

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

Directors edition

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What you need to know—Q1–2014

Welcome to the first quarter edition of *The quarter close*. So far this year we've seen new accounting alternatives for private companies take root. A changing landscape still lies ahead with the impending issuance of the new revenue standard and guidance on discontinued operations.

What else is blossoming this quarter? Read on for the latest developments.

Front and center. There's been substantial interest in the FASB's recently-issued private company accounting alternatives related to goodwill and hedge accounting. The benefits of adopting the alternatives are fairly intuitive, but the potential pitfalls may not be.

Accounting hot topics. We share thoughts on how to evaluate whether a profit-sharing arrangement is equity or a bonus, and identifying participating securities to use in the two-class method of EPS. We also revisit the guidance for reporting revenue on a gross versus net basis, and highlight tax considerations for separate company financial statements.

Hot off the press. We give you the scoop on some recent FASB decisions that significantly affect several ongoing projects. We also spotlight a new IFRS standard on levies that's now effective. The latter should be on the radar for any company with international subsidiaries that use IFRS locally.

And more. Along with the latest corporate governance developments, we provide an update on how regulatory changes in the European Union (EU) may affect companies with EU-based subsidiaries.

Video perspectives. We take a closer look at the private company accounting alternative on goodwill. Also, today's evolving business models have kept gross versus net revenue presentation at the forefront. We take you through some of the key considerations when making the assessment.

PwC's publication *Setting the standard* published its final issue in December 2013. You can find updates on key standard setting developments under Issues-Accounting and reporting at www.cfodirect.com.

Front and center

Private companies mull adoption of accounting alternatives

The FASB's January release of two accounting alternatives for private companies planted the seeds of change—and it isn't taking long for them to bear fruit. Some private companies—both family-owned and private-equity owned—are showing significant interest in early adopting one or both of the new alternatives.

The basics of the accounting alternatives

The first alternative simplifies accounting for goodwill. It allows a private company to amortize goodwill on a straight-line basis over a period of up to ten years, and apply a trigger-based, single-step impairment test at either the entity level or the reporting unit level (rather than just at the reporting unit level).

The second alternative allows private companies (but not financial institutions) to apply simplified hedge accounting to their receive-variable, pay-fixed interest rate swaps, as long as the swaps meet certain criteria. The benefits of this approach? Companies can:

- assume there is no ineffectiveness in the hedge relationship (provided there are no changes to the debt or swap),

► **Click here to learn more about the simplified goodwill alternative.**

- take more time to complete the required documentation necessary to apply hedge accounting (completion by the financial statement issuance date, instead of at the inception of the hedge relationship), and
- measure the swap at the easier-to-determine settlement value (instead of fair value).

Private companies can elect to apply one or both of the alternatives in their 2013 financial statements, as long as those financial statements have not been made available for issuance prior to the release of the final guidance (that is, January 16, 2014).

Every rose has its thorns...

Companies that adopt either of these alternatives would need to "unwind" them if they become an SEC-registered company, or are otherwise required to have their financial statements included in an SEC filing. Despite this, we understand some private-equity owned companies plan to early adopt one or both of the alternatives. If they decide to register with the SEC at some point, the cost of unwinding the accounting alternatives will just be another cost of going public.

For more information

To learn more about the private company accounting alternatives, read [Dataline 2014-05, Goodwill accounting alternative—FASB and PCC issue final standard for private companies](#). Also keep an eye out for our upcoming *Dataline* on the simplified hedge accounting alternative.

Accounting hot topics

This quarter's hot topics:

- Accounting for profit-sharing plans
- Two-class method of computing EPS
- Gross versus net revenue presentation
- Tax considerations for separate company financial statements

Profit-sharing arrangements—equity or a bonus?

As companies grow their businesses, they continue to seek innovative ways to incentivize their employees. Structuring a profit-sharing arrangement as an equity interest aligns the employee's interests with the company's, and could provide tax savings. However, just because it's legally structured as "equity" doesn't mean it's accounted for that way.

Looking past the legal form

One common structure awards employees a "unit" or "profits interest" in a partnership or limited liability corporation (LLC).

Often, this partnership or LLC is an "upstream" or "sister" entity under common control. This could provide the employee with favorable tax treatment as compared to a traditional cash bonus.

Some deeper digging could reveal that the "units"—although legally equity interests—lack some of the key characteristics of equity. For example, the employees might not have participation rights, such as voting, distribution, and/or liquidation rights. Or, the employees might not retain vested interests upon leaving the company (or the units can be repurchased for other than fair value), so that profit sharing is effectively tied to employment.

Accounting implications

Awards that do not have characteristics of equity are in substance a profit-sharing bonus. They should be recorded as cash bonus liabilities, and distributions are treated as compensation expense for accounting purposes.

Awards of equity interests that have equity characteristics are within the scope of the stock-based compensation guidance. But that doesn't guarantee equity classification. Companies still need to assess the features of the award to determine the appropriate classification. For example, some plans have repurchase features that can result in liability accounting.

For more information

For more details on the accounting for awards to employees of “pass-through” entities, see Chapter 3 of our [*Guide to Accounting for Stock-based Compensation*](#).

Double the classes, double the fun for EPS

Calculating earnings per share (EPS) is simple math. Knowing all of the variables that go into the equation is not so simple. In particular, identifying participating securities is an important—and sometimes overlooked—aspect of the EPS computation.

How do participating securities affect EPS?

A participating security is anything other than a share of common stock that, in its current form, is entitled to receive dividends. Under the two-class method of calculating EPS, undistributed earnings are allocated between common stock and participating securities. This can result in a lower basic and diluted EPS.

A common misconception is that companies need not worry about participating securities if they don't currently pay dividends. However, it's the contractual right to participate in dividends—not the declaration or payment of dividends—that triggers the requirement to apply the two-class method.

Identifying participating securities

Participating securities come in many varieties. Companies should carefully review the terms of all stock awards and financial instruments to determine if they are participating securities. Unvested stock (aka “restricted stock”) is one type of participating security that can take companies by surprise.

Gross versus net revenue presentation—applying an old standard in a new business age

As business models evolve, arrangements involving multiple parties are becoming more common. This raises the question of which party is the principal (reporting revenue on a gross basis) and which is only an agent (net reporting) in the transaction. Although the accounting guidance hasn't changed in over a decade, applying it to scenarios that weren't contemplated when the guidance was written can be challenging. It's also an area of continued SEC focus as it directly affects the top line.

Applying existing concepts to new transaction types

One example is the sale of intangible products, including virtual goods. These arrangements frequently involve multiple parties working together in contrast to traditional reseller arrangements. Some of the typical indicators used to assess whether

gross or net reporting is appropriate may not be as relevant or persuasive in these fact patterns, such as “inventory risk.”

While all factors must be considered, three indicators are typically more relevant in sales of intangible products: (1) who is the primary obligor to the customer, (2) who has the right to establish pricing, and (3) whether the entity earns a fixed amount or percentage of what the customer pays. Pricing and which party earns what amount is usually evident in the terms of the agreement. However, due to the collaborative nature of many of these arrangements, identifying the primary obligor often requires significant judgment.

► *Click here to learn more about applying gross vs. net considerations in today's business environment.*

Getting to the root of a gross versus net analysis

In all gross versus net assessments, each indicator should be evaluated on the continuum from strong to weak. It's not a quantitative assessment of how many gross or net indicators exist. The place to start is a careful review of all contracts between the parties involved. However, the understanding of the arrangement shouldn't stop with the legal contracts. Companies need to consider other factors, such as how the product or service is marketed to customers.

The final conclusion should reflect the economic substance of the transaction. For example, if a company concludes that gross reporting is appropriate, the economics of the arrangement should suggest that it is buying and reselling goods or services. If that's not the case, then the company may need to revisit its analysis.

Lastly, companies should keep in mind that they must separately assess each deliverable in the arrangement. It's possible that revenue from one deliverable will be presented on a gross basis, while revenue from another deliverable is reported on a net basis.

For more information

To learn more about gross versus net considerations, see [Dataline 2013-29](#), *2013 year-end financial reporting considerations*.

Allocating income taxes to separate company and carve-out financials

Many companies file consolidated tax returns that cover group members. When those members need to issue separate financial statements, an accounting challenge arises: How should the consolidated amount of current and deferred tax expense be allocated among the subsidiaries? Carve-out financial statements face a similar challenge.

Options exist for allocation methods, but one is commonly preferred

There isn't a prescriptive method for allocating consolidated income tax expense. The guidance simply requires a method that is systematic, rational, and consistent with income tax accounting principles. But the SEC staff believes that the “separate return basis” is preferred. SEC-filed financial statements that don't use this allocation method typically require a pro forma income statement showing the outcome if it had been used.

When the separate return method is used, the subsidiary's tax provision is based on hypothetical, separately-filed returns for the subsidiary. Critical or material judgments involved in creating such a hypothetical tax return should be disclosed in the separate financial statements.

Carve-out financial statements

Carve-out financial statements refer to separate financial statements that are "carved-out" from those of a larger business, often for purposes of divesting a business unit. Preparing the tax provision for carve-out financial statements can be complicated, particularly if separate financial statements (including a tax provision) have not historically been prepared. The methods for allocating tax expense in a carve-out scenario are essentially the same as for separate financial statements.

For more information

To learn more about this topic, read our publications [*Seven principles to consider when preparing a tax provision for subsidiary or carve-out financial statements*](#) and [*Preparing carve-out financial statements: Navigating the financial reporting challenges*](#).

Hot off the press

In March, the FASB released a proposed framework to improve its process for evaluating existing and future disclosure requirements. The board is hoping to receive feedback from interested parties on what types of information it should consider when deciding on required disclosures. Comments are due July 14.

The FASB isn't alone in revisiting disclosures. The SEC issued a report in December where it concluded that a re-evaluation of disclosure requirements is in order. Plans for a roundtable to gather input from investors and others are in process, though no date has been set.

FASB moves forward independently on financial instruments project

Although the financial instruments project is a joint project of the FASB and IASB, the FASB's most recent decisions continue to move it away from the path the IASB is taking. On the classification and measurement half of the project, the FASB decided to abandon two fundamental aspects of what it had proposed a year ago: the cash flow characteristics test and a new model to determine how to classify and measure financial instruments.

On the topic of impairment, the FASB decided that the "current expected credit losses" model—which it originally proposed to apply to all financial assets—should only apply to financial assets measured at amortized cost. Financial assets that are measured at fair value with changes in fair value going through other comprehensive income will be subject to a different impairment model. The new model utilizes the principles of the current expected credit losses model, but effectively caps the credit loss at the difference between fair value and amortized cost. This decision is responsive to feedback received during the comment letter process.

Changes to consolidation guidance sprouting up all over

The FASB has made some significant decisions this quarter with regard to several different projects. Though the decisions were made on separate projects, they all affect consolidation accounting.

Endorsement of private company exemption from certain VIE requirements

The FASB endorsed an additional private company alternative that provides private companies with an exemption from applying the variable interest entity (VIE) consolidation model to certain common control leasing arrangements if certain criteria are met. Look for a final standard in late March or April 2014. Early adoption will be permitted.

Decisions on the consolidation project

The FASB's initial goal was to make a surgical fix to one aspect of the consolidation guidance to avoid unintended outcomes for asset managers and financial institutions. However, the decisions they've made to date about how to proceed will actually impact several aspects of the consolidation guidance and will apply to all companies. The FASB is considering changes in the following three areas: (1) how to evaluate control in the voting model, (2) when an entity is a VIE, and (3) how to evaluate economics when determining who consolidates a VIE. That means both the VIE model and the voting model for consolidation are expected to change.

What does all of this mean? A company's consolidation conclusion could change, and more entities, especially partnerships, are likely to be VIEs. A new standard could come as soon as the end of this year.

FASB plows a new direction on insurance project

The FASB recently decided to scale back the scope of its project on insurance contracts. Notably, this decision narrows the applicability of new guidance to insurance companies only (at least for now). And, it likely signals the end of joint efforts with the IASB to issue a new, mostly-converged standard on accounting for insurance contracts.

Cutting back the scope is a welcome change for many

The FASB decided the scope of the project going forward should be focused on identifying targeted improvements to existing US GAAP for long-duration insurance contracts (the breadth of which has yet to be determined). For short-duration insurance contracts, the FASB plans to focus only on enhancements to disclosure requirements. The board also voted to limit the project scope to insurance entities, but left the door open to add certain contracts written by non-insurers, if deemed necessary.

IFRS guidance on levies may change accrual timing

Companies should take note of a new IFRS interpretation on the accounting for levies (IFRIC 21), effective in 2014. The scope is broad, affecting recognition of non-income-based taxes (such as property and commercial taxes) and fees or levies paid by certain industries to governments. Given the extent of IFRS reporting, the guidance will affect companies in many countries, including subsidiaries of US companies that apply IFRS. The guidance also affects companies in a broad range of industries, with banking, retail, transportation, and utilities among the most likely to feel the impact.

Accounting implications

In general, levies are imposed by governments through legislation and are often measured by reference to a company's revenues, assets, or liabilities (for example, 1% of revenue). The standard requires companies to evaluate a broad range of government payments to determine if they are in the scope of the new guidance.

For more information

Further guidance and examples can be found in [Straight Away 119](#).

Regulatory matters

EU looks to approve audit reforms

The European Union (EU) and a majority of the 28 EU member states reached an agreement about the European Commission's (EC) audit reform proposals. The proposed legislation is complex and, in some cases, unclear due to ambiguous language and the range of member state options. Although it covers many areas, the reforms that will have the greatest impact are in the areas of mandatory audit firm rotation and restrictions on non-audit services provided by auditors to their audit clients.

Mandatory audit firm rotation

Mandatory audit firm rotation will require all EU public interest entities (PIEs)¹ to rotate their auditors every ten years with the ability to extend this period in certain limited circumstances. Member states can implement a shorter rotation period and, under certain conditions can extend it. Transition agreements are effective at the earliest in 2020 for audit firms with tenure of 20 consecutive years or greater. Audit committees will be responsible for overseeing this process.

Restrictions on non-audit services

The new legislation will restrict which non-audit services can be provided by the auditor of a PIE and will require the audit committee to pre-approve them. The new list of prohibited services goes further than the SEC's list by including areas such as legal, HR and investment strategy services, internal control design and implementation, and tax compliance and advice. Non-audit fees will be capped at 70% of the group audit fees received (likely to be defined as the average of fees over the last three years).

What's next?

A formal vote—necessary to become law—will likely occur by mid 2014. The provisions of the legislation are likely to be applicable two years after, with the exception of mandatory firm rotation, which will be subject to transitional arrangements. Read the March edition of [Regulatory and standard setting developments](#) for more information.

¹ PIEs are defined as entities governed by the law of an EU member state with transferable securities listed on a regulated EU exchange, all credit institutions and insurance undertakings, as well as any other entities designated by a member state as a PIE.

Reminder: SEC filings on conflict minerals due in May

Time is almost up for SEC registrants required to report on their use of conflict minerals (tin, tungsten, tantalum, or gold). The first filing with the SEC is due May 31, 2014. Although there is an outstanding appeals court case against the SEC related to this rule, there's no indication of when the judges will make a final ruling. As such, companies should be working toward the filing deadline.

Once they put pen to paper, many companies find drafting the filings—a Form SD and, if required, a Conflict Minerals Report (CMR)—is more difficult than expected. This is because the disclosure requirements, particularly for the CMR, are less prescriptive than many other SEC filings, requiring companies to exercise significant judgment as to what to include and how detailed to make their disclosures.

On the horizon

EITF finalizes one issue, readies pushdown accounting consensus for comment

At its March meeting, the EITF reached a final consensus on an issue dealing with the treatment of certain types of performance conditions in stock-based compensation awards. It also reached a consensus for exposure related to pushdown accounting.

Share-based payment conclusions

If a share-based payment has performance targets that can be achieved after the requisite service period, the Task Force concluded that they should be treated as vesting conditions. As a result, this type of performance condition should not affect the grant-date fair value of the award, delaying expense recognition until achievement of the performance target is probable.

This new guidance will be applicable in 2016 for most companies, but can be early adopted. It applies to awards issued or modified after the effective date, but can also be elected for existing awards outstanding at the date of the adoption.

What's next?

The pushdown consensus will be exposed for comment shortly. For more background on the topics discussed and other EITF matters, read our [*March 2014 EITF observer*](#).

Corporate governance

Cybersecurity—not “if” but “when”

Data breaches continue to make headlines on a regular basis, with each one exacting a hefty cost. In addition to the potential loss of intellectual property and customer data, data breaches can also cause harm to a company's brand and reputation. Cybersecurity is a business issue that can impact any organization that uses the internet or wireless technology to conduct business. And in some industries, cybersecurity concerns can threaten growth.

Top of mind for many CEOs and boards

Companies are changing the way they think about cybersecurity. Historically, it may have been managed only by the IT department. Now companies and their boards are discussing company-wide cybersecurity investments. In PwC's [*17th Annual Global 2014 CEO Survey*](#), 69% of respondents say they are somewhat concerned or extremely concerned about cyber threats, and 39% of CEOs say cybersecurity is an area where they are making investments.

Government initiatives related to cybersecurity

The amount of federal government attention focused on cybersecurity reinforces the need for directors to be engaged in IT oversight. Here's a sampling of recent initiatives:

- The Obama administration released a set of industry standards and best practices to help organizations manage cybersecurity risks.
- The US Department of Homeland Security created a cybersecurity framework to help identify and prioritize actions for reducing cybersecurity risk. It's also a tool for aligning policy, business, and technological approaches to managing that risk.
- The SEC announced it will hold a cybersecurity roundtable and webcast on March 26.

For more information

For additional cybersecurity and IT oversight considerations see the February edition of [*BoardroomDirect*](#) and our publication [*Shareholder questions: Considerations for 2014 annual meetings*](#).

Edited by:

Don Keller

Partner, Center for Board Governance
Phone: 1-512-695-4468
Email: don.keller@us.pwc.com

Josh Paul

Partner
Phone: 1-408-817-1269
Email: joshua.paul@us.pwc.com

Brad Jansen

Senior Manager
Phone: 1-973-236-4335
Email: bradley.j.jansen@us.pwc.com

Elizabeth Paul

Partner
Phone: 1-973-236-7270
Email: elizabeth.paul@us.pwc.com

Kathleen Bauman

Director
Phone: 1-973-236-5118
Email: kathleen.bauman@us.pwc.com

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