

The quarter close A look at this quarter's financial reporting issues

Directors edition

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What you need to know—Q3–2013

Welcome to the third quarter 2013 edition of *The quarter close*.

While many people were enjoying the lazy days of summer, standard setters continued to move the ball forward on a number of topics. The FASB kicked off the quarter with several private company proposals. Not to be left on the sidelines, the PCAOB also issued several proposals in August. Read on for the latest developments.

Front and center. The Private Company Council is again in the spotlight this quarter, something public companies—yes, public companies—should take note of.

Accounting hot topics. Our team has assembled a roster of hot topics that includes a focus on the statement of cash flows, accounting for common control transactions, and contingencies.

Hot off the press. We explain why the FASB proposal on accounting for insurance contracts deserves attention from more than just the insurance industry. Our highlight reel also includes the FASB's going concern proposal.

Video perspectives. With the new revenue model on the one-yard line, what implications should companies consider? What are companies doing to respond to the SEC's whistleblower rule? And how should companies be addressing the new COSO framework in their internal control processes? Our experts provide the play-by-play analysis for your financial reporting experts.

PCAOB developments. We discuss the new proposal for additional disclosure in the external audit opinion as well as current perspectives on mandatory audit firm rotation and retendering.

Corporate governance. We share a few highlights of the results of our 2013 Annual Corporate Directors Survey. The candid responses to this year's research provide directors with actionable benchmarking that serves as a platform for discussion of how their boards can address the challenges of the evolving corporate governance landscape.

Front and center

Private company developments may have public company implications

The Private Company Council (PCC) continues to tackle accounting and reporting issues facing private companies. In the coming months, the PCC will look to carry the alternatives it has proposed across the goal line, which could be important for public companies as well.

Definition of a public business entity

Spurred by the activities of the PCC, the FASB issued an exposure draft on the definition of a public business entity, which essentially creates a de facto definition of a private entity. The proposed definition does not replace the definitions of a public entity currently existing in US GAAP. Instead, this definition will be used to determine which entities are eligible for PCC-driven accounting and reporting alternatives.

Under the FASB's proposal, an entity meeting any of several criteria will be considered a public business entity. This proposed definition will result in more companies being

“public business entities” than under today’s US GAAP. Accordingly, companies need to pay careful attention to where they fall out.

Common control leasing arrangements

The FASB recently released for public comment a PCC proposal that would provide private companies the option not to apply the variable interest entity (VIE) model to certain common control leasing arrangements. Those electing to adopt the proposal would be required to make incremental disclosures about common control leasing arrangements.

Update on other proposed alternatives

The PCC previously proposed three alternatives relating to accounting for identifiable intangible assets, goodwill, and certain interest rate swaps. The PCC will redeliberate these alternatives at its October 1 meeting.

For more information

Comments on the proposed definition of a public business entity and the proposed common control leasing alternative are due September 20 and October 14, respectively. For more information on the proposed definition of a public business entity and the latest developments on the PCC proposals, refer to our [*Private company reporter*](#) publication series.

Accounting hot topics

This quarter’s hot topics:

- Statement of cash flows
- Common control transactions
- Contingencies

Cash flows deserve top billing

Financial statement users often find the statement of cash flows the most informative statement in the financial statements. So it's important that companies get it right.

This quarter we emphasize that the statement of cash flows should get the focus it deserves.

Avoiding fumbles

An attention to detail is critical when it comes to preparing the statement of cash flows. For example, cash payments made to acquire property, plant, and equipment are classified as investing activities. However, if the acquired asset was not paid for at the reporting period end, the asset purchase should be disclosed as a noncash activity, not reflected in the cash flow statement. Other common noncash activities include obtaining an asset by entering into a capital lease and acquiring a business using stock as payment. Infrequent transactions can also pose presentation challenges in the statement of cash flows.

Planning is key

Companies should have a robust process for gathering and assessing the data necessary to prepare the statement of cash flows. This may also be of interest to audit committee directors. The process may include the use of questionnaires that capture information like non-recurring transactions, or identify items that should be disclosed as noncash.

► ***Click here to watch our experts discuss the updated COSO framework.***

The recent release of COSO's updated control framework provides a great opportunity for companies to revisit the statement of cash flows in their financial reporting process.

Common control transactions—understanding the playbook

Preparing financial statements for use in connection with a sale or an initial public offering often requires carving out operations or combining divisions or entities. Typically, the accounting basis for the entity will depend on whether a transfer is accounted for as an exchange between entities under common control or a business combination.

Entities under common control

Common control of separate entities exists when an individual, enterprise, family or group of collaborative shareholders controls each entity, usually through ownership of 50% or more of the voting interest. Family has a narrow definition when applying the common control guidance—it includes only immediate family members (married couples and their children). Otherwise, for a group of shareholders to apply the common control guidance, generally a pre-existing written agreement to vote a majority of the entities' shares in concert must exist.

In common control transactions, nonfinancial assets and liabilities are transferred at historical carrying amounts. How the transfer is presented in the financial statements depends on whether the transferred assets constitute a business. A simple transfer of assets will be reflected by the receiving entity from the date of receipt.

In contrast, if the transfer represents a business, the receiving entity will reflect the receipt of the business as a change in reporting entity. This means that the historic financial statements of the transferred business are combined with the historic financial statements of the receiving entity for all periods presented, as if the combination had been in effect since inception of common control.

Don't forget about income taxes

Common control transactions may have unexpected tax implications—just because the assets are recorded at historical carrying amounts does not mean that the tax treatment is consistent. There could be a difference in the tax basis of transferred assets and liabilities, as well as other tax accounting implications. These implications will depend on the structure, substance of the arrangements, and the jurisdiction(s) in which the transaction takes place. Close coordination between your company's financial reporting personnel and the tax department is key.

Contingencies—focus on fundamentals

On paper, many of the concepts underlying accounting for contingencies may seem like basic blocking and tackling. But applying some concepts to real-life facts and circumstances can pose challenges.

Litigation settlements—sometimes there's more to it

The terms and conditions of a legal settlement may not be straightforward. A settlement could contain other elements, like future rights and obligations. If a settlement includes more than one element, companies may use the multiple element revenue guidance to allocate consideration paid or received to the various elements.

Assessment of subsequent events

Companies may obtain additional information related to loss contingencies subsequent to the balance sheet date, but before the financial statements are issued. In this case, companies should assess whether the subsequent event provides further clarification of facts that existed as of the balance sheet date. If so, they should record the loss and adjust the contingency accrual.

Contingencies related to insurance recoveries

Determining how and when to account for expected insurance proceeds can be less-than-straightforward. For property and casualty claims (e.g., involving fixed assets), if the recovery is probable, a receivable is recognized for the amount expected to be recovered. But the amount recorded should not exceed the loss recognized in the financial statements.

Business interruption insurance that protects against lost revenues or profits is handled differently. Business interruption receivables and the related gains are not recognized prior to the insurance carrier acknowledging the claim is covered and communicating the amount to be paid—a higher bar than the "probable" threshold necessary for property and casualty claims.

Hot off the press

This quarter, we review the impact of the FASB's proposal on insurance contracts outside of the insurance industry. We also break down the EITF's decisions from its September meeting. But first...

A few quick hits

James Kroeker, former SEC Chief Accountant, was named vice-chairman of the FASB. The vice-chairman position was reinstated so that Kroeker could ease the growing demands on FASB chairman Russell Golden. Kroeker fills a seat left open by the retirement of former FASB chairman Leslie Seidman.

The FASB's going concern proposal is out for comment. It would require all entities to make certain disclosures when management concludes that the odds that the entity will not be able to meet its obligations for a period of time after the financial statement date are either *more likely than not* or *probable*.

FASB insurance proposal could affect more than just insurers

The FASB's proposal on insurance contracts would apply to contracts as opposed to just insurance companies. This change from current practice means the proposed guidance could have implications for any entities writing insurance and guarantee contracts, such as banks and companies outside the financial services industry.

What are the implications?

The FASB has identified some banking and service products, such as trust preferred securities, certain types of indemnifications, and stand-by letters of credit, as being within the scope of the proposal. Under the proposed model, expected losses on these contracts would be recognized immediately instead of through the current incurred loss model used by some companies today.

Certain guarantees issued by nonfinancial service companies are also in the scope of the FASB proposal, such as indemnifications or guarantees of a customer's or supplier's debt. Additionally, fixed-fee service contracts may also be in the scope of the proposal, unless three conditions are met.

What should companies be thinking about now?

The implementation guidance in the FASB's proposal includes some banking and service examples where the conclusions reached may come as a surprise to companies outside of the insurance industry. Companies should carefully assess their products to determine if they are within the scope of the FASB's proposal. They may also want to consider providing the FASB feedback on the proposal by submitting a comment letter.

SEC matters

► **One of the first Dodd-Frank rules implemented related to the SEC's whistleblower program. Click here to see our experts explain its impact and how companies can prepare.**

SEC roster filled; ready to finalize gameplan

Kara Stein (D) and Michael Piwowar (R) were sworn in as commissioners of the SEC, replacing Elisse Walter and Troy Paredes, respectively. Current SEC chairman Mary Jo White was also confirmed to a full term that will expire on June 5, 2019.

Chairman White's priorities include completing rulemaking mandates of the Dodd-Frank and Jumpstart our Business Startups Acts, bolstering the agency's enforcement function, and investing in cutting-edge technology necessary to perform the SEC's mission.

SEC scores a win on conflict minerals after setback on extractive disclosures

A district court upheld the SEC's rule on disclosing the use of conflict minerals, rejecting all of the claims filed by the plaintiffs. Though the plaintiffs have filed an appeal, the first required filing date of May 31, 2014 for calendar year 2013 is still in effect.

In a separate case, a different judge in the same district court vacated the SEC's rule requiring companies in the extractive industries to disclose payments to governments. The SEC plans to rewrite the rule and re-propose it for public comment.

Invest in money market funds? SEC proposal could affect your companies

In June, the SEC proposed two alternatives for amending rules governing money market funds. The asset management industry has been giving the proposal its due attention. But other companies that invest in money market funds should also monitor the proposed rule as there is a possibility that it may affect their financial reporting.

Today, most companies classify investments in money market funds as cash equivalents. The SEC indicated that it does not expect its proposal—which would result in money market funds having a floating net asset value—to change this classification. However, in certain instances, companies may need to consider whether declines in value could affect the classification.

If the proposal is approved, companies may need to revise their investment policies. Certain companies may have treasury policies that restrict investment in funds that have

a floating net asset value. In this case, they may need to find alternate investment options, or consider revising their treasury policies.

For more information

To gain additional insight into the proposal and its potential implications, read our publication [A closer look](#), *Money market funds: The SEC's long awaited proposal*.

IFRS developments

IFRS: Progress towards global adoption?

In June, the IFRS Foundation published 'jurisdictional profiles' of 66 territories (members of the G20 plus 46 others). The profiles describe how each territory is using IFRS and their decision regarding the use of IFRS. The IFRS Foundation observed that there was strong support for global adoption of IFRS, with 95 percent of the territories having made public commitments supporting IFRS. It also noted that of the 80 percent of territories that have adopted IFRS for companies with publicly traded securities, very few modifications to IFRS standards have been made.

For further IFRS updates, refer to PwC's [IFRS News – September 2013](#).

Audit reporter

PCAOB issues proposals aimed at improving auditor reporting

In August, the PCAOB issued a proposal to make key changes to the auditor's report intended to communicate more information to stakeholders.

Overview of the PCAOB proposals

The PCAOB proposal on auditor reporting would require the auditor's report to communicate 'Critical Audit Matters.' These matters are those that: (1) involve the most difficult, subjective, or complex auditor judgments, (2) pose the most difficulty in obtaining sufficient evidence, or (3) pose the most difficulty in forming an opinion on the financial statements.

The proposal also mandates the inclusion of the audit firm's tenure, as well as disclosures about independence, and an enhanced description of the auditor's responsibilities. It also includes reporting on other information—that is, information outside the financial statements that is contained in documents that include the audited financial statements (for example, management's discussion and analysis).

In conjunction with the auditor reporting proposal, the PCAOB also proposed a new auditing standard that would require the auditor to perform additional procedures with respect to other information in the company's annual report that is filed with the Securities and Exchange Commission.

For more information

Comments on the PCAOB proposals on auditor reporting and other information are due December 11. For more information on the PCAOB proposals, see [In brief 2013-40](#), *PCAOB proposes significant changes to the auditor's report*, and [In brief 2013-41](#), *PCAOB proposes new auditing standard on other information*.

International players head in different directions on auditor rotation and retendering

For some time, legislators and regulators around the globe have been discussing the role mandatory firm rotation or retendering should play in facilitating audit quality. Interestingly, in the last few months, they seem to have reached different conclusions.

In the second quarter, the European parliament was first to vote to adopt a series of measures that include mandatory audit firm rotation, with an extension available if certain criteria are fulfilled. Then in July, US lawmakers in the House of Representatives passed a bill that banned the PCAOB from mandating audit firm rotation. This was followed a few weeks later by the UK Competition Commission recommending mandatory retendering of FTSE350 audits every five years, with extension to seven years in exceptional circumstances.

All of these proposals require additional legislation to become law. But in a time when accounting and auditing standard setters are working together towards more globally consistent practices, this is one area where legislators seem to be heading in different directions.

On the horizon

Revenue standard nearing release, plans for transition drafted

The FASB and IASB met in July and confirmed their prior decisions related to the key areas discussed below. However, the boards are continuing their stakeholder outreach related to these areas, among others, and plan to meet in September and October to discuss them. Accordingly, the decisions reached as described below are subject to change. The boards still plan to issue a final standard later this year.

Variable consideration

The amount of revenue companies receive for the goods or services they provide might not be fixed—for example, volume-discounted pricing in manufacturing industries or early completion bonuses in construction. The boards have agreed that the revenue recognized should include an estimate of such variable consideration. However, management must be confident the revenue recognized will not be subject to significant reversal in the future. Revenue recognized should include any minimum amount of variable consideration expected to be received (and subsequent changes to that amount), even if the entire amount cannot be estimated.

► ***Click here to watch our experts discuss how the upcoming revenue model could affect your company.***

Bad debt vs. price concessions

Under the proposed standard, price concessions will reduce the amount of revenue, while bad debt will be presented as an operating expense. Some constituents requested additional clarity to help make the distinction between the two. The boards agreed to clarify the distinction in the final standard.

For more information

For more information on the boards' recent decisions discussed above and more, see [In brief 2013-38](#), *Boards re-deliberate aspects of joint revenue project*.

Leases exposed, comment period closed...now stay tuned

The FASB and IASB issued their long-awaited leases proposal in May with comments due September 13. Not surprisingly, the boards have received significant feedback on this pervasive topic and will soon begin to determine which aspects of the proposal they will revisit.

What does the proposal say?

The proposal achieves a key objective of putting substantially all leases on lessees' balance sheets, and it creates a “dual model” for determining the income statement treatment for lessees and lessors. The proposal creates a presumption that most leases of property (e.g., real estate) will have a straight-line income statement impact and most leases of non-property (e.g., equipment) will have a front-loaded income statement impact. However, these presumptions can be overcome in certain situations.

How are stakeholders responding to the proposal so far?

While many are supportive of putting most leases on lessees' balance sheets, there continues to be a wide variety of views about the best way to accomplish that. That diversity has both preparers and users questioning whether the benefits of the proposal outweigh the costs. The FASB's Investor Advisory Committee (IAC) declined to support the proposal, stating that it is not an improvement to current accounting.

What's next?

The boards are holding several roundtables in September and October to obtain further feedback on the proposals. Given the expectation of further debate on key elements of the proposal, a final standard is unlikely to be released before 2014.

For more information

Tune into our [webcast](#) on October 9 at 11:00 am (EDT) to learn more about the comments received by the boards on the proposal. To learn more about the proposal, read [Dataline 2013-13](#), *Leases—The Great Divide: The new leases landscape*, or view the archive of PwC's two-part webcast that provides an [overview of the proposal](#) and discusses the [implications](#) beyond financial reporting.

Integrated reporting, sustainability accounting gaining momentum

Stakeholders are taking notice of the activities of the International Integrated Reporting Council (IIRC) and the Sustainability Accounting Standards Board (SASB). Both organizations are driving interest in the reporting of nonfinancial information, such as environmental, social, and governance data. These organizations are not standard setters or regulators, and thus companies voluntarily elect to apply their guidance.

What is "integrated reporting?"

Conceptually, integrated reporting would build on the existing financial reporting model to present additional information about a company's strategy, governance, and performance. It is aimed at providing a complete picture of a company—ultimately in a single report—including how the company demonstrates stewardship and creates and sustains value.

Some companies are investigating integrated reporting through a pilot program established by the IIRC. To date, the companies participating (including some from the US) are fans, reporting that improved internal information and more concise, less complex reporting are among the benefits they have experienced. Testing of the proposed framework is expected to begin in 2014.

What are Sustainability Accounting Standards?

The SASB develops sustainability accounting standards for voluntary use by companies, primarily those listed publicly in the US. The standards focus on disclosing material nonfinancial information about sustainability topics (e.g., investment in companies with high climate risk exposure). The SASB's standards are designed for disclosure in SEC filings, such as the Form 10-K. Certain proposed standards for the healthcare industry have already been issued.

For more information

Read our [Point of view](#), *Integrated reporting: Going beyond the financial results*, to find out how integrated reporting may help companies respond to investors' calls for more information regarding environmental, social, and governance issues. You can also read PwC's [comment letter](#) on the IIRC's integrated reporting framework, as well as our [comment letter](#) on the SASB conceptual framework.

Corporate governance

Highlights of the Annual Corporate Directors Survey

PwC's *2013 Annual Corporate Directors Survey: Boards Confront an Evolving Landscape* highlights the unprecedented change in corporate governance since the financial crisis. New perspectives on boardroom composition, higher levels of stakeholder engagement, more emphasis on risk and strategies, and a high rate of change in the digital world are accelerating the evolution of the boardroom.

This year PwC's Center for Board Governance is releasing survey results in four separate installments throughout September. Here's a snapshot of some of the survey results:

- More than half of survey respondents said their primary motivation for sitting on a board is intellectual stimulation; compensation was low on the list.
- While more than one-third of respondents believe someone on the board should be replaced, nearly half of directors believe there are impediments to replacing a fellow board member.

- There is a chasm between directors who believe it is appropriate to communicate governance issues directly with shareholders and those who do not.
- More directors than last year believe there is a clear allocation of risk oversight responsibilities between the board and its committees, but many say it could still be improved.

For more information

To see the full survey results and read our insights into the responses, visit the PwC *Annual Corporate Directors Survey* [website](#).

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