

## Heads Up

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Regardless of an entity's level of interest in the PCC alternatives, whether the entity qualifies as a public business entity is important because it will determine the entity's eligibility for relief (e.g., deferred effective dates) under all future standard setting.

## New Options for Private Companies FASB Offers Simplified Approaches to Goodwill and Hedge Accounting

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On January 16, 2014, the FASB issued ASUs [2014-02](#)<sup>1</sup> and [2014-03](#),<sup>2</sup> which offer eligible private companies simplified alternative approaches to account for goodwill and interest rate swaps, respectively. These alternatives were initially developed by the Private Company Council (PCC) and ultimately endorsed by the FASB. Entities can early adopt the accounting alternatives and apply them in any period for which financial statements have not yet been made available for issuance.

### A Snapshot of the New Accounting Alternatives

Topic	The new guidance:
Goodwill accounting alternative	Permits the amortization of goodwill and eliminates the requirement to test goodwill for impairment annually. If a triggering event occurs, this alternative will simplify impairment testing by (1) allowing entities to perform the impairment test at the entity level rather than the reporting-unit level and (2) requiring less extensive analysis to measure impairment.
Simplified hedge accounting approach	Simplifies the application of hedge accounting to certain interest rate swaps by providing entities more time to complete their hedge documentation, permitting entities to measure the hedging swap at settlement value rather than fair value, and allowing entities to assume no hedge ineffectiveness in their hedging relationship. This approach results in an income statement profile that is consistent with the recognition of fixed-rate borrowing expense.

The FASB also recently issued [ASU 2013-12](#),<sup>3</sup> which defines the term "public business entity." The definition of a public business entity establishes, in part, the scope of alternatives developed by the PCC. Specifically, entities that do not qualify as a public business entity are eligible to elect PCC alternatives as long as they satisfy any additional scope criteria those alternatives may include.

**Editor's Note:** Even before the FASB issued its ASU defining a public business entity, certain provisions of U.S. GAAP distinguished between public and private companies. However, the differences in accounting treatment were generally limited to disclosure and effective date. Now that these differences also extend to recognition and measurement, the dividing line between public and private companies — established by the definition of a public business entity — takes on greater significance. In addition, this definition will be universally used in all future U.S. GAAP standard setting when the distinction is necessary. So regardless of an entity's level of interest in the PCC alternatives, whether the entity qualifies as a public business entity is important because it will determine the entity's eligibility for relief (e.g., deferred effective dates) under all future standard setting.

<sup>1</sup> FASB Accounting Standards Update No. 2014-02, *Accounting for Goodwill* — a consensus of the Private Company Council.

<sup>2</sup> FASB Accounting Standards Update No. 2014-03, *Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps — Simplified Hedge Accounting Approach* — a consensus of the Private Company Council.

<sup>3</sup> FASB Accounting Standards Update No. 2013-12, *Definition of a Public Business Entity — An Addition to the Master Glossary*.

## Definition of a Public Business Entity

ASU 2013-12 defines a public business entity to establish the types of entities that are not eligible to elect the alternatives developed by the PCC. The definition is also intended to simplify U.S. GAAP by establishing a single definition of a “public” entity to be used prospectively by the PCC and FASB. Under the ASU, a public business entity is defined as a business entity (which excludes not-for-profit entities and employee benefit plans)<sup>4</sup> that meets any one of the following criteria:

- a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).
- b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.
- c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.
- d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.
- e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity’s filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

There may be limited cases in which entities previously viewed as nonpublic will qualify as a public business entity.

While the criteria in the definition of a public business entity are largely drawn from similar definitions already in the *FASB Accounting Standards Codification (ASC)* (e.g., the definition of “public entity” or “publicly traded company”), criterion (a) is not included in certain definitions and criterion (e) is not included in any definitions. As a result, there may be limited cases in which entities previously viewed as nonpublic will qualify as a public business entity. Conversely, because a subsidiary of a public company is not automatically by extension a public business entity under the ASU, there may be instances in which an entity previously viewed as public will not qualify as a public business entity for purposes of its stand-alone financial statements.

This change to what constitutes a “public” entity for financial reporting purposes is prospective thus far<sup>5</sup> and accordingly will not affect an entity’s treatment under existing accounting guidance when the reporting requirements vary between public and private companies (e.g., segment reporting). However, such change will affect an entity’s (1) ability to adopt ASUs 2014-02 and 2014-03 as well as future PCC alternatives and (2) eligibility for other relief in future general standard setting (e.g., transition and effective date exceptions). ASU 2013-12 does not contain an effective date. However, an entity would apply the definition of a public business entity in connection with its adoption of the first new ASU that uses the term.

While an entity’s assessment of the above criteria will often be straightforward, criterion (e) could be an exception, especially for entities whose financial information is available to the public. Many constituents raised questions about criterion (e) as included in the original exposure draft. During redeliberations, the FASB clarified this criterion and provided additional guidance. For example, in the ASU’s basis for conclusions, the Board indicates that “contractual restrictions on transfer” consist of requirements for “management preapproval on [the] resale” of securities, and that the U.S. GAAP financial

<sup>4</sup> Although not-for-profit entities and employee benefit plans are not considered public business entities, they are also not automatically eligible to elect accounting alternatives developed by the PCC. Instead, the PCC and FASB will consider extending alternatives to these types of entities on a standard-by-standard basis.

<sup>5</sup> The FASB is expected to consider adding a project to its technical agenda that would replace similar existing definitions.

statements a business entity is required by law, contract, or regulation to make “publicly available” include “financial statements that are made available publicly upon request or posted to an entity’s website for public access.” Further, the Board clarified that Reports of Condition and Income (i.e., call reports) required of financial institutions are not U.S. GAAP financial statements under this criterion because “[they] do not require compliance with all of the footnote requirements under U.S. GAAP.” Entities whose financial information is available to the public will need to assess the nature of the information currently available.

**Editor’s Note:** Private companies that might consider going public in the future should be cautious about electing the alternatives developed by the PCC until the SEC clarifies what, if any, transition guidance there would be for entities that become a public business entity after electing the PCC alternatives. Also, entities should exercise similar caution if they are contemplating the future sale of a significant stake in the business to potential investors that could include SEC registrants. On the basis of the first criterion, an entity that may otherwise not qualify as a public business entity would become one for purposes of including its financial statements in another entity’s SEC filing (e.g., as a result of an investor’s applying Regulation S-X, Rule 3-05<sup>6</sup> or 3-09<sup>7</sup>). Regardless of how an entity becomes a public business entity, it would potentially need to eliminate any previously elected PCC alternatives from its historical financial statements before including them in its own or another entity’s SEC filing. The SEC staff recently indicated that it would be considering whether to allow any transition relief in these circumstances.<sup>8</sup>

To alleviate the cost and complexities associated with the goodwill impairment test under ASC 350, ASU 2014-02 offers private companies a simplified accounting alternative for goodwill.

## Goodwill Accounting Alternative

To alleviate the cost and complexities associated with the goodwill impairment test under ASC 350,<sup>9</sup> ASU 2014-02 offers private companies a simplified accounting alternative for goodwill. The ASU explains that during outreach performed by the PCC, “users of private company financial statements indicated that the goodwill impairment test performed today provides limited decision-useful information because most users of private company financial statements generally disregard goodwill and goodwill impairment losses in their analysis of a private company’s financial condition and operating performance.” Not-for-profit entities are not within the scope of the new guidance.

A private company that elects the accounting alternative under ASU 2014-02 would be required to apply it to all existing goodwill and new goodwill recognized after the effective date. In addition, a private company would be required to comply with related subsequent measurement and disclosure requirements in the accounting alternative.

Under ASU 2014-02, private companies can elect simplified accounting for the following:

- *Amortization of goodwill* — Private companies are allowed to amortize goodwill on a straight-line basis over a useful life of (1) 10 years or (2) less than 10 years if the entity is able to demonstrate that a shorter useful life is more appropriate.

<sup>6</sup> SEC Regulation S-X, Rule 3-05, “Financial Statements of Businesses Acquired or to Be Acquired.”

<sup>7</sup> SEC Regulation S-X, Rule 3-09, “Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons.”

<sup>8</sup> At the September 25, 2013, CAQ SEC Regulations Committee [joint meeting](#) with the SEC staff, the SEC staff indicated that it would be thinking about what transition alternatives might be available to an entity that applies PCC alternatives and later becomes a public business entity, acknowledging that the changes could be extensive. During the discussion, the SEC staff reflected on emerging growth companies, noting that although such companies are permitted to follow nonpublic effective dates related to new or revised standards, they are considered public business entities and are unable to use PCC alternatives in their filings.

<sup>9</sup> For titles of *FASB Accounting Standards Codification* references, see Deloitte’s “[Titles of Topics and Subtopics in the FASB Accounting Standards Codification](#).”

Under ASU 2014-02, private companies are required to test goodwill for impairment only when a triggering event occurs instead of having to perform the test annually (or more frequently if indicators of impairment exist).

**Editor’s Note:** Sometimes, amortizing goodwill over a shorter useful life could be more appropriate (though such an assessment is not required if an entity chooses to use 10 years). Consider, for example, an entity that specializes in selling medical devices for critical care and surgery. If the entity acquires another entity solely to obtain access to the latter’s ventricular assist devices (i.e., proprietary patented technology) and the useful life of this proprietary technology is less than 10 years, the acquiring entity would be able to demonstrate, in the absence of other facts and circumstances, that the goodwill arising from the business combination should be amortized over the useful life of the ventricular assist devices rather than over 10 years.

- *Frequency of the test for impairment* — Under ASU 2014-02, private companies are required to test goodwill for impairment only when a triggering event occurs instead of having to perform the test annually (or more frequently if indicators of impairment exist).
- *Method of impairment testing* — Private companies can make an accounting policy election to test goodwill for impairment at either the entity level or the reporting-unit level. In addition, ASU 2014-02 eliminates step 2 of the goodwill impairment test; as a result, private companies that elect the simplified goodwill accounting alternative would measure goodwill impairment as the excess of the entity’s (or reporting unit’s) carrying amount over its fair value (i.e., by using the measurement in step 1 of the goodwill impairment test under ASC 350-20).

**Editor’s Note:** If goodwill is impaired, ASU 2014-02 requires the impairment amount to be calculated only on the basis of existing requirements in step 1 of ASC 350-20, thereby eliminating the complexities associated with applying step 2 of the goodwill impairment test in ASC 350-20 (i.e., the hypothetical purchase price allocation to the individual assets and liabilities other than goodwill to determine the goodwill impairment amount). The [Appendix](#) of this *Heads Up* contains a decision flowchart that outlines the application of the alternative accounting for goodwill.

Private companies that elect the accounting alternative are required to amortize goodwill attributable to equity method investments. Although goodwill associated with the equity method investment would not be tested for impairment under the guidance in ASU 2014-02, the equity method investment itself must still be assessed for impairment in accordance with ASC 323-10-35-32.

If elected, the simplified goodwill accounting alternative in ASU 2014-02 must be applied prospectively to (1) goodwill existing as of the beginning of the period of adoption and (2) all new goodwill recognized in annual periods beginning after December 15, 2014, and in interim periods within annual periods thereafter. Private companies would commence amortization of goodwill existing as of the beginning of the period of adoption. Early application is permitted for any annual or interim period for which an entity’s financial statements have not yet been made available for issuance. Upon adoption of the accounting alternative, an entity must make an accounting policy election to test goodwill for impairment at either the entity level or the reporting-unit level.

Summarized below are the disclosures requirements applicable to private entities that elect the goodwill accounting alternative under ASU 2014-02.

Additions to goodwill

Since ASU 2014-02 permits goodwill amortization, private companies that elect the alternative accounting are required to disclose amortizable goodwill in a manner similar to the disclosure of other finite-lived intangible assets under ASC 350. Private entities that elect the accounting alternative are required to disclose the following information about additions to goodwill:

- a. The amount assigned to goodwill in total and by major business combination or by reorganization event resulting in fresh-start reporting
- b. The weighted-average amortization period in total and the amortization period by major business combination or by reorganization event resulting in fresh-start reporting.

Information for each period for which a statement of financial position is presented

An entity that elects the accounting alternative is not required to present changes in goodwill in a tabular reconciliation as required by ASC 350-20-50-1. Instead, in each period for which a statement of financial position is presented, an entity is required to disclose the following information in either the financial statements or the notes to the financial statements:

- a. The gross carrying amounts of goodwill, accumulated amortization, and accumulated impairment loss
- b. The aggregate amortization expense for the period
- c. Goodwill included in a disposal group classified as held for sale in accordance with paragraph 360-10-45-9 and goodwill derecognized during the period without having previously been reported in a disposal group classified as held for sale.

Goodwill impairment loss

If a goodwill impairment occurs, an entity that elects the accounting alternative is required to disclose the following in the period in which goodwill impairment loss is recognized:

- a. A description of the facts and circumstances leading to the impairment
- b. The amount of the impairment loss and the method of determining the fair value of the entity or the reporting unit (whether based on prices of comparable businesses, a present value or other valuation technique, or a combination of those methods)
- c. The caption in the income statement in which the impairment loss is included
- d. The method of allocating the impairment loss to the individual amortizable units of goodwill.

In the ASU’s basis for conclusions, the FASB notes that private companies would continue to apply the existing disclosure requirements for goodwill in ASC 350 and ASC 805 as applicable.

**Editor’s Note:** In connection with its endorsement of the goodwill alternative, the FASB added a project to its technical agenda to consider changes to goodwill accounting for public business entities and not-for-profit entities. The Board directed the FASB staff to research simplified goodwill accounting options, including (1) the PCC alternative; (2) the amortization of goodwill over its useful life, not to exceed a maximum number of years; (3) the direct write-off of goodwill; and (4) a simplified impairment test. As this project takes shape, it is likely to influence a private company’s assessment of whether to ultimately adopt the PCC’s goodwill alternative.

Since ASU 2014-02 permits goodwill amortization, private companies that elect the alternative accounting are required to disclose amortizable goodwill in a manner similar to the disclosure of other finite-lived intangible assets under ASC 350.

## Simplified Hedge Accounting Approach

At times, private companies find it difficult to issue fixed-rate debt because of cost or other constraints. As a substitute, they may choose to issue variable-rate debt and then enter into a pay-fixed, receive-floating interest rate swap to achieve the desired economic result.

Under current U.S. GAAP, public entities must account for the issued debt separately from the interest rate swap and generally must measure the debt at amortized cost and the interest rate swap at fair value. The result is an accounting measurement mismatch that gives rise to volatility in the income statement unless the strict criteria for cash flow hedge accounting in ASC 815 are met and such treatment is elected.

To make it easier for private companies that are not financial institutions<sup>10</sup> to achieve the desired accounting treatment (i.e., the income statement profile of having issued fixed-rate debt) and avoid the complexity of having to comply with the stricter cash flow hedge accounting requirements of ASC 815, ASU 2014-03 allows private companies to use a “simplified hedge accounting approach.” Under this approach, qualifying private companies may assume that there is no ineffectiveness in a cash flow hedging relationship involving a variable-rate borrowing and a pay-fixed, receive-variable interest rate swap when all of the following criteria are satisfied:

1. “Both the variable rate on the swap and the borrowing are based on the same index and reset period” (e.g., the rate on the swap and the debt are both three-month LIBOR). The ASU clarifies that the index need not be a benchmark interest rate described in ASC 815-20-25-6A.
2. “The terms of the swap are typical . . . and there is no floor or cap on the variable interest rate of the swap unless the borrowing has a comparable floor or cap.” The ASU indicates that “typical” means “plain vanilla.”
3. “The repricing and settlement dates for the swap and the borrowing match or differ by no more than a few days.”
4. “The swap’s fair value at inception (that is, at the time the derivative was executed . . . ) is at or near zero.”
5. “The notional amount of the swap matches the principal amount of the borrowing being hedged,” which “may be less than the total principal amount of the borrowing.”
6. “All interest payments occurring on the [hedged portion of the] borrowing during the term of the swap (or the effective term of the swap underlying the forward starting swap) are designated as hedged.”

**Editor’s Note:** Private companies that hope to apply the simplified hedge accounting approach still must assess the likelihood that the swap counterparty will comply with the terms of the contract (i.e., perform) in accordance with ASC 815-20-25-122. Therefore, an entity cannot apply the simplified hedge accounting approach if it is no longer probable that the swap counterparty will not default.

An entity also can apply the simplified hedge accounting approach to hedging relationships that involve a forward-starting swap as long as “the occurrence of forecasted interest payments to be swapped is probable.”

A private company that elects to apply the simplified hedge accounting approach to a qualifying hedging relationship must continue to account for the interest rate swap and the variable-rate debt separately on the face of the balance sheet. However, it would be able to assume no ineffectiveness in the hedging relationship, thereby essentially achieving the same income statement effects as if it had issued fixed-rate debt because changes in the value of the swap would be deferred to other comprehensive income and then released to the income statement as the hedged interest payments affect earnings.

A private company that elects to apply the simplified hedge accounting approach to a qualifying hedging relationship would be able to assume no ineffectiveness in the hedging relationship, thereby essentially achieving the same income statement effects as if it had issued fixed-rate debt.

<sup>10</sup> ASC 942-320-50-1 defines financial institutions as “banks, savings and loan associations, savings banks, credit unions, finance companies, and insurance entities.”

A private company can elect to apply the simplified hedge accounting approach to any qualifying receive-variable, pay-fixed interest rate swap on an instrument-by-instrument basis.

An entity that applies the simplified hedge accounting approach also may elect to measure the related hedging receive-variable, pay-fixed interest rate swap at its settlement value rather than fair value. (The ASU states that the primary difference between settlement value and fair value is that settlement value does not consider nonperformance risk.) If an entity elects to measure an interest rate swap at settlement value, it must continue to disclose the information required under ASC 815 for derivative and hedging instruments and under ASC 820 for fair value measurements (although it may disclose the swap's settlement value instead of fair value in such disclosures).

A private company can elect to apply the simplified hedge accounting approach to any qualifying receive-variable, pay-fixed interest rate swap on an instrument-by-instrument basis. To apply the approach, the private company would have to satisfy existing ASC 815 hedge accounting designation and documentation requirements. However, the company would have up until "the date on which the first annual financial statements are available to be issued after hedge inception" to prepare such documentation (i.e., it would be exempt from the requirement under ASC 815 to have the documentation in place at hedge inception).

**Editor's Note:** In addition to simplifying the criteria to qualify for cash flow hedge accounting, ASU 2014-03 clarifies that a swap accounted for under the simplified hedge accounting approach would not be considered "an instrument that is accounted for as a derivative instrument under [ASC] 815" in an entity's assessment of whether it qualifies for the scope exemption in ASC 825-10-50-3. This clarification may relieve private companies from having to provide all of the fair value disclosures described in ASC 825.

ASU 2014-03 is effective for annual periods beginning after December 15, 2014, and in interim periods within annual periods beginning after December 15, 2015. Early adoption is also permitted for any annual or interim period for which the entity's financial statements have not yet been made available for issuance. A private company that adopts the simplified hedge accounting approach may do so by using either a full retrospective or a modified retrospective method. (Under both methods, the company would record a cumulative catch-up adjustment in the period of adoption, which would be the current period under the modified retrospective method or the earliest period presented under the full retrospective method.) Companies that elect to apply the simplified hedge accounting approach can apply it to any qualifying swap existing as of that date and to any future qualifying swap. Companies also will need to provide certain disclosures on their adoption of the approach.

## Other PCC Matters

In connection with the issuance of ASU 2013-12 defining a public business entity, the FASB and PCC jointly issued a final version of the [Private Company Decision-Making Framework](#),<sup>11</sup> which guides the FASB and PCC in determining whether and when to provide alternatives to private companies. This document helps the FASB and PCC (1) evaluate the respective needs of private-company and public-company financial statement users and (2) identify opportunities to reduce the cost and complexity of financial reporting for private companies.

Also, at the PCC's November 12, 2013, meeting, several other projects on its technical agenda were discussed:

- *Applying Variable Interest Entity Guidance to Common Control Leasing Arrangements* — This [proposal](#)<sup>12</sup> would give private companies the option of not applying the variable interest entity consolidation guidance to certain interests in lessor entities that are under common control. During redeliberations, the

<sup>11</sup> *Private Company Decision-Making Framework: A Guide for Evaluating Financial Accounting and Reporting for Private Companies.*

<sup>12</sup> FASB Proposed Accounting Standards Update, *Applying Variable Interest Entity Guidance to Common Control Leasing Arrangements* — a proposal of the Private Company Council. For additional details, see Deloitte's August 27, 2013, [Heads Up](#).

During its inaugural year, the PCC considered adding other topics to its technical agenda, including the accounting for uncertain tax positions and the disclosures that are required of development-stage entities.

PCC added a fourth scope criterion<sup>13</sup> to this alternative and has since received comments from constituents expressing concern about applying the criterion. Accordingly, before requesting FASB endorsement, the PCC plans to redeliberate the scope of this proposal at its January 28, 2014, meeting.

- *Accounting for Intangible Assets in a Business Combination* — This [proposal](#)<sup>14</sup> would permit an entity to recognize fewer intangibles in a business combination and would simplify the measurement of some intangibles that continue to be recognized. The PCC received input from constituents that this proposal would not result in substantial reductions in cost or complexity for financial statement preparers. As a result, the PCC directed the FASB staff to research alternatives that would allow an entity to recognize even fewer intangible assets. Further deliberation is expected at the PCC's January 28, 2014, meeting.
- *Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps — Combined Instruments Approach* — The "combined instruments" approach in the original interest rate swap proposal would allow for the variable-rate debt and the interest rate swap to be accounted for as a single, combined instrument. During redeliberations, the PCC decided to treat this approach as a separate agenda topic and directed the FASB staff to conduct additional research regarding circumstances in which the approach would be appropriate. Further deliberation is expected at the PCC's meeting on January 28, 2014.

**Editor's Note:** During its inaugural year, the PCC considered adding other topics to its technical agenda, including the accounting for uncertain tax positions and the disclosures that are required of development-stage entities. The PCC did not advance the uncertain tax positions topic because initial outreach did not identify immediate practice issues. However, the development-stage entity topic was ultimately elevated to the FASB technical agenda and has resulted in a [proposed ASU](#)<sup>15</sup> that would eliminate the inception-to-date disclosure requirements that are unique to development-stage entities.

Also at the November meeting, the PCC provided the FASB with private-company perspectives regarding projects on the FASB's technical agenda, including leases and the reporting of discontinued operations. The PCC also discussed feedback it received from private-company stakeholders at its recent town hall meeting and announced plans to hold a similar [town hall meeting](#) in May 2014.

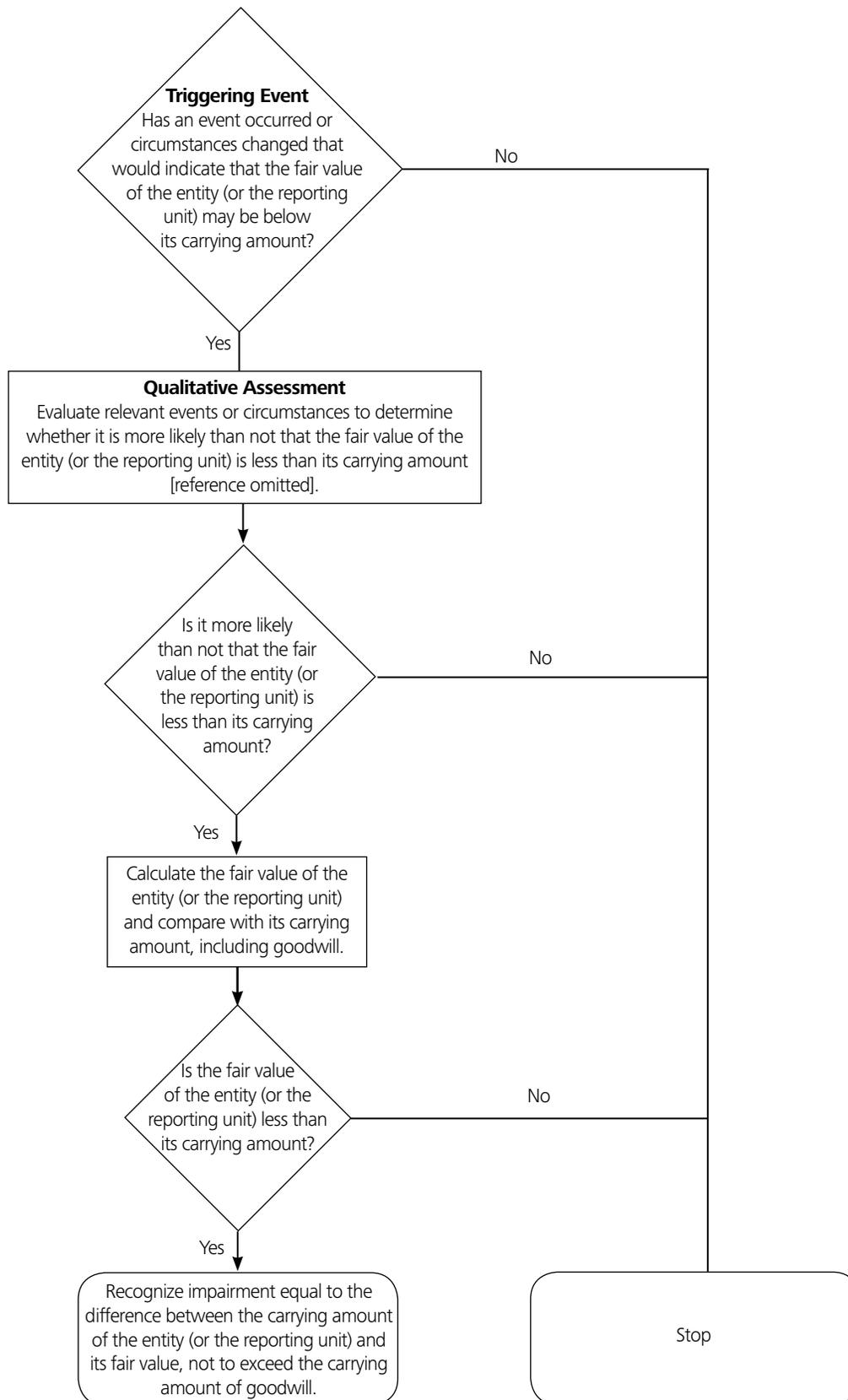
<sup>13</sup> For additional details, see Deloitte's November 15, 2013, [journal entry](#).

<sup>14</sup> FASB Proposed Accounting Standards Update, *Accounting for Identifiable Intangible Assets in a Business Combination* — a proposal of the Private Company Council. For additional details, see Deloitte's July 9, 2013, [Heads Up](#).

<sup>15</sup> FASB Proposed Accounting Standards Update, *Development Stage Entities (Topic 915): Elimination of Certain Financial Reporting Requirements*. For additional details, see Deloitte's November 8, 2013, [journal entry](#).

## Appendix — Alternative Accounting for Goodwill

The decision flowchart below was reproduced from ASU 2014-02. It outlines application of the alternative accounting for goodwill.



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