

## Heads Up

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## So Close, Yet So Far

# Boards Discuss Constituent Feedback on Impairment Proposals

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### Introduction

The approach used to recognize impairment losses on financial assets, which could potentially result in delayed recognition of such losses, was identified during the financial crisis as a major weakness in current guidance. After years of separately and jointly deliberating various models to remedy that weakness, the FASB and IASB each released their third of three formal proposals on recognizing credit losses on financial assets.<sup>1</sup>

The boards received feedback on their proposals in formal comment letters and as a result of outreach performed to gain a better understanding of stakeholders' perspectives. Outreach activities included conference calls with one or more organizations, face-to-face meetings, industry and other committee meetings, and limited field testing. Respondents comprised users of financial statements, preparers, auditors, standard setters, and other interested parties (including industry organizations and regulators).

Although the boards' proposals have changed over time, one constant has been the diversity of stakeholder views on them. Disagreement has sometimes been most evident between respondents of disparate type (e.g., between users of financial statements and preparers) or geographic location (i.e., between U.S. and international respondents).<sup>2</sup> Constituents' views on the proposals are summarized briefly below. The [appendix](#) to this *Heads Up* outlines details of the proposals and compares feedback on the proposals as presented by the staffs at the boards' July 2013 joint meeting.<sup>3</sup>

### Overview of Feedback

Constituents disagreed with one another on numerous aspects of the models, including the following:

- *Immediate recognition of all lifetime expected credit losses* — Many U.S. investors and some regulators supported the FASB's impairment model, which requires up-front recognition of all expected credit losses over the term of the financial asset (rather than only a portion of those expected credit losses in certain circumstances, as the IASB proposes); they maintained that reserve adequacy is imperative. However, U.S. preparers generally raised concerns about recognizing all lifetime expected credit losses immediately. Specifically, they noted that (1) the asset's net carrying amount would be understated on day 1 and (2) interest income (i.e., compensation for credit risk) would not be matched with the recognition of credit-loss expense.

<sup>1</sup> The FASB issued its proposed Accounting Standards Update, *Financial Instruments — Credit Losses*, on December 20, 2012 (comments were due by April 30, 2013). The IASB issued its exposure draft, ED/2013/3, *Financial Instruments: Expected Credit Losses*, on March 7, 2013 (comments were due by July 5, 2013). For a discussion of the FASB's and IASB's proposals, see Deloitte's [December 21, 2012](#), and [March 12, 2013](#), *Heads Up* newsletters, respectively.

<sup>2</sup> Types of respondents are specified only when their responses reflected disagreements among them (e.g., users and preparers).

<sup>3</sup> See FASB Memorandum No. 232 (which includes the FASB staff's feedback summary) and IASB Agenda Papers 5 through 5C.

- *Immediate recognition of less-than-lifetime expected credit losses* — Unlike proponents of the FASB’s impairment model, investors, preparers, and others outside the United States generally supported the IASB’s approach, which would require entities to immediately recognize only 12 months of expected credit losses in certain circumstances. They disliked the FASB’s approach of recognizing all lifetime expected credit losses on all assets for two reasons. First, they observed that it would be difficult to estimate such losses reliably, especially for assets that are still performing and not considered at risk of not performing. Second, they noted that a model that immediately recognizes lifetime expected credit losses on all assets ignores the idea that pricing of financial assets incorporates some expectation of credit loss.

Aspects of the proposals on which constituents generally agreed include the following:

- *Need for convergence* — Because of the global impact of the credit crisis, convergence has been a consistent theme of feedback throughout the history of the joint impairment project. Although commenters and constituents have expressed their belief that convergence is important and have encouraged the FASB and IASB to continue working together, their opinions differ on what a converged model should look like. Further, some have stated that the boards should first focus on improving current guidance in a timely fashion.
- *Expected credit loss model* — Most respondents supported the transition to an expected credit loss model. Under that model, entities would estimate credit losses on the basis of historical information, current information, and reasonable and supportable forecasts of expected collectability of cash flows and recognize such losses earlier than they would under the incurred loss model in current guidance. However, because much confusion was expressed about the meaning of “reasonable and supportable forecasts” during the FASB’s outreach activities, the FASB explained the types of information that entities could use to make forecasts and assured stakeholders that forecasts and predictions of economic conditions over the entire life of the asset would not be required.
- *Single model* — Most respondents agreed that a single impairment model for all financial assets measured at amortized cost or at fair value through other comprehensive income (FV-OCI) would be preferable to the current multiple impairment models, which can vary (e.g., depending on whether the asset is a security). Some respondents favored the current approach for debt securities, and a number stated that more practical expedients should be permitted for such instruments.
- *Simpler approach for PCI assets* — Most respondents to the FASB’s proposal agreed on the need to simplify the accounting for losses on purchased credit-impaired (PCI) financial assets under current U.S. GAAP, which in some cases requires a different treatment for changes in expectations depending on whether such changes are favorable or unfavorable. Also, most respondents agreed that PCI assets should be presented “gross” on the financial statements.
- *Disclosures* — Most users agreed with the disclosure requirements proposed by both boards. Most other respondents agreed with the objective of the disclosures, but noted that they might be too detailed, restrictive, and onerous.

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## Next Steps

The FASB and IASB will most likely begin redeliberations in September of this year. Given the disparate feedback and the general preference by constituents of each board for that board’s own model, it is unclear whether the boards can fully converge their respective standards. Final guidance is not expected until 2014. No effective date has been set, but feedback generally indicated that constituents would need at least two to three years to implement a final standard (i.e., if a standard is finalized in 2014, it should be effective no earlier than 2017).

## Appendix — Comparison of Stakeholder Views on the FASB’s and IASB’s Proposed Impairment Models

The table below highlights key aspects of the proposals and compares constituent feedback on them.

Topic	FASB’s Proposed Model	Feedback on the FASB’s Proposed Model	IASB’s Proposed Model	Feedback on the IASB’s Proposed Model
Scope	<ul style="list-style-type: none"> <li>Financial assets (including trade receivables) measured at amortized cost or at FV-OCI.</li> <li>Lease receivables.</li> <li>Loan commitments not measured at fair value through profit or loss (FVTPL).</li> <li>Reinsurance receivables.</li> </ul>	<p>Some investors supported the proposal to have a single credit-loss impairment model for all assets; other investors wanted a separate impairment model for assets at FV-OCI.<sup>4</sup></p> <p>Preparers generally disagreed with the proposed approach and preferred either of the following:</p> <ul style="list-style-type: none"> <li>Retaining the existing other-than-temporary impairment model for debt securities (which is “well understood [and] applied consistently”<sup>5</sup>).</li> <li>Modifying the practical expedient (e.g., to allow entities not to record an impairment allowance for assets with low credit risk — see “<a href="#">Practical expedient</a>” below).</li> </ul>	<ul style="list-style-type: none"> <li>Financial assets (including trade receivables) measured at amortized cost or at FV-OCI.<sup>6</sup></li> <li>Lease receivables.</li> <li>Loan commitments not measured at FVTPL.</li> <li>Financial guarantee contracts within the scope of IFRS 9<sup>7</sup> that are not measured at FVTPL.</li> </ul>	<p>Respondents generally supported the proposed scope. However, some preferred keeping loan commitments outside the scope, noting that current guidance on loan commitments is sufficient; that is, entities should apply IAS 37<sup>8</sup> when measuring a provision for a loan commitment that is not within the scope of IAS 39<sup>9</sup> (i.e., has not yet been drawn down).</p>
Timing (and amount) of loss recognition	<p><b>Single</b>-measurement approach.</p> <p>The impairment allowance reflects the estimate of current expected credit losses (i.e., all contractual cash flows that entities do not expect to collect over the expected term of the asset). All expected credit losses are recognized at initial recognition except for PCI assets (see “<a href="#">Measurement of expected credit losses</a>” below).</p>	<p>The majority of investors supported the proposed model. In particular, they supported the removal of the probability threshold that is currently in place (i.e., the incurred loss model) and agreed that all expected credit losses should be recognized at origination and subsequently. Some said that they would not support a requirement that entities recognize all credit losses only if a default event is expected within a certain period.</p> <p>The majority of preparers disagreed with the proposal, expressing concerns that recognition of all expected credit losses at origination and subsequently:</p> <ul style="list-style-type: none"> <li>Would result in an asset’s being recorded at an amount lower than its fair value at the time of origination, which is inconsistent with the economics of the transaction.<sup>10</sup></li> <li>Would not match the timing of interest income recognition on that asset.</li> <li>May have a significant impact on regulatory capital.</li> </ul> <p>Instead, preparers preferred a model that would (1) retain a threshold for recognition of all expected credit losses or (2) recognize only a limited time portion of the expected credit losses (e.g., those for the foreseeable future or some specific period).</p>	<p><b>Dual</b>-measurement approach.</p> <p>Generally,<sup>11</sup> the impairment allowance is measured at an amount equal to either of the following:</p> <ul style="list-style-type: none"> <li>Twelve-month expected credit losses.</li> <li>Lifetime expected credit losses if, as of the reporting date, <b>the credit risk has increased significantly</b> since initial recognition.<sup>12</sup></li> </ul> <p>For instruments with low credit risk, an allowance equal to 12 months of expected credit losses would be measured regardless of whether there has been a significant increase in credit risk.</p>	<p>Most respondents, including users, supported this proposed model (i.e., a credit deterioration model). Most respondents preferred not requiring entities to recognize expected credit losses before there has been some amount of deterioration in credit quality; however, they said that they could accept the 12-month expected credit losses estimate as a practical compromise to reflect the underlying economics while minimizing the implementation cost.</p> <p>Some regulators expressed concern that a 12-month period may not adequately reflect expected credit losses on particular financial instruments.</p>

<sup>4</sup> In particular, those investors thought that there would be no need to separately recognize credit losses through net income because recording all fair value changes in OCI is sufficiently transparent.

<sup>5</sup> See FASB Memorandum No. 232.

<sup>6</sup> The model does not apply to equity instruments that an entity irrevocably elected to measure at FV-OCI at initial recognition.

<sup>7</sup> IFRS 9, *Financial Instruments*.

<sup>8</sup> IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

<sup>9</sup> IAS 39, *Financial Instruments: Recognition and Measurement*.

<sup>10</sup> Also, as noted in FASB Memorandum No. 232, “some preparers expressed concern that upfront recognition of lifetime expected credit losses may hinder an investor’s ability to understand and analyze the extent of change in credit loss expectations since origination (or acquisition) because of the size of the upfront losses being recorded, particularly in growing portfolios.”

<sup>11</sup> Exceptions are made for (1) trade receivables without a significant financing component, (2) trade receivables with a significant financing component and lease receivables for which an entity elected the simplified approach, and (3) purchased and originated credit-impaired assets. See “[Simplified approach](#)” and “[PCI financial assets](#)” below.

<sup>12</sup> If there is objective evidence of an asset’s impairment, such asset would be included in this category.

Topic	FASB's Proposed Model	Feedback on the FASB's Proposed Model	IASB's Proposed Model	Feedback on the IASB's Proposed Model
Measurement of expected credit losses	<p>Estimate of expected credit losses must:</p> <ul style="list-style-type: none"> <li>• Be based on relevant information that is available without undue cost or effort, including information about past events, current conditions, and reasonable and supportable forecasts that affect the expected collectability of the financial instrument's future cash flows.</li> <li>• Include the probability that (1) a credit loss results and (2) no credit loss results.</li> <li>• Not be estimated solely on the basis of the most likely outcome.</li> <li>• Reflect the time value of money.</li> </ul>	<p>Respondents generally agreed that entities should use past, current, and reasonable and supportable forecasts to estimate expected credit losses. However, preparers were concerned about:</p> <ul style="list-style-type: none"> <li>• Operational difficulty that entities would face when making forecasts over the remaining life of an asset, as well as the reliability of such estimates.<sup>13</sup></li> <li>• Additional audit and regulatory scrutiny over such estimates.</li> </ul> <p>In addition, preparers differed from one another on the concept of "implicit" time value of money. Some suggested clarifying which measurement approaches would reflect the time value of money principle, while others indicated that there should be no specific reference to this principle in the guidance.</p>	<p>Estimate of expected credit losses must:</p> <ul style="list-style-type: none"> <li>• Be based on relevant information that is available without undue cost or effort, including information about past events, current conditions, and reasonable and supportable forecasts that affect the expected collectability of the financial instrument's future cash flows.</li> <li>• Be based on a probability-weighted assessment of expected contractual cash flows not expected to be recovered.</li> <li>• Include the probability that (1) a credit loss results and (2) no credit loss results.</li> <li>• Not be estimated solely on the basis of the most likely outcome.</li> <li>• Reflect the time value of money.</li> </ul>	<p>Respondents generally agreed with the types of information on which the measurement of expected credit losses should be based. However, many disapproved of the range of discount rates available for use (i.e., between and including the effective interest rate (EIR) and risk-free rate), believing that a single rate (in most cases, the EIR) should be required.</p>
PCI financial assets <sup>14</sup>	<ul style="list-style-type: none"> <li>• An allowance is recognized for contractual cash flows not expected to be collected at initial recognition on the balance sheet (i.e., the initial allowance is relative to the contractual cash flows, not the expected cash flows reflected in the price paid at acquisition).</li> <li>• Subsequent changes in current expected credit losses (including contractual amounts not originally reflected in the purchase price) are recognized in earnings, and the allowance is updated.</li> </ul>	<p>Respondents generally supported the proposed model for PCI assets, observing that the gross presentation on the balance sheet would simplify investors' analysis and be easier for preparers to apply. In addition, they suggested that (1) the same impairment approach be applied to all purchased financial assets (not only to PCI assets) and (2) the FASB clarify how the new impairment guidance would apply to existing PCI assets upon transition to any final standard.</p>	<ul style="list-style-type: none"> <li>• No allowance is recognized for contractual cash flows that are not expected to be collected at initial recognition on the balance sheet (see FASB column).</li> <li>• The cumulative change in lifetime expected credit losses since initial recognition is recognized as a loss allowance. Twelve-month expected credit losses are never used to measure the impairment of such financial assets.</li> <li>• Favorable changes in lifetime expected credit losses are reflected as an impairment gain even if the cumulative changes in lifetime expected credit losses are positive and exceed the amount of expected credit losses that were included in the estimated cash flows at initial recognition.</li> </ul>	<p>Many respondents did not agree with the IASB's presentation approach. Rather, they supported a gross approach similar to that proposed by the FASB.</p>

<sup>13</sup> The FASB subsequently noted that it was not the Board's intention to create such operational difficulty. FASB Memorandum No. 232 notes that "an entity is not expected to forecast and predict economic conditions over the entire *life* of the asset; rather, it is only expected to update historical loss experience for current conditions and reasonable and supportable forecasts about the future (with the forecasts being made over a shorter, more reliable period of time). [F]or the periods beyond those that are able to be reasonably and supportably forecasted, entities could revert to a historical average loss experience or freeze the furthest reasonable and supportable forecast." However, credit unions and other smaller entities indicated that they typically do not have access to historical loss data and thus would incur significant implementation costs.

<sup>14</sup> The IASB's approach for PCI assets also applies to originated credit-impaired assets.

Topic	FASB's Proposed Model	Feedback on the FASB's Proposed Model	IASB's Proposed Model	Feedback on the IASB's Proposed Model
Interest recognition	Entities calculate interest on a gross cost basis (i.e., not reduced for the allowance for expected credit losses); however, nonaccrual of interest may apply (see "Nonaccrual of interest" below).	The majority of comments related to interest recognition focused on nonaccrual of interest (see "Nonaccrual of interest" below).	Entities calculate interest revenue by applying the EIR <sup>15</sup> to the gross carrying amount except in the following cases: <ul style="list-style-type: none"> <li>For purchased or originated credit-impaired assets, they calculate interest by applying the credit-adjusted EIR<sup>16</sup> to the amortized cost (gross carrying amount less impairment allowance).</li> <li>When there is objective evidence of impairment, they calculate interest by applying the original EIR to the amortized cost of the financial asset in the subsequent reporting period.</li> </ul>	Most respondents disagreed with the proposals, stating that calculating interest revenue on the net amount creates a separate category of assets on which to calculate interest income and complicates the model, thereby making it less operational. They preferred one interest revenue recognition model that uses the gross carrying amount.
Nonaccrual of interest	Financial assets are 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."	Investors generally agreed with the proposed guidance. Preparers, however, expressed diverse views. Such views ranged from a preference for not including nonaccrual guidance in U.S. GAAP to adding the guidance but revising the proposed principle (e.g., by reconciling its nonaccrual threshold with that of the regulatory institutions; clarifying how the principle would apply to credit cards, PCI assets, and debt securities; and clarifying when interest income should be reinstated).	Not applicable. Interest is recognized in the statement of profit or loss and OCI regardless of the extent of credit losses. See "Interest recognition" above for exceptions to using the gross carrying amount for interest recognition purposes.	Although "nonaccrual" was not proposed in the IASB's model, many respondents did not agree with the IASB's proposal to calculate interest revenue on a net basis. Some suggested allowing entities to continue recognizing interest on the gross carrying amount; others preferred the FASB's nonaccrual proposal because of its simplicity and consistency with some regulatory treatments.
Practical expedient	Entities are not required to record an impairment allowance for an FV-OCI financial asset if both of the following apply: <ul style="list-style-type: none"> <li>The asset's fair value exceeds its carrying amount.</li> <li>The expected credit losses are deemed insignificant.</li> </ul>	Preparers expressed a variety of views on this topic, including a preference for: <ul style="list-style-type: none"> <li>Revising the practical expedient so that entities would not be required to record an impairment allowance if <b>either</b> of the two proposed criteria is met (as opposed to both).</li> <li>Removing the first criterion from the practical expedient criteria (i.e., whether the asset's fair value exceeds its carrying amount) because such criterion may not reflect credit risk.</li> <li>Providing a practical expedient that would allow entities not to record an impairment allowance for debt instruments for which the credit risk is low (e.g., U.S. Treasury securities and other similar debt instruments).</li> </ul>	No practical expedient. However, for instruments with credit risk that has significantly increased but still remains low, the allowance would be equal to 12 months of expected credit losses (e.g., "investment grade" financial assets).	Most respondents requested clarification of both the definition of "low credit risk" and how to apply that definition in a deterioration model. However, many respondents agreed that simplification is warranted for instruments that are still high quality. Regulators, on the other hand, believed that significant deterioration should be reflected consistently.

<sup>15</sup> The EIR is the rate used to exactly discount estimated future cash flows. It does not take into account the expected credit losses through the remaining life of the financial asset to the asset's gross carrying amount or amortized cost (for objectively impaired financial assets that are not PCI financial assets or originated credit-impaired financial assets).

<sup>16</sup> The credit-adjusted EIR is used to exactly discount the estimated future cash flows through the remaining life of the PCI financial asset or originated credit-impaired financial asset to its amortized cost. This rate differs from the EIR because it takes into account the expected credit losses in the estimate of future cash flows.

Topic	FASB's Proposed Model	Feedback on the FASB's Proposed Model	IASB's Proposed Model	Feedback on the IASB's Proposed Model
Simplified approach	None. The current expected credit loss model is applied in all cases except those in which the practical expedient applies.	See "Practical expedient" above.	<p>A simplified approach would be used for trade and lease receivables as follows:</p> <ul style="list-style-type: none"> <li>For trade receivables with no significant financing, entities would always recognize lifetime expected credit losses (i.e., would not use a dual-measurement approach).</li> <li>For trade receivables with a significant financing component and for lease receivables, entities could choose a policy of only applying the lifetime expected credit losses instead of applying the dual-measurement approach.</li> </ul>	The majority of respondents agreed with the simplified approach, although a few believed that, among other things, either one model should apply to all instruments (i.e., no simplified approach for anything) or current guidance should continue to apply to short-term trade receivables (i.e., such receivables should be excluded from the scope of the new impairment guidance).
Modifications of debt instruments	For a troubled debt restructuring (TDR), entities would consider the new series of contractual cash flows and adjust the cost basis of the asset so that the EIR (post-TDR) is the same as the original EIR. The basis adjustment would be calculated as the amortized cost basis before modification less the present value of the modified contractual cash flows (discounted by the original EIR). For non-TDR modifications that do not result in derecognition, the EIR would be adjusted prospectively.	<p>Some preparers believed that the distinction between TDRs and non-TDRs remains relevant; other preparers said that such distinction is no longer relevant under the single impairment model.</p> <p>In addition, some preparers asked the FASB to clarify whether (1) the basis adjustment is permitted to increase the cost basis of the asset and (2) expected prepayment can be considered in the determination of the basis adjustment under the proposed guidance.</p>	For debt restructurings that do not result in derecognition, entities would adjust the gross carrying amount of the asset to reflect the revised contractual cash flows and recognize a modification gain or loss. Entities would discount the gross carrying amount (by the asset's original EIR) in calculating the present value of the asset's estimated future contractual cash flows.	Most respondents agreed with the proposals; however, they requested guidance on when a modification would result in derecognition (because IFRSs currently do not address this). Some respondents that disagreed stated that they would support the proposals if they applied solely to modifications made only for significant credit-risk concerns (or credit-impaired assets).
Effective date and transition	The effective date for the final guidance has not been proposed. Entities would be required 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.	Preparers generally agreed with the proposed transition requirements. However, many favored an implementation period of no less than two years to give entities enough time to update information systems and consider implementation issues. Some preparers suggested that for smaller (resource-constrained) entities, the FASB allow an adequate transition period <b>and</b> consider "simpler and less costly estimation techniques [and] condensed disclosure requirements." <sup>17</sup>	An effective date for the final guidance has not been proposed. Transition requirements would be applied retrospectively (i.e., to all of an entity's currently outstanding instruments) except when it is not possible to determine, without undue cost or effort, the relative deterioration of the asset since initial recognition, in which case the entity would evaluate the absolute credit quality as of the date of transition. Comparative information would not be required unless the entity can provide it without the use of hindsight.	Most respondents agreed with the transition proposals and stated that a three-year lead time would be necessary to implement any new requirements.

<sup>17</sup> See FASB Memorandum No. 232.

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