Accounting Standards Review: May 2023

This report gives investors the scoop on what's happening at the Financial Accounting Standards Board (FASB), the International Accounting Standards Board (IASB), and how newly issued accounting standards updates (ASUs) affect fundamental research.

Each of the ASUs below will affect how companies report financial information, but none of them will impact our financial models. Details are below. Details on other recent ASUs and their impact on our models are here.

Learn more about the best fundamental research

ASU 2022-05 – Financial Services—Insurance (Topic 944)

This update aims to reduce implementation costs and complexity associated with the adoption of ASU 2018-12, Financial Services - Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts (LDTI).

Prior to this update, ASU 2018-12 required companies to communicate why previously recognized gains or losses have changed because of the adoption of a new accounting standard.

With this latest update, insurance entities may now elect to exclude contracts that meet certain criteria from applying the amendments in ASU 2018-12. To qualify for such accounting policy elections, the following conditions must be met:

1. Insurance contracts must have been derecognized because of a sale or disposal of individual or a crop of contracts or legal entities and
2. The entity must not have significant continuing involvement with derecognized contracts.

FASB believes that because derecognized long duration contracts have no effect on an insurance company's future cash flows, requiring reclassification under ASU 2018-12 would not have been useful to investors.

The amendments in this update are effective beginning December 15th, 2022. This update has no effect on an insurance company's cash flows and requires no changes to our models.

ASU 2023-01 – Leases (Topic 842)

This update addresses questions that remained following the adoption of ASU 2016-02 Leases (Topic 842). It specifically responds to private company stakeholders' concerns about applying Topic 842 to related-party arrangements between entities under common control.

The following two issues are addressed in this update:

1. Terms and Conditions to be Considered
   Previously, private entities had to determine the enforceable terms and conditions of a common control arrangement to apply Topic 842, which is often difficult and costly for these entities. The amendments in this update provide a practical expedient for private companies and not-for-profit entities to use written terms and conditions of a common control to determine the following:

   a. Whether a lease exists and, if so,
   b. The classification of and accounting for that lease.

   This expedient may be applied on an arrangement-by-arrangement basis. If no written terms and conditions exists, the entity is prohibited from applying the practical expedient and must evaluate enforceable terms and conditions to apply Topic 842. This ASU is expected to reduce costs associated with implementing and applying Topic 842.

Important Disclosure Information is contained on the last page of this report.
The recipient of this report is directed to read these disclosures.

2. Accounting for Leasehold Improvements
   Previously, private entities were required to amortize leasehold periods consistent with the shorter of remaining lease term and useful life of the improvements. Stakeholders noted that amortizing leasehold improvements associated with arrangements between entities under common control determined to be leases over a period shorter than the expected useful life of the leasehold improvements may lead to financial reporting that does not faithfully represent the economics of those leasehold improvements. This situation was most pertinent with common control leases with short lease terms. Multiple methods of accounting for these improvements also exist, which caused further reporting differences. The amendments in this update require leasehold improvements associated with common control leases to be:

   a. Amortized by the lessee over the useful life of the leasehold improvements as long as the lessee controls the use of the underlying asset.
   b. Accounted for as a transfer between entities under common control through an adjustment to equity if the lessee no longer controls the use of the underlying asset.

The amendments in this update are effective for fiscal years beginning after December 15, 2023 and require no changes to our models since we do not cover these types of entities.

ASU 2023-02 – Investments – Equity Method and Joint Ventures (Topic 323)

This update provides additional guidance regarding accounting for investments in qualified affordable housing projects. In ASU 2014-01, Investments—Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects, companies were given the option to apply the proportional amortization method to account for investments made primarily for the purpose of receiving income tax credits and other income tax benefits when certain requirements were met. ASU 2014-01 limited the proportional amortization method to investments in low-income housing tax credit (LIHTC) structure investments. Such limitations led to other equity investments in other tax credit structures to be typically accounted for using the equity method, which resulted in investment income, gains and losses, and tax credits being reported gross on the income statement.

ASU 2023-02 removes the prior limitation and allows companies to account for tax equity investments, regardless of the tax credit program from which the tax credits are received, using the proportional amortization method if conditions are met.

The amendments in this update are effective for fiscal years beginning after December 14, 2023 for public entities and require no changes to our model.

This article was originally published on May 17, 2023.

Disclosure: David Trainer, Kyle Guske II, Sam Moorhead, and Italo Mendonça receive no compensation to write about any specific stock, sector, style, or theme.

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1. Legacy fundamental datasets suffer from significant inaccuracies, omissions and biases.
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Best Fundamental Data in the World

Forthcoming in The Journal of Financial Economics, a top peer-reviewed journal, Core Earnings: New Data & Evidence proves our Robo-Analyst technology overcomes material shortcomings in legacy firms' data collection processes to provide superior fundamental data, earnings models, and research. More details.

Key quotes from the paper:

- "[New Constructs'] *Total Adjustments* differs significantly from the items identified and excluded from Compustat's adjusted earnings measures. For example… 50% to 70% of the variation in *Total Adjustments* is not explained by *S&P Global's (SPGI) Adjustments* individually." – pp. 14, 1st para.
- "A final source of differences [between New Constructs' and S&P Global's data] is due to data collection oversights…we identified cases where Compustat did not collect information relating to firms' income that is useful in assessing core earnings." – pp. 16, 2nd para.

Superior Models

A top accounting firm features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg's in Getting ROIC Right. See the Appendix for direct comparison details.

Key quotes from the paper:

- "…an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [as New Constructs does] can investors get an accurate calculation of ROIC." – pp. 8, 5th para.
- "The majority of the difference…comes from New Constructs' machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies." – pp. 4, 2nd para.

Superior Stock Ratings

Robo-Analysts' stock ratings outperform those from human analysts as shown in this paper from Indiana's Kelley School of Business. Bloomberg features the paper here.

Key quotes from the paper:

- "the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant." – pp. 6, 3rd para.
- "Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts." – pp. 20, 3rd para.

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