Governance Insights Center

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Approaching the 2016 year-end financial reporting season

Five things for audit committees to think about

The 2016 calendar year-end financial reporting season is approaching and audit committees are preparing for their year-end meetings. Here, we highlight some of the financial reporting issues, SEC trends and other developments that audit committees should be thinking about.

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1. Are we on course to adopt the new revenue recognition standard?

In May 2014, the FASB issued its new standard on revenue recognition. The standard, which largely removed industry-specific guidance, is meant to allow investors to better compare financial statements across companies and industries. It is also intended to simplify today's revenue recognition guidance by making it principles-based. But, depending on the company or industry, the new standard could greatly change the timing of, recognition of, and, in some cases, the amount of, revenue compared to the current rules. These changes could have ripple effects on key performance measures and debt covenant ratios, and could ultimately affect contract negotiations, budgets, and even business models.

What should the audit committee be thinking about?

The 2018 effective date may seem far away, but audit committees need to be thinking about the new standard now. Many companies have experienced or anticipate difficulties implementing the new standard—with a potentially time-consuming review of customer contracts topping the list of implementation challenges. Yet our research finds that three-fourths of public companies are still assessing the impact, and only 17% say they have taken the next step toward implementation.[1] The SEC has been closely watching and has expressed some concern over company readiness.[2]

When is it effective?

For calendar year companies, the new FASB standards will take effect in the first quarter of 2018. Non-calendar year companies must comply during the first interim period within annual reporting periods beginning after December 15, 2017. Nonpublic entities have an additional year. A company can apply the new revenue standard retrospectively, including using certain practical expedients. Or, the cumulative effect of applying the new standard to existing contracts can be reflected in the opening balance of retained earnings on the effective date—with proper disclosures.

1 PwC/FERF, *2016 Revenue recognition survey*, 2016.

2 SEC Chief Accountant Wesley R. Bricker, Remarks before the 2016 AICPA Conference on Current SEC and PCAOB Developments, December 5, 2016.

In light of this, audit committees should review their companies' proposed implementation timeline. Does it align with the effective date? Is it realistic given the complexity of the company's operations, business model and attendant revenue streams as well as the policy, system, process and control updates required?

Audit committees will want to understand:

- How management has interpreted the new standard and its assessment of the impact on the company's revenue model
- Management's project plan for implementation, including when key milestones will be met
- How new decision points and required disclosure will affect IT systems, processes, and internal controls, and how management is evaluating existing contracts, revenue models, and business practices
- Whether current filings properly disclose the potential impact of the new standard, if known
- The expected impact on pay programs and any related changes to company policies and practices
- The impact on current business activities, contract negotiations, budgeting, and key metrics

Where to go for more information:

CFOdirect resources on revenue recognition

Accounting advisory resources on revenue recognition

2. Are we comfortable with the company's use of non-GAAP measures?

Use of non-GAAP measures in company filings has grown over the past several years, as companies seek to give investors what they see as a fuller picture of company performance. SEC regulations allow the use of these measures, but there are strings attached (such as needing to present the most comparable GAAP figure first and including a reconciliation of the non-GAAP amount to the GAAP figure). In recent years the SEC has targeted the use of non-GAAP measures that it believes could be potentially misleading to investors. And in May 2016, the SEC staff issued clarifying guidance on the use of these measures. The update calls out potentially problematic practices, including:

- Performance measures that exclude normal, recurring cash operating expenses necessary to operate a company's business
- Use of non-GAAP measures inconsistently between periods without disclosing the change and the reasons for change
- Non-GAAP measures that exclude non-recurring charges but do not exclude non-recurring gains
- Individually-tailored accounting principles used to calculate non-GAAP earnings—for example, a non-GAAP revenue metric that accelerates revenue recognition
- Disclosures that cause a non-GAAP measure to be more prominent than the closest comparable GAAP measure

Recent SEC comment letters on the topic have focused on a few key areas. The most common issue identified is the failure to include the most directly comparable GAAP financial measure with equal or greater prominence. The SEC is also frequently asking companies to explain how the non-GAAP measures help investors understand the company's operations and financial results. Additionally, the SEC has targeted improper labeling of non-GAAP measures that sound too similar to a GAAP measure.

What should the audit committee be thinking about?

Audit committees will want to understand what non-GAAP measures are being used in filings, and why. They should ask management how they will ensure that when the measures are used, it is done in line with the new SEC guidance. Audit committees will also want to:

- Read the disclosure that includes non-GAAP measures (and other key metrics communicated to analysts) and decide whether it is fair, balanced, and transparent
- Understand how management ensures that the calculation of the non-GAAP measures and other key metrics are accurate and consistent with those of prior periods considering that the information is not typically covered by a company's internal control over financial reporting and is not audited
- Look to peers to evaluate whether use of non-GAAP measures is commonly accepted and measures used are similar
- Understand how non-GAAP measures could affect executive compensation
- Evaluate whether the use of these measures complies with SEC regulations and updated guidance

Where to go for more information:

Audit Committee Excellence Series: To GAAP or non-GAAP? The SEC is watching

3. How will we be impacted by the new lease accounting standard ?

In February 2016, the FASB issued a new standard on lease accounting. The new standard could impact almost all companies to some extent, but lessees will likely see the biggest changes. Lessees will now need to recognize virtually all of their leases on the balance sheet (i.e., a liability for the future lease payments and a corresponding right-of-use asset), even if the lease is embedded in another arrangement, such as a long-term contract. Each lease also needs to be classified as an operating or finance lease. Operating leases will have straight line rent expense. Finance leases will follow a traditional interest-amortization model.

When is it effective?

For most calendar year entities, the new FASB standards will take effect in the first quarter of 2019. Private companies have an additional year to comply. Companies are required to adopt the standard using a modified retrospective transition approach, which requires application of the new guidance at the beginning of the earliest comparative period presented in the year of adoption. Early adoption is permitted. Lessors may want to consider interactions with the revenue standard and adopt at the same time.

Although this is an accounting change, systems and data issues will likely present challenges for companies. In preparation, management will need to identify and review all existing leases and other contracts that may contain embedded leases. Once the leases are identified, all lease terms will need to be analyzed to measure the amounts that will go on the balance sheet. This could be a time-consuming and difficult effort, depending on the number of leases, their variety and complexity, the availability of records, and the sophistication of current systems.

What should the audit committee be thinking about?

Management will need to discuss with the audit committee how it is analyzing the impact of this new standard on the company. Audit committees will also want to understand:

- The effort required to get the information necessary, and the planned timeline to ensure adoption by the required date
- Management's process for creating a complete and accurate inventory of leases
- How management has evaluated the impacts beyond financial reporting (e.g., debt covenants, apportionment of income for state taxes, and determining whether to lease or buy in the future)

Where to go for more information:

Accounting advisory resources on lease accounting standards

10Minutes on the new US lease standard

4. Should we enhance our audit committee proxy disclosures?

Over the last several years, there has been a growing interest by investors, regulators, and other stakeholders in better understanding the audit committee's role in oversight of the external auditor. In response, a growing number of audit committees have chosen to voluntarily provide more relevant and useful information to investors and other stakeholders about how they perform their role. And recent research affirms the continued rise in such voluntary proxy disclosures by S&P 500 companies.[3] In particular:

- *Audit partner selection*—43% now state that the audit committee is involved in audit partner selection, compared to 13% in 2014
- *Audit firm evaluation/supervision*—34% now discuss criteria considered when evaluating the audit firm, up from 8% in 2014
- *Audit firm selection/ratification*—31% now disclose the audit committee's considerations in recommending the audit firm's appointment, up from 13% in 2014
- *Audit firm compensation*—17% now explicitly state the role the audit committee plays in negotiating audit fees, up from 8% in 2014

What should the audit committee be thinking about?

Audit committees considering changes should re-read their previous disclosure with an eye to how they can better explain the work that they do to investors and other stakeholders. Audit committees will also want to consider:

- Asking management to propose sample disclosure covering the categories to the left, and others tracked in the Center for Audit Quality's *2016 Audit Committee Transparency Barometer*
- Benchmarking proxy disclosures of peers and competitors
- Reviewing the proxies of companies that have already embraced enhanced disclosure

3 Center for Audit Quality/Audit Analytics, *2016 Audit Committee Transparency Barometer,* November 2016.

5. Do we have our arms around recent developments in the income tax space?

As audit committees think about where to spend more time, the income tax area may be moving up the list. A number of issues are converging in this area, including a continued emphasis by the SEC staff on income tax disclosures as noted in comment letters, and a new FASB standard related to tax accounting for intercompany transactions.

In addition, there are developments in the way governments—including the US—are looking at changing tax laws or furthering enforcement. For example, governments around the world facing budget shortfalls are questioning whether multinational companies are paying their "fair share" of taxes. The OECD's[4] base erosion and profit shifting (BEPS) project is likely to spur significant changes in the taxation of international businesses in the future, and may trigger the need for changes to companies' tax structures.

There have been several recent developments in the tax area that audit committees should be aware of:

- **FASB standard update on intra-entity transfers.** In October 2016, the FASB issued new guidance that will require the immediate recognition of the current and deferred tax consequences from an intra-entity asset transfer of an asset other than inventory. One such example would be the sale of intellectual property. This guidance is effective in 2018 but can be adopted in 2017, but only during the first quarter. When adopted, this new guidance could have a significant impact on the company's effective tax rate.
- **Internal Revenue Code (IRC) Section 385 regulations.** Also in October 2016, the US Treasury Department and Internal Revenue Service finalized new regulations under Section 385, which relates to intercompany borrowings. The new rules are intended to minimize the ability of US entities to deduct interest on certain borrowings from foreign related parties by treating them as equity instead of debt for US federal tax purposes. Depending on a company's global structure, this change in tax law could have an impact going forward. Generally, there is no impact until 2017 but the rules may apply to arrangements already in place. The new regulations also impose significant new documentation requirements.

4 The Organization for Economic Co-operation and Development (OECD) is an intergovernmental economic organization with 35 member countries.

Looking forward, tax reform is certainly top of mind in Washington and around the world. President-elect Trump's call for action on comprehensive tax reform, including significantly lowering business income tax rates, is expected to receive strong support from Republicans in Congress. House Republicans have been drafting language for the tax reform "blueprint" that they released earlier this year, which differs in some respects from Trump's tax proposals. House Speaker Paul Ryan (R-WI) has said a Republican-controlled Congress could quickly adopt tax reform in 2017 by using "budget reconciliation" procedures that allow legislation to be approved in the Senate with a simple 51-vote majority, instead of the 60 votes generally needed to advance legislation.

What should the audit committee be thinking about?

Audit committees will want to understand the impact of recent developments in tax policy on a global basis and stay updated on the potential impact of US tax reform efforts under the new administration. Audit committees will also want to:

- Understand the potential impact of the OECD's BEPS project on the global tax picture
- Discuss with management their assessment of the impact of the new FASB guidance on intra-entity asset transfers and IRC Section 385 regulations
- Stay updated on recent trends in SEC comment letters related to income taxes to assess the adequacy of current disclosures and other areas of focus

Where to go for more information:

10Minutes on the OECD's BEPS project

In brief: FASB simplifies tax accounting for intra-entity asset transfers

How PwC can help

To have a deeper discussion about how this topic might impact your business, please contact your engagement partner or a member of PwC's Governance Insights Center.

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