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Investment Management
Accounting and Financial Reporting Update

November 11, 2013

Financial Services Industry

Contents

Foreword

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We are pleased to announce our sixth annual accounting and financial reporting update for the investment management sector.

The publication is divided into three sections: (1) "Updates to Guidance," which highlights changes to accounting and reporting standards that investment management entities need to start preparing for now; (2) "On the Horizon," which discusses standard-setting topics that will affect investment management entities as they plan for the future; and (3) "Other Topics" that may be of interest to entities in the investment management sector.

The 2013 accounting and financial reporting updates for the banking and securities, insurance, and real estate sectors are available (or will be available soon) on US GAAP Plus, Deloitte's new Web site for accounting and financial reporting news.

In addition, don't miss our upcoming publication, *SEC Comment Letters — Including Industry Insights*, which discusses our perspective on topics that the SEC staff has focused on in comment letters issued to registrants over the past year, including an analysis of comment letter trends in each financial services sector.

As always, we encourage you to contact your local Deloitte office for additional information and assistance.

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Introduction

After the "fiscal cliff" compromise in the U.S. Congress, much investor uncertainty and anxiety abated, and the U.S. stock market improved during 2013. The investment management sector particularly welcomed this improvement given the increase in popularity of lower-fee, passive investments. Although the global economic environment is uncertain, reputable investment management firms stand poised for opportunities as a result of an expected increase in retirement investment accounts.

Business Outlook

Assets under management are on track to exceed pre-financial-crisis levels, helping to offset the fee pressure witnessed by the sector over the past five years. Investors have become increasingly jittery about risk, exacerbated by the flash crash and trading glitches that rocked the financial markets. Trading is becoming more commoditized, which has led to efficiencies and lower costs for investment managers. Reputable and established investment managers can take advantage of the increasing capital in retirement accounts to increase their asset-based fee revenue.

Regulatory Reform

Under the JOBS Act,[1] investment managers (namely, hedge funds) may now advertise their investments to the general public. With this change, however, comes the addition of regulations, including those requiring entities to perform steps to verify that limited partners are accredited investors and to submit forms to the SEC. In addition, regulations on over-the-counter trading are being implemented and include rules on the use of authorized clearing houses. FATCA, which imposes new tax-reporting obligations on managers of offshore funds both domestically and abroad, requires institutions to register with the IRS by April 25, 2014, or be subject to a strict 30 percent withholding tax on both the income and gross proceeds of the manager's assets.

IFRS Convergence

The incorporation of IFRSs into the U.S. domestic financial reporting system has been a source of considerable debate since the SEC's initial IFRS roadmap was released in 2008. Since then, the SEC has undertaken several projects to further explore the possibility of adopting IFRSs. The SEC formalized many of these efforts in its 2010 Work Plan, which directed the SEC staff to evaluate six topics related to whether, and if so, when and how to incorporate IFRSs into the U.S. financial reporting system. In July 2012, the SEC staff released a final report summarizing its findings related to the work plan; however, the report did not discuss recommendations for U.S. incorporation or implementation of IFRSs. The SEC has not yet decided whether IFRSs will be adopted partly because of delays in the finalization of the FASB's and IASB's convergence projects related to revenue, leases, and financial instruments. However, the culmination of these projects, along with increasing international pressure, may prompt the SEC to make a decision in the near future. Registrants are encouraged to be aware of developments as they arise.

For additional information about industry issues and trends, see Deloitte's 2013 Financial Services Industry Outlooks.

[1] For a list of abbreviations used in this publication, see Appendix B.

Updates to Guidance

Balance Sheet Offsetting

Background

In December 2011, the FASB issued ASU 2011-11[1] (subsequently codified in ASC 210-20), which established new disclosure requirements regarding the nature of an entity's rights of setoff and related arrangements associated with its financial instruments and derivative instruments and their potential effect on the entity's financial position, and in January 2013, the FASB clarified the scope of the ASU 2011-11 offsetting disclosure requirements by issuing ASU 2013-01 (also codified in ASC 210-20) — collectively, "the ASU."

The requirements are effective for all entities for fiscal years beginning on or after January 1, 2013, and interim periods within those annual periods.

Scope

ASU 2013-01 limits the scope of the required offsetting disclosures to the following instruments or transactions:

- "Recognized derivative instruments accounted for in accordance with [ASC] 815, including bifurcated embedded derivatives, repurchase agreements and reverse repurchase agreements, and securities borrowing and securities lending transactions that are offset in accordance with either [ASC] 210-20-45 or [ASC] 815-10-45."
- "Recognized derivative instruments accounted for in accordance with [ASC] 815, including bifurcated embedded derivatives, repurchase agreements and reverse repurchase agreements, and securities borrowing and securities lending transactions that are subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are offset in accordance with either [ASC] 210-20-45 or [ASC] 815-10-45."

The ASU clarifies that only derivatives accounted for in accordance with ASC 815, including bifurcated embedded derivatives, are within the scope of the disclosure requirements. Instruments that meet the definition of a derivative in ASC 815 but that are subject to one of the scope exceptions under ASC 815 are outside the scope of the disclosure requirements.

Required Disclosures

Under ASC 210-20-50-3 and 50-4, an entity must disclose, at a minimum, the following information "in a tabular format, separately for assets and liabilities, unless another format is more appropriate":

a. The gross amounts of those recognized assets and . . . liabilities

b. The amounts offset in accordance with the guidance in [ASC] 210-20-45 and [ASC] 815-10-45 to determine the net amounts presented in the statement of financial position

c. The net amounts presented in the statement of financial position [i.e., (a)–(b)]

d. The amounts subject to an enforceable master netting arrangement or similar agreement not otherwise included in (b) [along with the] amounts related to financial collateral (including cash collateral)

e. The net amount after deducting the amounts in (d) from the amounts in (c).

[1] For the full titles of standards, topics, and regulations, see Appendix A.

Amounts shown for items (a) through (c) should be grouped by type of instrument or transaction; however, amounts shown for items (c) through (e) may be shown by type of instrument or by counterparty. Also, the amounts reported for item (c) must be reconciled to amounts presented in the statement of financial position, and the total amount disclosed for item (d) cannot exceed the amount shown for item (c) for a given financial instrument.

An entity also must describe the rights of setoff associated with its recognized financial instruments subject to an enforceable MNA or similar agreement disclosed in item (d) above, including the nature of those rights. The tabular and qualitative disclosure requirements are minimum requirements; an entity may need to supplement these disclosures with additional qualitative disclosures to fully describe the effect of the rights of setoff and related arrangements on the entity's financial instruments and derivatives and its financial position.

See Deloitte's February 5, 2013, *Heads Up* for further discussion of the ASU 2013-01 disclosure requirements.

Transition

The disclosure guidance must be applied retrospectively for any period presented that begins before the date on which the entity initially adopts the requirements.

Interaction With IFRSs

While the balance sheet offsetting project began as a joint effort between the FASB and the IASB to eliminate significant differences between the offsetting model in U.S. GAAP and that in IFRSs, the boards ultimately decided to retain their existing offsetting accounting models and to require entities to provide more comprehensive disclosures about balance sheet offsetting. Concurrently with the FASB's issuance of ASU 2011-11, the IASB amended IFRS 7 to require essentially the same disclosures as those required by the ASU. However, the IASB has not changed the scope of its disclosure requirements since the issuance of ASU 2013-01 and, as a result, fewer financial instruments are subject to the offsetting disclosure requirements under U.S. GAAP than under IFRSs.

Thinking It Through

Under the amended guidance, a company must disclose when certain derivatives or financial instruments are potentially subject to offsetting to allow financial statement users to assess the effects of gross and net exposures on the company's financial position. Complying with the offsetting disclosure requirements may be particularly challenging for investment companies because they generally have numerous financial instruments that fall within the scope of the guidance.

Also, fund accounting personnel may not have the legal expertise to determine whether MNAs and other arrangements that cover instruments within the scope of the amended guidance are enforceable. In the data-gathering process, investment companies and their advisers may therefore benefit from coordination between financial reporting personnel and legal personnel.

Although certain investment companies may hold financial instruments that qualify for offsetting, they may elect to present those positions gross in the statement of financial position. To ensure compliance with the standard, they may need to expend considerable effort gathering data about collateral not recognized on the balance sheet if such information was not previously tracked as part of the financial reporting process.

Investment companies should also evaluate the application of their uniform pricing policies because the new guidance requires disclosure of amounts related to financial collateral. An investment company's collateral management system may not have been designed to accommodate its financial reporting pricing policies. As a result, a financial instrument held both as an investment and as collateral could be assigned a different fair value by different internal systems. Investment companies need to be prepared to address such scenarios and ensure they use the appropriate values in their disclosures.

Since investment companies typically use multiple systems to track financial instrument data, especially if they have multiple service providers or use various sub-advisers, current system infrastructure might not be equipped to closely track, on an ongoing basis, information about rights of setoff for instruments within the scope of the amended guidance. Because of the frequency of reporting this disclosure, companies should ensure that their financial reporting infrastructure allows for adequate monitoring and analysis of the data and establish appropriate internal controls.

Lastly, other U.S. GAAP provisions require investment companies to disclose information about certain amounts that offset in the statement of financial position as well as information about (1) related collateral (pledged or received) and (2) exposures to credit risk. Although investment companies may have complied with these provisions, they should not assume that they have satisfied the disclosure requirements under the amended offsetting guidance — the scope of those requirements may differ.

Investment Companies

Overview

In June 2013, the FASB issued ASU 2013-08, which amends the criteria under which an entity qualifies as an investment company in accordance with ASC 946. While the ASU is not expected to significantly change which entities qualify for the specialized investment-company guidance in ASC 946, it (1) introduces new disclosure requirements that apply to all investment companies and (2) amends the measurement criteria for interests in other investment companies.

Key Provisions

Definition of an Investment Company

Under ASU 2013-08, entities that are regulated under the Investment Company Act of 1940 (the "1940 Act") are within the scope of ASC 946 regardless of whether they meet the revised investment-company criteria. Entities that are not regulated under the 1940 Act must evaluate whether they have both of the following fundamental characteristics of an investment company:

a. It is an entity that does both of the following:

   1. Obtains funds from one or more investors and provides the investor(s) with investment management services

   2. Commits to its investor(s) that its business purpose and only substantive activities are investing the funds solely for returns from capital appreciation, investment income, or both.

b. The entity or its affiliates do not obtain or have the objective of obtaining returns or benefits from an investee or its affiliates that are not normally attributable to ownership interests or that are other than capital appreciation or investment income.

In addition to these fundamental characteristics, an investment company would generally possess the following "typical" characteristics:

a. It has more than one investment.

b. It has more than one investor.

c. It has investors that are not related parties of the parent (if there is a parent) or the investment manager.

d. It has ownership interests in the form of equity or partnership interests.

e. It manages substantially all of its investments on a fair value basis.

To qualify as an investment company, an entity must have all of the fundamental characteristics. An entity that does not have one or more of the typical characteristics is not necessarily precluded from qualifying as an investment company but will need to determine how its activities are consistent with those of an investment company. An entity should consider its purpose and design when evaluating whether it possesses the characteristics of an investment company.

Thinking It Through

The FASB decided on a two-tiered approach for developing the characteristics of an investment company. This approach is more flexible than that in the original proposal, which would have required an entity to meet all of the proposed requirements to qualify as an investment company. If an entity displays only some of the typical characteristics, it will need to use judgment to determine whether it qualifies as an investment entity. The burden of proof is on the entity to demonstrate how its activities are consistent with those of an investment company. The entity's documentation would need to be comprehensive and take into account the examples in ASU 2013-08. Further, if the entity's status changes from noninvestment company to investment company as a result of the new guidance, the entity will be required to disclose such change in status and the reasons for the change.

Measurement of Underlying Investments

An investment company must measure all of its investments in noninvestment-company investees at fair value (including controlled investments and equity method investments) but is exempt from this requirement for an interest in an operating entity that provides services related to the investment company's investment activities (e.g., an investment adviser or a transfer agent). The equity method or consolidation would be used to account for such investments depending on the investment company's level of influence.

While the ASU prohibits use of the equity method for interests in other investment companies, the FASB decided not to provide specific guidance on how an investment company should account for a controlling interest in another investment company, thus allowing current practice to continue.

Thinking It Through

An entity that is no longer an investment company may be required to consolidate a subsidiary or account for an investment under the equity method when adopting ASU 2013-08. The initial measurement of the interests of the subsidiary or investments under the equity method should be based on the amounts that would have been reflected in the entity's financial statements as if the ASU had always been effective — that is, the amounts that would have been recorded if the investee had been consolidated or the equity method applied from the date that the entity initially became involved with the investee. However, if determining these carrying values is not practicable, the entity may apply the guidance in ASC 805 on business combinations or ASC 323 on the equity method on the adoption date of the ASU. In addition, an entity may elect the fair value option under ASC 825-10 for eligible assets and liabilities of a consolidated subsidiary and its equity method investees. If the fair value option is elected, it must be elected for all of the consolidated subsidiary's eligible financial assets and liabilities. Entities can elect the fair value option on a subsidiary-by-subsidiary basis.

Investments Held by Noninvestment Companies

Under the ASU, a noninvestment-company parent must retain the specialized industry-specific guidance applied by its investment company subsidiary or equity method investee in its consolidated financial statements.

ASU 2010-10 provides an indefinite deferral from the consolidation requirements in ASC 810 for interests in certain investment companies (or entities that account for their investments under ASC 946). In addition, ASU 2009-12 provides a practical expedient for determining the fair value of investments in certain entities. The ASU amends the criteria for qualifying for the deferral and for the practical expedient. Therefore, a reporting entity will need to evaluate whether its interest in another entity continues to qualify for the deferral in ASU 2010-10 or the practical expedient in ASU 2009-12.

Thinking It Through

An entity that is no longer considered an investment company under ASU 2013-08 will cease to qualify for the indefinite deferral requirements in ASU 2010-10, in which case the entity must reconsider its consolidation requirements under ASC 810.

Disclosures

The ASU requires an investment company to disclose that it is an investment company and that it is applying the specialized guidance in ASC 946. It also requires an entity to disclose whether there has been a change in its status as an investment company and, if so, the reasons for the change. Finally, the ASU requires an investment company to disclose information related to (1) whether it has provided financial support (e.g., type, amount, and reasons for the financial support) to any of its investees or (2) financial support that it is contractually required to provide.

In addition, as a result of perceived concerns regarding the transparency of investments by investment companies in other investment companies (e.g., fund-of-funds structure), the FASB has added a project to its agenda to require "disclosures in an investment company's financial statements that will provide transparency into the risks, obligations, and expenses of an investee that is also an investment company."[2]

Effective Date and Transition

The ASU is effective for an entity's interim and annual reporting periods in fiscal years that begin after December 15, 2013. Entities whose status changes as a result of adopting the ASU will record the effect of adoption as an adjustment to beginning retained earnings (or opening net assets) in the period of adoption. Early adoption is prohibited.

Thinking It Through

An entity's change in status to an investment company under the ASU will result in the recognition of the difference between the fair value and the carrying amount (or parent's portion of the assets minus liabilities for consolidated investments) of the investment company's investees as of the date of the change in status. Other adjustments may include the release of unrealized amounts (e.g., AOCI for AFS securities).

Liquidation Basis of Accounting

On April 22, 2013, the FASB issued ASU 2013-07, which provides guidance on when and how to apply the liquidation basis of accounting and on what to disclose. The ASU is intended to increase the consistency and comparability of financial statements prepared under the liquidation basis of accounting. Before the ASU's issuance, there had been limited guidance on this topic under U.S. GAAP. The ASU applies to both public and nonpublic entities; however, investment companies regulated under the Investment Company Act of 1940 (the "1940 Act") are excluded from its scope.

Effective Date and Transition

The ASU applies to entities that determine that liquidation is imminent during annual reporting periods beginning after December 15, 2013, and interim reporting periods therein. Early adoption is permitted. The ASU's guidance is to be applied prospectively from the date liquidation is imminent. If an entity is reporting on the liquidation basis of accounting as of the effective date under other authoritative guidance on when and how to apply the liquidation basis of accounting (e.g., terminating employee benefit plans), it does not need to apply the guidance in this ASU. However, all other entities that report liquidation basis financial statements as of the effective date would be required to recognize a cumulative-effect adjustment as of the date of adoption for differences resulting from applying the ASU.

[2] From the project page on the FASB's Web site.

Overview

The ASU requires an entity to use the liquidation basis of accounting to present its financial statements when it determines that liquidation is imminent, unless the liquidation is the same as the plan specified in an entity's governing documents created at its inception. According to the ASU, liquidation is considered imminent in either of the following situations:

a. A plan for liquidation has been approved by the person or persons with the authority to make such a plan effective, and the likelihood is remote that any of the following will occur:

    1. Execution of the plan will be blocked by other parties (for example, those with shareholder rights)

    2. The entity will return from liquidation.

b. A plan for liquidation is imposed by other forces (for example, involuntary bankruptcy), and the likelihood is remote that the entity will return from liquidation.

An entity's liquidation plan differs from the plan specified in its governing documents if the entity must dispose of its assets for a value other than fair value.

If an entity determines that liquidation is imminent and applies liquidation basis of accounting, it would initially measure its assets to reflect the amount it expects to receive in cash or other consideration. In certain circumstances, if fair value approximates the amount of consideration to be collected upon liquidation of the asset, the entity may measure the asset at fair value. Under the liquidation basis of accounting, the entity would be required to recognize and measure previously unrecognized assets that it intends to sell during the liquidation (e.g., trademarks). The entity would present — separately from the measurement of the assets or other items anticipated to be sold in liquidation — the expected aggregate liquidation and disposal costs (including selling costs such as commissions) to be incurred during the liquidation process. To measure liabilities (excluding accruals recorded in liquidation for disposal costs and ongoing expenses), the entity would use other applicable U.S. GAAP adjusted for changes in assumptions resulting from its decision to liquidate (e.g., a change in the timing of payments); however, the entity's liabilities should not be reduced on the basis of the assumption that the entity will be legally released from its obligation. In addition, the entity would estimate and accrue the expected future costs and income to be incurred or realized during the course of liquidation, such as management fees and audit and legal fees, if and when the entity has a reasonable basis for estimating these amounts. The entity would remeasure all balances as of each subsequent reporting period.

Presentation and Disclosures

Under the ASU, an entity must present, at a minimum, (1) a statement of net assets in liquidation and (2) a statement of changes in net assets in liquidation. In addition to presenting disclosures required under U.S. GAAP that are relevant to a user's understanding of the liquidation basis financial statements, an entity is also required to disclose certain other information related to the liquidation as specified in ASC 205-30-50-2.

Thinking It Through

Scope

Entities that are regulated investment companies under the 1940 Act are excluded from the scope of the ASU. The ASU does not permit other entities, such as nonregulated investment companies, to "apply this scope exception by analogy." However, nonregulated limited life investment companies should also consider the whether the anticipated liquidation plan follows that which was specified in their governing documents as inception. The ASU states a "plan of liquidation does not follow a plan that was specified in the entity's governing documents at its inception if the entity is forced to dispose of its assets in exchange for consideration that is not commensurate with the fair value of those assets."

In addition, the scope exception in ASU 2013-07 may hinder the comparability of registered investment companies' going-concern-based financial statements and nonregistered investment companies that use liquidation basis financial statements. In particular, there may be differences between (1) the valuation of certain assets (e.g., fair value as opposed to the estimated cash to be received upon disposal) and (2) the recognition of operating expenses expected to be incurred during the liquidation period (if a reasonable basis was used to estimate them) and disposal costs.

Estimating Expense Accrual

Under ASC 205-30-25-7, an entity is also required to "accrue costs and income that it expects to incur or earn (for example, payroll costs or income from preexisting orders that the entity expects to fulfill during liquidation) through the end of its liquidation if and when it has a reasonable basis for estimation." Developing estimates of future costs may be challenging because certain costs depend on the length of the liquidation period (e.g., an entity may continue to incur administrative costs and other fees to maintain its financial statements during the liquidation period). Therefore, an entity should undertake efforts to determine how long it will take to liquidate because such determination may be a factor in the development of an estimate of future expenses. Because such estimates may be uncertain, an entity should use judgment to determine whether it has a reasonable basis for its estimates. It should then evaluate its estimate and adjust it (as necessary) each subsequent reporting period.

Private-Company Standard Setting

The Private Company Council (PCC), which was formed in late 2012, works jointly with the FASB to improve the accounting standard-setting process for private companies.

Private-Company Decision-Making Framework

The PCC and FASB have worked together to develop a private-company decision-making framework (PCDMF) for identifying and evaluating U.S. GAAP accounting alternatives (i.e., exceptions or modifications) for private companies. Earlier this year, the FASB and PCC jointly issued an invitation to comment on an updated version of the PCDMF. The PCDMF identifies the following five areas in which alternatives for private companies might be considered: (1) recognition and measurement, (2) disclosures, (3) presentation, (4) effective date, and (5) transition. For more information, see Deloitte's April 25, 2013, *Heads Up*. The PCDMF is expected to be finalized by the end of this year.

The Definition of a Public Business Entity

The PCC and FASB have also considered the specific types of entities that would be eligible to adopt accounting alternatives developed under the PCDMF. In connection with establishing the scope of the PCDMF, the FASB issued for comment a proposed ASU that would (1) amend the *FASB Accounting Standards Codification* Master Glossary to add and define the term "public business entity" (PBE) under U.S. GAAP and (2) clarify what other types of entities, in addition to PBEs, would be outside the scope of the PCDMF once it is finalized. For more information, see Deloitte's August 19, 2013, *Heads Up*.

Defining a PBE is central to establishing which entities will be eligible to elect the accounting alternatives being developed by the PCC. On the basis of the definition originally proposed, an entity would be deemed a PBE if it met any one of five specific criteria, such as filing financial statements with the SEC. During redeliberations, the FASB discussed feedback received on each criterion and ultimately agreed to retain all criteria without substantial modification. A final ASU on the definition of a PBE is expected before the end of this year.

Thinking It Through

Although the proposed definition of a PBE is largely aligned with similar definitions used in existing practice, one key difference is that a subsidiary of a public company is not, by default, a PBE and thus for separate financial statement purposes it would therefore have to independently assess whether it meets any of the PBE criteria. Therefore, subsidiaries of public companies that do not independently meet the definition of a PBE could potentially adopt PCC alternatives for their stand-alone financial statements.

Proposed Accounting Alternatives for Private Companies

After the PCDMF was established, the PCC developed — and the FASB endorsed and issued for public comment — four proposed ASUs that contain U.S. GAAP accounting alternatives for private companies:

- *Goodwill* — This proposal outlines an alternative method of accounting for goodwill that would (1) permit an entity to amortize goodwill, (2) require a test for impairment only upon the occurrence of a triggering event, and (3) simplify the way the impairment test is performed. During redeliberations, the PCC voted to retain the amortization requirements and permit goodwill to be amortized over a period of 10 years but specified that a shorter period could be used if such period was appropriate under the circumstances. In addition, the PCC voted to revise the level at which goodwill is tested and give entities the option to test it at either the entity level or the reporting unit level. The PCC reaffirmed the proposal's effective date (i.e., 2015 for calendar-year companies, with early adoption permitted) and transition (i.e., prospectively applied to existing and future goodwill balances).

- *Interest rate swaps* — This proposal provides two alternative methods of accounting for certain interest rate swaps: the simplified hedge accounting approach and the combined instruments approach. During redeliberations, the PCC voted to approve the simplified hedge accounting approach with minor scope adjustments and clarifications, and it agreed on certain transition and implementation guidance. The PCC also decided to eliminate the combined instruments approach from the current proposal and consider it separately after the FASB staff performs additional research. The PCC reaffirmed the proposal's effective date (i.e., 2015 for calendar-year companies, with early adoption permitted) and transition requirements (i.e., modified retrospective or full retrospective).

- *Identifiable intangible assets acquired in a business combination* — This proposal 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. Further, the PCC discussed whether recognizing any intangible assets separately from goodwill gives users of private-company financial statements decision-useful information. As a result, the PCC directed the FASB staff to research alternatives that would subsume most, if not all, intangible assets into goodwill and to consider what enhanced disclosures would be warranted in such case.

- *Consolidation of variable interest entities* — This proposal would give an entity the option of not applying the VIE consolidation guidance to certain interests in lessor entities that are under common control. The proposal did not include an effective date but indicates that the guidance would be applied retrospectively, with an adjustment to the opening balances for the earliest period presented. The PCC has not yet started redeliberating this proposal.

For more information, see Deloitte's July 9, 2013, and August 27, 2013, *Heads Up* newsletters. It is anticipated that final standards for the goodwill and interest rate swap accounting alternatives will be issued in time for entities to potentially consider early adoption in this calendar year.

Thinking It Through

An entity's ability to adopt these accounting alternatives will be based not only on the definition of a PBE but also on the scope of each individual accounting alternative. As proposed, the interest rate swap alternative cannot be used by financial institutions and the VIE consolidation alternative only applies to circumstances in which (1) substantially all of the activity between the two parties is lease-related and (2) the entities are under common control.

On the Horizon

Leases Project

Background

On May 16, 2013, the FASB and IASB issued a revised joint ED on lease accounting. The ED, released by the FASB as a proposed ASU, introduces a new accounting model that would require entities to record substantially all leases in the statement of financial position. The proposal was issued primarily to address stakeholders' concerns about off-balance-sheet financing arrangements for lessees and would improve financial statement reporting transparency related to leases. If finalized, the proposed ASU would substantially converge the FASB's and IASB's accounting models for lease arrangements.

Lessee Accounting

The proposed accounting model for lessees is based on a right-of-use (ROU) approach, which results in the recognition of all leases (except certain short-term leases) as a lease obligation and ROU asset in the lessee's statement of financial position. The boards agreed on two different lease classification approaches for determining a lessee's subsequent accounting for the ROU asset — (1) the financing lease approach (i.e., Type A leases) and (2) the straight-line-expense approach (i.e., Type B leases).

A lessee would determine which method to apply on the basis of the nature of the underlying asset (property or something other than property) and the lease terms.

Lessor Accounting

The proposed model would require lessors to classify leases similarly to the way lessees classify them (i.e., as either Type A leases or Type B leases). Type A leases would be accounted for under the receivable-and-residual approach, which requires the lessor to (1) derecognize the leased asset, (2) recognize a lease receivable for its right to lease payments over the lease term, and (3) recognize the expected value of the residual asset at the end of the lease. Type B leases would be accounted for under the operating lease approach, which would closely mirror current operating lease accounting for lessors.

Next Steps

The boards received more than 630 comment letters on the ED, which are currently being analyzed, and indicated that they will begin redeliberations in the fourth quarter of 2013. On the basis of this timeline, a final standard could be issued sometime in 2014 but is not expected to be effective any sooner than January 1, 2017 (for calendar-year reporting periods ending on December 31, 2017).

See Deloitte's May 17, 2013, *Heads Up* for more information about the revised ED.

Thinking It Through

The proposed leasing guidance could have a significant impact on investment managers. Specifically, many investment managers currently account for their real estate leases as operating leases. Under the proposal, they would be required to record these arrangements in their financial statements. In addition, investment managers would need to evaluate arrangements for items such as office equipment and terminals to determine whether the arrangements contain leases.

Revenue Recognition

Background

In November 2011, the FASB and IASB issued a revised ED on revenue arising from contracts with customers, and they have continued to redeliberate various aspects of this proposal. On November 6, 2013, the FASB voted to move forward with preparing a final revenue standard. The final standard is expected to be issued during the first quarter of 2014.

The proposed model is based on a core principle under which an entity "shall recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services." In applying the proposed provisions to contracts within its scope, an entity would:

- Identify the contract with a customer.
- Identify the performance obligations in the contract.
- Determine the transaction price.
- Allocate the transaction price to the performance obligations in the contract.
- Recognize revenue when (or as) the entity satisfies a performance obligation.

The revised ED, issued by the FASB as a proposed ASU, significantly expands the current requirements for disclosures about revenue recognition. The boards' objective in requiring the additional disclosures "is to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers." Under the proposed ASU, entities will be required to disclose both quantitative and qualitative information about (1) the amount, timing, and uncertainty of revenue (and related cash flows) from contracts with customers; (2) the judgment, and changes in judgment, exercised in applying the proposal's provisions; and (3) assets recognized from costs to obtain or fulfill a contract with a customer.

Effective Date and Transition

For public entities, the ASU would be effective for reporting periods (fiscal and interim) beginning after December 15, 2016. Early application would not be permitted; however, entities reporting under IFRSs would have the option of early adopting the standard. Nonpublic entities have the option of one of the following three alternative adoption dates:

- The public-company effective date.
- Annual reporting periods beginning after December 15, 2016, including interim periods thereafter (i.e., same initial year of adoption as public entities, but nonpublic entities would be allowed to postpone adopting the ASU during interim reporting periods in that year).
- Annual reporting periods beginning after December 15, 2017, including interim periods therein (i.e., one-year deferral).

In applying the ASU, entities would have the option of using either retrospective transition (with certain practical expedients) or a modified approach. Entities that choose retrospective application would also consider the requirements in ASC 250. Under the modified approach, an entity would recognize "the cumulative effect of initially applying the revenue standard as an adjustment to the opening balance of retained earnings [at the date] of initial application." The proposed guidance would apply to contracts for which the entity has remaining performance obligations to fulfill as of the effective date but would not apply to contracts that were completed (i.e., the entity has no remaining performance obligations to fulfill) before the effective date. In the year of adoption, entities would also be required to disclose an explanation of the impact resulting from the adoption of the ASU as well as the financial statement line item and respective amount that are directly affected by the standard's application.

Thinking It Through

Aspects of the proposed guidance that could affect investment managers include the following:

- *Performance-based fees* — The proposed standard would supersede the guidance in ASC 605-20 (i.e., EITF D-96) that allows entities to recognize performance-based fees either (1) at the point at which revenue would not be subject to future reversal or (2) at the amount that would be due under the contract at any point in time as if the contract had ended at that point. Entities would instead apply the proposed standard's guidance on including variable consideration in the transaction price. The proposed guidance would require the use of judgment in the determination of whether performance-based fees (or a portion thereof) are included in the transaction price and, if so, the amount eligible to be recognized as revenue. Such fees are often based on future market performance, which is difficult to accurately predict. Further, having to estimate such a significant amount under the new guidance may lead to variability in revenue reporting. The effect of such variability also could be compounded by the timing of recognition of compensation expense tied to performance fees.

- *Contract costs* — The proposal contains specific guidance on the capitalization of costs to obtain and fulfill a contract. The FASB plans to retain the cost guidance in ASC 946-605-25-8 that permits distributors of mutual funds that do not have a front-end sales fee to defer and amortize incremental direct costs. Other costs incurred to obtain or fulfill a contract with a customer would be accounted for under the proposal's cost guidance.

- *Up-front fees* — Investment managers may own a broker fund that distributes sponsored products for which it receives front-end-loaded distributions or up-front fees. The proposal requires an assessment of whether up-front fees are related to a performance obligation. If the up-front fees are determined not to be related to a performance obligation (i.e., unrelated to an obligation that results in the transfer of a promised service), revenue would be deferred and recognized over the service period. This could potentially be a change from current practice. Investment managers have noted that the service period for managing a client account is difficult to determine as the tenure of a client relationship may be indefinite, or may be terminated by the client at will.

Since the final standard will supersede the majority of industry-specific revenue recognition guidance, the revenue recognition practices of investment management companies could change in a number of ways. Entities should begin now to evaluate the standard's potential effects.

Because accounting standards continue to be more "principles based," entities must generally increase their use of judgment in applying them. The proposal requires entities to "disclose the judgments, and changes in the judgments, made in applying this proposed guidance that significantly affect the determination of the amount and timing of revenue from contracts with customers." However, entities could also elect to discuss how those judgments might affect comparability with other entities in their industry.

Financial Instruments Project — Classification and Measurement

Background

On February 14, 2013, the FASB released for public comment a proposed ASU on the recognition, classification, measurement, and presentation of financial instruments. Comments on the proposal were due by May 15, 2013. (See Deloitte's February 14, 2013, and August 2, 2013, *Heads Up* newsletters for an overview of the proposed ASU and a summary of feedback from stakeholders, respectively.)

Under the proposal's mixed-attribute model:

- Entities would be required to classify a financial asset into one of the following three categories on the basis of the asset's contractual cash flow characteristics and the business model in which it is managed: (1) amortized cost, (2) fair value through other comprehensive income (FV-OCI), or (3) fair value through net income (FV-NI). A financial asset meets the contractual cash flow characteristics criterion if the contractual terms "give rise on specified dates to cash flows that are solely payments of principal and interest [SPPI] on the principal amount outstanding." Generally, financial assets that fail to meet the SPPI criterion are classified and measured at FV-NI. For a financial asset that meets the SPPI criterion, an entity would perform the business model assessment to determine whether the asset should be classified and measured at amortized cost, FV-OCI, or FV-NI measurement attribute.
- Financial liabilities would be accounted for at amortized cost, with certain exceptions.
- Equity investments would be accounted for at FV-NI unless (1) they result in consolidation, (2) the equity method of accounting applies, or (3) the investment does not have a readily determinable fair value and the entity has elected to apply a practicability exception.
- Embedded features in a hybrid financial asset would no longer be analyzed for bifurcation from the host contract. Instead, entities would be required to classify hybrid financial assets in their entirety on the basis of the contractual cash flow characteristics criterion and the entity's business model. Under the proposal, features that are bifurcated under current practice may cause a hybrid financial asset to fail the SPPI test; as a result, the hybrid instrument may need to be classified as FV-NI in its entirety. How an entity evaluates various features is a key part of the redeliberations discussed below.
- The existing unconditional fair value option for financial instruments would be replaced with a conditional option.[1]

The proposal defines principal as the "amount transferred by the holder at initial recognition" and interest as "consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time, which may include a premium for liquidity risk."

The proposed ASU identifies three distinct business models under which assets may be held and managed:

1. *Hold-to-collect* — Assets are held to collect contractual cash flows. Financial assets that meet the SPPI criterion and that are held in a hold-to-collect business model are accounted for at amortized cost.

[1] The proposal states that under this option, an entity may irrevocably elect to account for the following instruments at FV-NI:

> [A] group of financial assets and financial liabilities for which both of the following conditions are met:
>
> a. The entity manages the net exposure relating to the financial assets and financial liabilities (which may be derivative instruments subject to [ASC] 815) on a fair value basis.
>
> b. The entity provides information on a net exposure basis to its management. . . .
>
> [A] hybrid financial liability provided that neither of the following conditions exists:
>
> a. The embedded derivative or derivatives do not significantly modify the cash flows that otherwise would be required by the contract.
>
> b. It is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative or derivatives is prohibited.

In addition, an entity may irrevocably elect to account for an instrument that qualifies for the FV-OCI classification at FV-NI.

2. *Hold-and-sell* — Assets are held to collect contractual cash flows and sold. In other words, the entity has not determined whether it expects to hold or sell the assets. Financial assets that meet the SPPI criterion and that are held in a hold-and-sell business model are accounted for at FV-OCI or, optionally, at FV-NI.

3. *Neither of the above* —Financial assets held in neither a hold-to-collect nor a hold-and-sell business model are accounted for at FV-NI.

Recent Redeliberations

In response to comments received on the proposed ASU and on the IASB's proposed amendments in ED/2012/4, the FASB and IASB made several tentative decisions about the contractual cash flows characteristics assessment at their joint board meeting on September 18, 2013 — specifically, the definition of interest and features that may change the timing and amount of cash flows. The following summarizes the boards' tentative decisions at the meeting.

Meaning of Principal

Principal is the amount that was transferred by the current holder of the financial asset (i.e., at the investor's initial recognition).

Meaning of Interest

The underlying rationale for the SPPI test is to identify instruments that provide a basic lending-type return and for which amortized cost or FV-OCI is an appropriate measurement category. A feature that could affect a financial asset's cash flows (both in each period and on a cumulative basis) by only a de minimis amount would not cause the asset to fail the SPPI test. Elements of interest include the time value of money[2] and credit risk, and may also include consideration for costs associated with holding the financial asset over time (e.g., servicing or administrative costs), liquidity risk, or profit margin.

In assessing whether interest rate provides consideration just for the passage of time, the entity must consider (1) the currency in which the instrument is denominated, (2) the tenor of the interest rate, and (3) relevant market practices. Holders of financial assets will be required to use either a qualitative or quantitative analysis to determine whether the time value component of interest is limited to the passage of time. A fair value option will not be available to entities seeking to avoid complexities associated with performing the assessment.

In the assessment of the time value of money when the interest rate is modified (e.g., by an interest rate tenor mismatch feature):

- Entities would determine how different the contractual cash flows could be from the cash flows that would arise if there were a perfect link between the interest rate and the period for which the rate is set. For example, an instrument whose interest rate resets every month to a three-month rate would have an interest-rate-reset mismatch. An entity would compare the instrument's cash flows with those of another instrument that is identical in every way except that it resets monthly to a one-month rate.

- Contractual cash flows that could be more than significantly different from those of the benchmark instrument would cause an asset to fail the SPPI test.

[2] Time value of money is the element of the return on a financial instrument that provides consideration for just the passage of time, excluding a return for risks (such as credit and liquidity risk) and costs associated with the financial instrument.

- Entities should use undiscounted cash flows.
- A fair value option would not be available to entities seeking to avoid complexities associated with performing the assessment.

Regulated interest rates that involve interest rate tenor mismatches could be treated as proxies for the time value of money if the rates:

- Provide consideration for the time value of money.
- Do not introduce risks or volatilities that are unrelated to the elements of interest in basic lending-type relationships.

Contingent Features

For features that would affect an instrument's cash flows only upon the occurrence of a contingent event, an entity should consider both the nature of the triggering event and the resulting cash flows. The boards tentatively decided to clarify that the nature of the contingent triggering event in itself does not determine the classification of the financial asset.

The FASB and IASB disagree on how contingent features[3] that result in cash flows that are not SPPI should be assessed:

- The IASB supports retaining current guidance in IFRS 9; that is, if cash flows are not SPPI, the feature would cause the instrument to fail the SPPI condition unless it is nongenuine.[4]
- The FASB voted to allow for features that result in cash flows that are not SPPI, but only if the likelihood of the event's occurrence is remote. If, after initial recognition, the probability of the event's occurrence is no longer remote, the financial asset would be reclassified as FV-NI.

Prepayment Features

The FASB and IASB also disagree on how prepayment[5] features should be considered in the assessment of the SPPI condition:

- The IASB tentatively decided that prepayment features would not cause an asset to fail the SPPI test if the fair value of the prepayment feature is insignificant at initial recognition, the financial asset is acquired or originated with a significant premium or discount, and the financial asset is prepayable at an amount that represents par accrued and unpaid interest (and may include reasonable additional compensation for the early termination of the contract). Prepayments that substantially represent unpaid amounts of principal and interest on the principal amount outstanding, and any reasonable additional compensation for the early termination of the contract, would not cause an asset to fail the SPPI test.
- The FASB supports permitting prepayment features that result in cash flows that are not SPPI when the likelihood of occurrence of such cash flows is remote. If, after initial recognition, the probability of the occurrence of cash flows is no longer remote, the financial asset would be reclassified as FV-NI.

[3] Under the proposed ASU, a contractual term may give rise to contingent cash flows (i.e., changes in the timing or amount of cash flows) that are SPPI. A contingent term that results in cash flows that are not SPPI would cause an asset to fail to meet the SPPI criterion regardless of the probability of the contingent event's occurrence unless the contingent event is extremely rare, highly abnormal, and very unlikely to occur.

[4] Nongenuine features are features that are extremely rare, highly abnormal, and very unlikely to occur.

[5] Under the proposed ASU, prepayment provisions give rise to cash flows that are SPPI if both of the following conditions are met:

a. The provision is not contingent on future events, other than to protect . . .
   1. The holder against the credit deterioration of the issuer (for example, defaults, credit downgrades, or loan covenant violations) or a change in control of the issuer [or]
   2. The holder or issuer against changes in relevant taxation or law.

b. The prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the early termination of the contract.

Next Steps

At a future meeting, the boards plan to discuss additional matters related to the cash flow characteristics test and will clarify the SPPI criterion, which will involve further redeliberations of the items discussed at the September 18, 2013, joint board meeting. The FASB will then determine whether to proceed with the SPPI criterion under the current proposal on classifying financial assets or pursue a different approach (e.g., one approach might be to retain existing GAAP requirements for evaluating embedded derivative features in hybrid financial assets). The boards will also discuss the business model assessment at a future meeting.

Thinking It Through

The FASB decided to exclude investment companies that are subject to the specialized industry guidance in ASC 946 from the proposed ASU's scope. Such investment companies would continue to apply the specialized industry guidance under ASC 946.

Financial assets and financial liabilities that are not accounted for under ASC 946 would be subject to the guidance in the proposed ASU. Further, such instruments would be subject to the relevant presentation and disclosure requirements under the proposal.

Consolidation Project

Background

In November 2011, the FASB issued a proposed ASU that would provide guidance on assessing whether a decision maker is acting as a principal or as an agent when performing a consolidation analysis. The proposed guidance, which would replace the indefinite deferral in ASU 2010-10 for interests in certain entities, would amend the criteria for determining whether an entity is a VIE and, if so, whether a reporting entity is the VIE's primary beneficiary. The proposal would also revise the definitions of participating and kick-out rights and amend the evaluation of limited partnerships for consolidation. See Deloitte's November 4, 2011, *Heads Up* for more information on the proposal.

See last year's *Accounting and Financial Reporting Update* for information about the feedback the FASB received on the proposed ASU.

Thinking It Through

While the FASB's consolidation project was initially intended to address interests in entities that qualified for the deferral in ASU 2010-10, the proposed guidance may affect the consolidation conclusions for all entities evaluated under ASC 810-10. Accordingly, all reporting entities will need to reevaluate their assessment of whether (1) an entity is a VIE and (2) the reporting entity is the VIE's primary beneficiary. As they did when adopting FASB Statement 167, entities may need to expend considerable effort gathering information on all entities subject to evaluation under ASC 810-10 and performing analyses, documenting conclusions, and updating disclosures to comply with the revised standard.

Current Status

The Board is currently redeliberating feedback received on its proposed ASU. A final ASU is not expected before the second half of 2014.

Repurchase Agreements

Background

The criteria under ASC 860 for determining whether the transferor maintained effective control and thus accounted for the repurchase agreement as a secured borrowing rather than as a sale (and a forward repurchase agreement) are as follows:

- "The financial assets to be repurchased or redeemed are the same or substantially the same as those transferred."
- "The agreement is to repurchase or redeem [the financial assets] before maturity, at a fixed or determinable price."
- "The agreement is entered into contemporaneously with, or in contemplation of, the transfer."

Some constituents expressed concerns about the application of the first and second bullets above. Many constituents view repos as financing transactions even though the accounting literature allows for sale accounting in some cases. They believe that the "substantially the same" and "before maturity" aspects of the first and second bullets above could be interpreted as allowing sale accounting in circumstances in which the Board did not intend to allow it. Others indicated that more robust disclosures were needed about the (1) nature of the transactions, (2) uses of funds received, and (3) impact of repos on an entity's credit standing and liquidity. In January 2013, the FASB issued a proposed ASU that would amend U.S. GAAP by requiring repos that meet the criteria for secured-borrowing accounting, including repos that settle at the maturity of the transferred assets, to be accounted for as secured borrowings rather than as sales with forward repurchase agreements.

After discussing the feedback received, the FASB continued to redeliberate its proposed ASU and made a number of tentative decisions related to the topics below at its October 2013 meeting.

Repurchase Agreements That Settle at Maturity

The Board tentatively decided to amend ASC 860 to require entities to account for repurchase agreements that settle at maturity ("repos to maturity") as secured borrowings.

Repurchase Financings

The Board tentatively decided to affirm the guidance in the proposed ASU that would eliminate the requirement in ASC 860 for entities to determine whether to account for repos entered into as part of a repurchase financing separately or as linked to the initial transfer. The Board decided that such repos would be accounted for separately, which would be consistent with the accounting for other repos.

Substantially-the-Same Criterion

The Board tentatively decided to clarify the substantially-the-same assessment under ASC 860 related to dollar-roll transactions. It decided that a dollar-roll transaction that does not include a trade stipulation would not be expected to result in the return of a substantially-the-same financial asset, whereas a dollar-roll transaction that includes a trade stipulation could, in fact, be considered to result in the return of a substantially-the-same asset. At the October 2013 Board meeting, the FASB staff clarified that dollar-roll transactions subject to this guidance that are within the scope of ASC 860 would include transactions that involve a transfer of an existing asset with a forward agreement to repurchase a TBA security.

Thinking It Through

Securities repurchased under dollar-roll transactions typically comply with SIFMA's "good-delivery" guidelines. The Board's tentative decision clarifies that for repurchased TBA securities to be considered substantially the same (under ASC 860) as the securities transferred under the first leg of the dollar-roll transaction, the dollar-roll agreement must include trade stipulations related to the type and quality of the TBA security to be repurchased. This tentative decision would reduce the amount of judgment entities would need to use in assessing what types of securities meet the substantially-the-same guidance in ASC 860.

Disclosure Requirements and Scope of Disclosures

The Board tentatively decided to require entities to disclose information about transfers of assets accounted for as sales in which there is a continuing exposure to the transferred assets. The objective of the disclosures is to give financial statement users information that helps them understand the nature of the transactions, the transferor's continuing exposure to the transferred financial assets, and the presentation of the components of the transaction in the financial statements. As specified in the meeting's summary of decisions, the Board tentatively agreed to require the following disclosures:

a. The carrying amounts of assets derecognized as of the date of the initial transfer in transactions for which an agreement with the transferee remains outstanding at the reporting date, by type of transaction (for example, repurchase agreement, securities lending, sale and total return swap, and so forth). If the amounts have changed significantly from prior periods or are not representative of the activity throughout the period, a discussion of the reasons for the change should be disclosed.

b. Information about the transferor's ongoing exposure to the transferred financial assets by type of transaction [in paragraph (a)]:

    1. A description of the arrangements that result in the transferor retaining exposure to the transferred financial assets by type of transaction

    2. The risks related to the transferred financial assets to which the transferor continues to be exposed after the transfer

    3. As of the reporting date, the following amounts to provide users of financial statements with information about the reporting entity's maximum exposure to financial assets that are not recognized in its statement of financial position:

        i. The fair value of assets derecognized by the transferor for transactions described in paragraph (a) by type of transaction.

c. Amounts recorded in the statement of financial position arising from the transaction by type of transaction in paragraph (a), for example, the carrying value or fair value of forward repurchase agreements or swap contracts. To the extent these amounts are captured in the derivative disclosure requirements under [ASC] 815-10-50-4B, an entity should provide a cross-reference to the appropriate line item in the disclosure.

These disclosures would apply to transactions that "comprise a transfer of financial assets to a transferee and an agreement done in contemplation of the initial transfer with the same transferee that results in the transferor retaining substantially all of the exposure to the return of the transferred financial asset throughout the term of the transaction."

Transition and Reexposure

The Board tentatively decided to require entities to record a cumulative-effect adjustment to beginning retained earnings for transactions outstanding as of the period of adoption. Entities would not need to disclose any transition information beyond that already required by ASC 250.

The Board directed the staff to perform further outreach on operational aspects of the tentative decisions as well as on the effective date, the possibility of early adoption, and the applicability of the amendments to private companies. After it reviews the feedback from outreach, the Board will decide whether to expose its tentative decisions for public comment.

Going Concern

Background

Under U.S. GAAP, an entity's financial reports reflect its assumption that it will continue as a going concern until liquidation is imminent.[6] However, before liquidation is deemed imminent, an entity may have uncertainties about its ability to continue as a going concern. Because there are no specific U.S. GAAP requirements related to disclosing such uncertainties, auditors are responsible for assessing the nature, timing, and extent of an entity's disclosures on the basis of applicable auditing standards.[7] Such application has resulted in diversity in practice, which the proposal aims to alleviate.

FASB's Going-Concern Proposed ASU

On June 26, 2013, the FASB issued a proposed ASU that would provide guidance on determining when and how to disclose going-concern uncertainties in the financial statements. Under the proposal, management would be required to perform interim and annual assessments of an entity's ability to continue as a going concern within 24 months of the financial statement date. An entity would have to disclose uncertainties about such an ability if (1) it is "more likely than not" (MLTN) — that is, a likelihood of more than 50 percent — that it will not be able to meet its obligations within 12 months of the financial statement date or (2) it is "known or probable that the entity will be unable to meet its obligations within 24 months after the financial statement date." Although the proposed ASU applies to all entities, a public entity would also have to assess whether there is "substantial doubt" about its ability to continue as a going concern and, if so, would need to provide specific disclosures. Comments on the proposed ASU were due by September 24, 2013.

The proposed ASU extends the responsibility for performing the going-concern assessment from auditors (as required under current auditing standards[8]) to management and contains guidance on how to perform a going-concern assessment and when going-concern disclosures would be required under U.S. GAAP.

Key Provisions of the Proposed ASU

Disclosure Thresholds

As noted above, an entity would be required to disclose information about its potential inability to continue as a going concern when either:

> a. It is more likely than not that the entity will be unable to meet its obligations within 12 months after the financial statement date. . . . [or]
>
> b. It is known or probable that the entity will be unable to meet its obligations within 24 months after the financial statement date.

In applying the disclosure threshold outlined in (a) and (b) above, entities would be required to evaluate all conditions and events (including positive and mitigating conditions) except for management's plans that are outside the ordinary course of business.[9]

In addition, the proposed ASU indicates that the MLTN threshold is not intended to be a "formula-based likelihood calculation"; rather, it is a "benchmark" in the determination of whether disclosures are required. The proposal provides examples of events that suggest that an entity may be unable to meet its obligations.

[6] In accordance with ASC 205-30, once liquidation is deemed imminent, an entity must apply the liquidation basis of accounting.

[7] PCAOB AU Section 341A.

[8] PCAOB AU Section 341A.02.

[9] The proposal defines actions that are "outside the ordinary course of business" as those "of a nature, magnitude, or frequency that are inconsistent with actions customary in carrying out an entity's ongoing business activities." The proposal also provides examples of management's plans that are outside the ordinary course of business.

Thinking It Through

Under current auditing standards, an auditor is required to evaluate the adequacy of going-concern disclosures after concluding that there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. Accordingly, the MLTN threshold may result in an entity's having to disclose uncertainties about its ability to continue as a going concern earlier than is required under current practice.

In addition, a public entity would be required to evaluate whether there is substantial doubt[10] about its ability to continue as a going concern. Unlike the disclosure threshold outlined above, the substantial-doubt assessment takes into account management's plans outside the ordinary course of business. Nonpublic entities would not be required to perform the substantial-doubt assessment.

Time Horizon

At the end of each reporting period (including interim periods), an entity would be required to assess its ability to meet its obligations as they become due for up to 24 months after the financial statement date. In the 12 months after the financial statement date, the entity would assess whether it is MLTN that it would not be able to meet its obligations. Beyond 12 months, the entity would consider only information about events or conditions whose impact is "known or probable" to the entity's going-concern presumption.

Thinking It Through

The proposal's assessment period is longer than that in current auditing literature, which requires auditors to "evaluate whether there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time, . . . not to exceed one year beyond the date of the financial statements being audited."[11]

Disclosure Content

If an entity triggers the MLTN threshold, it would be required to provide footnote disclosures similar to those required by current auditing literature.[12] The proposal indicates that these disclosures would describe the following:

a. Principal conditions and events that give rise to the entity's potential inability to meet its obligations

b. The possible effects those conditions and events could have on the entity

c. Management's evaluation of the significance of those conditions and events [and any mitigating factors]

d. Mitigating conditions and events

e. Management's plans that are intended to address the entity's potential inability to meet its obligations.

The proposal explains that these disclosures may change over time as new information becomes available.

In addition, if a public entity determines that there is substantial doubt about its ability to continue as a going concern within 24 months after the financial statement date, the entity would be required to disclose that it has such doubt by using specific wording described in the proposal.[13]

[10] According to the proposal, substantial doubt "exists when information about existing conditions and events . . . indicates that it is known or probable that an entity will be unable to meet its obligations as they become due within 24 months after the financial statement date."

[11] PCAOB AU Section 341A.02.

[12] PCAOB AU Section 341A.10.

[13] Under the proposal, if an SEC filer "determines that there is substantial doubt about its going concern presumption, the entity shall disclose that determination in its financial statements through the use of the phrase *there is substantial doubt about the entity's ability to continue as a going concern within 24 months after the financial statement date* or similar wording that includes the terms substantial doubt, and *ability to continue as a going concern* or *ability to prepare financial statements under the going concern presumption*."

Effective Date

The guidance in the proposal would be applied prospectively for reporting periods after the final standard's effective date, which has not yet been established.

Comment Letter Feedback

While respondents generally supported the project to incorporate going-concern disclosure guidance into U.S. GAAP, they expressed a number of concerns, including that the Board should (1) clarify or revise the disclosure thresholds and the assessment of whether management's plans are inside or outside the ordinary course of business, (2) work with the PCAOB and ASB to ensure that the auditing guidance is consistent with U.S. GAAP and that the effective dates of their respective projects are coordinated with the FASB's project, and (3) require non-SEC filers, in addition to SEC filers, to evaluate and disclose substantial doubt about their going-concern presumption.

At its meeting on November 6, 2013, the FASB agreed to continue deliberating the proposed ASU and, as described in the Summary of Board Decisions, focus specifically on:

1. Initial disclosure threshold including information to be assessed
2. Consideration of management's plans outside the ordinary course of business
3. Disclosure content
4. 24-month assessment period
5. Substantial doubt threshold
6. Applicability of substantial doubt to non-SEC filers.

In addition, the Board approved the staff's plan to perform outreach with various stakeholders and expects to continue deliberating in January 2014.

EITF Issue No. 12-G, "Accounting for the Difference Between the Fair Value of Assets and Liabilities of a Consolidated Collateralized Financing Entity"

Background

In 2012, the EITF added Issue 12-G to its agenda to address the diversity in practice related to the accounting for the measurement difference that arises at initial recognition between the fair value of the assets and liabilities upon consolidation of a CFE.[14] Specifically, some entities record the initial difference between the fair value of the CFE's assets and liabilities directly to appropriated retained earnings while others record the difference in earnings. The FASB's July 2013 proposed ASU would amend the initial and subsequent measurement requirements for the consolidated CFE's liabilities.

[14] In July 2013, the FASB issued a proposed ASU that defines a CFE as a "variable interest entity [VIE] that holds financial assets, issues beneficial interests in those financial assets, and has no more than nominal equity. The beneficial interests have recourse to the related financial assets of the [CFE] and are classified as financial liabilities. A [CFE] may hold nonfinancial assets temporarily as a result of default by the debtor on the underlying debt instruments held as assets by the [CFE] or in an effort to restructure the debt instruments held as assets by the [CFE]." Examples include collateralized debt obligation or collateralized loan obligation entities.

Key Provisions

Under the proposed ASU, an entity that elects or is required to measure a consolidated CFE's financial assets at fair value may also elect to use the following calculation to measure the CFE's financial liabilities, which is based largely on the fair value of the CFE's financial assets:

a. The sum of the following two amounts:

   1. The fair value of the financial assets held by the [CFE]

   2. The carrying value of any nonfinancial assets held by the [CFE]

b. Less the sum of the following two amounts:

   1. The sum of the fair value of financial assets and the carrying value of nonfinancial assets attributable to the beneficial interest owned by the reporting entity

   2. The carrying value of any beneficial interests that represent compensation for services rendered by the reporting entity.

An entity that makes this election would apply the calculation above at initial measurement (i.e., when it becomes the primary beneficiary of a VIE that is a CFE and therefore consolidates the CFE) and in subsequent periods. In addition, entities that consolidate a CFE would be prohibited from electing the fair value option in ASC 825 for a consolidated CFE's financial liabilities. As a result, entities would generally measure a consolidated CFE's financial liabilities either by using the calculation above or at amortized cost if the proposed ASU becomes effective.

Effective Date and Transition

For public companies, the amendments would be effective for fiscal years beginning after December 15, 2013, and interim periods therein; however, for nonpublic entities, they would be effective for fiscal years beginning after December 15, 2014, and interim and annual periods thereafter. Entities that previously measured a consolidated CFE's assets and liabilities at fair value would use one of the following two transition methods: (1) prospective (i.e., reclassify amounts recorded in equity to either financial assets or financial liabilities as of the beginning of the period of adoption) or (2) retrospective (i.e., apply the updates as of the beginning of the first annual period in which ASU 2009-17 was adopted). Entities that did not previously measure a consolidated CFE's financial assets at fair value may elect to do so at adoption but would be required to apply this final consensus prospectively.

Next Steps

The EITF will further discuss this Issue at its November 14, 2013, meeting.

Thinking It Through

Most respondents do not support the measurement approach in the proposed ASU. Some indicated that the guidance on measuring the CFE's financial liabilities is ambiguous. In addition, some believe that the proposed measurement approach could result in the recognition of noneconomic net income when there are differences between the calculated carrying of the CFE's liabilities and the amounts paid to acquire the interests from third parties. Most respondents to the proposed ASU have indicated that they prefer an approach that focuses on the reporting entity's net economic position in the CFE (i.e., similar to the approach in the original ED).

Other Topics

COSO Framework

The 2013 Framework

On May 14, 2013, the Committee of Sponsoring Organizations of the Treadway Commission (COSO)[1] released an updated version of its *Internal Control — Integrated Framework* (the "2013 Framework"). In addition, COSO released two illustrative documents, *Illustrative Tools for Assessing Effectiveness of a System of Internal Control* (the "Illustrative Tools") and *Internal Control Over External Financial Reporting: A Compendium of Approaches and Examples* (the "ICEFR Compendium"), as well as an executive summary of the 2013 Framework.

COSO's primary objective in updating and enhancing the framework is to address the significant changes to business and operating environments that have taken place over the past 20 years. While the fundamental concepts in the 2013 Framework are similar to those in the original framework issued in 1992 (the "1992 Framework"), the 2013 Framework adds or expands discussions about each component and principle. For example, although the concept of identifying and responding to risks was present in the 1992 Framework, the 2013 Framework includes more detailed discussions about risk assessment concepts, including those related to inherent risk, risk tolerance, how risks may be managed, and linkage between risk assessment and control activities.

The 2013 Framework also creates a more formal structure for designing and evaluating the effectiveness of an entity's ICFR by (1) using 17 principles to explain the concepts underlying the five components[2] of ICFR and (2) creating a more formal way of designing and evaluating ICFR in accordance with the principles. Unlike the 1992 Framework, the 2013 Framework explicitly includes the concept of considering the potential for fraud risk in the assessment of risks to the achievement of an organization's objectives. The 2013 Framework also specifies that in an effective system of internal control, each of the five components and relevant principles are required to be present and functioning and that the five components are required to operate together in an integrated manner.

COSO provides a transition period — from May 14, 2013, to December 15, 2014 — for entities to move to the 2013 Framework. The 1992 Framework will continue to be available during the transition period. However, it will be superseded after December 15, 2014. Entities are encouraged to "transition their applications and related documentation to the updated Framework as soon as is feasible under their particular circumstances."

The impact of the 2013 Framework on management's assessment of the effectiveness of ICEFR will depend on how a company applied and interpreted the concepts in the 1992 Framework. The existing system of internal control may or may not clearly demonstrate that all the relevant principles are present and functioning. The ICEFR Compendium and the Illustrative Tools may help companies apply the 2013 Framework.

For a more detailed discussion on the 2013 Framework, see Deloitte's June 10, 2013, *Heads Up*.

The FASB's Disclosure Framework Project

Background

In July 2012, the FASB issued a DP as part of its project to develop a framework to make financial statement disclosures "more effective, coordinated, and less redundant." The DP identifies aspects of the notes to the financial statements that need improvement and explores possible ways to improve them. If implemented, some of the ideas in the DP could significantly change the Board's process for creating disclosure requirements in future standards and could alter those in existing standards. See Deloitte's July 17, 2012, *Heads Up* for additional information.

[1] COSO is a joint initiative of five private-sector organizations and is dedicated to providing thought leadership by developing frameworks and guidance on enterprise risk management, internal control, and fraud deterrence. The five private-sector organizations are the American Accounting Association, the American Institute of Certified Public Accountants, Financial Executives International, the Institute of Management Accountants, and the Institute of Internal Auditors.

[2] Control environment, risk assessment, control activities, information and communication, and monitoring activities.

Summary of Comment Letter Feedback

Comments on the FASB's DP were due by November 30, 2012. The FASB received over 80 comment letters from various respondents, including preparers, professional and trade organizations, and accounting firms. Respondents generally supported the project, including the concept of making disclosure requirements more flexible. In addition, many respondents believed that excessive disclosures reduce transparency and effectiveness. However, many were also concerned that reducing the volume of disclosures was not one of the project's stated objectives and that the DP's proposed decision process may actually lead to an increase in disclosures.

Respondents also requested clarification on certain aspects of the DP, including (1) defining the "boundary" or purpose of the notes to the financial statements, (2) applying relevance and materiality concepts to disclosures, and (3) differentiating between the Board's process for setting disclosure requirements and the entity's process for determining the appropriate disclosures to provide in its financial statements.

Further, many respondents encouraged the Board to work with regulatory bodies, such as the SEC, to ensure more effective and less redundant disclosures.

Redeliberations

In response to the feedback received, the Board is currently redeliberating certain aspects of the DP and has tentatively agreed to make separate decisions about (1) the process for creating disclosure requirements and (2) an entity's decision process for determining what to disclose.

Specifically, the Board has tentatively decided to:

- Clarify what information should be included in or excluded from the notes to the financial statements.
- Not require entities to include forward-looking disclosures, unless such disclosures provide information about existing circumstances that have implications for the future. Such information may include expectations and assumptions that are used to explain inputs to items presented or disclosed in the financial statements (e.g., forward-looking impairment assumptions that were used to calculate a recognized asset impairment).
- Take into account the needs of donors (for not-for-profit entities).
- Add or revise certain questions in the DP to reflect various conclusions reached during redeliberations to exclude employee benefit plans from the Board's decision process.

Next Steps

After completing its redeliberations and additional outreach, the Board plans to issue separate EDs on (1) the Board's decision process for creating disclosure requirements and (2) the entity's decision process for determining what to disclose. The FASB expects to issue the first ED by January 15, 2014.

Dodd-Frank Act Updates

Background of the Dodd-Frank Act

The passage of the Dodd-Frank Act in July 2010 brought a number of key reforms to the U.S. financial system. Over the past three years, the SEC has acted on a number of provisions in the Dodd-Frank Act by (1) proposing and approving various rules, (2) completing certain mandated studies, (3) submitting certain required reports, and (4) creating various offices and committees. This section summarizes Dodd-Frank Act activity that has occurred since the last edition of this publication.

Final Rule on Broker-Dealer Audit and Reporting Considerations

On July 30, 2013, the SEC issued a final rule amending certain annual reporting, audit, and notification requirements for broker-dealers under Rule 17a-5 and Rule 17a-11 of the Exchange Act. The final rule was issued in response to the Dodd-Frank Act's mandate to improve oversight of broker-dealers.

Under the final rule, a broker-dealer that has custody of customer assets (i.e., a "carrying broker-dealer") must file a compliance report with the SEC verifying that it (1) is in compliance with broker-dealer capital requirements, (2) protects the assets it maintains for customers, and (3) sends periodic account statements to customers. In contrast, a broker-dealer that does not have custody of customer assets (i.e., a "noncarrying broker-dealer") must file an exemption report indicating its exemption from the requirements in SEC Rule 15c3-3. Regardless of whether the broker-dealer submits a compliance report or an exemption report, it must engage a PCAOB-registered independent public accountant to examine or review certain statements included in the broker-dealer report. The examination or review of the broker-dealer compliance and exemption forms is subject to PCAOB standards.

In addition, the final rule expands the broker-dealer Exchange Act examination regulations by requiring a broker-dealer to (1) submit a newly created quarterly report (i.e., the "Form Custody" report) containing information on whether and, if so, how "it maintains custody of its customers' securities and cash" and (2) allow the SEC and SRO staff to, upon request in writing, review and discuss the examination workpapers with the independent public accountant.

Most of the final rule's amendments will become effective on June 1, 2014. However, the amendments to Section 17a-5(e)(5) became effective on October 21, 2013, and the amendments to Section 17a-5(a) and (d)(6) and the requirement to file the Form Custody report will become effective on December 31, 2013.

Rescission of Supervised Investment Bank Holding Company Rules

On July 12, 2013, the SEC issued a final rule implementing Section 617 of the Dodd-Frank Act, which requires the elimination of rules (under Section17(i) of the Exchange Act) establishing the SEC's program for overseeing supervised investment bank holding companies (SIBHCs). The final rule also rescinds certain SIBHC-related exemptive provisions in the SEC's rules for (1) broker-dealer risk assessment and (2) delegation of authority.

This final rule became effective on July 18, 2013.

Final Rule to Disqualify Felons and Other "Bad Actors" From Offering or Selling Securities in Certain Exempt Offerings

On July 10, 2013, the SEC issued a final rule implementing Section 926 of the Dodd-Frank Act. Under the final rule, covered persons, including the issuer, its predecessors and affiliated issuers, and other persons,[3] are precluded from using the Regulation D, Rule 506, exemption[4] to offer securities if they are party to certain disqualifying events, including:

- Felony or misdemeanor criminal convictions, court injunctions, or restraining orders in connection with the (1) sale or purchase of a security or (2) submission of a false filing to the SEC.

[3] In addition to the issuer (and the issuer's predecessors and affiliated issuers), the final rule's definition of covered persons includes the following: (1) "any director, officer, [footnote omitted] general partner or managing member of the issuer"; (2) "any beneficial owner of 10% or more of any class of the issuer's equity securities"; (3) "any promoter connected with the issuer in any capacity at the time of the sale"; (4) "any person that has been or will be [compensated — directly or indirectly] for solicitation of purchasers in connection with sales of securities in the offering"; and (5) "any director, officer, general partner, or managing member of any such compensated solicitor."

[4] When securities are offered to the general public, issuers are generally required to register the securities with the SEC. When certain conditions are met, however, an issuer may be exempt from registering its securities. Issuers that issue exempt securities typically rely on the exemption in Regulation D, Rule 506.

- Final orders from federal and state banking, credit union, savings association, insurance, or other regulatory agencies that prohibit the issuer from associating with one of their regulated entities or from otherwise engaging in activities that they regulate.
- Certain SEC disciplinary orders related to brokers, dealers, municipal securities dealers, investment companies, and investment advisers and their associated persons.
- SEC cease-and-desist orders related to violations of certain antifraud provisions and registration requirements of the federal securities laws.

The final rule clarifies that although it applies to disqualifying events that occur after its effective date, issuers must disclose events that occurred before the effective date in securities offerings filings.[5] However, the final rule contains a "reasonable care" exception that would allow an issuer to use the Rule 506 exemption when it can show that it did not know and could not have known that a covered person participating in the offering was party to a disqualifying event.

This final rule became effective on September 23, 2013.

Final Rule to Help Prevent Identity Theft

The Dodd-Frank Act shifted responsibility for issuing rules to detect, prevent, and mitigate identity theft under the Fair Credit Reporting Act from the FTC to the SEC and CFTC. Consequently, on April 10, 2013, the SEC and CFTC jointly issued a final rule requiring SEC-regulated entities that meet the definition of a "financial institution" or "creditor" (e.g., broker-dealers, mutual funds, and investment advisers) to implement a program to identify and mitigate identity theft.

While the requirements in the final rule are "largely identical" to those previously mandated under the FTC and other agencies, the final rule notes that an entity's identity theft program should be designed to (1) identify relevant types and occurrences of identity theft red flags and (2) appropriately respond to such red flags. Entities should also periodically evaluate and update their identity theft programs. Initiatives such as staff training programs and service provider oversight should also be implemented. Further, entities that issue debit or credit cards will be required to take certain measures when they receive requests for new cards shortly after they receive a "change of address" notification related to a consumer's account.

This final rule became effective on May 20, 2013, and must be complied with by November 20, 2013.

Final Rule on Lost Securityholders and Unresponsive Payees

On January 16, 2013, the SEC issued a final rule that amends Rule 17Ad-17 of the Exchange Act in response to Section 929W of the Dodd-Frank Act. Previously, Rule 17Ad-17's requirement to search for lost securityholders applied only to recordkeeping transfer agents; under the final rule, it applies to broker-dealers and other security market participants as well. For a "not yet negotiated" check (i.e., not cashed) of $25 or more, payment agents[6] will be required to notify a "missing securityholder"[7] — within seven months of a check's issuance — that the check was issued but not cashed. The final rule also clarifies that its added notification requirements "shall have no effect on state escheatment laws."

This final rule became effective on March 23, 2013, and must be complied with by January 23, 2014.

Extension of Exemptions for Security-Based Swaps

On January 29, 2013, the SEC amended the expiration date of its interim final rule containing certain exemptions for security-based swap arrangements. The interim final rule that initially went into effect on July 11, 2011, expired on February 11, 2013. The amendment extends the expiration date to February 11, 2014.

[5] As noted in footnote 232 of the final rule, timing of a disqualifying event for transition is determined on the basis of a triggering event — for example, the timing of a conviction as opposed to the timing of the underlying conduct. Thus, if a triggering event (e.g., a conviction or court order) occurs after the effective date of the final rule, it will be a disqualifying event that would preclude the issuer from relying on the Regulation D, Rule 506, exemption.

[6] The final rule defines a payment agent as "any issuer, transfer agent, broker, dealer, investment adviser, indenture trustee, custodian, or any other person that accepts payments from the issuer of a security and distributes the payments to the holders of the security."

[7] As defined in the final rule.

Under Title VII of the Dodd-Frank Act, the Securities Act and Exchange Act were amended to incorporate the term "security-based swap" into the definition of "security." The SEC adopted this interim final rule to exempt offers and sales of "security-based swaps" from the provisions of the Securities Act (other than the antifraud provisions of Section 17(a)), the registration requirements of the Exchange Act, and the provisions of the Trust Indenture Act of 1939 until the SEC releases final rules on the definition of "security-based swap" and "eligible contract participant."

Proposed Rule on "Pay Ratio" Disclosure

On September 18, 2013, the SEC issued a proposed rule to implement Section 953(b) of the Dodd-Frank Act. Under the proposal, a registrant subject to the filing requirements of Regulation S-K, Item 402, would need to disclose (1) the median of the annual total compensation of its employees and (2) the ratio of this median to its CEO's annual pay. Emerging growth companies,[8] smaller reporting companies,[9] and foreign private issuers[10] would be exempt from this requirement.

According to the proposed rule, the SEC received nearly 23,000 comment letters on Section 953(b). In addition to expressing varying degrees of support for the disclosures, commenters had concerns about their complexity and the costs of implementing them. The proposal indicates that to mitigate such concerns, registrants would be permitted flexibility in:

- Identifying the population of employees for whom to calculate the median employee income. The population must include full-time, part-time, seasonal, domestic, and foreign employees "employed as of the last day of the registrant's last completed fiscal year" but may also (1) include all employees or (2) be on the basis of a statistical sample.
- The methods they use to identify the median annual total compensation of their employees.
- Use of reasonable estimates to calculate annual total compensation, any element of total compensation, and the annual total compensation of the median employee.

In addition, a registrant could annualize the income of full-time employees who have not worked the entire year (i.e., newly hired employees) but would not be permitted to annualize part-time or seasonal employees' compensation. In addition, registrants would not be permitted to adjust a non-U.S. employee's income for cost-of-living differences.

Comments on the proposed rule are due by December 2, 2013. See Deloitte's October 2013 *Corporate Governance Monthly* Hot Topics article for more information.

SEC and Other Federal Agencies Issue Proposed Rule on Credit Risk Retention

On August 28, 2013, the SEC and five other federal agencies[11] jointly issued a proposed rule that revised their 2010 proposal to implement the credit risk retention requirements mandated by the Dodd-Frank Act.[12] Except for securitization transactions of ABS that are collateralized exclusively by qualified residential mortgages (as defined in the proposed rule), sponsors of securitization transactions — or their majority-owned affiliates — would be required to "retain not less than 5 percent of the credit risk of the assets collateralizing the asset-backed securities."

Like the original proposal, the proposed rule permits securitizers to select a form of risk retention from a menu of specified options. It thus gives them the flexibility to choose a credit risk retention structure that is consistent with current securitization market practices. The available options include:

- Vertical risk retention, which is achieved by holding, at a minimum, 5 percent of the fair value of each class of ABS issued in a securitization transaction, regardless of whether the interest is "certificated." Under this option, the securitizer would have an interest in the entire structure of the securitization transaction.

[8] As defined in Section 3(a) of the Exchange Act.

[9] As defined in Regulation S-K, Item 10(f)(1).

[10] Foreign private issuers include those that file annual reports and registration statements on Forms 20-F and 40-F.

[11] The Office of the Comptroller of the Currency; the Board of Governors of the Federal Reserve System; the Federal Deposit Insurance Corporation; the Federal Housing Finance Agency; and the Department of Housing and Urban Development.

[12] Credit risk retention requirements were established by Section 15G of the Exchange Act in accordance with Section 951 of the Dodd-Frank Act.

- Horizontal risk retention, which is made up of "first-loss residual interest" retention, representing a minimum of 5 percent of the fair value of all ABS interests issued (the "eligible horizontal residual interest"). The interest may consist of either a single class or multiple classes in the issuing entity, but in either case the interest retained must represent the most subordinated ABS interest(s).

- Any combination of vertical risk retention and horizontal risk retention in a total amount equal to 5 percent of the fair value of all ABS interests issued.

Comments on the proposed rule were due by October 30, 2013.

Thinking It Through

A sponsor's flexibility under the proposed rule to hold more of an eligible vertical interest in lieu of an eligible horizontal residual interest could potentially reduce the significance of the risk profile of the sponsor's economic exposure to the securitization vehicle, which is one of the characteristics the sponsor evaluates when determining whether to consolidate the securitization vehicle for accounting purposes under ASU 2009-17.

Proposed Rules and Interpretive Guidance on Cross-Border Security-Based Swap Activities

On May 1, 2013, the SEC issued a proposed rule to implement certain provisions of Title VII of the Dodd-Frank Act related to parties that engage in cross-border security-based swap activities. The intent of the proposed rule is to further improve regulatory oversight over derivatives and provide interpretive guidance to help registrants apply the rule's requirements to derivatives with elements that are partially transacted within and outside of the United States.

Under the proposed rule, a security-based swap transaction would be subject to Title VII requirements if the transaction is entered into by a U.S. person[13] or otherwise executed in the United States. Acknowledging that foreign jurisdictions are also working to implement regulatory schemes related to derivatives trading and that regulatory overlap may result, the proposed rule would allow a foreign market participant involved in a security-based swap transaction to rely on the requirements of its home jurisdiction (the proposed rule calls this approach "substituted compliance"). Whether a foreign market participant could rely on a foreign regulatory scheme (rather than under Title VII, as required by the proposed rule) would depend on whether the use of such a scheme would result in an outcome consistent with that expected under the proposed rule. The proposed rule also notes that an "all-or-nothing" approach is not required. That is, if the parties to the transaction decide to apply the substituted compliance approach, they have flexibility to adopt some of the foreign regulatory scheme's requirements and may defer to the proposed rule's requirements for elements for which consistent outcomes are not expected to be achieved.

In addition, the proposed rule (1) provides guidelines on when a non-U.S. person is required to register with the SEC as a security-based swap dealer or major security-based swap participant and (2) details other regulatory requirements applicable to a security-based swap dealer and a major security-based swap participant.

The proposed rule also includes other guidance related to security-based transactions, clarifying when these transactions would (1) need to be reported to a data repository or (2) be subject to the public disseminating, clearing, and trade execution requirements. Moreover, the proposed rule provides guidelines on when security-based swap infrastructures (e.g., clearing agencies, execution facilities, and data repositories) would need to register with the SEC. Finally, the proposed rule clarifies when a security-based swap data repository would be allowed to remit data to a requesting regulator without the required indemnification agreement (i.e., when the indemnification agreement requirement would be waived).

Comments on the proposed rule were due by on July 22, 2013. The SEC has not indicated when a final rule will be adopted.

[13] A U.S. person, as defined by the proposed rule, would be any (1) "natural person resident in the United States"; (2) a "partnership, corporation, trust, or other legal person organized or incorporated [in] the United States or having its principal place of business in the United States"; or (3) an "account of . . . a U.S. person."

Other Dodd-Frank Activities

In addition to the proposed and final rulemaking activity mandated by the Dodd-Frank Act, the SEC completed the following studies and reports for Congress since the previous version of this publication:

- An annual report on use of data collected from advisers to hedge funds and other private funds to aid in monitoring system financial risk (July 25, 2013).
- A report on the activities of the *Office of Minority and Women Inclusion* (April 24, 2013).
- A study on the rating process for structured finance products and the feasibility of an assignment system (December 18, 2012).

Other Dodd-Frank Rulemaking Yet to Come

While a number of the Dodd-Frank Act's objectives have been accomplished, the SEC still needs to address certain significant areas, some of which are not specifically related to financial reporting (i.e., more corporate governance). For example, the Dodd-Frank Act directs the SEC to establish rules on executive compensation, including:

- Rules to implement the Dodd-Frank Act's "clawback" provisions (i.e., recovery of executive compensation after the registrant's financial statements are restated).
- Rules requiring proxy disclosure about whether employees and directors are allowed to hedge the value of any securities granted to or otherwise owned by them.

In addition, the SEC plans to propose rules to define "other significant matters" related to broker voting on uninstructed shares.

Money Market Fund Reform

Background

In the aftermath of the financial crisis of 2008, the SEC tightened regulations that require money market funds (MMFs) to (1) shorten the maturities and improve the credit quality of the investments they hold, (2) comply with the regulations' liquidity provisions, and (3) expand disclosures about their investment portfolios and shadow net asset values (NAVs). In November 2012, the Financial Stability Oversight Council (FSOC) issued for public comment proposed recommendations that would make MMFs less susceptible to "runs" and increase the transparency of their risks. The FSOC has not yet asked the SEC to act on the proposed recommendations and seems unlikely to do so in light of the new, separate proposed rule[14] on MMFs issued by the SEC in June 2013.

The SEC's June 2013 proposal (whose comment period ended on September 17, 2013) outlines the following two main alternatives (or combination of them) for addressing potential systemic risks in MMFs:

- *Floating NAV* — Require prime institutional MMFs to have a floating NAV by mandating that they use market-based valuations instead of amortized cost valuations. Fluctuating daily share prices would be (1) reported on the basis of market value changes related to a fund's portfolio and (2) rounded to the nearest hundredth of a percent[15] rather than penny rounded.

[14] Comments on the proposed rule were due on by September 17, 2013.

[15] The proposal would "require that each money market fund round prices and transact in its shares at the fourth decimal place in the case of a fund with a $1.00 target share price (i.e., $1.0000) or an equivalent level of precision if a fund prices its shares at a different target level (e.g., a fund with a $10 target share price would price its shares at $10.000)."

- *Liquidity Fees and "Redemption Gates"* — Allow MMFs[16] to continue to price their shares at a stable $1.00 per share[17] by rounding the fund's NAV to the nearest 1 percent (i.e., the nearest penny) and rescind the use of amortized cost to value the funds. In addition, under this alternative, when a fund's weekly liquid assets (as defined in the proposed rule) fall below 15 percent of its total assets:
  - The fund would, with limited exceptions, be required to impose a 2 percent liquidity fee on all redemptions unless its board determines that the fee is not in the best interests of the fund or determines that a lower fee would be in the fund's best interests.
  - The fund's board could impose a temporary suspension on redemptions (or "gate") for up to 30 days in any 90-day period.
  - The fund would be required to provide certain notifications promptly to the public.

The proposal would also require MMFs to (1) enhance their disclosures, (2) strengthen their "stress-testing," (3) increase their diversification, and (4) disclose additional information about their holdings and liquidity.

Thinking It Through

Both the front- and back-office operations of MMF sponsors may need to expend considerable effort to comply with the proposed requirements. For example, systems may need to be updated to comply with the floating NAV requirement. The proposal's application beyond MMFs would also need to be considered, such as the need for new IRS guidance to exempt institutional prime MMFs from the wash sales rules so that purchases and redemptions within a 30-day period could be netted for tax purposes. A number of industry comment letters opposed the application of both a floating NAV and the potential for liquidity fees and gates, asserting that the combination would discourage investors from using MMF products. Conversely, the presidents of all the Federal Reserve regional banks as well as other voices from the banking sector have maintained that the SEC's proposal for a floating NAV for institutional prime MMFs does not go far enough and have called for a floating NAV for both retail and institutional MMFs. Whether the SEC retains the liquidity and gating features as tools to address systemic risks or broadens the floating NAV requirement to all MMFs remains unclear. However, given the amount of interest in resolving these matters, it is likely that the SEC will try to make a final decision soon.

[16] As stated in the SEC's fact sheet on the proposal, "[g]overnment money market funds would be exempt from the fees and gates requirement. However, these funds could voluntarily opt into this new requirement."

[17] MMFs traditionally have been priced with a stable NAV of $1.00 on the basis of the requirement that these funds' investments be short term and highly liquid.

Appendixes

Appendix A — Glossary of Standards and Other Literature

The standards and literature below were cited or linked to in this publication.

FASB ASC References

For titles of *FASB Accounting Standards Codification* references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

FASB Accounting Standards Updates and Other FASB Literature

See the FASB's Web site for the titles of:

- Accounting Standards Updates.
- Proposed Accounting Standards Updates.
- Pre-Codification literature (Statements, Staff Positions, EITF Issues, and Topics).
- Concepts Statements.

SEC Final Rules

33-9383, *Extension of Exemptions for Security-Based Swaps*

33-9408, *Money Market Fund Reform; Amendments to Form PF*

33-9414, *Disqualification of Felons and Other "Bad Actors" From Rule 506 Offerings*

34-68668, *Lost Securityholders and Unresponsive Payees*

34-69359, *Identity Theft Red Flags Rules*

34-69979, *Rescission of Supervised Investment Bank Holding Company Rules*

34-70073, *Broker-Dealer Reports*

34-70468, *Extension of Temporary Registration of Municipal Advisors* (extension)

SEC Proposed Rules

33-9452, *Pay Ratio Disclosure*

34-69490, *Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants*

34-69491, *Reopening of Comment Periods for Certain Rulemaking Releases and Policy Statement Applicable to Security-Based Swaps Proposed Pursuant to the Securities Exchange Act of 1934 and the Dodd-Frank Wall Street Reform and Consumer Protection Act*

34-70277, *Credit Risk Retention*

SEC Regulation D

Rule 506, "Exemption for Limited Offers and Sales Without Regard to Dollar Amount of Offering"

SEC Regulation S-K

Item 10, "Application of Regulation S-K"

Item 402, "Executive Compensation"

PCAOB Literature

AU Section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*

International Standards

See Deloitte's IAS Plus Web site for the titles of:

- International Financial Reporting Standards.
- International Accounting Standards.
- EDs.

Appendix B — Abbreviations

Abbreviation	Description
ABS	asset-backed securities
AFS	available for sale
AICPA	American Institute of Certified Public Accountants
AOCI	accumulated other comprehensive income
ASB	Accounting Standards Board
ASC	FASB Accounting Standards Codification
ASU	FASB Accounting Standards Update
CFE	collateralized financing entity
CFTC	U.S. Commodity Futures Trading Commission
COSO	The Committee of Sponsoring Organizations of the Treadway Commission
DP	discussion paper
ED	exposure draft
EITF	Emerging Issues Task Force
FASB	Financial Accounting Standards Board
FSOC	Financial Stability Oversight Council
FTC	Federal Trade Commission
FV-NI	fair value through net income
FV-OCI	fair value through other comprehensive income
GAAP	generally accepted accounting principles
IAS	International Accounting Standard

Abbreviation	Description
IASB	International Accounting Standards Board
ICEFR	internal control over external financial reporting
ICFR	internal control over financial reporting
IFRS	International Financial Reporting Standard
MLTN	more likely than not
MMF	money market fund
MNA	master netting arrangement
NAV	net asset value
OCI	other comprehensive income
PBE	public business entity
PCAOB	Public Company Accounting Oversight Board
PCC	Private Company Council
PCDMF	private-company decision-making framework
SEC	Securities and Exchange Commission
SIBHC	supervised investment bank holding company
SIFMA	Securities Industry and Financial Markets Association
SPPI	solely payments of principal and interest
SRO	self-regulatory organization
TBA	to be announced
VIE	variable interest entity

The following is a list of short references for the Acts mentioned in this publication:

Abbreviation	Act
Community Reinvestment Act	Community Reinvestment Act of 1977
Dodd-Frank Act	The Dodd-Frank Wall Street Reform and Consumer Protection Act
Exchange Act	Securities Exchange Act of 1934
FATCA	Foreign Account Tax Compliance Act
1940 Act	Investment Company Act of 1940
JOBS Act	Jumpstart Our Business Startups Act
Securities Act	Securities Act of 1933

Appendix C — Other Resources

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