JUNE 2014
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AN ALERT FROM THE BDO NATIONAL ASSURANCE PRACTICE

BDO FLASH REPORT
FASB

SUBJECT

ELIMINATION OF DEVELOPMENT STAGE ENTITY REQUIREMENTS

SUMMARY

Recently, the FASB issued ASU 2014-10[1] to eliminate the concept of a development stage entity (DSE) from U.S. GAAP. This change rescinds certain financial reporting requirements that have historically applied to DSEs and is intended to result in cost-savings for affected entities, such as certain start-up or research and development entities. The new standard also changes one related aspect of the variable interest entity (VIE) consolidation guidance in Topic 810. The ASU is available here.

SCOPE AND EFFECTIVE DATE:

The new standard provides separate transition guidance for the rescission of the DSE requirements and for the update to the consolidation guidance in Topic 810.

DSE requirements **—** For public business entities, the amendments are effective for annual reporting periods beginning after December 15, 2014 and interim periods therein. All other entities will apply the same effective date for annual periods, i.e., those periods that begin after December 15, 2014. However, the amendments are applicable to the interim periods of non-public business entities that begin after December 15, 2015. The rescission of the DSE reporting requirements applies retrospectively.

In addition, ASU 2014-10 introduces new disclosure requirements about the reporting entity's risks and uncertainties that apply based on the effective dates above. While the elimination of the DSE requirements applies retrospectively, the new disclosures are required prospectively.

Early adoption is permitted for financial statements that have not yet been issued or made available for issuance.

[1] *Elimination of Certain Financial Reporting Requirements, Including an Amendment to Variable Interest Entities Guidance in Topic 810, Consolidation*

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Consolidation update — Public business entities will apply the amendments to Topic 810 for annual reporting periods beginning after December 15, 2015 and interim periods therein. All other entities will apply them for annual reporting periods beginning after December 15, 2016 and interim reporting periods beginning after December 15, 2017.

The amendments apply retrospectively and generally incorporate the transition provisions of Statement 167.[2] That is, the impact on whether an entity is considered a VIE and who, if anyone, is the primary beneficiary is performed as of the date that the reporting entity first became involved with the potential VIE or the most recent reconsideration date. This could be many years in the past and the transition provisions address situations in which it may not be practicable to obtain the information that is necessary to perform the analysis at those dates.

Early adoption of the amendments to Topic 810 is permitted for financial statements that have not yet been issued or made available for issuance.

BACKGROUND AND MAIN PROVISIONS:

Prior to ASU 2014-10, a DSE was an entity that was devoting substantially all of its efforts to establishing a new business and for which its planned principal operations had not commenced, or if they had, there was no significant revenue being generated. As such, a DSE was required to provide certain inception-to-date information in the statements of income, cash flows, and shareholder equity. In addition, the financial statements were labeled as those of a DSE and certain specific footnote disclosures were required.

The new ASU eliminates all of those requirements. In reaching that conclusion, the FASB noted that technological advances have enabled users of the financial statements to obtain information about prior periods (e.g., through the EDGAR system), that such information is not relevant in many cases, and that it can be costly to provide. Specifically, the Board was aware that some entities remain in the development stage for many years, raise multiple rounds of financing through complex equity-linked transactions, and then incur significant audit costs with respect to that activity.

In lieu of those requirements, the ASU establishes a new disclosure requirement in Topic 275, which states "An entity that has not commenced principal operations shall provide disclosures about the risks and uncertainties related to the activities in which the entity is currently engaged and an understanding of what those activities are being directed toward."[3] An example of this disclosure is reproduced in the Appendix to this *Flash* Report.

With respect to consolidation, Topic 810 indicates an entity is a VIE if it lacks certain characteristics. One of those characteristics addresses whether the entity has a sufficient amount of equity at risk. DSEs previously made that assessment based on whether the amount of invested equity was sufficient to permit the entity to finance the activities that it was currently engaged in, and, the entity's governing documents allowed for additional equity investments. This assessment differed from that required of non-DSEs. It generally resulted in DSEs being able to conclude they were not VIEs with less equity than would otherwise be required.

The ASU eliminates the DSE exception in Topic 810.[4] Consequently, all entities will use the same benchmark to determine whether a sufficient amount of equity at risk exists. Directionally, this could increase the number of entities that are considered VIEs, although the impact in practice is not expected to be significant. But due to this concern, the FASB provided additional time in the effective dates for the amendments to Topic 810 for reporting entities to plan for the impact of the new consolidation requirements. As such, entities are encouraged to review their arrangements and contracts now to determine whether their consolidation conclusions will change upon adoption.

[2] *Amendments to FASB Interpretation No. 46(R)*

[3] Paragraph 275-10-50-2A

[4] The DSE guidance was previously contained in paragraph 810-10-15-16.

APPENDIX - DISCLOSURES OF RISKS AND UNCERTAINTIES FOR ENTITIES THAT HAVE NOT COMMENCED PRINCIPAL OPERATIONS[5]

This Example illustrates one way to comply with the disclosures required by [ASU 2014-10].

NewCompany, Inc. (the Company) is a business that has not commenced planned principal operations. The Company is designed to develop and manufacture specialized environmental test equipment for measuring air quality. The Company's first product is a rapid-result test kit to identify certain airborne contaminants in high-risk environments. The Company's activities since inception have consisted principally of acquiring technology patents, raising capital, and performing research and development activities. The following illustrates disclosure required by [ASU 2014-10] of the nature of activities for an entity that has not commenced principal operations.

> NewCompany, Inc. (the Company) is a business whose planned principal operations are the design, engineering, and manufacturing of air quality test equipment. The Company is currently conducting research and development activities to operationalize certain patented technology that the Company owns so it can manufacture rapid-result test kits for certain airborne contaminants in high-risk environments.
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> During the last year, the Company secured a research facility in Norwalk, Connecticut, which houses all of its employees and research and development activities. The Company also is in the process of raising additional equity capital to support the completion of its development activities to begin manufacturing the test kits as soon as possible.
>
> The Company's activities are subject to significant risks and uncertainties, including failing to secure additional funding to operationalize the Company's current technology before another company develops similar technology and test kits.

The disclosure [above] provides all of the following:

1. Information necessary for financial statement users not familiar with the activities of the Company to identify and consider the broad risks and uncertainties associated with businesses that have activities that are similar to those in which the Company is engaged. From the disclosures provided, financial statement users that have a general knowledge of business matters should be able to assess both of the following:
    a. That the Company's activities are subject to different and varied risks, including the risk that the entity may be affected by the rapidly changing and intensely competitive technology market
    b. That the Company is dependent on additional capital resources for the continuation and expansion of its business activities.
2. Information that facilitates the overall understanding of the financial information provided. That kind of disclosure could provide users with a basis for understanding the Company's financial information and comparing that information with similar entities or other relevant statistics.

[5] Reproduced from paragraphs 275-10-55-3A and 55-3B