Emerging market risks and challenges for financial accounting and reporting

Overview

Companies across the Financial Services Industry (FSI) are facing increased risks and challenges as a result of the constantly evolving complexities presented by financial accounting, reporting and regulatory requirements. The key to staying ahead in the constantly evolving environment is for finance departments to be value drivers and make sound policy, process and technology decisions based on comprehensive, but dynamic analyses. It is also important that financial Institutions recognize inherent industry risk and challenges as well as determine compliance with both external regulations and internal policies and procedures.

Deloitte’s Financial Accounting and Valuation Services (FAV&S) professionals provide an end-to-end solution to our clients’ financial accounting, reporting and valuation needs. Our deep industry knowledge and insights allow us to anticipate market trends, identify implications and develop clear points of view on relevant industry issues. Leveraging our core capacity as technical accounting advisors and our understanding of the operational complexities of the account-post-report continuum, we provide a full spectrum of services assisting with non-routine complex transactions, accessing the capital markets (e.g., potential IPO readiness), preparing for acquisitions and divestitures, enhancing and automating accounting and reporting processes, addressing material weaknesses, significant deficiencies, or other financial reporting issues in the form of on-call accounting support or a transaction-specific project.

Change is on the horizon

FASB/IASB projects and potential financial accounting and reporting impact on FSI sectors

As both the IASB and FASB continue their convergence efforts through select projects leading to a pervasive impact across the FSI industry, companies will need to keep a close watch on the progress and prepare for both near and long term financial accounting and reporting...
challenges along with impacts to regulatory reporting demands. Additionally, as of late, the Boards have elected to go with different accounting models for some topics. As a result, some global institutions may be required to maintain dual accounting processes to satisfy reporting jurisdiction requirements. Accounting standard differences also present challenges as companies deal with the reporting challenges associated with cross-border M&A activity.

Our professionals advise clients on how to navigate through complex regulatory filings, corporate transactions, assessing and improving accounting and reporting processes, leading to increased efficiency, minimizing compliance risks and increased transparency. Specifically, we assist financial services companies in satisfying and enhancing the operationalization of their broad reporting needs by streamlining the overlaps between their financial reporting and management reporting along with regulatory, statutory and U.S. Securities and Exchange Commission (SEC) reporting requirements.

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**Industry challenges and emerging market trends**

Beyond the technical changes to the accounting guidance, the following trends within the financial services industry will drive an evolution of accounting and reporting requirements.

**Trends across the FSI industry**

- Regulatory reform and capital requirement changes
- Heightened emphasis on risk management activities
- Data management and technology improvements
- Emphasis on operational efficiencies
- Divestitures, mergers and acquisitions
- Legal entity rationalization

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1 Accounting for Financial Instruments
Participants in the Banking and Securities sector are facing increased complexities and challenges resulting from the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). A few examples of such challenges are the shift from a bilateral trading model to a centralized clearing model for over-the-counter (OTC) derivatives and the enhanced reporting requirements for margin and capital. FAV&S professionals assist companies in navigating through such regulatory challenges and in implementing processes designed to facilitate ongoing financial and regulatory reporting requirements, for example, by assisting with the development of capabilities related to data collection, aggregation and analysis for reporting to swap data repositories.

Regulations on risk retention requirements, derivatives and the Volker Rule are imposing restrictions in certain product and service offerings — for example, restrictions on proprietary trading activities, which can be a significant profit source for financial institutions. FAV&S professionals have been helping financial institutions in identifying and implementing permissible (i.e., Volker Rule-exempt) existing and future hedge strategies, while defining key reporting requirements and developing broad controls and processes for financial reporting.

Multiple FASB projects — Financial Instruments and Leasing may require financial institutions to institute new processes and systems to appropriately identify and classify instruments and comply with enhanced disclosures on the face of the financial statements. FASB’s impairment model may lead to streamlining of the impairment guidance, but has a significant impact on banks and requires enhanced analytics from preparers, particularly smaller institutions.

Further, the new lease accounting exposure draft is expected to have impact on a bank’s compliance with capital and other regulatory requirements along with impact to financial performance metrics and ratios, existing joint venture agreements and financial covenants. Large retail banks with branch real estate leases may be hit hard as this new proposal will require an evaluation of their existing lease information repositories for completeness and accuracy. Potential challenges will include inventorying lease arrangements, assessing lease classification, including estimates of the economic life and fair value of the leased assets, evaluating the timing and classification of lease-related revenue and expenses.

Companies in the Insurance sector are watching the FASB and IASB with a keen eye. Several accounting standards setting projects have implications for the insurance industry, but none more than the insurance contracts project, which strikes at the heart of the industry’s financial reporting. That said, the entire nature of an insurer’s balance could change when the financial instruments projects on classification and measurement and impairment of financial assets will also have significant implications for the industry. Given the uncertainties around both the specifics and timing of these required changes, many insurance companies are faced with difficulties in determining when to undertake significant implementation efforts, balancing the challenges related to the complexity, costs and the uncertainty around the measurement and presentation changes to the financial statements. Our FAV&S professionals have assisted insurance companies in determining the accounting and reporting repercussions of intercompany reinsurance treaties, structured reinsurance entities and in other areas such as assessing payout losses and reviewing and restating financial statements.

In addition to accounting change, insurers are also facing regulatory concerns. Insurers, particularly global insurance companies, will likely be faced with a need to maintain multiple financial reporting bases for their U.S.-based insurance entity and their foreign subsidiaries due to different tax, statutory and financial reporting requirements. Additionally, foreign subsidiaries with European-based entities will have to conform to reporting requirements under Solvency II. U.S.-based insurers will also need to file an Own Risk and Solvency Assessment (ORSA) Summary Report which is expected to be mandated as a result of state adoption of the National Association of Insurance Commissioners (NAIC)’s Risk Management and Own Risk and Solvency Assessment Model Act. On many levels, this represents a substantial change in insurance regulation in the United States and is expected to have a major impact imposing significant challenges to some insurers in terms of aligning technology and resources to determine readiness.

FAV&S professionals have assisted large insurance companies in complying with regulatory reporting requirements as a bank holding company under the Dodd-Frank Act which involved current state analysis of its reporting system and a gap assessment along with helping the company evaluate creation of a legal entity based financial reporting structure, which did not exist previously.
The Real Estate sector is seeing a range of developments related to changing accounting standards and emerging sub-sectors as non-traditional real estate investment trusts (REITs) continue to join the industry and more investments are made in the single-family space.

There are a growing number of public, “non-traditional” real estate companies which have announced their intention to convert to REIT status. A key driver for this change is the strong reputation of REITs for paying dividends, which is becoming increasingly valuable in today’s capital markets. As a part of a REIT establishment and conversion, our FAV&S professionals assist companies in addressing the challenges around specific accounting policies, as well as process engineering to gather financial information for forecasting and reporting REIT status and supplemental disclosures.

On the accounting front, lessors and lessees of property and equipment will be impacted by the upcoming changes in lease accounting. If certain criteria are met, the exposure draft could allow lessors of real estate to continue to apply operating lease accounting. For leases that do not meet these criteria, a receivable and residual model would be required. For lessees, leases with terms greater than one year would require a right-of-use asset and a liability to make lease payments on the balance sheet. This will be a significant change for lessees as the operating model will no longer be applied. Our experienced team of FAV&S professionals is well positioned to assist in developing an action plan to help companies implement the proposed standard on leases, specifically in the areas of accounting interpretation and process assistance.

In addition, engineering and construction (E&C) companies are expected to be particularly impacted by the revenue recognition model where companies choose retrospective application on long-term construction contracts. The newly-issued revenue recognition guidance could also affect accounting for sales of real estate companies since the industry specific guidance on this topic would be revoked.

E&C firms often win projects in partnership with other firms or governmental organizations, such as private-public partnerships. These partnership structures are often complex with more than one party having a significant role. The result is the potential for accounting challenges in assessing potential consolidation, equity method of accounting and joint venture accounting and reporting on an initial and ongoing basis.

Our FAV&S team helps E&C organizations address a wide range of issues around their accounting and financial reporting challenges, ranging from technical accounting to services focused on helping enhance financial operations and accounting processes to increase efficiency, and potentially reduce costs and compliance risks.

Companies in the Asset Management sector are likely to experience significant impacts due to the convergence and accounting changes due to two recent proposals in addition to the regulatory complexities driven by requirements such as greater transparency, operational efficiencies and governance and oversight.

The first proposal, which would amend the existing consolidation requirements by introducing principal versus agent guidance, would remove the current deferral of consolidation guidance (ASU 2009-17) for certain investment entities and require asset managers to re-evaluate the consolidation drivers for their managed products. The operational challenges of such a change could be particularly significant for asset managers who do not currently maintain and warehouse their legal entity structures and ownership tracking in a centralized location. Further, asset managers would also be faced with implementation challenges related to the consistent application of such principals-based guidance.

Deloitte’s FAV&S professionals have been able to effectively add value to numerous asset managers by providing accounting and reporting solutions to streamline and operationalize the implementation of such complex standards. Our FAV&S professionals have teamed up with our technology team to create a customizable global entity management solution to act as a centralized repository of legal entities. The solution is also customizable to capture transaction details and structure documentation, as well as a built-in automated consolidation decision tree to assist with the initial and on-going required accounting analysis for each legal entity. Further, the solution could also feature customizable business processes, reports and dashboards.

The second FASB proposal, which introduces a more conservative revenue recognition model (to the one widely currently being used by asset managers to account for their performance-based fees), is also expected to create a number of accounting and operational challenges as well as potential timing mismatches for the recognition of the performance-based fees and the related compensation expenses (in situations where the performance-based fees are allocated to the general partner and then further allocated to employees).
Further, the regulatory changes resulting from the Dodd-Frank Act relating to Form PF will also impact the asset management industry and create implementation and regulatory reporting challenges. Our FAV&S professionals have teamed up with the Financial Technology team to provide a powerful and dynamic technology solution (Compliance Suite™) that assists in the preparation of Form PF, AIFMD, and other regulatory filing requirements while also featuring robust performance monitoring, pipeline, and relationship tracking. This intuitive, easy-to-use and scalable solution provides the flexibility that is essential for today’s rapidly evolving business and regulatory landscape.

Lastly, companies in the asset management sector continue to face challenges around fair value determination and the robustness around companies’ processes to support judgment made with respect to management estimates. Securities Exchange Commission (SEC) has often required the companies to describe the control procedures they perform to validate independent prices from third-party pricing services or securities dealers that are used to corroborate, or are the sole or primary source of the companies’ fair value measurements along with sufficiency of the related fair value disclosures.

Deloitte industry excellence

Deloitte’s professionals are dedicated to serving financial services industry clients and are committed to delivering value. Our clients include banks, securities firms, insurance companies, asset managers and real estate companies in the United States and around the world.

Leveraging the unique combination of industry proficiency and a deep understanding of the technical and reporting requirements, combined with our technology and process skills, our FAV&S practitioners are best suited to provide a host of different services, which places us ahead of competitors and reinforces our stature as world class advisors, particularly with our clients. We have effectively assisted companies in the financial services industry address their accounting and financial reporting challenges, while enhancing financial reporting transparency, increasing operational efficiency, reducing cost, and minimizing compliance risks, thereby providing customized solutions to our clients.

Our people

As financial services companies search for better ways to satisfy their regulatory compliance requirements and address a wide range of issues around financial reporting, including the preparation of financial statement and regulatory filings, and the application and implementation of accounting standards for U.S. GAAP and IFRS, our FSI-focused resources:

- Include more than 1500 partners, principals and directors
- Encompass a network of more than 9000 professionals
- Key locations include Boston, Charlotte, Chicago, Los Angeles, New York, San Francisco and Washington, D.C.

Many of Deloitte’s professionals have previously held industry or government positions. Our professionals belong and actively participate in industry associations and are committed to contributing innovative thought leadership.

The Deloitte Center for Financial Services (the Center) is another excellent resource which supports our extensive U.S. financial services practice and provides insight and research to assist senior-level decision makers within various FSI sectors. The Center is staffed by a group of professionals with a wide array of in-depth industry experiences as well as cutting-edge research and analytical skills. Through its research, roundtables and other forms of engagement, the Center seeks to be a trusted source for relevant, timely and reliable insights.

Our services

Drawing from our extensive industry-aligned technical resources, our FAV&S practitioners bring together multidisciplinary capabilities, diverse experience and a broad knowledge base that provides our financial services companies’ assistance with complex transactions, both strategic and operational and help execute enterprise-wide transformation initiatives.

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2 Data Source as of December 2013
Deloitte can help with:

- Complex accounting issues and SEC reporting
- Mergers and acquisitions (M&A) activities, divestitures and initial public offerings
- Enhancing operational accounting
- Accelerated external reporting

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