

# *The quarter close*

A look at this quarter's  
financial reporting issues

## *Directors edition*

June 20, 2013

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## Front and center

### New SEC and FASB leadership takes the wheel

As we head into the second half of 2013, both the SEC and FASB have new chairs steering the course forward.

#### *Mary Jo White sworn in as SEC chairman*

After confirmation by the Senate, Mary Jo White took over as SEC chairman in April. Since then, White has been assembling her supporting team, including tapping Keith Higgins, a partner at Ropes & Gray LLP, to head the SEC's Division of Corporation Finance. She also appointed Acting Director George Canellos and Andrew Ceresney, formerly a partner at Debevoise & Plimpton LLP, as co-directors of the Division of Enforcement.

While it is still early in her tenure, White stated during her confirmation hearings that further strengthening the SEC's enforcement function and completing the rulemaking mandated by the Dodd-Frank Act and JOBS Act are key priorities.

Meanwhile, President Obama recently announced his nominations to succeed current Commissioners Elisse Walter and Troy Paredes, whose terms end this year. The two nominees are Kara Stein, an aide to Senator Jack Reed, and Michael Piwowar, chief Republican economist for the Senate Banking Committee.

#### *Leslie Seidman passes the gavel to Russell Golden*

The Financial Accounting Foundation, which oversees the FASB, announced in April that Russell Golden, a current FASB board member, will take over as FASB chairman effective July 1. Golden spent six years on the FASB staff before he was appointed as a board member in September 2010. Golden has cited bringing the convergence projects to closure and improving financial reporting for private companies as his initial areas of focus.

### A divided FASB issues revised leases model

The FASB and IASB reached a major milestone this quarter by issuing their long-awaited rework of the leases proposal. But the debate is not over yet, as even the board members aren't in agreement on the revised model—three FASB and two IASB board members offered alternative views.

#### *A new dividing line for leases*

The proposal achieves a key objective: putting substantially all leases on lessees' balance sheets. However the details have created controversy. One area of contention is the "dual model" for determining the income statement treatment.

For lessees, the proposal creates a presumption that most leases of property (for example, real estate) will have straight-line expense recognition and most leases of non-property (for example, equipment) will have front-loaded expense recognition. However, these presumptions can be overcome in certain situations.

► *Click here to watch our experts discuss how the leases proposal could affect your company, and what companies are doing now to prepare.*

Lessors will also apply a dual model. Using the same dividing line as lessees, lessors will either recognize straight-line income (presumed for property) or apply a new “receivable and residual” approach (presumed for non-property).

### **Private Company Council produces initial proposals**

The Private Company Council has only been up and running since December, but it has already identified ways to simplify financial reporting for private companies. Its initial proposals, if finalized, would significantly modify existing accounting guidance for intangible assets, goodwill and interest rate swaps.

*For more information*

To learn more about the proposals and next steps, read the June 2013 edition of [\*Private company reporter\*](#).

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## **Accounting hot topics**

### ***This quarter’s hot topics:***

- Balance sheet offsetting disclosures
- Revenue recognition: gross versus net
- Income tax accounting: tracking court cases
- Stock compensation: performance awards

### **Balance sheet offsetting—the rubber hits the road**

The new balance sheet offsetting disclosures made their debut in first quarter financial statements. Although the FASB took action in January to limit the scope of the requirements, companies faced a number of implementation issues as they developed their disclosures. The disclosures provide gross and net information about transactions that are: (a) offset in the balance sheet or (b) subject to an enforceable master-netting arrangement or similar agreement, regardless of whether they are actually offset in the balance sheet.

*For more information*

For information about common questions on this topic, see [Dataline 2013-06](#), *Balance sheet offsetting—Questions and interpretive responses about the new disclosure requirements*.

### **“Gross versus net” still a challenge after all these years**

The guidance for assessing whether to recognize revenue on a “gross” or “net” basis is over a decade old. However, it continues to be a hot topic, especially as new business models and types of transactions emerge. Arrangements that can create accounting challenges include services and “bundled” offerings.

*Identity crisis—who’s the principal and who’s the agent?*

As a refresher, the accounting guidance provides indicators to help identify the party that is the principal in a transaction. A principal recognizes revenue on a gross basis (the amount billed to the customer), while an agent recognizes revenue net (the amount billed to the customer less the amount paid to a supplier). One of the stronger indicators

in a gross versus net assessment is determining which party has inventory risk—a concept that may seem irrelevant to service revenue. However, the concepts underlying inventory risk are equally applicable to services, so they are important for companies to consider.

### **Tax court cases—are they on your company's radar?**

At any given time, there are potentially dozens of ongoing federal, state and international tax court cases. Developments in these cases aren't just important for income tax planning and compliance purposes. They could have a material effect on a company's tax accounting position and, in some situations, have an immediate impact on the bottom line.

#### *Why tracking court case developments is important*

The accounting and disclosure implications of a court decision can be immediate. In the period that cases are decided or other new information arises, companies should assess the effect on existing deferred taxes and uncertain tax positions. Additionally, companies should consider possible refund claims or positions to be taken in the future.

#### *For more information*

For discussion of a selection of current court cases that your company may want to stay on top of, refer to our [WNTS Publication](#), *Judiciary tax actions warrant closer review*.

### **Linking pay to performance—stock compensation pitfalls**

Executive compensation continues to be in the spotlight, whether it's "say-on-pay" or the pending Dodd-Frank "clawback" rules. Compensation arrangements often aim to link executives' pay to their performance and key business objectives. However, this can sometimes lead to increased accounting complexity, especially for stock-based awards.

#### *Performance metrics—are they objective?*

To establish a "fixed" measurement date for an award, there must be a mutual understanding between the company and the employee of the requirements to obtain the award. Said differently, performance metrics or targets need to be clearly defined and objectively determinable. If not "fixed", an award is subject to variable (or "mark-to-market") accounting.

#### *Other conditions can lead to liability accounting*

The stock compensation guidance defines three types of conditions: service, performance, and market conditions. If an award is indexed to a factor that falls outside of these defined categories (an "other" condition), it must be recorded as a liability and remeasured each period until settled.

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## *Hot off the press*

### **COSO refreshes its Internal Control-Integrated Framework**

After more than twenty years, COSO has refreshed its widely accepted internal control framework. Much has changed in the way businesses operate in the last two decades. The updated framework provides guidance to help keep controls current and has been enhanced to apply to business objectives beyond financial reporting. It is also principles-based, preserving the important role of judgment in designing and implementing internal control and assessing effectiveness.

#### *The familiar “COSO cube” with seventeen new principles*

COSO hasn't done away with the five components of a system of internal control: control environment, risk assessment, control activities, information and communication, and monitoring activities. However, the update articulates seventeen principles that are fundamental concepts embedded in the original framework. It also expands beyond external financial reporting to address other important forms of reporting, including external non-financial reports such as sustainability reporting.

#### *For more information*

COSO has announced that the update will supersede the original framework on December 15, 2014. For more details on the framework and two new companion documents, see [Dataline 2013-09, COSO issues the updated Internal Control-Integrated Framework and related illustrative documents](#). For ways to leverage the updated framework, read [10Minutes on why the COSO Update deserves your attention](#).

### **Discontinued operations—FASB proposes retro model**

Responding to concerns that today's definition of a discontinued operation is too broad, the FASB is proposing a new threshold. The revised definition is aimed at capturing only major strategic shifts in a company's operations, and aligns more closely with current IFRS guidance.

#### *A revised threshold for discontinued operations*

Today, a discontinued operation is a component with operations and cash flows that can be clearly distinguished, and can range from an asset group to a reportable segment. Under the proposal, only components (or groups of components) that are part of a single coordinated plan to dispose of a separate major line of business or major geographical area of operation will be presented as discontinued operations.

The proposal also eliminates today's guidance that precludes presentation as discontinued operations if the company has significant continuing involvement in the operations or cash flows with the disposed component.

## FASB gives “investment company” definition a tune-up

After several twists and turns, the FASB finalized its updated definition of an “investment company” in June. The revised definition is more of an enhancement to existing guidance than a complete overhaul. As a result, companies that are currently considered to be investment companies would, in most cases, continue to be investment companies under the new definition. Companies that meet the definition will report all of their investments at fair value.

*For more information*

The new definition is effective for interim and annual reporting periods in fiscal years that begin after December 15, 2013. For more information, see [In brief 2013-30](#), *FASB issues final standard on investment companies*.

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## SEC matters

► *Click here to watch our experts discuss the SEC’s conflict minerals rule.*

### Timing slips for conflict minerals lawsuit; SEC issues FAQs

The new SEC chairman has set her sights on fulfilling the remaining Dodd-Frank rulemaking mandates. However, many companies have been slow to react to one of the SEC’s Dodd-Frank rules: disclosures about conflict minerals. Recently, the legal challenge against this rule was moved to a different court, likely delaying a decision until later this year.

The SEC’s rule requires new reporting by companies that use conflict minerals—tantalum, tin, gold, or tungsten—in their products. Due to the pervasive use of these minerals, we expect the rule to affect a large number of companies. The initial report is due May 31, 2014 and covers the 2013 calendar year. With time quickly running short to prepare, companies delaying their efforts due to the pending legal challenge may want to rethink their strategy.

*For more information*

For more on the practical steps companies can take now, see our recently issued [10Minutes on conflict minerals](#). The SEC staff also recently released a series of FAQs to address certain interpretive questions they have received. The FAQs are located on the SEC’s [website](#).

### SEC gives thumbs-up to social media

In an April release, the SEC clarified that social media outlets, including Facebook and Twitter, can be used to communicate with investors. However, companies must first alert investors about which social media they plan to use.

Current SEC guidance (Regulation FD) requires companies to distribute material information in a non-exclusive manner so that all investors have access to it at the same time. The SEC’s announcement does not change that guidance. Instead, it clarifies that Regulation FD should be applied to social media similar to how it is applied today to information on company websites.

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## *Audit reporter*

### **PCAOB explores ways to measure audit quality**

In May, the PCAOB provided a first look at defining and identifying measures of audit quality. Still in its early stages, the project explores indicators that could assist the PCAOB in its regulatory processes and policymaking, and potentially be shared with audit committees, investors, or the general public. Expect to hear more on these initiatives in the upcoming months.

#### *Standard-setting update*

Recent PCAOB activity includes a revised proposal<sup>1</sup> on the auditor's evaluation of related parties, significant unusual transactions, and financial relationships and transactions with executive officers. The PCAOB views these areas as key contributing factors in a number of financial statement frauds. Much of the proposal is consistent with the PCAOB's February 2012 release. One notable revision clarifies that the auditor's evaluation of executive compensation arrangements is intended for risk assessment purposes, as opposed to drawing conclusions about their appropriateness.

#### *International developments*

Many in the U.S. are closely watching the outcomes of various new regulations overseas. Recently, the UK's Financial Reporting Council revised their audit reporting standard. It now requires auditors reporting on companies that apply the UK Governance Code to include additional information in their reports, such as an overview of the scope of the audit, and how the concept of materiality was applied.

Separately, the European parliament voted to adopt a series of measures that include mandatory audit firm rotation after 14 years, with extension to 25 years if certain criteria are fulfilled. The EU Council of Ministers continued its audit reform considerations, working toward a shorter mandatory firm rotation period and further restrictions to non-audit services, and contemplating the role of European authorities to coordinate auditor oversight. These reforms are still subject to further negotiation and approvals, expected later this year.

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## *On the horizon*

### **FASB green lights insurance contracts proposal**

After several years of joint discussions with the IASB, the FASB decided to move forward with a draft proposal on insurance contracts. Proposals from both boards could arrive as soon as the end of June, but they will not be fully converged.

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<sup>1</sup> For more information on this proposal, see [In brief 2013-25](#), *PCAOB repropose related parties auditing standard and related amendments*.

### *Who could be affected?*

“Insurance contracts” are broadly defined in the proposed guidance. Unlike current U.S. GAAP, the guidance would apply to contracts as opposed to a particular class of entities, meaning it could have implications for entities writing insurance contracts that are not insurers, such as banks. The changes being considered to current accounting are significant.

## **Financial instruments—more work ahead?**

Last month, feedback poured in on the FASB’s two proposals on financial instruments. Here we provide some highlights of the proposals and observations from the comment letters.

### *Impairment—two models*

The FASB received more than 300 comment letters before the comment period closed in May. While the FASB’s model has received praise for its operational simplicity, some struggle with the conceptual merits of a “day one” loss that is likely to result from the model.

### *Classification and measurement—praise for a simplified model*

The FASB received over 100 comment letters on its classification and measurement proposal. Many praised the FASB and IASB’s efforts to create a single, simplified model. However, some aspects of the proposal raised concerns. These include the “cash flow characteristics test” that must be met to measure instruments at amortized cost and the level of restrictions on allowable sales for instruments measured at amortized cost. Additionally, some believe the “fair value option” should continue to be more broadly permitted.

### *For more information*

For more background on the proposals, see [Dataline 2013-01](#), *Credit losses on financial assets—An overview of the FASB’s current expected credit loss model*, and [Dataline 2013-05](#), *Financial instruments classification and measurement—FASB issues its exposure draft*.

## **FASB shifts gears on “repos-to-maturity”**

In January, the FASB issued a proposal that would have required, among other things, a change in the accounting for a certain type of repurchase agreement known as a “repo-to-maturity.”<sup>2</sup> However, feedback on that proposal has caused the FASB to rethink its approach. The FASB tentatively decided to retain the current accounting model for this type of agreement and address the objective of the proposal through additional disclosures.

### *For more information*

For more information, see [In brief 2013-28](#), *FASB suggests a disclosure approach for the repurchase agreement project*.

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<sup>2</sup> A “repo-to-maturity” is a repurchase agreement in which the specified repurchase date is the maturity date of the transferred financial asset.

## **Final consensus on two EITF topics, three more exposed**

The EITF took on a full agenda at its June meeting. The meeting produced two final consensus decisions on the topics discussed below.

### *EITF reaches final decision on presenting unrecognized tax benefits*

The EITF decided that companies should net their unrecognized tax benefits against all same-jurisdiction NOLs or tax credit carryforwards that would be used to settle the position with a tax authority. Gross presentation would still be required in certain circumstances, for example when same-jurisdiction unrecognized tax benefits and NOLs or tax credit carryforwards exist, but the company knows they will not be used to actually offset one another. Because diversity in practice existed in this area in the past, the Task Force's decision will likely be a change from current practice for many companies.

### *Final consensus adds new benchmark interest rate for hedge accounting*

Companies applying hedge accounting can designate a benchmark interest rate as the risk being hedged. In the past, only two rates qualified as benchmark interest rates in the United States: the interest rate on direct treasury obligations of the U.S. government and the London Interbank Offered Rate (LIBOR) swap rate.

The EITF decided that the Fed Funds Effective Swap Rate (also known as the Overnight Index Swap Rate) should also be an allowable benchmark interest rate. As a result, we expect derivative products that are indexed to this rate to become more prevalent.

### *For more information*

For more background on the topics discussed and other EITF matters, read our [June 2013 EITF observer](#).

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## **Corporate governance**

### **Introducing ProxyPulse: insights into proxy voting trends**

This quarter, the PwC Center for Board Governance debuted ProxyPulse, for corporate directors and others interested in proxy voting trends. ProxyPulse was created in collaboration with Broadridge Financial Solutions to provide data and analysis on proxy season voting. Broadridge processes the proxy voting for over 80% of outstanding shares of U.S. publicly listed companies — over 600 billion shares.

The first edition of ProxyPulse explores the differing voting behaviors of institutional and retail investors. It also summarizes the voting results for director elections, as shareholders continue to support director nominations by a significant margin. Read the first ProxyPulse report in a special edition of [BoardroomDirect](#) and visit [www.proxypulse.com](http://www.proxypulse.com) for more information.

## Nasdaq reconsiders internal audit proposal

The Nasdaq is back at the drawing board on a proposed rule that would have required listed companies to establish an internal audit function by the end of the year. Numerous comments critical of the proposal cited the burden on smaller companies and the short time frame for compliance, causing the exchange to withdraw the proposal. Nasdaq plans to revise and resubmit the proposed rule in the near future.

## Two PwC publications help directors navigate the IPO process

A company that is planning to go public has a lot on its plate. Becoming a public company is a transformational event requiring many different parts of the business to work together towards this goal. Decisions about the company's board and its governance processes are addressed in two recent PwC publications.

*[Governance for Companies Going Public – What Works Best™](#)* provides insight on key governance considerations for companies contemplating a public offering. These include understanding IPOs and directors' roles, building a board, understanding key governance influences, protecting directors, and preparing for the first year as a public company. A companion publication, *[Going public? Five governance factors to focus on](#)*, helps executives and directors navigate the process by grouping governance factors into five categories.

► *Considering accessing the public markets? Click here to watch our experts discuss best practices, including overseeing the process and understanding governance alternatives.*

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