Happy holidays!

As this year draws to a close, we wish you and your family a joyful holiday season and a new year filled with happiness! May you experience the gift of time to create treasured memories with the special people in your life.

ACCOUNTING

Updated guidance on accounting for debt modifications and restructurings

We have updated our white paper, *Fundamentals of accounting for debt modifications and restructurings*, which summarizes the relevant guidance on how a borrower accounts for the modification, restructuring or exchange of a loan and provides numerous examples of how to apply this guidance. New content on the following topics has been incorporated into the updated white paper:

- The effects of prepayment options when determining the appropriate accounting for a debt modification or exchange, including how the existence of a prepayment option in the related debt often results in application of the modification accounting model instead of the extinguishment accounting model
- Considerations involved when the debt being modified, exchanged or restructured is with a related party (e.g., an equity holder in the borrower)
- Considerations involved in accounting for fees charged by a lender acting in an investment banking or underwriting capacity for purposes of coordinating the modification or exchange of loans across all lenders (including itself) participating in a loan syndication

Sample hedge election for private company electing simplified approach

We have updated our white paper, *Simplified accounting for private companies: Certain interest rate swaps*, to include a sample of the documentation that could be prepared by a private company in connection with electing the simplified hedge accounting approach (simplified approach) provided by the Financial Accounting Standards Board in its Accounting Standards Update (ASU) 2014-03, *Derivatives and Hedging (Topic 815): Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps — Simplified Hedge Accounting Approach*.

In addition to providing sample documentation, our white paper includes background information about why the simplified approach was developed as well as discussion of:

- The types of entities that are eligible to elect the simplified approach
- The benefits of a private company electing the simplified approach as well as important points for a private company to consider before making a decision to elect the simplified approach
- The criteria that must be met to apply the simplified approach
AUDITING

COSO: Principle 17

The 2013 COSO Internal Control-Integrated Framework retains the five components of internal control (i.e., control environment, risk assessment, information and communication, control activities and monitoring activities) included in the original 1992 Framework; however, it adds 17 principles associated with these five components that are necessary for effective internal control. This is the last in a series of biweekly articles discussing each of these important principles.

The final COSO principle, and thus the final article in this series, addresses the evaluation and communication of internal control deficiencies – potential or real shortcomings in some aspect of the system of internal control that have the potential to adversely affect the ability of the entity to achieve its objectives. Principle 17 of the COSO Framework states: The organization evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the board of directors, as appropriate.

Deficiencies in an entity’s components of internal control and underlying principles may surface from a variety of sources, including monitoring activities, input from other components of internal control and information from external parties, such as customers, vendors, auditors and regulators. The organization also may identify opportunities to improve the efficiency of internal control and areas where changes to the current system of internal control may provide a greater likelihood that the entity’s objectives will be achieved. Communicating internal control deficiencies to the right parties to take corrective actions is critical for entities to achieve objectives, and most entities also want to communicate potential opportunities for improvement to the appropriate parties as well.

Internal control deficiencies usually are reported to the parties responsible for taking corrective action and to at least one level of management above that person. Alternative communication channels also should exist for reporting sensitive information, such as illegal or improper acts. Further, deficiencies may be reported to senior management and the board of directors depending on the reporting criteria as established by the entity, regulators or standard-setting bodies, as appropriate. Additionally, deficiencies may need to be reported externally depending on the type of entity and the regulatory, industry or other compliance requirements to which it is subject.

The initial communication of internal control deficiencies is only the starting point for dealing with them. Management then should track whether remediation efforts are conducted on a timely basis. Deficiencies that are not remediated on a timely basis usually should be communicated to at least one level of management above the party responsible for taking corrective action. In addition, management may need to revisit the selection and implementation of monitoring activities, including a mix of ongoing and separate evaluations, until corrective actions have remediated the internal control deficiency.
Take a fresh look at your segment reporting

Public entities are required to disclose certain information about their reportable segments, which requires identification of the operating segments within its business. Identification of operating segments also factors into the determination of the reporting units used for goodwill impairment testing by both public and private entities. Identification of an entity’s reportable and operating segments can be complex and is often cited by the SEC staff as an area in which SEC registrants can improve their compliance with the requirements.

In a speech delivered at the 2014 American Institute of Certified Public Accountants’ Conference on Current SEC and PCAOB Developments (the conference), Dan Murdock, Deputy Chief Accountant in the SEC’s Office of the Chief Accountant, encouraged SEC registrants to take a fresh look at their segment reporting to ensure consistency with the overall objective of the guidance in Topic 280, Segment Reporting, of the Financial Accounting Standards Board’s Accounting Standards Codification (ASC). This objective requires disclosure of information about the entity’s different types of business activities and the economic environments in which it operates for the purpose of facilitating the following for financial statement users: (a) understanding the entity’s performance, (b) assessing the entity’s prospects for future net cash flows and (c) making informed judgments about the entity. Mr. Murdock specifically suggested that entities consider the following when taking a fresh look at their segment reporting:

- **Identification of Chief Operating Decision Maker (CODM).** One of the required characteristics of an operating segment is regular review of its operating results by the CODM for purposes of allocating resources and assessing performance. Depending on the facts and circumstances, the CODM may be the entity’s chief executive officer (CEO), chief financial officer (CFO) or chief operating officer (COO). However, the CODM is not limited to one of these roles. Identification of the CODM is based on the function performed (i.e., making key operating decisions) and not the title of the person or group performing the function. If the CEO is focused on strategic activities, consideration must be given to whether the key operating decisions are being made by the CFO, COO or another person or group.

- **Use of organization charts to identify operating segments.** An entity’s organization chart is one data point that should be considered when identifying an entity’s operating segments. In other words, an entity’s organization chart is not a determinative source for purposes of operating segment identification.

- **Reliance on CODM reporting package to identify operating segments.** While an important data point when identifying operating segments, the information included in the CODM reporting package is not a determinative source for this purpose. Taking information out of the CODM reporting package does not necessarily mean the information should not be taken into consideration when identifying operating segments. Information beyond what is included in the CODM reporting package that may need to be considered in identifying operating segments includes, but is not limited to, the entity’s overall management structure, its budgets and forecasts and the determination of executive compensation.

- **Determination of whether two or more operating segments possess similar economic characteristics.** To aggregate two or more operating segments into one operating segment, certain criteria must be met. These criteria are meant to establish a high bar for aggregation. One of the criteria requires the segments to have similar economic characteristics. There are no bright lines provided for purposes of assessing the similarity of economic characteristics between two or more operating segments.

- **Identifying dissimilarities between operating segments.** Another of the criteria that must be met to aggregate two or more operating segments involves determining whether the segments are similar with respect to: (a) the products and services sold, (b) the production processes employed, (c) the types or classes...
of customers to which they sell, (d) the distribution methods used and (e) the regulatory environment in which they operate. Two or more operating segments must be similar with respect to all five attributes to meet this aggregation criterion. If the operating segments are similar with respect to only four of the attributes, aggregation is not permitted. If there are some dissimilarities identified in analyzing whether each of these attributes are similar across the operating segments, consideration must be given to whether those dissimilarities are material. For example, if there is significant overlap between the class of customer to which each operating segment sells, but one of the operating segments has a material revenue stream to a class of customer to which the other operating segment does not sell, aggregation of the operating segments would not be permitted.

In general, a significant amount of judgment must be exercised in identifying an entity’s operating segments and reportable segments. That judgment must be consistent with the overall objective of the segment reporting guidance in ASC 280 at all times. In his speech, Mr. Murdock observed that “most entities will have more than one reportable segment and less than ten.” As such, there may be a heightened need for an entity that has historically only had one reportable segment to take a fresh look at how it identifies and aggregates its operating segments.

In addition, the staff of the SEC’s Division of Corporation Finance emphasized certain disclosure items related to segment reporting during their presentation at the conference. Among the matters emphasized were: (a) making adequate disclosures about the factors used to identify segments, (b) complying with the enterprise-wide disclosures in ASC 280 and (c) improving the information disclosed with respect to the aggregation of operating segments. These matters of emphasis highlight the need for an entity to take a fresh look at its segment reporting disclosures as well as its identification and aggregation of operating segments as it prepares for the 2014 financial reporting cycle.

**Preferability letters when goodwill impairment testing date is changed**

When an entity is not eligible to elect or has not elected the private company goodwill accounting alternative, goodwill must be tested annually for impairment and on an interim basis if certain triggering events occur. The annual goodwill impairment test for each reporting unit may be performed any time during the fiscal year, provided the test is performed at the same time every year. If a change in the annual goodwill impairment testing date is material, it would be considered a change in accounting principle. Before the change can be made, it must be deemed preferable and an SEC registrant must obtain a preferability letter from its auditor.

Paragraph 105-10-05-6 of the Financial Accounting Standards Board’s Accounting Standards Codification (ASC) indicates that the guidance in the ASC does not have to be applied to immaterial items. For purposes of determining whether a change in the annual goodwill impairment testing date is material, reference has been made to views expressed by the SEC staff in a 2002 speech and subsequent discussions at several SEC Regulations Committee meetings. In expressing those views, the SEC staff indicated that a preferability letter is not needed if goodwill is not material to the reporting entity. If goodwill is material to the reporting entity, a preferability letter would be needed upon a change to the annual goodwill impairment testing date.

In December 2014, Carlton E. Tartar, Associate Chief Accountant in the SEC’s Office of the Chief Accountant, provided a different view in a speech he delivered at the American Institute of Certified Public Accountants’ Conference on Current SEC and PCAOB Developments. The changed view indicates that a preferability letter is not needed if the change to the annual goodwill impairment testing date “is not viewed to have a material effect on the financial statements in light of the registrant’s internal controls and requirements under Topic 350 to assess goodwill impairment upon certain triggering events.” This signals that the focus of assessing the materiality of a change to the annual goodwill impairment testing date has evolved from considering whether goodwill is material to the reporting entity to whether the change itself has a material effect on the entity’s
financial statements. If an entity determines that a change in the annual goodwill impairment testing date is not material to the entity’s financial statements and, therefore, a preferability determination is not required, the entity should prominently disclose those facts in the notes to its financial statements.

FINANCIAL SERVICES

Proposed disclosures about investments in other investment companies

In 2011, the Financial Accounting Standards Board (FASB) issued a proposed Accounting Standard Update (ASU), Financial Services — Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements, which, if finalized, would have required an investment company to consolidate controlling financial interests in another investment company in a fund-of-funds structure. However, stakeholders strongly disagreed with this proposed requirement and stated that transparency could be provided through disclosure about investee funds in the notes to the investment company’s financial statements.

As a result, the FASB recently issued a proposed ASU, Financial Services – Investment Companies (Topic 946): Disclosures about Investments in Other Investment Companies. If finalized, the proposed amendments would require a feeder fund in a master-feeder arrangement to provide the master fund’s financial statements along with its financial statements. The proposed amendments also would expand the scope of the current requirement to disclose certain information about investments held by investee funds that exceed five percent of the reporting entity’s net assets to include reporting investment companies that are regulated under the Investment Company Act of 1940.

The proposed ASU is available for comment until February 17, 2015.