2013 year-end financial reporting considerations
Leading practices, lessons learned, and reminders

Overview
In this Dataline, we take a look at aspects of financial reporting that have continued to present challenges to financial statement preparers, and transactions and arrangements prevalent in today’s economic environment that have unique or complex accounting implications.

While not an all-inclusive list, the Dataline provides timely reminders for companies navigating the year-end financial reporting process. While many of the topics are not new, they continue to be challenging, based on SEC staff comment letters, restatements, revisions, and our own observations.

The following is a brief summary of the topics covered:

**Cash flows**
- Cash flow presentation of non-routine and challenging routine transactions

**Other comprehensive income**
- New accounting standard effective this calendar year that requires presentation and disclosure of the changes in each component of accumulated other comprehensive income

**Revenue recognition**
- Complexities in navigating the multiple element guidance
- Determining whether revenues should be presented based on gross receipts or net margins

Note: The impending new global revenue standard is not addressed here. For the latest updates, see Dataline 2013-23, Revenue from contracts with customers: Boards wrap up redeliberations—A look at the recent decisions.
**Income taxes**

- Complexities in analyzing uncertain tax positions across multiple jurisdictions
- Considerations when an entity asserts that it will indefinitely reinvest foreign earnings (the “APB 23” exemption)
- Judgments involved in establishing or reversing a valuation allowance

**Segments**

- Determining reportable segments, including the aggregation of operating segments into a single reportable segment

**Goodwill and long-lived asset impairment**

- Considerations for impairment assessments for goodwill and long-lived assets, particularly the qualitative (or “step zero”) approach for goodwill

**Acquisitions**

- Distinguishing between an acquisition of an asset (or group of assets) and that of a business, with examples

**Variable interest entities, joint ventures, and equity method investments**

- Determining whether an investor has an interest in a variable interest entity (VIE); in particular, the “equity at risk” test and reconsideration events
- Considerations for “joint ventures,” even when they don’t meet the accounting definition
- Accounting for basis differences between the investor’s cost basis and the underlying carrying amounts of an equity method investee’s assets and liabilities, with an example

**Accounting changes and errors**

- Distinguishing changes in accounting principle from changes in estimate or error corrections and revisions from restatements, with a summary of the relevant reporting requirements for each

**Financial instruments**

- Evolving practice of measuring fair value using the Overnight Index Swap (OIS) rate for discounting certain collateralized derivatives, as opposed to the historical practice of using LIBOR
- Proper characterization of fair value measures in the fair value hierarchy
- Accounting for equity-linked financing instruments (for example, debt issued with warrants for equity securities)
- Extinguishment gains when debt holders may be related parties
Contingencies

- Guidance and practical examples related to the accounting for and disclosure of contingencies

Stock compensation

- Determining the grant date for awards with performance conditions, with examples
- Non-forfeitable dividend features

PwC observation:
The 2013 AICPA Conference on Current SEC and PCAOB Developments was held on December 9-11, 2013. Speakers at that conference offered insights on some of these topics, including asset acquisitions versus business combinations, goodwill, segments, and income taxes. See PwC’s Dataline 2013-27, Highlights of the 2013 AICPA National Conference on Current SEC and PCAOB Developments.

Also, there are several other trends we have observed in comment letters over the past year. We recently held two webcasts that discuss recent comment letter trends, which can be found on CFOdirect at the following link:

SEC comment letter trends webcasts

We have also issued several industry-specific comment letter trend publications, which are available on CFOdirect:

SEC comment letter trends by industry sector

Cash flows

1. The statement of cash flows continues to be challenging for preparers as it may not receive significant focus until the very end of the financial reporting process. Accordingly, we highlight the cash flow impact of a non-routine transaction, as well as a few more routine, but sometimes misclassified transactions.

Contingent consideration liabilities

2. Contingent consideration, as defined in ASC 805-10-20 (for example, an “earnout” clause), that will be settled in cash is measured at fair value and recorded as a liability on the acquisition date. The liability is subsequently remeasured to fair value through the income statement each reporting period. When the liability is settled, presentation in the statement of cash flows depends on the amount of cash paid in relation to the original liability recorded on the acquisition date.

3. If the cash paid to settle the liability is less than or equal to the acquisition-date fair value, the cash outflow is a financing activity. This is because the contingent consideration is considered a form of financing by the seller. If the cash paid exceeds the acquisition-date fair value, the cash flow presentation is split: cash paid up to the amount of the acquisition-date fair value is a financing cash outflow and the excess (the amount charged to net income subsequent to the acquisition date) is a cash outflow from operating activities. Consider the following example.
**Example:** On November 1, 2012, Entity A acquires a business from Entity S for $50 million in cash, plus an additional $5 million if revenues of the acquired business reach $10 million in the year following the acquisition date. The fair value of the contingent consideration is $3.5 million at the acquisition date. On June 30, 2013, Entity A remeasures the fair value of the liability to $4 million. In the fourth quarter of 2013, the acquired business achieves $11 million in revenue triggering the payment of $5 million by Entity A to settle the contingent consideration obligation.

The cash flow treatment of the contingent consideration by Entity A (a calendar year end company) is presented below for select periods.

<table>
<thead>
<tr>
<th>Cash flow statement inflow/(outflow)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Amounts in 000’s</strong></td>
</tr>
<tr>
<td>Net income</td>
</tr>
<tr>
<td>Noncash activity</td>
</tr>
<tr>
<td>Operating</td>
</tr>
<tr>
<td>Investing</td>
</tr>
<tr>
<td>Financing</td>
</tr>
<tr>
<td><strong>Total cash outflow</strong></td>
</tr>
<tr>
<td>Noncash disclosure</td>
</tr>
</tbody>
</table>

(A) Cash paid for acquisition
(B) Acquisition-date fair value of contingent liability. On December 31, 2012, this should be included with the disclosure of the fair value of assets and liabilities acquired as a noncash investing activity. On December 31, 2013, this represents the amount of cash paid up to acquisition date fair value.
(C) Change in fair value of liability ($4 million - $3.5 million)
(D) Excess cash paid compared to acquisition date liability ($5 million - $3.5 million)

**Additional guidance may be found in** Chapter 2 and 8 of PwC’s *Global Guide to Accounting for Business Combinations and Noncontrolling Interests* (2013 edition).

**Accounts payable related to capital expenditures**

.4 Entities often assume that all additions to the property, plant & equipment (PP&E) balance should be reported as capital expenditures in the investing section of the statement of cash flows. However, PP&E additions purchased or received at period end, but not yet paid for, should not be reported as an investing activity. Instead, unpaid additions should be disclosed as a noncash investing and financing activity, either on the face of the statement of cash flows or in the footnotes. When these amounts are paid in a subsequent period for prior-period capital acquisitions, they should be included in investing activities.

.5 Assets acquired under capital leases should also be excluded from capital expenditures in the investing section. When the lessee records the leased asset in PP&E and a liability for the capital lease obligation, there is generally no cash outflow at inception. The new capital lease obligations should be disclosed as a noncash investing and financing activity. As the entity makes future lease payments, those cash outflows are presented in the financing section of the statement of cash flows.
PwC observation:
If capital expenditures are material, entities should have processes and controls in place to identify noncash additions. Setting up a separate account in the accounts payable subledger for PP&E-related purchases, including capital leases, is one way to easily identify noncash additions. This will help facilitate the appropriate presentation in the statement of cash flows.

Overdrafts
.6 The presentation of book overdrafts differs from that of bank overdrafts in the statement of cash flows. A book overdraft occurs when an entity’s outstanding checks issued on a particular bank account exceed the entity’s book cash balance for that account, resulting in a credit balance in the general ledger. Given that these credit balances are typically reflected as accounts payable, they are included in the adjustments to reconcile net income to net cash provided by operating activities in the statement of cash flows.

.7 On the other hand, a bank overdraft occurs when a financial institution has honored checks in excess of the available funds on hand in a particular account. In essence, the financial institution has provided a short-term loan to the entity. Given that these loans are classified as debt on the balance sheet, they are reflected as borrowings in the financing section of the statement of cash flows.

.8 Questions also arise as to whether bank and book overdraft liabilities can be presented on a net basis on the balance sheet (offset against cash accounts). Bank and book overdrafts can only be offset against cash accounts (with debit balances) or receivables with the same counterparty if the right of setoff, as defined in ASC 210-20-45-1, exists. Generally, neither bank nor book overdrafts will meet the right of setoff conditions. This is usually either because there are not any cash or receivables with the same counterparty or if there are, the entity does not intend to net settle the credit and debit balances.

PwC observation:
As part of a centralized cash management function, many entities use zero-balance accounts for handling routine accounts payable activities. In those cases, an entity should carefully evaluate any negative cash account balances to determine whether bank overdrafts exist. If the account in question is linked to an overdraft facility whereby checks presented for payment are immediately payable by the financial institution regardless of the funds in the account, the overdraft may be considered a bank overdraft and would be classified as a financing inflow in the statement of cash flows.

Other comprehensive income
.9 In February 2013, the FASB issued ASU 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. For calendar year-end public entities, 2013 is the first year-end for which the standard is effective (non-public entities will adopt this new guidance in 2014). The new standard requires presentation of the changes in each component of accumulated other comprehensive income (OCI), separating the change between reclassifications out of accumulated OCI and current period revaluation adjustments.
The standard did not introduce any new guidance for reporting OCI and many of the disclosures were historically presented elsewhere in the financial statements. However, a number of questions arose as entities prepared their interim financial statements throughout the year regarding the appropriate placement of the new required information. Importantly, the standard requires all information to be presented in one place, either on the face of the statement of comprehensive income or in the footnotes. Amounts can be shown either pretax or net of tax, but the presentation should be consistent in each period.

Entities are also required to present, either parenthetically on the face of the financial statements or in the footnotes, the income statement line items affected by significant amounts reclassified from accumulated OCI. An exception to this provision exists for components of accumulated OCI that are not required to be reclassified in their entirety to net income, such as amounts amortized into net periodic pension cost.

PwC observation:
Questions have arisen as to which tax rate should be applied to reclassifications out of OCI: the tax rate in effect when the item was initially recorded in OCI or the tax rate in effect at the time of reclassification to net income. We believe the tax rate in effect at the time of reclassification to net income is the appropriate rate. This approach maintains consistency with the offsetting tax effect recognized in net income under the intraperiod tax allocation requirements of ASC 740, Income Taxes. This may well result in using different tax rates for different components of accumulated OCI if the reclassified items relate to different tax jurisdictions or currently have different tax implications than when the items were originally recorded in accumulated OCI (for example, when there have been changes in valuation allowance).

Additional guidance may be found in Dataline 2013-03, Reclassifications from accumulated other comprehensive income—FASB issues guidance on the amounts reclassified from accumulated other comprehensive income.

Revenue recognition

While we await the issuance of the new revenue recognition standard, multiple element arrangements and “gross versus net” assessments continue to create challenges under today’s revenue guidance. As business models and strategies evolve, revenue arrangements often change as well, requiring continuous focus on the related revenue recognition policies.

Multiple deliverable arrangements

While the guidance in ASC 605-25, Multiple-Element Arrangements, is not new, the proper allocation of consideration to multiple deliverables continues to be an area of focus. Prior to the adoption of current guidance, entities that did not have vendor specific objective evidence (VSOE) or verifiable objective evidence (VOE) of fair value of undelivered items could not account for these items separately. As a result, revenue associated with the delivered and undelivered items was combined into a single unit of accounting, and deferred until all items were delivered.

Under current guidance, it is not necessary to have VSOE or VOE of fair value in order to separately account for deliverables. It is only necessary that:
a) the delivered item(s) has(have) value to the customer on a standalone basis; and

b) if the arrangement includes a general right of return relative to the delivered item(s), delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the entity.

.15 If separate units of accounting are identified, an entity then determines a relative selling price for the separate units of accounting using the highest level of available evidence within the following hierarchy:

a) VSOE

b) Third-party evidence (TPE) or VOE

c) Best estimate of selling price (BESP)

.16 While BESP is consistent with the objective of determining VSOE of selling price—that is, the price at which the vendor would transact if it sold the deliverable regularly on a standalone basis—an entity may not simply assert that VSOE and TPE do not exist. Rather, an entity must perform analyses to validate the assertion that VSOE and TPE do not exist by considering information that is reasonably available without undue cost and effort. The SEC staff may request these types of analyses, as well as the analyses performed to determine BESP, as part of the SEC comment letter process.

PwC observation:

When an entity purchases a product from another entity and merely resells that product at its cost plus a reseller’s mark-up, generally VSOE or TPE is considered to exist for that particular unit of accounting. In this scenario, it would be difficult to assert that some other BESP value should be used. It is critical for entities to have processes and controls in place to identify the highest level of evidence available for purposes of performing the relative selling price allocation.

Gross versus net presentation

.17 The question of whether revenue should be presented “gross” or “net” arises in many industries and business models. Some more common examples include arrangements to sell services that will be performed by a third party and arrangements with third-party suppliers to drop-ship products directly at a customer site. If two or more parties are involved in providing a good or service to an end customer, the parties must assess whether to present revenue on a gross basis (gross receipts from the customer) as a principal or on a net basis (net amounts retained) as an agent.

.18 The guidance in ASC 605-45, Revenue Recognition – Principal Agent Considerations, for determining whether an entity is acting as a principal or an agent in an arrangement was written more than a decade ago. At that time, the focus of the guidance was primarily on the sale of products. However, the model is applied broadly and affects many industries. It also remains a frequent area of SEC comment.

.19 The guidance in ASC 605-45-45 includes a series of indicators rather than determinative factors; therefore, evaluating the indicators requires careful consideration, judgment, and contemporaneous documentation. When considering the indicators in the context of a specific arrangement, evaluation of each indicator might not result in a simple “yes” or “no” response. Instead, the evaluation may reveal where that indicator falls in a continuum, such as being a strong, weak, or neutral indicator of who is the gross reporting party.
While no single indicator is determinative and the totality of evidence should be considered, determining the primary obligor in the arrangement is a significant consideration in this assessment. Other indicators that should be weighed heavily include determining the party that has general inventory risk and the right to establish pricing.

The indicator for general inventory risk would seem on the surface to be irrelevant for service arrangements; however, it should not be automatically disregarded. An entity should consider, for example, whether it would be obligated to compensate a third-party service provider for the services performed even if the customer does not accept the work.

Determining the proper presentation of revenue hinges on understanding the economic substance of the arrangement. This includes evaluating the written contractual terms and available marketing materials, and understanding the intent of the parties. A gross versus net presentation assessment is required for each unit of accounting in a multiple deliverable arrangement and it is possible that different conclusions might be reached for different deliverables, as illustrated in the example below.

**Example:** A retailer sells both a digital camera and an extended warranty to an end-customer. The retailer concludes that the digital camera and extended warranty are separate deliverables and units of accounting. The extended warranty will be serviced entirely by a third-party service provider.

Since a third party is involved in the arrangement, the retailer performs a gross versus net analysis to determine whether it is the principal or agent in the transaction for both units of accounting. Based on a consideration of the relevant indicators, the retailer concludes that it is likely the principal with respect to the sale of the digital camera. However, the retailer concludes that it is the agent for the sale of the extended warranty.

On that basis, the retailer would present the consideration allocated to the digital camera as revenue and the cost of the camera as cost of goods sold within the income statement. For the extended warranty, the retailer would present in revenues only the net amount of (a) the consideration allocated to the extended warranty, less (b) the service fee paid to the third-party service provider. The net amount presented for the extended warranty sale represents the retailer’s “commission” for selling the warranty as an agent for the service provider.

**Income taxes**

The accounting for income taxes involves numerous complexities and practical challenges. This is particularly the case for entities that operate in multiple jurisdictions or have experienced losses in recent years. Our focus this year is on three areas that require significant judgment. Those three areas are uncertain tax positions (UTPs), unremitted foreign earnings, and valuation allowances.

**Uncertain tax positions**

The accounting model for UTPs in ASC 740 is challenging for preparers because tax laws, related regulations, and legal interpretations are voluminous and complex. Consequently, it is sometimes unclear whether a particular position taken in a tax return will ultimately be sustained if challenged by the tax authorities.
The model for UTPs consists of two steps: (1) recognition and (2) measurement. The first step requires a determination of whether it is more likely than not that a tax position is sustainable under the applicable tax law based on the technical merits. If the recognition threshold for the tax position is met, the second step requires that only the portion of the tax benefit that is greater than 50% likely to be realized upon settlement with a taxing authority be recorded.

An entity performs this assessment when the tax position is taken on the tax return; however, accounting for UTPs is a continuous process that requires an entity to reassess unresolved UTPs at each balance sheet date. Each assessment should contemplate any relevant external developments (for example, new legislation or regulation and/or case law), as well as new information identified through the tax authority’s audit process.

To the extent the expected outcome of a position changes, any adjustment to the UTP should be recorded in the period the assessment changes, which might be before final resolution of the matter. However, changes must be based on new information, not merely a re-evaluation of existing information, which could be indicative of an error.

In addition to reassessing outstanding UTPs at each reporting period, entities should update the related disclosures if there are changes in ongoing tax audits or developments in state, federal, or international tax court cases that may have a significant impact on the financial statements. Entities should also disclose the tax years that remain subject to examination by major tax jurisdiction.

**Indefinite reinvestment of unremitted foreign earnings**

The accounting for income taxes presumes full recognition of all deferred tax liabilities. However, ASC 740-30-25-17 provides an exception for deferred tax liabilities associated with unremitted earnings of foreign subsidiaries as well as other “outside basis differences” related to foreign subsidiaries. This exception is conditional upon an entity’s assertion that it will indefinitely reinvest foreign earnings outside the parent’s tax jurisdiction and thus, indefinitely defer the incremental tax consequences of remitting those earnings to the parent.

The assertion of indefinite reinvestment needs to be made at each layer in the corporate hierarchy with respect to subsidiaries of each entity outside that entity’s home jurisdiction. “Parent” in this context, therefore, refers to each intermediate parent company, not just the ultimate parent.

In order to assert indefinite reinvestment and avoid recording an incremental tax liability, parent company management must have both the ability and intent to indefinitely reinvest the foreign earnings. Sustaining that assertion requires an entity to have a specific plan to reinvest those earnings in the foreign jurisdiction and an ability to demonstrate that the funds are not needed by the parent (for example, to fund debt obligations). It is not sufficient to simply point to a history of not remitting foreign earnings.

When asserting indefinite reinvestment of foreign earnings, an entity should consider, among other things:

- The amount of cash held in foreign jurisdictions compared to cash held domestically in relation to strategic plans (cash needs) for those jurisdictions in the foreseeable future
- Cash flow forecasts for the parent and foreign subsidiaries including near-term liquidity needs, such as funding for pension obligations or debt maturities
- Whether historical actions, such as previous repatriations, might be inconsistent with the entity’s assertion
If an entity includes liquidity disclosures in its financial statements or MD&A indicating that it will need to raise capital in the short term, or the parent’s cash flow forecast shows a need for cash, it may be very difficult to assert indefinite reinvestment. Additionally, if an entity has historically repatriated foreign earnings, it may be difficult to assert that undistributed foreign earnings will be indefinitely reinvested.

Entities should also assess the adequacy of their disclosures, which should include:
(a) the cumulative amount of indefinitely reinvested foreign earnings and other elements of the outside basis difference; and (b) the amount of the tax liability that would be incurred if those earnings were repatriated (or a statement that it is impracticable to determine such amounts).

**PwC observation:**
The indefinite reinvestment assertion requires cross-functional coordination between finance, treasury, tax, legal, business development, and management of the foreign subsidiaries. Relegating the evaluation to the tax or finance department alone is likely to lead to inconsistent documentation or even an inaccurate assertion of indefinite reinvestment.

**Valuation allowances**

The starting point in assessing the need for a valuation allowance on deferred tax assets is an entity’s recent history of income (or loss) in a particular tax jurisdiction. A general rule-of-thumb is that an entity should assess its cumulative pre-tax results, adjusted for “permanent” differences between book and taxable income, for three years (the current period and two preceding years). This is an “all in” analysis that includes nonrecurring items such as restructuring or impairment charges as well as other comprehensive income, discontinued operations, and extraordinary items.

While only a single data point in the analysis, a cumulative loss represents a significant piece of objective negative evidence that would require significant positive evidence to overcome the need for a valuation allowance. When there is a history of losses and/or a reasonable expectation of future losses, an entity should carefully consider and contemporaneously document all positive and negative evidence assessed in concluding whether or not a valuation allowance is needed.

Importantly, the absence of a cumulative three-year loss is not, by itself, sufficient evidence to avoid recording a valuation allowance. Changes in the company’s future outlook should be reflected timely in the valuation allowance assessment, not simply after three years of cumulative losses have materialized. Similarly, it is not necessarily appropriate to wait until an entity has three years of cumulative income to release a previously recorded valuation allowance.

**PwC observation:**
When considering the need for a valuation allowance, it’s important to remember that the analysis is performed on a jurisdiction-by-jurisdiction basis. This often poses a challenge because entities rarely manage their business forecasts on a taxable legal entity jurisdictional basis. Therefore, entities should have a process in place to create jurisdictional forecasts that reconcile to the total business unit, segment, or entity-wide forecasts and are consistent with forecasts used in other analyses, such as asset impairment analyses.
Once an entity records a valuation allowance, the entity needs to continually (quarterly for public companies) reassess the circumstances that gave rise to the valuation allowance to determine if and when to release the allowance. Because of the judgment required, management should contemporaneously document all evidence considered and the rationale for why it did or did not establish or release a valuation allowance. The SEC staff is particularly focused on the timing of the release of valuation allowances and judgments made in prior periods based on the information available at the time.

Additional guidance may be found in
- PwC’s Tax Accounting Services year-end hot topics publication (coming soon)

Segments
One area of segment reporting that continues to receive significant focus is the aggregation of two or more operating segments into a single reportable segment. The segment reporting guidance in ASC 280-10-50-11 permits (but does not require) aggregation of operating segments if (1) the operating segments have similar economic characteristics and (2) the segments are similar in all of the following areas:

a) The nature of the products and services
b) The nature of the production processes
c) The type or class of customer for their products and services
d) The methods used to distribute their products or provide their services
e) If applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities

A common technique for assessing whether operating segments have similar economic characteristics is to compare their gross margins. In making that comparison, two points should be noted: (1) the standard refers to “long-term average gross margins” and (2) “similar” in this context should be assessed in relation to the percentage difference between gross margins, not the absolute difference in percentage points. For example, if one operating segment has a 25 percent gross margin and another operating segment has a 20 percent margin, that five percentage point difference is a 20 percent difference in gross margins, and is not likely to be considered “similar.”

While the above example uses a 20 percent difference, there is not a bright line for determining whether gross margins or other performance metrics are economically similar. Therefore, this assessment requires significant judgment. The SEC staff continues to challenge aggregation when segments are similar in the five qualitative areas above, but do not possess similar long-term economic characteristics.

As discussed above, it is common to look to gross margins to determine whether operating segments have similar economic characteristics. However, if other measures of financial performance (for example, EBITDA, return on assets, or operating profit) are regularly provided to the chief operating decision maker (CODM) and used by the CODM in assessing performance and allocating resources, it may also be appropriate to consider those metrics.
When evaluating similar economic characteristics, entities should not only consider recent historical information, but also future expectations and forecasts. Additionally, as business models evolve and organizations change, entities should periodically reassess their aggregated operating segments to ensure they continue to meet the aggregation criteria.

**Impairment of long-lived assets**

Long-lived tangible and intangible assets that an entity intends to hold and use are subject to impairment testing only when events or changes in circumstance indicate that the carrying amount may not be recoverable. The guidance in ASC 360-10-35-21 provides examples of events that may trigger a recoverability test.

When required to be performed, the impairment test is a two-step process: (1) a test of recoverability and, if the carrying amount is not recoverable, (2) measurement of the impairment. A critical aspect of properly performing the recoverability test is identifying the appropriate asset groups.

**Identifying asset groups**

An asset group is defined as the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities. One way to determine if asset groups are independent of each other is assessing the interdependency of revenues and shared costs between the groups.

Assessing the interdependency of revenue is largely a focus on the interchangeability of products delivered to a common customer base (for example, a product made at one location that can be exchanged for a product made at another location). Shared costs might also indicate that assets should be grouped at a higher level. This analysis should focus on those costs that have a direct impact on revenue-producing activities, such as a shared sales force. Back office “shared services,” such as payroll or accounts payable processing, would typically not indicate that assets should be grouped at a higher level, as these types of activities are not core to the operation and use of the asset.

**Measuring an impairment loss**

If the first step of the test indicates there is an impairment, the measurement of the impairment loss is the difference between the fair value of the asset group and its carrying amount. The fair value of the asset group should include the fair value of any unrecognized assets, such as patents and customer lists, that are part of the asset group. And while the undiscounted cash flows used in assessing whether an impairment exists can be a useful starting point for estimating the fair value of the asset group, market participant assumptions must be used in place of the entity’s own assumptions.

If an impairment loss exists for an asset group, the loss should be allocated to the long-lived asset(s) in the asset group. This is done on a pro rata basis using the relative carrying amounts of the assets, except that any individual long-lived asset should not be reduced below its fair value.

If no impairment loss exists for the asset group, an impairment loss should not be recorded against an individual asset in that asset group, even if an entity knows that the carrying value of that individual asset exceeds its fair value.
Reassessing useful lives

.52 Entities should assess each reporting period whether there are events or circumstances that warrant an adjustment to the useful lives of their long-lived assets. In particular, the triggering events that cause an entity to perform a recoverability test could indicate the need to shorten the useful life of an asset even if an impairment loss is not recorded. However, entities should have controls and processes in place to reassess useful lives each reporting period regardless of a triggering event. This reassessment should also include estimated salvage (or residual) values.

Additional guidance may be found in Chapter 10 of PwC’s Global Guide to Accounting for Business Combinations and Noncontrolling Interests (2013 edition).

Goodwill—qualitative impairment test

.53 In ASU 2011-08, Testing Goodwill for Impairment, the FASB introduced a qualitative approach to the goodwill impairment test. This qualitative assessment is commonly referred to as “step zero,” and was effective for fiscal years beginning after December 15, 2011. Step zero is an assessment of whether it is more likely than not that a reporting unit’s fair value is less than its carrying amount. ASC 350-20-35-3C provides a series of indicators that should be considered in making the more-likely-than-not evaluation. If the fair value of the reporting unit is greater than the carrying value, then proceeding to step one of the goodwill impairment test is not necessary. However, if a reporting unit’s fair value is less than the carrying value, step one must be performed.

.54 An entity can apply the step zero approach on a reporting unit-by-reporting unit basis. For any reporting unit, the entity can decide to proceed directly to step one of the impairment test (comparison of reporting unit fair value to carrying amount), even if it applied the step zero approach in a prior period.

PwC observation:

Step one of the impairment test can be complex, time-consuming, and costly due to the valuation models used to determine the fair value of a reporting unit. These complexities and costs were expected to decrease with the availability of the qualitative assessment. However, many entities have found that obtaining adequate support and documenting the qualitative assessment can also be time-consuming, especially for reporting units where the fair value in the most recent impairment test did not significantly exceed its carrying amount.

Entities with reporting units that had a significant cushion in a prior period step one impairment test and have not experienced significant adverse changes may benefit the most from applying step zero. Entities that perform the qualitative assessment should ensure they have robust documentation in place to support their conclusions.

Refreshing step one

.55 A positive factor that entities often point to in their qualitative assessments is a significant excess of fair value over carrying value in the most recent step one test. A question that frequently arises is how long an entity can rely on a previous step one assessment before a new step one should be performed. The guidance does not specify when (or even whether) an entity should refresh its step one test. Determining the period of time that it is appropriate to rely solely on a qualitative assessment requires judgment and careful assessment of the relevant facts and circumstances, especially given today’s volatile economic environment.
Disclosures

.56 The qualitative goodwill impairment testing standard did not change any of the existing goodwill disclosure requirements. However, through the comment letter process, the SEC staff has identified disclosures that it believes are important, including:

- whether the registrant used the qualitative assessment and, if so, the specific reporting units analyzed, and
- the list of events and circumstances considered in the qualitative assessment (rather than defaulting to the examples listed in ASC 350-20-35C).

.57 In addition, when qualitative trends of the business may suggest that applying step zero was inappropriate, the SEC staff has asked registrants to explain why they used step zero and to provide their key assumptions and sensitivity analyses.

Step one reminders

.58 Step one of the quantitative goodwill impairment test often involves the use of third-party valuation experts. Ultimately, management is responsible for the results of the valuation. Therefore, it is critical that management understand and validate the underlying data and assumptions in the forecast, as well as the valuation assumptions, including the discount rate, terminal value, and any control premium.

.59 The market capitalization of a public entity is generally not used to directly determine the fair value of its reporting units. However, the aggregate fair value of an entity's reporting units should reconcile to the entity's market capitalization within a reasonable range. Any difference between the aggregate fair value of the reporting units and the market capitalization typically results from a control premium that is not reflected in the quoted market price of the entity's stock.

PwC observation:

Entities should ensure that assumptions used in the cash flow projections for step one of the goodwill impairment test are internally consistent with those used in other impairment tests (such as indefinite- and long-lived assets, and deferred tax assets) as well as management’s long-term budgets and forecasts.

Additional guidance may be found in

- Dataline 2011-28, Goodwill impairment—FASB issues guidance that simplifies goodwill impairment test and allows early adoption
- Chapter 11 of PwC’s Global Guide to Accounting for Business Combinations and Noncontrolling Interests (2013 edition)

Variable interest entities

.60 The accounting model for identifying and accounting for variable interest entities (VIEs) is complex and highly judgmental. Importantly, the consolidation analysis for any entity first starts with a consideration of whether the entity is a VIE. Included below is a summary of the model and key aspects entities should consider when navigating the model.

.61 An investor entity is required to consolidate another entity if the investor entity has a controlling financial interest in the entity. The first step in this analysis is to determine
whether the entity is a VIE. If the entity is a VIE, then the VIE consolidation model should be applied. If the entity is not a VIE, then an investor should apply the voting-interest entity consolidation model. Determining whether an entity is a VIE is critical not only to ensure that the proper consolidation model is applied for accounting purposes, but also because the disclosure requirements under the two consolidation models are different.

**Equity investment at risk**

.62 If an entity has a variable interest in another entity, then it must evaluate whether the entity meets any of the VIE characteristics in ASC 810-10-15-14. An investor should first identify the parties that have an equity investment at risk. The starting point for determining who has equity investment at risk is based on the equity reported on the entity’s financial statements (“GAAP equity”). Based on the guidance in ASC 810-10-15-14(a), an equity investment at risk has the following characteristics:

1. Equity investment at risk participates significantly in profits and losses regardless of voting rights

<table>
<thead>
<tr>
<th>PwC observation:</th>
</tr>
</thead>
<tbody>
<tr>
<td>The equity investment must share in both the net income and losses of the entity. If an equity investment only shares in the net income of the entity and is not exposed to losses, it would not be considered at risk, even if it is recorded as equity in the entity’s financial statements. For example, preferred stock with a fixed rate of return that is insignificant compared to the total expected return of the entity would not be considered an equity investment at risk.</td>
</tr>
</tbody>
</table>

2. Equity investment at risk excludes certain forms of “investment” that do not present a substantive risk of loss to the investor. Those exclusions are:

   a) equity interests that the legal entity issued in exchange for subordinated interests\(^1\) in other VIEs,

   b) equity interests that are acquired with funds provided to the investor by other parties involved with the entity in question, and

   c) equity interests that are funded by loans or guarantees of loans by the legal entity.

<table>
<thead>
<tr>
<th>PwC observation:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Only an equity investor that has “skin in the game” is considered at risk. Therefore, if an investment is funded with “paper” rather than cash in another VIE, by funds provided by another investor involved with the entity, or by entity itself (via loans or guarantees), then the equity investment is not considered to be at risk.</td>
</tr>
</tbody>
</table>

\(^1\) Subordinated interests include common stock or other interests that will absorb some or all of a variable interest entity’s expected losses, including common stock, beneficial interests in assets of the entity, or other subordinated financial support.
The following example illustrates how an incorrect assessment of equity investment at risk can impact the assessment of whether an entity is a VIE:

**Example:** Investor A and Investor B have 45% and 55% interests, respectively, in the voting common stock of Entity X, a legal corporation. Investor A contributed assets in return for its equity interest, and Investor B received its equity interest for its “know how” and management skills. Voting rights and distribution of profits and losses are directly proportional to common stock interests. By virtue of its 55% common stock interest, Investor B has the power to direct the most significant activities of Entity X.

Which party(ies) has/have equity at risk?

Investor A is the only party that has equity at risk in this scenario. Investor B does not have equity at risk since it did not contribute any assets in exchange for its equity interest. Investor B does not have any “skin in the game” as it does not have risk of loss of capital. Therefore, the entity will likely be a VIE since, among other reasons, the power over the most significant activities of Entity X is held outside of the equity at risk.

One might incorrectly assume that both Investor A and B have equity at risk since both hold equity and voting interests in Entity X. This assessment likely would have led to an incorrect conclusion that the entity is not a VIE; as a result, VIE disclosures would have been inappropriately omitted from the investor’s financial statements. In this example, the consolidation conclusion likely would be the same under both models. However, in other circumstances, the consolidation conclusion could be different depending on whether the voting interest entity or the VIE model is applied.

**PwC observation:**

The example above highlights the importance of carefully evaluating which parties hold equity at risk before evaluating the other characteristics of a VIE.

While we have highlighted this one important aspect of the VIE model, it is important to critically assess each step of the VIE model and all relevant facts and circumstances, including the purpose and design of the entity. What may be perceived to be a minor detail can have a significant impact on the accounting conclusion and the related disclosures.

**Reconsideration events**

The analysis of whether an entity is a VIE must be reassessed when certain triggering events occur as prescribed in the guidance. An example of a trigger that requires VIE reassessment is when an entity issues debt or equity. The analysis of whether the entity is a VIE could change depending upon the voting and economic rights conveyed in the debt or equity issued. In contrast, the reassessment of which party consolidates the VIE is not trigger-based and must be performed each reporting period. Therefore, entities should have processes in place to help identify information that could lead to a change in the VIE assessment or which party should consolidate the VIE.

**Joint ventures**

Recently, we have seen an increase in transactions in which two parties share their expertise to expand a business to a new territory. In some cases, the entity created is in the legal form of a corporation or a limited liability company, and is referred to as a “joint venture.”
If the venture meets the definition of a corporate joint venture in ASC 323-10-20, the venturers are assumed to share control and would each apply the equity method of accounting. If the venture doesn’t meet the definition of a corporate joint venture, several questions may arise, including the investor’s accounting for its interest as well as the investee’s accounting basis for the contributions received at inception of the arrangement.

**PwC observation:**

Many arrangements referred to as “joint ventures” do not meet the accounting definition of corporate joint venture. These ventures are often considered VIEs, which require careful analysis under the VIE accounting guidance. If the entity is a VIE, caution should be applied if the preliminary conclusion is that shared power exists and none of the interested parties consolidates the VIE. This could be the case if the VIE has a shared board between the investors that makes decisions about the most significant activities. Evaluating the contractual board decision-making is critical to support the assertion that the most significant decision-making is made at the board level rather than by management or through another contract. It is also important to ensure the investors are not related parties or de facto agents, since this distinction would require one of the investors to consolidate the VIE via the application of the related party tiebreaker.

If the venture is not a VIE, then each investor needs to evaluate whether it should consolidate the entity under the voting interest model. This model generally focuses on the party that holds the majority of the voting equity interests. In many joint venture arrangements, however, investors hold substantive participating rights (as defined in ASC 810-10-25-11), in which case the majority equity holder would not consolidate the entity. In those situations, each investor would typically report its investment under the equity method of accounting, as the presence of substantive participating rights is a strong indicator of significant influence.

**Equity method investments**

If an investor holds significant influence in an entity through traditional voting common stock, but does not consolidate the entity, it will generally apply the equity method of accounting. The accounting for equity method investments can be difficult and requires significant judgment, particularly when identifying in-substance common stock and accounting for basis differences.

**In-substance common stock**

Although the equity method of accounting was originally intended to apply only to investments in common stock, ASC 323-10-15-13 also requires consideration of whether an investor has significant influence through in-substance common stock. Therefore, investments such as preferred stock should be evaluated to determine if they are in-substance common stock of the investee entity.

In-substance common stock is an investment in an entity that has risk and reward characteristics that are substantially similar to that entity’s common stock. To determine whether an investment is substantially similar to the entity’s common stock, the investor has to perform a qualitative analysis that considers three characteristics of the investment:

- Subordination—the investment has no substantive liquidation preference over the common shareholders
- Risks and rewards of ownership—the investment has similar rights to participate in earnings, losses, capital appreciation, and depreciation as common stock either
through dividends or conversion rights that are not subject to significant contingency

- No investee obligation to transfer value—the investment does not require the investee to transfer value to the investor in preference to the common shareholders (for example, a mandatory redemption feature or non-fair value put option).

.71 All three of these characteristics must be met for an investment to be considered in-substance common stock. The initial determination of whether an investment is in-substance common stock should be made on the date the investor obtains the investment and has the ability to exercise significant influence.

.72 When assessing whether preferred stock is in-substance common stock, it is important to determine whether the preferred stock features are substantive. For example, if preferred stock has a fixed price put option feature that is not substantive, then it would not be viewed as an obligation to transfer value and may be considered in-substance common stock. Similarly, if an entity’s capital structure is created with nominal common stock ($1) and significant preferred stock ($99) with no other sources of capital, the investment would not have a substantive liquidation preference. Thus, the preferred stock might be considered in-substance common stock since it is absorbing income and losses like the common stock.

**Basis differences**

.73 When an investor acquires its interest in an investee, other than at formation of the entity, the investor’s cost basis in the investment generally will not equal its share of the underlying net assets of the investee. That difference is known as a “basis difference.” The guidance in ASC 323-10-35-5 and 35-13 indicates that an investor should account for basis differences as if the investee were a consolidated subsidiary. Therefore, the investor prepares hypothetical acquisition accounting for its investment on the date of the acquisition and then adjusts its pro-rata share of the investee’s results in subsequent periods as if the entity were consolidated using that basis.

**Example:** Investor A pays $1,000,000 for a 25% interest in Entity B. Net assets of Entity B at the acquisition date as recorded in Entity B’s US GAAP financial statements are as follows:

<table>
<thead>
<tr>
<th>Cash</th>
<th>$ 200,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed assets</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Marketable bonds</td>
<td>100,000</td>
</tr>
<tr>
<td>Deferred tax liability</td>
<td>(200,000)</td>
</tr>
<tr>
<td>Net assets</td>
<td>1,100,000</td>
</tr>
<tr>
<td>x 25%</td>
<td>275,000</td>
</tr>
</tbody>
</table>

Investor A’s share of B’s net assets = $725,000 (25% x $1,100,000)

The basis difference related to Investor A’s investment is $725,000 ($1,000,000 purchase price less $275,000 share of net assets).

On the acquisition date, Investor A records the investment on its balance sheet at $1,000,000. To account for its investment under the equity method, Investor A performs a hypothetical purchase price allocation to Entity B’s net assets—essentially, determining the fair value of Entity B’s assets and liabilities—and allocates the $725,000 basis difference to the individual assets and liabilities. This includes goodwill and intangible assets that may not be recorded in Entity B’s financial statements as illustrated in the table below.
<table>
<thead>
<tr>
<th>Entity B book value</th>
<th>Entity B fair value</th>
<th>Difference</th>
<th>Entity A's 25% share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash $300,000</td>
<td>$300,000</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Fixed assets 1,000,000</td>
<td>2,000,000</td>
<td>$1,000,000</td>
<td>$250,000</td>
</tr>
<tr>
<td>Patents -</td>
<td>800,000</td>
<td>800,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Deferred tax liability (200,000)</td>
<td>(920,000)</td>
<td>(720,000)</td>
<td>(180,000)</td>
</tr>
<tr>
<td>Goodwill -</td>
<td>1,820,000</td>
<td>1,820,000</td>
<td>455,000</td>
</tr>
<tr>
<td>Total $1,100,000</td>
<td>$4,000,000</td>
<td>$2,900,000</td>
<td>$725,000</td>
</tr>
</tbody>
</table>

(A) Residual difference between fair value of identifiable tangible and intangible assets and liabilities and implied entity fair value (see (B) below).
(B) 25% interest purchased for $1,000,000 → fair value of 100% is $4,000,000.

**PwC observation:**

Although it may be difficult to obtain the information necessary to determine the fair value of an investee’s assets and liabilities, the entire basis difference cannot be assumed to represent goodwill. An investor that has significant influence is expected to have sufficient insight into the investee’s business and assets and liabilities to determine the drivers of the basis difference.

.74 Basis differences that relate to depreciable or amortizable assets or liabilities are amortized or accreted in conjunction with recognizing the equity income/loss by the investor for its proportionate share of the investee’s net income. There is no “day one” accounting when basis differences are determined and basis differences are never directly recognized in the investor’s financial statements, only embedded in its investment carrying amount and tracked in a separate memo account. However, the investor will need to develop a process (and related controls) to track its share of the basis difference for each asset and liability of the investee.

.75 The portion of the basis difference that represents hypothetical goodwill is not separately evaluated for impairment. Rather, an entity evaluates the entire carrying amount of an equity method investment using the other-than-temporary-impairment model in ASC 350-20-35-32. If an investor recognizes an impairment loss, any impairment recorded by the investee in its separate financial statements should be considered to ensure that the investor and investee losses are not double-counted.

**Asset acquisition versus business**

.76 Assessing whether an acquisition is an acquisition of assets or a business is an important first step when determining how to report the transaction. Some of the differences between the two models are highlighted in the table below:
<table>
<thead>
<tr>
<th>Area</th>
<th>Business combination</th>
<th>Asset acquisition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Measurement of assets and liabilities</td>
<td>Fair value of each asset and liability (goodwill as residual)</td>
<td>Allocate purchase consideration based on relative fair values of assets acquired (no residual)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>Recognized as standalone asset</td>
<td>No goodwill recognized</td>
</tr>
<tr>
<td>Transaction costs</td>
<td>Expense in period of acquisition</td>
<td>Include as part of purchase price</td>
</tr>
<tr>
<td>Contingent consideration</td>
<td>Record at fair value; mark-to-market subsequently (through the income statement, if required to be settled in cash or other assets)</td>
<td>Generally record when probable and reasonably estimable</td>
</tr>
<tr>
<td>In-process research &amp; development</td>
<td>Capitalize as an indefinite-lived intangible asset until project is completed or abandoned</td>
<td>Expense assuming no alternative future use</td>
</tr>
</tbody>
</table>

**Definition of a business**

.77 The guidance in ASC 805-10-55-4 states that a business consists of (a) inputs and (b) processes applied to those inputs that (c) have the ability to create outputs. It is important to note that a collection of inputs and processes only needs to be capable of producing outputs to meet the definition of a business. An example is a start-up activity that has yet to commence production of products (outputs), but has the inputs and processes in place capable of producing the products.

.78 Not all of the inputs and processes need to be transferred by the seller for the acquired group to be considered a business. If certain administrative processes are not transferred, but the key inputs and processes to create the outputs are transferred, the definition of a business would likely be met. Further, when an acquired group is missing some inputs or processes, it could still meet the definition of a business. If a market participant could integrate the acquired group with its existing inputs and processes, or easily replace the missing inputs or processes, then the acquired group would likely meet the definition of a business.

**Example:** Acquirer A purchases a commercial office property from Company R that is currently leased and for which Company R employees perform lease administration and building management services. Acquirer A will legally assume the leases in place in connection with the acquisition, and the leasing personnel will become employees of Acquirer A. However, the building management personnel (security, cleaning, maintenance) and property management contracts will not be assumed. Acquirer A can readily obtain those services in the marketplace, either with companies that it currently does business with or other providers.

**Analysis:** It is likely that the acquired property would be a business as Acquirer A purchased inputs (building) and processes (in-place leases and lease administration) that could be used to create outputs (leased office space). The fact that rental income is present immediately after the acquisition is a strong indicator that a business has been acquired. Furthermore, the processes not acquired (security, cleaning, maintenance, and property management) could be easily obtained in the marketplace. Thus, from a market participant point of view, the critical inputs were transferred.
Example: Acquirer B purchases a commercial office property that is vacant and no employees or other contracts are assumed in connection with the acquisition.

Analysis: In this case, it is likely that the acquired asset is not a business as Acquirer B only acquired an input (the building) and did not acquire any processes. Evaluating whether or not a market participant would be able to replicate or easily replace the necessary processes is not relevant since no processes were acquired.

PwC observation:
Each assessment of whether an acquisition meets the definition of a business requires judgment and a thorough analysis of all facts and circumstances. The analysis can be especially challenging in the pharmaceutical (start-up / pre-revenue drug candidates), real estate (revenue-generating assets), and transportation (revenue-generating assets) industries.

Additional guidance may be found in
- Chapter 1 of PwC’s Global Guide to Accounting for Business Combinations and Noncontrolling Interests (2013 edition)
- Mergers & acquisitions – a snapshot, Did I buy a group of assets or a business? Why should I care?

Accounting changes and error corrections
.79 Distinguishing between a change in accounting principle, change in estimate, and error correction can sometimes be difficult, but the distinction is critical to applying the reporting framework under ASC 250-10-45:

- A change in accounting principle is applied retrospectively, unless impracticable (a high hurdle).
- A change in estimate is reflected currently in the period of the change and prospectively, if applicable (for example, a change in the estimated useful life of an asset).
- An error correction is effected by restating or revising (if immaterial) the misstated financial statements.

.80 A change in accounting principle is a change from one generally accepted method of accounting to another generally accepted method. If an entity was improperly applying an accounting method historically and wishes to change to a generally accepted method, this would be reported as the correction of an error.

.81 In some cases, determining the type of accounting change requires judgment. The following questions may be helpful in making this distinction:

- What was the impetus for the change?
- Did the basic estimation model change, or just the inputs?
- Why did the inputs change and when were the data supporting the new inputs first observed or observable?
• Is the entity applying the new method to a new business, new assets or liabilities, or new classes of transactions?

• If the entity is using a new model for an existing class of transactions or balances, are the effects of applying the new model significantly different from the results under the old model?

• Has the business experienced significant changes in the nature of the assets and liabilities or transactions that warrant a different accounting approach?

**Preferability**

.82 An elective change in accounting principle, from one acceptable method to a new acceptable method, is permitted only if the new method is preferable. The determination of preferability requires judgment and is based on facts and circumstances. The literature contains no specific criteria, but, in practice, the following factors are commonly considered in assessing preferability:

• Does the change improve comparability of the entity’s reporting with that of its peers? To what extent do direct peers use the proposed method?

• Does the change align with the way the entity manages its business?

• Has there been (or is there expected to be) a change in the entity’s business that supports the accounting change?

• How do external factors (for example, market, industry, or economic) support the change?

.83 An entity that concludes an accounting change is preferable is required to disclose the justification for the change, as well as the effects of the change on net income for the period in which the change is made. The disclosure should clearly explain why the newly adopted accounting principle is preferable to the previously applied accounting principle. Additionally, public entities are required to file, together with their Form 10-Q or 10-K for the period in which the change is first reported, a letter from their independent registered public accounting firm indicating the change is preferable.

.84 ASC 270, *Interim Reporting*, indicates that whenever possible, an entity should apply accounting changes in the first interim period in a fiscal year so as not to “obscure operating results and complicate disclosure of interim financial information.”

**Change in accounting principle—impracticability**

.85 A change in accounting principle is required to be applied retrospectively (that is, all prior periods must be restated), unless impracticable. ASC 250-10-45-9 provides guidance on when an entity may conclude it is impracticable to apply the change.

**PwC observation:**

A change in accounting principle is a significant undertaking because of the retrospective application requirement. It is necessary to gather a significant amount of data and analysis to retrospectively apply the change, or validate the assertion that it’s impracticable to do so.
**Error corrections**

.86 When an entity identifies an error in previously-issued financial statements, the first step is to determine whether it was material to any previously issued financial statements and/or correction of the error in the current period would result in a material misstatement of the current period’s financial statements. For SEC registrants (and also as best practice for all entities), SAB Topic 1-M, Materiality, requires both a qualitative and quantitative assessment of materiality. Importantly, the guidance does not specify any “bright line” threshold for materiality. In practice, 5% of income (pre-tax or after tax) is generally regarded as a “rule of thumb” for the quantitative measure of materiality, but entities should carefully consider the quantitative materiality measure that is most appropriate for the particular financial statement(s) to which the errors relate.

.87 Entities must use a dual approach that considers both the “iron curtain” method (focuses on balance sheet impacts) and the “rollover” method (focuses on income statement impacts) to determine whether an error is material to previously issued or current financial statements.

.88 SAB Topic 1-M provides a series of considerations, not necessarily all inclusive, for the qualitative assessment of materiality. These include whether the misstatement:

- arises from an item capable of precise measurement or whether it arises from an estimate,
- masks a change in earnings or other trends,
- hides a failure to meet analysts’ consensus expectations,
- changes a loss into income or vice versa,
- involves a segment that has been identified as playing a significant role in the operations or profitability,
- affects compliance with regulatory requirements,
- affects compliance with loan covenants or other contractual requirements,
- has the effect of increasing management’s compensation, and/or
- involves concealment of an unlawful transaction.

.89 The FASB’s guidance only contemplates reporting the correction of an error by restating the previously-issued financial statements. For public companies, such a restatement requires filing a Form 8-K, under Item 4.02, which publicly announces to financial statement users that the previously-issued financial statements should no longer be relied upon.

.90 Many identified errors do not result in a material misstatement to previously-issued financial statements. In that case, an Item 4.02 Form 8-K is not required, and the error may be corrected in one of two ways:

- Recording an out-of-period adjustment, with appropriate disclosure, in the current period, assuming that such correction does not create a material misstatement in the current period
- Revising (rather than restating) the prior period financial statements the next time they are presented in future filings
A revision disclosure is similar to a restatement disclosure, but the audit opinion is not modified, nor are the financial statement columns labeled “restated.”

**PwC observation:**
The revision method has sometimes been referred to as a “stealth restatement.” However, a restatement and a revision are substantively different. A restatement is the required reissuance of materially misstated financial statements whereas a revision is a voluntary correction of errors that are immaterial in the current and prior periods. Importantly, a revision is appropriate only in those circumstances where the previously-issued financial statements have not been materially misstated.

In addition to considering the materiality of the errors and the appropriate manner of reporting, entities should consider whether the misstatements were the result of pervasive control issues that could rise to the level of significant deficiencies or material weaknesses.

Additional guidance may be found in Dataline 2013-22, *Evaluating errors in previously-issued financial statements—Applying the “dual method.”*

### Use of overnight index swap rate in derivatives valuation

Derivative pricing practices have evolved in recent years as market participants refine their pricing approaches to capture the elements underlying the pricing of derivative transactions in a changing market. One such evolution is to the use of the Overnight Index Swap (OIS) rate to value certain collateralized derivatives.

Since the financial crisis, there has been an increase in the use of credit enhancements such as collateral. In addition, many market participants recognize that the funding advantages from collateral that may be rehypothecated has value and should be considered in derivative pricing. As a result, today, most major derivatives dealers discount the cash flows on certain collateralized derivative transactions at a rate commensurate with the terms of the collateral (for bilateral derivatives) or variation margin (for centrally cleared transactions). Thus, certain collateralized derivatives may be presumed to require valuation based on discounting at the OIS rate.

In fact, in a recent speech (September 18, 2013) at the 2013 AICPA Conference on Banks and Savings Institutions, the SEC staff indicated that the use of the OIS rate to value certain collateralized derivatives is becoming more prevalent in the marketplace. Also, the FASB noted in the basis for conclusions of ASU 2013-10 that as a result of the financial crisis, there has been an increase in exposure to OIS. The FASB also noted there is an increased use of OIS as a discount rate to value collateralized derivatives because that rate reflects the lower cost of financing a collateralized instrument.

The migration from discounting based on LIBOR, or a similar rate, to a rate such as OIS that is more reflective of the funding benefits obtained from the collateral posted has been, and continues to be, an evolutionary process. The degree of market acceptance and, thus, inclusion of OIS discounting within pricing may vary across asset classes. For example, typically the adoption of OIS discounting for interest rate products has been
more pervasive, whereas for other transaction classes the adoption of OIS discounting is occurring at a slower pace.

As a result, companies should assess the appropriate valuation basis for their derivative transactions for each class of transactions separately based on the following factors, among others:

- the type of derivative contract,
- the currency of the transaction and collateral,
- tenor,
- the underlying risk, and
- the nature of the collateral and the terms under which it is posted.

**PwC observation:**
The migration to discounting based on a rate such as OIS continues to be an evolutionary process. As discussed above, valuations derived using LIBOR-based discounting for certain products may no longer be the most appropriate representation of fair value under ASC 820. This evolution will result in many practical challenges, including making changes to systems used for valuation.

**Additional guidance may be found in**
- Dataline 2013-25, *Derivative valuation—The transition to OIS discounting*
- PwC’s *Guide to Accounting for Derivative Instruments and Hedging Activities* (2013 edition)
- PwC’s *Global Guide to Fair Value Measurements* (2013 edition)

**Fair value hierarchy**

The FASB amended ASC 820 in 2011 to enhance the disclosure requirements for fair value measurements, among other changes. This amended guidance was effective for most companies in 2012. Much of the feedback since adoption has focused on the new disclosures—in particular, the requirement that all assets and liabilities (both financial and non-financial) measured or disclosed at fair value be categorized by the level in the fair value hierarchy.

The purpose of the fair value hierarchy is to indicate the relative reliability of the inputs to fair value measurements, not the valuation techniques used. However, the complexity of a valuation model may influence the nature (and therefore level) of the inputs.

A fair value measurement, which may be the result of multiple inputs, is categorized in its entirety by reference to its lowest level (i.e., least reliable) significant input. Determining the correct level in the fair value hierarchy of a reporting entity’s investments requires significant judgment and management’s analysis should be well-documented. The three levels within the fair value hierarchy are as follows:
• Level 1 (highest): Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets

• Level 2: Inputs, other than quoted prices for identical instruments, that are observable for the asset or liability, either directly or indirectly. This might include quoted prices for identical instruments or liabilities traded as assets in markets that are not active.

• Level 3 (lowest): Unobservable inputs (for example, a reporting entity’s own data)

A common misconception is that securities that are “less risky” should be categorized in Level 1. For instance, many might perceive US Treasury securities as essentially risk free, and, therefore, within Level 1 of the fair value hierarchy. However, certain Treasury securities are more appropriately categorized in Level 2 because they do not trade in an active market.

Incorrectly categorizing a fair value measurement within the fair value hierarchy may have broader implications than just inappropriate financial statement disclosures. Entities may have risk management policies or debt agreements with covenants that prohibit investment in Level 3 assets. Further, the lower the level, the more disclosures are required. Mischaracterizing a Level 3 investment as Level 2, for instance, would result in the omission of certain required disclosures from the financial statements.

**Understanding the inputs**

The first step in determining the proper level of a fair value measure is a thorough understanding of the nature and sources of the inputs. Ultimately, this is management’s responsibility, regardless of the nature of the asset or who performs the valuation. Even if management has elected to outsource the valuation for particular assets, management should still maintain the necessary controls and processes in place to understand and evaluate the inputs to and results of the valuation.

**Significance of inputs**

In assessing the significance of an input to the overall fair value measurement, a reporting entity should (a) consider the sensitivity of the asset’s or liability’s overall value to changes in that input and (b) assess the likelihood of variability in the value of that input over the life of the asset or liability. In other words, entities should consider not only how significant the input is at the measurement date, but also the input’s potential impact to the fair value measurement in the future.

**Observability of inputs**

Inputs that are “observable,” as defined in ASC 820, are developed using market data, such as publicly available information about actual events or transactions, and reflect the assumptions that market participants would use when pricing the asset or liability.

Dealer quotes are observable only if the dealer stands ready and willing to transact at that price. Brokers, on the other hand, report what they see in the market but usually are not ready and willing to transact at that price. In order for broker quotes to be observable, they need to be corroborated by other market events or data. Generally, if an input is supported by only a single broker quote, it would not be considered a Level 1 input. It may be a Level 2 input if observable market information exists for comparable assets and/or the broker is willing and able to transact in the security at that price. In many cases, a single broker quote may be indicative of a Level 3 measure if there are no comparables and the quote is provided with no commitment to actually transact at that price.
This guidance also applies to inputs provided by third-party pricing services. Sometimes it may not be clear if the pricing information actually represents a consensus of reported prices from multiple brokers; therefore, it may not be clear if the broker(s) will transact at those prices. To support an assertion that information obtained from a consensus pricing service represents a Level 2 input, the reporting entity should perform due diligence to understand how the price was developed, including understanding the nature and observability of the inputs used to determine that price. Just obtaining multiple broker quotes based on Level 3 inputs does not raise the categorization to Level 2.

PwC observation:
Ensuring that external pricing vendors provide the necessary information to support a categorization in the fair value hierarchy is important and may require extra effort. If the entity does not receive the required information, it may avail itself of the third-party pricing exception which permits it to exclude certain other required disclosures. However, if the exception is used, then the measurement must be categorized in Level 3.

Level 1

An unadjusted quoted price in an active market provides the most reliable fair value measurement, and if available, should be used to measure fair value in that market. The fair value guidance states that there should not be an adjustment, such as blockage factors or control premiums, to Level 1 inputs.

In practical terms, therefore, the list of instruments that likely qualify as Level 1 inputs is fairly narrow:

- Listed equity securities traded in active, deep markets (for example, NYSE, NASDAQ, Pink Sheets, etc.)
- On-the-run Treasury bonds
- Treasury bills (both on- and off-the-run, because of the high volume of trades and pricing that is based on those trades)
- Exchange-traded futures and options
- Open-ended mutual funds with published daily net asset values (NAV) at which investors can freely subscribe to or redeem from the fund
- Closed-ended registered mutual funds (for example, exchange-traded funds or ETFs) traded on active markets (the exchange price may represent a Level 1 input)

---

3 This exception in ASC 820-10-50-2(bbb) allows a reporting entity to omit certain quantitative disclosures about unobservable inputs that are not developed by the reporting entity (for example, prices from prior transactions or obtained from third-party pricing sources).
4 On-the-run Treasury bonds and notes are the most recently issued of a given maturity. They are the most frequently traded, and therefore, the most liquid.
5 Off-the-run Treasury bonds and notes are those that were issued before the most recent issue and are still outstanding.
.110 Under Dodd-Frank regulations, certain derivatives transactions, such as interest rate and credit default swaps, are required to be executed through clearinghouses. Each day, the clearinghouse provides a “value mark” that dictates the amount owed by/to the counterparty. Because this value mark is not a value at which an entity could open or close the trade at that particular point in time, the value mark is not a Level 1 fair value input.

**Level 2**

.111 The categorization of the above instruments as Level 1 requires that they are traded in an active market. If an instrument isn’t traded in an active market, it may fall to Level 2. Examples of instruments that are typically Level 2 measures include:

- Most US public debt
- Short-term cash instruments and liquid derivative products
- Investments in other types of funds, such as certain hedge funds (which may also be Level 3) and proprietary mutual funds that are not traded on an exchange

.112 ASC 820 also provides some examples of Level 2 inputs that may be used in valuing non-financial assets. One example is the price per square foot (a typical valuation multiple) for a commercial office building that is derived from observable market data.

**Level 3**

.113 Level 3 inputs are used only when more observable inputs are not available. Some common examples of assets that are usually based on Level 3 inputs include:

- Complex instruments, such as longer-dated interest-rate and currency swaps and structured derivatives
- Fixed income asset-backed securities, depending on the specific asset owned—i.e., the specific tranche—as well as the nature of the valuation model used, and whether the inputs are observable
- Investments in private equity funds or hedge funds not classified as Level 2

.114 ASC 820 provides several examples of assets that are based on Level 3 inputs, including a three-year option on exchange-traded shares, which requires an implied volatility input (not observable); the initial measurement of an asset retirement obligation; and the valuation of a reporting unit of an entity.

.115 Because Level 3 inputs are considered the most subjective, and therefore, are perceived to produce the least reliable fair value measures, assets that are measured at fair value based on Level 3 inputs require the most disclosure. Required disclosures include a rollforward of those assets measured at fair value on a recurring basis. In addition, both Level 2 and Level 3 measurements require qualitative descriptions of the valuation techniques, inputs, and quantitative information by asset class.

.116 In the past year, the SEC has commented on both the quantitative and qualitative disclosures, particularly those related to information obtained from external pricing services. In certain cases, these comments resulted in requests to include enhanced disclosure in subsequent periods. Some areas in which the SEC has asked for more information are as follows:
• How the entity performs and takes responsibility for all fair value measurements, even those performed by external pricing services

• Whether controls exist over the evaluation of information provided by external pricing services (for example, whether the valuations are reviewed by management or a valuation committee)

• Whether the inputs obtained from the pricing services are adjusted by management in the entity’s valuation of the instrument, and if so, how

• As more information is available from pricing services, whether it is appropriate to apply the third-party pricing exception

**PwC observation:**

The level of a particular instrument in the fair value hierarchy may change over time, particularly as markets evolve, certain markets become more or less liquid, and inputs become more or less observable. Therefore, it is important to evaluate the continued appropriateness of the levels in which fair value measurements are categorized at each reporting date.

**Additional guidance may be found in**

- Dataline, *Accounting for centrally cleared swaps—Understanding the implications of Dodd-Frank Title VII* (coming soon)
- Chapters 4 and 5 of PwC’s *Global Guide to Fair Value Measurements* (2013 edition)

---

**Equity-linked financing instruments**

.117 Equity-linked financing instruments include convertible debt, convertible preferred stock, and debt instruments with detachable warrants for preferred or common equity instruments. Issuers of equity-linked financing transactions typically pay a lower cash coupon or dividend. This is because in addition to paying a finance charge for the use of the lender’s capital, the issuer is simultaneously selling an option on its equity.

.118 The accounting rules for these types of instruments are extremely complex, and the summary here is intended only as a reminder of the key considerations. To determine the appropriate accounting treatment for an equity-linked financing, an issuer should first determine if the equity-linked component is embedded in a host instrument or freestanding. Freestanding instruments are accounted for separately from the host instrument. Embedded instruments require a second analysis to determine if the component should nevertheless be accounted for separately.

---

6 A detachable warrant is one that is originally issued in conjunction with another security (often debt) that may be exercised or traded separately following the issue date.
**Freestanding versus embedded**

.119 ASC 480, *Distinguishing Liabilities from Equity*, defines a freestanding financial instrument as one that is entered into:

a) separately from any other financial instruments or equity transactions, or

b) with another transaction but legally detachable and separately exercisable.

.120 When evaluating whether the equity-linked component is freestanding or embedded, the issuer should consider the following observations on the guidance:

- Components that were issued separately and at different times are generally freestanding.

- While components that may be legally transferred separately are generally freestanding, a component that must be transferred with the instrument with which it was issued is not automatically considered to be embedded.

- Individual rights within a component may be exercised separately from other components that remain outstanding. Alternatively, other rights may be structured such that once a right in a component is exercised, the other components may no longer remain outstanding. Separate exercisability is a strong indicator that the component is freestanding.

.121 Preparers should read all contracts entered into contemporaneously in their entirety to ensure that all substantive terms are identified. When the contract (or arrangements consisting of multiple contracts entered into contemporaneously) contains more than one component, each component needs to be analyzed separately to determine if it is considered legally detachable or separately exercisable.

**Assessing embedded components**

.122 Under ASC 815-15-25-1, embedded components must be accounted for separately as derivatives if all of the following criteria are met:

a) The economic characteristics and risks of the embedded derivative are not *clearly and closely related* to the economic characteristics and risks of the host contract.

b) The hybrid instrument is not measured at fair value with changes in fair value recorded in earnings.

c) A separate instrument with the same terms as the embedded component would be a derivative instrument under the derivatives guidance.

.123 Criterion (b) is a factual determination; whereas, criteria (a) and (c) require judgment.

**Clearly and closely related (criterion a)**

.124 To determine whether the embedded derivative is clearly and closely related to the host (criterion a), an entity must first evaluate whether the host instrument is more akin to debt or equity. While legal form debt instruments are considered to have debt hosts, legal form equity instruments may have either debt or equity hosts, depending on the instrument’s features. Attributes management should analyze include, but are not necessarily limited to, the following:
a) Redemption features

b) The nature of the returns (stated or fixed rate or participation in the earnings of the issuer)

c) Whether the return (dividend right, interest) is mandatory or discretionary

d) Voting rights

e) Collateral requirements

f) In the case of preferred stock, whether the holders

- participate in the residual net assets of the entity in liquidation beyond the par value of the preferred shares
- have a preference in liquidation
- have creditor rights (i.e., the right to force bankruptcy)

.125 Any one of these factors on its own is not determinative of the nature of the host, and therefore, judgment is required to weigh all relevant facts and circumstances.

.126 After determining the nature of the host, the next step is evaluating the nature of the component. Generally, a component that is equity-like will be clearly and closely related to an equity host (such as cumulative participating perpetual preferred stock) and a debt-like component will be clearly and closely related to a debt host (such as convertible debt).

.127 If the embedded component is clearly and closely related to its host, the component need not be accounted for separately. Instead, the hybrid instrument in its entirety is accounted for in accordance with other applicable GAAP.

PwC observation:

In September 2013, the EITF reached a consensus, which is currently out for comment, that requires entities to use the “whole instrument approach” when evaluating whether the host contract in a hybrid financial instrument is more akin to debt or equity from the perspective of both the issuer and the investors (EITF Issue 13-G).

Although the guidance would be applicable to all companies, we believe this proposal may impact private companies more significantly. In particular, it may affect those whose investors include private equity funds, as those entities often use complex hybrid instruments containing a variety of debt-like and equity-like features to provide financing.

Meeting the definition of a derivative (criterion c)

.128 If an issuer determines that the embedded component is not clearly and closely related to its host, it should evaluate whether the embedded component (a) meets the definition of a derivative or (b) qualifies for a scope exception to the derivatives and hedging guidance. If the embedded component would be a derivative on its own and does not qualify for a scope exception, the embedded component is separated from the host and measured at fair value through current earnings. However, if the component
qualifies for a scope exception, such as the scope exception for the issuer’s own equity, it need not be bifurcated from the host contract and accounted for separately.

.129 One example of an embedded component that would have otherwise been required to be bifurcated is the conversion option in an issuer’s convertible debt that is convertible into a fixed number of shares of publicly traded common stock. The conversion option is the embedded component and it would meet criteria (a), (b), and (c), but would qualify for the scope exception on the issuer’s own equity.

### Additional guidance may be found in

- Chapters 2 and 7 of PwC’s *Guide to Accounting for Financing Transactions: What You Need to Know about Debt, Equity and the Instruments in Between* (2013 edition)
- Chapters 2 and 3 of PwC’s *Guide to Accounting for Derivative Instruments and Hedging Activities* (2013 edition)
- EITF observer, September 2013 meeting highlights

### Gains on extinguishment of debt when debt holders own equity

.130 In today’s economic environment, many entities continue to restructure their debt instruments. One particular issue raised this year is the treatment of a gain on extinguishment of debt when the debt holders also hold equity.

.131 When an entity modifies the terms of its debt or a loan facility or exchanges its debt for new debt with the same creditor, the first step is to determine whether the modification represents a troubled debt restructuring (TDR). A restructuring is a TDR for accounting purposes if (a) the borrower is experiencing financial difficulties and (b) the lender grants a concession. If the specific criteria for a TDR are not met, then the debt or loan facility amendment should be evaluated to determine whether it should be accounted for as a modification or an extinguishment.7

.132 A TDR, a modification that is deemed an extinguishment, or the repayment of debt may result in a gain (referred to as an extinguishment gain). If the original debt holders in the restructuring also hold an equity interest in the issuer of the debt, they may be considered related parties.8 Transactions with the related party debt holders that benefit the issuer may be deemed capital transactions. This raises a question as to whether the extinguishment gain should be included in the issuer’s current earnings or reflected as a contribution of capital.

.133 The SEC staff has weighed in on the issue of gains on extinguishment of debt payable to related parties in non-troubled debt situations.9 While the staff has not provided any “bright line” views, the staff has provided questions to consider when performing the analysis, including (but not limited to):

---

7 See ASC 470-50-40-6 through 40-12 for a discussion of the quantitative test to determine whether a restructuring is a modification or extinguishment (the “10% test”).
8 ASC 470-50-40-2
9 Remarks before the 2010 AICPA National Conference on Current SEC and PCAOB Developments by Sagar S. Teotia
• What was the role of the related party in the extinguishment?

• Why would the related party agree to a restructuring that resulted in a gain for the issuer (i.e., implying that the related party accepted consideration less than fair value)?

• Was the substance of the arrangement the forgiveness of debt that was owed to a related party?

**PwC observation:**
No explicit guidance exists for all possible scenarios, and the SEC staff has left the question of the appropriate accounting open to judgment. However, we believe if all debt holders have equity interests in the issuer, the debt restructuring may be, in substance, a capital transaction. Therefore, the gain should be recorded in equity.

The analysis is more complicated when only some of the debt holders are also equity holders. We believe a key question is whether the transaction results in a significant shift in economics away from debt holders to equity holders. If significant debt holders own no equity, it is a strong indicator that the gain is appropriately included in earnings, and not in equity. Likewise, if significant equity holders own no debt, it is a strong indicator that the gain is appropriately included in earnings, and not in equity.

The above analysis applies only to extinguishment gains. Extinguishment losses would only be reflected as capital distributions (for example, charged directly to equity rather than earnings) if they are pro rata to all equity holders.

**Additional guidance may be found in** Chapter 5 of PwC’s *Guide to Accounting for Financing Transactions: What You Need to Know about Debt, Equity and the Instruments in Between* (2013 edition).

**Contingencies**

.134 The accounting models for loss contingencies and gain contingencies in ASC 450, *Contingencies*, differ. However, the key consideration for each is timing of recognition and providing appropriate forewarning disclosures.

**Gain contingencies**

.135 Contingent gains should not be recognized prior to when they are realized or realizable. The term *realized* means that cash (or other assets such as claims to cash) has been received without expectation of repayment or refund. The term *realizable* means that the assets expected to be received or held are readily convertible to known amounts of cash or claims to cash. The assessment of whether a gain is realized or is realizable requires significant judgment. An entity should thoroughly document the factors considered and rationale for its conclusion.

.136 For example, if a settlement is reached in a lawsuit and the entity is only waiting to receive the cash award, the entity may record the gain (assuming collectability is not an issue) because it is realizable. However, if a settlement is in discussion, but has not yet been agreed to by both parties, it would generally not be appropriate to record a gain until such settlement is reached. Similarly, if a favorable verdict has been received in a lawsuit, but the other party still has the opportunity to appeal, it generally would not be appropriate to recognize the gain until all appeals have been exhausted. At that point, it
may also still be necessary to assess the enforceability of the judgment if the other party does not have assets (or sufficient assets) in the jurisdiction in which the verdict was rendered.

.137 Contingent gains related to insurance recoveries warrant special consideration. To the extent that recovery is probable (a lower threshold than realized or realizable), the portion of an insurance claim that relates to recovery of an incurred loss may be recognized when the loss is recognized. For this purpose, a “loss” does not include lost revenue. If the insurance claim is in dispute (i.e., the carrier has denied coverage), a rebuttable presumption exists that recoverability of the claim is not probable and should not be recognized.

.138 Claims for insurance recoveries in excess of recorded book losses are considered gain contingencies, and require the gain to be realizable or realized prior to recognition. For example, an insurance policy might provide for payment of the “replacement cost” of fixed assets in excess of book value or recovery of “lost profits.”

Example: An entity has an insurance policy to cover loss of property, including machinery and equipment. In October 2013, a fire destroys a specific piece of machinery that is insured for $1 million. While the insurance carrier has not formally agreed to the $1 million claimed loss by December 31, 2013, the entity concludes it is probable that $1 million will be received. As of the date of the fire, the entity’s net book value of the specific piece of equipment is $700,000. The following entries would be made in the fourth quarter (in thousands):

- Debit – Loss Equipment $700K
- Credit – Equipment $700K
- Debit – Insurance receivable $700K
- Credit – Gain $700K

Although it is probable the $1 million insurance recovery will be received, the $300,000 excess of the anticipated insurance recoveries over the net book value of the destroyed equipment should be accounted for as a gain contingency and would not be recognized until it is realizable or realized. Any amounts spent to replace the destroyed equipment would be subject to the normal accounting guidance for the acquisition of fixed assets.

.139 Material contingent gains should be disclosed. However, ASC 450-30-50 cautions that care should be taken such that disclosures of gain contingencies are not misleading.

Loss contingencies

.140 A loss contingency is recorded when an event occurs that triggers a potential obligation and the loss is (a) probable and (b) reasonably estimable. Even if both of those conditions are not met, disclosure may still be necessary if it is at least reasonably possible that a loss has been incurred. ASC 450 does not require accounting or disclosure of the loss contingency when the likelihood of a loss is remote.

.141 When a loss contingency meets the disclosure threshold, regardless of whether the loss has been recognized, the required disclosures include

- the nature of the contingency, and
- an estimate of the possible loss, or range of loss, or a statement that such an estimate cannot be made.
When a loss is recognized, the SEC staff has frequently focused on whether the registrant provided any “foreshadowing” disclosures in periods prior to the loss recognition. The SEC expects that foreshadowing disclosures should include discussion of how loss contingencies could possibly be settled and the range of the possible loss. As an entity gains information about a potential loss, these disclosures should evolve. Specifically, as a contingent loss gets closer to being resolved, it would be unusual for an entity to disclose that it is unable to estimate the loss and therefore, not disclose a range of loss.

**PwC observation:**

Questions often arise around the accounting for subsequent events occurring prior to issuing the financial statements for contingencies that existed as of period end. Just as the basic recognition models for gain contingencies and loss contingencies differ, so too may the accounting for subsequent events.

In general, the resolution of a gain contingency after period end would be recognized in the period of resolution (i.e., not “pushed back” to the period end financial statements). However, new information related to a loss contingency, including resolution after period end, generally would be pushed back and reflected in the period end financial statements if the subsequent event confirms circumstances that existed as of period end.

**Stock-based compensation**

The guidance in ASC 718, *Stock Compensation*, for stock-based compensation has not changed since 2006; however, entities continue to experience challenges in its application. This year, we highlight the determination of whether a grant date has been established and the accounting for non-forfeitable dividends.

**Grant date**

It is important to identify the grant date of a stock-based award because it is the date that the fair value of the award is measured. One of the criteria for establishing a grant date is that the employer and employee have reached a mutual understanding of the award’s key terms and conditions. When an award has a performance condition that is subject to change at the discretion of the compensation committee or the board of directors (or some other senior management committee), it can be particularly difficult to determine the grant date.

A mutual understanding of the terms of an award with a performance condition is not achieved until the performance condition has been clearly defined and the performance metrics are objectively determinable. In making this assessment, it is often helpful to consider the award from the employee’s perspective. Would the employee know what target he or she is working toward and be able to calculate it? If not, the grant date probably has not been established.
Example: In December 2013, the CEO is granted stock options that vest based on seven years of service and a performance condition that requires achieving budgeted revenue for fiscal 2014. The budget will be approved by the board of directors, of which the CEO is a member, in April 2014. The entity has a proven history of achieving budgeted revenue for the past seven years.

Grant date: Although the CEO is a member of the board and the entity has a history of achieving budgeted revenue, the grant date is not established until April 2014 when the budget is finalized and approved. Only at that point is the performance condition clearly defined and the performance metric objectively determinable, and therefore, a mutual understanding of the terms exists.

Example: In December 2013, each member of the senior leadership team is granted restricted stock that vests based on four years of service and a performance condition that requires achieving basic earnings per share (in accordance with US GAAP) of $0.50 for calendar year 2014.

Grant date: A grant date is established in December 2013 because the performance condition is clearly defined and the performance metric is objectively determinable, and therefore, a mutual understanding of the terms exists.

Example: In fiscal year 2013, an employee is granted stock options that vest based on five years of service and a performance condition that requires achieving “adjusted” earnings before interest, taxes, depreciation and amortization (EBITDA) of $500 million for fiscal year 2014.

Grant date: Although the performance metric has been quantified, additional information is needed about the definition of “adjusted” EBITDA before concluding the grant date is established. If adjusted EBITDA is not clearly defined and the adjustments are subject to interpretation by the compensation committee or board of directors, it may be difficult to conclude the performance condition is objectively determinable and that a mutual understanding of the terms of the award exists.

PwC observation:
Discretion in adjusting targets or actual results for items deemed “unusual” can put significant pressure on a conclusion that the performance metrics are objectively determinable and, thus, a mutual understanding of the terms of an award exists. Careful analysis and contemporaneous documentation of management’s judgments regarding an entity’s past practice, and all other relevant facts and circumstances is necessary.

Non-forfeitable dividends

Some share-based compensation arrangements provide for the payment (or at least accrual) of dividends on employee awards. Non-forfeitable dividends are those that an employee retains regardless of whether the employee vests in the award. Non-forfeitable dividends on liability-classified awards are recorded as additional compensation expense.

The accounting for non-forfeitable dividends on equity-classified awards depends on whether the awards are expected to vest. For awards expected to vest, non-forfeitable dividends are recorded as a reduction of retained earnings, similar to other dividends. The estimate of the awards expected to vest should be adjusted when the forfeiture rate assumption is adjusted to reflect actual forfeitures. For example, a reclassification from
retained earnings to compensation cost would be necessary to account for dividends paid on awards originally expected to vest that are ultimately forfeited.

.148 For awards not expected to vest (i.e., awards expected to be forfeited), non-forfeitable dividends are recorded as compensation expense.

**PwC observation:**
Determining awards that are expected to vest versus those that are expected to be forfeited is a function of the entity’s forfeiture rate assumption. Management should review its forfeiture rate assumption for reasonableness at least annually, and potentially quarterly, considering both forfeiture experience to date and a best estimate of future forfeitures of currently outstanding unvested awards. Further, management should thoroughly document the analysis performed to calculate and reassess the forfeiture rate.

.149 Non-forfeitable dividends also impact earnings per share. Awards with non-forfeitable rights to dividends are considered participating securities (whether liability-classified or equity-classified) and the two-class method is required for calculating earnings per share (EPS). Whether or not the entity has actually paid any dividends, the two-class method allocates earnings away from common shareholders to the participating security holders when determining the numerator for EPS purposes. While the calculation of the two-class method is mechanical in nature, it hinges on the completeness and accuracy of an entity’s identification of participating securities.

**Additional guidance may be found in PwC’s Guide to Accounting for Stock-based Compensation** (2013 edition).

**Questions**
.150 PwC clients who have questions about this Dataline should contact their engagement partner. Engagement teams that have questions should contact the Accounting Services Group in the National Professional Services Group.

- Business Combinations: 1-973-236-7801
- Compensation: 1-973-236-7802
- Financial Instruments: 1-973-236-7803
- Revenue: 1-973-236-7804
- Consolidation/Financing & Real Estate: 1-973-236-7805
- Tax: 1-973-236-7806

Engagement teams may also contact their designated SEC Services consultant (if applicable) or any member of SEC Services.
DataLINES address current financial-reporting issues and are prepared by the National Professional Services Group of PwC. They are for general information purposes only, and should not be used as a substitute for consultation with professional advisors. To access additional content on financial reporting issues, register for CFOdirect Network (www.cfodirect.pwc.com), PwC’s online resource for financial executives.

© 2013 PricewaterhouseCoopers LLP, a Delaware limited liability partnership. All rights reserved. PwC refers to the United States member firm, and may sometimes refer to the PwC network. Each member firm is a separate legal entity. Please see www.pwc.com/structure for further details.