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The quarter close

A look at this quarter's financial reporting issues

Directors edition

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What's inside

What you need to know—Q3–2014

Welcome to the third quarter edition of *The quarter close*. Without pausing to take a victory lap after completion of the final revenue standard, the FASB is using its momentum to address some fast-paced simplification items and work toward wrapping up several other significant projects.

As we race toward the end of the third quarter, read on for the latest developments.

Front and center. Many companies have their accounting pit crews working on a plan to implement the new revenue standard. We provide a snapshot of the standard's effect. We also highlight the potential financial and non-financial impact, and suggest who in the company (other than the accounting department) should be engaged.

Accounting hot topics. We provide insights on what is needed in anticipation of a spin-off. In addition, while many companies are focused on the new revenue standard, we share why some companies may be challenged by how to apply the current guidance to their evolving product offerings. We also spotlight some common speed bumps navigating sale-leaseback accounting.

Hot off the press. The FASB unveiled new requirements for companies to assess their ability to continue as a going concern. In addition, the IASB issued its final standard on classifying, measuring, and impairing financial instruments.

And more. Along with the latest corporate governance developments, we provide insight into the FASB's plans for consolidation guidance.

Video perspectives

Spotlight on the hot topic videos included this quarter

Top 5 financial statement line items impacted by the new revenue standard

Spin-offs

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

Front and center

New revenue standard — time to start your engines

The race is on for companies to kick off implementation of the new converged revenue recognition standard. With public companies facing a 2017 effective date, it's not too soon to start assessing the potential impact on financial statements and businesses as a whole.

Pervasive impact across industries and throughout companies

The objective of the new revenue standard is to provide a single, comprehensive revenue recognition model for all contracts with customers to improve comparability within industries, across industries, and across capital markets. The effect on companies' financial statements will vary depending on industry and current accounting practices. However, new extensive disclosure requirements will impact all companies.

Some companies have begun to develop a project plan and identify areas that require more focus. They recognize that the significant increase in disclosure requirements could require new systems, processes and internal controls to capture information that has historically not been necessary for financial reporting purposes, including in interim financial statements. Both the accounting changes, and the costs to implement them, will likely represent a substantial investment — in resources, time, and money — for many companies.

For more information

Our guide *Revenue from contracts with customers - 2014 global edition* discusses each of the steps in the new accounting model, highlighting key aspects and providing illustrative examples. In addition, our Revenue page on CFOdirect is a one-stop library for all PwC publications related to the new revenue standard — from the executive-level *In the loop* publication to our industry-level insights.

Who in the company will be affected by the new revenue standard

The new revenue standard will affect top line revenue numbers for many companies. But it may also have an indirect effect on other financial statement line items, some of which fall under the purview of departments other than accounting. This means that there are likely non-accountants that may need to understand the potential implications of the revenue standard.

▶ Click here to learn which Top 5 line items will be affected by the new revenue standard.

Human resources — Compensation plans that have a revenue-based trigger, such as sales commissions, bonuses and other incentive compensation agreements, may be affected by the change in timing of revenue recognition. While revenue contracts might remain the same, companies that record revenue differently under the new rules may want to revisit performance targets in employees' bonuses and other compensation.

Tax — There are certain instances where revenue recognition for tax purposes depends on revenue recognition for financial accounting purposes. For example, the timing of recognition of advance payments could accelerate cash taxes payable. And even if the timing of revenue recognition for tax remains unchanged, there may be new temporary differences to account for if the timing changes for financial reporting. In addition, there could be an impact to transfer pricing strategies and documentation, specifically when using revenue or profit-based methods for establishing the transfer pricing.

Treasury — The new standard requires companies to determine if a transaction has a significant financing component. Cash that is received in advance, or where the customer is provided with extended payment terms, could result in interest expense or interest income being recognized. Also, since debt covenants are often based on a measure of net income, or a metric such as EBITDA, the new standard could affect covenant compliance.

In addition to these three frontrunners, others in the company may also need to be engaged in implementation of the new revenue standard. For example, information technology may be asked to enhance or change revenue recognition software; investor relations may be asked to develop a strategy and communications for sharing the impact of the standard with investors; and the sales organization may be asked to reconsider selling approach and contract terms.

For more information

Our webcast *Revenue recognition: What actions companies can take to prepare* focuses on indirect implications of the new revenue standard.

Applying the new revenue guidance to the SEC five-year selected financial data table

Companies that file financial statements with the SEC are required to present a selected financial data table covering five years of information, including revenue. However, the primary financial statements only include income statements for three years. This difference in time periods raised a question as to what companies will be required to include in the selected financial data table if they elect the retrospective method of applying the new revenue recognition standard.

During a meeting of the FASB's Financial Accounting Standards Advisory Council, an SEC staff member indicated that the Division of Corporation Finance will not object if companies that elect to retrospectively adopt the new standard only apply it to selected financial data for the same years as presented in their primary financial statements. However, companies should provide transparent disclosure regarding the basis of presentation and lack of comparability.

Accounting hot topics

This quarter's hot topics:

- Preparing to execute a spin-off
- Gross vs. net revenue for virtual goods
- Avoiding failed sale-leasebacks

Don't spin wheels during a spin-off

Spin-off transactions are growing in number, but preparing financial statements for the company being spun off is often not a simple exercise. Companies contemplating a spin-off need to be agile and have good mechanics in place to execute the plan timely and efficiently.

Framework for performing a spin-off

The first step in performing a spin-off is determining what is going to be spun off — that forms the basis for determining which entities, businesses or divisions comprise the historical financial statements. Next, preparing for and executing the transaction takes multiple steps. These include identifying the right sponsors for the process and the spun-off company, identifying resources both internally and externally, and preparing the financial statements for the spun-off entity — often called “carve-out” financial statements. Lastly, it’s important to remember that the new business needs to stand ready to operate as a separate public company once the spin-off is completed.

The challenges of carve-out financial statements

▶ Click here for more on our experts’ perspectives on best practices for completing a spin-off.

Carve-out financial statements provide the historical financial position and results of operations of the spun-off entity. They are used in public filings and provide the basis for pro forma information — and are frequently the most resource-consuming part of a spin-off. So what’s involved in getting them road-ready?

One challenge is ensuring that the financial statements reflect all costs of doing business. Costs that may have been recorded at an aggregate level by the parent need to be included in the spin-off’s financial statements, through specific identification of expenses or through allocations when specific identification isn’t feasible. This could include taxes, pension costs, and stock-based compensation costs, among many others. Existing internal allocations from the parent to the entity being spun off may be different than those necessary for carve-out financials.

Breaking out assets and liabilities can be equally challenging. Although attributing certain assets like fixed assets may be straightforward, how or whether to split out others may be more challenging. Factors to consider include level of usage, control of the asset, and whether the asset is going to be owned by the spun-off entity post-spin. One example is a parent company that owns an asset used by multiple entities — like a corporate jet. The jet may remain on the parent’s books, but the carve-out financials need to include an expense allocation representing the cost of using that aircraft.

Preparing for when the rubber meets the road

Early planning and identification of resources is critical to a successful spin-off. The new business needs to stand on its own, which means having governance, investor relations, and treasury functions in place, preparing the finance function to be ready to issue annual and quarterly financial statements, and executing transition services agreements while moving IT systems and other shared services to standalone platforms.
For more on spin-offs, watch our *Corporate divestitures webcast*, and read our publications *Corporate exit strategies - Selecting the best strategy to generate value* and *Preparing carve-out financial statements - Navigating the financial reporting challenges*.

Recognizing revenue for sales of virtual goods

Companies that offer virtual goods, such as gaming companies or advertising networks, often road test new business models. At times, it can be difficult to apply current U.S. GAAP to these new business models, leaving companies debating whether to record revenue gross (if they are the principal in the arrangement) or net (if they are the agent).

Applying indicators for gross vs. net reporting to virtual products

Current U.S. GAAP provides various indicators to help companies determine whether to report revenue on a gross or net basis. The application of these indicators requires judgment, and is not an all-or-nothing test. There are a number of indicators that point to gross reporting. Some of the more determinative indicators supporting gross reporting include:

- The company is the primary obligor in the arrangement
- The company has general inventory risk (i.e., economic risk of resale)
- The company has latitude in establishing the price

Applying these indicators to transactions for the sale of virtual goods can be tricky. For example, a company may offer an automated advertising exchange where advertising space on websites is bought and sold via an auction, and advertisers can use the space within milliseconds. There is no traditional general inventory risk, and the level of pricing latitude is limited because the pricing is dictated by an auction.

As a result, more weight is put on other indicators — principally, who is the primary obligor in the arrangement? It is also important to understand what economic risk and potential upside is available for each party. Agents generally do not have economic risk. In contrast, principals generally have incremental responsibilities and more economic risk in the form of variable margin, or risks similar to those associated with inventory, such as obsolescence, excess capacity, and fluctuations in market demand.

Flagging down the facts

In order to determine who the principal is in the arrangement, it is critical to understand the role of each of the parties. The contractual terms along with other pieces of information, such as marketing material, are significant because they shed light on the obligations and responsibilities of each party. Applying this concept to the automated advertising exchange, for example, the company would need to consider whether the arrangement should be characterized as a sale of advertising space or a service arrangement where the company is providing matchmaking services between sellers and buyers.

Sale-leaseback transactions: there is no such thing as a free ~~lunch~~ lease

While there have not been any recent changes in the accounting guidance surrounding the sale and leaseback of real estate, the recently released revenue guidance will change the landscape for such transactions in the future. That, in turn, has increased the focus on sale-leasebacks today.

Rationale for a "rent free" lease

In some sale-leasebacks, a seller finds a buyer willing to close on the sale of property, but the buyer allows the seller to continue using the property "rent free" for a relatively short period of time (as long as the seller covers all of its occupancy costs). In substance, the seller's motive is to sell the asset rather than to finance its operations.

The economic rationale for the "rent free" lease is that it is more efficient for the buyer to pay the seller a lower amount that incorporates the value for the lease, as this completely eliminates potential credit risk of the seller defaulting on its lease obligations. However, this approach can cause accounting problems.

When "free" isn't a good thing

Sale-leaseback accounting requires that, to qualify for sale accounting, the lease must be a "normal" leaseback and the buyer-lessor cannot be protected from potential losses resulting from the lease. For example, the lessee cannot collateralize its obligations to the lessor, or give the lessor more than an insignificant security deposit.

In a "rent free" lease, since cash is constructively received by the seller when the buyer pays the reduced amount, it obviates the need for any collateral or credit protection. Accordingly, a "rent free" lease arrangement fails the stringent sale-leaseback accounting guidance and prevents the seller from recognizing a sale of the asset.

If a seller enters into a sale-leaseback that does not meet all of the accounting requirements, it would typically characterize the transaction as if it had taken out a mortgage rather than sold an asset. There is little guidance in this area and the accounting is complex — from assessing the value of the "free" lease, to determining the interest rate and considering the impact on depreciation expense or impairment. Given the complexities, companies should carefully consider a "rent free" lease in a sale-leaseback transaction.

Hot off the press

As many companies move toward using cloud computing for data storage and software needs, their accounting for the fees associated with these arrangements has gone in different directions — some classify it as an expense, while others record it as a depreciable asset. To encourage more consistency, the FASB released a proposal providing a map of how to account for these fees. Read In brief US2014-15, *FASB proposal to shed some light on the accounting for the Cloud,* for more information.

The PCAOB released a Staff Consultation Paper asking for input on potential changes to the auditing standards with regard to auditing estimates and fair value measurements. Companies may be interested in providing feedback on how auditing changes could affect them. Our In brief US2014-16, *PCAOB staff seeks comment on auditing estimates and fair value,* provides a high level overview.

Finally, the SEC announced the appointment of James Schnurr as its new chief accountant, replacing Paul Beswick.

New FASB rule requires going concern assessment

Starting in calendar year 2016, companies will be required to formally assess their ability to continue as a going concern and provide disclosures under certain circumstances. Although some companies may provide disclosure on this topic today, their disclosures are often guided by U.S. auditing standards, which technically do not govern management's footnote disclosures.

A new standard issued by the FASB explicitly requires the assessment at interim and annual periods, and provides management with its own disclosure guidance. The standard is applicable to both public and nonpublic companies, and can be adopted early. Learn more in In brief US2014-17, *FASB introduces going concern assessment and disclosure requirements*.

IASB takes checkered flag on financial instrument accounting

In July, the IASB published the complete version of IFRS 9, *Financial instruments*, which replaces the guidance in IAS 39. It reflects the culmination of the board's project to revise the guidance for financial instruments, which focused on classification and measurement, impairment and hedging (the hedging portion was completed and released in November 2013). Although the IASB and FASB initially worked to converge their financial instrument standards, ultimately their paths diverged, resulting in the IASB issuing a different standard in advance of the FASB.

Classification and measurement

IFRS 9 has three classification categories for debt instruments: amortized cost, fair value through other comprehensive income, and fair value through profit or loss. The proper classification will depend on a company's business model for managing these financial assets and their contractual cash flow characteristics.

Equity instruments will be recorded at fair value. If the equity instruments are held for trading, all changes in fair value are presented in profit of loss. A company can make an irrevocable election to present the changes in fair value through other comprehensive income as long as the instruments are not held for trading.

Impairment

The new standard introduces the expected credit losses model for recognizing impairment losses, which replaces today's incurred loss model. Under the new model, when companies initially record the loan on their books, they will record an initial loss based on possible defaults within 12 months. From that point forward, when there has been a significant increase in credit risk since inception, losses recorded will be based on all possible default events over the expected life of the financial instrument.

For more information

The new standard is effective for annual periods beginning on or after January 1, 2018, with early application permitted. For more information, see In depth US2014-05, *IFRS 9 — Classification and measurement,* and In depth US2014-06, *IFRS 9 — Expected credit losses*.

On the horizon

FASB nears the finish line on its consolidation project

The next round of changes to the consolidation accounting guidance is expected later this year. After completing its consideration of feedback received on a 2011 proposal, the FASB decided in July to move forward and issue a final standard. The changes will apply to companies across all industries, and historical consolidation conclusions and disclosure requirements could be affected. Companies should also consider the impact of the new guidance as they enter into new transactions.

Though financial services companies are likely expecting to experience some impact, companies in other industries may be surprised to learn that revised consolidation guidance could also affect them — particularly those that are involved with limited partnerships or similar entities. Limited partnerships are frequently used in the oil & gas, transportation, real estate, and asset management sectors, among others. The changes are expected to cause more limited partnership structures to be variable interest entities, which would, at a minimum, trigger a new consolidation analysis and additional disclosures. Consolidation conclusions may also change for entities that are already variable interest entities due to changes in how companies would need to consider related party relationships in the analysis.

For more information

The new standard will be effective in 2016 for calendar year-end public companies and early adoption will be permitted. Nonpublic entities will have an additional year before being required to adopt the changes. The FASB plans to issue the final standard in the fourth quarter of 2014. To obtain a preview of the anticipated changes, read In depth US2014-04, *Consolidation – a new standard is imminent*.

Corporate governance

Audit committees gauge the value of internal audit

Companies have many moving parts — and things can go wrong, even when you have good people and thoughtfully designed processes. That's why so many audit committees look to internal audit as their eyes and ears. While the importance of internal audit is clear, PwC's 2014 State of the internal audit profession study found that about two thirds of board members believe internal audit adds significant value to the company.

PwC has published an edition of Audit Committee Excellence Series, *Achieving excellence: Overseeing internal audit,* that shares what audit committees can do to help internal audit improve its performance and provide more value to the organization. This includes:

- Empowering the internal audit function by providing visible audit committee support
- Helping internal audit define its role, especially when management may have different ideas about where internal audit should spend its time
- Establishing clear reporting lines, appropriate leadership, and sufficient resources and expertise

Tips for maintaining an effective whistleblower program

Both the Sarbanes-Oxley and the Dodd-Frank Acts address the role and protection of whistleblowers. The Sarbanes-Oxley Act calls for the audit committee to oversee operation of a confidential hotline at the company level. The Dodd-Frank Act created a separate department at the SEC with a whistleblower hotline that provides cash rewards to whistleblowers whose testimony leads to a conviction.

PwC recently participated in a webcast sponsored by the Anti-Fraud Collaboration on how to improve whistleblower programs. The webcast included some key takeaways for audit committees and boards to consider when establishing and reviewing a whistleblower program:

- Is there a feedback loop to the individual reporting the complaint?
- Have we communicated the availability of the company whistleblower hotline across the company?
- Have we evaluated whether an allegation indicates a deficiency in internal control over financial reporting?
- Could the allegation have potential legal implications?

For more information

Our July 2014 edition of *BoardroomDirect* provides additional insights on how to maintain an effective whistleblower program.

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