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The quarter close

A look at this quarter's financial reporting issues

Directors edition

June 18, 2015

What's inside

What you need to know—Q2–2015

Welcome to the second quarter edition of *The quarter close—Directors edition*. Though we may get a little break over our nation's birthday to enjoy barbecues, parades and other holiday traditions, there's no sign of slowdown in the realm of accounting and regulatory developments.

This quarter, we share the latest areas of focus, and what you can expect to see on the horizon (besides those July 4th fireworks).

Accounting hot topics. Sometimes it makes sense for companies to change accounting policies. We summarize how to approach this change, and what to consider with regard to timing. Next, we share reminders for SEC requirements (and accounting considerations, in our video) to consider during a business combination. We also discuss approaches for managing foreign currency volatility.

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

Hot off the press. Implementation questions continue to arise related to the new revenue guidance. We provide an overview of what's new since last quarter. Shifting gears, we provide insight into why the FASB's new proposal on not-for-profit accounting may spark change in financial statement presentation for all companies.

On the horizon. We provide high-level updates on proposals from the FASB related to stock-based compensation, equity method accounting, and measurement period adjustments. We also discuss new guidance related to investments valued using net asset value.

And more. Along with the latest corporate governance developments and thought leadership, we provide an overview of a new proposed rule from the SEC regarding pay vs. performance disclosures.

Video perspectives

Spotlight on the hot topic videos included this quarter

Merger & acquisition activity

Equity method accounting: Assessing significant influence

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

Foreign currency volatility

Earnings per share: the impact of restricted stock

Accounting hot topics

This quarter's hot topics:

- Changing accounting policy elections
- Reminders—SEC requirements for a business combination
- Managing risk from fluctuations in foreign currency

Considering changing an accounting policy? Get ahead of the curve by planning in advance

In certain areas of GAAP, companies can elect from more than one acceptable accounting principle when establishing an accounting policy. Examples include methods for inventory costing, accounting for actuarial gains and losses in pensions, and recognizing breakage revenue.

Companies can change their selected accounting policies under certain circumstances. First, companies have to ensure that the change is not a correction of an error or a change in estimate (see The quarter close, Q2 2013, *Accounting changes—principle, estimate, or error?)*. Companies also have to conclude that the new accounting policy is preferable to the original one.

What makes one accounting principle "preferable" to another?

Preferability can vary from company to company, and can change over time. For example, an accounting change might be preferable because an authoritative body (standard setter or regulator) indicates that one accounting principle is preferable to another—this may have happened after the original accounting policy was elected. Another example might be that changing the accounting principle improves financial reporting.

Who needs to agree that the change is preferable?

Public companies that make material accounting changes are required to obtain a preferability letter from their auditors. The letter indicates whether the company's change to an alternative principle is, in the auditor's judgment, preferable under the circumstances. While preferability must be established for all accounting changes, only changes that have a material effect on the comparability of the financial statements to prior periods require a preferability letter.

Disclosure and recasting

A change in accounting policy that has a material impact to prior period financial statements is required to be reported through retrospective application to all prior periods, unless impracticable. If it is impracticable, the new accounting principle should be applied prospectively as of the earliest date practicable.

When is the ideal time to change an accounting principle?

Deciding when to change an accounting principle is up to the company based on its specific facts and circumstances. U.S. GAAP recommends that, whenever possible, a company should adopt any accounting changes during the first quarter of its fiscal year, as changes after the first quarter have a tendency to obscure operating results and complicate interim disclosures.

Companies that are considering an offering or capital-raising transaction may benefit from adopting an accounting change during their fourth quarter. Reporting and disclosure requirements in an offering document may be simpler because the change will already be reflected in the annual financial statements if the accounting change is adopted during the fourth quarter.

For more information

Our Audit Committee Excellence Series publication, *Achieving excellence: Overseeing accounting changes– including the new revenue recognition standard*, provides directors additional insight on understanding and overseeing accounting changes.

Staying on track with SEC reporting requirements when executing a business combination

▶ *Click here to learn more about business combination accounting considerations.*

Business combinations have many complex accounting considerations to be considered (see our video box for a discussion about some of these). However, there are several SEC reporting matters to consider as well. Rule 3-05 of Regulation S-X (S-X 3-05) outlines the SEC's requirements for filing historical financial statements related to business acquisitions.

Periods for which historical financial statements are required

S-X 3-05 uses a sliding scale to determine the periods for which historical annual financial statements of the acquired subsidiary are required. The sliding scale is based on the level of significance calculated using the significant subsidiary tests[1]. One, two, or three years of audited annual financial statements may be required depending on the significance of the acquired subsidiary. In addition, subsequent comparative unaudited interim financial statements may also be necessary depending upon the timing of the transaction.

Pro forma requirements

In addition to historical financial statements for significant acquisitions, registrants are also required to provide certain pro forma financial information prepared in accordance with S-X Article 11, as if the acquisition was consummated as of the date of the most recent balance sheet presented and as of the beginning of the most recent fiscal year presented for purposes of the pro forma income statement. In most cases, the pro forma financial information consists of an income statement for the most recent annual period and subsequent interim period, and a balance sheet as of the end of the latest income statement period included.

Timing for providing financial statements and notifications

A domestic registrant has to file a Form 8-K within 4 business days of the consummation of a significant business combination. The required historical and pro forma financial information is often filed by a subsequent amendment within a "grace period" of 71 calendar days after the 4th business day following completion of the acquisition.

Addressing financial statement effects of FX volatility

Numerous macroeconomic factors have caused significant currency volatility across the globe, the likes of which haven't been seen in decades. Determining how to mitigate the effects of currency volatility on financial statements is a risk management decision, and is dependent upon the nature of the exposure. Most companies consider three types:

Transaction exposures—Gains or losses on recorded monetary assets or liabilities that are denominated in currencies other than a company's functional currency.

[1] As set forth in Rule 1-02(w) of Regulation S-X.

Economic exposures—Economic gains or losses that occur when a company expects to purchase goods or sell product in a currency other than its functional currency. For example, a U.S. business may have a significant customer base in Europe that prefers to purchase in Euro. The company is economically exposed to changes in the Euro-to-U.S. dollar exchange rate, even though the future purchases or sales are not yet recognized in the financial statements.

▶ Click here to learn more about managing foreign currency volatility.

Translation/accounting exposures—Exposures that manifest themselves in increased/decreased reported assets, liabilities, and earnings, as the U.S. dollar weakens or strengthens versus other currencies around the world. This is simply a function of translating functional currency financial statements into the reporting currency.

Can these risks be hedged?

Companies frequently hedge their transaction and economic exposures by executing forwards, options, or other financial instruments. These derivative instruments can help mitigate the functional currency cash flow exposure caused by changes in currency exchange rates. Many companies also avail themselves of hedge accounting for these trades, which can help to reduce volatility in reported earnings.

A company can also receive hedge accounting for the impact of translation on its net investment in foreign operations, but the impact on its translated earnings cannot be hedged from an accounting perspective (i.e., reported earnings will still reflect volatility). Some also believe that the impact of translation on reported earnings need not be hedged as the gains and losses are essentially "paper" gains and losses, and don't actually reflect financial performance.

Companies frequently choose to address the accounting exposure by providing disclosures around the impact currency has had on their financial statements. This can be done in various ways, but many prefer to quantify the effect of changing exchange rates on key financial statement line items, or by providing "constant currency" disclosures in their MD&A or earnings releases to provide a better focus on core operational results.

For more information

In addition to the advice shared in our video, our recent In the loop, *Financial reporting implications of foreign currency reporting—what can your company do?*, provides additional insight on this topic.

Hot off the press

FASB, IASB, and TRG turn the corner on revenue recognition implementation issues

The FASB and IASB discussed five implementation issues related to the new revenue standard during their March joint board meeting. The issues were all previously discussed by the Transition Resource Group (TRG). Both boards agreed to propose a new practical expedient to provide relief from evaluating contract modifications prior to the date of initial application of the standard. The boards also agreed to propose other practical expedients and clarifications to the standard, though the boards were not fully aligned on their approaches.

TRG debates revenue recognition implementation issues

In March, the TRG held its fourth meeting to discuss implementation issues related to the new revenue standard. The TRG discussed eight issues, some of which are expected to be discussed by the FASB and the IASB at a future date. These include issues related to payments made to a customer and identifying whether a series of distinct goods or services should be accounted for as a single performance obligation.

Boards are converged in proposing a one year deferral

The FASB issued a proposal to defer the effective date of the standard by one year, but to permit entities to adopt one year earlier if they choose (i.e., as of the original effective date). Comments on the proposal were due in May.

The IASB also issued a proposal to defer the effective date by one year. The IASB's proposal retains the option for entities to early adopt the standard. Comments on the proposal are due on July 3.

Both boards decided a deferral is necessary to provide adequate time to resolve implementation issues and finalize any amendments to the standard.

Next steps for the FASB and IASB

The FASB already issued one proposal to amend certain aspects of the standard related to licenses of intellectual property and identifying performance obligations (discussed at the joint board meeting in February). It will issue a second proposal covering the new practical expedients and other clarifications (discussed at the March joint board meeting) in the near term, with a 45-day comment period.

The IASB will incorporate the amendments that were agreed to during the joint meetings into a package of proposed amendments that will be subject to the IASB's due process and will be exposed for comment later this year.

For more information

For additional background on the specific issues discussed at these meetings, including our insights, read In transition US2015-03, *FASB and IASB decide on additional changes to revenue standard,* and In brief US2015-13, *IASB votes to propose one-year deferral of new revenue standard; FASB issues its proposal.*

Proposed not-for-profit changes may signal changes ahead for all companies

The FASB's recent proposal to change the not-for-profit financial reporting model could be a sign of things to come for all business entities. While some aspects of the proposal reflect changes in areas that are uniquely not-for-profit, others deal with changing fundamental aspects of the underlying U.S. financial reporting model. The latter reflects the influence of the earlier, more far-reaching FASB Financial Statement Presentation project that re-envisioned the reporting framework for business entities, but was abandoned in 2011.

Proposal changes the definition of "operating" and cash flow presentation

The cornerstone of the proposal is a new conceptual approach to defining and reporting "operating activities." It's a significant departure from the operating and non-operating distinctions used today, which are voluntary and focus primarily on how management views the business. Under the proposal, a subtotal for operating activity would become a required GAAP measure. In addition, the FASB would specify the nature of items that can be reported as “operating,” with the primary focus on the core business (or in not-for-profit parlance, “mission”) activities. By definition, “operating” would not include transactions associated with an entity’s generic investing or financing activities, such as investment income or interest expense. And, because an entity cannot operate without capital assets, activities (and cash flows) associated with property and equipment used in day-to-day operations would inherently be considered operating.

The proposal would also significantly modify the cash flow reporting model to better align the “operating” section of the statement of cash flows with the “operating activity” reported in the performance statement. For example, cash payments to acquire property and equipment would become operating cash outflows, rather than investing cash outflows. Similarly, investment income received and interest paid would no longer be considered operating cash flows; instead, they would be reported in the investing and financing sections, respectively. The FASB would also require use of the direct method of reporting operating cash flows, which is rarely used today.

Why should companies other than not-for-profits care?

Because the FASB has similar research projects on its agenda for business entities, the not-for-profit proposal may be a potential bellwether of what’s ahead for business entities. For example, in a recent speech, the FASB vice chairman said, “We’ve concluded the acquisition of PP&E (plant, property and equipment) is an operating use of cash, not investing, so we’re pursuing a cohesiveness principle.” This statement seems to indicate that similar changes may be ahead for all business entities.

For more information, see our Point of view, *The financial reporting framework - Could changes to the not-for-profit (NFP) standard impact for-profit entities?* and stay tuned for an upcoming In depth on this topic.

On the horizon

Wishing for a holiday from new standard setting? This might not be your quarter. Here are some quick updates and reminders on developments coming out of the FASB.

FASB proposes stock-based compensation simplifications

The FASB has proposed multiple simplifications to the accounting for stock-based compensation. The proposals may have significant effects on net income, EPS, and the statement of cash flows. Read In brief US2015-17, *FASB proposes to simplify the accounting for share-based payments*, for a summary of the proposals.

Comments sought on equity method proposals

The FASB is seeking comment on two proposed simplifications to the equity method of accounting. The first eliminates the requirement that investors separately account for basis differences. The second eliminates the requirement that an investor account for an equity method investment retrospectively when it increases its ownership to a level that initially qualifies for the equity method.

FASB drives to simplify measurement-period adjustments in a business combination

The FASB issued a proposal that is intended to simplify the accounting for business combinations by removing the requirement to record changes to provisional amounts that arise during the measurement period retrospectively. Under the proposal, during the measurement period, an acquirer would recognize adjustments of provisional amounts in the reporting period in which the adjustment amount is determined (i.e., record the cumulative effect of the change in the current period).

New FASB guidance affects companies measuring fair value using net asset value

Current U.S. GAAP permits companies to measure the fair value of certain investments using the net asset value per share as a practical expedient. Investments valued using the practical expedient are required to be categorized within the required fair value hierarchy disclosure. The FASB issued new guidance that removes this requirement. Instead, investments valued using the practical expedient must be included as a separate line item that reconciles the total fair value of investments in the disclosure to the amount on the balance sheet. The new guidance also changes certain other disclosure requirements. Calendar year-end public companies are required to adopt the new guidance in 2016; private companies get an additional year. Early adoption is permitted.

Regulatory matters

SEC proposes "pay vs. performance" disclosures

In April, the SEC proposed a rule requiring registrants to disclose the relationship between executive compensation actually paid and the financial performance of the registrant for a time period of up to five years. The proposed disclosure, mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act, would be required in proxy or information statements in which executive compensation disclosure is required. The proposed disclosure would not apply to emerging growth companies or foreign private issuers.

Proposed disclosures

Highlights of the proposed disclosures include:

- Total compensation (as defined in 402(c) of Regulation S-K) for the principal executive officer and the average total compensation for the remaining named executive officers;
- Executive compensation actually paid to the principal executive officer and the average for the remaining named executive officers. This information is already required to be included in the Form 10-K, but for this rule's purposes, it must be modified to exclude certain changes in the actuarial values of defined benefit plans and to include the value of equity awards at vesting, rather than when granted;
- Total shareholder return (TSR) of the registrant (as defined in Item 201(e) of Regulation S-K) and TSR of a peer group of the registrant;
- XBRL tagging of the amounts disclosed; and
- Explanation of the relationship between the executive compensation actually paid and the registrant's TSR, as well as the relationship between the registrant's TSR and the peer group's TSR.

What's next

The comment period for the proposed rule ends July 6, 2015. Companies may want to consider drafting sample disclosures to help them understand the relationship between actual executive compensation and total shareholder return over time. This exercise may help companies formulate comments to submit to the SEC in response to the proposal.

Corporate governance

Shareholder activists spark fireworks in boardrooms

Shareholder activism is exploding. The number of activists is increasing, and their tactics and strategies are changing. Nearly 300 new activist hedge funds have been launched since 2003, with total assets under management now exceeding $100 billion[2].

Companies of a variety of sizes and industries should be alert to the possibility of shareholder activism. Activists can target companies for varying reasons, with underperformance relative to peers often a common factor.

Companies that put themselves in the shoes of an activist will be most able to anticipate, prepare for, and respond to an activist campaign. Preparation is critical. While companies will need to consider how to respond based on their facts and circumstances, an effective plan generally includes objectively evaluating the activist's strategies, looking for areas around which to build consensus, and even proactively engaging with the activist and key shareholders to tell the company's story.

For more information

For additional insight, refer to our recent publications: *Shareholder activism: The who, what, when, & how*, *Shareholder activism: Strategies for mitigating risk and responding effectively* and In the loop, *Shareholder activism—are you prepared to respond?*

Expansion of audit committee responsibilities requires a fresh look at role, composition, and performance

Today's audit committees face a new challenge as they are increasingly asked to take on more oversight responsibilities. These may include oversight of IT, third-party risks, conflict minerals, and general "risk oversight." Audit committees have also become the place where board responsibilities without a clear-cut owner are allocated—akin to the board's "junk drawer." From an external perspective, audit committees are also being impacted by a changing regulatory environment.

Considering their expanded role, audit committees need to determine whether the scope of their responsibilities and obligations are reasonable and achievable. They also need to assess whether they have the right composition to ensure effective oversight. This includes considering whether their members have the optimal mix of experience, expertise, size, and leadership. Focusing on whether additional skills or experiences would be helpful is important. Audit committees also need to undertake a robust annual self-assessment process that allows members to participate in frank discussions about their performance and commit to taking action based upon the assessment results.

[2] Preqin Special Report: Hedge Fund Activist Report (June 2014), (available at www.preqin.com/docs/reports/Preqin_Special_Report_Activist_Hedge_Funds_June_14.pdf)

For more information

Our May edition of the Audit Committee Excellence Series, *Achieving excellence: Role, composition, and performance,* provides practical and actionable insights and perspectives to help audit committees maximize their performance.

How does diversity affect directors' approach to board oversight?

Despite steps taken in several countries to adopt quotas for female participation on boards, and significant efforts undertaken by a number of organizations in the U.S. to increase gender diversity on boards, the number of women serving as directors has not changed significantly over the last six years.

Within this context, there are two fundamental questions about gender representation and director performance that deserve to be asked:

- Are there really differences in how male and female directors approach their oversight roles?
- Do the practices of boards with female directors vary from those of other boards?

We analyzed the results of our Annual Corporate Director Survey by gender to see if we could determine answers to these questions. Some of our findings include:

- Both men and women are concerned about director-shareholder communications, but male director concerns are deeper.
- Women want to spend more time on IT despite already higher levels of engagement, and are more concerned about the digital skills of today's boards.

For more information

For more of the findings of our gender-based analysis of directors, read our *PwC's Annual Corporate Director Survey – The gender edition*.

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