Views on, analysis of and news about US GAAP and SEC reporting
A Canadian perspective

US GAAP Today

Winter 2014

Issue 2014-1

Another quiet quarter

During the Fall of 2013, the FASB's efforts have been directed toward completing the revenue project. A final standard is in the wings for early 2014. The other main developments during the quarter were to define "public business enterprise" and ratify some EITF consensuses. In this edition, we provide updates on the various projects of the FASB, EITF and PCC.

The SEC staff participated in the annual conference on financial reporting for SEC registrants and we outline some of the highlights of the conference in US GAAP Today.

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Common abbreviations

ASC	Accounting Standards Codification
ASU	Accountings Standards Update
COSO	The Committee of Sponsoring Organizations of the Treadway Commission
ED	Exposure Draft or Proposed Accounting Standards Update
EITF	Emerging Issues Task Force of the Financial Accounting Standards Board
FAF	Financial Accounting Foundation
FASAC	Financial Accounting Standards Advisory Committee
FASB	The Financial Accounting Standards Board
FinREC	The Financial Reporting Executive Committee of the American Institute of Certified Public Accountants
IASB	The International Accounting Standards Board
IFRS	International Financial Reporting Standards
PCC	Private Company Council
SEC	Securities and Exchange Commission

In this issue

News

News on ASUs issued

The FASB only issued one Accounting Standards Update during the final quarter of 2013. The Emerging Issues Task Force finalized consensuses on five issues which were ratified by the FASB in December 2013, of which two were formally issued in January 2014. Both the FASB ASU and the EITF consensuses are amendments or clarification of existing standards.

Setting the stage for private enterprise GAAP

ASU 2013-12: Definition of a public business entity

The FASB and the PCC have been working on a decision-making framework for evaluating financial accounting and reporting for private enterprises. The purpose of ASU 2013-12 is to define which companies would be within the scope of the PCC Framework. The FASB addressed the issue by including in the Master Glossary a definition of public business entity. These entities would be excluded from the PCC Framework.

The ASU introduces a single definition of public business entity which will be used in the future for setting FASB standards. The amendment does not affect any existing standards which will continue to rely on existing scope guidance.

The definition of public business entity is based on previous definitions of a public entity. That definition has been expanded to now include entities required to file or furnish financial statements with the SEC as well as entities that voluntarily file or furnish financial statements with the SEC. Public business entities will also include an entity that has securities not subject to contractual transfer restrictions and is required to prepare US GAAP financial statements and make them publicly available on a periodic basis.

Not for profit entities and employee benefit plans are excluded from the definition of public business entity.

There is no effective date for the ASU; however, the term 'public business entity' is already being used in new ASUs being issued by the FASB.

Eliminating the difference in fair values

EITF Issue 12-G: Measuring the Financial Assets and Financial Liabilities of a Consolidated Collateralized Financing Entity

In December 2013, the FASB ratified the EITF's consensus on Issue 12-G. An ASU should be issued in early 2014. Collateralized financing entities (CFEs) qualify as variable interest entities and certain CFEs are required to be consolidated under the VIE guidance. The financial assets and liabilities of the CFE may be measured at fair value as required by US GAAP or as elected by the reporting entity.

In some instances, the aggregate measurement of the fair value of the assets differed from the aggregate measurement of the fair value of the CFE's beneficial interests (liabilities); even though there were no material equity interests and the beneficial interests only had recourse to the assets of the CFE. The EITF reached a consensus to require the financial assets and financial liabilities of a consolidated CFE to be measured on the basis of either the fair value of the CFE's financial assets or financial liabilities, whichever is more observable.

The guidance is to be applied on a modified retrospective basis. For public entities, the effective date will be fiscal years, and interim periods within those years, beginning after December 15, 2014. For non-public entities, the effective date will be fiscal years beginning after December 15, 2015, and interim periods thereafter. Early adoption will be permitted.

Service concessions not leases

ASU 2014-05: Service concession arrangements

In November, the EITF reached a final consensus on accounting for certain service concessions and the FASB ratified this consensus in December 2013. An ASU was issued in early 2014.

Service concession arrangements involve contracts under which a public sector entity (grantor) grants a private entity (operator) the right to operate and/or maintain the grantor's infrastructure assets (e.g., airports, toll roads, prisons, and hospitals).

IFRS has an interpretation which outlines the accounting for service concessions. The consensus developed by the EITF does not provide explicit guidance for the accounting for service concessions, but does prohibit service concession to be accounted for as leases. Further, the assets of the service concession cannot be recognized or presented as property, plant and equipment of the operating entity.

Entities will be required to apply the guidance to arrangements that exist on the date of adoption on a modified retrospective basis. The effective date for public entities will be fiscal years, and interim periods within those years, beginning after December 15, 2014. The effective date for non-public entities will be fiscal years beginning after December 15, 2014, and interim periods thereafter. Early adoption will be permitted.

Timing of foreclosure/ repossession clarified

ASU 2014-04: Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure

This consensus was developed to provide guidance on the timing of classifying repossessed or foreclosed residential properties as other real estate owned (OREO) by banks or similar lenders (creditors). Current US GAAP requires a loan to be reclassified to OREO upon a troubled debt restructuring that is "in substance a repossession or foreclosure", where the creditor receives "physical possession" of the debtor's assets regardless of whether formal foreclosure proceedings take place.

The consensus will require a creditor to reclassify a collateralized consumer mortgage loan to OREO upon obtaining legal title to the real estate collateral, or the borrower voluntarily conveying all interest in the real estate property to the lender to satisfy the loan through a deed in lieu of foreclosure or similar legal agreement.

Entities will have an option to apply the guidance on either a modified retrospective or prospective basis. For public entities, the effective date will be fiscal years, and interim periods within those years, beginning after December 15, 2014. For non-public entities, the effective date will be fiscal years beginning after December 15, 2014, and interim periods thereafter. Early adoption will be permitted.

The EITF also considered the classification of government insured residential mortgage loans on foreclosure. An exposure draft of a consensus has been issued.

Other issues

ASU 2014-01: Accounting for Investments in Qualified Affordable Housing Projects

This issue deals with the accounting for Low Income Housing Tax Credit (LIHTC) investments. A final ASU is expected to be issued in 2014. The FASB has asked its staff to consider whether further guidance should be developed for accounting for other investment tax credits.

News on joint projects with IASB

Revenue

Proposed ASU issued: November 2011
Comments were due: March 2012

The FASB and IASB are wrapping up the revenue project and expect to issue a final revenue standard during the first quarter of 2014. The FASB staff is drafting a final ASU for a written ballot vote by the Board. The purpose of the project was to clarify the principles for recognizing revenue and to develop a common revenue standard for US GAAP and IFRSs.

During the last three months of 2013, the two Boards considered three interrelated issues that continue to be of concern to various parties – the constraint on revenue recognition for variable consideration, classification of licenses and collectability of revenue.

Variable consideration

Consideration may be variable if adjustments can be made to the transaction price for discounts, rebates, price concessions, refunds, credits, incentives, performance bonuses, royalties or other items. Contingency based fees would also be variable consideration. The two Boards had placed a constraint on the amount of variable consideration. Recent redeliberations introduced a confidence level to the constraint. The transaction price will now include an estimate of variable consideration to the extent it is probable (highly probable for IFRS) that a significant reversal will not occur. A significant reversal would occur if there is a significant downward adjustment on the amount of cumulative revenue recognized from the contract with the customer. Significant judgment will be required to assess whether there are circumstances that may cause a significant reversal of cumulative revenue.

Management will still be required to determine if a minimum amount or a portion of the variable consideration would not result in a significant reversal if included in the transaction price. Also, the amount of variable consideration included would have to be updated at each reporting date to reflect changes in circumstances.

These provisions will likely affect those companies that have deferred revenue under current guidance because the price was not fixed or determinable. Companies in the asset management, construction, pharmaceutical and life sciences and technology industries will likely be most affected by these changes.

The Boards also agreed to include an exception for licenses of intellectual property with a sales or usage based royalties. These amounts will be included in the transaction price only when the sale or usage occurs. This exception is only applicable to intellectual property licenses and will not apply to other arrangements with royalty revenue streams.

Licenses

The two Boards decided that licenses should be classified either as dynamic or static. Dynamic licenses provide customers with access to intellectual property as it exists at any point in time whereas static licenses provide access to the intellectual property that does not change after the license is provided to the customer. Revenue for dynamic licenses is recognized over time whereas revenue for static licenses is recognized when control has transferred to the customer and the license term has begun.

Specific criteria have been developed for classifying licenses as being dynamic. These criteria may be subject to significant interpretation upon implementation and will need careful assessment in determining the nature of the revenue stream. However, if the license fees are solely based on sales or usage royalties, the classification of the licenses will not be required as those revenues will be recognized only when the sale or usage occurs. These provisions are expected to be significant for entertainment and media, pharmaceutical and life sciences and technology companies.

Collectibility

The Boards agreed to introduce a collectability threshold as a gate to the first step of the revenue recognition model. The revenue model can only be applied if it is probable that the entity will collect the consideration to which it is ultimately entitled. This will have to be assessed at the inception of the contract and would only consider customer credit risk. Other uncertainties such as performance or measurement risk are not considered. The use of probable will mean there are different thresholds for US GAAP and IFRS. Under US GAAP, probable reflects a 75% to 80% probability whereas IFRS reflects a greater than 50% probability. The Boards believe this difference is consistent with the existing guidance in the respective standards. Revenue on contracts not meeting the collectability threshold would not be recognized until the performance of the contract is complete and either all consideration is received and non-refundable or the contract is cancelled and amount received are non-refundable.

Classification and measurement of financial assets

Proposed ASU issued in February and April 2013
Comments were due: May 2013

The Board continued to discuss the proposals to revise classification and measurement guidance for financial assets. The joint Board discussions have been focused on clarifying the use of the business model.

The business models for classification

The Boards tentatively decided that the assessment of the business model should refer to the actual management of financial assets to generate cash flows and create value and whether the likely actual cash flows will result primarily from the collection of contractual cash flows, sales proceeds or both. The business model assessment should also allocate financial assets to a measurement attribute that will provide the most relevant and useful information about how activities and risks are managed to generate cash flows and create value. Further the assessment should be made at the same level as the financial assets are managed. Clarifications as to how the business model should be assessed were also developed.

The timing of any reclassifications has been harmonized with the FASB agreeing that any reclassifications of financial assets would be on the first day of the first reporting period following the change in the business model.

Clarifications were made to the application guidance for the hold-to-collect business model. These clarifications will re-enforce the cash flows realization concept, emphasize that infrequent and/or insignificant sales may not be inconsistent with the model, clarify that sales information should not be considered in isolation and clarify that credit risk management activities to minimize potential credit losses are integral to the model.

The two fair value measurement categories will be retained with a business model for fair value through other comprehensive income (FVOCI) and the fair value through profit or loss (FVPL) as a residual measurement category. Financial assets managed and evaluated on a fair value basis or held for trading would continue to be measured at FVPL.

The application guidance for the FVOCI measurement category has been clarified that the financial assets classified as FVOCI are managed to achieve the business model objectives, such as liquidity management, by collecting both contractual cash flows and to selling; and both the collection of contractual cash flows and realization of cash flow through sales are integral to the performance of the FVOCI business model.

Contractual cash flows

Separately, the FASB had tentatively decided to abandon the proposals for the contractual cash flow assessment, referred to as the solely payment of principal and interest model (SPPI) for the purposes of classifying financial statements. This conclusion was based on concerns over the complexity of the assessment. As a consequence, the Board decided to retain the current accounting requirements for the bifurcation of embedded derivatives in hybrid financial assets. Further analysis will be done to determine whether a contractual cash flow assessment should be developed for classifying the host contract.

News on FASB Projects

Reporting for development stage entities normalized

Development stage entities (Topic 915)
Proposed ASU issued: November 7, 2013
Comments were due: December 23, 2013

Development stages entities have had to provide significant additional historical information from the date of inception to the current year. The FASB is now modernizing the requirements by eliminating certain information which had limited relevance and was not used by investors. These provisions would reduce data collection and maintenance and audit costs. The FASB has not published a timetable for completion of this project.

The exposure draft proposes to eliminate:

- The definition of development stage entity.
- Presentation of inception-to-date information in the statement of income, cash flows and shareholders' equity.
- Labelling of financial statements as those of a development stage entity.
- Disclosures about the development stage activities of the entity and the change from development stage to operating.

In addition, the development stage conditions for considering whether an entity is a variable interest entity will be removed and all entities within the scope of the variable interests sections of the Consolidation topic would have to be assessed using the same qualitative and quantitative evaluations.

Transfers and servicing: Repurchase agreements and similar transactions

Transfers and servicing (Topic 860)
Proposed ASU issued: January 15, 2013
Comments were due: March 29, 2013

The FASB issued a proposed ASU to improve the current accounting and disclosure requirements for repurchase agreements and other transactions involving a transfer and a forward agreement to repurchase transferred assets at a fixed price from a transferee. The new guidance will also address application issues and marketplace changes.

In December, 2013, the FASB completed its redeliberations on the proposed ASU and a final ASU is being prepared for a written ballot. A final ASU is expected to be published during the first half of 2014.

During the quarter, the Board affirmed the disclosures about transfers of assets accounted for as a sale and the asset quality for transfers of assets subject to repurchase agreement or similar transactions that are accounted for as secured borrowings.

The changes are to be adopted using a cumulative catch-effect approach. The effective date will be for annual periods beginning on or after December 14, 2014 for public business entities and December 14, 2015 for all other companies. Public business entities will not be allowed to adopt the ASU early.

Narrowing discontinued operations

Presentation of financial statements (Topic 205)
Proposed ASU issued: April 2013
Comments were due: August 2013

In April 2013, the FASB issued an exposure draft to improve the definition and reporting of discontinued operations. The objective was to narrow the number of disposals of assets that qualified for reporting as discontinued operations and to converge with the IFRS requirements for discontinued operations.

During the quarter, the FASB finalized their redeliberations on proposed ASU for reporting discontinued operations. A final ASU is expected in the first quarter of 2014.

The ASU would apply to all of an entity's discontinued operation except for an entity's oil and gas properties accounted for using the full cost method.

The main change is to the definition of discontinued operations. While a discontinued operation still represents a component or group of components that have been disposed of or are classified as held for sale, the disposal now must represent a strategic shift in the entity's operations that has had or will have a major effect on the entity's results. This may occur when there is a disposal of a separate line of business, a separate major geographic area of operations or a combination of parts of a line of business or geographic area that make up a major part of the entity's operations and financial results. An acquired business that is classified as held for sale on the date of acquisition will also be included in discontinued operations. Continuing involvement criterion will be eliminated.

Income or loss from discontinued operations will be presented in the income statement in the same manner as currently required. However, the ASU will require assets and liabilities related to discontinued operations to be reclassified for all period-ends presented.

Several new disclosures are proposed for discontinued operations including summarized financial information for significant equity accounted for investees. In addition, disclosures about pretax profit or loss will be required for disposals of individually material components that do not qualify as discontinued operations.

The ASU would be applied on a prospective basis to all disposals or classifications as held for sale that occur for annual periods beginning on or after the effective date. The effective date for public entities is December 14, 2014 and for non-public entities it is December 14, 2015.

Consolidation – principal versus agent analysis

Consolidation (Topic 810)
Proposed ASU issued: November 2011
Comments were due: February 2012

The FASB continues its redeliberations on the proposed ASU for the evaluation of whether a decision maker is a principal or agent for purposes of consolidation. The proposed ASU is also expected to eliminate inconsistencies in evaluating kick-out and participating rights and make amendments to the evaluation of whether a general partner controls a limited partnership.

During the last quarter of 2013, the FASB decided money market funds that comply with or operate in accordance with requirements similar to Rule 2a-7 of the Investment Company Act of 1940 would be excluded from its proposals for this ASU.

Further discussions will continue during 2014. The FASB has not indicated when this project will be completed.

Bringing going concern disclosures into GAAP

Presentation of Financial Statements (Topic 205)
Proposed ASU issued: June 2013
Comments were due: September 2013

The purpose of this project is to introduce into US GAAP guidance for evaluating and disclosing going concern uncertainties and to improve the timeliness and quality of disclosures about such uncertainties. A proposed ASU was issued in June 2013 with a comment period that ended in September 2013.

The FASB will begin its redeliberations of the proposals and have decided to address the initial disclosure threshold, consideration of management's plans outside the ordinary course of business, the 24-month assessment period, the substantial doubt threshold and required disclosures.

Accounting for goodwill for public business entities

In development – no proposed ASU issued

During the quarter, the FASB endorsed amendments to US GAAP that will permit entities other than public business entities to elect a less complex approach to accounting for goodwill. In conjunction with this endorsement, the FASB has begun a project to reduce the complexity of the subsequent accounting for goodwill for public business enterprises. The staff has been asked to consider the PCC alternative, amortization of goodwill over its useful life with a maximum period, direct write-off of goodwill or a simplified impairment test.

Investment company disclosures

In development – no proposed ASU issued

The FASB has been considering disclosures in an investment company's financial statements that will provide transparency into the risks, returns, and expenses of an investee that is also an investment company. An exposure draft is expected to be issued in the first quarter of 2014.

The FASB decided to require disclosures in an investment company's financial statements about investments in unconsolidated investment companies and the first level of investments in another investment company. Implementation guidance may be provided to discourage creation of multiple tiers of investment companies to circumvent the proposed disclosures.

Disclosures would be required for each investment in another investment company that has a carrying value exceeding five percent of the entity's net assets at the reporting date. These disclosures would include the dollar amount of management and incentive fees associated with the investment fund (or, alternatively, the percentage of amounts); fair value of and its share of income or loss from the investee fund; and whether percentage ownership of the investee fund is between 20% and 50% or greater than 50% of the net assets of the investee fund. The disclosures would be required in any financial statements, annual or interim, that include a schedule of investments.

News on EITF projects

Bifurcation of embedded derivatives and shares

Determining whether the host contract in a hybrid financial instrument issued in the form of a share is more akin to debt or equity
Exposure draft issued: October 23, 2013
Comments were due: December 23, 2013

Hybrid financial instruments may include shares that include conversion rights, redemption rights, voting rights, liquidation and dividend payment preferences and other features. One or more of these features may meet the definition of a derivative under US GAAP. The embedded features would be accounted for as a separate embedded derivative if certain criteria are met. One criterion for separation is whether the economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract. This analysis requires assessing whether the host contract is more akin to an equity or debt instrument and whether the embedded features are equity-like or debt-like.

There has been diversity in practice and different methods for making these assessments. The proposal provides interpretative guidance to assist in making the assessment.

For hybrid instruments issued in the form of shares, issuers and investors would determine the nature of the host contract by assessing all the stated and substantive terms and features of the hybrid instrument as a whole, including the embedded features. Judgment will be required in weighing each of the terms and features of the hybrid instrument. No single term or feature would necessarily determine the nature of the host contract.

Performance conditions in share based payments

Accounting for share based payments when the terms of an award provide that a performance target could be achieved after the requisite service period
Exposure draft issued: October 23, 2013
Comments were due: December 23, 2013

Some share based payment awards are designed with a service period shorter than the period for the performance condition. As a result, employees may be entitled to an award when service is no longer required. Companies have been using different methods to account for such awards.

The consensus developed by the EITF proposes that such awards be treated as awards with performance conditions that affect the vesting of the award. This will result in compensation cost being recognized if it is probable that the

performance condition will be achieved. The amount of compensation recognized would be based on the awards expected to vest and be adjusted to the number of awards that actually vest when the conditions are met.

Government insured mortgage loans

Classification of certain government insured residential mortgage loans upon foreclosure
Exposure draft issued: January 20, 2014
Comments due by: April 30, 2014

The FASB ratified for exposure and the EITF proposes consensus on government insured mortgage loans. Different practices currently exist for accounting for such loans when the creditor has foreclosed on the borrower.

The EITF is proposing that government guaranteed residential mortgage loans for which the creditor has the intent and ability to recover the full unpaid principal balance of the loan be reclassified to a separate receivable at the time of foreclosure.

This consensus would complement the recent ASU issued on accounting for consumer residential mortgage loans that have been foreclosed.

When to pushdown

Recognition of new accounting basis (pushdown) in certain circumstances
In development – no EITF consensus for exposure issued

US GAAP has limited guidance for determining when the cost of acquiring an entity should be used to establish a new accounting and reporting basis (pushdown) in the separate financial statements of an acquired entity. The SEC requires public companies to apply pushdown accounting in certain situations. This situation has resulted in diversity in practice which the EITF is trying to address. An exposure draft of an EITF consensus is expected to be issued during the first half of 2014.

At its November meeting, the EITF tentatively decided to require pushdown accounting when a public entity becomes substantially wholly-owned as a result of a business combination, and to provide an option to apply pushdown accounting upon a change in control. Indicators for use of the option are being developed. Non-public entities would be exempt from the requirements, but could elect to apply pushdown accounting upon a change in control.

The Task Force also tentatively concluded that goodwill would be recognized in the separate financial statements; however, bargain purchase gains would not be recognized. Also, acquisition-related debt would not be pushed down unless the debt was required to be recognized as a liability in the separate financial statements under US GAAP.

News on PCC projects

Private company decision making framework

The FASB and PCC have approved *A Guide for Evaluating Financial Accounting and Reporting for Private Companies* (the Guide). The Guide will be used to consider whether and in what circumstances to provide alternative recognition, measurement, presentation, disclosure, transition requirements and effective dates for private companies using US GAAP.

The Guide includes principles for determining:

- Recognition and measurement guidance – considers the relevance of the information to users and the cost and complexity of applying the guidance.
- Presentation requirements – assesses the relevance of the presentation to typical users of private company financial statements and whether note disclosures would address those needs.
- Disclosure requirements – considers the relevance of information to typical users of private company financial statements and the ability of users to access management to obtain additional information.
- Transitional requirements – consider practical expedients or alternative basis.
- Effective date – generally will be one year after applicable to public business entities unless there is an immediate need for amendments to become effective.

Endorsement of PCC decisions

The FASB endorsed two PCC decisions to streamline accounting for non-public entities:

- PCC Issue 13-01B: *Accounting for goodwill* will allow private enterprises to elect to amortize goodwill and to test goodwill for impairment at the entity or reporting unit level when the carrying value of the entity may be less than its fair value. Any impairment charge would be the excess of the carrying value of the entity over its fair value.
- PCC Issue 13-03A: *Accounting for receive-variable, pay-fixed interest rate swaps – simplified hedge accounting approach* will allow private enterprises, other than financial institutions, to elect a simplified hedge accounting approach for certain types of interest rate swaps. This approach assumes no ineffectiveness and private enterprises can elect to measure the designated swap at the settlement value rather than fair value. The approach will also allow a longer period to complete hedge documentation.

The other PCC Project to consider a combined instruments approach for interest rate swaps is to be discussed further once the FASB staff has completed more research on the approach.

Final ASUs on these amendments were issued in January 2014: ASU 2013-02 and ASU 2013-03, respectively.

Common control leasing VIEs

Proposal approved by PCC – exposure draft not yet issued

The PCC has finalized an accounting alternative that would permit a private company lessee to elect not to consolidate a lessor entity that is under common control when the lessee is the primary beneficiary of the VIE or lessor entity. To qualify for this election, the lessee and lessor must be under common control with the common activities being limited to the leasing arrangements. Also the debt of the lessor, if any, can only be collateralized by the leased assets and not any other assets of the lessee. This election would have to be applied to all applicable leasing arrangements.

The VIE disclosures would be replaced with disclosures about significant financial support arrangements between the lessee and lessor.

The proposals, if endorsed by the FASB, would be applicable on a full retrospective basis for years beginning on or after December 14, 2014.

News on AICPA projects

Guidance on testing goodwill issued

In November 2013, the AICPA Financial Reporting Executive Committee issued the *AICPA Accounting and Valuation Guide: Testing goodwill for impairment* (the Guide). The purpose of the Guide is to assist companies in conducting their assessments of goodwill. The Guide is nonauthouritative but reflects the input of the FASB and the SEC staff.

The Guide reviews the concepts and application of the fair value measurement included in ASC Topic 820 and outlines a process to obtain information or make assumptions about required information when measuring fair value of a reporting unit. The process considers the unit of account, the valuation premise, the potential markets, market access, valuation approaches and determination of fair value. The Guide does not promote any specific valuation approach.

The Guide provides guidance on a number of the more difficult issues in measuring goodwill such as:

- Assigning operating and corporate assets and liabilities to multiple reporting units. Detailed examples of such allocations are included in the Guide.
- How to measure goodwill attributable to noncontrolling interests with and without minority interest discounts.
- The optional qualitative assessment to determine if Step 1 on the goodwill impairment test is necessary, including specific examples that should be considered and examples of documentation to support the assessment.
- Observations on the effects of NCI when measuring fair value.
- Illustrations of different valuation approaches using comprehensive examples of the income approach (discounted cash flows method) and the market approach (the guideline public company method and the guideline company transactions method). These illustrations include detailed schedules to demonstrate the development of data and assumptions for the respective approaches.

The Guide provides helpful information in working through the assessment of goodwill required on an annual basis.

News on SEC developments

Countdown to conflict minerals reports

The SEC rule on reporting about conflict minerals is effective for the 2013 calendar with the first reports required by the end of May 2014. The rule requires manufacturers to disclose whether their products may contain minerals sourced from the region of the Democratic Republic of the Congo.

Currently, the US Court of Appeals of the District of Columbia is hearing an appeal to a lower court ruling that upheld the SEC rule. While two judges have raised concerns about the current rules, it is not clear whether there will be any ruling before the date the first reports are due. It is expected that some aspects of the rule will change. However, the rule was mandated by the Dodd-Frank Act and will likely require some reporting of conflict minerals.

With the approaching deadline, some companies have already been publicly reporting their findings. On the assumption that the rules will not be overturned before the filing dates, companies should be continuing with their investigations and due diligence to be able to prepare a report when due.

Views on 2013 disclosures

In December 2013, the AICPA National Conference on Current SEC and PCAOB Developments was held in Washington D.C. Speakers from the SEC, FASB, IASB, Centre for Audit Quality, AICPA, preparers and auditors highlighted the latest developments, issues, best practices and observations for SEC registrants.

The presenters at the conference focused on:

- Effective disclosures;
- Reducing complexity of accounting standards and increasing transparency of financial information;
- Staying focused on internal control over financial reporting; and
- Executing high quality audits.

Effective disclosures

Disclosure overload has become a common theme for standard setters, regulatory agencies and others. The SEC staff addressed this issue by asking registrants to increase the transparency, clarity and precision of disclosures about material matters rather than increasing the volume of disclosures. They indicated that disclosures should emphasize matters that are material to investors and significantly impact operating results. Registrants should also reconsider disclosures that are immaterial or unnecessary.

Some best practices for effective disclosure outlined by the SEC staff at the conference are:

- Disclosures should be used to help investors understand the "full story" and "connect the dots". For example, disclosures should explain how key performance indicators/metrics and non-GAAP measures relate to financial performance. In addition, filings should be reviewed for internal inconsistencies.
- Accounting policy alternatives selected should be clearly described in the notes to the financial statements, particularly important policies involving choices such as revenue and pensions.
- Trends and uncertainties that have had or could have a material effect on the financial statements should be discussed in MD&A. Examples are goodwill assessments, expected returns on plan assets for pensions and valuation allowances for deferred income taxes.
- Disclosures should be in context and balanced. For example, the discussion about the realizability of deferred income tax assets should cover both positive and negative evidence.
- Language used in disclosures should be precise and defined. The use of terms that are not defined or understood in US GAAP could confuse users and result in differing interpretations.
- Duplicative or redundant disclosures should be removed where possible. For example, duplications that are often found in filings include the repetition of significant accounting policies in the MD&A section on critical accounting policies; the repetition of information about legal proceedings in the financial statements, MD&A and other sections of annual filings; and inclusion of information about new accounting pronouncements when the expected impact to the company is immaterial.

Financial reporting hot topics – US GAAP

The SEC staff did not make any announcements about whether IFRSs would become an accounting framework that domestic US registrants could use to prepare their financial statements. The staff indicated that they continue to consider this option, but their time has been devoted to other rule making required by the Dodd-Frank Act.

The SEC staff outlined some of the accounting and financial reporting issues they have identified through their reviews during the year.

Income taxes

Income tax rate reconciliations in the notes to the financial statements could be improved by clearly labelling reconciling items to identify the nature of the item and by not aggregating or offsetting material reconciling items. MD&A should include a discussion of material reconciling items for each material including the related tax rate and amount of tax. The SEC staff has also found inconsistencies between the reconciling items disclosed in the notes to the financial statements and elsewhere in the filings. Registrants were also reminded to evaluate whether adjustments to tax provisions were changes in estimates or errors.

Valuation allowances for deferred income taxes were also a common item commented on in SEC reviews. Often, explanation about valuation allowances are boilerplate and too vague. Such explanations fail to explain key judgments made in establishing, adjusting or releasing the valuation allowance. Companies should address the four sources of taxable income and material uncertainties, assumptions and limitations associated with each source; foreign tax credits and net operating losses including the period over which credits and carry forwards are expected to be realized; and positive and negative evidence and their relative magnitude used to support the need for a valuation allowance. The SEC staff indicated that the initial recognition or reversal of a valuation allowance would likely lead to questions on the timing and judgments involved.

Another hot topic is the indefinitely reinvested foreign earnings. Some registrants have omitted disclosures about the unrecognized tax liability required by US GAAP. Further, the SEC expects a discussion in the MD&A of events that would cause the reinvested earnings to become taxable and evidence to support the assertion about foreign earnings and the impact on the parent's liquidity needs. SEC is expected to challenge registrants when the circumstances are inconsistent with parent's liquidity needs.

Pensions/Other post-employment benefit plans

More attention is being placed on pensions and other post-employment benefit plans due to low interest rate environment, the optionality in accounting methods under US GAAP and the significant assumptions used in accounting for benefit plans, particularly the discount rate and assumption about expected rate of return on plan assets.

The SEC staff has focused on the disclosures of accounting policy elections in the financial statements. These include the methods used to amortize actuarial gains or losses; periods over which actuarial gains or losses are amortized; and determination of the expected return on plan assets. Robust disclosures are expected about assumptions used, particularly for the expected return on plan assets.

In the MD&A, the emphasis has also been on the expected return of plan assets with requests for sensitivity analysis, range of alternative assumptions, historical performance of plan assets and limitations on such information and explanation of changes in the expected return on plan assets. The SEC also expected disclosures about unexpected or unusual relationships such as significant contributions obscuring a negative return on plan assets.

Business combinations

Questions have been raised about the classification of acquisitions as business or asset acquisitions, particularly involving real estate with existing lease arrangements. The SEC staff has indicated registrants should consider a market participant view, document analysis contemporaneously and consult with Office of the Chief Accountant regarding complicated matters.

The SEC staff have also been concerned about measurement period adjustments and reminded registrants about the US GAAP requirements. There is a concern certain of these adjustments may be error corrections.

Segments

Segments continue to be a perennial hot topic. Concerns related to the appropriate identification of operating segments even when there are shared costs between business units. Also questions are often raised about the aggregation of segments and whether those segments have similar economic characteristics.

Goodwill

Disclosures about new goodwill arising on an acquisition could be improved by explaining the sources of expected synergies and why a premium was paid.

Questions may be raised by the SEC about an entity's goodwill when there have been adverse business changes or the market capitalization falls below carrying value of the entity. Early warning disclosures about potential impairments continue to be important. Critical accounting estimates should explain circumstances and assumptions that could be reasonably expected to affect the impairment assessment. Also, disclosures should be made about "at risk" reporting units including the percentage by which the fair value exceeds the carrying value at most recent test, amount of goodwill in such reporting units, the methods and key assumptions used to assess goodwill, how the assumptions were determined, the degree of uncertainty associated with key assumptions, and potential events that could affect key assumptions.

Also, the SEC has found the explanations of why impairments occur to be lacking in entity-specific details.

Non-GAAP measures

Non-GAAP measures continue to be under the microscope. The SEC has been particularly concerned about measures that include pension related adjustments to remove the impact of actuarial gains and losses and actual plan returns. The SEC expects non-GAAP measures to be clearly labelled and not use common GAAP terms that may confuse investors. Clear explanations of how the measure is calculated should be provided. Further, registrants should ensure the context for the measure is appropriate. The SEC provided an example of a measure such as "total cash cost per ounce" used in the mining industry. Such a measure could be confusing when material net revenue from by-products are deducted. The SEC has suggested full disclosure of the composition of the measure should be made including considering with and without calculations.

Operating metrics

Operating metrics such as comparable store sales and website users generally have no standard definitions. The SEC staff expects these metrics to be clearly defined along with explanation of how they are calculated and any limitations or risks associated with the use of these metrics. Any discussion of the metric should be balanced and explain how the metric affects revenue and operating results.

Operations in China and other foreign jurisdictions

Companies may consolidate variable interest entities with operations in China or other foreign jurisdictions. When such foreign VIEs are consolidated, registrants should disclose how the arrangements convey power and economic benefits and significant contractual terms, mutual consent provisions, revocability clauses, expiry dates, any uncertainty about enforceability and how these terms and conditions affect the consolidation conclusion.

The SEC reminded registrants also to make disclosures about risks specific to any Chinese operations such as concentration of operations in China, reliance on contracts to consolidate a VIE, any legal uncertainties associated with the organization of the entity, potential conflicts of interest, limited legal protections available to investors, and any cash transfer and exchange restrictions.

Simplification of accounting standards

Paul Beswick, the SEC Chief Accountant encouraged standard setters to continuing exploring how to simplify accounting standards for all companies, not just private enterprises. He believes that the FASB should not make wholesale changes, but rather focus on specific issues in the existing standards and make targeted improvements to simplify the standards.

Valuations have become more important to financial reporting. Mr. Beswick also sees a need for improvements in the valuation profession – standards and practices for valuation should be improved to enhance the confidence of investors and others that rely on valuations.

ICFR

The SEC staff reminded registrants to stay focused on the importance of internal control over financial reporting. The staff believes maintaining ICFR must be an iterative and ongoing process with appropriate involvement of management and support throughout the company.

PCAOB inspection findings on auditor's attestation of ICFR have raised concerns with the SEC that there may be similar problems with management's evaluations of ICFR and may be potentially indicative of risk for unidentified material weaknesses. The SEC staff may increase intensity of focus on ICFR. The SEC staff encouraged registrants to read the recent settlement agreement with JP Morgan resulting from the failure to maintain effective disclosure controls and procedures, ICFR and filing of inaccurate reports with SEC.

Registrants need to specify which COSO Framework they are using in their ICFR evaluations. Staff indicated they will more likely question registrants using an outdated framework with the passage of time.

High quality audits

The SEC continues to focus on auditor independence and audit quality and continues to support the initiatives of the PCAOB. Mr. Beswick comments that the audit committee is in the best position to evaluate whether an auditor is performing a high quality audit. He cautioned audit committees not to compromise audit quality by placing too much focus on fees.

More information

For more information on the SEC views on accounting and financial reporting matters, please consult with your local engagement team or PwC's National Accounting Consulting Services SEC partners.

Our people are ready to help you understand US GAAP. If you have questions or want to discuss the developments in this publication or other developments, our people in the US GAAP Reporting Group will be happy to answer your questions and have a discussion with you.

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