Deloitte.

Heads Up

December 21, 2012
Volume 19, Issue 33

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Under the CECL model, a reporting entity would recognize an impairment allowance equal to the current estimate of expected credit losses for financial assets as of the end of the reporting period.

You're the One
FASB Settles on Single Impairment Model for Financial Assets

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Introduction

On December 20, 2012, the FASB issued a proposed ASU[1] to obtain feedback on its current expected credit loss (CECL) model for accounting for the impairment of financial assets. Unlike the current impairment models under U.S. GAAP, the proposed CECL model is a single impairment approach for financial assets measured at amortized cost or fair value through other comprehensive income (FV-OCI) that would apply regardless of the form of the asset (e.g., loan versus debt security).[2] Under the CECL model, a reporting entity would 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. Comments on the proposal are due April 30, 2013.

Editor's Note: The CECL model is the third impairment model the FASB has exposed for comment (this proposal and the first model were FASB-only, and the second model was a supplementary document published jointly with the IASB in January 2011). Through June 2012, the FASB and the IASB jointly deliberated a three-bucket impairment model for financial assets. However, after constituents expressed significant concerns that the joint model could be difficult to understand, operationalize, and audit, the FASB separately decided to develop an alternative impairment model. Because it did not receive similar feedback from its constituents, the IASB tentatively decided to continue deliberations of the jointly developed model and has recently concluded those deliberations. However, the boards may resume joint deliberations after they receive comments on their respective proposals. The IASB plans to issue an exposure draft on impairment in the first quarter of 2013. See Appendix E for a comparison of the FASB's proposed model and the IASB's current thinking on impairment.

[1] FASB Proposed Accounting Standards Update, *Financial Instruments — Credit Losses.*

[2] Note that the proposed model replaces several existing U.S. GAAP impairment models. See Appendix F for a tabular summary of those models.

Overview

Scope

The CECL model would apply to all financial assets measured at amortized cost or FV-OCI;[3] however, in certain limited circumstances, a practical expedient would be permitted (see Relief From the CECL Model for Certain High-Quality Debt Instruments below). Reinsurance receivables that result from insurance transactions within the scope of ASC 944,[4] trade and lease receivables, and loan commitments not measured at fair value through net income (FV-NI) would be included in the model's scope.

Expected Loss Approach

Under the current impairment models in U.S. GAAP (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. The CECL model, however, does not include a recognition threshold. Rather, at the end of each reporting period, the impairment allowance is recognized on the basis of *expected* credit losses (i.e., contractual cash flows not expected to be collected). Further, the CECL model would not prescribe a unit of account (e.g., an individual asset or a group of financial assets) to be used in the measurement of credit impairment.

Credit impairment would be recognized as an allowance — or contra-asset — rather than as a direct write-down of the amortized cost basis of a financial asset. An entity would, however, write off the carrying amount of a financial asset if "the entity [ultimately] determines that it has no reasonable expectation of future recovery. The allowance for [the] expected credit losses shall be reduced by the amount of the financial asset balance written off. Recovery of a financial asset previously written off shall be recognized by recording an adjustment to the allowance for expected credit losses only when consideration is received."

Credit impairment would be recognized as an allowance — or contra-asset — rather than as a direct write down of the amortized cost basis of a financial asset.

If financial assets are measured at FV-OCI and the practical expedient[5] is not used, the estimate of expected credit losses would be recognized in earnings[6] and presented as a contra-asset that reduces the amortized cost of the asset, while a change in fair value resulting from noncredit components would be recognized in OCI.

Editor's Note: Both the FASB's and the IASB's proposed impairment models are based on expected credit losses and may address some constituents' concerns that recognition of incurred losses is "too little, too late."

In addition, the CECL model would replace the current guidance under U.S. GAAP (ASC 310-30, formerly SOP 03-3[7]) on the accounting for purchased credit-impaired (PCI) assets (see Appendix A for additional information) and would add explicit nonaccrual accounting guidance (see Appendix B for more information, including other aspects of the new model).

For a comparison of current U.S. GAAP and the FASB's proposed impairment model, see Appendix D.

Measurement of Expected Credit Losses

The proposed ASU requires the estimate of current expected credit losses to:

- Incorporate the time value of money.

[3] These two categories (amortized cost and FV-OCI) stem from the FASB's project on the classification and measurement of financial instruments. For more information about the FASB's tentative decisions on classification and measurement, see Deloitte's September 24, 2012, *Heads Up*.

[4] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

[5] See discussion below in Relief From the CECL Model for Certain High-Quality Debt Instruments.

[6] In addition, as decided by the FASB in its project on classification and measurement of financial instruments, foreign-currency gains and losses on foreign-currency-denominated debt securities classified at FV-OCI would also be recognized in earnings.

[7] AICPA Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer.*

- Reflect all "internally and externally available information considered relevant in making the estimate. That information includes information about past events, including historical loss experience with similar assets, current conditions, and reasonable and supportable forecasts and their implications for expected credit losses."
- Reflect at least two possibilities: (1) that a credit loss exists and (2) that no credit loss exists. A probability-weighted calculation that includes more than these two possibilities is not required but may be used. Furthermore, the estimate would not represent a best- or worst-case scenario or the entity's best point estimate of expected credit losses.
- Reflect "how credit enhancements (other than those that are freestanding contracts) mitigate expected credit losses."[8]

Although the estimate of expected credit losses must incorporate multiple possible outcomes and the time value of money, entities would not be required to perform a discounted cash flow analysis for individual securities at the end of each reporting period. A number of measurement approaches satisfy the requirements of the CECL model and could therefore be used by entities to develop an estimate of expected credit losses. Some alternatives specifically mentioned in the proposed ASU include "loss-rate methods, roll-rate methods, probability-of-default methods, and a provision matrix method using loss factors." The FASB also notes in the proposed ASU that using the fair value of collateral (less estimated costs to sell) for collateral-dependent loans implicitly satisfies the requirements.

The proposed ASU would 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.

In addition, for loan commitments within the proposal's scope, an entity would be required to "estimate [expected] credit losses over the full contractual period over which the entity is exposed to credit risk [under an unconditional] present legal obligation to extend credit." Such an estimate would take into account both the likelihood that funding will occur and the expected credit losses on commitments to be funded.

Relief From the CECL Model for Certain High-Quality Debt Instruments

During the FASB's outreach activities, some constituents expressed concerns about potentially having to record small impairments on high-quality debt instruments in a gain position (i.e., fair value exceeds carrying amount) because the proposed model would require the calculation of an expected value that incorporates the possibility of loss. To alleviate this concern, the FASB decided to provide a practical expedient for financial assets measured at FV-OCI. Under the practical expedient, entities would not be required to record an impairment allowance for such assets if both of the following conditions are met:

- The fair value of the financial asset exceeds its amortized cost.
- The amount of expected credit loss for the financial asset is insignificant.

Impact on Entities

The guidance in the proposal could significantly affect entities whose financial assets are within its scope. Such entities may need to perform an assessment of their financial systems to evaluate their ability to support a new set of impairment procedures, which will have to be applied to all financial assets within the proposal's scope (not just those with "incurred losses").

Effective Date and Transition

The proposed ASU would 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. An effective date for the final guidance has not yet been proposed.

[8] The proposed ASU states, "A freestanding contract is entered into either: (a) Separate and apart from any of the entity's other financial instruments or equity transactions (b) In conjunction with some other transaction and is legally detachable and separately exercisable."

Appendix A — Application of the CECL Model to PCI Financial Assets

The example below was adapted from the proposed ASU. It illustrates how the CECL model would apply to PCI financial assets, which the proposal defines as "[a]cquired individual assets (or acquired groups of financial assets with shared risk characteristics at the date of acquisition) that have experienced a significant deterioration in credit quality since origination, based on the assessment of the acquirer."

Editor's Note: This definition closely aligns with the scope of ASC 310-30 (formerly SOP 03-3).

PCI Financial Assets

Under the CECL model, entities would use the same approach to estimating expected credit losses for PCI financial assets that they do for originated and non-PCI assets. The impairment allowance at acquisition, and subsequently, would be based on management's current estimate of the *contractual* cash flows that the entity does not expect to collect. Under the proposed ASU, the discount embedded in the purchase price attributable to expected credit losses as of the date of acquisition must not be recognized as interest income,[9] which is consistent with current practice.

After initial recognition of the PCI financial asset and its related allowance, a reporting entity would continue to apply the CECL model to the asset. Consequently, any subsequent changes to its estimate of expected credit losses — whether unfavorable or favorable — would be recorded as impairment expense (or reduction of expense) during the period of change. This differs from current accounting for PCI assets, under which favorable changes in credit losses that are in excess of the allowance are treated as prospective yield adjustments that affect earnings of future periods.

Example

On January 1, 20X3, SCP Bank purchases a portfolio of residential mortgage loans for $750,000; the aggregate par amount of the portfolio is $1,000,000. On the date of acquisition, the bank expects to collect $825,000 (i.e., there is an expected credit loss of $175,000). The remaining difference between the purchase price and the par amount of the portfolio represents a non-credit-related discount to par ($75,000). On the basis of its assessment, SCP Bank concludes that the portfolio of loans meets the definition of a PCI financial asset.

On January 1, 20X3, SCP Bank would record the following entry:

Dr. Loans receivable (par)	$	1,000,000		
Cr. Noncredit discount			$	75,000
Cr. Allowance for credit impairment				175,000
Cr. Cash				750,000

To record PCI financial assets and establish related impairment allowance.

In recognizing interest income, SCP Bank deems the amortized cost of the portfolio to be $925,000 (i.e., the sum of the purchase price ($750,000) and the discount attributable to credit ($175,000). The $75,000 non-credit related discount will be accreted into interest income over the life of the portfolio. The $175,000 impairment allowance will be updated in subsequent periods in accordance with the CECL model, and any changes in the impairment allowance — whether favorable or unfavorable — are recognized immediately through earnings. As a result, the credit discount ($175,000) is never recognized as interest income.

[9] Example 6 in the proposed ASU outlines a practical approach by which the entity would not recognize the discount embedded in the purchase price as interest income and integrate the model into existing systems. Under such approach, the entity deems "the amortized cost of the asset, at acquisition, as equal to the sum of the purchase price and the associated expected credit loss at the date of acquisition. . . . By doing so, the asset is accreted from this [deemed] amortized cost to the contractual cash flows [that is, par] without ever recognizing as interest income the purchase discount attributable to expected credit losses at acquisition."

Appendix B — Other Aspects of the CECL Model

Interest Income Recognition

During redeliberations on the impairment project, the FASB reaffirmed that interest income recognition should be based on contractual cash flows.[10] Consequently, the recognition of interest income will remain "decoupled" (i.e., separate) from credit losses.

Nonaccrual Accounting

The practice of nonaccrual accounting currently stems from guidance issued by regulatory bodies like the Office of the Comptroller of the Currency, the Federal Reserve, and the Federal Deposit Insurance Corporation. The proposed ASU would add a nonaccrual accounting principle to U.S. GAAP under which a financial asset would be placed on nonaccrual status "when it is not probable that the entity will receive substantially all of the principal or substantially all of the interest. . . . If it is not probable that the entity will receive payment of substantially all of the principal," the entity would apply the cost recovery method.[11] Conversely, "[i]f it is probable that the entity will receive payment of substantially all of the principal but it is not probable that the entity will receive payment of substantially all of the interest (which may be the case if the value of collateral exceeds the amortized cost basis)," the entity would apply the cash basis method.[12]

Modified Financial Assets

The FASB decided not to comprehensively reconsider the accounting for modifications (e.g., when a modification results in derecognition or what constitutes a troubled debt restructuring (TDR)). It did, however, decide that reporting entities should apply the CECL model to modified financial instruments. For TDRs, an entity would consider the new series of contractual cash flows and adjust the cost basis of the asset so that the postmodification effective interest rate is the same as the premodification effective interest rate. In other words, the entity would adjust the cost basis of the asset "so that the effective interest rate (post-troubled debt restructuring) is the same as the original effective interest rate, given the new series of contractual cash flows. The basis adjustment would be calculated as the amortized cost basis before modification less the present value of the modified contractual cash flows (discounted at the original effective interest rate)." For non-TDR modifications that do not result in derecognition, the effective interest rate would be adjusted prospectively.

[10] Note that for PCI assets, the discount embedded in the purchase price that is attributable to expected credit losses should not be recognized as interest income (see Appendix A).

[11] Under the cost recovery method, an entity records cash receipts first as a reduction to the carrying amount of the asset. Once the entity recovers the entire carrying amount, it then applies additional cash payments it receives to recover any previously written-off amounts of principal and recognizes any excess as interest income.

[12] Under the cash basis method, an entity recognizes interest income as it receives cash payments. It then applies cash payments in excess of contractual interest to reduce the principal balance of the asset and records any excess as a reduction of the carrying amount of the asset.

Appendix C — Presentation and Disclosure Requirements

Presentation

The proposed ASU requires an entity to recognize the estimate of expected credit losses as a valuation allowance (or a contra-asset) in the statement of financial position, not as a cost-basis adjustment to the asset. As noted previously, for financial assets measured at FV-OCI, the estimate of expected credit losses would be presented as a contra-asset that reduces the amortized cost of the asset. Therefore, for financial assets measured at FV-OCI, effectively only the net amortized cost amount (amortized cost less the allowance for expected credit losses) would be presented on the face of the statement of financial position.

Disclosure Requirements

The proposed disclosures are designed to inform investors about the credit risk inherent in an entity's portfolio, how management monitors the credit quality, and management's estimate (and changes in its estimate) of expected credit losses. Many of the disclosures required under the proposal are similar to those already required under U.S. GAAP as a result of ASU 2010-20.[13] However, the proposed ASU conforms those disclosure requirements to the CECL model and adds specific requirements related to the proposal's practical expedient and nonaccrual guidance. Accordingly, entities would be required to disclose information related to:

- Credit quality.[14]
- Allowance for expected credit losses.
- Rollforward of amortized cost of certain debt instruments.[15]
- Reconciliation between fair value and amortized cost for debt instruments classified at FV-OCI.
- Past due status.
- Nonaccrual status.
- PCI assets.
- Collateralized financial assets.
- FV-OCI assets for which the practical expedient to not measure expected credit losses is applied.

[13] FASB Accounting Standards Update No. 2010-20, *Disclosures About the Credit Quality of Financing Receivables and the Allowance for Credit Losses*.

[14] Short-term trade receivables resulting from revenue transactions within the scope of ASC 605 are excluded from these disclosure requirements.

[15] The following assets would be excluded from these disclosure requirements:

- Receivables resulting from revenue transactions within the scope of ASC 605.
- Reinsurance receivables resulting from insurance transactions within the scope of ASC 944.
- Loan commitments that are not measured at FV-NI.

Appendix D — A Comparison of Current U.S. GAAP and the FASB's Proposed Model

The following table compares current U.S. GAAP with the FASB's proposed impairment model for financial assets.

Subject	Current U.S. GAAP	Proposed ASU
Recognition threshold	Depending on the nature of the financial asset, credit losses must be either probable or other than temporary before recognition.	No recognition threshold. However, see discussion of the practical expedient below.
Measurement approach	Varies, depending on the nature of the financial asset and unit of account. Some approaches used in practice include: • Fair value measurement. • Present value of expected cash flows. • Fair value of the underlying collateral.	Not prescribed. However, the estimate of current expected credit losses must: • Reflect all reasonable and supportable information. • Incorporate the time value of money. • Reflect at least two possibilities: (1) that a credit loss exists and (2) that no credit loss exists. • Reflect how credit enhancements (other than those that are freestanding contracts) mitigate expected credit losses.
Impairment reversal	Loans: valuation allowance is adjusted. Debt securities: reversal not permitted.	Required if there is a favorable change in the estimate of current expected credit losses.
PCI assets	No allowance is initially recorded. Impairment is generally recognized if there is a decrease in the estimate of expected cash flows to be collected. If there is a **significant increase** in the estimate of expected cash flows to be collected, the effective interest rate is adjusted prospectively.	An allowance is initially recognized for the contractual amounts not expected to be collected. Impairment is recognized if there is an increase in current expected credit losses. If there is a decrease in expected credit losses (i.e., an increase in cash flows expected to be collected), the impairment allowance is reversed; no adjustment is made to the effective interest rate.
Nonaccrual accounting	Practice of nonaccrual accounting stems from regulatory guidance.	Requires the use of nonaccrual accounting if "it is not probable that the entity will receive substantially all of the principal or substantially all of the interest."
TDRs	Treated as the continuation of an old loan. Impairment is recorded as an allowance, not a write-off.	Treated as the continuation of an old loan. Impairment from the restructuring is recorded as a write-off.

Appendix E — A Comparison of the IASB's Tentative Decisions and the FASB's Proposed Model

As reflected in its tentative decisions through December 2012, the IASB's model would apply to all financial assets measured at amortized cost or FV-OCI and would require all applicable assets to be placed into one of two categories at the end of each reporting period. For impairment purposes, for assets in the first category, an allowance equal to 12 months of expected credit losses would be recognized (i.e., the expected present value of all cash shortfalls over the life of the financial asset that are associated with the probability of a loss in the 12 months after the reporting date). For assets in the second category, an allowance equal to lifetime expected credit losses would be recognized. Changes in estimates of expected credit losses would be recognized as an impairment expense in the period of the change.

In measuring the expected credit losses, entities would consider:

- All reasonable and supportable information (including forward-looking data).
- A range of possible outcomes and the likelihood and reasonableness of those outcomes (i.e., not merely an estimate of the "most likely outcome").
- The time value of money.

Upon initial recognition, assets would be recognized in the first category, except for PCI financial assets and assets for which a simplified approach (described below) is applied. An asset would subsequently be transferred to the second category if there has been significant deterioration in credit quality since initial recognition. An entity would consider the term of the asset and the original credit quality of the asset. For example, for assets with higher credit quality, the entity would recognize lifetime expected credit losses if the asset deteriorates to below "investment grade."

The nature of the IASB's general model requires the transfer of assets between the first category (i.e., 12-month expected credit losses) and the second category (lifetime expected credit losses) in both directions. In other words, if the transfer criteria are no longer satisfied, the asset would be returned to the first category (i.e., 12-month expected credit losses).

However, because the IASB acknowledged that there may be situations in which a simplified approach would be appropriate, it decided that the impairment allowance for PCI financial assets would always be lifetime expected credit losses (i.e., PCI financial assets do not begin in the 12-month expected-credit-loss category). In addition, for trade receivables with a significant financing component and for lease receivables, an entity could choose to apply either the general approach or a simplified approach under which lifetime credit losses are always recognized. For trade receivables without a significant financing component, the simplified approach would be required; an entity would not be permitted to classify such trade receivables in the first category but rather in the second, in which it would measure the allowance as lifetime expected credit losses.[16] Under the simplified approach, the entity would not need to monitor credit quality for transfers between categories.

The table below highlights some of the key similarities and differences between the FASB's proposed model and the IASB's current thinking related to impairment.

Subject	FASB's Proposed ASU	IASB's Tentative Decisions
Scope	The proposed ASU applies to: • Financial assets measured at either amortized cost or FV-OCI. • Reinsurance receivables. • Trade and lease receivables. • Loan commitments not measured at FV-NI.	Generally the same as the FASB's.
Recognition threshold	None. Impairment is based on expected (rather than incurred) credit losses. However, the FASB does not require entities to record an impairment allowance for a FV-OCI financial asset if **both** of the following apply: • Its fair value exceeds its carrying amount. • The expected credit losses are deemed insignificant.	None. Impairment is based on expected (rather than incurred) credit losses. The IASB does not provide an exception for FV-OCI financial assets.
Measurement	Current expected credit losses (i.e., all contractual cash flows that the entity does not expect to collect).	For assets in the first category, 12 months of expected losses (see further description above). For assets in the second category, lifetime expected credit losses.

[16] The entity may use a provision matrix as a practical expedient.

Subject	FASB's Proposed ASU	IASB's Tentative Decisions
Transfer criteria between categories	Not applicable in CECL model. Only one measurement objective.	Transfer to lifetime expected credit losses when there has been significant deterioration in credit quality since initial recognition. The term of the asset and the original credit quality of the assets are taken into account. For assets of higher credit quality, lifetime expected losses would be recognized when the credit quality of those assets deteriorates to below "investment grade." Transfer back to 12-month expected credit losses when transfer criteria no longer satisfied.
Presentation of impairment allowance	Valuation allowance (or contra-asset).	Same as the FASB's.
PCI financial assets	Applies CECL model. Impairment allowance represents current expected credit losses. Interest income recognition is based on purchase price plus the initial allowance accreting to contractual cash flows.	The impairment allowance for PCI financial assets is always based on the change (from the original expectation at acquisition) in lifetime expected credit losses. Interest income recognition is based on initially expected (rather than contractual) cash flows.
Nonaccrual accounting	An entity would be required to place a financial asset on nonaccrual status "when it is not probable that the entity will receive substantially all of the principal or substantially all of the interest."	The IASB currently does not permit a nonaccrual principle nor would its proposed approach introduce one. However, for assets that have become credit-impaired, interest income is based on the net carrying amount of the asset.[17]
Write-offs	An entity would write off the carrying amount of a financial asset if "the entity [ultimately] determines that it has no reasonable expectation of future recovery."	Same as the FASB's.

[17] As noted in the minutes of the IASB's July 2012 meeting, "credit-impaired assets" are defined as those assets for which there is objective evidence of the criteria in paragraphs 59(a)-(e) of IAS 39, *Financial Instruments: Recognition and Measurement*. The IASB indicated that such assets will be a subset of financial assets with an impairment allowance measured at lifetime expected losses.

Appendix F — Impairment Models Under U.S. GAAP

The table below highlights several impairment models under current U.S. GAAP for loans and debt securities.

Impairment Models for Loans and Debt Securities		
Guidance	**Scope**	**Measurement Objective**
ASC 450-20	Large groups of smaller-balance, homogeneous loans that are collectively evaluated for impairment.	All probable and reasonably estimable losses.
ASC 310-10-35	Loans that are identified for individual evaluation.	If it is probable that all of the contractual cash flows will not be collected, the difference between the carrying amount and the present value of the expected future cash flows discounted at the original effective interest rate. Certain practical expedients exist.
ASC 310-30	Loans acquired with deteriorated credit quality.	See ASC 310-10-35 or ASC 450-20, as applicable (as discussed in ASC 310-30-35-10). Or, for a loan accounted for as a debt security, see ASC 320-10-35 (as discussed in ASC 310-30-35-8). Recoveries (i.e., reversals of impairments) are not permitted for a loan accounted for as a debt security.
ASC 320-10-35 ASC 325-40-15	Debt securities (including beneficial interests in securitized financial assets).	If the investor intends to sell a debt security or it is more likely than not the investor will be required to sell the security before recovery of its amortized cost basis, impairment is deemed to be other than temporary and the difference between the amortized cost and fair value of the security is recognized in earnings. However if (1) the investor does not intend to sell, (2) it is not more likely than not that the investor will be required to sell the security before recovery, and (3) the investor does not expect to recover the entire cost basis of the security, the security is other than temporarily impaired and only the credit-related component of the impairment loss is recognized in earnings, and the noncredit portion is recorded in OCI. Credit losses might be measured in accordance with ASC 310-10-35, ASC 325-40, or ASC 310-30 depending on the circumstances. Recoveries are not permitted for debt securities.

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