Current Trends in Mergers & Acquisitions & Accounting Hot Topics
Agenda

Current Trends in Mergers & Acquisitions  Michelle Ritchie

Accounting Hot Topics:
FASB and Standard Setting Update  Ken Lemelin
Leasing  Sheri Wyatt

SEC and PCAOB Update  Sarah Martin
SEC Reporting and Comment Letter Trends  Sarah Martin

IFRS Update  Ken Lemelin

Income Tax Accounting – Judgments and Estimates  Chris McGowan
Current trends in mergers and acquisitions
Topics

Overview of recent market trends
Deal issues being encountered in today’s market
Summary and outlook for 2013
Questions
Overview of recent market trends
Recent annual deal volumes have been relatively consistent after a decline in 2008-2009


Source: M&A activity is compiled from Thompson Reuters which aggregates deal activity from around the world using multiple sources to confirm deal occurrence and their respective characteristics. Thompson Reuters has been used for deal activity information from 2000 – Jun-13.
Strong M&A activity in Q4-12 led to a slower first half in 2013

Source: Thompson Reuters
Global trends fairly consistent with US trends, although European and emerging markets vary


Source: Thompson Reuters
**US inbound deal activity is between 12-14% of total deal volume**


- **2008**: 14%
- **2009**: 14%
- **2010**: 14%
- **2011**: 14%
- **2012**: 13%
- **LTM Jun-13**: 12%

Source: Thompson Reuters

PwC
US outbound deal activity is higher than inbound activity at 15-18% of total US deal activity


Source: Thompson Reuters
Deal activity is spread across various sectors, with concentrations in Tech and Industrials.
The proportion of deal activity by sector has remained relatively consistent in recent years.


Source: Thompson Reuters
*Note: Other includes: Government and Agencies and Retail
Deal issues being encountered in today’s market
Why do due diligence?

- Understand the “true story” of the business
- Determine normalized earnings
- Differences in interim/monthly financial information
- Analyze future expectations
- Identify issues – goal differs from that of an audit
Overview of valuation approach

Enterprise Value

Multiple of EBITDA or similar measure, such as discounted cash flow, free cash flow, etc.

Working capital

A level of working capital to be delivered at closing

Debt and cash

Identify liabilities that should reduce purchase price if assumed by the buyer.

Total purchase price calculation in the Agreement

Other items
Due Diligence Adjustments (1 of 2)

Quality of Earnings
- Reported EBITDA
- +/- Normalized adjustments
  - Management adjustments
  - Due diligence adjustments
  - Pro-forma adjustments
  - Other considerations

= Adjusted EBITDA

- Common due diligence adjustments to reported EBITDA:
  - Changes in accounting principles
  - One-time items (non-recurring or non-core expenses)
  - New or lost significant customers
  - Discontinued product lines
  - Effects of restructurings and severance
  - Discontinued operations
  - Gains/losses on sales of fixed assets
  - Related Party transactions (e.g., royalty payments, services/goods transferred), to the extent they will not continue post transaction at the same rates
Quality of Earnings
- Reported EBITDA
- +/- Normalized adjustments
  - Management adjustments
  - Due diligence adjustments
  - Pro-forma adjustments
  - Other considerations
= Adjusted EBITDA

• Common due diligence adjustments to reported EBITDA:
  - Personal/family related expenses
  - Extraordinary bonuses
  - FX transaction gains/losses
  - Stand-alone cost issues
  - Changes/reversals in reserves or accrual estimates and methodologies
  - Cost capitalization items – cash spend vs. P&L charges
  - Excessive legal fees or one-time legal settlement expense or income
  - Adjustments proposed by auditors, but waived due to materiality
Summary and outlook for 2013
The M&A market landscape is competitive

- Competition is driving valuations
- Shortage of quality assets
- Growing list of willing acquirors
- Need for confidence and greater preparation
- Competition is driving timelines
Sustained deal activity expected through end of 2013 driven by a number of factors

- Competitive marketplace
- Readily available financing & strong equity markets
- Corporate levels of cash at $1.29 trillion
- Search for growth and value creation
Software transactions will likely dominate volumes driven by the shifts in cloud, mobile and security

Private equity funds continue to play an active role

Divestitures expected as hardware-centric technology players refocus on a software-centric future

Ongoing cloud and mobile convergence, coupled with record levels of cash, lend confidence to deal activity rebound
Health Industries outlook

Health industries
• Consolidation of assets expected to continue
• Implementation of major provisions of the Affordable Care Act may cause companies to look for innovative partnerships, etc.

Pharma
• Looking for innovative technologies and products to support growth and diversify portfolios
• Looking beyond BRIC to new ‘frontier markets’ to seek growth and innovation
Financial Services outlook

Regulatory costs

Valuation gap remains

Depressed organic growth

Different perceptions of future profitability presents a challenge

Activity in H2-13 may come from:
• divestitures of non-core assets by major European institutions
• restructuring by US financial services companies as they comply with regulations

Depressed organic growth presents a challenge.
Retail & Consumer outlook

Solid deal fundamentals – corporate growth and PE funds

Finding quality businesses a challenge

Mismatches between buyer and seller price expectations

Relatively positive trends in consumer sentiment & retail sales

Continued cross border retail activity
Summary

Increased US M&A activity as

(a) Market conditions are in place to support growth

(b) US recession recovery

However, headwinds abroad may impact focus areas

Global CEO Survey shows Deals as a top priority

Organic growth in line with GDP falls short of long-term goals

Credit is available

Equity markets at record highs

Debt multiples remain relatively strong
Questions?
Accounting Hot Topics
Leasing, IFRS, Tax, and SEC Hot Topics
FASB and Standard Setting Update
### The current state of convergence projects – FASB timeline

<table>
<thead>
<tr>
<th>Project</th>
<th>Q3 2013</th>
<th>Q4 2013</th>
<th>1H 2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue recognition (effective 2017)</td>
<td>![Comment period]</td>
<td>![Deliberations / Redeliberations]</td>
<td>![Exposure draft (or re-exposure)]</td>
</tr>
<tr>
<td>Financial Instruments – classification &amp; measurement</td>
<td>![Comment period]</td>
<td>![Deliberations / Redeliberations]</td>
<td>![Final standard]</td>
</tr>
<tr>
<td>Financial Instruments – impairment</td>
<td>![Comment period]</td>
<td>![Deliberations / Redeliberations]</td>
<td>![Final standard]</td>
</tr>
<tr>
<td>Financial Instruments – hedging</td>
<td>![Comment period]</td>
<td>![Deliberations / Redeliberations]</td>
<td>![Final standard]</td>
</tr>
<tr>
<td>Leases</td>
<td>![Comment period]</td>
<td>![Deliberations / Redeliberations]</td>
<td>![Final standard]</td>
</tr>
<tr>
<td>Insurance contracts</td>
<td>![Comment period]</td>
<td>![Deliberations / Redeliberations]</td>
<td>![Final standard]</td>
</tr>
</tbody>
</table>
The current state of FASB – only projects

- Repurchase agreements
- Consolidation (effective TBD)
- Discontinued operations
- Going concern
- Definition of nonpublic entity

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<tr>
<td>Definition of nonpublic entity</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Legend:
- Comment period
- Deliberations / Redeliberations
- Exposure draft (or re-exposure)
- Final standard
On The Horizon – Leasing
Lease accounting overhaul
Perceived problems with existing lease accounting rules

Lessee

• Financial statements do not clearly depict the impact of operating leases
• “Bright lines” reduce transparency and comparability
• Opportunities to structure transactions to achieve a particular lease classification
• Current accounting believed to be conceptually flawed

Lessor

• Question around whether lessor accounting is “broken”
Lease project
Timeline

<table>
<thead>
<tr>
<th>Effective Date</th>
<th>Years Presented in SEC Financial Statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY 2017</td>
<td>FY 2015, FY 2016, FY 2017</td>
</tr>
<tr>
<td>FY 2018</td>
<td>FY 2016, FY 2017, FY 2018</td>
</tr>
</tbody>
</table>
FASB alternative views

Proposal is complex and does not meet user needs

- Hinders users’ abilities to assess the amount, timing, and uncertainty of the cash flows
- Does not represent an improvement to existing requirements for lessees
- Benefits do not justify the costs
- Proposed disclosures do not provide decision-useful information
# Summary of key changes...from the starting point

## Definition of a lease / embedded lease

<table>
<thead>
<tr>
<th>Current Model</th>
<th>2013 ED</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Many embedded leases are off balance sheet operating leases</td>
<td>• On balance-sheet treatment for embedded leases</td>
</tr>
<tr>
<td></td>
<td>• A lease requires control over an identified asset</td>
</tr>
</tbody>
</table>

## Lessee accounting

<table>
<thead>
<tr>
<th>Current Model</th>
<th>2013 ED</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Operating lease</td>
<td>• All leases on balance sheet (except short term leases)</td>
</tr>
<tr>
<td>• Capital lease</td>
<td>• Income statement:</td>
</tr>
<tr>
<td></td>
<td>• Financing approach (Type A)</td>
</tr>
<tr>
<td></td>
<td>• Straight line approach (Type B)</td>
</tr>
</tbody>
</table>

## Lessor accounting

<table>
<thead>
<tr>
<th>Current Model</th>
<th>2013 ED</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Operating lease</td>
<td>• Operating leases approach</td>
</tr>
<tr>
<td>• Direct financing lease or Sales-type lease</td>
<td>• Receivable and residual approach</td>
</tr>
<tr>
<td>• Leveraged leases</td>
<td>• No more leveraged leases accounting</td>
</tr>
</tbody>
</table>

## Lease term

<table>
<thead>
<tr>
<th>Current Model</th>
<th>2013 ED</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Include renewal options that are &quot;reasonably assured&quot; of being exercised</td>
<td>• Include renewal options where lessee has “a significant economic incentive” to exercise</td>
</tr>
</tbody>
</table>

## Variable lease payments

<table>
<thead>
<tr>
<th>Current Model</th>
<th>2013 ED</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Contingent rentals are generally expensed as incurred</td>
<td>• Usage or performance-based rents are not included</td>
</tr>
<tr>
<td>• Rents based on index/rate and in-substance fixed are included</td>
<td>• Rents based on index/rate and in-substance fixed are included</td>
</tr>
<tr>
<td>• Remeasurement not required</td>
<td>• Remeasurement required</td>
</tr>
</tbody>
</table>
**Definition of a lease; embedded lease**

**Identified Asset:** Use of the asset is fundamental to the arrangement, but need not be contractually specified.

**Control:** The company can direct and benefit from the use of the asset.
The chart above depicts the impact on earnings for a basic 10-year lease with an initial annual rent of $2,000, a 2% annual escalation rate and an assumed incremental borrowing rate of 7%.

Lessor model would have a similar impact.
## Consumption based principle

<table>
<thead>
<tr>
<th>Other than property (Type A)</th>
<th>Property (Type B)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Consumption</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Residual</strong></td>
<td></td>
</tr>
<tr>
<td><strong>FV or Life</strong></td>
<td></td>
</tr>
<tr>
<td>Start of Lease</td>
<td></td>
</tr>
<tr>
<td>Lease term</td>
<td></td>
</tr>
<tr>
<td>End of Lease</td>
<td></td>
</tr>
</tbody>
</table>

### Pricing

Lease payments designed to provide return on and of (i.e. principle) lessor’s investment down to residual

### Presumption

Asset consumed

### Property (Type B)

<table>
<thead>
<tr>
<th><strong>Consumption</strong></th>
<th><strong>Residual</strong></th>
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</thead>
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<tr>
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<td>End of Lease</td>
<td></td>
</tr>
</tbody>
</table>

### Pricing

Lease payments designed predominantly to provide return on investment

### Presumption

Asset not consumed
The new dividing line

- Property
  - *Major or substantially all
  - Less than major and less than substantially all
- Non-Property
  - *More than insignificant
  - Insignificant

* Lease term or payments compared to the economic life or fair value of the asset
Components and primary asset

Do you have a lease?

Separate lease and non-lease elements

Do you have more than one lease component?

Determine nature of asset for each lease component for classification*

*If component has elements of property and non-property, assess which element is the “primary asset”
## Lessee accounting

<table>
<thead>
<tr>
<th></th>
<th>Balance Sheet</th>
<th>Income Statement</th>
<th>Cash Flows</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financing (Type A)</td>
<td>Right-Of-Use (ROU) asset</td>
<td>Amortization expense</td>
<td>Principal = Financing</td>
</tr>
<tr>
<td></td>
<td>(1)</td>
<td>Interest expense</td>
<td>Interest = Operating (3)</td>
</tr>
<tr>
<td></td>
<td>Lease liability (2)</td>
<td>Lease expense</td>
<td>Variable = Operating</td>
</tr>
<tr>
<td>Straight line / Short</td>
<td></td>
<td></td>
<td>Operating</td>
</tr>
<tr>
<td>term (Type B)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1. Initially measured at same amount of liability plus initial direct costs
2. Measured at present value of lease payments; subsequently measured at amortized cost using effective interest method
3. Presentation may be different under IFRS
# Lessor accounting

<table>
<thead>
<tr>
<th>Balance Sheet</th>
<th>Income Statement</th>
<th>Cash Flows</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receivable and residual (Type A)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Derecognize part of underlying asset and record:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lease receivable (1)</td>
<td>Profit on asset derecognized (3)</td>
<td>Operating</td>
</tr>
<tr>
<td>Residual asset (2)</td>
<td>Interest income on receivable and residual (4)</td>
<td></td>
</tr>
<tr>
<td>Straight line (Type B)</td>
<td>Underlying asset remains on balance sheet</td>
<td>Lease income – straight line over term of lease</td>
</tr>
</tbody>
</table>

1. Present value of lease payments plus initial direct costs
2. Measured at an allocation of carrying amount of leased asset
3. Profit allocated to receivable and residual on relative fair value basis. Profit on receivable is recognized on day one; any profit on the residual asset is not recognized until asset sold or re-leased at end of lease term
4. Interest on residual based on estimated residual value
**Lease term**

**Lease extension options**
- Included when the lessee has a “significant economic incentive” to exercise an option to extend (or not to terminate) the lease

**Indicators**
- Likely to be similar to those considered today
- Substantive bargain renewal options or economic penalties for non-renewal

**Application questions**
- Likely on how “significant economic incentive” differs from the existing “reasonably assured” guidance
## Variable lease payments

<table>
<thead>
<tr>
<th>INCLUDE</th>
<th>(in measurement of the lease obligations and assets)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contingencies that are based on a rate or an index</td>
<td></td>
</tr>
<tr>
<td>Any contingency that is an in substance (or “disguised”) fixed lease payment</td>
<td></td>
</tr>
<tr>
<td>Any portion of residual value guarantees that are expected to be paid* and</td>
<td></td>
</tr>
<tr>
<td>“Term option penalties” when consistent with renewal option assumptions</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>EXCLUDE</th>
<th>(unless in-substance fixed lease payments)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variable lease payments that are usage-based (e.g. number of miles drive) or performance-based (e.g. based on tenant sales)</td>
<td></td>
</tr>
</tbody>
</table>

*For lessors, payments structured as residual value guarantee (RVG) should be included in the lease receivable at the commencement date.

Note: Remeasure if facts or circumstances indicate a significant change.
Remeasurement considerations

Do lease payments depend on an index or rate?

Have there been significant change in relevant factors?

Is there a significant modification to the contractual terms?

Is there a significant economic incentive to exercise any options to extend or terminate the lease?
## Transition

- For existing capital, sales-type, direct financing leases
  - No adjustment to existing assets and liabilities at transition date required
  - Specific guidance on the subsequent measurement of those assets and liabilities is provided within the standard

- For existing operating leases, see below

### Full Retrospective

- Apply new rules at commencement for each lease

### Modified Retrospective

<table>
<thead>
<tr>
<th>Lessees</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease liability at transition based on remaining payments. Use incremental borrowing rate at effective date (portfolio basis)</td>
<td></td>
</tr>
<tr>
<td>Type A lease: Right of use asset at transition based on proportion of lease liability at commencement, calculated based on remaining lease payments plus/minus prepaid/accrued rent</td>
<td></td>
</tr>
<tr>
<td>Type B lease: Right of use asset equals the lease liability plus/minus prepaid/accrued rent</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Lessors (Type A)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease receivable at transition based on remaining lease payments</td>
<td></td>
</tr>
<tr>
<td>Derecognize portion of underlying asset</td>
<td></td>
</tr>
<tr>
<td>Recognize residual at transition based on receivable and residual approach</td>
<td></td>
</tr>
</tbody>
</table>

- Hindsight allowed
- Initial direct costs need not be estimated

- Leveraged leases eliminated
- Prepaid and accrued rent adjusts asset

PwC
Resources

- PwC CFOdirect Network
- PwC Dataline: Leases – The Great Divide:
  The new leases landscape (No. 2013-13)
- PwC 10 Minutes on Lease Accounting
- Other publications related to tax impact of proposed standard and its impact on various industries (industrial manufacturing, rail, consumer products, real estate, etc.)
- PwC GAAP Accelerator Tool
  - A web-based platform offering comprehensive project management framework
  - More information can be found on You Tube at [http://www.youtube.com/watch?v=gwzad3mTTRQ](http://www.youtube.com/watch?v=gwzad3mTTRQ)
SEC and PCAOB Update
Key SEC agenda items

- Very active regulatory agenda
  - Response to the economic downturn/financial crisis
  - Creation and implementation of Dodd-Frank
  - Emphasis on corporate governance
- Considerable political and budgetary pressure
  - Historic 3-2 commissioner votes along party lines
  - Significant legal challenges to new rules
- Division of Enforcement continues to be high profile
- Decision on IFRS for domestic registrants
- The JOBS Act
- Iran Threat Reduction and Syrian Human Rights Act of 2012
- 2012 AICPA Conference on current SEC and PCAOB Developments
Significantly reorganized over past few years
- Flatten structure, revamp handling of tips, facilitate swift prosecution through cooperation, create specialized units
- 3 task forces established which include: the Financial Reporting and Audit Task Force, the Microcap Fraud Task Force, and the Center for Risk and Quantitative Analytics

2012 enforcement activity
- $3.1bn in penalties and disgorgements
- 29 financial crisis related actions against 38 individuals (24 CEOs)
- 58 actions related to insider trading
- 79 actions for financial fraud and issuer disclosure violations
- Continued increase in FCPA activity

Whistleblower activities
Restatement trends
10 year comparison (Source: Audit analytics)

Total restatements per unique filer

![Bar chart showing restatement trends from 2003 to 2012.](chart.png)
**Restatement trends**
(Source: Audit analytics)

- The primary causes of restatements have not changed over the past several years
- Top ten restatement causes:
  1. Debt, quasi-debt, warrants & equity (BCF)
  2. Tax expense, benefit, deferral and other issues
  3. Cash flow statement
  4. Acquisitions, mergers, disposals and reorganization accounting issues
  5. Revenue recognition
  6. Accounts/loans receivables, investments & cash issues
  7. Liabilities, payables, reserves, and accrual estimates
  8. Deferred, stock-based, and/or executive compensation
  9. Expenses (payroll, SGA, other)
  10. Intangible or fixed asset issues
PCAOB proposes significant changes to the auditor's report

- On August 13, 2013 the PCAOB proposed a new auditing standard and related amendments that would require the auditor to disclose additional information in the auditor’s report about the audit and the auditor.

- Significant changes to the auditor’s report would include:
  - The communication of critical audit matters specific to the audit
  - A statement containing the year the auditor began serving consecutively as the company’s auditor
  - A statement regarding the auditor’s existing requirements to be independent of the company
  - Enhancements to existing language in the auditor’s report related to the auditor’s responsibilities for fraud and the notes to the financial statements
  - Communications pursuant to another proposed standard on Other Information that the PCAOB issued concurrently

- The comment period ends December 11, 2013
PCAOB proposes new auditing standard on other information

- On August 13, 2013 the PCAOB proposed a new auditing standard and related amendments that address the auditor’s responsibility with respect to other information. The proposed standard would:
  - Apply to the auditor's responsibility with respect to other information in a company's annual report that is filed with the SEC under the Securities Exchange Act of 1934 and that contains the company's audited financial statements and the related auditor's report
  - Enhance the auditor's responsibility with respect to other information by adding procedures for the auditor to perform in evaluating the other information based on relevant audit evidence obtained and conclusions reached during the audit
  - Require the auditor to evaluate the other information for a material misstatement of fact as well as for a material inconsistency with amounts or information, or the manner of their presentation, in the audited financial statements
  - Require communication in the auditor's report regarding the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information
- The comment period ends December 11, 2013
SEC filing review process

- Each registrant to be reviewed at least once every three years
- Depth and scope varies in the type of review and nature of comments (full review, accounting/legal review, or limited review)
- Comparison of SEC filings to other publicly available data (e.g., press releases)
- Comment letters and responses are publicly available via EDGAR 20 business days after review is completed or registration statement is effective
- Division of Corporation Finance recently created 4 new offices to enhance its disclosure review and policy operations:
  - Office of Disclosure Standards
  - Financial Services review office
  - Asset backed-securities
  - Capital markets trends
- Creation of new industry group for large financial institutions
Tips for responding to the staff

- Best practice – Respond fully and completely to the comments
  - Provide all of the facts relevant to the comment
  - Cite the relevant rule, regulation or accounting literature supporting the accounting or disclosure
  - Show practice of comparable companies within the industry
  - Include a draft disclosure or a template
- Contemporaneous documentation (basis of key assumptions and methodology) supporting the estimates and judgments including materiality matters (SAB 99) is key in resolving comments
- Allow adequate time to respond; inform the staff if you need more time
- Ask the staff if you don’t understand their comment
- Keep relevant individuals in the company informed as to the status including the Board, securities counsel and auditors
Tips for responding to the staff

• If you need to discuss comments with the staff, be prepared for the call
  - CFO or controller should lead the discussion – not the advisors
  - Rehearse before the call; assign roles and responsibilities
• Plan that resolving comments may take more time than anticipated
• Keep the interaction with the SEC professional and formal
• Reminder – the comments and your responses will become public
• Keep in mind that many of the staff typically remain with the SEC for a long time
Primary focus areas are:
• Timing of loss recognition
• Disclosures regarding reasonably possible losses
• Accounting policy for legal costs
• Disclosure of indemnification and loss sharing arrangements

• Disclose each item in the effective tax rate reconciliation that exceeds 5% of income tax expense at the statutory rate
• Inappropriately combining items relating to foreign jurisdictions in the tax rate reconciliation
• Disclose allocation of pretax income between foreign and domestic and the related taxes
• Provide quantified information about tax benefits when a material tax benefit is derived from a particular jurisdiction
• Challenge company’s assertion that subsidiary earnings are indefinitely reinvested when registrant has liquidity issues
**Comment letter trends**

**Segment Reporting**

Staff compares other public information to segment disclosures for consistency

Operating segments must have “similar economic characteristics” to be aggregated

Changes in operating segments may impact goodwill impairment test

**Goodwill Impairment**

Staff comments focus on "foreshadowing" disclosures in periods prior to impairment losses

Additional disclosure for reporting units that are at risk for failing step one of impairment test. A reporting unit may be "at risk" if the reporting unit's fair value is not "substantially in excess of its carrying value."
Comment letter trends

Revenue

One or multiple units of accounting

Gross vs. net presentation considerations

Disclosure of reseller/distributor arrangements

Separate presentation required for revenue and cost of revenue line items for bundled arrangements (products vs. services)

Determination of selling price between VSOE, TPE and BESP

Disclose the effects of changes in contract accounting estimates
Comment letter trends

Non-GAAP Measures

Ensure companies present the most directly comparable GAAP measure with equal prominence and with reconciliation.

Describe why the non-GAAP measure is useful information to investors and how management uses the measure.

Disclose the limitation of non-GAAP measures as far as comprehensiveness and comparability.

Prohibition of non-GAAP measures that exclude expenses that are integral to operating the business.
SEC has challenged registrants that don’t provide quantitative information for unobservable inputs
Disclose weighted average of significant inputs when the range is wide
Looking for expanded disclosures about valuation techniques for “Level 2” fair value measurements
Looking for greater granularity around the qualitative disclosures
Comment letter trends

MD&A

- Provide an executive overview
- MD&A should not simply repeat information provided elsewhere; rather, explain the "whys" and "implications"
- Discuss trends, which may have a material impact on future operating results and liquidity
- Critical accounting estimates should discuss how changes in assumptions impact operating results; provide sensitivity analysis for assets that may be impaired in the future
- Focus on liquidity – stranded cash offshore
- Discuss cash flows including drivers of changes in cash flows from operations and trends in cash flow, particularly when cash flow does not correlate to income from operations (e.g., positive cash flow, but operating losses, or vice versa)
- Discuss cyber attacks that have affected, or could materially affect, products, services, customer or supplier relationships, or competitive conditions
IFRS Developments – Globally and in the US
Recent developments

• Most of the world’s capital markets now require IFRS, or some form thereof, for financial statements of public-interest entities

• The remaining major capital markets without an IFRS mandate:
  - US: No current plans to change for domestic registrants; full IFRS allowed for foreign private issuers
  - Japan: Voluntary adoption allowed, but no mandatory date established
  - India: Public statements around intention to adopt, but no formal plans in place
  - China: Currently use a form of IFRS, with intent to fully converge at some undefined future date
SEC staff’s IFRS work plan: the journey

February 2010
SEC publishes a statement of continued support for a single set of high-quality, globally accepted accounting standards, and acknowledged that IFRS is best positioned to serve that role.

October 2010
The first Work Plan progress report issued. It included a routine update on the Staff’s work to date, with no indication of the SEC’s direction.

July 2011
SEC Staff sponsored roundtables to discuss benefits and challenges of potentially incorporating IFRS into the financial reporting system for US issuers.

May 2011
SEC Staff releases a paper describing a possible method to incorporate IFRS into the US financial reporting system:
• US GAAP would remain
• Active endorsing/interpreting FASB
• Incorporation over 5-7 years
• Early adoption not discussed

July 2012
SEC Staff completes IFRS Work Plan:
• Important milestone in journey to single set of high-quality, globally accepted accounting standards
• No final decision made on whether, when, and how IFRS may be incorporated in the US financial reporting system
• Voluntary adoption not discussed
• No timeline of next steps provided

November 2011
SEC Staff released two papers, pursuant to the SEC staff’s IFRS Work Plan:
• Consistency of IFRS application
• Remaining IFRS/FASB framework differences


**SEC staff IFRS work plan: the highlights**

- Adopting IFRS as authoritative guidance in the US not supported by the vast majority of participants in the US capital markets, and would not be consistent with the methods of incorporation followed by other major capital markets

- Substantial support for exploring methods (such as the endorsement method) of incorporating IFRS that demonstrate the US commitment to the objective of a single set of high-quality, globally accepted accounting standards

- Does not include a final decision on whether, when, or how IFRS should be incorporated in the US financial reporting system

- No timeline of when this decision will be made, nor next steps necessary to make this decision were discussed in the final report

- Does not substantively address whether US public companies should be allowed to adopt on a voluntary basis
SEC staff IFRS work plan: the highlights

- Work Plan covers six key areas:
  - Sufficient development and application of IFRS for the US domestic reporting system
  - Independence of standard-setting for the benefit of investors
  - Investor understanding and education regarding IFRS
  - Regulatory environment (studying the effect of a change on US regulators like the IRS, NAIC, OCC, etc.)
  - Impact on issuers
  - Human capital readiness
The reaction

• Those in the US wanting clarity on the road ahead for IFRS were disappointed

• Those outside the US wanting a US commitment to IFRS or, at least, tangible progress toward that goal were frustrated

• In October 2012, the Staff of the Trustees of the IFRS Foundation released a response to the SEC Staff’s final report:
  - While the response recognizes that the size of the US economy presents significant challenges that are unique to the US, it states that the challenges can be overcome with the appropriate political will to make a commitment to the mission of a set of global standards
  - It also discusses responsive actions to certain of the SEC Staff’s concerns, outlines different conclusions in some areas than those reached by the SEC Staff, and provides certain information that the Foundation Staff believes complements the SEC Staff’s analysis
Our point of view: the US path to IFRS remains uncertain

- The long-term vision of using IFRS as the global, high-quality, consistently applied, accounting framework remains compelling; however:
  - Priority convergence projects will not be completed until 2013 and beyond, and the “era” of formal convergence is approaching an end
  - Lack of a business or political mandate for rapid change: support has waned for full, near-term, mandatory adoption of international standards in the US
  - SEC concerns remain, including comprehensiveness, and consistency of application
- Full acceptance of a move to international standards appears to be off the table, at least in the foreseeable future
- Some form of the endorsement method, described by the SEC Staff in their May 2011 paper, is worth pursuing to continue the movement of US GAAP closer to IFRS over a long period of time
**Is IFRS relevant in the US anymore**

- Although a mandatory (or voluntary) change to IFRS for US public companies is no longer in the foreseeable future, IFRS is increasingly relevant to many companies, big and small, public and non-public:
  - Cross-border, M&A activity
  - Reporting needs of non-US stakeholders
  - IFRS requirements of non-US subsidiaries
  - US GAAP changes resulting from FASB and IASB coordinated efforts
- Being accounting bilingual is increasingly important
Is IFRS relevant in the US anymore

- What companies should consider doing now
  - Stay engaged in the standard-setting process by participating in roundtables and comment letter processes
  - Develop a good understanding of the impacts resulting from foreseeable US GAAP change, and identify what can be done now
  - Maintain some degree of corporate oversight of non-US subsidiaries' IFRS accounting, as complex transactions arise, policies require changing, and new IFRS standards are adopted
  - Develop or obtain detailed IFRS skills, depending on the level of M&A activity, global tax strategies, or reporting needs of non-US stakeholders
Tax Accounting Series

Judgments and risks in income tax accounting and disclosure: What management and audit committees should know
Topics

- Judgments, estimates and assertions
- Unique risks
- Current regulatory and investor landscape
- Big stakes and high-visibility areas
- Questions management and boards should be asking
- Performance improvement
- Possible fresh look by standard setters
Judgments, estimates and assertions

#1 material weakness

- Income tax is the most frequent accounting area identified as a material weakness by the clients of each of the Big-4 accounting firms

Top 10 restatement

- For 10 years, income taxes have ranked among the top 10 restatement issues
Judgments, estimates and assertions

- Tax on foreign earnings
  - Largest unrecorded liability

- Deferred tax asset impairment
  - Largest expense ever recorded
Unique risks

Why still? Why now?

• Multi-jurisdictional tax law changes and complexities
• Reliance on separated systems and processes
• Income tax accounting standard is comparatively “old”
  - Often out of sync with other accounting standards and trends
  - Environment and circumstances not originally anticipated
• Current landscape
  - Dynamic legislative/regulatory environment
  - Heightened scrutiny by investors, regulators and other stakeholders
  - International business expansion and restructurings
  - Complexity of financing and investment transactions
Unique risks

Key drivers in management judgment

- Pre-tax accounting
- Future plans and expectations
- Income tax accounting models

Management judgment
Unique risks

Cross-functional collaboration

- Treasury
- Tax
- Accurate income tax accounts
- Accounting
- Operations
- Business Development
- Legal counsel
- Compensation & benefits

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Current regulatory and investor landscape

Income tax accounting focal points

• Areas of SEC and investor focus
  - Impairment assessment of deferred tax assets
  - Tax reserves
  - Indefinite reinvestment of foreign earnings

• PCAOB reviews
  - Focus on audit evidence, procedures and documentation with respect to the judgments, estimates and assertions relating to the above items
**Big stakes and high-visibility areas**

**Impairment of deferred tax assets**

**Critical takeaways...**

- Deferred tax assets are not fair-valued, thus impairment charges can be magnified
- Accounting model differs from other asset impairment models
  - Historically weighted analysis vs. forward-looking
  - Lagging pro-cyclical impact
- Assessment at jurisdictional level based on tax return filing
  - Often differs from management’s strategic/operational view of the business
- Impairment may be necessary in situations even when...
  - Company is profitable on a worldwide basis
  - Carry-forward period of tax attributes is long or unlimited
  - Company expects to return to profitability in the foreseeable future
  - Other assets are not impaired
“We note your discussion of both the positive and negative factors considered in determining your ability to realize your deferred tax assets; however, it is not clear how you weighted those factors in making your determination. Please revise future filings to provide an expanded discussion of the analysis you performed in determining that you would recognize your remaining deferred tax assets. Refer to ASC 740-10-30-17 and, specifically, ASC 740-10-30-21.”
Form 10K – 12/31/10

Notes to the Financial Statements

The Company conducted an analysis to assess the need of a valuation allowance at December 31, 2010. As part of this assessment, all available evidence, including both positive and negative, was considered to determine whether based on the weight of such evidence, a valuation allowance for deferred tax assets was needed. In accordance with ASC Topic 740-10, Income Taxes (ASC 740), a valuation allowance is deemed to be needed when, based on the weight of the available evidence, it is more likely than not (a likelihood of more than 50%) that some portion or all of a deferred tax asset will not be realized. The future realization of the tax benefit depends on the existence of sufficient taxable income within the carryback and carryforward periods.

Form 10K – 12/31/11

Notes to the Financial Statements

In the Company’s consideration of the weight of the available evidence, the Company provided more weight to evidence that was more objectively verifiable. In 2010 and 2011, the most significant weight was given to the cumulative income/loss position. In 2010 when the Company was in a cumulative loss position, the Company recorded a valuation allowance of $15.6 million. The remaining deferred tax assets, for which a valuation allowance was not established, related to amounts that could be realized through future reversals of existing taxable temporary differences and through available tax planning strategies. The Company’s estimates of future taxable income in 2010 were limited to tax planning strategies and no weight was placed on future taxable income expected to be generated through management’s approved business plans.

At December 31, 2011, the Company gave significant weight to the fact that the Company had returned to a cumulative income position in the fourth quarter of 2011. The Company had availability in its carryback years, current deferred income tax liabilities that are expected to absorb a portion of the deferred tax asset balance and sufficient projected future taxable income. As such, the Company determined that a valuation allowance was not required at December 31, 2011 and the Company reversed the deferred tax valuation allowance of $15.6 million during the fourth quarter of 2011.
**Big stakes and high-visibility areas**

*Tax on foreign earnings*

**Critical takeaways...**

- Ability to assert indefinite reinvestment is driven by a company’s overall business strategy, financial plans and structure of investments
  
  - Cross-functional collaboration is imperative

- Disclosure of the unrecorded tax liability is required, unless determined “impracticable”
  
  - Financial statement assertion that an estimate is impracticable requires appropriate company-specific support

- Calculation of the liability can be highly judgmental and subject to continual re-measurement
Big stakes and high-visibility areas

Tax on foreign earnings

Corning Inc
Form Type: 10K
Period Covered: 12/31/10
Auditor: PwC

“We note that you repatriated $1.1 billion of current year earnings from certain foreign subsidiaries during the fourth quarter of 2010.

In this regard, we have the following comments: Please tell us and revise your disclosure to fully explain the reasons you repatriated $1.1 billion of current year earnings from certain foreign subsidiaries; Please tell us and revise your disclosure to address how you concluded, in light of your repatriation in the fourth quarter of 2010, that you have the ability and intent to invest $8.9 billion of accumulated foreign unremitted earnings indefinitely as of December 31, 2010.

Please refer to ASC 740-30-25-17 though 19; and Please clarify why the repatriation of $1.1 billion of current year earnings from certain foreign subsidiaries resulted in a $265 million tax benefit for excess foreign tax credits.”
**Big stakes and high visibility areas**

**Tax on foreign earnings**

**Form 10K – 12/31/10**

Management Discussion and Analysis

We currently provide income taxes on the earnings of foreign subsidiaries and affiliated companies to the extent these earnings are currently taxable or expected to be remitted. As of December 31, 2010, taxes have not been provided on approximately $8.9 billion of accumulated foreign unremitted earnings that are expected to remain invested indefinitely. It is not practical to calculate the unrecognized deferred tax liability on those earnings.

Certain foreign subsidiaries in China and Taiwan are operating under tax holiday arrangements. The nature and extent of such arrangements vary, and the benefits of such arrangements phase out through 2014 according to the specific terms and schedules of the relevant taxing jurisdictions. The impact of the tax holidays on our effective rate is a reduction in the rate of 3.1, 7.3 and 5.3 percentage points for 2010, 2009 and 2008, respectively.

While we expect the amount of unrecognized tax benefits to change in the next 12 months, we do not expect the change to have a significant impact on the results of operations or our financial position.

**Form 10Q - 9/30/2011**

Management Discussion and Analysis

In the quarter ended March 31, 2010, Corning included in the computation of its estimated annual effective tax rate a tax benefit of $265 million related to an expected fourth quarter repatriation of $1.1 billion of 2010 foreign earnings. The repatriated earnings represented a portion of the current year earnings of certain foreign subsidiaries and affiliates located in Asia and thus were not previously permanently reinvested.

There were two factors influencing Corning’s decision to consider repatriating these 2010 earnings. One was Corning’s decision, as announced early in 2010, to pursue acquisitions that were expected to require cash to be available in the U.S. in excess of amounts expected to be generated from domestic sources. The second factor was proposed federal tax legislation which, if enacted, could significantly increase the tax cost of repatriation after 2010. Because there had been no change in our longer term international capital expansion plans as of the first quarter, our intent to indefinitely reinvest foreign earnings accumulated through the year ended December 31, 2009 was not changed by these factors. As of the year ended December 31, 2010, Corning had $8.9 billion of foreign unremitted earnings that it intends to keep indefinitely reinvested. It is not practical to calculate the unrecognized deferred tax liability on those earnings with reasonable accuracy.

Of this amount, nearly 70% consists of:

**Non-liquid operating assets or short term liquidity required to meet current international working capital needs; and**

**SCP or other joint venture unremitted earnings that require a joint determination with our partners to remove any indefinitely reinvested representation.**

Additionally, in the third quarter of 2010, Corning announced a significant multi-year investment plan that was expected to result in 2011 capital investment of $2.4 billion to $2.7 billion, the substantial majority of which would be spent internationally and would include over the term of the plan: $800 million for additional LCD capacity in China; capacity expansion for Eagle XG LCD glass and Corning □ Gorilla □ Glass in Asia; expansion of automotive substrate facilities in China and Germany; and a new manufacturing and distribution center in China for our Life Sciences businesses. These factors in addition to the fact that Corning has sufficient access to funds in the U.S. to fund currently anticipated domestic needs result in our ability and intent to indefinitely reinvest our foreign unremitted earnings of $8.9 billion as of December 31, 2010.
Big stakes and high-visibility areas

Tax reserves

Critical takeaways...

• Accounting model presumes taxing authorities have full knowledge of all relevant information
• Unique measurement model based on cumulative probability
• High hurdle for retention of US reserves after completion of an IRS audit even though the statute of limitations remains open
• Tax reserves cannot be netted against corresponding benefits in other jurisdictions
• Assessment of tax reserves must include consideration of whether the necessary business operations and transactions support tax positions – the positions cannot be assessed merely on the basis of assumptions included in a tax expert opinion or transfer pricing report


**Big stakes and high-visibility areas**  
*Tax reserves*

**SEC comment letter**

“We noted disclosures on pages 36 and 37 that your unrecognized tax benefits were reduced by $44 million in fiscal 2009.

We also note this reduction does not appear to be immaterial to your financial statements since you indicate your fiscal 2009 income tax expense was reduced by $29.5 million as a result of the referenced $44 million reduction. Yet, we did not see any discussion that

**provided a detailed analysis of the reasons for such reduction.**

Please note that a company should address the questions that arise once the critical accounting estimate or assumption has been identified, by analyzing, to the extent material, such factors as how they arrived at the estimate, how accurate the estimate/assumption has been in the past, how much the estimate/assumptions has changed in the past and whether the estimate/assumption is reasonably likely to occur and would have a material effect.

Refer to Section V of our Release 33-8350 and consider revising your disclosures related to uncertain tax positions in future filings.”
Questions management and boards should be asking

- What are the key assumptions supporting financial statement estimates and assertions?
  - How would a minor change in the assumptions impact amounts recorded or disclosed?
  - How reliable is the underlying data supporting the assumptions and assertions?
  - Is there sufficient disclosure of the assumptions and the potential impact of a change in the assumptions?
  - How does the organization ensure timely cross-functional coordination between all affected departments?
  - How does the organization ensure adequate contemporaneous documentation supporting its conclusions?
Appendix – SEC Comment Letter Trends
Comment letter trends – goodwill and impairments

- Disclose the basis for determining reporting units
- Disclose methodology and key assumptions used to test for impairment, as well as the basis for selecting those key assumptions
- Disclose the specific facts and circumstances that gave rise to impairments
- Disclose any assets or reporting units for which impairment charges are reasonably likely to occur in the next 12 to 24 months
- Provide sensitivity analysis
Comment letter trends – goodwill and impairments

• For reporting units that are at risk of failing step one of the impairment test, include the following disclosures
  - Percentage by which fair value exceeded carrying value as of the most recent fair value calculation
  - Amount of goodwill allocated to the unit
  - Key assumptions that drive fair value
  - Discussion of uncertainties associated with key assumptions and any reasonably likely events that could result in an impairment in the next 12 to 24 months
Comment letter trends – MD&A

- Increased transparency, better (not necessarily more) in-depth analysis, and plain English
- Provide an executive overview
- Quantify significant reasons underlying variances
- Discuss trends which may have a material impact on future operating results and liquidity
- Foreign currency matters (e.g., Venezuela)
- Critical accounting estimates
  - Discuss how changes in judgments, estimates, and other variables impact operating results
  - Fair value estimates (impact of credit risk)
Comment letter trends – MD&A

- Focus on liquidity
  - Disclose items that impact the availability of credit
  - Compliance with covenants, including likelihood of covenant defaults
  - Tabular presentation of financial covenants versus actual ratios

- Cash flows
  - Discuss drivers of changes in cash flows from operations
  - Discuss trends in cash flow, particularly when cash flow does not correlate to income from operations (e.g., positive cash flow, but operating losses, or vice versa)
Sample SEC comments – results of operations

- Clearly disclose and quantify each material factor that contributed to the change in revenue and operating income, indicating the impact by geographic area
- Provide insight into the underlying business drivers or conditions that contributed to these changes
- Disclose the impact that the current weakened economy has had on your business and describe how and the extent to which it has or you expect it to have on your results of operations
- Describe any other known trends or uncertainties that have had or you expect may reasonably have a material impact on your operations and if you believe that these trends are indicative of future performance

For further guidance, refer to Item 303 Regulation S-K and the Commission’s Interpretive Release on Management’s Discussion and Analysis of Financial Condition and Results of Operation.”
Comment letter trends – segment reporting

- Interaction of ASC 280 (segment reporting) and ASC 350 (goodwill)
- Who is the Chief Operating Decision Maker (CODM)
- Information provided to CODM but “not used”
- Assertions of only “one segment” is a red flag
- “Similar economic characteristics” is the gatekeeper for aggregation
- The Staff will often request a copy of the CODM package and compare to:
  - Disclosures in registrant’s website and articles in outside publications
  - Press release and Form 10-K business disclosures
  - Statements made by the company during analyst calls
“During your quarterly earnings conference calls, we noted various discussions of revenues and profit margins related to your various business lines. Please tell us whether such business lines represent separate operating segments as defined in FASB ASC 280-10-50-1 and the basis for your determination. If they represent separate operating segments, please revise to include the disclosures required by paragraphs FASB ASC 280-10-50-20. In this connection, please expand Management's Discussion and Analysis to analyze sales, profitability and the cash needs of each segment.”

“Given the different regions and areas that you appear to operate in, please help us understand how your chief operating decision maker can assess performance and make decisions regarding the allocations of resources by viewing operations at your current operating segment level.”
Comment letter trends – non-GAAP measures

• Requirements
  - Describe relevance of the measure
  - How does management use the measure
  - How should investors use the measure
  - Limitations on the measure
  - Non-comparability among companies
  - Include appropriate reconciliation to net income or operating cash flows

• Common pitfalls
  - Inappropriate items being excluded from non-GAAP measure
  - GAAP amounts are not given equal or greater prominence to non-GAAP amounts
  - Use of non-GAAP measures in an earnings release and the related analyst calls, with no discussion or disclosure of the measures in the periodic reports (e.g., Forms 10-K and 10-Q)
“We remind you that while there is no prohibition against removing a recurring item, companies must meet the burden of demonstrating the usefulness of any measure that excludes recurring items, especially if the non-GAAP financial measure is used to evaluate performance.”

“We note your presentation of basic earnings per share by subsidiary, which represent non-GAAP financial measures. Please disclose how these measures are used by management and in what way they provide meaningful information to investors. Additionally, please identify these per share measures as non-GAAP measures of performance and disclose that the non-GAAP measures should not be considered as an alternative to earnings per share determined in accordance with GAAP as an indicator of operating performance. Refer to Item 10(e)(1)(i) of Regulation S-K and Question 104.03 of our “Compliance and Disclosure Interpretations regarding the Use of Non-GAAP Measures,” available on our website at www.sec.gov.”

“Your current disclosure regarding the reasons for presenting this non-GAAP measure appears overly broad...your discussion should specifically explain why each item is being eliminated and provide a more thorough explanation of what each item represents...”
Comment letter trends – income taxes

- Enhance disclosures regarding pre-tax income from US and foreign jurisdictions
- Discuss underlying factors included in the effective tax rate reconciliation
- Changes in valuation allowance – providing detailed support for the recognition or release of a valuation allowance
- FIN 48 (ASC 740)
  - Address whether it is reasonably possible that total amounts of unrecognized tax benefits will significantly increase or decrease within the next 12 months
  - Evaluation of impact of uncertain tax positions on contractual obligations (Item 303(b) of Regulation S-K)
- Indefinite reinvestment of foreign earnings (overseas cash) and liquidity constraints
Sample SEC comments – income taxes

“Please revise your income tax rate reconciliation to disaggregate the material components of ’permanent differences’ and ’other temporary differences’ into more meaningful components so that investors are able to more clearly understand the nature of each significant adjustment.”

“Please tell us how you determined the amount of tax benefit allocated to each financial statement component and how your allocations comply with ASC 740-20-45. Include your computation of the intra-period allocation.”

“We note from your disclosures, that as of [date], $XX million, or XX% of your total cash balance, relates to your international operations. You disclose your intention to indefinitely reinvest this cash and subsequent earnings and cash flows to improve and expand facilities and operations of your international business opportunities outside of the United States. For this reason, the majority of your cash at [date] is not available for domestic general corporate purposes. Since the majority of your operations are located in the United States, please expand your liquidity disclosures to clearly describe how your international cash policy affects your liquidity. Your discussion and analysis should provide a clear picture of your ability to generate cash and to meet existing and known or reasonable likely future cash requirements.”
Comment letter trends – revenue recognition

- The Staff compares the revenue/distribution channels discussed in the Business section with revenue policy disclosures in footnotes and comments on inconsistencies
  - Disclose whether registrant has one or multiple units of accounting
  - Gross vs. net presentation considerations
  - Enhance disclosure of resellers/distributors arrangements
- Separate presentation required for revenue and cost of revenue line items for bundled arrangements (products versus services)
- Disclosure regarding critical estimates
- Use of the word “generally”
- Disclose the effects of changes in contract accounting estimates on earnings
Sample SEC comments – revenue recognition

“We noted that you classify revenue on the face of your income statement as either capital sales or rental revenues. In light of your disclosures that you earn revenues from the sales of products, rentals and the provision of services, please tell us your consideration of Rule 5-03 (b) of Regulation S-X with regard to presenting revenues (and cost of revenues) from products and services separately.”

“We note the discussion of revenue arrangements that include multiple deliverables. Please tell us the nature of transactions that result in the recognition of multiple elements. Also, tell us the nature of each significant element and how you determine the fair value of those elements.”
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