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The quarter close

A look at this quarter's financial reporting issues

Directors edition

December 17, 2014

What's inside

What you need to know—Q4–2014

Welcome to the fourth quarter edition of *The quarter close*. As the curtain closes on 2014, we focus on what to expect from the FASB in the upcoming months, as well as considerations for SEC filings.

Accounting hot topics. We provide insight into the potential effect of the revenue standard on compensation plans, and discuss what companies should be considering now. In addition, as many companies consider taking advantage of low interest rates, we share tips for identifying embedded derivatives in new or modified debt agreements.

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

Hot off the press. Companies with pension or other postretirement benefit plans should take note of new mortality tables, which could affect reported liabilities. And, the Transition Resource Group has provided feedback to the FASB and IASB on some of the first implementation questions related to the new revenue standard.

And more. Along with an update on corporate governance trends, we spotlight the SEC's focus on internal controls. We also provide a preview of new private company guidance coming soon from the FASB.

Video perspectives

Spotlight on the hot topic videos included this quarter

Top 5 financial reporting reminders

Click on the pictures or titles to launch the videos.

Other videos included in this edition of The quarter close:

Accounting for stock-based compensation modifications

Identifying embedded derivatives in debt agreements

Regulatory update interview with Troy Paredes

SEC comment letter trends

Insights on upcoming consolidation guidance from the FASB

Financial services companies

Non-financial services companies

Separate company financial statements (S-X 3-09)

Accounting hot topics

This quarter's hot topics:

- Effect of new revenue standard on compensation plans
- Identifying embedded derivatives

Avoid last-minute drama — assess the effect of new revenue guidance on compensation now

The FASB's new revenue guidance could change the timing or pattern of revenue recognition for many companies. Employee compensation arrangements tied to revenue or earnings will likely be affected, but changing those arrangements can also have accounting consequences.

Will your company's compensation plans be affected?

The impact on compensation plans will depend on how closely compensation is tied to revenue recognition. It will clearly impact sales commission-based plans. However, companies may also want to consider modifying other compensation plans — both cash- and stock-based. For example, companies may want to adjust earnings-based performance targets to take into account new revenue recognition patterns. Other companies might "lose" some deferred revenue when they adopt the revenue guidance. This could occur if the revenue needs to be reflected as part of a cumulative adjustment to retained earnings or pushed back to a prior year. This could impact the measurement of multi-year awards.

Companies that issue awards covering multiple year periods and performance targets should pay particular attention to targets for years after the 2017 effective date of the new revenue guidance. It may be wise to incorporate revised projections reflecting the new guidance when determining 2017 and later targets. Companies might also consider designing interim or transitional awards that bridge the impact of the revenue changes until the new guidance is in effect and revised plans can be established.

What to do now and why

▶ Click here to learn about how to account for stock-based compensation modifications.

The first step for management in addressing this issue is to inventory all compensation plans that are tied to revenue or earnings. Companies need to decide whether to make potential modifications to those arrangements, what modifications make sense, and when to put them into place. This can require a delicate balance of mitigating the potential financial costs while ensuring the design of the compensation plans continues to meet business objectives, including employee motivation, retention and recruitment goals.

Modifying existing performance targets in stock-based awards can result in additional expense recognition. Companies should consider that possibility when deciding when or whether to modify existing arrangements, and when creating any new arrangements that will go into effect prior to the 2017 effective date of the revenue guidance. In addition, companies should consider the FASB's other major standard setting projects that are nearing their final curtain call (e.g., financial instrument impairment and leasing), which could also impact a company's earnings. Directors should inquire about potential modifications to compensation plans resulting from the new revenue recognition standard.

For more information

Read more on this topic in *Incentive compensation — impact of new revenue accounting rules*. In addition, our *Guide to Accounting for Stock-based Compensation* provides more details and guidance on accounting for new or modified awards.

The backdrop of “cheap money” brings embedded debt features to center stage

▶ *Click here to learn more about debt features that could qualify as embedded derivatives.*

Many companies are exploring issuing new debt or modifying existing debt before potential interest rate increases by the Federal Reserve. Companies that issue new debt or modify existing debt should carefully evaluate whether certain features of the contract may constitute embedded derivatives. These types of features may require bifurcation and separate recognition and measurement. Embedded derivatives rarely have the word “derivative” associated with them in the debt agreement, which can make them difficult to identify.

For more information

To see a full script of potential embedded derivatives, read Chapter 3 of our *Guide to Accounting for Derivative Instruments and Hedging Activities*.

Hot off the press

The often-elusive income statement classification known as “extraordinary items” is no more. The FASB voted to eliminate the concept for 2016 calendar year-ends, but it can be early adopted once the final standard is issued. Both retrospective and prospective application are available.

The pre-issuance external review process for the FASB’s revised consolidation guidance yielded a number of technical issues that need resolution prior to the guidance being released. This will delay the issuance of the new guidance until at least February 2015.

The FASB added new projects to its agenda related to intangible assets (similar to the private company alternative), hedging, and short-term improvements to liability and equity. It also continues to pursue various simplification initiatives.

Transition Resource Group discusses revenue recognition implementation issues

In connection with the issuance of the new revenue standard, the FASB and IASB established a joint working group, the Transition Resource Group (TRG). This ensemble cast of preparers, auditors and users is tasked with informing the FASB and IASB about potential implementation issues and helping them determine what, if any, action will be needed to address those issues.

At the most recent meeting, the TRG worked with the boards to develop next steps for the issues discussed at the previous meeting and discussed five new issues. After taking the TRG discussion into consideration, the boards ultimately determined for each issue whether (a) no clarifying guidance was necessary, (b) clarifying guidance should be considered, or (c) additional research needed to be performed to determine if clarifying guidance was necessary.

Also at the TRG meeting, FASB Vice Chairman James Kroeker took the opportunity to discuss the effective date of the new revenue guidance, as the boards have received a number of requests to delay the implementation date. The FASB will take their cues from the results of outreach that will be performed over the next several months, and will announce a decision no later than the second quarter of 2015.

For more information

For more information about the specific issues discussed by the TRG and the outcome of those discussions, read In transition US2014-01, *Transition Resource Group debates revenue recognition implementation issues*.

New mortality tables may indicate an extended run of benefit payments

After years of lively discussions on mortality, the U.S. Society of Actuaries recently issued updated mortality tables and a related mortality improvement scale. The new mortality information indicates that life expectancies continue to increase. Because mortality is a key assumption in measuring pension and other postretirement benefit (OPEB) obligations, companies that use the new tables and improvement scale could see significant increases in the reported value of those obligations.

Are companies required to use the new mortality tables?

The accounting guidance for pension and OPEB plans does not prescribe the use of a specific mortality table or mortality improvement scale. However, as with all actuarial assumptions, the mortality assumption should represent management's best estimate of the expected duration of future benefit payments at the measurement date. The estimate should be based on the specific demographics and other relevant facts and circumstances for each plan. This means taking into account all relevant information available at the measurement date, including the new mortality tables and improvement scale.

What should companies do now?

Companies should discuss this new mortality data with their actuaries and consider it for their plans' next measurement date (which might be as soon as December 31, 2014 for calendar year-end companies). For companies that immediately recognize the impact of changes in actuarial assumptions in income, improved mortality experience could have a significant impact on fourth quarter results of operations. Directors of companies with these types of obligations may want to inquire about the potential impact of these changes.

For more information

To learn more about the considerations associated with using the new mortality tables, read In brief US 2014-18, *New mortality tables to impact benefit obligation assumptions*.

Do you have shares with embedded features (like conversion options)? New guidance clarifies their accounting

Many companies have shares with embedded features — such as a conversion option embedded in a share of preferred stock. Thanks to recent guidance from the FASB and EITF, these companies now have more direction for determining whether those embedded features need to be accounted for separately from their host shares. Companies affected by this new guidance will need to do some legwork since the rule requires modified or full retrospective application. And although the guidance is not effective until 2016 for calendar year-end companies, it can be early adopted.

How the new guidance helps

The new guidance requires companies to consider all terms and features, including the embedded feature(s) being evaluated for separate recognition, when determining whether a host contract is more akin to debt or equity. No single term or feature should be considered the "be-all and end-all" in determining the nature of the host contract. For example, if a preferred share has a redemption feature (a typical debt characteristic), that feature by itself would not be enough to determine that the preferred share is more akin to debt. Rather all features would need to be assessed.

In addition to providing clarity on the approach to evaluating embedded features, the FASB also included implementation guidance to assist companies in identifying the debt-like and equity-like indicators.

On the horizon

FASB to debut private company accounting alternative for certain intangibles

The FASB will soon release a fourth accounting alternative for private companies — this one is expected to reduce the cost and complexity of accounting for business combinations. Private companies electing the alternative will no longer be required to separately recognize intangible assets associated with non-compete agreements or certain customer-related intangible assets in a business combination. Companies adopting this alternative will likely recognize fewer intangible assets and more goodwill.

Adopting the intangible asset alternative — a two-part production

Companies that adopt the intangible asset alternative are also required to adopt the private company goodwill alternative issued by the FASB in early 2014. That alternative requires companies to amortize goodwill and eases the requirements related to goodwill impairment testing. Companies that adopt the goodwill alternative, however, are not required to adopt the intangible alternative.

Looking ahead

Companies electing the alternative will adopt it on a prospective basis for all business combinations entered into after the adoption date. Intangible assets that exist as of the beginning of the period of adoption should continue to be valued and recorded in accordance with existing guidance. The alternative is effective for calendar year-end companies in 2016, with early adoption permitted.

Regulatory matters

An interview with Troy Paredes, former SEC commissioner

In this video, former SEC commissioner Troy Paredes shares his views on the SEC's focus on financial reporting, its efforts with regard to the disclosure regime, the possibility of a decision on using IFRS in the US, and more.

SEC spotlights internal controls

Over the last year, SEC staff comment letters and speeches indicate increasing focus on the internal controls that underpin financial statements. Though internal control over financial reporting (ICFR) is more widely known, the effectiveness of disclosure controls and procedures (DC&P) is also now sharing top billing.

Comment letters around disclosure effectiveness and controls

▶ ***Click here for more on SEC comment letter trends.***

Companies are required to report on DC&P quarterly, in addition to disclosing if there were any material changes in ICFR. Nearly all of ICFR falls within the scope of DC&P, but there are aspects of DC&P that extend beyond what is considered ICFR — for example, risk factor disclosures.

The SEC staff's comments on internal controls have generally focused on incomplete or missing disclosures. They've also increasingly challenged companies' conclusions regarding the existence or severity of internal control deficiencies. Companies' assessments of ICFR and DC&P should deliberately assess the relationship between the two, as well as their relationship to the financial statements. It can be hard to support an assertion that disclosure controls are working well if there's a weakness in ICFR, or that ICFR is functioning appropriately if there's an accounting error identified.

Accounting reassessments and ICFR

Internal controls over judgmental accounting areas also continue to take center stage with the SEC — in particular, accounting areas requiring annual, ongoing or trigger-based reassessments. Effective ICFR builds in processes to monitor and address these accounting reassessments. Some common accounting reassessments include:

Segments – Companies are required to assess whether anything has occurred that could result in a change in reportable segments (for example, a change in operating segment economics, a change in the chief operating decision maker, or a change in the business model).

▶ *Select your company type below for a video discussing the potential effects of the upcoming consolidation guidance.*

Financial services

Non-financial services

Goodwill – Companies using a qualitative ("Step zero") impairment approach for goodwill should reassess annually whether it is appropriate to continue to use it. The internal controls associated with this process should ensure sufficient consideration of how changes in economic, market, and company performance conditions have changed since the last quantitative assessment was performed and since prior year.

Consolidation – The FASB plans to issue updated consolidation guidance in early 2015. The new guidance will not affect the requirements related to when companies need to reassess their consolidation conclusions — the trigger-based reassessment to determine which consolidation model to follow and the ongoing assessment of whether an investment should be consolidated will stay intact. However, the changes to the consolidation guidance as a whole are broad and impact both the voting and the variable interest entity (VIE) models. The new guidance will impact whether an entity is a VIE, as well as who consolidates the VIE. This means companies will need to update the design and test the operation of their controls to ensure they align with the new guidance. Thinking about the controls early may alleviate last minute surprises and allow the adoption process to be more effective and efficient, especially for companies early adopting in 2014 or 2015.

For more information

For more information and considerations regarding comment letter trends, see our industry-specific comment letter trends publications on CFOdirect.com.

Year-end reminder — significant equity method investees

SEC registrants are required to file separate annual financial statements for each equity method investee that exceeds 20% using either the SEC's investment test or the income test.

Early identification of when these separate financial statements are needed is critical for meeting annual reporting obligations, especially if the separate financial statements aren't readily available.

▶ *Click here to learn more about S-X 3-09's requirements for separate financial statements.*

Retrospective revisions to the registrant's financial statements —for instance, in connection with a discontinued operation — may trigger the need for separate financial statements of an equity method investee that was previously deemed insignificant. For example, if the registrant reports a discontinued operation, it would need to reevaluate the investee's significance in prior years.

The same "lookback" concept would generally apply to a retrospective revision for a change in accounting principle, although we understand the SEC staff is considering whether to grant an accommodation in connection with the new revenue standard.

Even if an investee doesn't meet the 20% threshold for providing separate financial statements, there still may be a requirement to provide summarized financial information (subject to a 10% aggregate threshold) relating to investees in the registrant's financial statements.

Corporate governance

Investors, directors provide insights on key governance trends

Each year, PwC conducts surveys of public company directors and institutional investors. These surveys gain insight into the trends that are shaping corporate governance and influencing the board of the future. While the investor and director perspectives shared in these surveys are often in alignment, substantial differences exist about certain issues.

Board composition

Both directors and investors agree that financial expertise is the top director attribute (93% of directors and 82% of investors say it's "very important"). Both parties also place industry and operational expertise high on their respective lists. However, investors prioritize risk management expertise more than directors (79% describe it as "very important" compared to 65% of directors).

Both directors and investors also believe that diversity is important to board composition. However, investors believe it is more difficult to overcome board diversity challenges than directors — 85% of investors believe there are hurdles to increasing gender diversity on boards compared to just 14% of directors. Also, investors and directors disagree about the root cause of these hurdles. Investors believe that directors don't want to change their current board composition to create a position for a diverse candidate. Directors indicate that a lack of awareness of qualified candidates is the primary contributor.

Board performance

Board performance is also a concern of both parties. We found that 36% of directors believe someone on their board should be replaced. These directors cite diminished performance due to aging, lack of expertise, and lack of preparation as the top reasons for their dissatisfaction with peers' performance. However, 53% of directors indicate that there are impediments to replacing an underperforming board member. Most frequently, they cite board leadership's discomfort addressing the issue. Investors are even more skeptical about removing directors — 94% see impediments to replacing a poor performer. Investors most frequently cite a "close relationship between the CEO and the underperforming director" as the greatest impediment.

For more information

For complete director and investor survey comparison results, read our upcoming publication *2014 Annual Corporate Directors Survey and 2014 Investor Resource Institute Survey comparison*.

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