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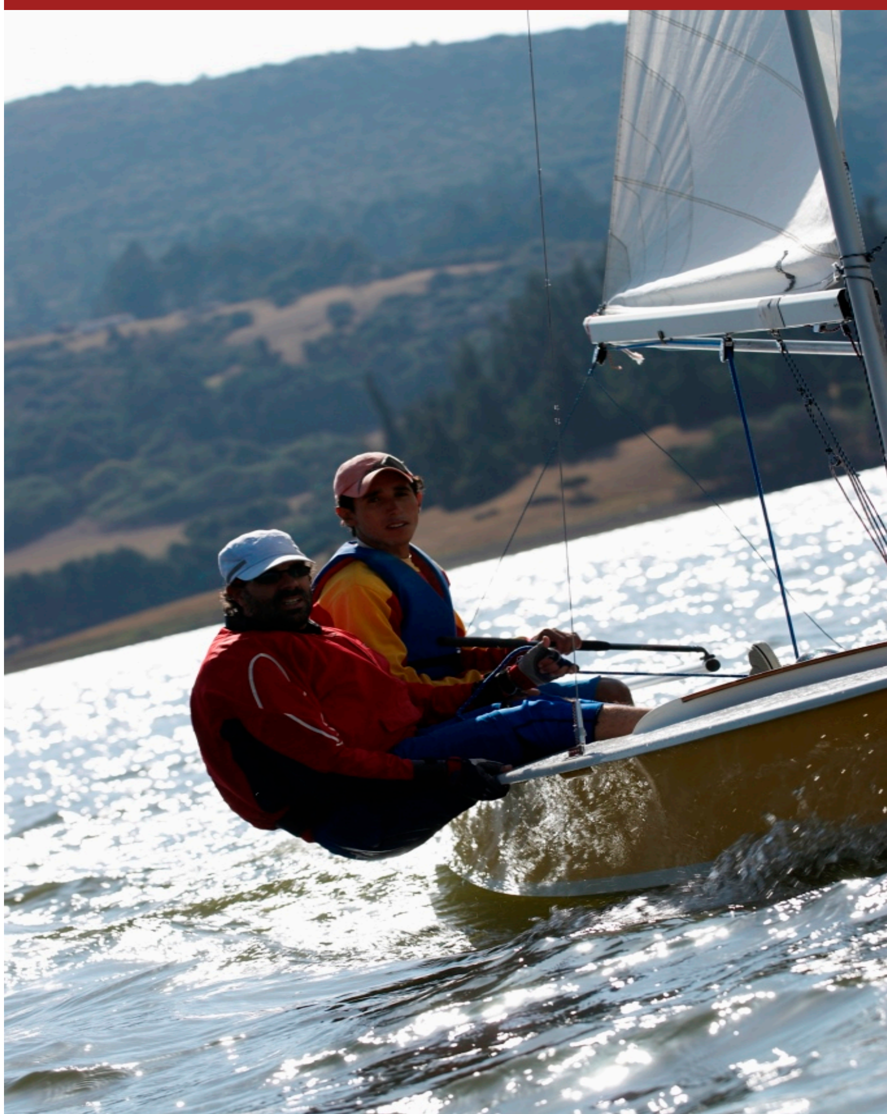
The quarter close

A look at this quarter's financial reporting issues

Directors edition

June 25, 2014



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What you need to know—Q2–2014

Welcome to the second quarter edition of *The quarter close*. Buoyed by the completion of the revenue standard, the FASB continues to sail forward with standard setting activities, including some "quick hit" items aimed at simplifying existing guidance.

As we cruise toward the end of the second quarter, read on for the latest developments.

Check out our suite of publications, webcasts, and videos on the new revenue guidance:

- **In depth US2014-01**, ***Revenue standard is final – A comprehensive look at the new model***
- **In the loop**: ***Reporting revenue — new model, new strategy?***
- **Series of general and industry webcasts**
- **Our experts' discussion of the new model's impact**

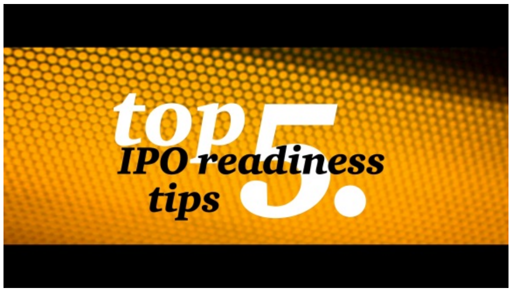
Accounting hot topics. With many companies casting off to IPO-land, we run down our Top 5 considerations when going public. We also focus on unique developments surrounding Venezuelan exchange rates and revisit the accounting guidance for software capitalization costs.

Hot off the press. Although the newly released revenue standard is garnering much of the attention, other new guidance will likely have a more immediate effect. For that reason, we spotlight the new discontinued operations guidance. We also discuss the private company VIE alternative, and examine how all of the private company alternatives could affect public companies that invest in private companies.

And more. Along with the latest corporate governance developments, we provide insight about what to look for from the standard setters next quarter, and an update on how regulatory changes are affecting financial institutions.

Video perspectives

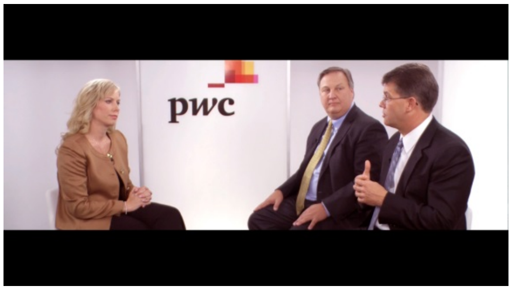
Spotlight on the hot topic videos included this quarter



Top five IPO reminders

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

Discontinued operations



Venezuelan exchange rates

Accounting hot topics

This quarter's hot topics:

- Top 5 considerations when going public
- Venezuelan exchange rates
- Accounting for software costs

Top 5 – Considerations for going public

This calendar year is on pace to generate the highest number of initial public offerings (IPOs) since 2007. A few years ago, companies often went through an IPO in a few short months. But now companies are getting started two to three years in advance to try to make the process smoother.

Boards of directors should consider the most common pitfalls of the IPO process, including those that pose a challenge to management. In that vein, we share our Top 5 considerations for going public based on our experience and what CFOs have indicated they wish they had known before going public.

Top 5 considerations for going public

5. *Ensure strong leadership* — Directors should be comfortable that they have the right person in place to lead the company during the IPO efforts. The right person will identify and make critical decisions, and empower the organization to make the transformation.

4. *Understand the company's readiness* — A first step in successful IPO processes is for management to complete a readiness assessment. This will identify skill and information gaps as well as prepare the company for questions from lawyers, bankers, investors, auditors, and the SEC. The board of directors should inquire about the results of the assessment to ensure it has a clear understanding of significant gaps and planned remediation.

3. *Evaluate the company's project management capabilities* — Success depends on execution. An understanding of the company's project management skills is an inherent part of an effective oversight function. Project management principles help leadership build the plan, monitor progress, identify gating issues, and keep the process on track.

2. *Understand the finance infrastructure* — The board should consider assessing the capabilities of the finance function well in advance of the IPO. They can do this by requesting that the company start acting like a public company before the IPO: close quarterly with an accelerated timeframe, prepare SEC-ready financial statements, including MD&A, report to the audit committee, and create a strong forecasting, planning and analysis function.

1. *Strive for a sustainable process* — *Being* public is the goal; *going* public is just the path to get there. The board of directors should consider the relevant functional areas—investor relations, corporate governance, internal controls, legal, tax, finance—to make sure they are ready to meet the ongoing requirements of public reporting.

▶ ***Click here for more on our experts' Top 5 considerations when going public.***

Changing tides in Venezuelan exchange rates

The relatively recent introduction of new exchange mechanisms for Venezuelan currency is causing accounting challenges for US companies with Venezuelan operations. Considerable judgment is necessary to determine which of the three legal exchange rates to use to remeasure bolivar-denominated monetary assets and liabilities, and to record associated revenues and expenses.

Background of the exchange rate options

▶ *Click here for our experts' insights on Venezuelan exchange rate accounting.*

Over 10 years ago, the Venezuelan government implemented controls to centralize the purchase and sale of foreign currency in the country. Since then, the bolivar has devalued significantly, and Venezuela has been considered a highly inflationary economy since 2010. Most US companies with operations in Venezuela have determined that those operations have a US dollar functional currency, requiring bolivar denominated monetary assets and liabilities to be remeasured into US dollars each reporting period.

Since the fourth quarter of 2013, determining which exchange rate to use for remeasurement purposes has been difficult since there have been three exchange mechanisms administered by the Venezuelan government, each with significantly different economic implications. Directors of companies with material Venezuelan operations should inquire into the implications of this exchange rate situation.

For more information

For more information, see Dataline 2014-07, *Implications of recent events in Venezuela*.

Navigating the guidance for software development costs

Most companies are incurring software costs—whether buying or developing software for their own use, or developing software to sell. The accounting treatment for these costs varies significantly depending on whether the company intends to use the software internally or to sell it. As software technology has evolved, arrangements for software as a service (SaaS) have become increasingly popular. With these agreements, it's often less clear which category ("internal use" or "to be sold") a company's software costs fall into.

Using decades-old guidance as a compass for current day software transactions

One example of a SaaS arrangement is where a vendor hosts software on its server that the customer accesses over the internet. To determine how to account for the cost of developing that software, the vendor considers the customer's rights: Can the customer contractually take possession of the software without significant penalty? Can the customer run the software itself, or have another party host it? If the answer to either of these questions is no, then the vendor is really selling a service and the software is considered "internal-use" for purposes of the vendor's software development cost accounting. If the answer to both questions is yes, then the vendor would account for the costs using the guidance for software to be sold.

Costs associated with a particular piece of software must follow one capitalization model or the other. Generally, the internal use model capitalizes costs earlier and for a longer period of time, and impairment testing is performed at the asset group level.

For more information

For more details on the accounting for software development costs, refer to Chapter 10 of our guide *Software Revenue Recognition—A User Friendly Guide to Navigating through the Latest Accounting Standards*.

Hot off the press

All hands on deck! The FASB and IASB released the new revenue standard at the end of May, and public companies will need to dive into the details relatively quickly. The new standard is effective for 2017 and may require comparative information depending on the transition method a company elects.

The FASB also recently released guidance that eliminated the concept of a development stage entity from GAAP. It also amended other guidance that had specific presentation or disclosure requirements for development stage entities, including the consolidation VIE guidance. For more information, read In brief 2014-10, *Development stage entity concept eliminated by the FASB.*

Cutting loose a business? FASB releases new guidance

In April, the FASB issued new guidance that changes the definition and disclosure requirements for discontinued operations. The guidance addresses concerns that too many disposals are currently classified as discontinued operations.

Discontinued operations = strategic shift plus major effect

▶ *Click here to learn about the most significant changes in the new discontinued operations guidance.*

The FASB now limits discontinued operations to disposals of components that represent a "strategic shift that has (or will have) a major effect on an entity's operations and financial results."

So what constitutes a strategic shift, and what is a "major" effect? The new guidance includes some examples to guide companies, but the assessment will often require judgment. Activities like disposing of a separate major line of business, a major geographical area of operations, or a major equity method investment, could qualify.

The winds of change had another significant effect on the guidance: Retaining significant continuing involvement with a disposed business no longer precludes discontinued operations presentation. Don't disregard continuing involvement all together – it may impact whether there has really been a strategic shift or if the shift will have a major net effect. A "before" and "after" snapshot of the financials (including continuing involvement) will help determine if the disposition will have a major net effect.

What's next?

Companies must apply the guidance to new disposals (and new held-for-sale classifications) beginning in 2015, with early adoption permitted. For more details and insights, read Dataline 2014-08, *Discontinued operations—Revised standard significantly changes criteria for discontinued operations and disclosures for disposals*.

Latest private company alternative is christened

Private companies that meet certain criteria can now choose not to apply the variable interest entity (VIE) model to certain common control leasing arrangements. These arrangements are fairly common in the private company world, and typically result in the lessee (the private company) consolidating a lessor entity. The end result of the new guidance is that private companies will likely apply lease accounting rather than consolidating an entity that holds the assets they lease.

Public companies with equity method investments in private companies may be affected if the private company investee elects the VIE (or any other) private company alternative.

What types of arrangements qualify?

The new guidance lays out four criteria, all of which must be met for the private company to apply the exemption:

1. The private company lessee and the lessor legal entity are under common control;
2. The private company has a lease arrangement with the lessor;
3. Substantially all activities between the private company and the lessor relate to leasing activities between those two entities; and
4. If the private company lessee explicitly guarantees or collateralizes any obligation of the lessor related to the leased asset, the leased asset's value exceeds the obligation's principal amount at the inception of the guarantee.

What's next

As with all private company alternatives, companies that may adopt this alternative should consider the likelihood of becoming a public business entity in the future. The alternative is effective for 2015, with early adoption permitted.

For more on the details of applying this new guidance, look for an upcoming *In depth*. Public companies with equity method investments in private companies can read about the potential implications of the private company alternatives (if adopted by their investees) in the May edition of the *Private company reporter*.

On the horizon

Quick hits — FASB developments

*On consolidation…*The FASB is expected to make a decision before the end of June as to whether to re-expose its proposed changes to consolidation guidance. When the FASB proposed revisions to this topic and asked for comments back in 2011, the effect of the changes were limited primarily to the asset management sector. Since then, the FASB has made a number of recent decisions that change several steps in the variable interest entity model, which every company will need to evaluate.

In addition, changes to the voting model were included in the initial exposure draft that could lead to more entities being consolidated across multiple sectors. All companies are encouraged to monitor the developments of the consolidation guidance so they are fully aware of how they may affect their financial statements and when thinking about potential transactions. For more information, read In brief 2014-08, *Consolidation—changes may affect all industries*.

*On simplification…*The FASB has committed to identifying areas of U.S. GAAP where cost and complexity can be reduced while maintaining or improving the usefulness of the information. In this vein, the board made decisions to:

- Measure inventory at lower of cost or net realizable value
- Eliminate the concept of extraordinary items and the related disclosure requirements

Both of these decisions will be exposed for comment over the summer. There are more simplification topics that the FASB is looking to address, so stay tuned for more quick-hitting decisions like these.

Regulatory matters

Though developments from regulators and auditing standard setters have been relatively quiet this quarter, there was at least one news release that drew attention: Chief Accountant Paul Beswick announced he would be leaving the SEC. A replacement has not been named.

Financial institutions prepare for new regulations

Financial institutions have been digesting the Volcker rule, US Basel III rules, and other new regulations for months to determine their impact. Though the implementation date for some of the rules stretches to 2018, the Volcker rule's first reporting requirements are due in September for the largest banks.

The latest on the Volcker rule

Among its many provisions, the Volcker rule restricts certain proprietary trading by banks and other financial institutions. It also requires financial institutions to implement enhanced compliance programs, including steps to support the newly required CEO attestation addressing the reasonableness of the program's design. Although the earliest deadline for compliance is mid-2015 for the largest banks, certain components of the enhanced compliance program should be in place before the start of proprietary trading metrics reporting in September 2014.

The rule also prohibits financial institutions from having ownership interests in hedge funds, private equity firms, or other interests that have the characteristics of a "covered fund" as defined in the rule. A recent focus is on whether certain collateralized loan obligations (CLOs) qualify as covered funds, and therefore would be prohibited. Some had hoped for a broader exemption for these types of funds. Rather than exempting them, the Federal Reserve (the Fed) instead extended the compliance deadline for CLOs by two years. Regardless of the compliance deadline, prohibited ownership interests may impact accounting classification (e.g., "held-to-maturity" classification may no longer be appropriate) and earnings (e.g., may affect impairment analysis) today.

Capital, capital, capital

Financial institutions subject to regulatory capital reporting face process and reporting changes under US Basel III rules. Changes to qualifying capital components, ratio thresholds, risk-weighted assets, and disclosure requirements, among others, mean that most banks are working to address the rules now. For most banks, the revised rules will become effective in 2015, with transition through 2018.

Results from the most recent Fed stress capital assessments also emphasize that supervised entities must continue to improve their capital planning processes regardless of whether they meet quantitative capital requirements.

Finally, the Basel Committee on Banking Supervision issued the near final version of its leverage ratio and disclosure guidance, which will be subject to further calibration until 2017. Final implementation by participating countries is expected by January 1, 2018.

For more information

For additional publications on financial services regulation, visit the webpage of our PwC's Financial Services Regulatory Practice. Also see our recent publications *Volcker rule clarity: Waiting for Godot* and *First take: Basel large exposures framework*.

Corporate governance

New publications provide directors with broad-based knowledge across variety of roles

Governance principles are universal. But how they are executed can vary depending on the company's jurisdiction, whether the company is public or private and the specific responsibilities of the director. PwC's Center for Board Governance has introduced two new series of publications focused on two very different populations of directors.

Addressing unique governance needs in a family business

Many family-owned companies have boards of directors comprised of family members or people close to them. This may not always provide the owners with the independent perspective or expertise they need as the company grows. *Family business corporate governance series* launched with a module focusing on the role of the board in a family business. A follow-up module will focus on how to build an effective board, and how the combined skillset of the board can assist with the challenging issues family businesses can face.

Anchoring the audit committee in knowledge it can act on

The *Audit Committee Excellence Series* (ACES) provides practical and actionable insights, perspectives, and ideas to help audit committees maximize committee performance. The inaugural edition addressed forward-looking information. It provided insightful ideas to help audit committees understand the pros and cons of providing forward-looking information, when such information is required and red flags that might indicate examples of unusual behaviors by management to try to meet consensus estimates.

The second edition of ACES is focused on one of the audit committee's most important responsibilities—financial reporting oversight. We spotlight techniques that help audit committees review financial results effectively and efficiently, including considerations they should address in advance of releasing financial press releases.

The next edition of ACES will provide creative ideas for engaging internal audit to help audit committees oversee and maximize the value of this important resource.

For more information

The first module of the *Family business corporate governance series* and our ACES publications can be obtained at PwC's Center for Board Governance website.

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