

AC Insights

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AC Insights provides audit committee members with a summary of financial reporting developments for public companies using US GAAP, how those developments might affect your company and things you may want to think about.

In this edition

In May, the IASB and FASB issued a new global accounting model for revenue recognition that will replace all existing guidance on revenue recognition. The new revenue guidance may result in significant changes for some companies. The FASB also made amendments to its standards to eliminate special requirements for development stage entities, to modify criteria for classifying components as discontinued operations, to change accounting and disclosures for certain repurchase agreements.

During the quarter, the SEC issued an order to amend some requirements of the Conflict Minerals Rule because of proceedings at the US Court of Appeals. SEC registrants are still required to provide Conflict Minerals Reports to the SEC. There were no other CSA or SEC regulatory developments during the quarter.

In auditing developments, CPAB has developed a Protocol for discussing their overall inspection findings as well as significant inspection findings for the audits of individual reporting issuers. The Protocol was designed to improve audit quality and provide for discussions between the auditor and the audit committee. In addition, CPAB released its 2013 report on its inspections of audit firms. Also, the PCAOB issued a new auditing standard on related parties and made amendments to existing standards to enhance auditor performance for significant unusual transactions and relationships and transactions with executive officers.

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FASB developments

One global revenue model

The IASB and FASB have issued their new standards on revenue recognition. Both IFRS 15: *Revenue from Contracts with Customers* and FASB ASU 2014-09: *Revenue from Contracts with Customers* will be the single source for accounting for revenue for all companies in all industries. The new standards replace all current guidance on revenue recognition in ASC Topic 605: *Revenue recognition* as well as industry specific guidance in the ASC Industry Topics. The new guidance will be included in ASC Topic 606: *Revenue from Contracts with Customers*.

While the standard setters have tried to preserve many of the existing principles and practices commonly used in revenue recognition, it is expected that **virtually all companies will see some level of change**. Current US GAAP was initially limited to the general guidance in the Conceptual Framework and augmented by guidance issued by the SEC through their staff accounting bulletins. Numerous industry and transaction specific guidance was developed over time to address narrow issues or transactions without a common revenue recognition framework. The new standard is a largely principles based framework for addressing revenue recognition issues comprehensively across all transactions, entities and industries. **Specific and detailed guidance continues to be provided to address the principle changes to and certain common issues encountered in revenue recognition**. There will be more judgment calls, different business processes and controls, and expanded disclosures. The implementation of the new standard may affect your company's key performance indicators and metrics, cash taxes, payments under compensation plans, compliance

with financing and other agreements, and how you do business.

It is expected that implementation issues will evolve as companies begin to think about the implications of the new standards on their industry and business. Implementation resource groups have been established by the IFRS, FASB and other accounting and auditing bodies. These groups as well as others will be providing implementation guidance and that guidance may influence initial views on what the standards mean.

What has changed?

Revenue will be recognized when control of the promised goods or service is transferred to the customer, not simply on the passing of risks and rewards to the customer. The measurement of contract consideration and how it is allocated to multiple elements of a contract will also change for many companies.

Disclosures about revenues have been increased significantly and will be required in both annual and interim financial statements. Even entities with minimal changes to their revenue accounting policies will need to develop procedures to gather the data necessary to make the disclosures.

The new standard will apply to all revenue contracts with customers except for lease contracts, insurance contracts, financial instruments, most guarantees, investments in other entities and certain non-monetary exchanges.

The new model for revenue recognition includes a five-step approach. The five steps may appear simple, but significant judgment will be needed in applying the underlying principles.

Step 1: Identify contract(s) with customer



Step 1 sets the contract boundary. Sellers must assess whether the contract is enforceable including whether the customer will pay the expected consideration. Similar to current US GAAP, two or more legal contracts are combined if, in substance, they are one arrangement. Detailed guidance is also provided on the accounting for contract modifications for all contracts, **not just construction contracts**.

Step 2: Identify the performance obligations in the contract



Step 2 focuses on identifying the elements within an arrangement, which are referred to as performance obligations. Performance obligations are to be accounted for separately if they are distinct functionally and distinct based on the substance of the contract.

Step 3: Determine the transaction price



The transaction price is the amount of consideration that the seller expects to be entitled to for the promised goods or services in the contract. The amount may be fixed or vary because of discounts, rebates, refunds, sales incentives, performance bonuses, penalties, contingencies or similar items. Variable consideration must be estimated and included in the transaction price if it is highly probable that the amount recognized will not result in a significant reversal of revenue in subsequent periods. Deferred or advance payments are required to be discounted unless the receipt of cash and the performance occur within 12 months of each other.

Step 4: Allocate the transaction price to the performance obligations



The transaction price is allocated to the separate performance obligations identified using a relative stand-alone selling price basis. The stand-alone selling price of a good or service is the price when the good or service is sold separately to a customer in similar circumstances and to similar types of customers. If a stand-alone selling price is not available, it may be estimated. In very limited circumstances, a residual approach may be used. The standard also permits allocation of discounts and variable consideration to some of the performance obligations if certain criteria are met.

Step 5: Recognize revenue when the performance obligation is satisfied



Revenue is recognized when the control of the goods or services is transferred to the customer. This may be over time or at a point in time. Examples of contracts that would be recognized over time include service type arrangements, contracts to develop or enhance assets that are controlled by the customer, or the development or production of items for a specific customer which cannot be redirected to other customers and for which the customer is obliged to pay for work completed. When revenue is recognized over time, the seller would recognize revenue by measuring the progress to completion using input or output methods. Contracts not meeting the criteria for revenue recognition over time are recognized at a point in time. Specific guidance has been provided for determining whether license revenue should be recognized over time or at a point in time.

The new standard also includes specific guidance on contract costs. Contract costs include incremental costs to obtain a contract and costs incurred to fulfil future performance obligations. These two types of costs must be accounted for separately. Recoverable incremental costs to obtain a contract are to be capitalized and amortized on a systematic basis consistent with the pattern of revenue recognition. Non-incremental costs such as salaries and benefits of sales persons cannot be capitalized. An exception is provided permitting costs to be expensed immediately if they would be amortized in one year or less.

Costs to fulfil a contract, such as design and preproduction costs, are capitalized if the costs relate to a contract or an anticipated contract that can be specifically identified, the assets will be used to satisfy performance obligations in the future, and the costs are recoverable. The capitalized fulfilment costs are amortized and subject to impairment assessments.

The FASB also made changes to the accounting for the disposal of property, plant, equipment, intangible assets and investment properties. The measurement and timing of recognition of a disposal of these assets will be based on the revenue guidance.

When is the standard effective?

For public entities, the new standard will be applicable for years beginning after December 15, 2016. Early adoption is not permitted.

For non-public entities, the new standard will be applicable for years beginning after December 15, 2017 and interim periods within annual periods beginning after December 15, 2018. Early adoption is permitted for years beginning after December 15, 2016.

The standard may be applied using a full retrospective method (with prior periods restated) or a modified retrospective basis (applied to open contracts as of beginning of the year of adoption with no restatement

of prior periods). If the modified retrospective method is selected, comparative disclosures are required for the current year as if the prior revenue policies continued to be applied.

What should you do now?

Management will want to know what the standard means to their business and what changes will need to be made. Further, implementation guidance will evolve as the various resource groups consider the implications of the standard. Management will have to keep informed about these developments.

Management will need to perform a comprehensive review of existing contracts, business models, company practices, accounting policies, information technology systems, and internal processes and controls to assess the extent of changes needed as a result of the new standard. While all companies are expected to be affected to some degree, the impact of the new standard will differ depending on the industry.

Management will also have to consider the transition provisions. Revenue is often a key figure for trend analysis and how the implications of the standard will be communicated to stakeholders. Until management understands the significance of the change to their revenue reporting, they may want to keep their options open.

PwC is ready to assist companies in preparing for the revenue changes. We can assist with project management and communication, a diagnostic survey of focus areas for the new standard, facilitate the assessment of key revenue streams and contracts to understand the qualitative and quantitative impact, and assist with pro-forma modelling to understand the key changes and facilitate communication with stakeholders. If you are interested in more information about our services, your engagement team will be pleased to discuss our services with you.

Is there more information?

For more information on the details of the new standard, please ask your engagement team for *In depth: Revenue standard is final—A comprehensive look at the new model*. This analysis is supplemented with various industry guides.

Development stage entities nixed

In June, the FASB issued ASU 2014-10: *Development Stage Entities (Topic 915) - Elimination of Certain Financial Reporting Requirements, Including an Amendment of Variable Interest Entities Guidance in Topic 810, Consolidation*. Development stage entities currently provide additional information about their financial performance and cash flows since inception, equity financings since inception, disclosures about development activities, as well as certain labelling requirements. The utility of this information was not considered relevant by many investors.

What is changing?

The Update eliminates the definition of development stage entity and all the incremental reporting requirements that were imposed on a development stage entity.

The Update also eliminates the exception in Topic 810 provided to development stage entities for determining whether such an entity is a variable interest entity based on the amount of investment equity at risk. Entities will now have to consider all the aspects of Topic 810 when considering entities with development stage activities.

When are the amendments effective?

The amendments related to disclosures about development stage entities will be effective for years beginning after December 15, 2014, on a retrospective basis. Non-public entities only have to apply the amendments to interim periods for years beginning after December 15, 2015.

The elimination of the VIE exception will be applicable to public entities for years beginning after December 15, 2015 and for non-public entities for years beginning after December 15, 2016 (and interim periods after December 15, 2017).

The amendment may be adopted early for annual or interim periods for which the entity's financial statements have not yet issued or made available for issue.

Scope of discontinued operations narrowed

Amendments were made to ASC Topic 205: *Presentation of Financial Statements* and Topic 360: *Property, plant and equipment* in April 2014 when the FASB issued ASU 2014-08: *Reporting Discontinued Operations and Disclosures of Disposals of Components of Entities*. Concerns of too many disposals of small groups of assets that reflected the evolution of the business has resulted in a change in the criteria for classifying an operation as a discontinued operation. These amendments also align the classification of discontinued operations with IFRS.

What has changed?

The Update requires a component of an entity that has been classified as held for sale or disposed of to be reported as a discontinued operation if it represents a strategic shift that has or will have a major effect on an entity's operations and financial results. A discontinued operation would include a component of an entity or a group of components of an entity, or a business (component). A disposal can be by sale, abandonment, or distribution to owners. A major shift in strategy may be a disposal of a major geographical area, a major line of business, a major equity investment, or other major parts of the entity.

Additional disclosures will be required about discontinued operations. In addition, disclosures will be required about disposals of individually significant components of an entity that are not discontinued operations.

When will the amendments be effective

The amendments will be effective for all disposals and classification of assets held for sale made within annual periods beginning on or after December 15, 2014. For non-public entities, the guidance only applies to interim financial statements for interim periods within annual periods beginning on or after December 15, 2015. No changes are made to components previously classified as discontinued operations under current GAAP. Early adoption is permitted.

Some changes for repos

New guidance on repurchase agreements and similar transactions has finally been issued by the FASB through ASU 2014-11: *Transfers and Servicing (Topic 860) – Repurchase-to-Maturity Transactions, Repurchase*

Agreements and Similar Transactions. The new standard amends the accounting guidance for “repo-to-maturity” transactions and repurchase agreements executed as repurchase financings. The amendments resulted from concerns about inconsistency in treatment of repo arrangements.

What has changed?

Repo-to-maturity transactions will be reported as secured borrowings. Under current accounting rules, these transactions may qualify for sale accounting if certain conditions are met.

Transferors will no longer apply the current “linked” accounting model to repurchase agreements executed contemporaneously with the initial transfer of the underlying financial asset with the same counterparty. Under the new standard, the accounting for each transaction instead will be evaluated on a standalone basis. This is expected to result in many of these repurchase agreements being reported as secured borrowings.

For repurchase agreements and securities lending agreements accounted for as secured borrowings as of a reporting date, the new standard requires obligors (transferors of collateral) to provide new disclosures. The new standard also requires additional disclosures by transferors for transactions that involve a transfer of a financial asset reported as a sale and accompanied by an agreement that results in the transferor retaining substantially all of the exposure to the economic returns of the transferred asset during the transaction's term.

When are the amendments effective?

With one exception, public entities are required to apply the accounting changes and comply with the enhanced disclosure requirements for the first interim or annual reporting period beginning after December 15, 2014. However, for repurchase and securities lending transactions reported as secured borrowings, the new standard's enhanced disclosures are effective for annual periods beginning after December 15, 2014 and interim periods beginning after March 15, 2015. A public entity may not early adopt the standard's provisions.

For all other entities, both the accounting and disclosure provisions are effective for annual periods beginning after December 15, 2014 and for interim periods beginning after December 15, 2015. These entities may elect to early adopt the new accounting standards for interim periods beginning after December 15, 2014.

SEC developments

Partial stay of Conflict Minerals Rule

In May 2014, the SEC issued an order staying the effective date for compliance of portions of the Conflict Minerals Rule on the basis that the US Court of Appeals for the District of Columbia concluded that certain statements required in the Report would violate the First Amendment. The statements that were at issue were those in reports to the SEC and on a registrant's websites that any of the registrant's products have "not be found to be 'DRC conflict free'". Companies are still required to file their Conflict Minerals Report, but will not have to identify any products as "DRC conflict undeterminable" or "not found to be 'DRC conflict free'". Rather the companies will have to report the products, the facilities used to produce the conflict minerals, the country of origin of the minerals and the efforts to determine the mine or location of origin.

On April 7, the SEC staff also updated their publication on *Frequently Asked Questions: Conflict Minerals*.

Auditing developments

Communicating CPAB inspection findings to audit committees

In March 2014, the Canadian Public Accountability Board (CPAB) issued the Protocol for audit firm communication of CPAB inspection findings. The Protocol was developed with the objective of having a positive impact on audit quality by enhancing the audit committee's ability to evaluate the quality and effectiveness of the audit. The Protocol is in response to the 2013 report on *Enhancing Audit Quality: Canadian Perspectives – The Role of the Audit Committee in External Audit Oversight* issued by The Role of the Audit Committee Working Group.

What has changed?

Audit firms will be required to provide audit committees of their reporting issuer clients with:

- CPAB's *Annual Public Report*, which outlines CPAB's common findings for the inspection of all firms for a given year. The Report also includes CPAB's recommendations to improve audit quality.
- Communications about the specific inspection of the audit file related to the reporting issuer. The communications would:
 - Describe the focus areas of the CPAB inspection.
 - Indicate whether or not there were any significant inspection findings. A significant inspection finding is "a significant deficiency in the application of generally accepted auditing standards related to a material financial balance or transaction stream when the audit firm must perform additional audit work in the current year to support the audit opinion and/or is required to make significant changes to its audit approach."
 - Disclose the significant findings, if any, as written by CPAB, the audit firm's response, actions taken by the firm in response to the findings and CPAB's disposition. The findings are expected to be communicated on a timely basis, shortly after the findings are finalized by CPAB.

This information will be confidential and audit committee members should ensure it remains confidential.

Audit committees are expected to discuss any significant finding with the audit firm to understand: the nature and cause of the significant finding; the additional work performed by the audit firm to address the finding and related results of that work; the impact, if any, on the previously issued or future financial statements of the reporting issuer; and any changes the auditor will make to its audit approach to address the finding.

The Protocol is voluntary. PwC has agreed to participate in the Protocol.

When is the Protocol effective?

The Protocol is effective for CPAB audit inspections commencing on or after March 1, 2014.

CPAB looks for sustainable improvement

In March 2014, CPAB issued its *Report on 2013 Inspections of the Quality of Audit in Canada – Ten Years of Progress*. The key insights resulting from the 2013 Report are:

- The trend in audit quality is positive and audit firms in Canada are taking the challenge to improve audit quality seriously. CPAB encourages audit committees to discuss with their audit firm how their audits will continue to be of the highest quality.
- The challenges and/or risks of operating in foreign jurisdictions also affect the audit. Management, the audit committee and other professional advisors need to understand these risks and mitigate them effectively.
- Changes to businesses including acquisitions of new businesses or entering into ventures often increases risk. Audit committees need to understand how the business and audit risks are addressed.
- CPAB encourages audit committees to have open dialogue with their auditors about how their audit firm has responded to the systemic findings in the CPAB Report.

The common inspection findings for the Big Four firms focused on the experience and scepticism of the auditors. The key findings were as follows:

- Firms need to enhance the professional scepticism of their staff. CPAB believes:
 - Senior members of the audit engagement team should be rotated frequently to avoid complacency or the threat of familiarity.
 - Senior engagement team members should be visible to both the client and the engagement staff, complete reviews of all significant areas of the audit file at the client site, engage staff in discussions about audit risk and quality and challenge their judgments, and never accept substandard work.
 - Engagement teams should be more challenging in their audit approach.
 - Training about exercising professional scepticism should be enhanced.
- Senior members of the engagement team, including the second partner, should be involved in the process of auditing estimates, in particular impairment of assets and going concern evaluations.
- Audit firms should critically evaluate how they approach an internal control audit and ensure engagement teams are appropriately trained to identify key controls and testing those controls.

A copy of the 2013 Report can be found at www.cpab-ccrc.ca or you can request a copy from your engagement team.

PCAOB amends certain standards

On June 10, 2014 the Public Company Accounting Oversight Board (PCAOB) adopted Auditing Standard No. 18: *Related Parties*, which is intended to strengthen auditor performance requirements for identifying, assessing and responding to the risks of material misstatement associated with a company's relationships and transactions with its related parties. The PCAOB also adopted amendments to certain PCAOB auditing standards that address the auditor's responsibilities with respect to a company's significant unusual transactions and a company's financial relationships and transactions with its executive officers.

The Board determined the existing standards in these areas do not contain sufficient required procedures and are not sufficiently risk-based, which can lead to inadequate auditor effort. Additionally, the Board's inspection and enforcement activities indicate that there are continuing weaknesses in auditors' scrutiny in these areas.

What has changed?

The related parties' standard is designed to strengthen the auditor's performance requirements by setting forth specific procedures for the auditor's evaluation of a company's identification of, accounting for and disclosure of relationships and transactions between the company and its related parties. The auditor is also required to communicate to the audit committee the auditor's evaluation and other significant matters arising from the audit regarding the company's relationships and transactions with related parties.

The amendments regarding significant unusual transactions were made to strengthen the auditor's performance requirements for the identification and evaluation of these transactions, including obtaining an understanding of their business purpose (or lack thereof) and whether significant unusual transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

Other amendments require the auditor to perform specific procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers, including compensation. The amendments do not require the auditor to make any determination regarding the reasonableness of compensation arrangements or recommendations regarding compensation arrangements.

When are the changes effective?

The standard and amendments, if approved by the SEC, will be applicable to all audits performed using the PCAOB standards for audits of financial statements for fiscal years beginning on or after December 15, 2014, including reviews of interim financial statements within those years.

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