The quarter close
A look at this quarter’s financial reporting issues

March 14, 2016

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What you need to know—Q1–2016

Welcome to the first quarter edition of The quarter close. As you hustle toward first quarter reporting, we shoot you the information you need to know.

Front and center. When you’re fresh off the annual reporting bench, it can sometimes be difficult to get into an interim reporting mindset. We offer our Top 5 interim reporting tips to get your head in the game.

Accounting hot topics. Given recent economic conditions, we offer reminders of the impairment drills you might want to practice in the first quarter. We also highlight the latest developments for implementation of the FASB’s new consolidation guidance, which is now effective for public companies. Finally, we pass along a few pointers for assessing the potential impact of the European Union’s most recent developments in State Aid investigations.

Hot off the press. The FASB’s on a scoring streak, with a host of new guidance issued in the first quarter. We spotlight two of them: (1) leasing and (2) recognition and measurement of financial instruments.

And more. Along with the latest corporate governance developments, we share what’s on the horizon for companies when the FASB releases the new stock-based compensation guidance this month.

Video perspectives

Spotlight on the hot topic videos included this quarter

Click on the pictures or titles to launch the videos.

SEC comment letter response process
Equity method: Application of the other-than-temporary impairment model
Derivatives and hedging overview

Pension plan risk and response
Pushdown accounting
SEC standard setting
Foreign currency risk & hedging
Interim reporting—keys to the game

The goal of interim reporting is to provide stakeholders with timely insight into a company’s performance and key developments since the annual financial statements were issued. To assist with your Q1 reporting, we’ve compiled a highlight reel of our Top 5 interim reporting considerations. We highlight two of those considerations here.

Changes in estimates and early warning disclosures

Financial statements reflect estimates and judgments that may affect the reported amounts of assets, liabilities, revenues, expenses, and the related disclosures. In interim periods, companies are required to disclose critical accounting estimates in MD&A when it’s at least reasonably possible that a material change in the estimate will occur in the near future.

For example, if new information suggests a company has a reporting unit that is now at risk for failing the first step of the goodwill impairment test, the company should consider providing early warning disclosures in the interim period, including:

- the amount of goodwill allocated to the reporting unit;
- a description of the methods and key assumptions used in the impairment test and how the key assumptions were determined;
- the percentage by which fair value exceeded carrying value as of the date of the most recent test;
- a discussion of the degree of uncertainty associated with the key assumptions; and
- a description of potential events and/or changes in circumstances that could reasonably be expected to negatively affect the key assumptions.

Interim reporting for significant equity method investees

Interim financial statements included in a Form 10-Q are required to include summarized income statement information about significant equity method investees. The summarized information is required for equity method investees that would be required to file quarterly financial information with the SEC and meet either the investment test or the income test under Rule 1-02(w) at the 20% significance level for any of the interim periods presented.

Companies should keep in mind that retrospective changes to their financial statements may trigger the need for summarized income statement information about equity method investees that were previously determined to be insignificant.
Time for tipoff: Consolidation standard goes live

The FASB’s updates to the consolidation guidance are now effective for calendar year-end public business entities. The targeted changes were primarily designed to address concerns of the asset management industry. However, the impact of the changes will affect entities across all industries—particularly those that use limited partnerships, such as the oil and gas, transportation, and real estate industries. In addition, companies in any industry that outsource decision making or have historically applied the “related party tiebreaker” guidance may see a change in their consolidation conclusion and disclosures.

During 2015, companies that were preparing to implement the new guidance, or early adopt it, started to raise some specific implementation questions. These questions touched several topics, including whether decision-maker fees should be deemed variable interests. The SEC staff has offered some coaching on how the guidance should be interpreted, which provided resolution on some of the implementation questions. However, others are still being worked through.

For more information

To learn more about the consolidation guidance and the latest implementation developments, read In depth US2015-08, New consolidation standard - updated insights (revised January 19, 2016).

Recent streak of economic losses may have accounting implications

The new year brought new economic woes in several forms, including a stock market decline and a continuing fall in oil and gas prices. Each of these may have impairment-related accounting and reporting implications for companies in the first quarter of 2016.

Impairments of operating assets and goodwill

As the downward trend in oil and gas prices has persisted into 2016, companies should continue to assess whether their operating assets may be impaired. Inventory should be recorded at the lower of cost or market (or net realizable value if you’ve early adopted the FASB’s recent accounting update on inventory valuation). Other operating assets may need to be tested for impairment if the asset (or asset group) is not recoverable (i.e., due to changes in the cash flow forecast). Refer back to our article on this topic in The quarter close—First quarter 2015 for more on these considerations.

As a result of the stock market decline in the first quarter of 2016, companies may need to assess whether the decrease in their fair value represents a triggering event for assessing goodwill for impairment.

A shoot-around on OTTI—potential impairment of investment assets

Many companies hold debt and equity securities of other companies as investments. These securities are impaired if their fair value is less than their cost / carrying value. If a security is impaired, the company must determine whether there is a temporary impairment or an other-than-temporary impairment (OTTI). Companies should test for OTTI at least every reporting period.
The first two questions to ask are: Do we intend to sell the security? Is it more likely than not that we will be required to sell the security before the fair value recovers? If the answer to either of these questions is yes, an OTTI exists and the impairment should be recorded.

If the answer to both questions is no, the company will need to evaluate whether the entire cost/carrying value of the security will be recovered. This determination is inherently judgmental, but some key factors to consider include:

- The length of time and the extent to which fair value has been less than cost/carrying value
- The financial condition and near term prospects of the issuer, including likelihood the issuer will be able to make future payments, if applicable
- Adverse conditions related to the security’s industry or geographic region
- Changes to rating of the security
- Subsequent decline in fair value of the security after the balance sheet date

Since equity securities don’t have contractual maturities, a company cannot demonstrate that it will recover its cost simply by holding it until some future date. As a result, forecasted recovery of an equity security is typically more subjective than debt securities and requires compelling evidence that the decline is temporary.

Assessing the accounting implications of European state aid rulings

Recently, the European Commission (EC) has questioned certain income tax rulings provided by European Union (EU) member states on transfer pricing and similar agreements under the broader state aid rules. These rulings may include favorable rates, subsidies, exemptions, or other concessions.

Many of the high-profile state aid investigations relate to individual concessions granted to particular companies by certain EU member states (including Luxembourg, Ireland, and the Netherlands). The outcomes of these investigations—some with decisions rendered, some ongoing—may indirectly affect your company.

Who should be focused on potential state aid exposures?

If your company has existing tax rulings from EU member states, it may be prudent to reassess them considering the broader context of the EC’s state aid investigations. Companies that plan to unwind existing tax structures or arrangements because of the decisions reached by the EC should consider early warning disclosure if the potential financial impact is expected to be significant.

Some companies that may have potential exposures have questioned how they should assess the potential risk. In many cases, the state aid developments would fall under the recognition, measurement, presentation, and disclosure requirements applicable to uncertain tax positions under ASC 740, Income taxes. However, there are some potential forms of unlawful state aid, including non-income based incentives, such as tariff reductions, that would be considered under other standards such as the contingency guidance. It is important for companies to understand the nature of the state aid issue being assessed to determine which guidance to use.
EC decision on Belgium may affect dozens of multinational companies

In January 2016, the EC concluded that selective tax deductions granted by Belgium under its "excess profit" tax scheme are illegal under EU state aid rules. The Belgian case is unique in that it is a specific provision of national tax law—not an individual agreement between a country and a company—that has been found to be illegal. The EC believes that the scheme benefitted at least 35 multinationals and estimates the total amount of underpaid taxes to be around €700 million.

The illegal state aid takes the form of a deduction on an income tax return and therefore represents an uncertain tax position. Since the Belgian government can still appeal the decision, companies that believe they could be affected by this ruling must apply judgment in evaluating their uncertain tax position. The ruling represents new information that would be considered for the first time in Q1 2016 for calendar year-end companies.
Lease convergence—not a slam dunk

The FASB and IASB have both issued their long-awaited guidance on lease accounting. The final standards are not fully converged, but they do have at least one major aspect in common—lessees will reflect virtually all leased assets on the balance sheet. The significance of the impact on a lessee’s income and cash flow statements will depend on whether the lessee is reporting under US GAAP or IFRS.

For lessors, the FASB and IASB adopted an approach that is substantially equivalent to today. However, certain changes were made mainly to conform leasing to the boards’ recently issued revenue recognition guidance.

What are the significant differences between the two new standards?

The most noteworthy difference between the new FASB and IASB standards relates to lessee accounting. The IASB guidance requires lessees to reflect most leases as finance leases, with certain exceptions. As such, expense recognition will be front-loaded relative to today’s operating leases, and will be presented as interest and amortization rather than rent expense.

In contrast, the FASB has retained a dual income statement model. Classification criteria are similar to today—absent the previous classification bright lines. A lessee will recognize lease expense on a straight-line basis for leases classified as operating leases. Leases classified as finance leases will be recognized similar to both capital leases today and the new model adopted by the IASB for most leases.

Under US GAAP and IFRS almost all leases will record a right-of-use asset and a corresponding lease liability. Both boards made exceptions for short-term leases, and the IASB also made an exception for “small assets.” These permitted exceptions will continue to be treated like operating leases today for both balance sheet and income statement purposes.

The lease liability will be remeasured in subsequent periods for modifications to the lease, changes in the expected payments due under residual value guarantees, or changes in incentives related to exercising certain options. The IASB also requires remeasurement when the cash flows of the lease change (e.g., rent increases due to changes in an index, such as the Consumer Price Index).

What’s next?

Companies should move forward with considering the potential impact of the new leasing guidance. Since most leases will now be recorded on the balance sheet, the new standard may affect balance sheet-related ratios or debt covenants. The changes in presentation may also impact EBIT and EBITDA for companies using IFRS since interest and/or amortization are added back while lease expense typically is not. Finally, changes are likely to have related impacts on systems and controls that will take time to assess.
The US GAAP leasing standard is effective for annual periods beginning on or after December 15, 2018 for public business entities and December 15, 2019 for all other entities. Early adoption is permitted, and adoption must be applied on a modified retrospective basis. Companies should consider the multiple relief provisions offered by the FASB when developing a transition plan.

The IFRS guidance is effective for annual reporting periods beginning on or after January 1, 2019. Companies can early adopt, but only in conjunction with the new IFRS revenue standard. IFRS does not require a full retrospective application but allows a simplified approach. However, full retrospective application is also permitted.

For more information

Make a fast break by reading In depth US2016-02, The leasing standard - A comprehensive look at the new model and its impact, for more information on the new lease guidance.

FASB inbounds new guidance on classifying and measuring financial instruments

The FASB issued the first of three expected updates affecting financial instrument accounting—this one focused on classification and measurement of financial assets and liabilities. The remaining updates are expected to be finalized during 2016 (related to impairment) and likely into 2017 (related to hedging).

The new guidance impacts: accounting for equity investments, accounting for financial liabilities under the fair value option, and the presentation and disclosure requirements for financial instruments. Certain financial institutions, such as retail and commercial banks and insurance companies, are most likely to be affected by the new guidance. Likewise, companies with large equity investment portfolios that are not currently being measured at fair value through net income may also be significantly impacted.

Some changes available for adoption sooner than others

The new guidance is effective for public business entities (PBEs) in fiscal years beginning after December 15, 2017. All other entities will have an additional year, or may early adopt as of the effective date for PBEs.

Certain provisions of the new guidance can be early adopted. For example, all companies can early adopt the provision to record certain fair value changes for financial liabilities in other comprehensive income for any period in which annual or interim financial statements have not yet been issued. However, only entities that are not PBEs can early adopt the provision to omit fair value disclosures for financial instruments at amortized cost.

For more information

To learn more about the specifics required by the new guidance, read In depth US2016-01, New guidance on recognition and measurement to impact financial instruments.
On the horizon

Forthcoming stock comp guidance scores trifecta of potentially significant financial statement impacts

The FASB’s latest pivot from major standard-setting projects to targeted simplifications will soon yield a final stock-based compensation simplification standard (expected this month). Though it will simplify the accounting, it may have significant effects on three high-profile areas for companies: net income, EPS, and the statement of cash flows.

For companies wanting to embrace the changes as soon as possible, immediate adoption is expected to be allowed. But there’s a catch: all elements of the amendments will need to be adopted at once rather than piecemeal.

Windfall pools get ejected

Under the new guidance, all excess tax benefits and tax deficiencies will be recognized in the income statement as they occur. This will replace the current guidance, which requires tax benefits that exceed compensation cost (windfalls) to be recognized in equity. It will also eliminate the need to maintain a “windfall pool,” and will remove the requirement to delay recognizing a windfall until it reduces current taxes payable.

The new guidance will also change the cash flow presentation of excess tax benefits, classifying them as operating inflows—consistent with other cash flows related to income taxes. Today, windfalls are classified as financing activities.

These changes may result in more volatile net earnings, especially for companies that are extensive users of equity compensation or that have volatile share prices. Similarly, effective tax rates will be subject to more variability since the new guidance reflects all tax benefit excesses and deficiencies in tax expense. Under today’s model, stock compensation generally doesn’t impact the effective tax rate since any difference between compensation cost and the ultimate tax deduction is reflected in APIC.

Finally, most companies with stock-based compensation will show additional dilutive effects in EPS calculations. This is because there will no longer be excess tax benefits recognized in APIC. Today those excess tax benefits are included in assumed proceeds from applying the treasury stock method when computing diluted EPS.

Maxing out withholdings

Under the current guidance, withholding anything more than the employee’s minimum statutory requirement as part of a net settlement triggers liability classification of the entire stock-based compensation plan. The new guidance will allow companies to provide net settlement of stock-based compensation to cover tax withholding as long as the net settlement doesn’t exceed the maximum individual statutory tax rate in the employee’s tax jurisdiction.

Private companies may consider the new rules something to cheer about. Net settlements today often don’t cover an employee’s full tax responsibility, meaning those individuals need to pay out of pocket to cover taxes. Since the underlying shares are illiquid, this can be a cash flow challenge for the employee. Under the amended guidance, the entire tax liability for the employee can be covered through net settlement.
To forfeit or not to forfeit

Under the amended standard, companies will be able to make an accounting policy election to either (1) continue to estimate forfeitures or (2) account for forfeitures as they occur. There’s no rebound opportunity here—you only get one shot to change your accounting policy. Any change after that would be considered a change in accounting principle, subject to all the requisite considerations (e.g., preferability assessment, retrospective application, etc.).

Nonpublic companies get a few additional opportunities to score

The new guidance will provide private companies with additional simplifications. For example, they will be able to estimate the expected term for most stock options using the same simplified method as SEC registrants. They can also make a one-time accounting policy election to switch from measuring all liability-classified awards at fair value to intrinsic value.

For more information

For more information on the new guidance, watch our March 29 webcast, Taking stock of stock compensation. Also keep an eye out for forthcoming In brief, In depth, and Private company reporter publications on the new standard.
**Corporate governance**

**Feeling like a rookie when it comes to overseeing IT?**

Overseeing a company's information technology activities remains a significant concern for today's boards of directors. Cybersecurity risks, the rapid pace of change, the complicated subject matter, and the technical jargon used to describe technology and associated risks make this a challenging area.

*Directors and IT*, our user-friendly guide specifically for boards, has been updated to help bridge the “IT confidence gap.” We offer an IT Oversight Framework that can help directors meet their IT oversight responsibility. This framework involves looking at all IT activities in a holistic manner and getting the right cybermetric information in the boardroom.

We share data and insights on what’s happening in the boardroom, including:

- which directors are currently involved in overseeing IT at the board level;
- whether boards need digital experts;
- how many board hours are spent discussing IT;
- how much IT spending is on security;
- whether directors are involved with reviewing IT budgets;
- how frequently today's board is communicating with the CIO; and
- whether the company needs a Chief Information Security Officer.

We also provide supplemental tools for directors, including background information, related potential rewards and risks, and board considerations on IT subjects (e.g., data security and privacy, mobile computing, cloud services, social media, and big data) that may be relevant to their companies.

For more information

Refer to the *Directors and IT* abridged or complete guides. For more insights on governance over IT issues, also read Paula Loop's recent blog, *Corporate Boards Giving More Attention to Information Technology*. 
## Appendix

Standards effective in 2016 or earlier for calendar year-end public companies

<table>
<thead>
<tr>
<th>ASU Year</th>
<th>Description</th>
<th>Public companies</th>
<th>Nonpublic companies</th>
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<tr>
<td>2015-01</td>
<td>Income Statement—Extraordinary and Unusual Items (Subtopic 225-20): Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items</td>
<td>Fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015*</td>
<td>Fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015*</td>
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<td>2015-02</td>
<td>Consolidation (Topic 810): Amendments to the Consolidation Analysis</td>
<td>Fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015*</td>
<td>Fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016, and interim periods beginning after December 15, 2017*</td>
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<td>ASU 2015-03</td>
<td>Interest-Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs</td>
<td>Public companies: Fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015*</td>
<td>Nonpublic companies: Fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015, and interim periods beginning after December 15, 2016*</td>
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<td>ASU 2015-15</td>
<td>Interest—Imputation of Interest (Subtopic 835-30): Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements - Amendments to SEC Paragraphs Pursuant to Staff Announcement at June 18, 2015 EITF Meeting</td>
<td>Should be adopted concurrent with adoption of ASU 2015-03*</td>
<td>Should be adopted concurrent with adoption of ASU 2015-03*</td>
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<td>ASU 2015-06</td>
<td>Earnings per share (Topic 260): Earnings Per Share (Topic 260): Effects on Historical Earnings per Unit of Master Limited Partnership Dropdown Transactions (a consensus of the Emerging Issues Task Force)</td>
<td>Fiscal years beginning after December 15, 2015, and interim periods within those fiscal years*</td>
<td>Fiscal years beginning after December 15, 2015, and interim periods within those fiscal years*</td>
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<td>ASU 2015-07</td>
<td>Fair Value Measurement (Topic 820): Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent) (a consensus of the Emerging Issues Task Force)</td>
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<td>ASU 2015-10</td>
<td>Technical Corrections and Improvements</td>
<td>Transition guidance varies based on the amendments in this Update. The amendments in this Update that require transition guidance are effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015*</td>
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<td>ASU 2015-16</td>
<td>Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments</td>
<td>Fiscal years beginning after December 15, 2015, including interim periods within those fiscal years. Apply prospectively to adjustments to provisional amounts that occur after the effective date*</td>
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<td>ASU 2016-03</td>
<td>Intangibles—Goodwill and Other (Topic 350), Business Combinations (Topic 805), Consolidation (Topic 810), Derivatives and Hedging (Topic 815): Effective Date and Transition Guidance (PCC 15-01)</td>
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*early adoption permitted
Standards effective after 2016 for calendar year-end public companies

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<td>Revenue from Contracts with Customers (Topic 606), as amended by ASU 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date</td>
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<td>Inventory (Topic 330): Simplifying the Measurement of Inventory</td>
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<td>ASU 2016-02</td>
<td>Leases (Topic 842)</td>
<td>Fiscal years beginning after December 15, 2018, including interim periods within those fiscal years*</td>
<td>Fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020*</td>
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<td>ASU 2016-04</td>
<td>Liabilities—Extinguishments of Liabilities (Subtopic 405-20): Recognition of Breakage for Certain Prepaid Stored-Value Products (a consensus of the EITF)</td>
<td>Financial statements issued for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years*</td>
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