

A white egg is placed in the center of a large pile of US one hundred dollar bills. The bills are scattered and overlapping, with some showing the portrait of Benjamin Franklin. The egg is smooth and white, contrasting with the textured and patterned paper of the currency. The background is filled with the intricate details of the bills, including serial numbers and the Federal Reserve seal.

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Investment Management Accounting and Financial Reporting Update

December 21, 2015

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Foreword

December 21, 2015

To our clients and colleagues in the investment management sector:

We are pleased to announce our eighth annual accounting and financial reporting update. The topics discussed in this publication were selected because they may be of particular interest to investment management entities.

Some of the notable developments and activities that occurred during 2015 were (1) the FASB's completion of the amendments to its consolidation requirements, (2) the continued activities related to the implementation of the FASB's new revenue guidance, and (3) the SEC's continued focus on rulemaking. Standard-setting activities that affect advisers are summarized in the first section of the publication, and standard-setting activities that affect funds are summarized in the second.

The 2015 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 Web site for accounting and financial reporting news.

In addition, don't miss our recently issued ninth edition of *SEC Comment Letters — Including Industry Insights — What "Edgar" Told Us*, 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

The U.S. stock market, which saw double-digit growth in 2014 and 2013,¹ slowed considerably in 2015. The market also experienced significant volatility during 2015, which has increased the pressure on advisers to produce returns that outperform benchmarks as well as to develop less costly exchange-traded funds such as those that have been seen in the trend of mutual fund outflows of late. Uncertainties in the Federal Reserve's timing for raising interest rates have further contributed to the market fluctuations and have been weighing on investor sentiment. Real estate and bond funds suffered similar fates during 2015 as Wall Street broadly braces for the impact of the recent interest rate hike, the first in nearly a decade.

Business Outlook

Recently, the markets have experienced increasing volatility as a result of concerns about interest rate hikes, the oil price bust, and economic conditions in China, which have given pause to institutional and retail investors alike. The market appears to be at an inflection point, leaving investment managers to scrutinize how best to position themselves for the years ahead. In addition, the continued emergence of exchange-traded funds has increased the onus on active managers to justify the fees they charge. To achieve desired returns, investors are turning to investment managers that employ specialized investment strategies, financial products, and entity structures (including business development companies (BDCs)). Among those investors are baby boomers whose pensions and retirement savings will continue to represent a large market share for investment managers. Further, as technology continues to improve, investors are seeking additional diversification in their portfolios.

The industry also faces increased regulatory compliance and competition. As a result, investment managers should expect greater compliance costs as well as pressure to produce higher returns for lower management fees. To retain existing investors and attract new prospects, investment managers will need to differentiate themselves.

Regulatory Reform

Over the past few years, regulators have increased their scrutiny of the investment management sector in an effort to address market exposures. Regulators continue to focus on more robust data reporting, including transparency of portfolio holdings and management fee and risk disclosures; cybersecurity; and derivative disclosure requirements. The SEC² has issued multiple releases containing staff guidance as well as new proposed rules on investment company reporting. These changes, among others, should be reviewed by investment companies, investment managers, auditors, and investors.

For additional information about industry issues and trends, see Deloitte's [2015 Financial Services Industry Outlooks](#).

¹ According to Bloomberg, the Standard & Poor's 500 increased by 11.4 percent and 26.4 percent for the years ended December 31, 2014 and 2013, respectively.

² For a list of abbreviations used in this publication, see [Appendix B](#).

Revenue Recognition

Background

In May 2014, the FASB and IASB issued their final standard on revenue recognition. The standard, issued as [ASU 2014-09](#)¹ by the FASB and as IFRS 15 by the IASB, outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance (e.g., ASC 946-605). Financial instruments that are within the scope of other Codification topics (e.g., the recognition of interest income and dividends) are excluded from the ASU's scope. For additional information about ASU 2014-09 as issued, see Deloitte's May 28, 2014, [Heads Up](#) and July 2014 [Financial Services Spotlight](#).

In response to concerns received by the FASB related to applying the new revenue recognition requirements, the Board issued the following three proposed ASUs this year (currently in different stages of consideration), which would revise the new revenue recognition guidance in ASU 2014-09:²

- [Principal Versus Agent Considerations \(Reporting Revenue Gross Versus Net\)](#) — The proposal would address issues related to how an entity should assess whether it is the principal or the agent in contracts that include three or more parties. Guidance would include (1) how to determine the unit of account, (2) whether the indicators in ASU 2014-09 are intended to help entities perform a single evaluation of control or represent an additional evaluation, and (3) how certain indicators are related to the general control principle. The proposal would also clarify that an entity should evaluate whether it is the principal or the agent for each good or service specified in a contract and thus whether an entity could be both the principal and agent for different performance obligations in the same contract. See Deloitte's September 1, 2015, [Heads Up](#) for more information.
- [Identifying Performance Obligations and Licensing](#) — The proposed amendments would clarify the guidance on an entity's identification of certain performance obligations. Proposed changes include guidance on immaterial promised goods and services and separately identifiable promises as well as (1) a policy election for shipping and handling fees incurred after control transfers and (2) clarifications related to licenses. See Deloitte's May 13, 2015, [Heads Up](#) and October 8, 2015, [journal entry](#), respectively, for more information.
- [Narrow-Scope Improvements and Practical Expedients](#) — The proposed guidance would (1) clarify how to assess whether collectibility is probable in certain circumstances to support the existence of a contract, (2) add a practical expedient for the presentation of sales taxes on a net basis in revenue, (3) clarify how to account for noncash consideration at contract inception and throughout the contract period, and (4) establish a practical expedient to address contract modifications upon transition. Changes as a result of this proposal are not expected to significantly affect the investment management industry. See Deloitte's October 2, 2015, [Heads Up](#) for more information.

Thinking It Through

Aspects of the new revenue recognition guidance that could potentially present implementation challenges for investment managers include the following:

- [Performance-based fees](#) — ASU 2014-09 provides specific requirements for contracts that include variable consideration (including arrangements whose consideration fluctuates depending on changes in the underlying assets managed by an investment manager). Specifically, it indicates that the estimated variable consideration (or a portion thereof) is included in the transaction price (and therefore eligible for recognition) only to the extent that it is probable that subsequent changes in the estimate would not result in a significant revenue reversal. This concept is commonly referred to as the "constraint." Since an investment manager's performance-based fees may be affected by the future performance of the underlying assets it manages, it is difficult to accurately predict how much of the performance-based fees payable to the entity are not subject to future reversal until the fees are finalized or close to being finalized.

¹ For the full titles of standards, topics, and regulations used in this publication, see [Appendix A](#).

² The IASB's July 2015 [ED](#) also proposes changes to IFRS 15.

Accordingly, for entities that currently apply Method 2 under EITF D-96 (codified in ASC 605-20-S99-1), the timing of revenue recognition for these fees may be significantly delayed by the ASU's constraint on the amount of revenue that may be recognized as of a reporting date. In addition, the ASU could accelerate the recognition of revenue for these fees for entities that currently apply Method 1 under EITF D-96. The ASU provides an example³ to illustrate how an entity would apply the new revenue recognition requirements to a management arrangement that includes performance-based fees. While the ASU could affect the recognition of these fees as revenue, the new guidance does not modify how entities should account for the associated costs (typically, compensation paid to employees). That is, although the performance-based revenue may be deferred until long after cash has been received by the entity, amounts distributed to employees may need to be recognized as an expense in the period in which the amounts are incurred.

- *Incentive-based capital allocations* — The ASU indicates that financial instruments that are within the scope of other Codification topics are not within the ASU's scope. However, it does not address whether contracts involving incentive-based capital allocations, such as those in the form of carried interests, are (1) revenue contracts within the scope of the ASU or (2) financial instruments that should be accounted for as equity-method investments. The AICPA's revenue implementation group for asset managers recently submitted to the FASB a white paper that presented the following two views about these arrangements: (1) they represent consideration for investment management services, in a manner similar to other incentive fees and, therefore, are within the scope of the ASU or (2) they meet the definition of a financial asset and should be accounted for under the equity method in accordance with ASC 323-30-S99-1.
- *Gross versus net presentation* — Often, an investment manager or its affiliates involve third parties to provide services it has agreed to perform. In this situation, the investment manager must determine whether "the nature of its promise is a performance obligation to provide the specified goods or services itself (that is, the entity is a principal) or to arrange for the other party to provide those goods or services (that is, the entity is an agent)." The ASU provides indicators and other implementation guidance to help an entity determine whether it is acting as a principal (with revenue recognized on a gross basis) or as an agent (with revenue recognized on a net basis). While the ASU's indicators for determining whether an entity is acting as a principal or as an agent in an arrangement are similar to the current requirements in ASC 605-45, the ASU's guidance on making this determination differs slightly from that of current U.S. GAAP by applying an overall principle based on the "control" notion and replacing the examples in the current guidance with more limited examples. As discussed above, in August 2015, the FASB issued a [proposed ASU](#) to clarify the principal-versus-agent guidance in ASU 2014-09, which may affect the principal-versus-agent determination for investment managers.
- *Management fee waivers and customer expense reimbursements* — Under U.S. GAAP, investment managers historically have recorded fee waivers and expense reimbursements as either (1) a reduction of revenue or (2) an expense when entities have concluded that such waivers or reimbursements are not refunds or rebates of the amount charged to the fund. We expect that the AICPA will provide guidance on this topic once the FASB has finalized its revisions to the guidance on principal-versus-agent considerations (see above).
- *Contract combinations* — Although entities are permitted by current U.S. GAAP to combine contracts under certain circumstances, the ASU requires contract combination when certain criteria are met. Since the contract combination requirement may change what investment managers previously regarded as a unit of accounting, each arrangement should be carefully evaluated.

³ ASC 606-10-55-221 through 55-225, *Example 25 — Management Fees Subject to the Constraint*.

- *Distribution fees received*— Under current U.S. GAAP, up-front distribution fees are generally recognized as revenue when received. However, under the ASU, investment managers would need to determine whether up-front distribution fees are related to the transfer of a separate promised service (a “distinct” performance obligation) or multiple separate promised services. If the up-front fees are related to the transfer of a service or services that are separable from other promises in the contract, the entity should recognize an allocated portion of the total consideration as revenue when it transfers the related service or services to the customer. However, if the activities associated with the fee are not related to a separate performance obligation, revenue recognition would be deferred. In addition, sales and distribution contracts may entitle the distributor to consideration that is variable (e.g., consideration that is based on quantity of shares purchased by the shareholder, assets under management, and time a shareholder is invested in a fund). The ASU requires that a distributor include variable consideration in the transaction price only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved. Distributors will need to evaluate whether variable consideration is constrained and therefore not eligible for recognition as revenue.
- *Third-party distribution fees paid*— The ASU retains the cost guidance in ASC 946-605-25-8 that requires an entity that receives CDSC fees and 12b-1 fees (or fees similar to, or substantially the same as, CDSC fees and 12b-1 fees) to (1) defer and amortize incremental direct costs associated with distributing a mutual fund’s shares and (2) expense indirect distribution costs when such costs are incurred. However, the ASU supersedes the guidance in ASC 946-605-25-8 on when to recognize as revenue the fees received from investors to compensate the entity for these costs (i.e., the current requirement is that these fees should be recognized as revenue when received). Accordingly, such fees would be subject to the overall revenue recognition model.
- *Transfer of rights to certain future distribution fees*— The ASU supersedes the industry-specific guidance in ASC 946-605, which requires immediate revenue recognition for the sale of rights to cash flows from future distribution fees if certain criteria are met. Since these arrangements may include provisions that protect the purchasers of such rights if certain events occur (e.g., termination of the 12b-1 plan by the fund’s independent board of directors), entities will need to carefully assess whether such arrangements should be accounted for as a borrowing in accordance with ASC 470 or evaluated as sales under the revenue standard. Entities that have applied ASC 946-605 and recognized as revenue the consideration received in these transactions will need to reassess their accounting for these arrangements.

Effective Date and Transition

In August 2015, as a result of stakeholder concerns, the FASB issued [ASU 2015-14](#),⁴ which delays the effective date of ASU 2014-09. Accordingly, the ASU is effective for public business entities for annual reporting periods (including interim reporting periods within those periods) beginning after December 15, 2017. Early adoption is permitted as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within those annual periods.

For nonpublic entities, the standard is effective for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. Nonpublic entities can also elect to early adopt the standard as of the following:

- Annual reporting periods beginning after December 15, 2016, including interim periods.
- Annual reporting periods beginning after December 15, 2016, and interim periods within annual reporting periods beginning one year after the annual reporting period of initial application of the new standard.

Implementation and Transition Activities

A number of groups are actively involved in implementation activities related to the new standard, including the TRG (see Deloitte’s [TRG Snapshot](#)), the AICPA’s revenue recognition task forces (including the Asset Managers Revenue Recognition Task Force), various firms, the SEC,⁵ and the PCAOB. Preparers should continue to monitor the activities of these groups before their adoption of the new guidance.

⁴ The IASB amended IFRS 15 a month later to delay its effective dates.

⁵ The SEC has indicated that it plans to review and update the revenue recognition guidance in SAB Topic 13 in light of the ASU. The extent to which the ASU’s guidance will affect a public entity will depend on whether the SEC removes or amends the guidance in SAB Topic 13 to be consistent with the new revenue standard.

Consolidation

Background

In February 2015, the FASB issued [ASU 2015-02](#), which amends the consolidation requirements in ASC 810. The amendments could significantly change an investment manager's consolidation conclusions. Specifically, the amended guidance will affect an entity's evaluation of whether (1) the fees it receives from managing a fund or asset-backed financing structure should result in the consolidation of the entity, (2) limited partnerships and similar entities should be consolidated, and (3) variable interests held by the reporting entity's related parties or de facto agents affect its consolidation conclusion. In addition, ASU 2015-02 eliminated the deferral of [ASU 2009-17](#) (formerly Statement 167) for investments in certain investment funds. Therefore, investment managers, general partners, and investors in these investment funds will need to perform a drastically different consolidation evaluation.

See Deloitte's [Consolidation — A Roadmap to Identifying a Controlling Financial Interest](#) for additional information about ASU 2015-02.

Determining Whether Fees Paid to an Investment Manager Are Variable Interests

One of the first steps in assessing whether a reporting entity is required to consolidate a legal entity is to determine whether the reporting entity holds a variable interest in that legal entity. An investment manager's determination that its decision-making fee arrangement is not a variable interest would generally result in a conclusion that the investment manager is not required to consolidate the legal entity. In addition, it could affect whether the legal entity being evaluated is a VIE. While the ASU retains the current definition of a variable interest, it modifies the criteria for determining whether a decision maker's fee is a variable interest.

Before ASU 2015-02, six criteria must have been met before a reporting entity could conclude that a decision maker's or service provider's fee does not represent a variable interest. The ASU eliminates the criteria related to subordination of the fees (ASC 810-10-55-37(b)) and significance of the fees (ASC 810-10-55-37(e) and (f)). Accordingly, after adoption of ASU 2015-02, the evaluation of whether fees paid to a decision maker represent a variable interest focuses on whether (1) the fees are commensurate with the services provided, (2) the fee arrangement includes only customary terms and conditions (i.e., they are "at market"), and (3) the decision maker (including certain of its related parties) has any other variable interests that would absorb more than an insignificant amount of expected losses or returns. As a result, it is expected that fewer fee arrangements would be considered variable interests under the ASU.

Although the requirement to evaluate whether a fee arrangement is commensurate and at market existed before the ASU, different views have evolved regarding the evidence a reporting entity needs to support its conclusion that a fee arrangement is commensurate and market. At the 2015 AICPA Conference on Current SEC and PCAOB Developments, an SEC staff member, Professional Accounting Fellow Chris Semesky, stated the following:

I would also like to address the evaluation of whether a decision-maker's fee arrangement is customary and commensurate. [Footnote omitted] This evaluation is done at inception of a service arrangement or upon a reconsideration event, such as the modification of any germane terms, conditions or amounts in the arrangement.

The determination of whether fees are commensurate with the level of service provided often may be determined through a qualitative evaluation of whether an arrangement was negotiated on an arm's length basis when there are no obligations beyond the services provided to direct the activities of the entity being evaluated for consolidation. This analysis requires a careful consideration of the services to be provided by the decision-maker in relation to the fees.



The evaluation of whether terms, conditions and amounts included in an arrangement are customarily present in arrangements for similar services may be accomplished in ways such as benchmarking the key characteristics of the subject arrangement against other market participants' arrangements negotiated on an arm's length basis, or in some instances against other arm's length arrangements entered into by the decision-maker. There are no bright lines in evaluating whether an arrangement is customary, and reasonable judgment is required in such an evaluation. A decision-maker should carefully consider whether any terms, conditions, or amounts would substantively affect the decision-maker's role as an agent or service provider to the other variable interest holders in an entity.

Therefore, we believe that the evaluation should focus on whether the fee arrangements are negotiated at arm's length (i.e., between unrelated parties) or have been implicitly accepted by market participants. Most decision-maker or service-provider fee arrangements are negotiated at arm's length or have been implicitly accepted by market participants when a more than insignificant amount of the investor interests in the potential VIE are held by an unrelated party or parties (e.g., when an asset manager has marketed a fund to outside investors).⁶ In these situations, there is a presumption that the fees will be commensurate (even if the services are not provided by others in the marketplace). To support a conclusion that the arrangement is at market (i.e., customary) a reporting entity would, in addition to demonstrating that negotiations were at arm's length or there was implicit acceptance by market participants, compare its fee arrangement with other arrangements it negotiated with third parties. Therefore, in these situations, it would typically not be necessary for a reporting entity to compare its fee arrangement to others in the marketplace to support its conclusion that the fee arrangement is commensurate and at market unless the reporting entity has no other internal benchmarks.

Thinking It Through

In accordance with ASU 2015-02, a manager of a CLO or CDO entity that receives a junior or subordinated fee may no longer have a variable interest in the entity if the manager does not have any other interests in the entity and the remaining criteria in ASC 810-10-55-37 are not met. Historically, the criteria related to subordination of the fees often resulted in a conclusion that the CLO or CDO manager's fee arrangement was a variable interest. This increases the likelihood that CLOs or CDOs will be deconsolidated upon the adoption of the ASU, particularly if the investment manager does not hold any other interests in the entity.

When evaluating whether a decision-making arrangement is a variable interest, the investment manager must determine whether it has any other variable interests that would absorb more than an insignificant amount of the legal entity's expected losses or returns. Although the ASU reduces the effects of interests held by an investment manager's related parties in this evaluation, different views evolved regarding how interests held by parties under common control with the investment manager should be incorporated into this evaluation.

Some initially interpreted the ASU to generally require a decision maker to include interests held by related parties under common control regardless of whether the decision maker held an interest in that related party. However, at the 2015 AICPA Conference on Current SEC and PCAOB Developments, Chris Semesky provided the following comments:

The next topic I would like to address is the evaluation of whether a decision-maker's fee constitutes a variable interest under the FASB's updated consolidation guidance. [Footnote omitted] After considering a number of questions posed by registrants, I would like to share with you several observations regarding implementation of the new guidance.

For purposes of illustration consider an entity that has four unrelated investors with equal ownership interests, and a manager that is under common control with one of the investors. The manager has no direct or indirect interests in the entity other than through its management fee, and has the power to direct the activities of the entity that most significantly impact its economic performance.

⁶ In some cases, a legal entity may not have direct outside investors; rather, the investors invest through another legal entity that was formed in conjunction with the legal entity (e.g., a master-feeder structure). In these circumstances, the lack of outside investors would not be an indication that the fees paid (or lack thereof) to the legal entity's decision maker are not commensurate and at market.

In this simple example, if the manager's fee would otherwise not meet the criteria to be considered a variable interest, the fact that an investor under common control with the manager has a variable interest that would absorb more than an insignificant amount of variability would not by itself cause the manager's fee to be considered a variable interest. The guidance to consider interests held by related parties when evaluating whether a fee is a variable interest specifically refers to instances where a decision-maker has an indirect economic interest in the entity being evaluated for consolidation. [Footnote omitted] However, in the instance where a controlling party in a common control group designs an entity in a way to separate power from economics for the purpose of avoiding consolidation in the separate company financial statements of a decision-maker, OCA has viewed such separation to be non-substantive.

In my example, if the manager determines that its fee is not a variable interest the amendments in ASU 2015-2 are not intended to subject the manager to potential consolidation of the entity. In other words, a decision-maker would not be required to consolidate through application of the related party tiebreakers once it determines that it does not have a variable interest in the entity.

Therefore, the decision maker should include variable interests in the legal entity held by its related parties under common control as part of its economic exposure in its evaluation of its fee arrangement under ASC 810-10-55-37(c) as follows:

- If the decision maker has an interest in its related party under common control (e.g., the decision maker owns 15 percent of the equity interest of the related party), the related party's interest should be considered the equivalent of a direct interest held by the decision maker (i.e., the entire interest, rather than a proportionate amount).
- If the decision maker does not hold an interest in the related party under common control (e.g., the related party is a sister company with no cross-ownership interest), the related party's interest would be excluded unless the interest was held by the related party in an effort to circumvent consolidation of the legal entity in the separate financial statements of one of the related parties under common control.

A reporting entity might be able to conclude that an interest held by its related party under common control was not provided to the related party in an effort to circumvent consolidation of the legal entity when, for example, (1) a founder and CEO of an asset manager invests his or her own money in a potential VIE directly or through personal family trusts or (2) a parent entity with a consolidated asset manager and a separate consolidated subsidiary actively trades in and out of funds but does not, by design, hold seed capital or long-term interests in a fund. The legal entity's design would rarely be used in either of these circumstances to circumvent the consolidation provisions. However, the same conclusion could not be reached by a regulated financial institution that transfers its beneficial interests in a securitization structure that it sponsors to an entity under common control to avoid consolidation of the securitization entity in its stand-alone financial statements. Accordingly, facts and circumstances should always be carefully considered.

Determining Whether a Limited Partnership or Similar Entity Is a VIE

The ASU amends the definition of a VIE for limited partnerships and similar entities. Under the ASU, a limited partnership is considered a VIE regardless of whether it has sufficient equity or meets the other requirements to qualify as a voting interest entity **unless** a single limited partner (LP) or a simple majority of all partners (excluding those held by the general partner (GP), entities under common control with the GP, and entities acting on behalf of the GP) has substantive kick-out rights (including liquidation rights) or the LPs have participating rights. As a result of the amendments to the definition of a VIE for limited partnerships and similar entities, partnerships historically not considered VIEs may need to be evaluated under the new VIE consolidation model. Conversely, partnership arrangements that include simple-majority kick-out or participating rights (rather than single-partner rights) may no longer be VIEs.

Although the ASU may not have caused an investment manager's consolidation conclusion to change, an updated analysis on the basis of the revised guidance would be required. In addition, even if a reporting entity determines that it does not need to consolidate a partnership that is a VIE, it would have to provide the existing extensive disclosures for any VIEs in which it holds a variable interest.

Determining Whether an Entity Other Than a Limited Partnership (or Similar Entity) Is a VIE

The ASU clarifies how a reporting entity should evaluate the condition in ASC 810-10-15-14(b)(1) (whether the equity holders (as a group) have power) for legal entities other than limited partnerships. Specifically, the ASU clarifies that in situations in which the equity holders have delegated the decision-making responsibility, and the decision maker's fee arrangement is a variable interest under ASC 810-10-55-37, the evaluation should focus on whether the equity holders have power over the legal entity's most significant activities through their equity interests. In making this assessment, the investment manager should consider whether the equity holders (investors in the fund) have the right to replace the investment manager as the decision maker. This is a significant change from the previous guidance, under which kick-out rights were only considered if they were held by a single party.

Example

Investment manager ABC enters into a management agreement with Fund X (a corporation). ABC manages the underlying investments and operations of the fund (i.e., directs the most significant activities of the fund) and earns a fee for its services that is commensurate and at market. As a result of ABC's other interest in X, its fee arrangement is considered a variable interest. However, the equity holders can constrain ABC's authority because they have the ability to (1) replace ABC as the fund manager, (2) approve ABC's compensation, and (3) determine X's overall investment strategy.

Under ASU 2015-02, the equity holders would have the power to direct the most significant activities of the fund, and if the fund does not meet any of the other conditions to be considered a VIE, it would be evaluated for consolidation under the voting interest entity model.

Thinking It Through

An example in the ASU indicates that the rights afforded to the equity investors of a series fund structure that operates in accordance with the 1940 Act would typically give the shareholders the ability to direct the activities that most significantly affect the fund's economic performance through their equity interests (i.e., they meet the condition in ASC 810-10-15-14(b)(1)). Accordingly, as long as the fund does not meet any of the other criteria to qualify as a VIE, the individual series would be evaluated for consolidation under the voting interest entity model.

However, while these rights are often given to the investors of a fund structure that is regulated under the 1940 Act, fund structures established in foreign jurisdictions (particularly those established in a structure similar to a series structure), or domestic funds that do not operate in accordance with the requirements of the 1940 Act, often do not give the equity investors similar rights. Consequently, the individual series in an international series fund structure are typically evaluated for consolidation as silos under the VIE model and will be consolidated if the investment manager has an economic interest (other than an "at-market" and "commensurate" fee arrangement) that could potentially be more than insignificant. As a general guideline, variable interests in the VIE that exceed, either individually or in the aggregate, 10 percent or more of the expected losses or expected residual returns of the VIE would meet this condition.

Which Party Should Consolidate?

In a manner consistent with the guidance in ASU 2009-17, the determination of whether an investment manager is required to consolidate a VIE under the ASU focuses on whether the investment manager has (1) the power to direct the activities that most significantly affect the economic performance of the VIE (power condition) and (2) a potentially significant interest in the VIE (economics condition). Although the ASU does not amend the existing threshold for evaluating whether an investment manager meets the economics condition, under the new consolidation requirements, if the fees paid to a VIE's decision maker are commensurate and at market, they should not be considered in the evaluation of the decision maker's economic exposure to the VIE, regardless of whether the reporting entity has other economic interests in the VIE. Under this new requirement, certain structures that were consolidated as a result of the significance of the fee arrangement would potentially need to be deconsolidated. This guidance applies to all entities that are VIEs, including limited partnerships and similar entities that are VIEs.

Thinking It Through

Under current guidance, an investment manager's assessment of whether it is the primary beneficiary of a VIE (and therefore must consolidate the VIE) that qualifies for the Statement 167 deferral focuses on whether the investment manager absorbs the majority of the VIE's variability as determined through quantitative analysis. Under the ASU, an investment manager would be required to consolidate a VIE if it meets both the power and economics conditions. Accordingly, an investment manager that has power over a VIE, but did not previously consolidate a VIE because it did not absorb a majority of the VIE's variability, may be required to consolidate the VIE if it holds an economic interest that could potentially be significant to the VIE (e.g., a 15 percent equity interest in the VIE).

The evaluation of which party controls a legal entity that is **not** considered a VIE focuses on the rights of the equity investors. Specifically, the analysis for limited partnerships would focus on whether **any of the LPs** have the substantive ability to unilaterally dissolve the limited partnership or otherwise remove the GP without cause and, if so, should consolidate the partnership. For all other entities, a party with a majority voting interest (i.e., greater than 50 percent) will generally be required to consolidate the entity.

Effects of Related Parties

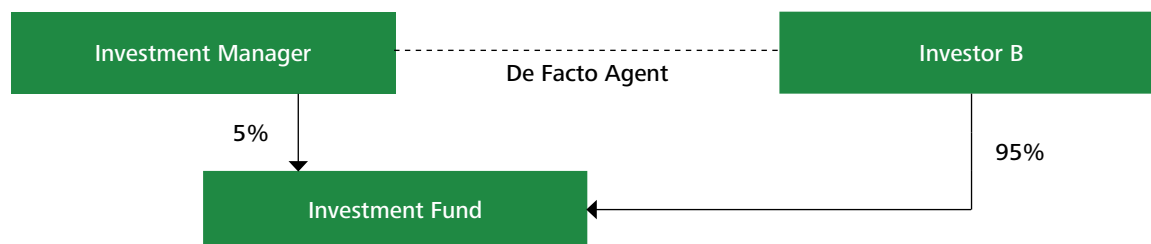
The ASU significantly amends how variable interests held by a reporting entity's related parties or de facto agents affect its consolidation conclusion. Specifically, the ASU reduces the effects of interests held by an investment manager's related parties in the evaluation of (1) whether the investment manager's fee arrangement is a variable interest and (2) the investment manager's economic exposure to the VIE.

In addition, the need to perform the related-party tiebreaker test (as well as mandatory consolidation by one of the related parties) will be less frequent under the ASU than under current U.S. GAAP. Specifically, the related-party tiebreaker test would need to be performed if power is considered shared among the related parties or if the parties in the decision maker's related-party group are under common control and together possess the characteristics of a controlling financial interest. In these situations, the purpose of the test would be to determine whether the decision maker or a related party under common control of the decision maker is required to consolidate the VIE.

Finally, if neither the decision maker nor any of its related parties are required to consolidate a VIE but the related-party group (including de facto agents) possesses the characteristics of a controlling financial interest, and substantially all of the VIE's activities are conducted on behalf of a single entity in the related-party group, that entity would be the primary beneficiary of the VIE. However, this requirement would not apply in certain qualified affordable housing projects that are currently within the scope of [ASU 2014-01](#).

Example

An investment manager establishes a fund on behalf of Investor B. The investment manager owns 5 percent of the equity in the fund, and B owns the remaining interests. The investment manager cannot be removed as the decision maker of the fund, and the investment manager cannot sell or liquidate its investment without the consent of B. The fund is considered a VIE. In addition, the investment manager and B are considered related parties (de facto agents).



When the investment manager and B each consider only their own respective interests, neither party would be required to consolidate the fund in its stand-alone financial statements. However, under ASU 2015-02, B would be required to consolidate the fund because the related-party group possesses the characteristics of a primary beneficiary, and substantially all of the VIE's activities are conducted on behalf of B.

Money Market Funds

The ASU eliminated the deferral in [ASU 2010-10](#) for a reporting entity's interest in money market funds (MMFs). Instead of the deferral, the ASU 2015-02 includes a scope exception to the consolidation requirements for a reporting entity's interest in an entity that is required to comply, or operates in accordance, with requirements similar to those for registered MMFs in Rule 2a-7 of the 1940 Act. The ASU clarifies the term "similar" and requires sponsors of MMFs that qualify for the scope exception to disclose any arrangements to provide support to the fund and whether they have provided any support during the periods presented.

Elimination of the ASU 2010-10 Deferral

ASU 2015-02 eliminated the deferral under ASU 2010-10 for investment funds. As a result, all entities that qualified for the deferral (which applies primarily to investment companies) will need to be evaluated under an approach similar to that in ASU 2009-17. Even if the new evaluation does not result in a different consolidation conclusion, investment managers will need to update their analysis and may be required to provide additional disclosures.

Effective Date and Transition

For public business entities, the ASU's guidance is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2015. For entities other than public business entities, the ASU's guidance is effective for annual periods beginning after December 15, 2016, and interim periods beginning after December 15, 2017. The ASU would allow early adoption for all entities but would require entities to apply the guidance as of the beginning of the annual period containing the adoption date. Modified retrospective application (including a practicability exception) would be required, with an option for full retrospective application.

Thinking It Through

As of the date of this publication, only a few investment managers and other financial institutions have early adopted ASU 2015-02. While adopting the ASU has resulted in the consolidation of certain funds that previously qualified for the Statement 167 deferral, for those that have adopted the ASU it generally resulted in a significant amount of deconsolidation, primarily of previously consolidated CLOs and CDOs and limited partnerships whose agreements did not include simple majority kick-out rights.

Reporting entities that have not adopted the ASU should start considering the extent to which they may need to change their processes and controls to apply the new guidance, including those related to obtaining additional information that may have to be provided under the disclosure requirements.

Effect of the Risk-Retention Rules on Consolidation

In October 2014, the SEC and five other federal agencies adopted a [final rule](#) that requires sponsors of securitizations, under certain conditions, to retain a portion of the credit risk associated with the assets collateralizing an asset-backed security (ABS). The retention of these interests may require reporting entities to consolidate securitization vehicles.

The type of interest retained by the sponsor (i.e., vertical, horizontal, or L-shaped) will affect the sponsor's economic exposure to the securitization structure and, accordingly, the sponsor's consolidation conclusion. If a sponsor holds the subordinate horizontal tranche of a securitization structure rather than a vertical interest (or a combination), there is greater risk that the structure would be consolidated by the sponsor under ASC 810. An entity's evaluation should take into account the sponsor's interests retained under the risk-retention requirements in addition to any other interests held by the sponsor.

See Appendix E of Deloitte's *Consolidation — A Roadmap to Identifying a Controlling Financial Interest* for additional information about the risk-retention requirements.

Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity

Background

In August 2014, the FASB issued [ASU 2014-13](#), which permits a reporting entity to use an alternative method for measuring the financial assets and the financial liabilities of a consolidated collateralized financing entity (CFE). Specifically, if an investment manager measures the financial assets and the financial liabilities of a consolidated CFE at fair value, the ASU allows the investment manager to measure both the financial assets and financial liabilities of the consolidated CFE by "using the more observable of the fair value of the [CFE's] financial assets and the fair value of the financial liabilities."

The ASU is effective for public business entities for annual periods beginning after December 15, 2015, and interim periods therein. For nonpublic entities, the guidance is effective for annual periods ending after December 15, 2016, and interim periods beginning thereafter. Early adoption is permitted. At initial adoption, a reporting entity may use either (1) a modified retrospective approach⁷ or (2) a full retrospective approach.

Thinking It Through

If an investment manager did not previously early adopt the measurement alternative in ASU 2014-13 for its consolidated CFEs, the reporting entity may decide to adopt both ASU 2014-13 and ASU 2015-02 (the new consolidation standard) at the same time. In addition, both ASUs allow public and nonpublic business entities to early adopt the guidance in any quarter during an annual period. However, if the adoption occurs during an interim period other than the first quarter, both ASUs require the reporting entity to reflect the transition as though the guidance had been adopted at the beginning of the annual period.

⁷ That is, by recording a cumulative-effect adjustment to equity as of the beginning of the annual period of adoption.

Scope

ASU 2104-13 defines CFEs as follows:

[VIEs that hold] financial assets, issues beneficial interests in those financial assets, and has no more than nominal equity. The beneficial interests have contractual recourse only to the related [financial] assets of the collateralized financing entity and are classified as financial liabilities. A collateralized financing entity may hold nonfinancial assets temporarily as a result of default by the debtor on the underlying debt instruments held as assets by the collateralized financing entity or in an effort to restructure the debt instruments held as assets by the collateralized financing entity A collateralized financing entity also may hold other financial assets and financial liabilities that are incidental to the operations of the collateralized financing entity and have carrying values that approximate fair value (for example, cash, broker receivables, or broker payables).

A reporting entity may apply the ASU’s measurement alternative when both of the following conditions are present:

- a. All of the financial assets and the financial liabilities of the [CFE] are measured at fair value in the consolidated financial statements under other applicable Topics, other than financial assets and financial liabilities that are incidental to the operations of the collateralized financing entity and have carrying values that approximate fair value (for example, cash, broker receivables, or broker payables).
- b. The changes in the fair values of those financial assets and financial liabilities are reflected in earnings.

Measurement

An investment manager that elects the measurement alternative would use the more observable of the fair value of the financial assets or the financial liabilities of the CFE as the basis for determining the initial measurement for both the financial assets and financial liabilities. For example, if the fair value of the financial liabilities is more observable, the initial value of the less observable financial assets would be calculated on the basis of the fair value of the financial liabilities. The following table provides the formulas used to calculate the less observable of the CFE’s financial assets and financial liabilities:

Financial Assets Are More Observable		Financial Liabilities Are More Observable	
	Fair value of financial assets ⁸		Fair value of the financial liabilities (other than the beneficial interests retained by the reporting entity) ⁹
Plus:	Carrying value of nonfinancial assets held temporarily	Plus:	Fair value of any beneficial interests retained by the reporting entity (other than those that represent compensation for services)
Less:	Fair value of any beneficial interests retained by the reporting entity (other than those that represent compensation for services)	Plus:	Reporting entity’s carrying value of any beneficial interests that represent compensation for services
Less:	Reporting entity’s carrying value of any beneficial interests that represent compensation for services	Less:	Carrying value of nonfinancial assets held temporarily
Equals:	The value of the financial liabilities of the CFE. ¹⁰	Equals:	The value of the financial assets of the CFE. ¹¹

If an investment manager chooses not to elect the measurement alternative for an eligible CFE, the investment manager would measure the fair value of the CFE’s financial assets and liabilities by using the requirements in ASC 820 for fair value measurement. In that case, any initial difference in the fair value of the financial assets and liabilities of the CFE would be reflected in earnings and attributed to the reporting entity in the consolidated statement of income (loss). Further, any subsequent changes in the fair value of the CFE’s financial assets and financial liabilities would be recorded in earnings and attributed to the reporting entity in the consolidated statement of income (loss).

⁸ The fair value of the financial assets should include “the carrying values of any financial assets that are incidental to the operations of the [CFE] because the financial assets’ carrying values approximate their fair values.”

⁹ The fair value of the financial liabilities should include “the carrying values of any financial liabilities that are incidental to the operations of the [CFE] because the financial liabilities’ carrying values approximate their fair values.”

¹⁰ The reporting entity should allocate this amount to the individual financial liabilities (other than the beneficial interests retained by the reporting entity), as applicable, by using a reasonable and consistent method.

¹¹ The reporting entity should allocate this amount to the individual financial assets (other than the beneficial interests retained by the reporting entity), as applicable, by using a reasonable and consistent method.

Thinking It Through

In each subsequent reporting period, an investment manager that has elected the measurement alternative would effectively record in earnings its own economic interest in the CFE, including (1) the “changes in the fair value of any beneficial interests retained by the reporting entity (other than those that represent compensation for services)” and (2) “[b]eneficial interests that represent compensation for services (for example, management fees or servicing fees).”¹²

An investment manager that has not elected the measurement alternative would account for changes in the fair value of the financial assets and financial liabilities of a consolidated CFE through earnings and attribute those earnings to the parent.

New Disclosures

Reporting entities that elect to apply the ASU’s measurement alternative approach to measure the financial assets and financial liabilities of a consolidated CFE are required to provide ASC 820 disclosures and the ASC 825 disclosures on financial instruments for the CFE’s financial assets and financial liabilities. In addition, reporting entities must disclose that the less observable measure has been calculated on the basis of the more observable of the fair value of the financial liabilities and financial assets.¹³

Thinking It Through

Reporting entities that elect to apply the measurement alternative will need to use judgment to determine whether the inputs used to measure the fair value of the CFE’s financial assets are more observable than those used to measure the fair value of the CFE’s financial liabilities. For help in applying the ASU’s guidance, reporting entities should refer to ASC 820 and consider the nature and source(s) of the inputs used in measuring the fair value of the CFE’s financial assets and financial liabilities. In addition, the reporting entity is required to categorize the less observable fair value measurement in the fair value hierarchy and must identify the inputs used to determine the less observable fair value measurement, the observability of those inputs, and whether the unobservable inputs are significant to the fair value measurement.

Classification and Measurement

Background

The FASB is currently finalizing amendments to its guidance on the classification and measurement of financial instruments, which it expects to issue by the end of the year. During its deliberations, the FASB decided to abandon a converged approach with the IASB and instead chose to retain much of the existing requirements in U.S. GAAP. However, the amendments contain changes related to the following:

- Accounting for equity investments (apart from those that are accounted for under the equity method or those that are consolidated).
- Recognition of changes in fair value attributable to changes in instrument-specific credit risk for financial liabilities for which the fair value option has been elected.
- Disclosure requirements for financial assets and financial liabilities.

¹² In accordance with ASC 810-10-35-8.

¹³ These disclosure requirements do not apply to those financial assets and financial liabilities that are incidental to the CFE and have carrying values that approximate fair value.

For public business entities, the new standard would be effective for fiscal years beginning after December 15, 2017, including interim periods therein. For all other entities, it would be effective for fiscal years beginning after December 15, 2018, and interim periods for the following year. Early adoption of certain of the standard's provisions would be permitted for all entities. Nonpublic business entities would be permitted to adopt the standard in accordance with the effective date for public business entities.

Classification and Measurement of Equity Investments

The amendments will require entities to carry all investments in equity securities at fair value, with changes in fair value recorded through earnings (FVTNI), unless the equity investments are accounted for under the equity method or are consolidated. For equity investments that do not have a readily determinable fair value, the guidance will permit a practicability exception under which the equity investment would be measured at cost less impairment, if any, plus or minus observable price changes in orderly transactions. This exception would not be available to reporting entities that are investment companies or broker-dealers in securities.

An entity that has elected the practicability exception for equity investments that do not have a readily determinable fair value is required to assess whether the equity investment is impaired by qualitatively considering the following indicators (from ASC 825-10-35-18 in the proposed ASU):

- a. A significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee
- b. A significant adverse change in the regulatory, economic, or technological environment of the investee
- c. A significant adverse change in the general market condition of either the geographic area or the industry in which the investee operates
- d. A bona fide offer to purchase, an offer by the investee to sell, or a completed auction process for the same or similar investment for an amount less than the carrying amount of that investment
- e. Factors that raise significant concerns about the investee's ability to continue as a going concern, such as negative cash flows from operations, working capital deficiencies, or noncompliance with statutory capital requirements or debt covenants.

If, on the basis of the qualitative assessment, the equity investment is impaired, the investee would be required to record an impairment equal to the amount by which the carrying value exceeds fair value. The investee would no longer be required to evaluate whether such impairment was other than temporary.

Thinking It Through

Under current U.S. GAAP, marketable equity securities that are not accounted for as equity-method investments are classified as either held for trading, with changes in fair value recognized in earnings, or available for sale (AFS), with changes in fair value recognized in OCI. The proposed requirement to classify and measure equity securities at FVTNI could significantly affect investors in bond and other debt funds. Although these funds invest in bonds or other debt securities, on the basis of existing guidance in ASC 320-10-50-4, investors in such bond funds are required to classify their investments as equity securities. Currently, such investments are often classified as AFS with changes in fair value recognized through OCI. Under the proposed guidance, however, investors will need to account for their investments in these bond funds as FVTNI (rather than recording the changes in fair value through OCI, which would only be permitted if the investor held the bond or debt securities in the fund directly).

Changes in Fair Value of a Liability Attributed to Changes in Instrument-Specific Credit Risk

For financial liabilities (excluding derivative instruments) for which the fair value option has been elected, the amendments will require an entity to separately recognize in OCI any changes in fair value associated with instrument-specific credit risk. The guidance indicates that the portion of the total change in fair value that exceeds the amount resulting from a change in a base market risk (such as a risk-free interest rate) may be attributable to instrument-specific credit risk, but also acknowledges that there may be other methods an entity may use to determine instrument-specific credit risk.

Changes to Disclosure Requirements

For nonpublic business entities, the amendments eliminate the requirement to disclose the fair value of financial instruments measured at amortized cost. In addition, for such financial instruments, public business entities would not be required to disclose (1) the information related to the methods and significant assumptions used to estimate fair value or (2) a description of the changes in the methods and significant assumptions used to estimate fair value. The guidance also clarifies U.S. GAAP by eliminating the provisions in ASC 825 that had been interpreted to permit an “entry” price notion for estimating the fair value of loans for disclosure purposes. The amendments require a public business entity to disclose the fair value in accordance with the exit price notion in ASC 820. In addition, all entities are required to disclose in the notes to the financial statement all financial assets and financial liabilities grouped by (1) measurement category (i.e., amortized cost or fair value — net income or OCI) and (2) form of financial asset (i.e., securities and loans/receivables).



Financial Instrument Impairment

Background

The FASB spent much of 2015 drafting amendments to its impairment guidance. The amendments will introduce the current expected credit loss (CECL) model, which is a new impairment model¹⁴ for certain financial instruments that is based on expected losses rather than incurred losses. Under the CECL model, an entity would recognize as an allowance its estimate of the contractual cash flows not *expected* to be collected. The FASB believes that the CECL model will result in more timely recognition of credit losses and will reduce the complexity of U.S. GAAP by decreasing the number of credit impairment models used to account for debt instruments.¹⁵

Under the existing impairment models (often referred to as incurred loss models), an impairment allowance is recognized only after a loss event (e.g., default) has occurred or its occurrence is probable. In assessing whether to recognize an impairment allowance, an entity may only consider current conditions and past events; it may not consider forward-looking information.

The CECL Model

Scope

The CECL model will apply to most¹⁶ debt instruments (other than those measured at FVTNI), trade receivables, lease receivables, reinsurance receivables that result from insurance transactions, financial guarantee contracts,¹⁷ and loan commitments. However, AFS debt securities will be excluded from the model’s scope and will continue to be assessed for impairment under ASC 320 (the FASB has proposed limited changes to the impairment model for AFS debt securities, as discussed [below](#)).

¹⁴ Although impairment began as a joint FASB and IASB project, constituent feedback on the boards’ “dual-measurement” approach led the FASB to develop its own impairment model. The IASB, however, continued to develop the dual-measurement approach and issued final impairment guidance based on it as part of the July 2014 amendments to IFRS 9. For more information about the IASB’s impairment model, see Deloitte’s August 8, 2014, [Heads Up](#).

¹⁵ Note that the proposed CECL model would replace or amend several existing U.S. GAAP impairment models. See Appendix B of Deloitte’s March 13, 2015, [Heads Up](#), for a tabular summary of those models.

¹⁶ The CECL model would not apply to the following debt instruments:

- Loans made to participants by defined contribution employee benefit plans.
- Policy loan receivables of an insurance entity.
- Pledge receivables (promises to give) of a not-for-profit entity.
- Loans and receivables between entities under common control.

¹⁷ The CECL model would not apply to financial guarantee contracts that are accounted for as insurance or measured at FVTNI.

Recognition of Expected Credit Losses

Unlike the incurred loss models in existing U.S. GAAP, the CECL model does not specify a threshold for the recognition of an impairment allowance. Rather, an entity will recognize an impairment allowance equal to the current estimate of expected credit losses (i.e., all contractual cash flows that the entity does not expect to collect) for financial assets as of the end of the reporting period. Credit impairment will be recognized as an allowance — or contra-asset — rather than as a direct write-down of the amortized cost basis of a financial asset.

Thinking It Through

Because the CECL model does not have a minimum threshold for recognition of impairment losses, investment managers will need to measure expected credit losses on assets that have a low risk of loss (e.g., investment-grade held-to-maturity debt securities). However, an “entity would not be required to recognize a loss on a financial asset in which the risk of nonpayment is greater than zero [but] the amount of loss would be zero.” U.S. Treasury securities and certain highly rated debt securities may be assets the FASB contemplated when it allowed an entity to recognize zero credit losses on an asset, but the Board decided not to specify the exact types of assets.

Measurement of Expected Credit Losses

Under the amendments, an entity’s estimate of expected credit losses represents all contractual cash flows that the entity does not expect to collect over the contractual life of the financial asset. When determining the contractual life of a financial asset, the entity would consider expected prepayments but would not be allowed to consider expected extensions unless it “reasonably expects that it will execute a troubled debt restructuring with the borrower.”¹⁸

The entity would consider all available relevant information in making the estimate, including information about past events, current conditions, and reasonable and supportable forecasts and their implications for expected credit losses. That is, while the entity would be able to use historical charge-off rates as a starting point in determining expected credit losses, it would have to evaluate how conditions that existed during the historical charge-off period differ from its current expectations and accordingly revise its estimate of expected credit losses. However, the entity would not be required to forecast conditions over the contractual life of the asset. Rather, for the period beyond the period for which the entity can make reasonable and supportable forecasts, the entity would revert to an unadjusted historical credit loss experience.

Thinking It Through

Measuring expected credit losses will most likely be a significant challenge for all entities, particularly financial institutions. Entities may also incur one-time or recurring costs associated with implementing the CECL model, such as those related to system changes, data collection, and using forward-looking information to estimate expected credit losses over the contractual life of an asset.

AFS Debt Securities

The impairment of AFS debt securities will continue to be accounted for under ASC 320. However, the amendments revise that guidance by:

- Limiting the credit losses recognized to the difference between the security’s amortized cost and its fair value.
- Requiring an entity to use an allowance approach (vs. permanently writing down the security’s cost basis).
- Removing the requirement that an entity must consider the length of time fair value has been less than amortized cost when assessing whether a security is other-than-temporarily impaired.
- Removing the requirement that an entity must consider recoveries in fair value after the balance sheet date when assessing whether a credit loss exists.

¹⁸ Quoted text is from the FASB’s [summary](#) of tentative Board decisions reached at its September 3, 2014, meeting.

Thinking It Through

The Board did not revise (1) step 1 of the existing other-than-temporary impairment model (i.e., an “investment is impaired if the fair value of the investment is less than its cost”) or (2) the requirement under ASC 320 that entities recognize the impairment amount only related to credit in net income and the noncredit impairment amount in OCI. However, entities would use an allowance approach when recognizing credit losses (as opposed to a permanent write-down of the AFS security’s cost basis). As a result, in both of the following instances, an entity would reverse credit losses through current-period earnings on an AFS debt security:

- If the fair value of the debt security exceeds its amortized cost in a period after a credit loss had been recognized through earnings (because fair value was less than amortized cost), the entity would reverse the *entire* credit loss previously recognized and recognize a corresponding adjustment to its allowance for credit losses.
- If the fair value of the debt security does not exceed its amortized cost in a period after a credit loss had been recognized through earnings (because fair value was less than amortized cost) but the credit quality of the debt security improves in the current period, the entity would reverse the credit loss previously recognized only in an amount that would reflect the improved credit quality of the debt security.

These revisions to the impairment model in ASC 320 could result in earlier recognition of impairment.

Transition

For most debt instruments, the amendments will require entities to record a cumulative-effect adjustment to the statement of financial position as of the beginning of the first reporting period in which the guidance is effective (modified retrospective approach). However, instrument-specific transition provisions are provided for other-than-temporarily impaired debt securities, purchased credit-impaired (PCI) assets, and certain beneficial interests within the scope of ASC 325-40.

Other Significant Decisions

The new guidance will also reflect the FASB’s tentative decisions related to the following:

- Practical expedients when measuring expected credit losses.
- Write-offs.
- Modifications.
- PCI assets.
- Certain beneficial interests within the scope of ASC 325-40.
- Loan commitments.
- Disclosures.

Effective Date and Early Adoption

The Board tentatively decided the following:

- For public business entities that meet the definition under U.S. GAAP of an SEC filer, the final standard will be effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.
- For public business entities that do not meet the definition of an SEC filer, the final standard will be effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years.
- For all other entities, the final standard will be effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years beginning after December 15, 2020.

The Board also tentatively decided that public business entities that meet the definition under U.S. GAAP of an SEC filer will not be permitted to early adopt the final standard. All other entities will be permitted to early adopt the final standard, but not before an SEC filer would adopt the standard.

Next Steps

The FASB expects to issue a final standard in the first quarter of 2016. For a comprehensive summary of the impairment project to date, see the [project update page](#) on the FASB's Web site.

Leases

Background

The FASB has been working with the IASB for almost a decade to address concerns related to the off-balance-sheet treatment of certain lease arrangements by lessees. The boards' proposed model would require lessees to adopt a right-of-use (ROU) asset approach that would bring substantially all leases, with the exception of short-term leases (i.e., those with a lease term of less than 12 months), on the balance sheet. Under this approach, a lessee would record an ROU asset representing its right to use the underlying asset during the lease term and a corresponding lease liability (in a manner similar to the current approach for capital leases).

Thinking It Through

The boards have spent a significant amount of time trying to define a lease arrangement to help constituents identify whether an arrangement contains a lease or represents an agreement to provide a service. The boards' revised leases ED, released by the FASB as a [proposed ASU](#) in May 2013, defines a lease as "a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration." The revised ED focuses on whether (1) the contract is based on an identified asset and (2) the lessee obtains the right to control the use of the asset for a particular period.

The definition of a lease will have a significant impact on whether an arrangement is within the scope of the new guidance. For example, under the FASB's requirements, an arrangement to provide access to "small ticket" items such as terminals, photocopiers, or computers could ultimately be considered a lease arrangement and therefore would need to be included on the investment manager's balance sheet. However, the IASB has decided to include an exemption for small ticket items in its final standard, and thus this guidance is not converged.

Lessee Accounting

While the boards agree that a lessee should record an ROU asset and a corresponding lease liability when the lease commences, the FASB and the IASB support different approaches for the lessee's subsequent accounting. The FASB decided on a dual-model approach under which a lessee would classify a lease by using criteria that are similar to the lease classification criteria currently in IAS 17. Under IAS 17, there are no "bright lines" such as those under current U.S. GAAP (e.g., the 90 percent fair value test in ASC 840). For leases that are considered finance leases (many current capital leases are expected to qualify as finance leases), the lessee would account for the lease in a manner similar to a financed purchase arrangement. That is, the lessee would recognize interest expense and amortization of the ROU asset, which typically would result in a greater expense during the early years of the lease. For leases that are considered operating leases (many current operating leases are expected to continue to qualify as operating leases), the lessee would recognize a straight-line total lease expense. For both types of leases, the lessee would recognize an ROU asset for its interest in the underlying asset and a corresponding lease liability.

Thinking It Through

The proposed leasing guidance could significantly affect investment managers that currently account for their real estate leases as operating leases. Under the proposal, they would be required to record these arrangements in their statement of financial position. In addition, as a result of the proposal's requirement to classify real estate leases by using an approach with criteria that are similar to those in IAS 17, investment managers could potentially recognize a different expense profile in their income statement. Specifically, under the proposed IAS 17 approach, a lessee would be required to separately assess the classification of land and other elements of a property lease unless the land element is clearly immaterial. This change may result in the bifurcation of more real estate leases into separate land and building elements that would be separately evaluated for lease classification purposes.

Lessor Accounting

In 2014, the boards discussed constituent feedback on the ED and decided not to make significant changes to the existing lessor accounting model. Rather, they agreed to adopt an approach similar to the existing capital/finance lease and operating lease models in ASC 840 and IAS 17. However, the FASB decided to align the U.S. GAAP classification requirements with the criteria in IAS 17. In addition, the FASB decided that for leases that are similar to current sales-type leases, the lessor would only be permitted to recognize the profit on the transaction if the arrangement would have qualified as a sale under the new revenue recognition guidance (ASC 606).

Next Steps

The FASB has completed its redeliberations on leases and is expected to issue a final standard in the fourth quarter of 2015 or in early 2016. The new guidance will be effective for public business entities for fiscal years beginning after December 15, 2018 (i.e., calendar periods beginning on January 1, 2019), including interim periods therein. For all other entities, the standard will be effective for annual periods beginning after December 15, 2019 (i.e., calendar periods beginning on January 1, 2020), and interim periods thereafter. Early adoption will be permitted.

Thinking It Through

A lessee would be required to apply a modified retrospective transition method when adopting the standard (i.e., as an adjustment to the opening retained earnings for the earliest period presented). When applying this method, the lessee could elect not to reevaluate (1) whether an existing contract is a lease or contains leases, (2) the lease classification for any existing leases, and (3) the accounting for initial direct costs for any existing leases (provided it elects all three forms of relief). Accordingly, the current lease obligation disclosures (on a discounted basis) may be a useful starting point for determining the effects of the proposed guidance.

FASB's Simplification Initiative

Debt Issuance Costs

Background

In April 2015, the FASB issued [ASU 2015-03](#), which changes the presentation of debt issuance costs in financial statements. The ASU specifies that "debt issuance costs related to a note shall be reported in the balance sheet as a direct deduction from the face amount of that note" and that "[a]mortization of debt issuance costs also shall be reported as interest expense." Under previous guidance, an entity reported debt issuance costs in the balance sheet as deferred charges (i.e., as an asset).

The amendments do not affect the current guidance on the recognition and measurement of debt issuance costs. For example, the costs of issuing convertible debt would not change the calculation of the intrinsic value of an embedded conversion option that represents a beneficial conversion feature under ASC 470-20-30-13. Thus, entities may still need to track debt issuance costs separately from a debt discount.

Thinking It Through

Requiring presentation of debt issuance costs as a direct reduction of the related debt liability (rather than as an asset) is consistent with the presentation of debt discounts under U.S. GAAP. In addition, it converges the guidance in U.S. GAAP with that in IFRSs, under which transaction costs that are directly attributable to the issuance of a financial liability are treated as an adjustment to the initial carrying amount of the liability. It also reflects the SEC staff's views regarding the treatment of equity issuance costs as a reduction of the gross proceeds of an equity offering. Further, it conforms U.S. GAAP to FASB Concepts Statement 6, which states, "Debt issue cost is not an asset for the same reason that debt discount is not — it provides no future economic benefit. Debt issue cost in effect reduces the proceeds of borrowing and increases the effective interest rate and thus may be accounted for the same as debt discount."

Since the ASU's issuance, practitioners have inquired about the appropriate balance sheet presentation of costs incurred in connection with revolving-debt arrangements. At the June 2015 EITF meeting, the SEC staff announced that it would "not object to an entity deferring and presenting [such] costs as an asset and subsequently amortizing the . . . costs ratably over the term of the line-of-credit arrangement." While the SEC staff's announcement, which was codified in August 2015 by the issuance of [ASU 2015-15](#), clarifies that revolving-debt arrangements are outside the scope of ASU 2015-03, it does not address whether the ASU's presentation approach is an acceptable accounting policy for such arrangements and, if so, how an entity should implement such an approach. Under the ASU, an entity would deduct debt issuance costs from the related debt liability. But it is unclear how the entity would present any remaining unamortized debt issuance costs if it repaid the amounts outstanding under the revolving-debt arrangement and still had an option to make new borrowings under the same arrangement. In this case, there would no longer be a liability with which to associate the costs. It is also unclear how the entity would present any remaining unamortized costs if the costs exceeded the amount currently outstanding under the revolving-debt arrangement.

Given the implementation questions associated with application of the ASU's presentation approach to revolving-debt arrangements, as well as questions about the acceptability of such application, we expect that many, if not most, entities will elect to apply the accounting policy outlined by the SEC staff at the June 2015 EITF meeting. Under that policy, an entity presents remaining unamortized debt issuance costs associated with a revolving-debt arrangement as an asset even if the entity currently has a recognized debt liability for amounts outstanding under the arrangement. Further, such costs are amortized over the life of the arrangement even if the entity repays previously drawn amounts.

Thinking It Through

Before adopting ASU 2015-03, an entity may have remeasured debt issuance costs into its functional currency by using historical exchange rates because (1) it presented debt issuance costs in the balance sheet as deferred charges under ASC 835-30 and (2) ASC 830-10-45-18(i) requires that deferred charges be treated as a nonmonetary balance sheet item that is remeasured by using historical rates.

Upon adopting ASU 2015-03, however, an entity presents debt issuance costs (other than costs related to line-of-credit or revolving-debt arrangements) in the balance sheet as a direct deduction from the related debt liability (in accordance with ASC 835-30-45-1A, as amended by ASU 2015-03) rather than as a deferred charge. The remeasurement of the carrying amount of the debt liability into the entity's functional currency, therefore, reflects any deduction related to debt issuance costs. Under ASC 830-10-45-17, monetary liabilities (including the carrying amount of a monetary debt liability that has been adjusted for debt issuance costs) are remeasured into the entity's functional currency by using current exchange rates.

Notwithstanding the Board's stated intention of not changing the recognition and measurement guidance on debt issuance costs, an entity that presented debt issuance costs (other than issuance costs associated with line-of-credit or revolving debt arrangements) as deferred charges and treated such costs as a nonmonetary item under ASC 830-10 before adopting ASU 2015-03 would need to (1) retrospectively adjust, upon transition to ASU 2015-03, its accounting for debt issuance costs under ASC 830-10 in accordance with ASC 835-30-65-1(c) and (2) perform remeasurement as of each subsequent reporting period by using current exchange rates.

Effective Date and Transition

For public business entities, the guidance in ASU 2015-03 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. For entities other than public business entities, the guidance is effective for fiscal years beginning after December 15, 2015, and interim periods beginning after December 15, 2016. Early adoption is allowed for all entities for financial statements that have not been previously issued. Entities would apply the new guidance retrospectively to all prior periods (i.e., the balance sheet for each period is adjusted).

The ASU requires an entity to "disclose in the first fiscal year after the entity's adoption date, and in the interim periods within the first fiscal year, the following:

1. The nature of and reason for the change in accounting principle
2. The transition method
3. A description of the prior-period information that has been retrospectively adjusted
4. The effect of the change on the financial statement line item (that is, the debt issuance cost asset and the debt liability)."

Employee Share-Based Payments

In June 2015, the FASB issued a [proposed ASU](#) on share-based payments as part of its simplification initiative. The proposed ASU would affect several aspects of the accounting for employee share-based payment transactions for both public and nonpublic entities, including the accounting for income taxes, forfeitures, minimum statutory withholding requirements, classification in the statement of cash flows, and classification of awards with repurchase features. In addition, the proposed ASU contains two practical expedients for nonpublic entities under which such entities can use the simplified method to estimate the expected term of an award and make a one-time election to switch from fair value measurement to intrinsic value measurement for liability-classified awards.

The FASB received over 60 comment letters on the proposal (which were due by August 14, 2015) from various respondents, including preparers, professional and trade organizations, and accounting firms. While respondents were generally supportive of the proposed changes, a number were concerned with a key provision related to accounting for excess tax benefits and deficiencies. Specifically, the ASU proposes to eliminate the APIC pool and require entities to record all excess tax benefits and deficiencies to the income statement. While respondents generally agreed with the Board's proposal to eliminate the APIC pool, many would prefer to record all excess tax benefits and deficiencies directly to equity.

For additional information about the proposed ASU, see Deloitte's June 12, 2015, [Heads Up](#).

Measurement-Period Adjustments

Background

In September 2015, the FASB issued [ASU 2015-16](#), which amended the guidance in ASC 805 on the accounting for measurement-period adjustments. The ASU was issued as part of the FASB's simplification initiative in response to stakeholder feedback that restating prior periods to reflect adjustments made to provisional amounts recognized in a business combination adds cost and complexity to financial reporting but does not significantly improve the usefulness of the information provided to users.

Key Provisions of the ASU

Under previous guidance, when an acquirer identified an adjustment to provisional amounts during the measurement period, the acquirer was required to revise comparative information for prior periods, including making any change in depreciation, amortization, or other income effects recognized in completing the initial accounting, as if the accounting for the business combination had been completed as of the acquisition date.

The ASU requires an acquirer to recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The effect on earnings of changes in depreciation or amortization, or other income effects (if any) as a result of the change to the provisional amounts, calculated as if the accounting had been completed as of the acquisition date, must be recorded in the reporting period in which the adjustment amounts are determined rather than retrospectively.

Thinking It Through

Although the ASU changes the accounting for measurement-period adjustments, it does not change the definition of a measurement-period adjustment, which is an adjustment to the amounts provisionally recognized for the consideration transferred, the assets acquired, and the liabilities assumed as a result of "new information obtained about facts and circumstances that existed as of the acquisition date that, if known, would have affected the measurement of those amounts as of that date." Errors, information received after the measurement period ends, or information received about events or circumstances that did not exist as of the acquisition date are not measurement-period adjustments.

Disclosure Requirements

The ASU also requires that the acquirer present separately on the face of the income statement, or disclose in the notes, the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date.

Effective Date and Transition

For public business entities, the ASU is effective for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017. The ASU must be applied prospectively to adjustments to provisional amounts that occur after the effective date. Early application is permitted for financial statements that have not been issued.

The only disclosures required at transition will be the nature of and reason for the change in accounting principle. An entity should disclose that information in the first annual period of adoption and in the interim periods within the first annual period if there is a measurement-period adjustment during the first annual period in which the changes are effective. For more information about the ASU, see Deloitte's September 30, 2015, [Heads Up](#).

Equity Method Simplification

In June 2015, the FASB issued a [proposed ASU](#) on equity method accounting as part of its simplification initiative. The proposal would eliminate the requirements for an investor to (1) account for basis differences related to its equity method investees and (2) retroactively account for an investment that becomes newly qualified for use of the equity method because of an increased ownership interest, as if the equity method had been applied during all previous periods in which the investment was held. Comments on the proposed ASU were due by August 4, 2015.

Thinking It Through

The comment letters to the FASB on the proposed ASU generally supported the Board's efforts to reduce the complexity related to the equity method of accounting. Most respondents approved of the Board's proposal to eliminate retrospective application of the equity method accounting in situations in which an investment qualifies for the use of such accounting as a result of an increased level of ownership. However, concerns were raised that eliminating the requirement to account for basis differences related to an equity method investee could introduce new challenges when the investee has a single (or a predominant) asset.

For additional information about the proposed ASU, see Deloitte's June 16, 2015, [Heads Up](#) and August 4, 2015, [comment letter](#) to the FASB.

Balance Sheet Classification of Debt

Background

As part of its simplification initiative, the FASB has tentatively decided to replace its current, fact-specific debt classification guidance with a cohesive principle that would be applied in the determination of whether debt liabilities should be classified as current or noncurrent in a classified statement of financial position. All debt arrangements (i.e., those that "provide a lender a contractual right to receive money and a borrower a contractual obligation to pay money on demand or on fixed or determinable dates"¹⁹) would be within the scope of the tentative decisions.

Thinking It Through

The scope of this project also includes convertible debt instruments, even though they may be settled in shares upon conversion, and mandatorily redeemable financial instruments that are classified as liabilities, even if they were issued in the form of an entity's equity shares.

Tentative Decisions

Debt Classification Principle

The Board has tentatively decided that "an entity should classify a debt as noncurrent if one or both of the following criteria are met as of the balance sheet date:

1. The liability is contractually due to be settled more than 12 months (or operating cycle, if longer) after the balance sheet date
2. The entity has a contractual right to defer settlement of the liability for at least 12 months (or operating cycle, if longer) after the balance sheet date."²⁰

¹⁹ See the [handout](#) for the FASB's July 29, 2015, meeting.

²⁰ Quoted text is from the FASB's [summary](#) of tentative Board decisions reached at its January 28, 2015, meeting.

Thinking It Through

Under existing U.S. GAAP, an entity in some cases considers transactions entered into after the balance sheet date, but before the financial statements are issued, in classifying debt as current or noncurrent. For example, an entity may exclude short-term obligations from current liabilities in certain circumstances if it has issued long-term obligations or equity securities to refinance a short-term obligation on a long-term basis after the balance sheet date but before the financial statements are issued. Under the Board's tentative decision, the classification would instead be made on the basis of the entity's rights and obligations as of the balance sheet date. The proposed classification principles would more closely align U.S. GAAP with IFRSs (i.e., paragraph 69 of IAS 1).

Although the classification of debt generally would be based on the facts and circumstances as of the balance sheet date, the Board tentatively decided to make an exception in certain circumstances when the entity receives a waiver of a debt covenant violation. When an entity violates a debt covenant on or before the balance sheet date, and the long-term debt becomes a short-term obligation, the entity would not automatically be required to classify the debt as current. If the lender grants the entity a waiver of the covenant before the entity's financial statements are issued, the entity would classify the debt as noncurrent and present the debt separately on the face of the balance sheet. The purpose of such presentation would be to notify financial statement users that this debt is classified as noncurrent even though the entity violated one or more covenants as of the balance sheet date. The exception would not apply to waivers that involve a debt modification or extinguishment under ASC 470-50.

For an entity's application of the waiver exception, the Board tentatively decided to retain existing U.S. GAAP guidance²¹ under which (1) the waiver of the current violation must be greater than 12 months from the balance sheet date and (2) it is *not* probable that the borrower will be unable to comply with the covenant by the covenant compliance dates within the next 12 months.

Subjective Acceleration Clauses

Subjective acceleration clauses are clauses under which the lender may accelerate the maturity date of the debt as a result of conditions that are not objectively determinable (e.g., if the debtor fails to maintain *satisfactory* operations or if a *material adverse change* occurs). The FASB tentatively decided that subjective acceleration clauses should affect the classification of debt only when such clauses are triggered.

Thinking It Through

Under current U.S. GAAP, long-term obligations subject to a subjective acceleration clause in certain circumstances (e.g., if the borrower is experiencing recurring losses or liquidity problems) are classified as current even if the lender has not invoked the clause. On the basis of the Board's tentative decision, however, it appears that a subjective acceleration clause would only affect the classification of debt when the entity's debt payment has been accelerated.

Disclosures and Transition

The FASB has tentatively decided to (1) incorporate into U.S. GAAP the disclosure requirements related to debt covenant violations that currently exist in SEC guidance²² and (2) require the disclosures for both public and nonpublic business entities. The Board has also decided to require entities to disclose the nature and existence of significant subjective acceleration clauses and debt covenants.

²¹ See ASC 470-10-45-1(b).

²² See SEC Regulation S-X, Rule 4-08 (ASC 235-10-S99-1(c)).

The guidance would apply on a prospective basis to all debt that exists as of the effective date. On transition, an entity would be required to disclose:

- The nature of and reason for the change in accounting principle.
- The effect of the change on affected financial statement line items in the current period.

The effective date will be determined after stakeholder feedback is received.

Next Steps

The FASB expects to issue a proposed ASU with a 60-day comment period.

Goodwill and Identifiable Intangible Assets for Public Business Entities and Not-for-Profit Entities

Background

In November 2013, the FASB endorsed a decision by the PCC to allow nonpublic business entities to amortize goodwill and perform a simplified goodwill impairment test. In addition, in 2014 the FASB endorsed the PCC's alternative that gives private companies an exemption from having to recognize certain intangible assets for (1) assets acquired in a business combination or (2) investments accounted for under the equity method or upon the adoption of fresh-start accounting. The Board received feedback on the PCC's decision indicating that many public business entities and not-for-profit entities had similar concerns about the cost and complexity of applying these requirements. In response, the Board added a project on goodwill and a separate project on intangible assets to its agenda in 2014.

Current Status and Next Steps

The goodwill project is currently in the initial deliberations phase. At its meeting on October 28, 2015, the FASB tentatively decided to split the project into two phases. The first phase would focus on simplifying the goodwill impairment test. In the second phase, the Board would work with the IASB to address stakeholder concerns related to the subsequent accounting for goodwill.

At the October meeting, the Board discussed how to simplify the goodwill impairment test and tentatively decided to remove step 2, thus eliminating the requirement to complete a hypothetical purchase-price allocation. The FASB also tentatively decided not to give entities the option to perform step 2 and to instead require them to adopt the simplified impairment test prospectively.

The identifiable intangible assets project is currently in the initial deliberations phase. At its October 28, 2015, meeting, the Board decided to continue further research in conjunction with the IASB's project on this topic.

Accounting Alternatives for Private Companies

Background

The following guidance (developed in 2014 by the Private Company Council (PCC)) is effective in 2015:

- *Goodwill* — In January 2014, the FASB issued [ASU 2014-02](#), which allows private companies to use a simplified approach to account for goodwill after an acquisition. Under such approach, an entity would (1) amortize goodwill on a straight-line basis, generally over 10 years; (2) test goodwill for impairment only when a triggering event occurs; and (3) make an accounting policy election to test for impairment at either the entity level or the reporting-unit level. The ASU also eliminates "step 2" of the goodwill impairment test; as a result, an entity would measure goodwill impairment as the excess of the entity's (or reporting unit's) carrying amount over its fair value. An entity that elects the simplified approach should adopt the ASU's guidance prospectively and apply it to all existing goodwill (and any goodwill arising from future acquisitions) existing as of the beginning of the period of adoption.

The ASU is effective for annual periods beginning after December 15, 2014, and interim periods with annual periods beginning after December 15, 2015. See Deloitte's January 27, 2014, *Heads Up* for more information.

- *Hedge accounting* — In January 2014, the FASB issued [ASU 2014-03](#), which gives private companies a simplified method of accounting for certain receive-variable, pay-fixed interest rate swaps used to hedge variable-rate debt. An entity that elects to apply the simplified hedge accounting to a qualifying hedging relationship would continue to account for the interest rate swap and the variable-rate debt separately on the face of the balance sheet. However, the entity would be able to assume no ineffectiveness in the hedging relationship, thereby essentially achieving the same income statement profile as with a fixed-rate borrowing expense. In addition, the entity is allowed more time to complete its initial hedge documentation. An entity that applies the simplified approach also may elect to measure the related swap at its settlement value rather than at fair value. Financial institutions (including banks, savings and loan associations, savings banks, credit unions, finance companies, and insurance entities) are specifically ineligible to elect this accounting alternative. The ASU is effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. Entities that elect the simplified approach should adopt the ASU under either a full retrospective or a modified retrospective method. See Deloitte's January 27, 2014, *Heads Up* for more information.
- *Identified intangible assets* — In December 2014, the FASB issued [ASU 2014-18](#), which gives private companies an exemption from having to recognize certain intangible assets for (1) assets acquired in a business combination or (2) investments accounted for under the equity method or upon the adoption of fresh-start accounting. Specifically, an entity would not be required to separately recognize intangible assets for noncompete agreements and certain customer-related intangible assets that arise within the scope of the ASU. Because the amounts associated with these items would be subsumed into goodwill, an entity that elects this accounting alternative would also be required to adopt ASU 2014-02 (see discussion above), resulting in the amortization of goodwill. Entities that elect the alternative should adopt the ASU prospectively to the first eligible transaction within the scope of the ASU that occurs in the annual period beginning after December 15, 2015 (with early adoption permitted), and all transactions thereafter. See Deloitte's December 30, 2014, *Heads Up* for more information.

Thinking It Through

Certain entities in the industry will meet the definition of a public business entity and therefore are not eligible for PCC alternatives. For example, broker-dealers that are required to file financial statements with the SEC will meet the definition of a public business entity (the confidential submission of financial information to the SEC by a "material associated person" of a broker-dealer also meets the definition of a public business entity). We had historically believed that a "material associated person" of a broker-dealer would not meet the definition of a public business entity when required to confidentially submit financial statements to the SEC. In October 2015, the staff in the SEC's Office of the Chief Accountant clarified that such an entity should be considered a public business entity.

Proposed Changes to Effective Date and Transition Guidance in Certain Private-Company ASUs

In September 2015, the FASB issued for public comment a [proposed ASU](#) that would give private companies a one-time unconditional option to forgo a preferability assessment the first time they elect a PCC accounting alternative within the proposal's scope. It would also eliminate the effective dates of PCC accounting alternatives that are within the proposal's scope as well as extend the transition guidance in ASU 2014-02 and ASU 2014-03. The proposal's amendments could affect all private companies within the scope of ASUs 2014-02 and 2014-03 as well as [ASU 2014-07](#) and ASU 2014-18. See Deloitte's October 6, 2015, *Heads Up* for more information.

Other Private-Company Matters

Throughout 2015, the PCC has discussed aspects of financial reporting that are complex and costly for private companies, including stock-based compensation, the application of VIE guidance to nonleasing common-control arrangements, and the balance sheet classification of debt.

At a recent meeting, the PCC agreed that it would continue to deliberate stock-based compensation and consider feedback received in connection with the FASB’s [proposed ASU](#) on employee share-based payment accounting improvements. See Deloitte’s June 12, 2015, [Heads Up](#) for more information.

The PCC also asked the FASB staff to research (1) examples that would clarify the application of VIE guidance to nonleasing common-control arrangements and (2) potential modifications to existing business scope exceptions to address application issues.

In addition, the PCC decided in February 2015 that it would not “amend the existing definitions of a nonpublic entity at this time. The existing definitions will remain in the FASB Codification until potentially amended at a later date by the FASB. The definition of a public business entity, [as amended by [ASU 2013-12](#)] should continue to be used for future accounting and reporting guidance.”²³

Statement of Cash Flows: Classification of Certain Cash Receipts and Cash Payments (EITF Issue 15-F)

To reduce diversity in the application ASC 230, the FASB added nine subissues related to EITF Issue 15-F to the EITF’s agenda in 2015:

Cash Flow Classification Issue	Status
<p>Debt Prepayment or Extinguishment Costs</p> <p>Cash payments for debt prepayment or extinguishment costs would be classified as cash outflows in financing activities.</p>	Consensus-for-exposure
<p>Settlement of Zero-Coupon Bonds</p> <p>At settlement, the cash outflows of a zero-coupon bond would be classified in operating and financing activities. The cash payment of the accreted interest would be classified in operating activities, while the cash payment attributable to the original proceeds (i.e., the principal) would be classified in financing activities.</p>	Consensus-for-exposure
<p>Restricted Cash</p> <p>Changes in restricted cash that affect an entity’s cash and cash equivalent balance would be classified as investing activities (i.e., on the basis of the nature of the cash flow). The remaining restricted cash-related issues will be discussed at a future meeting.</p>	Tentative decisions
<p>Contingent Consideration Payments Made After a Business Combination</p> <p>Contingent consideration payments that were not made on the acquisition date or soon before or after the business combination would be classified in operating and financing activities. Cash payments up to the fair value amount of the contingent consideration liability, including any measurement-period adjustments, that are recognized as of the acquisition date would be classified in financing activities, while any excess cash payments would be classified in operating activities.</p>	Consensus-for-exposure
<p>Proceeds From the Settlement of Insurance Claims</p> <p>The cash proceeds from the settlement of insurance claims would be based on the nature of the insurance coverage (i.e., nature of the loss), including lump-sum payments for which the nature of the loss can be reasonably estimated.</p>	Consensus-for-exposure
<p>Proceeds From the Settlement of Corporate-Owned Life Insurance (COLI) Policies</p> <p>Cash proceeds from the settlement of COLI policies would be classified in investing activities. However, an entity would be permitted, but not required, to align the classification of premium payments on COLI policies with the classification of COLI proceeds.</p>	Consensus-for-exposure

²³ See the PCC’s [overview](#) of decisions reached on PCC Issue No. 14-01.

Cash Flow Classification Issue (continued)	Status
<p>Distributions Received From Equity Method Investees</p> <p>Distributions received by an equity method investee would be classified in operating and investing activities by applying the cumulative earnings approach.</p>	Consensus-for-exposure
<p>Beneficial Interests in Securitization Transactions</p> <p>The transferor’s beneficial interests received as proceeds from the securitization of an entity’s assets would be disclosed as a noncash activity. Subsequent cash receipts on beneficial interests from the securitization of an entity’s trade receivables would be classified in investing activities.</p>	Consensus-for-exposure
<p>Application of the Predominance Principle</p> <p>The Task Force decided to retain and clarify the predominance principle in ASC 230.</p>	Consensus-for-exposure

The EITF has reached a consensus-for-exposure on all of the subissues except for Issue 3 (on restricted cash) and has decided that the guidance related to those eight subissues would be applied retrospectively to all periods presented. The Task Force has also decided to incorporate an impracticability²⁴ principle into the guidance.

Because Task Force members’ views differ on the guidance related to restricted cash, the EITF has directed the staff to perform further research. The Task Force is expected to continue discussing restricted cash and the effective date for the guidance at a future meeting. For more information, including tentative decisions reached by the EITF as of the date of this publication, see Deloitte’s November 2015 *EITF Snapshot*.



²⁴ The impracticability principle would be applied in a manner similar to ASC 250-10-45-9.

Investment Companies

Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share or Its Equivalent (ASU 2015-07)

Background

In May 2015, the FASB issued [ASU 2015-07](#), which is based on the final consensus reached by the EITF on Issue 14-B. Affecting entities with certain investments¹ for which the practical expedient² is used to measure fair value at net asset value (NAV), the ASU removes the disclosure requirement to categorize those investments within the fair value hierarchy. The ASU also amends or removes other disclosure requirements for eligible investments measured at NAV and contains consequential amendments to ASC 230-10 related to the statement of cash flows and to ASC 715-20 regarding sponsors of defined benefit plans.

Key Provisions

Rather than categorizing within the fair value hierarchy³ eligible investments that apply the NAV practical expedient, the ASU requires an entity to disclose the NAV of those investments to reconcile the fair value of the investments within the fair value hierarchy to the line item(s) presented in the statement of financial position. In addition, eligible investments that apply the NAV practical expedient no longer need to disclose the other information required by ASC 820-10-50-2, such as transfers between fair value levels, a level-three rollforward schedule, or the description of the valuation techniques for certain assets and liabilities.

Thinking It Through

Entities must still comply with the requirements in ASC 820-10-50-6A, which include disclosing the investment's NAV and the nature, risk, and redeemability of eligible investments that apply the NAV practical expedient in measuring fair value.

Also, in instances in which the practical expedient is used to measure fair value at NAV for all of an entity's investments, the information required by ASC 820-10-50-6A may be disclosed in a manner that complies with the ASU's requirement to reconcile the fair value of the investments in the disclosure to the line item(s) presented in the statement of financial position. Accordingly, an entity would not present a blank fair value hierarchy leveling tabular disclosure to meet the ASU's reconciliation requirement.

In addition, the ASU amends the scope of the disclosure requirements in ASC 820-10-50-6A to include only investments that (1) are eligible for the practical expedient and (2) have elected to apply the practical expedient in measuring fair value at NAV. The ASU also removes the guidance in ASC 820-10-50-6A(g), under which certain disclosures were required when it was probable that an investment would be sold for an amount different from the NAV.

Thinking It Through

ASU 2015-07 simplifies the reporting requirements by limiting the disclosures required by ASC 820-10-50-6A to those investments measured under the NAV practical expedient (rather than all eligible investments that may apply the practical expedient).

¹ ASC 820-10-15-4 and 15-5 provide the requirements for an investment's eligibility to apply the NAV per share (or its equivalent) practical expedient in measuring fair value.

² The NAV practical expedient is discussed in ASC 820-10-35-59 through 35-62.

³ Under ASU 2015-07, sponsors of defined benefit plans within the scope of ASC 715-20 that elect the NAV practical expedient to measure plan investments at fair value are also no longer permitted to be categorized within the levels of the fair value hierarchy in the plan investment footnote.

Investment companies that meet certain criteria⁴ may be exempt from presenting a statement of cash flows if certain conditions⁵ are met. ASU 2015-07 amends one of those conditions to include investments that apply the NAV practical expedient that “are redeemable in the near term at all times.”

Thinking It Through

The amendment to the exemption requirements is intended to continue to ensure that certain investment companies with liquid investments will not be required to present a statement of cash flows. Entities will need to determine whether the investments are “redeemable in the near term at all times” as of the reporting date. There is no bright-line definition of “near term.” However, by analogy to AICPA TIS 2220.25, a redemption period of 90 days or less would generally be considered near term.

Effective Date and Transition

For public companies, the ASU is effective for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years. The effective date is deferred by one year for private companies. Early adoption is permitted. The ASU should be applied retrospectively to all periods presented.

Repurchase Agreements

Background

In June 2014, the FASB issued [ASU 2014-11](#), which makes limited amendments to the guidance in ASC 860 on accounting for certain repurchase agreements (“repos”⁶). The ASU (1) requires entities to account for repurchase-to-maturity transactions as secured borrowings, (2) eliminates accounting guidance on linked repurchase financing transactions, and (3) expands disclosure requirements related to certain transfers of financial assets that are accounted for as sales and certain transfers (specifically, repos, securities lending transactions, and repurchase-to-maturity transactions) that are accounted for as secured borrowings.

Repurchase Agreements That Settle at Maturity

The ASU amends ASC 860 to include an exception that prohibits entities from accounting for repurchase-to-maturity transactions as sales. Specifically, ASC 860-10-40-5A (added by the ASU) states:

A repurchase-to-maturity transaction shall be accounted for as a secured borrowing as if the transferor maintains effective control (see paragraphs 860-10-40-24 through 40-24A).

The ASU does not change the other criteria in ASC 860 for assessing effective control; however, it clarifies that repos and securities lending transactions that do not meet all of the derecognition criteria in ASC 860-10-40-5 should be accounted for as secured borrowings. In addition, the ASU’s Basis for Conclusions clarifies that the repurchase-to-maturity exception should not be applied by analogy to “similar transactions that are settled in cash before the maturity of the transferred financial asset.”

Repurchase Financings

The ASU eliminates the guidance on repurchase financing transactions in ASC 860-10-40-42 through 40-47 and requires the transferor and transferee to symmetrically account for the initial transfer of the financial asset as a sale (provided that derecognition conditions are met) and purchase, respectively. In addition, the ASU requires entities to evaluate and account

⁴ See ASC 230-10-15(b).

⁵ See ASC 230-10-15(c).

⁶ In the mutual fund industry, these transactions are commonly referred to reverse repos.

for the repurchase component of the combined transaction in a manner similar to how they would evaluate and account for other typical repurchase agreements.

Thinking It Through

The ASU could significantly affect the financial reporting of entities with repurchase financing and repurchase-to-maturity arrangements. Upon adoption of the ASU, entities with outstanding arrangements that were previously derecognized would need to recognize and account for them as secured borrowings. In addition, certain regulated entities (e.g., banks and broker-dealers) would need to assess the ASU's effect on their compliance with regulatory and capital requirements.

Disclosure Requirements

The ASU contains new disclosure requirements related to certain transfers of financial assets that are accounted for as sales and collateral supporting repurchase agreements, securities lending transactions, and repurchase-to-maturity transactions that are accounted for as secured borrowings.

For certain transfers accounted for as sales, the transferor would need to disclose the following by type of transactions:

- The carrying amount of assets derecognized as of the date of derecognition.
- The amount of gross proceeds received by the transferor at the time of derecognition for the assets derecognized.
- Information about the transferor's ongoing exposure to the economic return on the transferred financial assets.
- Amounts arising from the transaction that are reported in the statement of financial position, such as those represented by derivative contracts.

The ASU specifically excludes from the scope of this disclosure requirement (1) dollar-roll transactions that qualify for sale accounting and (2) certain other transactions that are subject to the disclosure requirements of ASC 860-20-50-3 and 50-4.

For repos, securities lending transactions, and repurchase-to-maturity transactions accounted for as secured borrowings, ASC 860-30-50-7 requires the following disclosures:

- "A disaggregation of the gross obligation by the class of collateral pledged."
- "The remaining contractual tenor of the agreements."
- "A discussion of the potential risks associated with the agreements and related collateral pledged, including obligations arising from a decline in the fair value of the collateral pledged and how those risks are managed."

In addition, entities are required to reconcile the gross obligation of these arrangements to the gross liabilities of repos and securities lending transactions included in the offsetting disclosure of assets and liabilities under ASC 210-20-50-3(a) before offsetting adjustments. Any difference would be presented as a reconciling item.

Thinking It Through

Because the definition of a repo in ASC 210-20 applies only to securities whereas its definition in ASC 860 was amended to apply more broadly to all financial assets (e.g., loans, securities), reconciling differences can arise between the offsetting disclosures required under ASC 210-20-50-3(a) and the disclosures under ASC 860-30-50-7.

In addition, an entity that engages in these transactions should consider the extent to which it may have to change its systems and controls to identify information not previously captured by its accounting or operations systems and to ensure that the information reported is accurate and complete. For example, the entity may need to reconfigure its systems to appropriately track certain transfers of financial assets that qualify for sale accounting so that it can provide the information required under the ASU.

Transition and Effective Date

The ASU prescribes effective dates for the accounting changes and the disclosure guidance. These dates vary depending on whether the reporting entity is a public or nonpublic business entity.

For public business entities, the accounting changes in the ASU are effective for the first interim or annual period beginning after December 15, 2014. For all other entities, the accounting changes are effective for annual periods beginning after December 15, 2014, and interim periods beginning after December 15, 2015. Early application for a public business entity is prohibited; however, all other entities may elect to apply the requirements for interim periods beginning after December 15, 2014.

Public business entities would apply the disclosure requirements related to certain transactions accounted for as a sale to interim and annual periods beginning after December 15, 2014. Such entities would apply the disclosure requirements related to repos, securities lending transactions, and repurchase-to-maturity transactions accounted for as secured borrowings to annual periods beginning after December 15, 2014, and to interim periods beginning after March 15, 2015. For all other entities, the disclosure requirements are effective for annual periods beginning after December 15, 2014, and interim periods beginning after December 15, 2015. Entities are not required to present comparative disclosures before the effective date.

See Deloitte's June 19, 2014, [Heads Up](#) for more information.



Other Topics

Disclosure Framework

Background

In July 2012, the FASB issued a [discussion paper](#) as part of its project to develop a framework to make financial statement disclosures “more effective, coordinated, and less redundant.” The paper identifies aspects of the notes to the financial statements that need improvement and explores possible ways to improve them. The FASB subsequently decided to distinguish between the “Board’s decision process” and the “entity’s decision process” for evaluating disclosure requirements.



FASB’s Decision Process

In March 2014, the FASB released for public comment a [proposed concepts statement](#) that would add a new chapter to the Board’s conceptual framework for financial reporting. The proposal outlines a decision process to be used by the Board and its staff for determining what disclosures should be required in notes to financial statements. The FASB’s objective in issuing the proposal is to improve the effectiveness of such disclosures by ensuring that reporting entities clearly communicate the information that is most important to users of financial statements. See Deloitte’s March 6, 2014, [Heads Up](#) for additional information.

Entity’s Decision Process

In September 2015, the FASB issued a [proposed ASU](#) that would amend the Codification to indicate that the omission of disclosures about immaterial information is not an accounting error. The proposal, which is part of the FASB’s disclosure effectiveness initiative, notes that materiality is a legal concept applied to assess quantitative and qualitative disclosures individually and in the aggregate in the context of the financial statements taken as a whole. See Deloitte’s September 28, 2015, [Heads Up](#) for additional information.

Comments on the proposed ASU were due by December 8, 2015.

Topic-Specific Disclosure Reviews

In addition to proposing amendments to guidance, the FASB staff is analyzing ways to “further promote [entities’] appropriate use of discretion” in determining proper financial statement disclosures. The Board is applying the concepts in both the entity’s and the Board’s decision process in considering “section-specific modifications.” In the second half of 2015, the FASB reached tentative decisions about disclosure requirements in the following Codification topics:

- ASC 820 (fair value measurement).
- ASC 740 (income taxes).
- ASC 715-20 (defined benefit plans).
- ASC 330 (inventory).

Proposed changes to the disclosure requirements for fair value measurement and income taxes are discussed below.

Fair Value Measurement

Objective for Disclosures

On December 3, 2015, the FASB issued for public comment a [proposed ASU](#) that would amend the requirements in ASC 820 for disclosing fair value measurements. The proposed ASU would add the following objective to ASC 820 to encourage preparers to use discretion in complying with the disclosure requirements:

The objective of the disclosure requirements in this Subtopic is to provide users of financial statements with information about all of the following:

- a. The valuation techniques and inputs that a reporting entity uses to arrive at its measures of fair value, including judgments and assumptions that the entity makes
- b. The effects of changes in fair value on the amounts reported in financial statements
- c. The uncertainty in the fair value measurement of Level 3 assets and liabilities as of the reporting date
- d. How fair value measurements change from period to period.

In addition to establishing a disclosure objective, the Board has tentatively decided to make changes (i.e., eliminations, modifications, and additions) to the specific fair value disclosure requirements of ASC 820.

Eliminated and Modified Disclosure Requirements

Policy on Timing of Transfers Between Levels and Transfers Between Levels 1 and 2

The proposed ASU would remove the requirement in ASC 820-10-50-2C for an entity to disclose its policy on the timing of transfers between levels of the fair value hierarchy. An entity would still be required to have a consistent policy on timing of such transfers. The requirement to separately disclose the amounts transferred between Level 1 and Level 2 and the corresponding reason for doing so would also be removed.

Level 3 Fair Value Measurements

The Board made the following tentative decisions that affect disclosures about Level 3 fair value measurements:

- *Valuation process* — Remove requirements in ASC 820-10-50-2(f) (and related implementation guidance in ASC 820-10-55-105) for an entity to disclose its valuation processes for Level 3 fair value measurements.

Thinking It Through

Removing the disclosure requirement in ASC 820-10-50-2(f) will result in divergence between U.S. GAAP and IFRSs. The requirement was added to the FASB's and IASB's jointly issued standard on the basis of a recommendation by the IASB's expert panel. The panel explained that the disclosure would help users understand the quality of the entity's fair value estimates and give investors more confidence in management's estimate. The FASB tentatively decided to remove the requirement because it would conflict with the Board's proposed concepts statement. The Board indicated that disclosure of internal control procedures is outside the purpose of the notes to the financial statements and is not required under other topics in U.S. GAAP.

Removing this requirement does not change management's responsibility for internal controls over the valuation process and related auditor testing. Further, it should not affect investor confidence in the quality of the fair value estimate given the regulatory environment in the United States (e.g., SEC and PCAOB) as well as the intense scrutiny in this area. The Board also noted that investors are typically familiar with the overall valuation process.

- *Measurement uncertainty* — Retain the requirement in ASC 820-10-50-2(g) to provide a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs. However, the Board plans to clarify that this disclosure is intended to communicate information about the uncertainty in measurement as of the reporting date and not to provide information about sensitivity to future changes in fair value.

- *Quantitative information about unobservable inputs* — Require disclosure of the range **and** weighted average of the unobservable inputs to comply with the requirement in ASC 820-10-50-2(bbb) (as shown by example in the implementation guidance in ASC 820-10-55-103). Disclosing the period used to develop significant unobservable inputs based on historical data would also be required.
- *Level 3 rollforward* — Retain the Level 3 rollforward requirement for public business entities. For entities that are not public business entities, the Board tentatively decided to modify the Level 3 rollforward guidance and remove the requirement to disclose the change in unrealized appreciation or depreciation related to investments held as of the balance sheet date under ASC 820-10-50-2(d). Instead, disclosures would be required about transfers into and out of Level 3 and purchases of Level 3 investments. The Board indicated that entities are already required to disclose the ending balance in the fair value hierarchy table, and they could disclose transfers into (and out of) and purchases of Level 3 investments in a sentence rather than in a full rollforward as required today. A defined benefit plan sponsor would also remove the reconciliation of beginning and ending balances for plan investments categorized as Level 3 within the fair value hierarchy (i.e., the Level 3 rollforward) and would only be required to disclose transfers into and out of Level 3 and purchases of Level 3 assets in its defined benefit plan footnote (for more information about the FASB’s project on reviewing defined benefit plan disclosures, see the [project page](#) on Deloitte’s US GAAP Plus Web site).

Thinking It Through

The Board discussed the results of user outreach on the Level 3 rollforward and noted that some financial statement users believe that the rollforward is useful because it helps them understand management’s decisions, especially for different economic cycles. The full rollforward was generally deemed less useful for users of private-company financial statements. Transfers into and out of Level 3 were generally considered to be the most useful aspect of the rollforward.

NAV Disclosures of Estimates of Timing of Future Events

The following disclosures currently required under ASC 820-10-50-6A(b) and ASC 820-10-50-6A(e) would apply only when they have been communicated to the reporting entity by the investee or are otherwise made publicly available (even if not specifically communicated to the investor):

- “For each class of investment that includes investments that can never be redeemed with the investees, but the reporting entity receives distributions through the liquidation of the underlying assets of the investees, the reporting entity’s estimate of the period of time over which the underlying assets are expected to be liquidated by the investees.”
- “[W]hen the restriction from redemption might lapse.”

Thinking It Through

The objective of this change is to prevent an investor from having to make its own estimate when it does not have knowledge of the timing from the investee or other public source. In addition, [ASU 2015-07](#) removed the requirement for entities to categorize within the levels of the fair value hierarchy all investments they have measured under the NAV practical expedient.

New Disclosure Requirements — Unrealized Gains and Losses

Public business entities would disclose fair value changes for assets and liabilities held as of the balance sheet date disaggregated by fair value hierarchy level (i.e., Levels 1, 2, and 3) for (1) net income before taxes and (2) comprehensive income. This is currently only required for the Level 3 amounts within net income under ASC 820-10-50-2(c) and (d). This requirement would not apply to entities that are not public business entities in accordance with the private-company decision-making framework.

Transition and Next Steps

The proposed ASU requires that the modifications to disclosures about changes in unrealized gains and losses and the changes in the quantitative information about unobservable inputs (see discussion above) would be applied prospectively beginning in the period of adoption. Entities would apply all other changes in disclosures retrospectively to all periods presented.

The FASB did not propose an effective date. Rather, the Board indicated that it plans to determine such date after considering stakeholders' feedback on the proposed ASU. Comments on the proposed ASU are due by February 29, 2016.

Income Taxes

At its meeting on January 7, 2015, the FASB staff outlined potential revisions to the disclosure requirements in ASC 740 that would enhance a financial statement user's understanding of foreign taxes. The Board's efforts are largely driven by [findings](#) in the post-implementation review of Statement 109 that users want more information that will allow them to analyze (1) "the cash effects associated with income taxes, particularly current period taxes paid by jurisdiction (e.g., U.S. and foreign), and estimate future tax payments" and (2) "earnings determined to be indefinitely reinvested in foreign subsidiaries."

At its October 21, 2015, meeting, the FASB discussed income tax disclosure requirements related to income taxes paid, deferred income taxes, valuation allowances, and rate reconciliation and reached the following tentative decisions, which would apply to both public and nonpublic entities:

- *Income taxes paid* — The Board would add requirements for a reporting entity to disclose (1) when a change in tax law has been enacted and it is probable that the change will affect the reporting entity in a future period and (2) the disaggregation of the income taxes paid between foreign and domestic jurisdictions.
- *Deferred income taxes* — An entity would be required to disclose the balance sheet line item(s) in which deferred taxes are presented (i.e., a mapping of total deferred taxes to the balance sheet line items in which they are reported).
- *Valuation allowances* — An entity would need to explain the "nature and amounts of the valuation allowance recorded and released during the reporting period."¹
- *Rate reconciliation* — The Board tentatively decided that:
 - Nonpublic entities would be required to present a rate reconciliation in the notes to the financial statements, as ASC 740-10-50-12 currently requires for public entities.
 - A disaggregation of a component of the rate reconciliation would be required if the individual component is greater than or equal to 5 percent of the tax at the statutory rate in a manner consistent with SEC Regulation S-X.
 - An entity would be required to disclose a qualitative description of the items that have caused a significant year-over-year change to the effective tax rate.

In addition, the Board tentatively decided to require disclosures about the (1) gross amounts and expiration dates of carryforwards recorded on a tax return, (2) tax-effected amounts and expiration dates of carryforwards that give rise to a deferred tax asset, and (3) total amount of unrecognized tax benefits that offset deferred tax assets related to carryforwards.

The Board directed its staff to begin drafting a proposed ASU for public comment that would take into account all the tentative decisions reached to date regarding income tax disclosure requirements. Such decisions include the Board's previous tentative decisions made about disclosure requirements related to indefinitely reinvested foreign earnings and unrecognized tax benefits.

¹ Quoted text is from the FASB's [summary](#) of tentative Board decisions reached at its October 21, 2015, meeting.

Undistributed Foreign Earnings

On February 11, 2015, the FASB tentatively decided that entities should:

- Disclose information separately about the domestic and foreign components of income before income taxes. Further, entities should separately disclose income before income taxes of individual countries that are significant relative to total income before income taxes.²
- Disclose the domestic tax expense recognized in the period related to foreign earnings.
- Disclose unremitted foreign earnings that, during the current period, are no longer asserted to be indefinitely reinvested and an explanation of the circumstances that caused the entity to no longer assert that the earnings are indefinitely reinvested. These disclosures should be provided in the aggregate and for each country for which the amount no longer asserted to be indefinitely reinvested is significant in relation to the aggregate amount.
- Separately disclose the accumulated amount of indefinitely reinvested foreign earnings for any country that is at least 10 percent of the aggregate amount.



Unrecognized Tax Benefits

At its [meeting](#) on August 26, 2015, the FASB tentatively decided to:

- Add a disclosure requirement in the tabular reconciliation to disaggregate settlements between cash and noncash (e.g., settlement by using existing net operating loss or tax credit carryforwards).
- Add a disclosure requirement to provide a breakdown of the amount of total unrecognized tax benefits shown in the tabular reconciliation by the respective balance-sheet lines on which such unrecognized tax benefits are recorded.
- Eliminate the requirement in ASC 740-10-50-15(d) for entities to provide details of positions for which it is reasonably possible that the total amount of unrecognized tax benefits will significantly increase or decrease in the next 12 months.

Since the two new proposed disclosure requirements for unrecognized tax benefits are related to the tabular reconciliation, they will only apply to public entities.

The Board directed its staff to prepare examples of the proposed additional disclosures.

Interim Reporting

To date, the FASB has discussed five interim reporting concepts under its proposed concepts statement. The Board generally agreed that interim financial statements should describe “differences in recognition, measurement, and presentation of line items” and should explain “how the interim period relates to the entire year.”³ Two of the interim reporting concepts pertained to disclosing changes from the latest annual financial statements, and two pertained to disclosing items that are not peripheral or are “especially important.”

To determine the meaning of “especially important,” the Board will assess the interim disclosure requirements being proposed in the Board’s project on reviewing fair value measurement disclosures as well as the interim disclosure requirements related to revenue in ASC 270-10-50-1A. On the basis of this process, the FASB can assess whether entities should disclose an item or amount that has not changed but is especially important.

² In ASC 740, income before income taxes is also referred to as pretax financial income.

³ Quoted text is from a [handout](#) for the Board’s January 7, 2015, meeting.

SEC Update

Background

The SEC continues to focus on rulemaking, particularly in connection with its efforts to complete mandated actions under the Dodd-Frank Act. Key SEC rulemaking activities and other developments that have occurred since the last edition of this publication are discussed below.

SEC Proposes Rules for Investment Companies and Investment Advisers

In May 2015, the SEC issued two proposed rules that would “modernize and enhance” the reporting and disclosure requirements for investment companies and investment advisers. The purpose of the proposals is to improve the “quality of information available to investors” and facilitate the Commission’s collection and use of data that investment companies and investment advisers provide.

The [proposed rule](#) on investment-company reporting would require “mutual funds, ETFs and other registered investment companies” to report information in a new structured format that would be easier for the SEC and the public to analyze. Further, this proposal “would permit but not require registered investment companies to transmit periodic reports to their shareholders by making the reports accessible on a website and satisfying certain other conditions.”

The [proposed rule](#) for investment advisers would require disclosures that allow the SEC and investors to get a better picture of the advisers’ risk profiles. In addition, this proposal “would require advisers to maintain records of performance calculations and communications related to performance.”

Thinking It Through

Over recent years, the SEC has expanded its use of data analytics to measure risk in the investment management industry. These proposals were developed to increase the consistency of information given by different entities to the SEC (and investors). The changes have far-reaching implications that increase the frequency with which information is provided, the breadth of information that must be provided, and the usability of the information. Not only do the proposals affect reporting requirements in the near term but they may also provide insight into the direction of the SEC’s future rulemaking efforts.

For more information, see the [press release](#) on the SEC’s Web site.

SEC Proposes Reforms to Promote Effective Liquidity Management

In September 2015, the SEC issued a [proposed rule](#) on liquidity management. As noted in the SEC’s press release, the proposal would introduce a package of reforms “designed to enhance effective liquidity risk management by open-end funds, including mutual funds and exchange-traded funds (ETFs).” The proposal would require mutual funds and ETFs to “implement liquidity risk management programs and enhance disclosure regarding fund liquidity and redemption practices [to] better ensure [that] investors can redeem their shares and receive their assets in a timely manner.” The proposal would also give mutual funds (but not ETFs or money market funds) the option to engage in “swing pricing.” This would protect shareholders from dilution arising from costs associated with large subscription or redemption activity by adjusting the fund’s NAV to effectively pass on the costs stemming from flows into or out of the fund to shareholders associated with that activity.

Thinking It Through

In recent years, regulators have been steadily intensifying their focus on liquidity. The SEC's January 2014 *IM Guidance Update*, "Risk Management in Changing Fixed Income Market Conditions" (the "Update"), indicated that mutual fund advisers should consider (1) assessing and stress testing liquidity; (2) conducting more general stress testing and scenario analysis on inputs such as interest rate changes and widening of spreads; (3) performing risk management evaluation of portfolio composition, concentration, and diversification; (4) enhancing communications with the mutual fund's board of directors to include reporting of risk exposures and liquidity determinations; and (5) updating shareholder communications on the adequacy of disclosures and completing a communication plan should escalation to external stakeholders be required.

As a result of the Update, the SEC's Office of Compliance Inspections and Examinations quickly followed up with sweep exams focused specifically on fixed income fund liquidity. The sweep exams assessed, among other things, how much progress mutual fund advisers were making on the considerations discussed in the Update.

For more information, see the [press release](#) on the SEC's Web site.

SEC Issues Final Rule on Pay Ratio Disclosure

In August 2015, the SEC issued a [final rule](#) that requires a registrant to calculate and disclose (1) the median of the annual total compensation of all of its employees (excluding its principal executive officer (PEO)), (2) the PEO's annual total compensation, and (3) the ratio of (1) to (2). Starting with its first full fiscal year beginning on or after January 1, 2017, the registrant will include the disclosures in filings in which executive compensation information is required, such as proxy and information statements, registration statements, and annual reports. Emerging growth companies, smaller reporting companies, foreign private issuers, registered investment companies, and filers under the U.S.-Canadian Multijurisdictional Disclosure System are exempt from the rule's requirements.

Thinking It Through

The rulemaking associated with the new requirements has been controversial, as demonstrated by the SEC's receipt of over 287,400 comment letters on the original rule proposal and the Commission's 3–2 vote on the final rule. To address concerns expressed by commenters about the costs of complying with the requirements, the rule provides certain accommodations.

We expect that during the first year or two after adoption, some registrants may change their method of computing the pay ratio as they find more efficient and accurate ways to identify the median employee and to calculate annual total compensation. Once registrants find a method that works for them, however, they are advised to stick with it. Some shareholders, analysts, or other parties may view frequent method changes as a red flag, thereby drawing unwarranted attention to a registrant's pay ratio disclosure.

The final rule became effective on October 19, 2015.

For more information, see the [press release](#) on the SEC's Web site.

SEC Proposes New Clawback Requirements

In July 2015, the SEC issued a [proposed rule](#) that would require companies to adopt "clawback" policies on executive compensation. Specifically, the proposal, which was released in response to a mandate in Section 954 of the Dodd-Frank Act, "would direct the national securities exchanges and national securities associations to establish listing standards that would require each issuer to develop and implement a policy providing for the recovery, under certain circumstances, of incentive-based compensation based on financial information required to be reported under the securities laws that

is received by current or former executive officers, and require the disclosure of the policy.” This proposal marks the completion of the SEC’s issuance of proposed executive compensation rules under the Dodd-Frank Act.

Thinking It Through

In light of the proposed accelerated timeframe for adopting the mandatory compensation recovery policy and the fact that the recovery policy could apply to unearned and unvested awards of incentive-based compensation granted before the effective date of the new listing rules (if earned or vested after the effective date), an affected registrant should:

- Monitor the timing of both the issuance of the final SEC rule and the adoption of the changes’ new listing rules. This is because the registrant would have a limited amount of time (60 days as proposed) in which to amend its existing recovery policy or adopt a new policy once the listing rules have been approved.
- Establish a cross-functional team from its human resources and legal departments to:
 - Review the registrant’s existing recovery policy and begin considering changes that may be necessary to comply with the SEC’s final rule.
 - Review executive officers’ employment and/or letter agreements to (1) determine whether there is any potential conflict between the terms of the agreements and the proposed SEC rule and (2) consider whether the company needs to amend those agreements.
 - Review the form of the registrant’s stock award agreements, the terms of its annual bonus plan, and its long-term incentive plan to determine whether they permit the recovery of excess incentive-based compensation and whether they should be updated.

Comments on the proposed rule were due by September 14, 2015.

For more information, see the [press release](#) on the SEC’s Web site.

SEC Issues Proposed Rule on Pay Versus Performance

In April 2015, the SEC issued a [proposed rule](#) that would require public companies — except foreign private issuers, registered investment companies, and emerging growth companies — to disclose “the relationship between executive compensation actually paid and the financial performance of the registrant” in proxy or information statements in which executive compensation disclosures are required. In a [public statement](#), SEC Chairman Mary Jo White indicated that she believes that the proposed disclosure requirements would “assist shareholders in assessing a company’s executive compensation practices and policies [and] inform [them] when voting in an election of directors and in connection with a shareholder’s advisory vote on executive compensation.”

Thinking It Through

Many registrants may find it challenging to determine (1) where to present this disclosure and (2) how to integrate it into the other extensive compensation disclosures already required by the SEC rules. The proposal acknowledges that placement of the disclosure in the compensation discussion and analysis (CD&A) section of a filing would suggest that the relationship of pay to total shareholder return was a factor in establishing compensation, which may not be the case. Therefore, under the proposed rule, registrants retain the flexibility to place the required disclosure wherever they believe it is most appropriate in the proxy. In addition, registrants may continue to compute and present other performance measures, such as realizable compensation (as defined), that will allow them to “tell their own story” elsewhere in the CD&A.

Comments on the proposed rule were due by July 6, 2015.

For more information, see the [press release](#) on the SEC’s Web site.

SEC Proposes Increased Oversight of Broker-Dealers That Engage in Off-Exchange Trading

In March 2015, the SEC issued a [proposed rule](#) that would amend Rule 15b9-1 of the Exchange Act, under which certain broker-dealers are exempted from membership in a registered national securities association. Specifically, the proposal “would narrow an exemption that currently exempts certain brokers-dealers from membership in a national securities association if they are a member of a national securities exchange, carry no customer accounts, and have annual gross income of no more than \$1,000 that is derived from securities transactions effected otherwise than on a national securities exchange of which they are a member.” The purpose of the proposed amendments is to “enhance regulatory oversight of active proprietary trading firms, such as high frequency traders.”

Thinking It Through

The proposal would limit the exemption to the types of broker-dealers for which it was originally designed — those with businesses primarily conducted on an exchange floor and over which that exchange is positioned to oversee the entirety of their trading activity. The exemption would accommodate off-exchange transactions by floor-based dealers that are intended solely to hedge the risks of their floor-based activities.

SEC Issues Final Rule to Ease Smaller Companies’ Access to Capital

In March 2015, the SEC issued a [final rule](#) that amends and expands Regulation A, which exempts certain offerings from registration under the Securities Act. The rule implements a mandate in Section 401 of the JOBS Act to ease smaller companies’ access to capital.

Under Regulation A before the amendments, a company could offer up to \$5 million of securities in a 12-month period and no more than \$1.5 million of those securities could be offered by the company’s securityholders. Under the new rule, a company can offer and sell up to \$50 million of securities in a 12-month period if it meets specified eligibility, disclosure, and reporting requirements. The rule creates the following two tiers of offerings under Regulation A:

- “Tier 1: annual offering limit of \$20 million, including no more than \$6 million on behalf of selling securityholders that are affiliates of the issuer.”
- “Tier 2: annual offering limit of \$50 million, including no more than \$15 million on behalf of selling securityholders that are affiliates of the issuer.”

The final rule establishes offering and reporting requirements for issuers under both tiers; however, such requirements are more extensive for Tier 2 issuers, which must provide audited financial statements in their offering documents and file annual, semiannual, and current reports with the SEC. The rule also preserves, “with some modifications, existing provisions regarding issuer eligibility, offering circular contents, testing the waters, and ‘bad actor’ disqualification.”

The final rule became effective on June 19, 2015.

For more information, see the [press release](#) on the SEC’s Web site.

SEC Staff Issues Guidance on Amendments to Regulation A

In June 2015, the SEC staff issued [guidance](#) on its March 2015 amendments to Regulation A. The amendments, which were issued to implement Section 401 of the JOBS Act, exempt certain offerings from registration under the Securities Act.

Specifically, the amendments provide relief for entities that offer and sell up to \$50 million of securities in a 12-month period if they meet specified eligibility, disclosure, and reporting requirements. The amendments became effective on June 19, 2015.

The SEC staff also recently issued and revised a number of [C&DIs](#) to provide additional guidance on Regulation A. Specifically, the staff added questions 182.01 through 182.11 to the Securities Act Rules section and withdrew questions 128.01 and 128.03 from the Securities Act Forms section.

SEC and CFTC Issue Interpretation on Forward Contracts With Volumetric Optionality

In May 2015, the SEC and CFTC jointly issued an [interpretive release](#) that clarifies the CFTC’s “interpretation of when an agreement, contract, or transaction with embedded volumetric optionality would be considered a forward contract.” The interpretation is being released in response to a mandate of the Dodd-Frank Act as well as comments from market participants.

Thinking It Through

The interpretation clarifies that the forward exclusion from the swap and future delivery definitions applies to an agreement, contract, or transaction, even if it contains embedded volumetric optionality, when:

1. The embedded optionality does not undermine the overall nature of the agreement, contract, or transaction as a forward contract;
2. The predominant feature of the agreement, contract, or transaction is actual delivery;
3. The embedded optionality cannot be severed and marketed separately from the overall agreement, contract, or transaction in which it is embedded;
4. The seller of a nonfinancial commodity underlying the agreement, contract, or transaction with embedded volumetric optionality intends, at the time it enters into the agreement, contract, or transaction to deliver the underlying nonfinancial commodity if the embedded volumetric optionality is exercised;
5. The buyer of a nonfinancial commodity underlying the agreement, contract or transaction with embedded volumetric optionality intends, at the time it enters into the agreement, contract, or transaction, to take delivery of the underlying nonfinancial commodity if the embedded volumetric optionality is exercised;
6. Both parties are commercial parties; and
7. The embedded volumetric optionality is primarily intended, at the time that the parties enter into the agreement, contract, or transaction, to address physical factors or regulatory requirements that reasonably influence demand for, or supply of, the nonfinancial commodity.

The interpretation became effective on May 18, 2015.



Appendixes

Appendix A — Glossary of Standards and Other Literature

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

AICPA TIS

2220.25, "Impact of 'Near Term' on Classification Within Fair Value Hierarchy"

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](#) (exposure drafts and public comment documents).
- [Pre-Codification literature](#) (Statements, Staff Positions, EITF Issues, and Topics).
- [Concepts Statements](#).

Office of the Comptroller of the Currency

Bank Accounting Advisory Series — September 2015

Private Company Council Literature

PCC Issue No. 14-01, *Definition of a Public Business Entity*

SEC Final Rules

34-75611, *Registration Process for Security-Based Swap Dealers and Major Security-Based Swap Participants*

34-74835, *Pay Versus Performance*

34-74246, *Security-Based Swap Data Repository Registration, Duties, and Core Principles*

34-74244, *Regulation SBSR — Reporting and Dissemination of Security-Based Swap Information*

34-73407, *Credit Risk Retention*

33-9877, *Pay Ratio Disclosure*

33-9741, *Amendments to Regulation A*

SEC and CFTC Interpretive Release

34-74936, *Forward Contracts With Embedded Volumetric Optionality*

SEC Proposed Rules

34-75612, *Applications by Security-Based Swap Dealers or Major Security-Based Swap Participants for Statutorily Disqualified Associated Persons to Effect or Be Involved in Effecting Security-Based Swaps*

34-74835, *Pay Versus Performance*

34-74834, *Application of Certain Title VII Requirements to Security-Based Swap Transactions Connected With a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent*

34-74581, *Exemption for Certain Exchange Members*

34-74245, *Regulation SBSR — Reporting and Dissemination of Security-Based Swap Information*

33-9922, *Comment Period for Investment Company Reporting Modernization Release*

33-9861, *Listing Standards for Recovery of Erroneously Awarded Compensation*

33-9776, *Investment Company Reporting Modernization*

33-9723, *Disclosure of Hedging by Employees, Officers and Directors*

IA-4091, *Amendments to Form ADV and Investment Advisers Act Rules*

SEC Regulation S-X

Rule 4-08, "General Notes to Financial Statements"

SEC Staff Accounting Bulletins

SAB Topic 5.J, "New Basis of Accounting Required in Certain Circumstances" (rescinded by SAB 115)

SAB Topic 13, "Revenue Recognition"

SEC Office of Compliance Inspections and Examinations

Examination Priorities for 2015

SEC Guidance

Amendments to Regulation A: A Small Entity Compliance Guide

SEC and Financial Industry Regulatory Authority

Joint Report, "National Senior Investor Initiative — A Coordinated Series of Examinations"

International Standards

See Deloitte's [IAS Plus Web site](#) for the titles of:

- International Financial Reporting Standards.
- International Accounting Standards.
- [Exposure documents](#).

Appendix B — Abbreviations

Abbreviation	Description	Abbreviation	Description
ABS	asset-backed security	GP	general partner
AFS	available for sale	IAS	International Accounting Standard
AICPA	American Institute of Certified Public Accountants	IASB	International Accounting Standards Board
APIC	additional paid-in capital	IFRS	International Financial Reporting Standard
ASC	FASB Accounting Standards Codification	LP	limited partner
ASU	FASB Accounting Standards Update	MMF	money market fund
C&DI	SEC Compliance and Disclosure Interpretation	NAV	net asset value
CDO	collateralized debt obligation	OCA	SEC's Office of the Chief Accountant
CD&A	compensation discussion and analysis	OCI	other comprehensive income
CDSC	contingent deferred sales charge	PCAOB	Public Company Accounting Oversight Board
CECL	current expected credit loss	PCC	Private Company Council
CFE	collateralized financing entity	PCI	purchased credit-impaired
CFTC	U.S. Commodity Futures Trading Commission	PEO	principal executive officer
CLO	collateralized loan obligation	repo	repurchase agreement
COLI	corporate-owned life insurance	ROU	right of use
ED	exposure draft	SAB	SEC Staff Accounting Bulletin
EITF	Emerging Issues Task Force	SEC	Securities and Exchange Commission
ETF	exchange-traded fund	TIS	Technical Inquiry Service
FASB	Financial Accounting Standards Board	TRG	FASB-IASB joint revenue recognition transition resource group
FINRA	Financial Industry Regulatory Authority	U.S. GAAP	United States Generally Accepted Accounting Principles
FRM	SEC's Financial Reporting Manual	VIE	variable interest entity
FVTNI	fair value through net income		

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

Abbreviation	Act
Dodd-Frank Act	The Dodd-Frank Wall Street Reform and Consumer Protection Act
Exchange Act	Securities Exchange Act of 1934
JOBS Act	Jumpstart Our Business Startups Act
The 1940 Act	Investment Company Act of 1940
Securities Act	Securities Act of 1933

Appendix C — Other Resources

Deloitte Publications

Register to receive other Deloitte industry-related publications by going to www.deloitte.com/us/subscriptions. Publications pertaining to your selected industry (or industries), along with any other Deloitte publications or webcast invitations you choose, will be sent to you by e-mail.

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In addition, be sure to visit [US GAAP Plus](#), our free Web site that features accounting news, information, and publications with a U.S. GAAP focus. It contains articles on FASB activities and updates to the *FASB Accounting Standards Codification*[™] as well as developments of other U.S. and international standard setters and regulators, such as the PCAOB, AICPA, SEC, IASB, and IFRS Interpretations Committee. Check it out today!

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