss Recoveries, and Guarantees*.

5.8.2 Gain Contingencies

The standard for recognition of gain contingencies is substantially higher than that for recognition of loss contingencies. ASC 450-30 indicates that a gain contingency should usually not be recognized before realization (i.e., the earlier of when the gain is realized or when it is realizable). A gain contingency should not be recognized even if realization is considered probable.

Because of the number of uncertainties inherent in a litigation proceeding, gain contingencies resulting from favorable legal settlements generally cannot be recognized in income until cash or other forms of payment are received and the cash (or claim to cash) is not subject to refund or clawback. Gain recognition is not appropriate when a favorable legal settlement remains subject to appeal or other potential reversals. Often, gain contingency recognition will be deferred even after a court rules in favor of a plaintiff. Although it may be certain that an entity will receive proceeds from a legal settlement because there is no possibility of additional appeals, there may be other uncertainties that indicate that

the gain has not yet been realized. If a legal settlement is reached but is pending regulatory or legislative approval, gain recognition is not appropriate until all required levels of regulatory and legislative approval have been obtained. This is the case even if the entity can demonstrate that the settlement meets all criteria that are evaluated by a regulatory body when it is determining whether to grant approval.

For more information, see [Chapter 3](#) of Deloitte's Roadmap *Contingencies, Loss Recoveries, and Guarantees*.

5.8.3 Loss Recoveries

Technology entities may be entitled to recoveries pertaining to a previously recognized financial statement loss (e.g., an impairment of an asset or incurrence of a liability), as well as recoveries from business interruption insurance. Loss recoveries may be received from litigation settlements, insurance proceeds, or reimbursement of an employee's fraudulent activities through liquidation of the employee's assets.

The table below summarizes the four accounting models that an entity should consider when determining the recognition and measurement of expected proceeds related to a recovery: (1) the loss recovery model, (2) the gain contingency model, (3) a determinable mix of the loss recovery and gain contingency models (the "determinable mix model"), and (4) an indeterminable mix of the loss recovery and gain contingency models (the "indeterminable mix model").

Loss recovery model	An asset for which realization is probable should be recognized only up to the amount of the previously recognized loss. The analysis of whether recovery is probable is consistent with the guidance on loss contingency recognition.
Gain contingency model	Recovery proceeds related to a loss that has not been recognized in the financial statements should be accounted for as a gain contingency.
Determinable mix model	A combination of the loss recovery and gain contingency models is applied when recovery proceeds are expected to exceed the amount of the previously recognized loss. The probable recovery proceeds equal to the amount of the recognized loss should be accounted for by using the loss recovery model. The expected proceeds in excess of the recognized loss should be accounted for by using the gain contingency model. For an entity to apply the determinable mix model, there must be a direct linkage between the recovery proceeds and the specifically identifiable recognized loss.
Indeterminable mix model	An indeterminable mix of the loss recovery and gain contingency models results from a situation in which there is no clear evidence that the amount of the recovery proceeds is a recovery of previously recognized losses or costs (i.e., there is no direct linkage) or the amount of the loss or costs previously incurred is not objectively quantifiable (i.e., the losses or costs are not specific, incremental, identifiable costs or losses). Under these circumstances, the application of the gain contingency model would be appropriate for the entire amount of the recovery proceeds.

For more information, see [Chapter 4](#) of Deloitte's Roadmap *Contingencies, Loss Recoveries, and Guarantees*.

5.8.4 SEC Comment Letter Trends

The SEC staff continues to closely monitor SEC registrants' contingency disclosures, and it comments when such disclosures do not comply with U.S. GAAP or SEC rules and regulations.

The SEC staff frequently comments on:

- Lack of specificity regarding the nature of the matter.
- Lack of quantification of amounts accrued, if any, and possible loss or range of loss and/or disclosure about why such an estimate cannot be made.
- Insufficient detail about judgments and assumptions underlying significant accruals.
- Unclear language in disclosures (e.g., not using terms that are consistent with accounting literature, such as “probable” or “reasonably possible”) and failure to consider the disclosure requirements of ASC 450, [SAB Topic 5.Y](#), and SEC Regulation S-K, Item 103.
- Lack of disclosure of an accounting policy related to accounting for legal costs (when material) and uncertainties in loss contingency recoveries, including (1) whether ranges of reasonably possible losses are disclosed gross or net of anticipated recoveries from third parties, (2) risks regarding the collectibility of anticipated recoveries, and (3) the accounting policy for uncertain recoveries.

For more information about SEC comment letter themes related to contingencies, see [Section 2.3](#) of Deloitte’s Roadmap [SEC Comment Letter Considerations, Including Industry Insights](#).

5.9 Non-GAAP Financial Measures and Metrics

5.9.1 Non-GAAP Financial Measures

While an entity’s financial statements must be prepared in accordance with GAAP, many entities also elect to disclose non-GAAP financial measures¹⁰ — that is, numerical measures of an entity’s financial performance, financial position, or cash flows for which the GAAP counterparts are adjusted in some manner. Examples of common non-GAAP financial measures include EBITDA, adjusted EBITDA, adjusted earnings or adjusted EPS, and free cash flow

When using non-GAAP financial measures, an SEC registrant must be aware of certain SEC requirements, including the rules in SEC Regulation G and SEC Regulation S-K, Item 10(e). In addition, the SEC staff has published a number of [Compliance and Disclosure Interpretations](#) (C&DIs) (which are updated periodically) to clarify its views on many non-GAAP presentation issues. SEC officials have indicated in public forums that the SEC is looking for full compliance with the C&DIs in SEC filings.

The key requirements for disclosure of non-GAAP information in SEC filings, including press releases, are related to the following:

- *Prominence* — The most directly comparable GAAP measure should be presented with “equal or greater prominence” in accordance with SEC Regulation S-K, Item 10(e)(1)(i)A.
- *Misleading adjustments* — A non-GAAP measure should not be presented in a misleading manner (e.g., adjustments that are based on individually tailored accounting principles).
- *Reconciliation* — Registrants should present a quantitative reconciliation of the non-GAAP measure to the most directly comparable GAAP measure and should transparently describe all adjustments.

¹⁰ SEC Regulation S-K, Item 10(e)(2), defines a non-GAAP financial measure as “a numerical measure of a registrant’s historical or future financial performance, financial position or cash flows that:

(i) Excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable measure calculated and presented in accordance with GAAP in the statement of comprehensive income, balance sheet or statement of cash flows (or equivalent statements) of the issuer; or

(ii) Includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable measure so calculated and presented.”

- *Clear labeling* — Registrants should clearly label and describe non-GAAP measures and adjustments but should not, for example, use titles or descriptions that are confusingly similar to those used for GAAP financial measures.
- *Purpose and use* — Registrants should disclose why they believe the non-GAAP measure provides useful information to investors and, to the extent material, provide a statement disclosing the additional purposes, if any, for management's use of the non-GAAP measure.

The SEC staff has frequently cited its C&DI on prominence, [Question 102.10](#), when commenting on non-GAAP measures. Accordingly, it may be helpful for a registrant to note the following:

- If GAAP and non-GAAP measures are presented in a particular section of a document, the GAAP measures should be presented before the non-GAAP measures. For example, if a registrant wants to use certain non-GAAP measures in its discussion of results of operations, it should consider the order of presentation and discuss the GAAP results before the non-GAAP measures.
- When a registrant reconciles a non-GAAP measure to the most comparable GAAP measure, it should start with the GAAP measure.
- The registrant should not present a non-GAAP measure in more detail, or emphasize it more, than the comparable GAAP measure.
- The disclosures related to non-GAAP purpose and use should not state or imply that the non-GAAP measures are superior to, provide better information about, or more accurately represent the results of operations than GAAP measures.
- Certain presentations that give undue prominence to non-GAAP information, such as a full non-GAAP income statement, are prohibited.
- If non-GAAP measures are presented in a chart or graphic, the chart or graphic should include the most directly comparable GAAP measures or they should be displayed in an equally prominent location.

An overriding theme of the SEC's guidance on the use of or references to non-GAAP measures in public statements or disclosures is that they should not be misleading. Section 100 of the C&DIs also provides examples of potentially misleading non-GAAP measures, including those that:

- Exclude normal, recurring cash operating expenses necessary for business operations.¹¹
- Are presented inconsistently between periods, such as by adjusting an item in the current reporting period, but not a similar item in the prior period, without appropriate disclosure about the change and an explanation of the reasons for it.
- Exclude certain nonrecurring charges but do not exclude nonrecurring gains (e.g., "cherry picking" non-GAAP adjustments to achieve the most positive measure).
- Are based on individually tailored accounting principles, including certain adjusted revenue measures.

In addition to the examples discussed in the C&DIs, various other presentations could be considered misleading depending on the facts and circumstances.

For more information, see Deloitte's Roadmap [Non-GAAP Financial Measures and Metrics](#).

¹¹ The answer to Question 100.01 of the C&DIs states, in part, that "[w]hen evaluating what is a normal, operating expense, the staff considers the nature and effect of the non-GAAP adjustment and how it relates to the company's operations, revenue generating activities, business strategy, industry and regulatory environment. The staff would view an operating expense that occurs repeatedly or occasionally, including at irregular intervals, as recurring."

5.9.2 Metrics and KPIs

Financial or operational metrics, sometimes called KPIs, may also be included in a registrant's SEC filing to illustrate the size, profitability, and growth of the business or other relevant trends such as customer acceptance or retention. Metrics used by technology entities could include items such as:

- Annual recurring revenue.
- Bookings.
- Weighted average duration of contracts.
- The number of Web page views.
- Total customers or subscribers, the number of those who are active, or changes in either number.
- Operating or contribution margin.
- Customer retention rates (e.g., net revenue retention or core customer retention).
- Average revenue per user.
- Daily or monthly (1) number of active users or (2) usage.
- Number of "likes."
- Total impressions.

The SEC has indicated that registrants should consider the need to disclose KPIs or metrics that management uses in managing its business within MD&A, because such information may be material to an investor's understanding of the registrant's performance. For example, if a registrant that operates a gaming platform discloses online users and there are subsets of those online users that are material to an investor's understanding of the registrant's results of operations and financial position, the registrant should consider disclosing the subsets and explaining any differences between them. For some platforms, the monetization of U.S. users may differ from that of international users, and the monetization of mobile users may differ from that of desktop users. In addition, if a registrant that operates a marketplace platform discloses the number of visitors to its Web site, it should disclose how that metric is clearly and directly related to its results of operations and financial position. The registrant may disclose the number of individuals who visited its Web site but fail to note how this number differs from the number of visitors who actually purchased goods. Further, some e-commerce retailers disclose gross merchandise volume when they do not own the merchandise sold on their Web sites and record revenue on a net basis. Such disclosures should discuss why this metric is important and how it is linked to the registrant's results.

Metrics may be based on GAAP amounts, non-GAAP amounts, nonfinancial amounts, or any combination thereof. When using metrics, registrants should first consider whether an existing regulatory framework applies. For example, metrics based on non-GAAP measures would be subject to the requirements in SEC Regulation G and SEC Regulation S-K, Item 10(e). If metrics are not subject to an existing framework, registrants should consider what additional information they may need to present for investors to understand the metric presented. As clarified in [interpretive guidance](#) issued by the SEC in January 2020, the SEC would generally expect the following disclosures to accompany all KPIs and metrics in MD&A:

- A clear definition of the metric and how it is calculated.
- A statement indicating the reasons why the metric provides useful information to investors.

- A statement indicating how management uses the metric in managing or monitoring the performance of the business.
- Whether there are estimates or assumptions underlying the metric or its calculation that may be important for investors to understand.
- Disclosures accompanying any changes in the calculation or presentation of KPIs and metrics from period to period.

The guidance also reminds registrants of the importance of maintaining effective disclosure controls and procedures related to KPIs and metrics, including maintaining consistency and accuracy of disclosures.

For more information about the presentation and use of metrics and KPIs, see [Section 2.4](#) of Deloitte's Roadmap *Non-GAAP Financial Measures and Metrics*.

5.9.3 SEC Comment Letter Trends

SEC comments have continued to cover a wide range of matters related to non-GAAP measures and metrics.

Although there has been a decline in the number of comments related to prominence of non-GAAP measures, that topic has remained a focus of the staff. Comments have also focused on enhancing the disclosure related to the purpose and use of such measures, reconciliation requirements, and clear labeling. For example, a registrant in the technology industry may disclose revenue excluding traffic acquisition costs (ex-TAC) as a key non-GAAP measure. The SEC staff may request that the registrant reconcile the amount to GAAP gross profit (instead of revenue) and revise the title of the non-GAAP measure to better reflect the measure's nature (e.g., the registrant may decide to change the title to contribution ex-TAC). In addition, if a registrant does not present a gross profit subtotal on the face of the income statement but discusses cost of sales excluding depreciation and amortization in MD&A, it should disclose that the measure is a non-GAAP measure and comply with the applicable disclosure requirements. Further, the SEC has questioned the nature of certain adjustments that may be potentially misleading, such as those that use individually tailored accounting principles.

With respect to metrics and KPIs, SEC comments often request disclosures that (1) clearly define the metrics used and how they are calculated, (2) indicate the reasons why a given metric is useful to investors, (3) indicate how management uses the metric in managing or monitoring the performance of the business, and (4) determine whether disclosure of estimates and assumptions underlying the metric or its calculation is necessary for the metric to not be materially misleading. In addition, the SEC staff may raise questions when (1) certain metrics are not explained in MD&A, (2) changes are not appropriately quantified, and (3) it is unclear whether metrics represent KPIs. Because of the vast volume of metrics used, the SEC staff has been concerned that (1) metrics may not be presented with appropriate context and (2) the link between registrants' key metrics and their income and future profitability may not be clear. Registrants should review their metrics to ensure that the metrics are clearly defined, portray a balanced discussion, and remain relevant.

For more information, see [Sections 3.4](#) and [6.5.1.4](#) of Deloitte's Roadmap *SEC Comment Letter Considerations, Including Industry Insights*.

5.10 Initial Public Offerings

After a record-breaking year for IPOs and SPACs in 2021, the market has remained slow for several years amid various challenges, including volatile markets, geopolitical conflicts, inflation, interest rate increases, and supply-chain issues. Despite such challenges, private technology entities continue to evaluate the methods used to go public in anticipation of better market conditions in the future. Such methods include (1) “traditional” IPOs, in which private companies sell their equity in a public underwritten offering, and (2) nontraditional IPOs, which include those in which private operating companies choose to merge with SPACs to raise capital or use other financing alternatives, such as direct listings. Although nontraditional IPOs have gained popularity in recent years, the number of SPACs has notably decreased over the past year.

5.10.1 Types of Issuers

The requirements for an IPO can vary from entity to entity. Factors that may affect the requirements include:

- Whether the entity is a domestic issuer or a foreign private issuer.
- Whether the entity qualifies as a smaller reporting company (SRC).
- Whether the entity qualifies as an emerging growth company (EGC).

Once an entity completes a public offering and becomes an SEC registrant, it will also need to determine its SEC filer status as a large accelerated filer, an accelerated filer, or a nonaccelerated filer, which will further affect the entity's filing obligations and deadlines. An entity undertaking an IPO will initially be considered a nonaccelerated filer since large accelerated or accelerated filers must have filed at least one annual report and must have been subject to the requirements of Sections 13(a) and 15(d) of the Securities Exchange Act of 1934 (the “Exchange Act”) for at least 12 months. Accordingly, a registrant generally cannot be considered a large accelerated or accelerated filer for its first Form 10-K filing as a public entity. For more information about the types of issuers, see [Section 1.2](#) of Deloitte’s Roadmap *Initial Public Offerings*.

5.10.1.1 Smaller Reporting Companies

A registrant may qualify as an SRC on the basis of either a public float test or a revenue test. The thresholds for qualification as an SRC are as follows:

Criteria	Definition
Public float test	Less than \$250 million of public float as of the last business day of the registrant’s second fiscal quarter
Revenue test	Less than \$100 million of revenue as of the most recently completed fiscal year for which audited financial statements are available and public float less than \$700 million as of the last business day of the registrant’s second fiscal quarter

A key feature of reducing the reporting burden on SRCs is the scaling back of the requirements in both SEC Regulation S-X and SEC Regulation S-K.

An entity may qualify as both an SRC and an EGC; however, unlike the five-year limit for qualifying as an EGC, there is no time limit for qualifying as an SRC.

In addition, after its IPO, an entity could both (1) qualify as an SRC and be eligible for the scaled disclosure requirements available to such an entity and (2) be an accelerated filer and subject to those requirements, including the shorter deadlines for periodic filings and the requirement to include in the entity's filings an auditor's attestation report on internal control over financial reporting (ICFR), as required by Section 404(b) of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley").

The table below further summarizes the initial assessment criteria for SRC status on the basis of public float and revenue levels in the context of the requirements in Section 404(b) of Sarbanes-Oxley.

Status	Definition		Sarbanes-Oxley Section 404(b) Requirement
	Public Float	Annual Revenues	
SRC and nonaccelerated filer	Less than \$75 million	No limit	No
	\$75 million to less than \$700 million	Less than \$100 million	No
SRC and accelerated filer	\$75 million to less than \$250 million	\$100 million or more	Yes for non-EGCs; no for EGCs

For more information about SRCs, see [Section 1.5](#) of Deloitte's Roadmap *Initial Public Offerings*.

5.10.1.2 Emerging Growth Companies

An EGC is a category of issuer that was established in 2012 under the Jumpstart Our Business Startups Act (commonly known as the "JOBS Act") and was granted additional accommodations in 2015 under the Fixing America's Surface Transportation Act (commonly known as the "FAST Act"). The less stringent regulatory and reporting requirements for EGCs are intended to encourage such entities to undertake public offerings. A private entity undertaking an IPO will generally qualify as an EGC if it (1) has total annual gross revenues of less than \$1.235 billion during its most recently completed fiscal year and (2) has not issued more than \$1 billion in nonconvertible debt in the past three years. Once an entity completes its IPO, it must meet additional criteria to retain EGC status.

There are many potential benefits for registrants that file an IPO as an EGC. For example, EGCs:

- Need only two years of audited financial statements in an IPO of common equity.¹²
- May omit financial information (including audited financial statements) from an IPO registration statement if that financial information is related to periods that are not reasonably expected to be required at the time the registration statement becomes effective.
- May elect not to adopt new or revised accounting standards until they become effective for private entities.
- Are eligible for reduced executive compensation disclosures.

After a registrant files an IPO as an EGC, provided that the registrant retains its EGC status, additional accommodations are available for its ongoing reporting obligations. One of the most significant of these accommodations exempts EGCs from the requirement to obtain, from the entity's independent registered public accounting firm, an auditor's report on the entity's ICFR. EGCs are also exempt, unless the SEC deems it is necessary, from any future PCAOB rules that may require (1) rotation of independent

¹² This accommodation is limited to an IPO of common equity. As the SEC clarifies in [paragraph 10220.1](#) of the FRM, an entity will generally need to include three years of audited financial statements when entering into an IPO of debt securities or filing an Exchange Act registration statement, such as a Form 10, to register securities.

registered public accounting firms or (2) supplements to the auditor's report, such as communications regarding critical audit matters (CAMs), which are required for certain other issuers.¹³

After going public, a registrant will retain its EGC status until the earliest of:

- The last day of the fiscal year in which its total annual gross revenues exceed \$1.235 billion.
- The date on which it has issued more than \$1 billion in nonconvertible debt securities during the previous three years.
- The date on which it becomes a large accelerated filer (which is an annual assessment performed on the last day of the fiscal year on the basis of public float as of the end of the second fiscal quarter). To be considered a large accelerated filer, the registrant must have filed at least one annual report and must have been subject to the requirements of Sections 13(a) and 15(d) of the Exchange Act for at least 12 months. Accordingly, the registrant generally cannot be considered a large accelerated filer for its first Form 10-K filing as a public entity.
- The last day of the fiscal year after the fifth anniversary of the date of the first sale of common equity securities under an effective Securities Act of 1933 (the "Securities Act") registration statement for an EGC.

As noted above, an EGC may elect to adopt new accounting standards on the basis of effective dates that apply to non-public business entities (non-PBEs) (e.g., the option to first adopt a new standard in annual financial statements). However, such an election is available only for as long as the entity qualifies as an EGC. An entity may lose EGC status after the effective date for PBEs but before the effective date for non-PBEs. As discussed in [paragraph 10230.1](#) of the FRM, the SEC staff generally expects an EGC that loses its EGC status to comply with the PBE requirements in the first filing after loss of EGC status. Accordingly, a registrant that loses EGC status before adopting a new standard should reflect such adoption as of the beginning of the current fiscal year. Previously issued financial statements do not need to be amended unless the standard requires full retrospective application. Entities that lose EGC status during the IPO process would reflect adoption of any deferred standards in their first periodic report (i.e., on Form 10-Q or Form 10-K) after the IPO. Entities that lose EGC status after their IPO would reflect adoption of any deferred standards in their next periodic report (i.e., on Form 10-Q or Form 10-K) after loss of EGC status.

For more information about EGCs, see [Section 1.6](#) of Deloitte's Roadmap *Initial Public Offerings*.

5.10.2 Types of IPOs

An IPO represents a private entity's initial registration of debt or equity securities with the SEC. However, there are many ways in which an entity can become public, including:

- Sale of newly issued common shares to the public.
- The exchange of debt securities previously issued in a private transaction for registered debt securities.
- The registering of currently outstanding equity securities.
- The distribution of shares in a spin-off transaction by a public company.
- The registering of securities that are issued by a SPAC.

¹³ CAMs are required for audits of all issuers except (1) brokers and dealers; (2) registered investment companies other than business development companies; (3) employee stock purchase, savings, and similar plans; and (4) EGCs.

Regardless of the nature of the IPO transaction or the type of securities registered, upon effectiveness, the issuer will be “public” and will therefore be required to begin complying with the periodic reporting requirements of the Exchange Act (e.g., filing of Forms 10-K, 10-Q, and 8-K). For more information about the types of IPOs, see [Section 1.3](#) of Deloitte’s Roadmap *Initial Public Offerings*.

5.10.2.1 Special-Purpose Acquisition Companies

A SPAC is a newly created entity that raises cash in an IPO and uses it to fund the acquisition of one or more private operating entities. After the IPO, the SPAC’s management looks to complete an acquisition of a target entity within the period specified in its governing documents (e.g., 24 months). If an acquisition cannot be completed within this time frame, the cash raised in the IPO must generally be returned to investors. Because SPACs hold no assets other than cash before completing an acquisition, they are nonoperating public “shell companies” as defined by the SEC. If a target is identified and the SPAC is able to successfully complete the acquisition transaction, the private operating entity target will succeed to the SPAC’s filing status as a result of the merger. On the closing date of the acquisition, the former private operating entity, as the predecessor to the SPAC registrant, becomes a public entity and must be able to meet all the public-entity reporting requirements applicable to the combined entity.

For more information about SPACs, see [Section 1.7](#) and [Appendix D](#) of Deloitte’s Roadmap *Initial Public Offerings*.

5.10.2.2 Offerings Made in Accordance With Regulation A

Regulation A, as amended in 2015 (also referred to as Reg A or Reg A+), provides an exemption from the ordinary requirements of the Securities Act. This exemption allows U.S. and Canadian entities to raise up to \$75 million in a 12-month period by issuing certain types of securities, including equity securities. Regulation A requires that certain disclosure documents be submitted via EDGAR and allows for the confidential review of offering documents.

For more information about Regulation A, see [Section 1.8](#) of Deloitte’s Roadmap *Initial Public Offerings*.

5.10.3 The IPO Registration Statement

While the nature of the IPO may vary, before an entity may commence a public offering of securities, the entity, or “registrant,” must file a registration statement with the SEC under the applicable securities laws. The registration statement contains extensive financial and business-related disclosures about the entity and the securities being offered. A registrant provides such disclosures in accordance with (1) Regulation S-X, which sets forth the SEC’s reporting requirements for the financial statements, and (2) Regulation S-K, which sets forth the SEC’s reporting requirements for information outside the financial statements.

Once submitted to or filed with the SEC, an IPO registration statement is processed and reviewed by the staff of the Division. The purpose of the review is to determine whether the registration statement complies with the SEC’s disclosure requirements. An entity can generally expect the staff to complete its initial review and furnish the first set of comments within 27 calendar days. The entity would then respond to each of the SEC’s comments and reflect requested edits, as well as any other updates, in an amended IPO registration statement, which the SEC will also review. After the initial filing, the SEC’s review time can vary significantly but typically is within two weeks. An entity can expect several rounds of comment letters with follow-up questions on responses to original comments as well as additional comments on new information included in the amended registration statement.

Depending on the length of time between amendments, financial statements and other information included in the registration statement may need to be updated to reflect subsequent periods. Certain information, such as estimated pricing of the IPO and related disclosures, may not be known as of the initial filing date and therefore is not added until a later amendment. However, the SEC expects each draft of the registration statement to be substantially complete at the time of its submission, unless there are specific accommodations for omitting otherwise required information.

Once all the staff's comments are cleared, an entity will typically print a preliminary prospectus, commonly referred to as a "red herring," and go on a "roadshow" to meet with and present to prospective investors. After the roadshow, the entity and its counsel may request that the SEC declare the registration statement "effective" at a certain date and time, after which the securities will be registered and, if listed on an exchange, begin trading. Before the SEC declares the registration statement effective, the entity will need to obtain approval from the exchange on which it is expected to be listed. The IPO closing signifies the completion of the IPO, at which time the company's securities are issued to investors. Most registration statements will only become effective after the SEC comment process has been completed and an effective date has been requested by the company and granted by the SEC.

Entities may confidentially submit certain IPO registration statements to the SEC. The ability to file nonpublicly is a significant benefit because it allows entities to keep potentially sensitive information from customers or competitors until later in the IPO process. It also lets entities confidentially respond to SEC comments, update the draft registration statement, and continue to assess market conditions throughout the IPO process. Entities that use this benefit can also delay or withdraw the IPO, if desired, without public scrutiny.

While draft registration statements may be initially submitted nonpublicly, an entity will eventually be required to publicly file all previously submitted drafts unless it elects to withdraw the IPO. Specifically, all comments and the related responses, even if they were previously submitted confidentially, will be posted to the SEC's Web site no earlier than 20 days after the registration statement is declared effective. All confidential submissions must be filed publicly no later than 15 days before (1) a roadshow or (2) the requested effective date of the registration statement if no roadshow is planned.

For more information about the IPO registration statement, see [Section 1.4](#) of Deloitte's Roadmap *Initial Public Offerings*.

5.10.4 Identifying the Required Financial Statements for the Registration Statement

One of the more challenging aspects of preparing for an IPO is ensuring that the entity has identified the appropriate financial statements to include in the filing. There are many considerations related to determining the appropriate financial statements to include in the IPO registration statement. For example, management will need to identify and prepare the financial statements both for the registrant and for any predecessor entities. In addition to the complexities associated with identifying the required financial statements for the registrant and its predecessor(s), the entity must consider other potential financial statement requirements that may result in additional meaningful historical financial information for investors in the IPO. The specific requirements could be related to significant acquired or to be acquired businesses, equity method investments, guarantors of registered securities, or entities that collateralize registered securities.

When the circumstances are particularly complex, registrants may wish to submit a prefiling letter to the Division to preclear the planned financial statement presentation and avoid surprises or potential delays during the SEC's review of their IPO filing. Registrants may wish to seek modifications to their financial reporting requirements when the application of a rule results in the requirement to provide more information than the registrant believes is necessary. For example, a registrant may submit a prefiling letter in accordance with SEC Regulation S-X, Rule 3-13, referred to as a Rule 3-13 waiver, in which it requests to omit the financial statements for a significant acquired business or equity method investment.

Some of the more significant considerations in the determination of the financial statements include, but are not limited to, issues related to the following:

- Registrant determination.
- Recently organized registrant (e.g., shell company such as a SPAC) financial statements, which could include predecessor financial statements or carve-out financial statements.
- Financial statement periods, including interim financial statements and age of financial statements.
- Omission of certain financial information.
- Waiver and other requests.
- Businesses acquired or to be acquired.
- Equity method investees.
- Guarantors and issuers of guaranteed securities registered or being registered.
- Securities that collateralize registered securities.

For more information about (1) identifying the required financial statements for the registration statement, (2) financial statement preparation and disclosure requirements, and (3) other registration statement reporting (including MD&A and pro forma financial information), see [Chapters 2, 3, and 4](#), respectively, of Deloitte's Roadmap *Initial Public Offerings*.

5.10.5 Accounting Matters

This section highlights common accounting issues addressed in preparing financial statements for inclusion in an IPO registration statement. While some of the guidance may be directly applicable, some of it may be applied to IPO registration statements by analogy, may be complex, and may require significant judgment. Understanding the structure and substance of the transactions to effect the IPO is critical to making sound and reasonable judgments. During its comment process, the SEC staff will frequently ask management to explain the basis for those judgments, alternatives considered, and why the information provided to the user is representationally faithful. For additional observations related to frequently issued SEC staff comments, see Deloitte's Roadmap *SEC Comment Letter Considerations, Including Industry Insights*.

Some common accounting issues that arise in preparing IPO financial statements include, but are not limited to, the following:

- Carve-out considerations (see [Section 5.2.1](#) of Deloitte's Roadmap *Initial Public Offerings* and Deloitte's Roadmap *Carve-Out Financial Statements*).
- Spin-off transactions (see [Section 5.2.2](#) of Deloitte's Roadmap *Initial Public Offerings* and [Section 1.2.3](#) of Deloitte's Roadmap *Carve-Out Financial Statements*).
- Reorganization in anticipation of an IPO (see [Section 5.2.3](#) of Deloitte's Roadmap *Initial Public Offerings* and [Appendix B](#) of Deloitte's Roadmap *Business Combinations*).
- Related-party transactions (see [Section 5.3](#) of Deloitte's Roadmap *Initial Public Offerings*).
- Business combinations (see [Section 5.4](#) of Deloitte's Roadmap *Initial Public Offerings* and Deloitte's Roadmaps *Business Combinations* and *SEC Reporting Considerations for Business Acquisitions*).
- Valuation of financial instruments (see [Section 5.5](#) of Deloitte's Roadmap *Initial Public Offerings* and Deloitte's Roadmap *Fair Value Measurements and Disclosures (Including the Fair Value Option)*).
- Liabilities, equity, and temporary equity (see [Section 5.6](#) of Deloitte's Roadmap *Initial Public Offerings* and Deloitte's Roadmaps *Issuer's Accounting for Debt* and *Distinguishing Liabilities From Equity*).
- Offering costs (see [Section 5.7](#) of Deloitte's Roadmap *Initial Public Offerings* and Deloitte's Roadmaps *Issuer's Accounting for Debt* and *Distinguishing Liabilities From Equity*).
- Share-based compensation (see [Section 5.8](#) of Deloitte's Roadmap *Initial Public Offerings* and Deloitte's Roadmap *Share-Based Payment Awards*).
- Income taxes (see [Section 5.9](#) of Deloitte's Roadmap *Initial Public Offerings* and Deloitte's Roadmap *Income Taxes*).
- Earnings per share (see [Section 5.10](#) of Deloitte's Roadmap *Initial Public Offerings* and Deloitte's Roadmap *Earnings per Share*).
- Segments (see [Section 5.11](#) of Deloitte's Roadmap *Initial Public Offerings* and Deloitte's Roadmap *Segment Reporting*).
- Disaggregation of income statement expenses (see [Section 5.12](#) of Deloitte's Roadmap *Initial Public Offerings*).
- Subsequent events (see [Section 5.13](#) of Deloitte's Roadmap *Initial Public Offerings*).
- Unwinding private-entity accounting elections and practical expedients (see [Section 3.4](#) of Deloitte's Roadmap *Initial Public Offerings*).

5.10.6 Audit Considerations

After the financial statement requirements have been identified for a registration statement, the next step for the registrant's audit committee¹⁴ is to engage auditors to complete the necessary audits and reviews of the financial statements, as applicable. The SEC indicates on its [Web site](#) that the Securities Act, which governs registration statements, has two fundamental goals: (1) to "require that investors receive financial and other significant information concerning securities being offered for public sale" and (2) to "prohibit deceit, misrepresentations, and other fraud in the sale of securities." In accordance

¹⁴ If the entity has not yet formed an audit committee, other governing bodies the entity has charged with governance, such as a board of directors or owners, may fulfill this role before the entity becomes a public entity.

with these objectives, the Securities Act requires that an independent registered public accounting firm audit annual financial statements and read certain other financial information included in the registration statement. In addition, interim financial statements included in the registration statement may be subject to a review under PCAOB standards. In some instances, stub-period financial statements may also need to be audited.

Audited financial statements to be included in the IPO registration statement often will be subject to additional audit procedures because the standards governing audits of public entities are different from those for private entities. Specifically, the financial statement audits performed for a private entity and its independent auditor are subject to the auditing standards issued by the AICPA Auditing Standards Board; however, audits of financial statements included in a registration statement filed with the SEC need to be performed in accordance with PCAOB standards. Although the auditor may have previously expressed an opinion on the annual financial statements in accordance with AICPA auditing standards (i.e., auditing standards generally accepted in the United States, or “U.S. GAAS”), the auditor will need to issue an auditor’s report on the required annual financial statements in accordance with PCAOB standards for inclusion in the registration statement, or in accordance with both U.S. GAAS and PCAOB standards when the entity is submitting its draft registration statement confidentially. Auditors would also issue a report under two sets of standards (i.e., perform an audit in accordance with both U.S. GAAS and PCAOB standards, commonly referred to as a dual-standard report) in other scenarios, such as when a Form 10 is being filed (e.g., when currently outstanding equity securities are registered). To issue this auditor’s report, the auditor must be registered with the PCAOB and comply with all relevant PCAOB requirements.

Common audit issues that arise in preparing IPO financial statements include, but are not limited to, the following:

- Independence considerations.
- Restriction on the company’s employment of former audit personnel.
- Legal protective clauses in engagement letters.
- Rotation of audit partners.
- Changes in auditors.
- Completing audits and reviews.
- Consents.
- Comfort letters.
- ICFR.
- CAMs.

For more information about audit considerations, see [Chapter 6](#) of Deloitte’s Roadmap *Initial Public Offerings*.

5.11 Statement of Cash Flows

5.11.1 Introduction

While the accounting principles underlying the statement of cash flows have been in place for many years, challenges in interpretation and preparation have consistently made the statement of cash flows one of the leading causes of restatements and comments from the SEC staff for technology entities. The sections below highlight issues commonly encountered by technology entities that are associated with the classification of cash flows as operating, investing, or financing. For more information as well as insights into topics not addressed below, see Deloitte's Roadmap [Statement of Cash Flows](#).

5.11.2 Foreign Currency Cash Flows

The global nature of technology entities often gives rise to transactions that are denominated in a foreign currency and to businesses that operate in foreign functional currency environments. For example, many technology entities operate in more than one currency environment and therefore must translate the financial results of their operations into a single currency (referred to as the reporting currency).

For additional considerations related to the cash flow effect of transactions denominated in a foreign currency, see [Section 7.1](#) of Deloitte's Roadmap [Statement of Cash Flows](#).

5.11.3 Transactions Associated With Acquisitions

The technology industry continues to experience significant M&A activity, and transactions associated with acquisitions affect a company's statement of cash flows in various ways, such as the following:

- *Presentation of acquisition-related costs* — Except for certain debt and equity issuance costs, ASC 805 requires an entity to expense all acquisition-related costs as incurred. The acquisition-related costs should be reflected as operating cash outflows.
- *Debt in a business combination* — The classification in the statement of cash flows of cash paid to settle the acquiree's debt should be consistent with the acquirer's treatment of the debt in acquisition accounting (i.e., whether the debt was treated as a liability assumed in acquisition accounting). For example, if the acquirer assumes the acquiree's debt as part of the transaction, the acquirer will generally present the extinguishment as a financing activity.
- *Contingent consideration in a business combination* — ASC 805 requires the acquirer to recognize the acquisition-date fair value of the contingent consideration arrangement as part of the consideration transferred in exchange for the acquiree. There are different cash flow treatments depending on the classification of the contingent consideration (i.e., liability, equity) and the timing of contingent consideration payments.
- *Settlement of acquired liabilities after a business combination* — After an acquisition, the acquirer may make payments to settle a liability legally assumed in a business combination. The cash outflow related to the settlement of the liability could be classified as an operating, investing, or financing activity depending on the nature of the payment. For example, if the payment was for PP&E purchased on account and was made within three months of the original purchase date, it would represent an investing cash outflow. The payment should be classified as it would have been in the absence of the business combination.

For additional considerations related to an entity's accounting for a business combination and the related cash flow impact, see [Section 7.5](#) of Deloitte's Roadmap [Statement of Cash Flows](#).

5.11.4 Stock Compensation

The complexity of stock compensation arrangements often leads to additional presentation issues related to a technology entity's statement of cash flows. Two of the more common issues encountered by technology entities are as follows:

- *Settlement of equity-classified share-based payment awards* — When settling an equity-classified share-based payment award, an entity presents the settlement in its statement of cash flows on the basis of whether the amount paid to settle the award is greater than or less than the fair-value-based measure of the award on the settlement date. If the cash paid to repurchase the equity-classified award does not exceed the fair-value-based measure of the award on the repurchase date, such cash is presented as a cash outflow for financing activities. If the cash paid to repurchase the equity-classified award exceeds the fair-value-based measure of the award on the repurchase date, the cash paid in excess of the fair-value-based measure of the award is presented as a cash outflow for operating activities.
- *Settlement of liability-classified share-based payment awards* — In accordance with ASC 718-30, the grant-date fair-value-based measure and any subsequent changes in the fair-value-based measure of a liability-classified award through the date of settlement are recognized as compensation cost. Accordingly, the cash paid to settle the liability-classified award is effectively payment for employee services and is presented as a cash outflow for operating activities under ASC 230-10-45-17(b).

If the agreement to repurchase (or offer to repurchase) is considered a settlement of an equity-classified award, the cash paid to reacquire the entity's equity instruments is presented in a manner consistent with the discussion in the first bullet point above. If the agreement to repurchase (or offer to repurchase) is considered a modification of the equity-classified award that changes the award's classification from equity to liability, the cash paid to settle the liability-classified award should be presented in the statement of cash flows in a manner similar to the conclusion above. That is, under ASC 230-10-45-17(b), the cash paid to settle the liability-classified award is effectively payment for employee services and is presented as a cash outflow for operating activities.

For more information about an entity's accounting for stock compensation and the related cash flow impact, see [Section 7.3](#) of Deloitte's Roadmap *Statement of Cash Flows*.

5.11.5 Advance Payments Received From Customers or Other Third Parties

When determining the classification of the cash flows associated with advance payments received from customers or other third parties, or similar arrangements, an entity should consider the predominant source of those cash flows given the absence of relevant guidance in ASC 230 that addresses the classification of those cash receipts and cash payments.

When an entity receives advance payments from a third party in an agency relationship, which must be refunded to that same party or another third party, the cash receipts in these situations are akin to borrowings rather than for the provision of goods or services. The changes in those advance payments generally should be classified as financing activities in a manner consistent with our understanding of the SEC staff's view that the holding of funds on behalf of others is analogous to proceeds received from borrowings. Under this view, an entity may conclude that, as with bank deposits, the predominant source of the related cash flows is the receipt of cash in a custodial or fiduciary capacity.

According to this view, the borrowings are considered outstanding until the custodial entity delivers the funds to satisfy its client obligations and such delivery is deemed a repayment of the borrowing. Therefore, the cash receipts should generally be presented as financing cash inflows, with the subsequent repayments classified as financing cash outflows.

Example 5-6

Company M is a payroll processor that receives funds from clients in advance before it remits those funds to the client's employees. The cash flows from the funds received from, and paid on behalf of, M's clients are reported as financing activities in the statement of cash flows.

We believe that an operating classification may also be acceptable. When a supplier receives up-front payments from a customer (i.e., the payment represents consideration for the goods or services that the supplier provides to the customer), the receipt of such advance payments should be presented as operating cash inflows in accordance with ASC 230-10-45-16(a). In addition, refunds of customer deposits represent operating cash outflows in accordance with ASC 230-10-45-17(f).

Entities that plan on presenting the cash flow activity from this type of arrangement within operating activities should consider consulting with their accounting and financial advisers. According to this view, an entity may conclude that the predominant source of the related cash flows is the receipt and disbursement of cash as part of the entity's ordinary revenue-generating activities and an integral part of providing its service offering.

For similar discussion about an entity's accounting for advance payments from customers or other third parties and the related cash flow impact, see [Section 6.2.4](#) of Deloitte's Roadmap *Statement of Cash Flows*.

5.11.6 Deferred Costs

ASC 230 does not explicitly address the presentation of deferred costs (i.e., incurred costs that are deferred on the balance sheet). However, when determining the appropriate presentation in the statement of cash flows, an entity should consider the underlying principle described in ASC 230-10-10-1, which states that the "primary objective of a statement of cash flows is to provide relevant information about the cash receipts and cash payments of an entity during a period." Accordingly, the cash flow presentation should generally be in line with the balance sheet treatment. For example, cash outflows related to current assets or inventory that are recognized as a period expense in an entity's income statement should generally be classified as an operating activity in the statement of cash flows.

Example 5-7

Company E is a provider of software services to the health care industry. Recently, E has developed new software to market to new and existing customers. In accordance with ASC 985-20, E capitalizes the costs of developing the new software and therefore classifies the software development costs as an investing activity in its statement of cash flows. The software development costs are costs of developing a productive asset for E.

In this example, the software development costs paid by E are similar to construction costs paid by a manufacturing company to construct a manufacturing facility. That is, E's payments of costs incurred to develop new software create an asset that is used to generate future revenue in a manner similar to how a manufacturing facility generates future revenue for a manufacturer. In both cases, the cash outflows for costs of generating future revenue are presented as investing activities in the statement of cash flows.

For more information about an entity's accounting for deferred costs and the related cash flow impact, see [Section 7.7](#) of Deloitte's Roadmap *Statement of Cash Flows*.

5.11.7 Cloud Computing Arrangements

In accordance with ASC 350-40-45-3, cash flows to implement a CCA that is a service contract and that meet the capitalization criteria in ASC 350-40 must be presented in an entity's statement of cash flows "in the same manner as the cash flows for the fees for the associated hosting arrangement."

Capitalized implementation costs related to a CCA that is a service contract differ from capitalized costs associated with developing or obtaining internal-use software. Internal-use software is, by its nature, a recognizable intangible asset; accordingly, any incurred and capitalized costs associated with developing or obtaining internal-use software form part of the acquired asset and would generally also be considered an intangible asset. Therefore, cash outflows should generally be classified as an investing activity in the statement of cash flows.

However, a CCA that is a service contract does not give rise to a recognizable intangible asset because it is an executory service contract. Consequently, any costs incurred to implement a CCA that is a service contract would not be capitalized as an intangible asset (since they do not form part of an intangible asset); rather, such costs would be characterized in a company's financial statements in the same manner as other service costs and assets related to service contracts (e.g., prepaid expense). That is, these costs would be capitalized as part of the service contract, and financial statement presentation of the cash flows, the resulting asset, and related amortization would be consistent with the ongoing periodic costs of the underlying CCA.

For more information, see [Section 7.12](#) of Deloitte's Roadmap *Statement of Cash Flows*.