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The quarter close

A look at this quarter's financial reporting issues

Directors edition

March 18, 2015

What's inside

What you need to know—Q1–2015

Welcome to the first quarter edition of *The quarter close*. A new year brings new guidance from the FASB in the form of final standards and additional proposals.

This quarter, we guide you through the latest developments on the trek toward continuous financial reporting improvement.

Front and center. As companies address the business effects of the last year's peaks and valleys in oil and natural gas prices, we share five related accounting considerations that should be top of mind. In our video segment, our experts discuss business and accounting considerations that companies in all affected industries should consider.

Need to know which FASB standards are effective this year? Check out our quick reference list on www.cfodirect.com.

Accounting hot topics. The Affordable Care Act isn't new, but this quarter we walk you through some accounting implications that kick in this year. In addition, private companies can adopt an alternative accounting method for certain intangibles, but applying the guidance has some nuances. We tell you the markers to look for.

Hot off the press. We provide an update on how the FASB, IASB and TRG are navigating the questions around the new revenue standard. In addition, the new consolidation guidance is now on the map. Learn how it may affect the company on whose board you serve.

And more. Along with the latest corporate governance developments, we provide insight as to what to look for next quarter from the FASB.

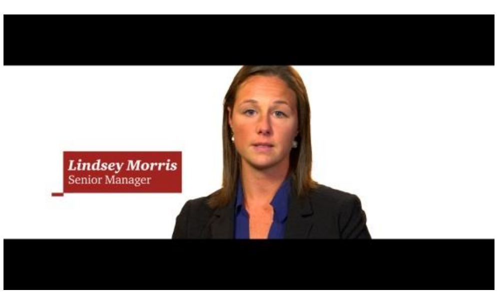
Video perspectives

Spotlight on the hot topic videos included this quarter

Oil price volatility: are you fit for $50 oil?

Click on the pictures or titles to launch the video perspectives.

Top 5 standards effective or adoptable in 2015



Cloud computing

Other videos included in this edition:

Private company accounting alternatives

Private company alternatives impact on public companies

SEC SX Rule 3-05

Front and center

Accounting implications of dips in oil and natural gas prices

Oil and natural gas prices fell off a cliff in the second half of 2014 and have remained low during the first few months of 2015. This plunge in prices has had a pervasive impact on the global economy and will continue to result in a number of accounting and financial reporting challenges for companies in certain industries. The decline in oil and natural gas prices should cause those companies to consider:

- *Valuation of inventories* – companies may need to adjust the historical cost of inventories in their balance sheets (e.g., impact on net realizable value)

- *Valuation of long-lived assets and investments* – companies may need to record an impairment charge to their long-lived assets and investments (e.g., revised assumptions in cash flow forecasts may result in the inability to recover the carrying value of a long-lived asset or may indicate an other-than-temporary loss in the value of an investment, etc.)

- *Accounting for income taxes* – companies may need to record a valuation allowance if they are in a net deferred tax asset position (e.g., decline in forecasted taxable income, etc.) and/or revisit their indefinite reinvestment assertions (e.g., impact on long-term investment plans, etc.)

- *Liquidity and going concern considerations* – companies may experience projected noncompliance with debt covenants, triggering of subjective acceleration clauses, and/or concerns over an entity's ability to continue as a going concern for a reasonable period of time

- *Financial statement disclosures* – companies may need to provide additional financial statement disclosures, including those related to uncertainties, assets at risk of impairment, and subsequent events

▶ Click here to learn more about the business effects of the decline in oil and natural gas prices.

For more information

To learn more about the impact of low oil and natural gas prices on business, read *The perils and blessings of low cost oil for growth markets*.

Accounting hot topics

This quarter's hot topics:

- Accounting implications of Affordable Care Act
- Applying the private company intangibles alternative

Should you be accruing for Affordable Care Act 'pay or play' penalties?

The Affordable Care Act (ACA) adds penalty provisions to the Internal Revenue Code for employers that do not offer health coverage meeting certain requirements to their full-time employees. These 'pay or play' rules begin in 2015 (payable in 2016). If the ACA health coverage requirements are not met, companies may need to estimate and record a liability for the penalties during 2015, which will likely require significant judgment.

When are the penalties imposed?

The mandate applies to employers with at least 50 full-time employees. These employers can either provide health care coverage that meets the ACA affordability and minimum value standards or face one of the following penalties:

- The 'A Penalty' applies if an employer does not offer health coverage to substantially all (95%) of its full-time employees and their dependents, and at least one full-time employee obtains subsidized coverage on a healthcare exchange.

- The 'B Penalty' applies if an employer offers health coverage to substantially all of its full-time employees and their dependents, but nonetheless, a full-time employee obtains subsidized coverage on an exchange. This may occur if the employer did not offer coverage to that employee or because the coverage offered was either unaffordable for that employee or did not provide minimum value (as defined by the mandate).

The A Penalty is calculated based on the total number of full-time employees (even if only one employee purchases subsidized coverage on an exchange). The B Penalty is calculated based on the number of employees that obtain subsidized coverage.

Certain transition provisions are available in 2015 as employers begin to comply with these requirements. For example, employers who offer coverage to at least 70% (rather than 95%) of their full-time employees in 2015 will not be subject to the A Penalty. Also, for 2015, employers with fewer than 100 full-time employees will not be subject to the penalties.

Accounting implications

The penalties are triggered when a full-time employee receives premium tax credits to buy health insurance on an exchange — but employers may not necessarily know when this happens. As such, companies may need to estimate when employees purchase coverage on a healthcare exchange.

Companies will need to (1) understand the complex provisions of the employer mandate, (2) gather the data necessary to determine if a penalty will be imposed, and (3) calculate, review and record any estimated liability. Appropriate internal controls should be established around these processes. Additionally, the penalties are not tax deductible; therefore, companies should consider projections of these penalties when developing their estimated annual effective tax rates.

For more information

For more information on the ACA employer mandates for 2015, read Insights from Human Resource Services, *Final rules on ACA's employer mandate include new transition relief.*

Adopting the private company alternative for intangibles? Consider these application nuances

Private companies that acquire a business now have the option not to separately recognize and value certain customer-related intangible assets and noncompete agreements. Some of the nuances of applying the new guidance may not be obvious, so tread carefully.

Which customer-related intangibles does it apply to?

The alternative applies to customer-related intangible assets acquired in a business combination (such as customer relationships and customer contracts), except for those that are "capable of being sold or licensed independent from other assets of the business." Because of this exception, things like customer lists, mortgage servicing rights, commodity supply contracts, and core deposits will likely still need to be separated.

Customer-specific considerations also have to be taken into account. For example, if certain customers on a customer list have not provided consent for their information to be sold, then they don't meet the definition of "capable of being sold." Therefore, the value associated with those customers would need to be carved out of the customer list intangible asset and subsumed into goodwill under this alternative.

One chance to adopt the alternative

Private companies that want to adopt the alternative must do so upon the first qualifying transaction that occurs in the fiscal year beginning after December 15, 2015 (early adoption permitted). Any subsequent election of the new guidance would be considered a change in accounting policy, subject to preferability, and applied retrospectively. The Private Company Council is considering whether to provide relief from this "one chance" approach to adoption for this and other private company alternatives, so stay tuned.

For more information

For more information about the intangibles accounting alternative and its application, read In depth US2015-02, *FASB provides private companies relief on intangibles*.

Hot off the press

FASB, IASB, and TRG make headway on revenue recognition implementation issues

In January, the Transition Resource Group (TRG) held its third meeting to discuss implementation issues related to the new revenue standard. The TRG provided an update on unresolved issues discussed at previous TRG meetings and discussed eleven new issues. After taking the TRG discussion into consideration, the FASB and IASB ultimately determined for each issue whether (a) no clarifying guidance was necessary, (b) clarifying guidance should be considered, or (c) additional research needed to be performed by the staff to determine if clarifying guidance was necessary. Some of the topics following the "(b)" trail then made their way onto the agenda for a joint board meeting in February.

FASB and IASB meet to discuss implementation issues

At their joint meeting, the FASB and IASB considered some of the implementation issues that TRG discussions indicated might need clarifying guidance. The boards were aligned on the need to address stakeholder feedback on licenses and performance obligations, but did not agree on the approach to do so.

The FASB supported amending the principle related to licenses whereas the IASB decided to simply clarify it. The FASB also intends to make several other changes to the guidance on licenses and identifying performance obligations. The IASB will instead explore adding additional examples and providing other educational materials. All decisions made at this joint board meeting are tentative and subject to final voting by the boards.

Next steps for the FASB and IASB

The FASB staff will draft a proposed update to the new revenue standard that includes the agreed-upon amendments and clarifications. The FASB is expected to issue the proposal for public comment during the second quarter of 2015.

The IASB is expected to perform additional outreach on the amendments that were agreed to by the board. The proposed amendments would be subject to the IASB's due process; however, a specific timeframe was not discussed.

Potential delay in the effective date

The boards did not discuss the results of the ongoing outreach on a potential delay in the effective date of the new standard. However, the FASB is expected to announce any delay in the effective date in the second quarter of 2015. The IASB has not provided a specific timeline on its decision regarding a potential delay in the effective date of the standard.

For more information

For additional background on the specific issues discussed at either meeting, including our insights, read In transition US2015-01, *Transition Resource Group debates revenue recognition implementation issues*, and In transition US 2015-02, *FASB and IASB debate potential changes to revenue standard*.

FASB reaches end of the road on consolidation project

The FASB's new consolidation guidance makes targeted amendments to the current consolidation guidance that could affect all industries. It also ends the deferral granted to investment companies from applying the variable interest entity guidance.

What's changed?

The new consolidation standard still has two models: one based on the notion that majority voting rights indicate control (the voting interest model) and another for assessing control through other means, such as management contracts or subordinated financial support (the variable interest model). But which model you should apply to your facts and circumstances may change under this new guidance.

Situations where the key decisions are made through contractual arrangements, where related parties are involved, or where the entity being assessed for consolidation is a limited partnership or similar entity could trigger additional analysis, different disclosures, or different consolidation conclusions.

What's next?

The standard is effective in 2016 for calendar year-end public companies. Nonpublic companies get an extra year. Early adoption is allowed.

To learn more about the new consolidation guidance, read In depth US2015-03, *New consolidation standard — The FASB guidance allows early adoption now,* and In the loop, *Consolidation changes — do they affect your company?*

On the horizon

Consistent cloud computing accounting on the horizon

Companies in all industries enter into cloud computing or hosting arrangements that provide them with access to software hosted by the software vendor. The question that frequently arises is whether that should be accounted for as a service (expensed as incurred) or treated as an asset (capitalized and subsequently amortized). Current U.S. GAAP doesn't explicitly answer that question, resulting in companies taking different paths.

In response, the FASB will soon issue new guidance that will help companies evaluate the accounting for these arrangements, including whether the arrangements contain a software license that should be accounted for separately from the hosting services.

Accounting hinges on two key criteria

Companies that are the customer in these arrangements first need to determine if they have the contractual right to take possession of the underlying software without significant penalty. If they do, they next need to assess whether it's feasible for them to either run the software on their own hardware or to contract with another party to run the software.

▶ Click here to learn more about accounting for cloud computing agreements.

If the arrangements meet both of these criteria, companies need to identify what portion of the cost relates to purchasing the software and what portion relates to paying for the service of hosting or running the software. The purchased software portion would be accounted for using the internal-use software guidance (i.e., some or all of the cost is likely capitalizable), and the service cost would be accounted for as an operating expense.

If the arrangements don't meet both of the criteria, the cost is considered an operating expense because the contract is essentially a service contract.

What's next?

The final standard is expected in the second quarter of 2015. It will be effective for calendar year-end public and private companies in 2016. Early adoption is permitted.

FASB continues to trailblaze with simplification proposals for share-based payment accounting

The FASB recently decided to move forward with drafting a proposal intended to simplify the accounting for share-based payment awards issued to employees. Certain of the proposals could have far-reaching implications for companies across all industries.

Income tax effects of share-based payments

One of the proposals that could have the most significant impact is a change to the accounting for the income tax effects of share-based awards. The FASB's proposal is to record all tax effects through the income statement, as opposed to recording certain amounts in Additional Paid in Capital (APIC). This proposal would eliminate the complications of tracking a "windfall pool" to determine the amounts to record in APIC. However, it would also increase the volatility of income tax expense. Additionally, the FASB will propose presenting all tax effects as an operating activity in the statement of cash flows, as opposed to presenting gross windfall tax benefits as a financing activity.

Minimum statutory holding requirements

The FASB is also proposing to revise current guidance that allows an entity to withhold shares upon vesting or exercise of an award to satisfy its tax withholding requirement, without resulting in liability classification of the award. Currently, the amount that can be withheld is strictly limited to the employer's minimum statutory withholding requirement, which creates administrative challenges for many companies. The FASB's proposal would allow entities to withhold an amount up to the highest applicable marginal tax rate, without causing liability classification of the award.

What's next?

We expect the FASB to issue its proposal in the second quarter, with a 60-day comment period. Companies that have significant share-based payment activity may want to begin considering the potential implications, and weigh-in on the proposal. Refer to Tax Insight, *FASB decides to propose changes to stock compensation tax accounting*, for further discussion of the proposed changes to tax accounting.

FASB takes steps toward simplifying income tax rules

Two new proposals from the FASB aimed at simplifying accounting for income taxes are officially on the table for comment. The proposals could affect a significant number of tax-paying entities. In particular, one of the changes — related to accounting for intra-entity asset transfers — could have a significant impact on income tax provisions and effective tax rates for companies to which it applies.Proposal #1 — Intra-entity asset transfers

Currently, the buyer and the seller in a consolidated reporting group are required to defer the income tax consequences of intra-entity asset transfers when the profits from the transfers are eliminated in consolidation. These asset transfers can encompass transactions such as fixed asset sales, intangible asset transfers, or inventory sales. Under the proposal, the tax impact to the seller on the profit from the transfers and the buyer's deferred tax benefit on the increased tax basis would be recognized when the transfers occur — front loading tax consequences that have historically been deferred until a later time.

Proposal #2 — Balance sheet classification of deferred taxes

Today's accounting rules require deferred taxes to be aggregated on a jurisdiction-by-jurisdiction basis and presented as a net current asset/liability and a net noncurrent asset/liability. To simplify presentation, the proposal would require all deferred tax assets and liabilities to be classified as noncurrent on the balance sheet.

What's next?

The comment period for the exposure draft ends on May 29, 2015. For more information, read In brief US2015-05, *FASB proposes two ASUs on income taxes as part of simplification initiative,* and Tax insight, *FASB decides to propose changes to income tax accounting*.

Corporate governance

Stepping into new territory with an accounting change? The audit committee should be involved

Audit committees play an important role when a company adopts a change in accounting principle. Many companies will soon have a significant change when adopting the new revenue recognition standard.

Accounting changes can impact many departments beyond the accounting function — especially accounting changes as significant as the new revenue standard. They can sometimes have noteworthy ramifications on a company's systems, processes, financial reporting, and disclosures.

Audit committees should make certain they have set aside adequate time to fully discuss with management the key aspects of the change, financial reporting and disclosure implications, broader business impact, and management's readiness and overall adoption strategy. With changes as significant as the new revenue standard, these discussions may need to happen well before the adoption occurs — especially since companies are required to disclose the expected impact of soon-to-be-adopted standards.

For more information

Our latest edition of the Audit Committee Excellence Series, *Achieving excellence: Overseeing accounting changes–including the new revenue recognition standard,* provides practical and actionable insights and perspectives to help audit committees maximize their performance.

Integrating the evolving governance environment into your boardroom agenda

Taking a fresh and critical look at the boardroom agenda helps directors ensure that they are addressing the rapidly changing governance environment. Consider the following:

- The number of both activist funds and companies they target are growing. Boards should evaluate the need to anticipate possible activist shareholder interaction and understand potential vulnerabilities.

- Emerging technologies continue to grow in influence and can impact a company's strategic plan. Directors should be familiar with how the company is keeping up with technological change and the activities of its known competitors and potential disruptors.

- Third-party and cyber risks can expose companies to significant bottom line and reputational repercussions. Directors should understand from management how the company is managing these types of risks.

Other topics, such as the company's crisis response plans, may also be timely for inclusion on the board's agenda.

For more information

Our 2014-2015 edition of *Key considerations for board and audit committee members* addresses topics for today's boardroom agenda.

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