

# *The quarter close*

## A look at this quarter's financial reporting issues

*September 12, 2011*

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## *What you need to know—Q3—2011*

Welcome to the third quarter 2011 edition of *The quarter close*. We head into fall with regulators and standard setters seeking input on a myriad of proposals—from rewrites of key accounting standards to mandatory audit firm rotation. It may be the kids who are going back to school, but it looks like we'll all have plenty of homework. We'll help you take stock of the current and forthcoming proposals, along with the other latest updates. Here is a preview of what you'll find inside:

**Front and center.** The FASB and IASB have almost wrapped-up their redeliberations of the priority joint projects. Now it's time for round two, as the boards prepare to re-expose the proposed revenue recognition and leasing standards. Also newsworthy this quarter: the Public Company Accounting Oversight Board has issued two concept releases that explore topics sure to spur debate.

**Hot off the press.** Here, we discuss the FASB's final decisions on goodwill impairment. Be sure to take note of this development, as companies may be able to apply the new rules as early as the third quarter. We also summarize the FASB's final decisions on multiemployer pension plan disclosures, as well as two new standards and one proposal from the FASB's Emerging Issues Task Force.

**Accounting hot topics.** The state of the economy and the recent U.S. debt downgrade have dominated the news headlines this quarter. We explore the financial reporting implications here. Also, we uncover the potential complexities in some common transactions, including features frequently found in debt and preferred stock financings, and compensation arrangements that often accompany business combinations.

**And lots more.** The debate over the future role of IFRS in the U.S. forges on, as the SEC continues its assessment of whether, when, and how to incorporate IFRS. We give you the scoop on the feedback received by the SEC on its proposed "endorsement" approach to incorporating IFRS. And, one year after the enactment of the Dodd-Frank Act, we highlight key areas of rulemaking yet to come from the SEC. We also take a look at some FASB proposals and discussion papers expected in the near future.

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## *Front and center*

### **Sharpen your pencils...revised proposals on their way**

In June, the FASB and IASB announced that they would re-expose the proposed revenue recognition standard. Not surprisingly, they have decided to follow suit with the proposed leasing standard. Both exposure drafts are expected before the end of the year. How will re-exposure affect overall timing of the projects? Final standards now won't be issued until later in 2012, and effective dates—although yet to be determined—likely will be pushed back too. Despite these delays, most observers seem to agree that re-exposure is the right path given the significant changes that have been made to the original proposals.

The other big news on leases: the boards appear to have settled on an accounting approach for lessors. Under the proposed approach, lessors would derecognize the leased asset, and record both a lease receivable and a residual asset for the portion retained by the lessor. It may sound straightforward, but the debits and credits may not be so simple. Some details still need to be worked out, including how to deal with leases

of “portions” of assets (for example, the lease of part of a building). Stay tuned for the final word on lessor accounting. Refer to [In brief 2011-31](#), *FASB and IASB agree to re-expose leasing ED and agree on one lessor accounting model*, for a summary of the latest decisions.

What about the financial instruments project? The FASB continues to redeliberate classification and measurement, while the FASB and IASB are jointly discussing the revised impairment model. Impairment has been a particular struggle. The boards have considered—and rejected—multiple approaches. Now, the boards have agreed to segregate a company’s portfolio into three categories to assess impairment: assets not affected by observable events, assets affected by observable events (but not specific to individual assets), and individual assets expected to default or that have defaulted. The boards have focused their efforts on refining this new approach and are expected to issue another exposure draft of the impairment model during the last quarter of 2011.

Although not yet official, it’s likely that the FASB will re-expose certain other aspects of the financial instruments proposals in addition to the impairment model. For a recap of the FASB’s deliberations, see [Dataline 2011-26](#), *Financial Instruments—An update on the FASB’s financial instruments project re-deliberations as of June 30, 2011*.

Meanwhile, the IASB has proposed a delay of the effective date of its new financial instruments standard on classification and measurement to allow more time for the completion of the other phases of the project, including impairment and hedge accounting. We summarize the proposal in [In brief 2011-34](#), *IASB proposes to delay IFRS 9 effective date*.

Be on the lookout for our upcoming edition of *Setting the standard* for more updates on these and the other joint standard-setting projects. Other recent PwC publications addressing current standard-setting topics that may be of interest include [10Minutes on the future of revenue recognition](#) and our [Point of view document: Reducing complexity—Our proposal to address this challenge](#).

## **PCAOB kicks off debate on auditor rotation and reporting model**

The Public Company Accounting Oversight Board (PCAOB) added to the summer reading list by issuing two highly anticipated concept releases in June and August. The first addresses the auditor’s reporting model, while the second focuses on auditor independence and audit firm rotation. Many of the topics addressed in these releases are also being debated internationally. As we discussed in last quarter’s [The quarter close](#), the European Commission’s “green paper” on audit policy issued in October 2010 addresses similar themes, including the role of the auditor and the independence of audit firms.

The PCAOB’s June [concept release](#) outlines several potential alternatives to the current auditor’s report. These alternatives range from tweaking the language in today’s report to adding an entirely new “auditor’s discussion and analysis” supplement containing the auditor’s views on management’s judgments, estimates, and accounting policies.

The August [concept release](#) largely focuses on mandatory audit firm rotation—a hotly debated topic explored multiple times over the years. In its release, the PCAOB seeks input on several matters including the advantages and disadvantages of requiring mandatory rotation of audit firms after ten years. The PCAOB is also seeking input on whether there are other ways to enhance auditor independence, objectivity, and professional skepticism.

***With this release, I hope to challenge critics and proponents alike to do their homework, come forward with facts, and add meaningful depth to the discussion, in order that we might reach resolution.***

-James R. Doty, PCAOB  
Chairman, [August 16, 2011](#)

The PCAOB has asked for comments by September 30 and December 14 on the auditor’s reporting model and audit firm rotation, respectively. Also coming up: a public roundtable on the auditor’s reporting model on September 15. The PCAOB is looking for feedback from a broad range of constituents. In particular, interest is growing outside the auditing profession. Many companies are getting engaged in the discussion, as they realize that the changes being discussed would reach far beyond auditors—affecting management, audit committees, and others.

For further information on the concept releases, refer to [In brief 2011-29, PCAOB explores possible changes to the auditor’s reporting model](#), and [In brief 2011-35, PCAOB seeks comment on auditor independence and audit firm rotation](#).

## Hot off the press

On the standard-setting front, the FASB announced final decisions on the qualitative goodwill impairment test and enhanced multiemployer pension plan disclosures. The final standards for these two projects are expected any day now—and both have effective dates that leave little time to prepare. So, companies may need to take quick action. Also, the FASB’s Emerging Issues Task Force (EITF) finalized two standards for entities in the health care industry, and exposed for comment another on accounting for real estate transactions.

The FASB still plans to issue several new proposals before the year is over. These upcoming proposals range from new guidance on consolidations to a discussion paper on a proposed private company standard-setting framework. It promises to be an active fourth quarter if the FASB keeps pace with its timeline. We highlight a few of these projects in “On the horizon.”

### Quick action on goodwill project could allow for early adoption in third quarter

After getting the green light from preparers and others, the FASB is moving forward with simplifications to the goodwill impairment test. This project is moving fast—a final standard is expected in the coming weeks. Although the changes aren’t required until 2012, early adoption will be permitted. That means companies with third and fourth quarter annual impairment testing dates may be able to take advantage of the new rules this year.

The new approach—which eliminates the requirement to calculate fair value at least annually and replaces it with an optional qualitative assessment—will likely save time and money for companies with reporting units that have plenty of “cushion” between fair value and carrying amount. For reporting units without significant cushion, companies will need to consider carefully whether to apply the qualitative assessment. One thing’s for certain: it will be important to clearly and comprehensively document a decision to bypass the quantitative test. Companies looking to adopt the new guidance early should begin assessing relevant factors for consideration in their qualitative assessment.

Look for an upcoming Dataline on the final standard, where we will cover the details and provide some practical observations on how to apply the new assessment. For now, you can find more background on this project in [Dataline 2011-20, Goodwill impairment—FASB proposes changes to impairment test](#), and [In brief 2011-36, FASB approves standard to simplify goodwill impairment test and allows for early adoption in 2011](#).

### Coming soon from the FASB...

Proposal	Expected timing*
Revenue (re-exposure)	September 2011
Consolidation: policy & procedures	September 2011
Consolidation: investment companies	September 2011
Codification corrections	September 2011
Investment properties	September 2011
Leases (re-exposure)	Q4 2011
Disclosures about risks and uncertainties	Q4 2011
Private company framework (discussion paper)	Q4 2011

\*Based on the FASB’s technical plan posted at [www.fasb.org](http://www.fasb.org) as of September 12, 2011

Up next for discussion: impairment of indefinite-lived intangibles. Many who commented on the goodwill proposal also urged the FASB to explore opportunities to simplify the impairment test for indefinite-lived intangible assets. Responding to this feedback, the FASB has added a short-term project to its agenda to address indefinite-lived intangibles.

## **Multiple new disclosures for multiemployer pension plans effective this year**

The FASB wrapped-up its discussions of a new standard for multiemployer pension plan disclosures at the end of July. As we reported in last quarter's edition of *The quarter close*, the board ultimately decided not to require certain of the quantitative disclosures that were proposed last year, in light of the feedback received on that proposal. The standard will, however, require enhanced disclosures of an employer's participation in a multiemployer plan. The new disclosures provide information about the overall financial health of the plan and the level of the employer's participation.

Public companies take note: although the final standard has not yet been issued, the FASB announced that it will be effective in 2011 for calendar year-end public companies and will require certain retrospective disclosures. Nonpublic companies will receive a one-year deferral. Although there are fewer required disclosures than originally proposed, companies may need to gather a considerable amount of information to comply with the new requirements. For more information, see [In brief 2011-33, FASB approves revised disclosures for multiemployer pension plans; effective for public companies in 2011](#).

## **Fees paid by health insurers—EITF agrees to align accounting treatment**

One outcome of the health care legislation<sup>1</sup> enacted last year took the form of new fees imposed by the federal government on health insurers and pharmaceutical manufacturers. Shortly after this legislation was passed, the EITF decided to address the accounting for these fees in two separate issues. The guidance for pharmaceutical manufacturers was finalized late in 2010. The guidance for health insurers has now been finalized as well. Consistent with its earlier decisions for pharmaceutical manufacturers, the EITF concluded that health insurers should present the annual fee as an expense in the income statement and recognize it ratably in the year in which it is due.

The guidance for health insurers is effective in 2014, when the fee initially becomes effective. For more information, see the June 2011 [EITF observer](#).

## **Revenue recognition for health care entities—a practical interim solution**

Pencils down. The EITF finally completed its work on what initially looked like a fairly simple question: how to record revenue and bad debts for a health care entity that doesn't assess a patient's ability to pay prior to providing services. This might occur, for example, when a hospital provides emergency care to uninsured patients. In those situations, the hospital's "due diligence" on what sources of payment might be available typically takes place after the fact.

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<sup>1</sup> The Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act were enacted in March 2010.

Current guidance allows health care entities to record revenue at an amount that reflects the full price for the care provided to uninsured patients. However, they rarely collect the full or even discounted amount from these patients. This results in what many perceive as a “gross-up” of revenue and bad debt expense.

After a few tries, the EITF reached a final consensus that adjusting the presentation of bad debts would best address the issue until the recognition question could be dealt with by the FASB and IASB’s joint revenue recognition project. The new guidance requires health care entities that are affected by the “gross up” of revenue and bad debts to present bad debt expense directly beneath patient service revenue on the face of the income statement as a component of net patient service revenue. The EITF was careful to narrow the scope of the guidance so as not to affect health care entities that have more traditional revenue recognition practices.

The new guidance is effective in 2012 for public companies, with nonpublic companies receiving an additional one-year deferral. For more information, see the June 2011 [EITF observer](#).

### **Deconsolidation of a real estate entity—sorting out the intersecting guidance**

The EITF often weighs in when two or more sources of accounting guidance might apply to the same transaction but yield different answers. Recently, the EITF tackled the issue of deconsolidation of an entity that is primarily comprised of real estate. Which literature trumps: consolidation guidance or real estate sale rules? The answer matters, since it’s often more difficult to meet the criteria for derecognition under the real estate sale rules, which require, among other things, a company to transfer the property or relinquish the title to the property. In a proposed consensus, the EITF gave the nod to real estate sale accounting for the situation addressed.

To give some context, here’s an example fact pattern. An investor owns an entity that primarily holds real estate that has been financed with non-recourse debt. The investor encounters difficult economic conditions, defaults on the loan, and loses control of the property to the lender holding the non-recourse debt. However, the investor does not transfer title to the property. The question arises whether the investor should continue to consolidate the entity and record the related financial results, particularly when the investor does not have any decision-making authority. In these default situations, deconsolidation could effectively result in a gain, which has raised a concern about early recognition of debt forgiveness.

The EITF began to address this topic almost a year ago. As is frequently the case, the issue broadened to other scenarios, including other deconsolidation situations involving in substance real estate, including the accounting by the lending institution holding the non-recourse debt. Would the lender now also be subject to real estate guidance once it controls the property and consolidates? If so, how would a subsequent shift of control be evaluated? After consultation with a working group, the EITF ultimately decided to narrow the scope to focus on the investor’s accounting in a default situation.

The EITF released a consensus for exposure in July. If you have an interest in expressing your view, mark October 3 (the end of the comment period) on your calendar. The EITF will take up the debate again at its November meeting. Another related topic likely to be discussed will be the impact of the FASB and IASB’s joint revenue recognition project on

these transactions. Since the new revenue guidance is slated to replace the real estate sales rules, it could have a future impact.

For more background on this issue, see the June 2011 [EITF observer](#).

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## ***Accounting hot topics***

### **It's the economy...the financial reporting implications of the debt downgrade and an uncertain economy**

“Rollercoaster ride” might best describe the stock market since Standard & Poor’s (S&P) downgraded U.S. long-term Treasuries last month. Throw into the mix a persistent European debt crisis and growing concern over a broader economic downturn, and you’ve got a recipe for further volatility. For most companies, these events have probably had a limited financial reporting impact—so far. But, more twists and turns may be coming around the next corner.

#### *Are U.S. Treasuries still “risk-free”?*

Fortunately, yes. S&P’s downgrade has not negatively impacted demand for U.S. government securities. In fact, the opposite has occurred. Yields on these securities have remained flat and in some cases decreased—reflecting, among other factors, continued investor confidence and the fact that the other two primary ratings firms have maintained their highest ratings for U.S. Treasuries. The prevailing view is that U.S. Treasuries continue to represent a “risk-free” rate.

Why is this so important? The risk-free rate is a key input in valuation assessments and affects a number of financial reporting matters: impairment testing, asset retirement obligations, share-based compensation, financial instrument valuation, hedging, and business combinations, among others.

#### *Other considerations*

What else should companies be thinking about? We’ve all learned from past experience that volatility and uncertainty can quickly lead to some significant financial reporting implications. Companies should consider the changing economic environment and monitor areas of their business that might be affected by an economic slowdown:

- Evaluate the impact of equity losses and counterparty risk on financial instrument impairment assessments.
- Consider how a further downgrade might impact investment policies and the ability to invest in certain securities.
- If considering a change in financing strategy, carefully evaluate the financial reporting impact of exchanging or modifying debt.
- Take a fresh look at areas of financial reporting that are dependent on forecasts, including long-lived asset impairment, hedging, and deferred income taxes, just to name a few.

Last but not least, companies may need to update or enhance their disclosures to appropriately reflect their circumstances in light of the current economic environment.

This may include disclosures about market risk, uncertainties, forward-looking information, and liquidity, among others.

Clearly, there's a lot to consider. Look for a Dataline coming soon that will take a deeper dive into this topic.

### **Presenting other comprehensive income—harder than it looks?**

You're probably aware of the most significant change resulting from the new guidance for presenting other comprehensive income: the elimination of the option to present it as part of the statement of changes in equity. But now that companies are in the process of evaluating whether to adopt the standard early, some are learning that it's not just a "cut and paste" exercise.

As a reminder, the standard requires companies to present items of net income and other comprehensive income either in one continuous statement or in two separate, but consecutive, statements. But don't stop reading...there's more. Perhaps the most notable other change is the new requirement to show reclassification adjustments (from other comprehensive income to net income) on the face of the statement under both the single or two-statement formats. Complying with this requirement may not be so straightforward for companies with reclassification adjustments that affect multiple line items (for example, pension-related adjustments). Suffice it to say that it's worth moving this one up on the to-do list, instead of waiting until the last minute.

Check out [Dataline 2011-24](#), *Presentation of comprehensive income—The FASB issues final standard on presenting other comprehensive income*, for more information and some examples of the new presentation requirements.

### **Financing transactions—complexities require careful navigation**

Capital is the lifeblood of a company. Debt and preferred stock have long served as important vehicles for companies to obtain that capital. But these securities are usually not "plain vanilla." Instead, they're accompanied by warrants, conversion options, and other features linked to a company's equity. Why do companies introduce these complexities? Equity-linked features frequently enable companies to lower their cash interest costs.

Accounting for the classification and measurement of securities—and their embedded features—can lead to unwanted surprises. Companies often expect to account for equity instruments (including warrants) as equity and debt as a liability under an amortized cost model. However, depending on their terms, freestanding warrants and embedded conversion options may have to be accounted for as derivative liabilities at fair value with changes in fair value recognized in income. Even embedded features that are not derivatives may require special accounting.

To properly account for these transactions, companies first need to obtain a thorough understanding of the terms of each instrument issued, the underwriting agreement, and any related derivatives that may have been entered into with a broker-dealer in connection with the transaction. Next, companies must navigate a maze of complicated accounting guidance that could require significant judgment.

Sound daunting? It can be. To help identify areas where complexities may arise, we recently issued [Dataline 2011-25](#), *Accounting for certain equity-linked financing transactions*.

## **Business combinations—whose compensation is it anyway?**

It happens all of the time: an acquired company's stock options vest automatically on the acquisition's closing date. At first glance, the accounting for this transaction may appear black and white. Most would assume the buyer would account for the acquisition of the vested awards (either with replacement awards or cash) as part of the consideration paid for the business. While that's often the case, in certain fact patterns, this and other employee compensation arrangements could affect the buyer's earnings—even if the employees are not required to perform any services in the post-acquisition period.

Why the potential for different outcomes? The guidance requires buyers to distinguish between parts of a transaction that are elements of the business combination and those that are not, including employee compensation arrangements. Transactions that are arranged primarily for the economic benefit of the buyer (or the combined entity) are accounted for in the post-acquisition financial statements, separate from the business combination. The guidance provides three factors to consider when making this determination: a) the reason for the transaction, b) who initiated the transaction, and c) the timing of the transaction.

If the seller's stock options or similar awards automatically vest based on a long-standing change-in-control provision in the awards' terms, the buyer would generally conclude that the accelerated vesting was not arranged for its benefit. In that case, no expense would be recorded in the post-acquisition financial statements. Fact patterns that become more "gray" include situations in which change-in-control or cash buyout provisions are added to employee awards shortly before the acquisition's closing date. In these situations, more judgment may be required to determine who benefited from adding the provision if both the buyer and the seller agreed to the change.

Other agreements might include discretionary change-in-control provisions or "dual trigger" provisions that result in vesting or cash buyout of awards if an individual is terminated within a defined period of time following the acquisition date (or is not offered a comparable position with the buyer). Depending on the facts and circumstances, the accounting rules might require the related charges for these agreements to be recorded in the buyer's post-acquisition financial statements.

In short, it can sometimes be difficult to determine who is benefiting from the arrangement. To sort it all out, it's important to understand the employee compensation arrangements that accompany a business combination, the pre-existing terms of the agreements, and any changes made during negotiations between the buyer and the seller. For more on compensation arrangements, see [M&A snapshot, \*Doing a deal? Be careful about employee compensation decisions.\*](#)

## **Intraperiod allocation—expect the unexpected**

Intraperiod *what?* That's a common reaction to a complex area of accounting that sometimes produces counterintuitive results. First, what is intraperiod allocation? It's the process of determining how much income tax expense or benefit to reflect in various financial statement components, such as continuing operations, discontinued operations, other comprehensive income, and equity, to name a few.

The underlying principle is relatively straightforward. First, determine the amount of tax expense or benefit attributable solely to continuing operations, without regard to other components. Any difference between the total tax expense or benefit for the period and the amount allocated to continuing operations is then allocated among all other

components based on each component's incremental effect on the total tax. This often is referred to as the "with-and-without" approach.

So what's the catch? There are exceptions to the general rule. For example, when there is a pretax loss from continuing operations, but pretax income from other financial statement components, the guidance requires a departure from the general "with-and-without" approach. The result is often a gross-up of tax benefit in continuing operations and tax expense in other components—even though overall a company has no tax expense or benefit. Other examples include:

- The tax effects arising from a change in tax law, rates, or status are specifically allocated to continuing operations.
- When there is a change in assertion with respect to a company's plans to indefinitely reinvest prior undistributed earnings of foreign subsidiaries, the tax effects attributable to the change are allocated to continuing operations.
- The tax effects of adjustments made to items originally recorded in other comprehensive income are reflected in continuing operations and not traced back to other comprehensive income.
- When there is a change in judgment about the realizability of a company's deferred tax assets due to a change in expectation of taxable income available in future years, the tax effects are specifically allocated to continuing operations.

The above list speaks for itself—allocation of a company's income tax provision can be complex and nuanced. For additional guidance on this topic, refer to our [Guide to accounting for income taxes](#).

### **A royal endorsement—U.K. legislative update**

In July, the Queen granted Royal Assent to Finance (No. 3) Act 2011 (the Act). The Act reduced the U.K. corporate income tax rate from 27% to 26%, effective April 1, 2011. Additionally, the Act includes a second rate reduction effective April 1, 2012, when the rate will drop to 25%.

When you're done celebrating the lower rates, don't forget the accounting implications. Companies should incorporate the tax law change into their annual effective tax rate and determine the appropriate tax rate to apply to deferred tax assets and liabilities based on when they are expected to reverse. Additionally, the impact of the reduced tax rates on a company's deferred tax accounts should be recorded discretely and included in income from continuing operations in the period that includes the date of enactment.

For additional information on this topic, refer to our [Tax Accounting Services NewsAlert](#), *Key tax accounting considerations of the United Kingdom's main corporate tax rate reduction*.

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## **SEC matters**

***I remain committed to finding a way to make it easier for shareholders to nominate candidates to corporate boards.***

-Mary L. Schapiro, SEC  
Chairman, [September 6, 2011](#)

### **Appeals court to SEC: not so fast on proxy access**

The U.S. Court of Appeals has weighed in on the ongoing debate over proxy access. In fact, the court didn't just weigh in, but struck down altogether the SEC's new proxy access rule. The rule in question, championed by shareholder rights advocates, would have required a company to include in its proxy statement shareholders' director nominees that meet certain requirements. The court concluded that the SEC did not adequately assess the economic effects of the rule. The SEC had delayed the rule's implementation last year after the U.S. Chamber of Commerce and the Business Roundtable filed a legal petition challenging the rule.

The SEC confirmed in September that it is not seeking a rehearing of the court's decision, nor will it seek Supreme Court review. However, another rule adopted by the SEC at the same time—and not challenged in court—would allow shareholders to submit proposals for proxy access on a company-by-company basis. The SEC had also delayed implementation of that rule, but it could go into effect this year. For more information, see our [BoardroomDirect Alert](#), *Federal Appeals Court rejects proxy access rule*.

### **Dodd-Frank—one year later**

Yes, a whole year has passed since enactment of the Wall Street Reform and Consumer Protection Act (Dodd-Frank or the Act). In that time, regulators have made progress on many of the Act's mandated rules, regulations, and studies, but there is still plenty to come. Here's a snapshot of a few rules yet to be adopted by the SEC. For more discussion of Dodd-Frank as it enters into its second year, see our [Closer Look special edition](#), *Unfinished Business: Dodd-Frank—Entering Year Two*.

#### ***Conflict mineral disclosures***

Originally scheduled to be adopted last April, the final rules on disclosures of conflict minerals are now expected by the end of the year. It might not be smooth sailing, though. As awareness about the potential implications of these rules continues to grow, many are concerned about the large number of companies that will be affected and their ability to comply if the rules are adopted as proposed.

As a quick refresher, these proposed rules apply to companies that use minerals from the Democratic Republic of the Congo and its adjoining countries ("DRC countries") in their products (so-called "conflict minerals"). Under the proposed rules, companies are required to assess whether they use conflict minerals that are "necessary to the functionality or production" of a product they manufacture, and determine (and disclose) whether the minerals originate from a DRC country. What's the challenge? In many cases, the current lack of transparency into the supply chain makes it difficult, if not impossible, for companies to trace the origin of the minerals they use.

Even though the rules are not yet final, companies should assess now whether they will be affected. Those who will be significantly affected may want to begin devising an action plan—if they haven't already—to comply with the upcoming rules. For more background on this issue, refer to our [Closer Look publication](#), *Disclosures Related to Use of "Conflict Minerals."* The conflict mineral provision of the Act was also discussed on a June [BoardVision episode](#) presented with the National Association of Corporate Directors.

### *Executive compensation disclosures and “clawbacks”*

Executive compensation is a perennial hot topic. It seems that everyone has an interest—boards, shareholder rights advocates, investors, regulators, and, of course, executives. The rules required by the Act in this area will affect all public companies. They include disclosures of internal pay equity (the so-called “CEO pay ratio”) and the relationship between executive compensation actually paid and the company’s financial performance. The Act also requires expanded clawback provisions that would recover from current or former executive officers any erroneously awarded compensation in the three years prior to an accounting restatement—whether or not the restatement resulted from misconduct.

Another factor causing angst: the Act left many of the details up to the SEC. This has companies wondering exactly how the SEC will interpret the Act’s requirements. When are the proposed rules coming? They are expected before the end of the year, with final rules to be adopted in 2012. This timing raises doubts that the new disclosure rules will be effective for the 2012 proxy season.

For more background on these matters, see our [Closer Look publication](#), *Executive Compensation*.

### *Derivatives regulation*

Regulators, including the SEC, have been actively working toward finalizing the complicated and controversial mosaic of proposals intended to reform the derivatives (swaps) markets. The Act subjects swaps, swap markets, and certain swap market participants to new, comprehensive regulation aimed at increasing transparency, reducing systemic risk, and ensuring orderly markets.

Not a financial services company? The new derivatives regulation could still affect you in a number of areas. For example, companies that currently conduct their hedging activities using customized over-the-counter swaps might choose to utilize exchange-traded swaps. However, using an exchange-traded swap with standardized terms could affect the application of hedge accounting, because certain swaps might not qualify for the shortcut and critical terms match methods of assessing effectiveness. The regulations also will impose extensive new recordkeeping and reporting requirements.

Many rules have been proposed in this area, but some rulemaking is still pending. It’s expected that some aspects of the new regulations could be in place by the end of the year, with full roll-out continuing into 2012. For background on derivatives regulation and to assess how your company may be affected, see our [Closer Look publication](#), *Derivatives Regulation and Changing Market Infrastructure for Nonfinancial Companies*.

### **Non-GAAP measures remain fertile ground for SEC comments**

If you think the debate over non-GAAP measures is yesterday’s news, think again. Through its interpretations and comments, the SEC continues to delineate what’s in and out of bounds. You may recall that in early 2010 the SEC updated its interpretative guidance on non-GAAP financial measures, encouraging companies to be consistent in how they portray their financial results to investors. The updated guidance was intended to remove certain perceived constraints that some believed discouraged companies from disclosing non-GAAP measures. Recent comments, though, reveal that the SEC believes some non-GAAP measures go too far. For example, the SEC recently has focused on non-GAAP measures that exclude expenses considered to be integral to operating the business.

So what should you do? Start with the basic principle: the SEC’s rules prohibit disclosure of *misleading* non-GAAP financial measures. For example, the SEC has specifically commented that the exclusion of normal cash operating expenses necessary to operate the business (such as advertising costs, customer acquisition costs, or salaries) could be misleading. What else? Here are a few reminders:

- Don’t present non-GAAP financial measures with greater prominence than GAAP measures. This includes both the order of presentation and the degree of emphasis. For example, the SEC may challenge a discussion of non-GAAP financial measures that significantly exceeds the length of the discussion of the corresponding GAAP measures. The SEC also believes that a full non-GAAP income statement attaches undue prominence to the non-GAAP information.
- When presenting a non-GAAP financial measure, don’t use terminology that would imply it is a standard measure. For example, a measure that includes adjustments to the standard definition of EBITDA should not be labeled “EBITDA.”
- If you have a GAAP net loss but plan to disclose non-GAAP net income, don’t forget the implications on earnings per share. Non-GAAP diluted earnings per share should include the effect of any dilutive potential common shares outstanding—even if they were antidilutive to the computation of diluted GAAP loss per share.

For more background on non-GAAP measures, see [Dataline 2010-03](#), *Non-GAAP measures—Updated guidance to enhance a company’s ability to communicate important information to investors*. Also, SEC observations on non-GAAP measures are discussed in [Dataline 2010-44](#), *Highlights of the 2010 AICPA National Conference on Current SEC and PCAOB Developments*.

## Have you updated your (filing) status?

When it comes to social networking, updating your “status” is an entirely voluntary exercise. However, “filing status” for an SEC registrant has meaningful implications, as it determines the due dates for annual and quarterly reports, and internal control reporting requirements under Sarbanes-Oxley Section 404. But why discuss filing status now?

A key factor in determining an SEC registrant’s filing status is its worldwide public float as of the end of its most recently completed second fiscal quarter. That means, for many registrants, now is the time to re-evaluate filing status. For registrants that may be changing filing status, it’s important to plan ahead. Every registrant is either: a) a large accelerated filer, b) an accelerated filer, or c) a non-accelerated filer. Moving from one category to another can have significant implications.

Here’s a high-level summary of the thresholds<sup>2</sup> for entering and exiting accelerated filer status (and note the thresholds for entering and exiting a filing status are not the same):

- A non-accelerated filer becomes an accelerated filer if its worldwide public float is at least \$75 million, and an accelerated filer becomes a large accelerated filer if its worldwide public float is at least \$700 million.
- A large accelerated filer exits large accelerated filer status and becomes an accelerated filer if its worldwide public float is less than \$500 million, and an accelerated filer becomes a non-accelerated filer if its worldwide public float is less than \$50 million.

<sup>2</sup> All thresholds are based on a registrant’s public float on the last business day of its most recently completed second fiscal quarter.

There are other requirements in addition to public float to consider. The complete criteria for determining filer status are outlined in Rule 12b-2 under the Securities Exchange Act of 1934.

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## ***IFRS developments***

### **SEC continues to solicit views on IFRS**

***The Commission's decision this year is a critical one and it is being closely watched by other jurisdictions around the world.***

- Kathleen L. Casey, former SEC Commissioner, [June 24, 2011](#)

As the end of the year draws near, there is growing interest in the SEC's much anticipated decision—that is, whether, when, and how to incorporate IFRS into the U.S. financial reporting system. The topic has popped up in recent high-profile speeches by individuals ranging from former SEC Commissioner Kathleen Casey, who officially ended her term in August, to incoming IASB Chairman Hans Hoogervorst. One thing is clear: there are strong opinions on the subject.

In early July, the SEC held a roundtable to further explore the possibility of incorporating IFRS into U.S. GAAP, as described in its May 2011 paper. In summary, the SEC's paper outlined an “endorsement” approach under which the FASB would change U.S. GAAP over a period of five to seven years by endorsing, and thereby incorporating, individual international standards into U.S. GAAP.

The feedback so far? Many are open to the general idea of endorsement, but have significant questions about how this approach would work. For example, some question how the SEC and FASB would determine when U.S.-specific changes to IFRS are necessary. Others are concerned that IFRS may not be consistently interpreted and implemented across jurisdictions. And, there are reservations about the lack of a clear timeline for IFRS adoption and implementation.

On the other hand, respondents have pointed out that incorporating IFRS into U.S. GAAP would minimize changes to existing contracts or regulations that reference U.S. GAAP. Lastly, some companies advocate that U.S. companies be given the option to adopt IFRS, even though that topic was not specifically addressed in the SEC's paper.

Now that the comment period has ended, the ball is in the SEC's court to make the next move. Two more SEC papers on IFRS are expected soon. One paper is expected to address the consistency in the application of IFRS across industries and jurisdictions. The second is expected to compare IFRS and U.S. GAAP to identify remaining differences in objectives between the two frameworks.

If you missed the “official” window of opportunity to comment on the SEC's endorsement approach, it's not too late to make your views known—comments can still be provided through the SEC's [website](#). For more information on the SEC's paper, refer to [In brief 2011-23](#), *SEC Staff Paper explores one possible method to incorporate IFRS in the U.S.*

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## *On the horizon*

### **FASB makes headway on a “differential framework” for private companies**

The Financial Accounting Foundation, the organization that oversees the FASB, hasn't yet announced any conclusions on standard setting for private companies. Its working group continues to explore the issue, including its assessment of the recommendations from the Blue-Ribbon Panel<sup>3</sup> earlier this year. In the meantime, however, the FASB is moving forward with its efforts to better address the needs of private company financial statement users and preparers.

This quarter, the FASB announced that it is making progress on a “differential standard-setting framework.” The Blue Ribbon Panel recommended developing such a framework for deciding whether and when private companies should have different requirements for recognition, measurement, presentation, disclosure, effective dates, and transition methods for financial accounting standards.

As a first step, the FASB looked at some key factors: a) the differences between users of private and public company financial statements and b) how the cost-benefit considerations of financial reporting vary between private and public companies. Refer to the [\*FASB in Focus\*](#) posted on the FASB's website for more on this initial assessment.

Next up? A discussion paper on the topic is slated for issuance next quarter. The paper is expected to expand on the proposed differential framework. Keep an eye out for this next opportunity to weigh in on the debate. The FASB will also be hosting two public roundtables in October to discuss concerns about existing standards with private companies, their auditors, and users of private company financial statements.

### **New consolidation guidance...coming soon?**

It's been anticipated for a while now, but it looks like the FASB is close to issuing two exposure drafts under the consolidation “umbrella.”

One exposure draft will include “principal” vs. “agent” considerations for variable interest entities, and would end the deferral from applying the current guidance<sup>4</sup> that was granted to certain investment entities. The FASB's proposals will follow on the heels of a major update by the IASB of its consolidations guidance, recently completed in May. Unlike the IASB's new standards, though, the FASB's proposals will not revisit consolidations as a whole. However, the FASB's proposed principal vs. agent guidance is expected to be consistent with the IASB's approach in this area.

The other exposure draft will focus on the definition of an investment company, an area where the FASB and IASB have been seeking common ground. In August, the IASB issued its proposal. It's expected that the criteria to qualify as an investment company in the FASB's exposure draft will be substantially converged with the IASB's proposal and will be more restrictive than current U.S. GAAP. Beyond the definition, however, some significant financial reporting differences will remain between U.S. GAAP and IFRS—for

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<sup>3</sup> In 2010, the Financial Accounting Foundation created the Blue-Ribbon Panel on Standard Setting for Private Companies, sponsored jointly with the American Institute of Certified Public Accountants and the National Association of State Boards of Accountancy, to address how accounting standards can best meet the needs of U.S. users of private company financial statements.

<sup>4</sup> Certain investment entities were granted a deferral from applying FAS 167, *Amendments to FASB Interpretation No. 46(R)* (codified in ASC 810).

example, whether an investment entity will account for a controlling interest in another investment entity at fair value or by consolidating the entity.

And that's not all...the FASB plans to issue a third exposure draft on investment properties—a separate, but related project. That proposal is expected to define an “investment property entity” and would require such an entity to measure its investment properties at fair value.

Check out our upcoming *Setting the standard* for more updates on these projects. We'll also keep you informed when the FASB issues its exposure drafts. For a summary of the IASB's new guidance and recent proposal see [In brief 2011-19](#), *IASB issues package of standards covering consolidation and joint venture accounting*, and [In brief 2011-37](#), *IASB proposes accounting guidance for investment entities*.

### **FASB moves its disclosure framework project forward**

The FASB made use of the summer recess on joint standard setting to pick up its disclosure framework project. While other projects had the spotlight in the first half of the year, work continued behind the scenes on this ongoing FASB initiative. This project is aimed at establishing an overarching framework intended to make financial statement disclosures more effective, coordinated, and less redundant.

In August, the FASB discussed a decision process it might use when establishing disclosure requirements for new accounting standards. The goal of the decision process is to focus on matters that are most important to users of a particular entity's financial statements. The desired result is a net reduction in disclosure volume, but an increase in the usefulness of the information disclosed.

Next, the FASB plans to issue a discussion paper early in 2012. The FASB expects this timing to coincide with the issuance of a comparable document by the European Financial Reporting Advisory Group, an advisory group to the European Commission, which has taken on a similar project from an international perspective. Expect to hear more on this project early next year.

### **EITF to take on another foreign currency challenge**

Foreign currency accounting is not for the faint of heart. Fortunately, the EITF has decided it's up for the challenge. The EITF will soon address a foreign currency conundrum: how should a parent company account for the cumulative translation adjustment when it sells a business that's part of—but not an entire—foreign entity? That is, should the cumulative translation adjustment related to the business be released into earnings upon sale? Currently, a conflict exists between the deconsolidation guidance and foreign currency guidance in this area. Stay tuned for more on this issue when the EITF reconvenes in November.

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## ***Corporate governance***

### **There's an “app” for that—introducing PwC's Board Center App**

Get timely insights on corporate governance issues and trends on the go! PwC's Board Center App, available for your iPad, brings together insights on strategy and growth, executive compensation, financial reporting developments, and risk management with the corporate director in mind.

Upon downloading this free App, you will have access to a full library of publications and on-demand videos, including the 10Minutes series, *To the point*, *BoardroomDirect*, *BoardVision*, and many other updates from PwC's Center for Board Governance. Get more information on our [Corporate Governance website](#).

**...those companies that best ensure that their employees view internal reporting as a viable and credible option to address possible securities law violations are more likely to have the wrongdoing reported internally first.**

-Sean X. McKessy, SEC Chief,  
Office of the Whistleblower,  
[August 11, 2011](#)

## **SEC whistleblower program—it's official**

The SEC's new whistleblower program officially became effective on August 12. As we discussed last quarter, the SEC passed the final rules in May to mixed reviews. Many were concerned that the final rules did not go far enough to avoid undermining a company's internal compliance program. While the rules do include certain incentives to encourage employees to report potential violations internally first, they do not *require* internal reporting prior to reporting a matter to the SEC.

Now that the SEC's whistleblower program is in place, it's a good opportunity to revisit internal compliance programs and implement improvements where warranted. For example, companies should assess their internal hotlines and other internal reporting mechanisms, and ensure they are easy to access and can be used without fear of retaliation. Management should remind employees about these programs and encourage them to "do the right thing" when it comes to reporting issues. It's also important to have the procedures and resources in place to make a timely assessment of all whistleblower complaints—both those received internally and via the SEC's whistleblower program.

For more discussion of the SEC's program and its implications, see our [Closer Look publication](#), *SEC Adopts Final Rules Establishing Whistleblower Program*.

## **Audit committee effectiveness—what works best**

The audit committee's role in ensuring accurate and transparent disclosure is more important than it has ever been. This fourth edition of *Audit committee effectiveness—what works best* helps audit committee members understand how best to carry out their many complex responsibilities and is intended to be a practical guide, providing information and best practices on topics that are most relevant to them. Find it on our [Corporate Governance website](#).

## **Other corporate governance publications**

The Summer 2011 edition of *BoardroomDirect* focuses on proxy season takeaways, final whistleblower rules, a director's role in IT strategy and cyber-security risk, and doing deals in China.

The latest edition of *To the point* presents an overview on what directors should be asking management about its strategies for adapting to the SEC's new whistleblower rules, more on Dodd-Frank's conflict minerals disclosure rules, and insight into the SEC's paper on one possible way to move from U.S. GAAP to IFRS over a period of time.

These publications are available on our [Corporate Governance website](#).

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## Appendix

### Effective dates for recently issued standards

ASU 2010-06, <i>Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements</i>	Interim and annual periods beginning after December 15, 2009 <sup>5</sup>
ASU 2010-20, <i>Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses</i>	Interim and annual reporting periods ending on or after December 15, 2010 <sup>6</sup>
ASU 2010-25, <i>Plan Accounting—Defined Contribution Pension Plans (Topic 962): Reporting Loans to Participants by Defined Contribution Pension Plans</i>	Fiscal years ending after December 15, 2010
ASU 2010-13, <i>Compensation—Stock Compensation (Topic 718): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades</i>	Fiscal years beginning on or after December 15, 2010
ASU 2010-15, <i>Financial Services—Insurance (Topic 944): How Investments Held through Separate Accounts Affect an Insurer’s Consolidation Analysis of Those Investments</i>	Fiscal years beginning after December 15, 2010
ASU 2010-16, <i>Entertainment—Casinos (Topic 924): Accruals for Casino Jackpot Liabilities</i>	Fiscal years beginning on or after December 15, 2010
ASU 2010-23, <i>Health Care Entities (Topic 954): Measuring Charity Care for Disclosure</i>	Fiscal years beginning after December 15, 2010
ASU 2010-24, <i>Health Care Entities (Topic 954): Presentation of Insurance Claims and Related Insurance Recoveries</i>	Fiscal years beginning after December 15, 2010
ASU 2010-27, <i>Other Expenses (Topic 720): Fees Paid to the Federal Government by Pharmaceutical Manufacturers</i>	Calendar years beginning after December 31, 2010
ASU 2010-28, <i>Intangibles—Goodwill and Other (Topic 350): When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts</i>	Fiscal years beginning after December 15, 2010 <sup>7</sup>

<sup>5</sup> The disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements are deferred until fiscal years beginning after December 15, 2010.

<sup>6</sup> For public entities, the disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010. [Note: Refer to ASU 2011-01 for deferral of the effective date for disclosures about troubled debt restructurings.] For nonpublic entities, all disclosures are effective for annual reporting periods ending on or after December 15, 2011.

<sup>7</sup> For nonpublic entities, the amendments are effective for fiscal years beginning after December 15, 2011.

ASU 2010-29, <i>Business Combinations (Topic 805): Disclosures of Supplementary Pro Forma Information for Business Combinations</i>	Business combinations with an acquisition date on or after the beginning of the first annual reporting period beginning on or after December 15, 2010
ASU 2011-01, <i>Receivables (Topic 310): Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20</i>	As of January 19, 2011
ASU 2011-02, <i>Receivables (Topic 310): A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring</i>	First interim or annual period beginning on or after June 15, 2011 <sup>8</sup>
ASU 2010-26, <i>Financial Services—Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts</i>	Fiscal years beginning after December 15, 2011
ASU 2011-03, <i>Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements</i>	First interim or annual period beginning on or after December 15, 2011
ASU 2011-04, <i>Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs</i>	Interim and annual periods beginning after December 15, 2011 <sup>9</sup>
ASU 2011-05, <i>Comprehensive Income (Topic 220): Presentation of Comprehensive Income</i>	Fiscal years beginning after December 15, 2011 <sup>10</sup>
ASU 2011-07, <i>Health Care Entities (Topic 954): Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities</i>	Fiscal years beginning after December 15, 2011 <sup>11</sup>
ASU 2011-06, <i>Other Expenses (Topic 720): Fees Paid to the Federal Government by Health Insurers</i>	Calendar years beginning after December 31, 2013

<sup>8</sup> The amendments should be applied retrospectively to the beginning of the annual period of adoption. For nonpublic entities, the amendments are effective for annual periods ending on or after December 15, 2012, including interim periods.

<sup>9</sup> For nonpublic entities, the amendments are effective for annual periods beginning after December 15, 2011.

<sup>10</sup> For nonpublic entities, the amendments are effective for fiscal years ending after December 15, 2012.

<sup>11</sup> For nonpublic entities, the amendments are effective for fiscal years ending after December 15, 2012.

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