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SEC Proposes Disclosure Simplification and Relief Related to Guarantors and Collateralizations of Securities

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Background

On July 24, 2018, the SEC issued a [proposed rule](#)¹ that would make specific amendments to simplify and streamline the disclosure requirements related to registered debt securities under SEC Regulation S-X, Rules 3-10^{2,3} and 3-16,⁴ which currently require separate financial statements for:

- Subsidiary issuers and guarantors of registered debt securities unless certain exceptions for condensed consolidating financial information or other narrative disclosures are met.
- Affiliates that collateralize registered debt offerings if the affiliates' securities are a substantial portion of the collateral.

¹ SEC Release No. 33-10526, *Financial Disclosures About Guarantors and Issuers of Guaranteed Securities and Affiliates Whose Securities Collateralize a Registrant's Securities*.

² SEC Regulation S-X, Rule 3-10, "Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered."

³ Rule 3-10 applies not only to registered guaranteed debt securities but also to guaranteed preferred securities whose payment terms are substantially similar to debt (e.g., trust preferred securities).

⁴ SEC Regulation S-X, Rule 3-16, "Financial Statements of Affiliates Whose Securities Collateralize an Issue Registered or Being Registered."

The proposed amendments “are intended to make the disclosures easier for investors to understand and to encourage these offerings to be conducted on [an] SEC-registered basis.” — SEC Chairman Jay Clayton

The proposed rule indicates that the primary source of information that investors in guaranteed or collateralized debt rely on is the consolidated financial statements of the parent company. With respect to the disclosure requirements related to issuers and guarantors of guaranteed debt securities or affiliates whose securities collateralize debt, the proposed rule would:

- Replace the requirement under Rule 3-10 to provide condensed consolidating financial information with a requirement to provide summarized financial information and other narrative disclosures when certain conditions are met.
- Simplify the requirements under Rule 3-10 to qualify for exceptions to provide alternative disclosure rather than full audited financial statements (e.g., by replacing the requirement that a subsidiary issuer or guarantor be 100 percent owned with a requirement that it be consolidated in the parent company’s financial statements).
- Remove the requirement in Rule 3-10(g) to provide preacquisition financial statements for recently acquired subsidiary issuers and guarantors.
- Replace the requirement to provide separate financial statements for an affiliate that collateralizes a substantial portion of a security with a requirement to provide summarized financial information and other narrative disclosures.
- Reduce the periods for which summarized financial information is required to only the most recent annual and interim periods.
- Relocate part of Rule 3-10 and all of Rule 3-16 to a new Article 13 in Regulation S-X.

These highlights are discussed in the sections below.

In drafting the proposed rule, the SEC took into consideration constituents’ feedback on its September 2015 [request for comment](#)⁵ on the effectiveness of financial disclosures about entities other than the registrant. Several respondents to that request stated that because of the cost of complying with Rules 3-10 and 3-16, many debt offerings either (1) are not registered with the SEC (i.e., private placements) and therefore limit the protections available to investors or (2) are structured in a specific manner to avoid the requirements of Rules 3-10 and 3-16 and therefore potentially limit the security provided by guarantees or collateral. The SEC addressed these and other concerns in the proposed rule by offering disclosure simplification and relief for certain debt issuers, which may increase registered debt issuances and thus increase options available to the investing public.



Connecting the Dots

While the SEC’s September 2015 request for comment also focused on SEC Regulation S-X, Rules 3-05⁶ and 3-09⁷ (and related requirements), the new proposed rule does not address potential changes to these rules. The SEC has indicated that proposed amendments to Rules 3-05 and 3-09 may be issued in the future. For more information about such potential proposals, see the [Disclosure Effectiveness Initiative](#) section below. For more information about the application of Rules 3-05 and 3-09, see Deloitte’s [A Roadmap to SEC Reporting Considerations for Business Combinations](#) and [A Roadmap to SEC Reporting Considerations for Equity Method Investees](#).

⁵ SEC Release No. 33-9929, *Request for Comment on the Effectiveness of Financial Disclosures About Entities Other Than the Registrant*.

⁶ SEC Regulation S-X, Rule 3-05, “Financial Statements of Businesses Acquired or To Be Acquired.”

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

Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered (SEC Regulation S-X, Rule 3-10)

The table below compares certain current disclosure requirements and definitions under Rule 3-10 with their counterparts under the proposed rule.

Rule 3-10	Current Requirements	Proposed Rule
Basic Premise		
	Subsidiary issuers and guarantors of registered securities are generally required to provide annual and interim financial statements. However, Rule 3-10 provides accommodations for alternative disclosures in certain cases.	The proposed rule omits the express language that subsidiary issuers and guarantors of registered securities are generally required to provide annual and interim financial statements. Financial statements can be omitted when certain conditions are met.
Guarantor Structures Eligible for Alternative Financial Disclosures		
	<p>Condensed consolidating financial information and qualitative disclosures, rather than separate financial statements, may be provided for the following qualifying guarantor structures:⁸</p> <ul style="list-style-type: none"> • An operating subsidiary⁹ issues securities guaranteed by its parent company, and no other subsidiary of the parent company guarantees the securities (Rule 3-10(c)). • A finance or operating subsidiary issues securities guaranteed by its parent company, and the securities are guaranteed by one or more other subsidiaries of the parent (Rule 3-10(d)). • A single finance or operating subsidiary guarantees securities issued by its parent company (Rule 3-10(e)). • Multiple finance or operating subsidiaries guarantee securities issued by their parent company (Rule 3-10(f)). 	<p>Summarized financial information and qualitative disclosures, rather than separate financial statements, may be provided if the guarantor structure meets either of the following requirements:</p> <ul style="list-style-type: none"> • The parent company issues or co-issues (on a joint and several basis with one or more of its consolidated subsidiaries) securities that are guaranteed by one or more consolidated subsidiaries. • A consolidated subsidiary issues or co-issues (with one or more other consolidated subsidiaries of the parent company) the securities, and the securities are fully and unconditionally guaranteed by the parent company.



Connecting the Dots

The proposed rule would simplify the determination of whether alternative financial disclosures may be provided in lieu of separate financial statements by replacing the various qualifying guarantor structures with two alternative criteria. The SEC expects guarantor structures that currently qualify under Rule 3-10 to continue to qualify under either of the two proposed alternative criteria.

⁸ Exceptions also apply to subsidiaries that co-issue, rather than guarantee, securities issued by their parent company.

⁹ Regulation S-X defines an operating subsidiary as a subsidiary that is not a finance subsidiary, and it defines a finance subsidiary as a subsidiary that "has no assets, operations, revenues or cash flows other than those related to the issuance, administration and repayment of the security being registered and any other securities guaranteed by its parent company." Currently, the designation of a subsidiary as either finance or operating may determine whether the structure qualifies for alternative disclosures in lieu of separate financial statements. The proposed rule does not distinguish between finance and operating subsidiaries.

(Table continued)

Rule 3-10	Current Requirements	Proposed Rule
Eligibility for Alternative Narrative Disclosures		
	<p>Narrative disclosure about the guarantee(s), rather than condensed consolidating financial information or separate financial statements, may be provided if the guarantor structure meets either of the following requirements:</p> <ul style="list-style-type: none"> • A finance subsidiary issues securities guaranteed by its parent company, and no other subsidiary of the parent company guarantees the securities (Rule 3-10(b)). • The guarantor structure qualifies for the use of condensed consolidating financial information, and all of the following conditions are met: <ul style="list-style-type: none"> ◦ The guarantee is full and unconditional. ◦ The parent company has no independent assets or operations.¹⁰ ◦ Nonguarantor subsidiaries are minor.¹¹ 	<p>The proposed rule provides that summarized financial information may be omitted if the disclosure is “not material to holders of the guaranteed security.” In such cases, a registrant must disclose a statement to that effect as well as the reasons why the information would not be material.</p> <p>An example provided in the proposed rule indicates that summarized financial information could be omitted if the parent company’s consolidated financial statements do not differ in any material respects from the summarized financial information for the issuer and guarantors as a group.</p>



Connecting the Dots

While the proposed rule does not explicitly provide for narrative disclosure, the overarching principle of materiality provides similar relief. The examples provided by the proposed rule eliminate certain bright-line thresholds associated with the determination that a parent company has no independent assets or operations, or that nonguarantor subsidiaries are more than minor, but otherwise largely align with the current structures that permit narrative disclosure. The guiding principle is to determine whether the summarized financial information would provide investors in the guaranteed securities with any material incremental information not already provided in the parent company’s financial statements.

¹⁰ A parent company has no independent assets or operations if each of its total assets, revenues, income from continuing operations before income taxes, and cash flows from operating activities (excluding amounts related to its investment in its consolidated subsidiaries) is less than 3 percent of the corresponding consolidated amount.

¹¹ Nonguarantor subsidiaries are minor when their total assets, stockholders’ equity, revenues, income from continuing operations, and cash flows from operating activities, individually and in the aggregate, are less than 3 percent of the parent company’s consolidated totals.

(Table continued)

Rule 3-10	Current Requirements	Proposed Rule
Additional Eligibility Requirements for Alternative Disclosures		
	<p>Alternative disclosures are available only when all of the following conditions are met:</p> <ul style="list-style-type: none"> Each subsidiary issuer/guarantor is 100 percent owned.¹² Each guarantee, regardless of whether it is made by the parent or by a subsidiary, is full, unconditional,¹³ and joint and several with all other guarantees. 	<p>Alternative disclosures would be available only when all of the following conditions are met:</p> <ul style="list-style-type: none"> Each subsidiary issuer/guarantor is consolidated. The parent company either issues or guarantees, on a full and unconditional basis, the guaranteed securities. <p>If a subsidiary guarantee is not full and unconditional or joint and several, and such terms are material, (1) the terms should be disclosed and (2) separate summarized financial information should be provided for any subsidiary guarantor that has not provided a full, unconditional, and joint and several guarantee.</p>
Required Qualitative Disclosures		
	<p>The SEC registrant is required to disclose the following:</p> <ul style="list-style-type: none"> If true, that each subsidiary issuer or subsidiary guarantor is 100 percent owned by the parent company. If true, that all guarantees are full and unconditional. If there is more than one guarantee, and if true, that all guarantees are joint and several. Any restricted net assets of subsidiary issuers or guarantors. Any significant restrictions on the ability of the parent company or guarantors to obtain funds from the parent company's subsidiaries. 	<p>To the extent material, the SEC registrant would be required to disclose information about the issuers and guarantors, the terms and conditions of the guarantees, and how the issuer and guarantor structure and other factors may affect payments to holders of the guaranteed securities.</p>

¹² Rule 3-10 (h)(1) states that a "subsidiary is '100% owned' if all of its outstanding voting shares are owned, either directly or indirectly, by its parent company. A subsidiary not in corporate form is 100% owned if the sum of all interests are owned, either directly or indirectly, by its parent company other than:

(i) Securities that are guaranteed by its parent and, if applicable, other 100%-owned subsidiaries of its parent; and
(ii) Securities that guarantee securities issued by its parent and, if applicable, other 100%-owned subsidiaries of its parent."

¹³ Rule 3-10(h)(2) states that a "guarantee is 'full and unconditional,' if, when an issuer of a guaranteed security has failed to make a scheduled payment, the guarantor is obligated to make the scheduled payment immediately and, if it doesn't, any holder of the guaranteed security may immediately bring suit directly against the guarantor for payment of all amounts due and payable."

(Table continued)

Rule 3-10	Current Requirements	Proposed Rule
Required Alternative Financial Disclosures		
	<p>The condensed consolidating financial information should be presented in a columnar format and may be condensed in both annual and interim periods, in accordance with the general guidance on interim financial statements in SEC Regulation S-X, Rule 10-01.^{14,15} Condensed consolidating financial information should be presented for the balance sheet and statements of income and comprehensive income, as well as for statements of cash flows as applicable, and should include any of the following columns if applicable:</p> <ul style="list-style-type: none"> • Parent. • Subsidiary issuer(s) of the security. • Subsidiary guarantor(s). • Nonguarantor subsidiaries. • Consolidating adjustments. 	<p>Disclosure of the following line items would be required when summarized financial information¹⁶ of the issuers and guarantors is presented:</p> <ul style="list-style-type: none"> • Current and noncurrent assets. • Current and noncurrent liabilities. • Redeemable stock. • Noncontrolling interests. • Revenues. • Gross profit. • Income (loss) from continuing operations. • Net income (loss). • Net income (loss) attributable to the entity. <p>The information may be presented on a combined basis; however, information related to subsidiaries that are not issuers or guarantors should be excluded. The method selected to exclude these balances should be reasonable in the circumstances.¹⁷</p>



Connecting the Dots

The proposed change in requirements would provide significant relief since (1) only certain captions from the balance sheet and income statement would have to be presented and (2) summarized financial information would not require disclosure of any information related to the statements of cash flows. In addition, the proposed rule would permit presentation on a combined basis for both issuers and guarantors, rather than requiring separate presentation of the parent, issuer, and guarantors. Further, the proposed rule would not require disclosure of any information related to nonguarantor subsidiaries or consolidating adjustments.

¹⁴ SEC Regulation S-X, Rule 10-01, "Interim Financial Statements."

¹⁵ The basis of accounting used to present the financial information is the same as the SEC registrant's, except that investments in subsidiaries are accounted for under the equity method rather than consolidated.

¹⁶ See SEC Regulation S-X, Rule 1-02(bb), "Definitions of Terms Used in Regulation S-X (17 CFR Part 210): Summarized Financial Information."

¹⁷ The proposed rule indicates that it may be appropriate to use the equity method of accounting for subsidiaries that are not issuers or guarantors.

(Table continued)

Rule 3-10	Current Requirements	Proposed Rule
Periods Presented	In registration statements related to the offering of the guaranteed securities and in periodic reports of the registrant on Form 10-K, Form 10-Q, or Form 20-F, a registrant is (would be) required to present: Condensed consolidating financial information for the same periods as required for the registrant.	Summarized financial information for only the most recent annual and interim period(s).



Connecting the Dots

The proposal to reduce the number of periods for which summarized financial information must be presented would also provide relief from current requirements since certain events require retrospective application in the financial statements, including (but not limited to) changes in (1) the guarantor structure and (2) accounting policies. By limiting the periods presented to only the most current annual and interim period, the proposed rule would substantially reduce the burden of retrospectively revising this financial statement disclosure, which is often cumbersome for registrants that present multiple years of condensed consolidating financial information.

Location of Disclosures

Condensed consolidating financial information and qualitative disclosures must be included in the audited annual financial statements and unaudited interim financial statements for both registered and to be registered securities.	For to be registered securities, a registrant would be permitted to provide the required disclosures in MD&A or immediately following “Risk Factors” in the registration statement for the offer and sale of the guaranteed securities. Alternatively, the registrant would be permitted to include this information in its financial statements. However, the annual disclosures would have to be audited. The registrant would be required to provide the disclosures in its interim and annual financial statements beginning with the Form 10-K or Form 20-F filed for the fiscal year during which the first bona fide sale of the guaranteed securities is completed.
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Connecting the Dots

The proposed rule is intended to reduce the time necessary to go to market with guaranteed securities. Allowing summarized financial information and other disclosures to be presented outside the financial statements would eliminate the time required to update and audit previously issued financial statements with the new information. However, if the proposed rule is adopted as currently drafted, registrants may need to consider whether underwriters will request or require some level of comfort regarding the summarized financial information to the extent that it is not included in the audited financial statements.

(Table continued)

Rule 3-10	Current Requirements	Proposed Rule
Suspension of Reporting Requirement		
	Condensed consolidating financial information and qualitative disclosures must be provided for as long as the guaranteed securities are outstanding, even if the subsidiary issuer or guarantor would otherwise be eligible for suspension of its reporting obligation. ¹⁸	A registrant would be permitted to cease providing summarized financial information and qualitative disclosures if the subsidiary issuer's or guarantor's reporting obligation has been suspended.
Requirements for Any Recently Acquired Subsidiary Issuer or Subsidiary Guarantor ("Recently Acquired Subsidiary Guarantor")		
	<p>Registration statements for debt securities must include the preacquisition financial statements of any recently acquired subsidiary guarantor if (1) the subsidiary has not been included in the audited consolidated results of the parent company for at least nine months of the most recent fiscal year and (2) the net book value or purchase price, whichever is greater, of the subsidiary is 20 percent or more of the principal amount of the securities being registered.</p> <p>The financial statements should include audited¹⁹ financial statements of the subsidiary for its most recent fiscal year preceding the acquisition and unaudited financial statements for any applicable interim periods.</p>	Under the proposed rule, there would be no requirement to provide preacquisition financial statements of any recently acquired subsidiary guarantor. In addition, no specific disclosures about a recently acquired subsidiary guarantor would be required. However, a registrant would be required to provide information about a recently acquired subsidiary guarantor if that information would be material to making an investment decision with respect to the guaranteed security.



Connecting the Dots

Under existing SEC rules the significance tests for determining whether acquiree financial statements are required for a recent acquisition are different under Rules 3-05 and 3-10(g). Therefore an SEC registrant must separately evaluate whether Rule 3-10(g) applies to a recently acquired subsidiary guarantor regardless of whether financial statements are required under Rule 3-05. Acquiree financial statements may be required under Rule 3-10(g) but not under Rule 3-05, or vice versa. This has often created confusion for registrants. The proposed rule would eliminate the requirement under 3-10(g) to provide separate financial statements of recently acquired subsidiary guarantors and, if adopted as currently drafted, may thereby eliminate this confusion. Financial statements for a recent acquisition would still be required if the acquisition exceeds the significance thresholds in Rule 3-05.

¹⁸ Reporting obligations may be suspended under Section 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act") or Exchange Act Rule 12h-3. For example, an entity may be eligible for suspension of its reporting obligation if, after the fiscal year of initial issuance, the securities of each class to which the registration is related are held of record by fewer than 300 persons at the beginning of the year.

¹⁹ The financial statements are required to be audited by a registered public accounting firm in accordance with the standards of the PCAOB.

Financial Statements of Affiliates Whose Securities Collateralize an Issue Registered or Being Registered (SEC Regulation S-X, Rule 3-16)

Under Rule 3-16, SEC registrants are currently required to include separate financial statements of affiliates whose securities constitute a “substantial portion of the collateral”²⁰ for any class of securities registered or being registered. These disclosures are intended to help investors evaluate an affiliate’s ability to satisfy its commitment in the event of default. Existing rules do not permit alternative disclosures in lieu of separate financial statements. In practice, Rule 3-16 may infrequently apply because the provisions in collateral agreements may limit the amount of collateral provided.

The proposed rule would remove the requirement for separate financial statements when the bright-line “substantial portion of collateral” test is met and instead would require certain financial and nonfinancial disclosures about the affiliate(s) and arrangement if material to investors in the collateralized security. Disclosures under the proposed rule would include the following:

- Summarized financial information as specified in SEC Regulation S-X, Rule 1-02(bb)(1), for each affiliate whose securities are pledged (the information may be presented on a combined basis).
- A description of the security pledged, each affiliate whose security is pledged, and the terms and conditions of the collateral arrangement (including events that may require delivery of collateral).
- A description of the trading market for the affiliates’ security pledged as collateral (or if no such market exists, a statement to that effect).
- Any other quantitative or qualitative information that is material to investors in the collateralized security.

For SEC registrants with affiliates whose securities collateralize an issue registered or being registered, the proposed rule would provide guidance similar to that proposed for guarantors on [periods presented](#), the [content of summarized financial information](#), and [filings when disclosures are required](#).²¹ For more information about the SEC’s proposed amendments to its disclosure requirements for guarantors, refer to the [table](#) above.

Requests for Comment

The SEC is interested in feedback from investors, companies, and other market participants on the proposed rule and does not require a specific format for the submission of comments. The proposed rule includes 107 numbered requests for comment. Some commenters may choose to present their views in a narrative format without any reference to specific questions posed by the SEC, and others may choose to answer all, or only some, of the specific requests for comment. Any format is acceptable, and the SEC encourages all types of feedback. Comments can be submitted through the SEC’s [Web site](#) and are due 60 days after publication of the proposed rule in the *Federal Register*. Any comments submitted will be posted to the SEC’s Web site.

²⁰ Rule 3-16(b) states that “securities of a person shall be deemed to constitute a **substantial** portion of collateral if the aggregate principal amount, par value, or book value of the securities as carried by the registrant, or the market value of such securities, whichever is the greatest, equals 20 percent or more of the principal amount of the secured class of securities” (emphasis added).

²¹ Historically, separate financial statements for affiliates that collateralize securities have not been required for Form 10-Q. However, the proposed rule would require the proposed disclosures in interim filings on Form 10-Q.

Disclosure Effectiveness Initiative

The proposed rule is part of the SEC's ongoing [disclosure effectiveness initiative](#), a broad-based review of the Commission's disclosure, presentation, and delivery requirements for public companies. See the appendix of Deloitte's December 10, 2017, [Heads Up](#) for (1) summaries of initiative activities and (2) Deloitte resources that provide additional information about each project.

Recently, the SEC also issued:

- A [final rule](#)²² that amends the definition of a "smaller reporting company" (SRC) to expand the number of companies that qualify for this classification and are therefore able to take advantage of the scaled disclosure requirements that apply to such entities. See Deloitte's July 2, 2018, [Heads Up](#) for more information about this change and the scaled disclosure requirements applicable to SRCs.
- A [final rule](#)²³ that requires the use of the Inline eXtensible Business Reporting Language (iXBRL) format for the submission of operating company financial statement information and fund risk/return summary information. See Deloitte's July 3, 2018, [Heads Up](#) for an overview of the iXBRL requirements.

Further, in recent [testimony](#) before the House Committee on Financial Services, SEC Chairman Jay Clayton discussed the Commission's commitment to advancing its disclosure effectiveness initiative. He stated that the SEC has made significant progress over the past year on projects related to the initiative and that the SEC is developing recommendations to finalize rule amendments that would eliminate redundant, overlapping, outdated, or superseded disclosure requirements. He also discussed the SEC's ongoing projects on (1) further changes to Regulation S-X related to requirements for financial statements of entities other than the registrant (e.g., acquired or to be acquired businesses) and (2) industry-specific disclosure requirements in the Commission's industry guides applicable to mining²⁴ and bank holding companies.²⁵ Stay tuned for future developments on these efforts.

²² SEC Final Rule Release No. 33-10513, *Smaller Reporting Company Definition*.

²³ SEC Final Rule Release No. 33-10514, *Inline XBRL Filing of Tagged Data*.

²⁴ SEC Industry Guide 7, "Description of Property by Issuers Engaged or to Be Engaged in Significant Mining Operations."

²⁵ SEC Industry Guide 3, "Statistical Disclosure by Bank Holding Companies."

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