

The quarter close

A look at this quarter's
financial reporting issues
Directors edition

June 17, 2011

What's inside

Front and center 1
SEC matters 3
IFRS developments 6
On the horizon 6



What you need to know—Q2—2011

Welcome to the second quarter 2011 edition of *The quarter close – Directors edition*. While summer brings visions of baseball, cookouts, and fun in the sun, there seems to be precious little time for those in financial reporting to kick back and relax. As we near the 2011 halfway mark, standard setters and regulators are shifting into overdrive to meet the ambitious goals they've set for the year. Whether you're a preparer, investor, or auditor—there's something for everyone. We'll give you a play-by-play of all the action, but here are some of the highlights:

Front and center. The FASB and IASB's deliberations on the joint standard-setting projects continue to take center stage, with more changes in timelines, late-breaking news on the revenue project, some significant shifts on leases, and plenty of feedback on the financial instruments proposals. Also in the spotlight this quarter: the SEC's latest release on the possible incorporation of IFRS into the U.S. financial reporting system.

On the horizon. Next, you'll find an update on a diverse range of topics, including some audit-related news. While we don't typically cover audit topics, we would be remiss if we didn't give you a flavor of what's happening on that scene. Why should you care? Proposals forthcoming from the Public Company Accounting Oversight Board (PCAOB) could require mandatory auditor rotation and significantly expand auditor reporting, among other topics. We also take a look at what's happening on the topic of private company standard setting and the FASB's latest move on multiemployer pension plan disclosures.

And lots more. Plenty is happening on the SEC front, too, with discussions beginning to heat up on IFRS and more Dodd-Frank rulemaking, including the highly anticipated whistleblower rules.

Front and center

Priority projects head into extra innings...and the boards throw a few curveballs

Call it a possible "win" for quality. In April, the FASB and IASB (the boards) announced an update to their timeline for the priority joint projects, citing the importance of taking the time to ensure the quality of these landmark accounting standards. Just this week, the boards decided to re-expose the proposed revenue standard and revised their projected issuance date for a final standard to September 2012. While the current planned timeline still indicates issuance of final standards for leases and financial instruments by the end of 2011, the boards will also be under considerable pressure to re-expose those projects as well.

We've summarized below some of the more significant movements on the revenue, leases, and financial instruments projects since our last edition of *The quarter close – Directors edition*. For a progress report on all of the boards' joint projects, see our recently-issued edition of [*Setting the standard*](#). You also might be interested in our [*Point of view document*](#): *Finding the right pace of standard setting*, which includes our perspectives on the revised timeline for the priority projects.

We agree that issuing high quality accounting standards is paramount. The boards should take whatever time is needed to accomplish this goal.

PwC Point of view: *Finding the right pace of standard setting*

Revenue—the boards gear up for the next round

Re-exposure isn't the only big news for the revenue project. The boards reaffirmed their proposal to require "full retrospective application" of the new guidance. What does that mean? In short, it means that companies will have to recast their prior period financial statements to reflect the new guidance when they adopt the new standard.

The boards have agreed, however, to provide some relief by allowing a few practical exceptions to the approach. For example, the boards will allow companies to use hindsight in certain cases and will not require companies to restate contracts that begin and end within the same reporting period. It remains to be seen whether this relief will be enough to ease concerns about the challenges of a retrospective transition approach.

The boards also recently tackled a number of other topics, including variable consideration, onerous contracts, licenses of intellectual property, and contract costs. One area that hasn't changed much is disclosure, as the boards decided to retain most of the proposed disclosures for public companies. Private companies, though, won't be required to make certain of these disclosures.

Leases—it ain't over until it's over...

In an unexpected move, the boards appear to have changed course again on a key aspect of the leasing project. Last quarter, we reported that the boards had tentatively decided that, for lessees, there should be a fundamental distinction between those leases that are primarily financing transactions in nature and those that are not. Expense for non-financing leases would be recorded by the lessee on a straight-line basis, similar to today's operating leases (although the leases would still be recorded on the balance sheet).

Sparking some controversy, the boards reversed this prior tentative decision in May and returned instead to a single approach for all leases. That means all leases will be treated as financings, resulting in a front-loading of expense.

Another tentative decision, though, appears to be holding up. Previously, the boards agreed to provide a simplified approach to accounting for short-term leases, defined as those with a maximum possible term of twelve months or less. While the boards may further refine their thinking on this topic, they've tentatively decided to give companies the option to account for short-term leases off balance sheet and on a straight-line basis, similar to today's operating lease model.

The boards also continue to grapple with lessor accounting. Two main views appear to be emerging. One view is that a single derecognition approach should be applied to all leases, as opposed to the dual approach proposed in the exposure draft. The other view is to retain current lessor guidance, but with some tweaks to conform to the decisions made on lessee accounting. The boards appear to be leaning toward the derecognition approach, but more discussion will be needed before a final decision is reached.

Financial instruments—still more ground to cover

Impairment accounting remains a struggle for the boards. Although intended as a compromise, their latest proposal was widely rejected. As the comment letters rolled in, the message became clear: go back to the drawing board. Most respondents liked the end-goal (a converged solution), but not the proposed path for achieving that goal. After discussing the feedback and possible alternatives, the boards have already started to flesh out a new model.

The FASB also received feedback on whether it should consider adopting the IASB's proposed hedge accounting approach. Once again, respondents cast their vote for a converged standard—with a leaning toward the IASB's more expansive consideration of the hedging model. However, it remains to be seen whether the FASB will decide to follow the IASB's lead.

As for determining what gets measured at fair value versus amortized cost, the FASB continues to work out the details of its revised model. Recently, the board clarified some points on the principles of “instrument characteristics” and “business strategy,” which will determine how to categorize and account for financial assets. Additionally, the FASB tentatively decided to retain today's approach when applying the equity method of accounting and accounting for hybrid financial instruments.

What's next?

Some big ticket items are still in play. Other than the revenue project, the boards have yet to announce whether they will re-expose the other priority projects. At a minimum, we expect the boards to post their updated drafts of the standards on their websites prior to finalizing them. It's critical to stay abreast of the latest updates in order to take advantage of the opportunities to make your voice heard on these important projects.

SEC tests the waters with a possible approach to incorporating IFRS

Meanwhile, the SEC has published a paper designed to kick-start the dialogue about how to incorporate IFRS into the U.S. reporting system. Keep in mind: no decision has yet been made about *whether* to incorporate IFRS. That's on tap for later this year. However, the SEC's latest release further explores an endorsement-type approach that a senior SEC official had previously floated as a trial balloon¹. Under this approach, the FASB would change U.S. GAAP over a period of five to seven years by endorsing, and thereby incorporating, individual IFRSs into U.S. GAAP. Notably absent from the paper: a discussion about whether U.S. companies might have the option of adopting IFRS early.

Response to this approach is likely to be mixed. A more gradual transition may appeal to some, while others, particularly larger multinational companies, may prefer a “big bang” approach. The SEC wants comments by July 31, so offer up your views now. We look at the SEC's paper in a bit more detail below, in “IFRS developments.”

A global economy in which billions cross borders with a click of a mouse demands accounting standards that cross borders with equal ease.

—Mary L. Schapiro, SEC Chairman, [May 24, 2011](#)

SEC matters

Deadlines come and go—Dodd-Frank rulemaking strains SEC

It may seem hard to believe, but April 21 marked the nine-month anniversary of the enactment of the Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act or the Act). It was also the deadline for a number of rulemaking requirements—and it was largely missed. Not that the regulators, including the SEC, haven't been hard at work. The missed deadlines are perhaps more reflective of the massive undertaking required to implement the Act.

¹ Refer to the [speech](#) given by Paul Beswick, SEC Deputy Chief Accountant, at the December 2010 AICPA National Conference on Current SEC and PCAOB Developments.

The SEC has pushed back its timeline for rulemaking in several areas including, among others, final rules on disclosures about conflict minerals, and proposed rules on executive compensation disclosures and compensation “clawback” requirements. Nonetheless, the SEC continues to march on and has issued multiple proposed and final rules this quarter. Companies should consider the need to refresh their risk factor disclosures related to these rules—especially as greater clarity begins to emerge about their impact.

Here we provide just a few examples of the SEC’s recent activity. To find more information about the Dodd-Frank Act, visit our [Financial Services Regulatory Practice website](#).

I believe that the final recommendation strikes the correct balance.

-Mary L. Schapiro, SEC Chairman,
[May 25, 2011](#)

Indeed, I fear the Commission has elected to implement a whistleblower program that favors a pound of cure over an ounce of prevention.

-Kathleen L. Casey, SEC
Commissioner, [May 25, 2011](#)

Final rules on whistleblower incentives divides the SEC

It wasn’t unanimous, but the SEC passed its final rules implementing the Whistleblower Incentives and Protection Program in May. The whistleblower program rewards individuals who provide the SEC with high-quality tips that lead to successful enforcement actions. As we reported last quarter, an area of particular concern to many was whether the whistleblower program would undermine internal compliance programs. This issue has been debated vigorously since the passage of the Dodd-Frank Act.

In its final rules, the SEC stopped short of requiring internal reporting first; however, the rules do have certain incentives to encourage employees to utilize internal reporting programs. The final rules also extend the time for a whistleblower to report to the SEC after first reporting internally—and still be treated as if he or she reported to the Commission at the earlier date—to 120 days, from the originally proposed 90 days. Do these changes go far enough? Some believe they do not, including the U.S. Chamber of Commerce, who issued a highly critical statement opposing the final rules.

We cover other changes from the proposal in a [BoardroomDirect Alert](#) and a [BoardVision episode](#) presented with the National Association of Corporate Directors on this topic.

Proposal requires compensation committee members to be independent

In March, the SEC proposed rules aimed at increasing the independence of compensation committees and their advisors. The proposed rules, among other requirements, generally: (1) require each compensation committee member to be an independent member of the board of directors, (2) provide certain factors for compensation committees to consider when assessing the independence of compensation consultants or other advisors, and (3) require disclosures regarding the use of compensation consultants.

The comment period ended in May after it was extended for an additional 20 days.

Proposed risk retention rules—will they affect consolidation?

Risk retention rules for securitization transactions (aka the “skin in the game” requirements) were released for comment in March. The rules, proposed by six federal agencies including the SEC, require sponsors of asset-backed securities to retain at least five percent of the credit risk of the assets underlying the securities and do not permit sponsors to transfer or hedge that credit risk. These rules apply to a number of transactions including those initiated by banks that securitize loans, as well as to corporations that securitize trade receivables. The comment period for the proposed rules was recently extended to August 1.

What might not be obvious at first glance: these rules could potentially have accounting implications. The FASB is currently deliberating proposed changes to the consolidation

guidance that would require companies with the power to direct the activities of another entity to determine if they are using those powers in the capacity of an “agent” or a “principal.” If a sponsor is determined to be the principal, it would be required to consolidate the entity. The connection? The risk retention rules require a sponsor to hold interests in certain securitization entities. The sponsor will have to consider these retained interests in its consolidation assessment under today’s guidance, and also in its assessment of whether it is a “principal” under the proposed consolidation guidance.

SEC reports on Sarbanes-Oxley, recommends status quo

Even though it’s been several years since the rules were issued, the debate hasn’t quite ended over the cost-benefit of Section 404(b) of the Sarbanes-Oxley Act of 2002 (Section 404(b)). Section 404(b) requires the auditor’s attestation on a company’s internal control over financial reporting. The Dodd-Frank Act directed the SEC to perform a study considering how it could reduce the burden of complying with Section 404(b) (including the possibility of exemption) for issuers with \$75-\$250 million in public float, while continuing to protect investors. Additionally, the SEC was to consider whether such actions would encourage issuers to list on U.S. exchanges.

The verdict? The SEC’s report, issued in April, recommends keeping the existing requirements. Among other things, the SEC’s report concludes that: (1) the costs of complying with Section 404(b) have declined over time, (2) investors generally view the auditor’s attestation as beneficial, (3) financial statement reporting is more reliable when the auditor is involved in internal control assessments, and (4) there is no conclusive evidence linking Section 404(b) requirements to the listing decisions of issuers of this size. In its report, the SEC also encouraged activities that have the potential to further increase the effectiveness and efficiency of Section 404(b) implementation. You can find the full report [here](#) on the SEC’s website.

Under the microscope—U.S.-listed companies with operations outside the United States

Recently, both the SEC and the PCAOB have publicly noted their focus on U.S.-listed companies with operations outside of the United States. This dovetails with other business headlines spotlighting U.S.-listed Chinese companies as a possible source of reporting problems. Against this backdrop, the SEC has also disclosed its mission to get more information about internal controls from those registrants with a majority of their operations outside of the United States. Specifically, the SEC has been asking questions about the educational background and professional experience of employees or outside consultants preparing financial statements in the non-U.S. locations.

What’s the SEC looking for? Ultimately, it is interested in learning whether the qualifications of the individuals preparing the financial statements support the conclusion that the company’s internal controls over financial reporting are effective. In fact, while a number of registrants have provided this information, it appears that some others have either elected to deregister or have amended their filings to disclose a material weakness in internal controls, acknowledging that they do not have adequate resources to prepare U.S. GAAP financial statements. All signs indicate that this will continue to be an area of focus for the SEC.

IFRS developments

SEC explores endorsement approach

As highlighted in “Front and Center,” the SEC is moving the conversation forward on how to incorporate IFRS into the U.S. financial reporting system. The SEC released a paper in May exploring a possible framework under which the FASB would endorse, and incorporate, individual IFRSs into U.S. GAAP. This process would occur over a period of five to seven years.

The ultimate objective? Convergence with IFRS. However, the endorsement mechanism, as described in the paper, would allow the FASB to modify or supplement IFRS in those instances necessary to protect U.S. investors—with the caveat that the SEC expects these modifications to be a rare occurrence.

In its paper, the SEC emphasized that the described framework was not the only approach or even necessarily the preferred approach. Also, at this point, the SEC has not made a final decision about whether to incorporate IFRS. What about a company who wants to early adopt IFRS? That option was outside the scope of this paper. However, the SEC did note that it is considering the possible mechanics and implications of such an option.

What would the future hold for the SEC and FASB?

According to the staff paper, the SEC would maintain its oversight of the FASB and the ultimate authority to prescribe accounting principles and standards to be followed by U.S. issuers. The FASB would continue as the U.S. standard setter. It would participate in the development of new standards, but the nature of its participation would differ from today. Rather than acting as the principal standard setter for new standards, the FASB would play an instrumental role by providing input and support to the IASB.

Also in the works

The SEC is also working on two other papers related to IFRS. One paper relates to the review of over 200 sets of IFRS financial statements to assess consistency in the application of IFRS. Another paper is expected to compare IFRS and U.S. GAAP to identify remaining differences in objectives between the frameworks.

Looking for feedback...

The SEC’s paper is another opportunity to provide your views. Comments on the paper are requested by July 31 and are not limited to comments on the framework described in the paper, but could address any possible approach to incorporate IFRS. Additionally, the SEC plans to hold roundtables on IFRS, the first taking place on July 7 to seek feedback from smaller issuers, investors, and regulators.

On the horizon

Spotlight on audit matters—new and newsworthy

If the past is any indication, changes in auditing requirements can reverberate broadly across many constituencies. The recent economic crisis has prompted regulators, standard setters, and others to take a closer look at audit matters, ranging from auditor selection to audit reports. Whether it’s the European Commission, the U.K. House of

Lords, or the PCAOB—it seems similar themes are being debated. Moreover, the various regulators are closely monitoring each other's activities. Auditors are clearly focused on these developments, but others should be too.

Whether you are an investor, auditor, preparer, audit committee member, academic scholar or other interested party, we will need your involvement.

-James R. Doty, PCAOB
Chairman [June 2, 2011](#)

One development grabbing headlines is a recent speech by PCAOB Chairman James Doty, who announced a planned concept release on the topic of mandatory auditor rotation. Also on tap: a second concept release intended to seek input on how to make today's auditor reporting model more meaningful for investors. For example, the PCAOB received feedback that investors would benefit from additional information about how the auditor assessed risk and the auditor's views on management's judgments, estimates, and accounting policies. The PCAOB will also be hosting roundtables in the third quarter.

All this activity follows on the heels of an initiative that's garnered considerable interest—the European Commission's "green paper" on audit policy that was issued in October 2010 as part of a broader look at the causes of the financial crisis. Similar to the PCAOB's project, the green paper discusses the role of the auditor and addresses issues regarding the independence of audit firms. At this time, the European Commission is in the process of considering the comments it received and preparing studies on policy options and cost-benefit.

What's next for private company standard setting recommendations?

Well, they're not gathering dust. The Financial Accounting Foundation (FAF), the organization that oversees the FASB, formed a working group to assess the Blue Ribbon Panel's recommendations, including its vision of creating a separate private company standard setter. The FASB is also busy behind the scenes, working on a private company reporting framework. What's this? The FASB would use the framework during deliberations to assess whether standards should provide exceptions or accommodations for private companies. To start, the FASB plans to publish a white paper later this year that looks at whether and how the needs of private company financial statement users differ from users of public company financial statements. The board will use feedback on the white paper to develop its framework.

Meanwhile, exceptions and accommodations for private companies continue to gain traction during FASB deliberations. For example, recent FASB decisions include extending the effective date of the statement of comprehensive income standard, providing a practical exception to reporting nonmarketable investments at fair value, and reduced revenue disclosures for nonpublic companies.

With all of this activity, it appears that the Blue Ribbon Panel's recommendations won't be the last word on private company standard setting. Expect to hear more on this topic in the upcoming months.

FASB tentatively scales back multiemployer pension plan disclosures

It's been out of the spotlight for a few months, but the FASB's project on multiemployer pension plan disclosures resurfaced at a FASB meeting late in May. As we reported back in Q4 2010, the FASB had deferred the planned effective date of the project due to concerns raised in the comment letter process. More specifically, the proposed requirement to disclose a company's estimated withdrawal liability was not embraced, as respondents were concerned that the disclosure would be confusing and misleading in situations where the company has no current expectation of withdrawing from the plan.

So where is the project headed? In a move likely to please preparers, the FASB tentatively decided not to require several of the proposed quantitative disclosures, including the controversial withdrawal liability. In lieu of these disclosures, the FASB tentatively decided that employers would be required to disclose certain identifying information about the plan. Additionally, the FASB explored whether to require a measure of the plan's funded status, similar to the Pension Protection Act of 2006 "zone status," which reflects the relative health of a multiemployer plan.

The tentative decisions appear to strike a balance between today's requirements, which are minimal, and the disclosure requirements proposed in the exposure draft. The FASB plans to wrap-up its redeliberations of this project soon and issue a final standard before the end of the year.

New post-implementation review—looking for your input

Along with other efforts to increase outreach to constituents, there is now a new avenue for providing feedback on the standard-setting process—after a standard has been implemented. The FAF sponsored a webcast in May to provide some additional details on its new post-implementation review process first announced late in 2010. Its primary goals are to review whether standards are functioning as intended and evaluate the costs of implementation.

The FAF plans to review standards approximately two years after issuance. Additionally, the reviewed standards will be selected based on certain criteria, including, for example, whether the standard is considered "controversial." The current plan is to review three standards a year.

So which standard is the guinea pig? The FAF has selected income tax uncertainties (formerly FIN 48) and expects to complete its review by the end of the summer. The FAF is looking for broad feedback from those who have a stake in the process—find a link on their [website](#) to participate.

Edited by:**John Barry**

Partner, PwC Center for Board Governance

Phone: 1-973-236-5460

Email: john.barry@us.pwc.com

Jan Hauser

Partner

Phone: 1-973-236-7216

Email: jan.hauser@us.pwc.com

Douglas Parker

Partner

Phone: 1-973-236-4707

Email: douglas.t.parker@us.pwc.com

Angela Ferguson

Director

Phone: 1-408-817-1216

Email: angela.fergason@us.pwc.com

The quarter close – Directors edition is prepared by the National Professional Services Group of PwC. This publication has been prepared for general information on matters of interest only, and does not constitute professional advice on facts and circumstances specific to any person or entity. You should not act upon the information contained in this publication without obtaining specific professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication. The information contained in this material was not intended or written to be used, and cannot be used, for purposes of avoiding penalties or sanctions imposed by any government or other regulatory body. PwC, its members, employees and agents shall not be responsible for any loss sustained by any person or entity who relies on this publication.

© 2011 PwC. All rights reserved. "PwC" refers to PricewaterhouseCoopers LLP, a Delaware limited liability partnership, which is a member firm of PricewaterhouseCoopers International Limited, each member firm of which is a separate legal entity.

To access additional content on accounting and reporting issues, register for CFOdirect Network (www.cfodirect.pwc.com), PwC's online resource for financial executives.