

## Heads Up

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Both the FASB and the IASB expect to finalize their new accounting standards for financial instruments sometime in 2010.

## Accounting for Financial Instruments May Never Be the Same Again

### An Update on the FASB's and IASB's Joint Project on Financial Instruments

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#### Introduction

In the wake of the global financial crisis, world leaders have called on accounting standard setters to improve the accounting for financial instruments<sup>1</sup> on the basis of "a single set of high quality, global accounting standards."<sup>2</sup> Key focus areas include the complexity of existing accounting standards for financial instruments, the extent to which financial assets and financial liabilities should be subject to fair value accounting, and how entities recognize and measure loan impairment.

Responding to this call, the FASB and the IASB are undertaking a joint project to reconsider their current accounting requirements for financial instruments. The project is moving fast. Both the FASB and the IASB expect to finalize their new accounting standards for financial instruments sometime in 2010.

The changes being contemplated by the two boards suggest that entities will soon need to prepare for radical changes to the manner in which they account for a wide range of financial instruments, including investments in debt and equity securities, loans, trade receivables, trade payables, interests in hybrid financial contracts, and an entity's own issued debt. While the changes will have the biggest impact for heavy users of financial instruments, such as banks, insurance companies, and other entities in the financial services industry, virtually no industry will be untouched. The changes affect how entities recognize, classify, and measure financial assets and financial liabilities; how they recognize and measure impairment of loans, receivables, and other financial assets; and how they apply hedge accounting to their derivative and hedging activities.

Currently, the two boards' approaches differ in important respects. For instance, the FASB's proposed approach calls for more fair value measurements than both current U.S. GAAP and IFRSs, whereas the IASB's proposed approach retains a mixed-measurement

<sup>1</sup> See, for example, the Group of 20 (G-20) leaders' [Declaration on Strengthening the Financial System](#) from the April 2, 2009, G-20 summit in London and the [Declaration on Further Steps to Strengthen the Financial System](#) from the G-20 Meeting of Finance Ministers and Central Bank Governors on September 4–5, 2009, in London. The G-20 comprises the world's leading industrialized and emerging market countries and was formed in 1999 to discuss key issues in the global economy.

<sup>2</sup> Excerpt from the [Leaders' Statement](#) given at the G-20 summit on September 24–25, 2009, in Pittsburgh.

The default classification category under the FASB's approach is fair value through earnings.

attribute model that is more similar to current U.S. GAAP and IFRSs, but prescribes different criteria for amortized cost measurements. In addition, the two boards' approaches to recognizing and measuring credit losses differ.

This *Heads Up* gives a comprehensive overview of the two boards' approaches to changing the accounting for financial instruments and an update on the joint Board meeting discussion on October 26, 2009. Appendix A includes a table summarizing the FASB's tentative decisions to date in this project. Appendix B compares, in tabular format, the IASB's July 2009 exposure draft on classification and measurement with subsequent decisions reached by the IASB. Appendix C contains a tabular comparison of the FASB's and IASB's tentative decisions to date on the project.

## The FASB's Proposed Approach to Financial Instruments

In recent months, the FASB has made a number of important decisions on how it proposes to change the accounting requirements for financial instruments.<sup>3</sup> The FASB's goal is to publish a comprehensive exposure draft by late 2009 or early 2010, with a comment deadline in April 2010. The FASB plans to finalize its new accounting requirements for financial instruments in the second half of 2010.

### Scope

The FASB's proposed approach applies to all financial assets and financial liabilities, with certain exceptions, such as employee stock options, equity investments and noncontrolling interests in consolidated subsidiaries, instruments classified in stockholders' equity, pension obligations, most insurance contracts, and lease assets and lease liabilities. The FASB has yet to decide whether equity method investments should be within the scope of the new accounting requirements.

**Editor's Note:** The scope of the project encompasses a broad range of financial instruments, including investments in debt and equity securities, investments in nonmarketable equity securities, loans, trade payables, trade receivables, derivative financial instruments, and debt liabilities.

### Recognition

Under the FASB's approach, an entity recognizes all of its financial instruments as either financial assets or financial liabilities, depending on the entity's present rights or obligations in the contracts.

### Classification Categories

Upon initial recognition, a financial instrument is classified into one of three categories for measurement and income recognition purposes:

- Fair value, with changes in fair value recognized in net income ("fair value through earnings").
- Fair value, with certain changes in fair value recognized in other comprehensive income ("fair value through other comprehensive income (FVTOCI)").
- Amortized cost.

Under the FASB's approach, an instrument cannot be reclassified after initial recognition.

### Classification Criteria

The default classification category under the FASB's approach is fair value through earnings. In the absence of other elections, therefore, a financial asset or financial liability must be measured at fair value, with changes in fair value recognized in earnings. In certain circumstances, however, an entity has the option to classify a financial instrument instead as FVTOCI or amortized cost.

<sup>3</sup> We reported on some of these decisions in our [July 27, 2009](#), and [August 18, 2009](#), *Heads Ups*.

Under the FASB's approach, in the statement of financial position, all financial instruments are subsequently measured at fair value, except for certain types of debt liabilities that the entity elects to measure at amortized cost.

The FASB has indicated that an entity may elect to classify a financial asset or financial liability as FVTOCI if the following criterion is met:

- The "entity's business strategy is to hold debt instruments with principal amounts for collection or payment(s) of contractual cash flows rather than to sell or settle the financial instruments with a third party." The entity's business strategy is "evaluated based on how the entity manages its financial instruments rather than based on the entity's intent for an individual financial instrument." However, the entity would need to "demonstrate that it holds a high proportion of similar instruments for long periods of time relative to their contractual terms."

**Editor's Note:** A hybrid financial instrument containing an embedded derivative that would need to be bifurcated and accounted for separately as a derivative under current U.S. GAAP (e.g., an investment in a convertible debt security for which the conversion feature can be net-settled) cannot be classified as FVTOCI; rather, such an instrument must be classified as fair value through earnings in its entirety (i.e., not just the embedded derivative, but the entire hybrid financial instrument, would be measured at fair value, with changes in fair value recognized in net income).

An entity may elect to classify certain types of its debt liabilities as amortized cost if the following two criteria are met:

- The "entity's business strategy is to hold the liability for payment(s) of contractual cash flows rather than to sell or settle the liability with a third party."
- Measurement of the liability at fair value "would create a measurement attribute mismatch."

### Initial Measurement

A financial instrument classified as fair value through earnings is initially measured at fair value. Any difference between the transaction price and that fair value is immediately recognized as a gain or loss in net income.

A financial instrument classified as either FVTOCI or amortized cost is initially measured at its transaction price. For a financial instrument classified as FVTOCI, any difference between the transaction price and fair value upon the first remeasurement after initial recognition is recognized in OCI.

**Editor's Note:** According to ASC 820-10-30-3 (formerly paragraph 17 of Statement 157<sup>4</sup>), "In many cases, the transaction price will equal the exit price and, therefore, represent the fair value of the asset or liability at initial recognition."

### Treatment of Transaction Costs and Fees

For a financial instrument classified as fair value through earnings, any initial transaction costs and fees (e.g., loan origination fees and costs) are recognized in net income immediately at inception of the transaction.

For a financial instrument classified as FVTOCI or amortized cost, transaction costs and fees are deferred in OCI and recognized as a yield adjustment over the life of the instrument in a manner consistent with current U.S. GAAP. In other words, the interest method is used to amortize such transaction costs and fees to earnings over the life of the instrument.

### Subsequent Measurement

In the statement of financial position, all financial instruments are subsequently measured at fair value, except for certain types of debt liabilities that the entity elects to measure at amortized cost (see [Classification Criteria](#) section above).

<sup>4</sup> FASB Statement No. 157, *Fair Value Measurements*.

The FASB's approach significantly expands the use of fair value in the financial statements and only permits amortized cost measurement in narrow circumstances for certain liabilities only.

**Editor's Note:** The FASB's approach significantly expands the use of fair value in the financial statements and only permits amortized cost measurement in narrow circumstances for certain liabilities only. Financial instruments that are measured at amortized cost under current U.S. GAAP, such as held-to-maturity securities and loans held for investment, would instead be measured at fair value in the statement of financial position. Fair value accounting would also apply to nonmarketable equity securities that are currently subject to the cost method of accounting.

For banks and other deposit-taking institutions, one of the key issues addressed in the project is how to measure core deposit liabilities. The FASB has yet to make a decision on this issue. However, it is considering an approach in which entities use the present value of the average core deposit liability amount, over an implied maturity period, to remeasure core deposit liabilities in each period. The discount rate is the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity. Note that this approach incorporates expectations about future deposits (not just existing deposits).

### **Income Recognition**

For a financial instrument classified as fair value through earnings, all changes in fair value are recognized in net income.

For a financial instrument classified as FVTOCI, the amount of the change in fair value recognized in OCI is the change in fair value excluding current-period interest accruals (including amortization or accretion of any premium or discount) and credit losses, which are recognized in net income. In addition, changes in fair value that were previously recognized in OCI are recognized in net income when they are realized through sale or settlement.

### **Presentation in the Statement of Financial Position**

Financial instruments classified as fair value through earnings and FVTOCI, respectively, are displayed separately on the face of the balance sheet.

For financial instruments classified as fair value through earnings other than debt liabilities, an entity must present the fair value amount on the face of the statement of financial position, but is not precluded from also presenting the amortized cost amount. For debt liabilities classified as fair value through earnings, an entity must present the amortized cost amount in addition to the fair value amount.

For financial assets classified as FVTOCI, an entity must present the following amounts in separate line items on the face of the statement of financial position:

- Amortized cost.
- Cumulative credit losses.
- Remaining difference between fair value and amortized cost.
- Fair value.

For financial liabilities classified as FVTOCI, an entity must present the following amounts in separate line items on the face of the statement of financial position:

- Amortized cost.
- Difference between amortized cost and fair value.
- Fair value.

### **Presentation in the Statement of Financial Performance**

In this project, the FASB has decided to propose changing U.S. GAAP to require entities to present one statement of financial performance, with a total for comprehensive income and a subtotal for net income as part of the basic financial statements in each reporting period. Entities would continue to only report basic and diluted earnings per share on the basis of net income.

Under the FASB's approach, financial assets in the FVTOCI category must be assessed for credit impairments.

For financial instruments classified as fair value through earnings, an entity must present only an aggregate amount for realized and unrealized gains or losses on the face of the statement of financial performance. An entity is not required to separately present current-period interest accruals, dividend accruals, or credit losses for financial instruments classified as fair value through earnings.

For financial instruments classified as FVTOCI, an entity must present the following amounts recognized in earnings separately on the face of the statement of financial performance:

- Current-period interest accruals.
- Credit losses.
- Realized gains or losses.

For financial instruments classified as FVTOCI, unrealized foreign-currency gains and losses are included in OCI and are not presented separately in the statement of financial performance.

For an entity's own debt classified as amortized cost, the entity must present separately the following amounts on the face of the statement of financial performance:

- Current-period interest accruals.
- Realized gains or losses.

### Impairment (Credit Losses)

Under the FASB's approach, financial assets in the FVTOCI category must be assessed for credit impairments. At the end of each period, management estimates the amount of future cash flows not expected to be collected. An impairment loss is recognized if there is a decrease in the net present value of cash flows expected to be collected. The cash flows are discounted at the effective interest rate used for accounting purposes to accrue interest income on the financial asset.

In estimating future cash flows, management would consider all available information relating to past events and existing conditions that are relevant to the collectibility of the financial asset, such as the remaining payment terms, the financial condition of the issuer, expected defaults, and collateral values, as well as existing environmental factors such as industry, geographical, economic, and political data indicating that some contractual cash flows are not expected to be collected. The entity would not consider possible future scenarios when estimating future cash flows.

**Editor's Note:** Unlike the IASB, the FASB is not currently exploring an expected-loss approach that incorporates expectations about future credit losses over the life of a financial instrument.

The FASB has not yet determined how interest income should be recognized on impaired financial assets.

### Hedge Accounting

The FASB has not yet made any decisions about hedge accounting. It plans to address this topic in November 2009. Issues that the FASB will consider include whether to revise or eliminate fair value hedge accounting and whether to revise the hedge effectiveness criteria for cash flow hedges.

### Effective Date and Transition

The FASB plans to decide on the effective date of, and transition to, the new accounting requirements in December 2009.

## The IASB's Proposed Approach to Financial Instruments

The IASB is further along in its project on accounting for financial instruments than the FASB. The IASB has divided its work into the following three phases:

- Classification and measurement.
- Impairment.
- Hedge accounting.

The IASB is expected to publish a final IFRS on the classification and measurement of financial assets in November 2009.<sup>5</sup> In addition, the IASB is expected to release an exposure draft of a proposed IFRS on impairment of financial assets in late October 2009 and an exposure draft of a proposed IFRS on hedge accounting in December 2009. The IASB plans to have all the new accounting requirements for financial instruments in place before the end of 2010.

### Scope

Like the FASB's approach, the IASB's new requirements apply to all financial instruments, with certain exceptions. Note, however, that the IASB recently decided to exclude financial liabilities (e.g., debt liabilities and trade payables) from the scope of its new IFRS on classification and measurement so that it would have more time to consider issues related to the impact of an entity's own credit risk on fair value measurements of financial liabilities. Therefore, the existing accounting requirements for financial liabilities in IAS 39<sup>6</sup> will continue to apply for the time being. Under the existing IAS 39, financial liabilities typically are measured at amortized cost, with certain exceptions (e.g., derivative liabilities, separated embedded derivative liabilities, trading liabilities, and nontrading liabilities designated under IAS 39's restricted fair value option are subject to fair value accounting).

### Classification

Under the IASB's approach, a financial asset is classified into one of three categories for measurement and income recognition purposes:

- Amortized cost.
- Fair value, with changes in fair value recognized in profit or loss ("fair value through profit or loss (FVTPL)").
- Fair value, with changes in fair value recognized in OCI ("FVTOCI").

Unlike the FASB's approach, the IASB's approach requires an entity to reclassify a financial asset after initial recognition if this asset no longer meets the conditions for its original classification (i.e., if the business model changes). The IASB expects such reclassifications to be infrequent.

### Classification Criteria

Under the IASB's approach, an entity classifies its financial assets (including hybrid contracts with a financial asset host) on the basis of an evaluation of:

- The entity's business model for managing its assets.
- The contractual cash flow characteristics of the asset.

If the objective of the entity's business model is to hold its assets to collect the contractual cash flows and an asset's contractual cash flows represent payments of principal and interest, an entity generally must classify the asset as amortized cost. If the entity has a different business model (e.g., it is a trading business), the entity generally must classify the assets as FVTPL. Similarly, if an asset's cash flows do not represent (or do not only

The IASB recently decided to exclude financial liabilities from the scope of its new IFRS on classification and measurement.

<sup>5</sup> We described the IASB's exposure draft on this topic in our [July 27, 2009, Heads Up](#).

<sup>6</sup> IAS 39, *Financial Instruments: Recognition and Measurement*.

represent) basic loan features (i.e., payments of principal and interest), the asset generally must be classified as FVTPL in its entirety. For instance, an equity investment or an investment in a convertible bond would not qualify for amortized cost classification, since such an investment does not contain only basic loan features.

**Editor’s Note:** Unlike the FASB’s approach, the IASB’s approach specifies a broad category of financial assets that must be classified as amortized cost. In many circumstances, therefore, entities can continue to measure at amortized cost financial assets that are carried at amortized cost under the existing IAS 39, such as many loans, receivables, and held-to-maturity investments. In addition, investments in debt instruments that are currently classified as available for sale and carried at fair value, with changes in fair value recognized in OCI, can often be reclassified to the new amortized cost category. The existing held-to-maturity classification and associated “tainting” requirements for held-to-maturity investments no longer apply (i.e., an entity would be permitted to sell financial assets classified as amortized cost to some degree without being precluded from using the amortized cost category for other financial assets).

Like the FASB’s approach, the IASB’s approach eliminates the existing bifurcation requirements for embedded derivatives in financial assets. Instead, the entire hybrid financial contract is evaluated under the classification criteria to determine whether it should be measured at amortized cost or fair value in its entirety. Thus, an entity typically must measure loans, receivables, held-to-maturity securities, and available-for-sale financial assets that currently contain bifurcated embedded derivatives at fair value through earnings in their entirety.

Like the FASB’s approach, the IASB’s approach eliminates the existing bifurcation requirements for embedded derivatives in financial assets.

There are two exceptions to the above classification requirements:

- For a financial asset that an entity would otherwise be required to classify as amortized cost, an entity may, upon initial recognition, irrevocably elect to measure the asset at FVTPL if that designation eliminates or significantly reduces an accounting mismatch. This is the so-called fair value option.
- For an equity investment that an entity does not hold for trading purposes, the entity may, upon initial recognition, irrevocably elect to classify the investment as FVTOCI. The entity is permitted to make this election on an instrument-by-instrument basis.

**Editor’s Note:** As with the FASB’s approach, all equity investments within the scope of the IASB’s project are measured at fair value. Unlike the FASB’s approach, however, the IASB’s approach permits an entity to classify equity investments that are not held for trading into the FVTOCI category. In addition, equity investments can no longer be classified as available for sale and an entity would no longer be permitted to measure certain unquoted equity investments (or derivatives linked to unquoted equity investments) without readily determinable fair values at cost.

## Classification Criteria — Application Issues

Hot topics under the IASB’s approach include the classification of (1) subordinated interests in securitizations (e.g., investments in collateralized debt obligations) and (2) financial assets acquired at a discount that reflects incurred credit losses. Initially, the IASB proposed that an entity should be required to classify such financial instruments as FVTPL. In its redeliberations, however, the IASB has concluded that such financial assets should be eligible for amortized cost measurement if they otherwise meet the conditions for such classification.

To determine whether an investor in a securitization interest can classify the investment as amortized cost, the investor must use a “look through” approach. Under this approach, the investor assesses:

- The characteristics of the underlying instruments in the securitization.
- The investment’s exposure to credit risk relative to the pool of underlying instruments in the securitization.

Under the IASB's approach, financial assets in the amortized cost category have to be assessed in each period for credit impairments.

For the investment to be eligible for amortized cost measurement, the securitization vehicle can only contain instruments that either (1) have basic loan features or modify the cash flows of the underlying instruments in a manner consistent with the "basic loan features" criterion or (2) align the cash flows between the underlying instruments and the issued securitization interests. For instance, certain purchased guarantees and interest rate swaps may be permitted. In addition, the credit risk of the investment in the securitization interest must be equal to or lower than the average credit risk of the underlying instruments in the securitization. If it is impracticable to apply a "look through" approach or the underlying pool of instruments can change in such a way that the underlying instruments are no longer eligible for amortized cost measurement, the investor must account for its investment at fair value.

**Editor's Note:** The IASB staff has suggested that the following types of financial assets would typically not qualify for amortized cost measurement, since they do not meet the basic loan features criterion:

- A loan that pays an inverse-floating rate (i.e., the interest rate has an inverse relationship to market interest rates).
- A nonrecourse debt instrument that is secured by specific collateral (that does not meet the basic loan features criterion), when the investor's claim is limited to the value of the collateral.
- A five-year constant maturity bond that pays a variable rate that is reset periodically on the basis of a five-year maturity.
- A perpetual debt instrument with an interest-deferral option that can be exercised if no dividend is paid on any class of share capital and additional interest does not accrue on those deferred amounts.
- A debt instrument with a choose-your-rate option, when the issuer can choose to pay one-month LIBOR for three months and that one-month LIBOR is not reset each month.

### Initial Measurement

At initial recognition, all financial assets are measured at fair value.

### Subsequent Measurement

As described above, under the IASB's approach, some financial assets subsequently must be measured at amortized cost and others at fair value on the face of the statement of financial position.

### Income Recognition

For financial assets classified as amortized cost, current-period interest accruals, credit losses, foreign-currency gains and losses, and realized gains or losses are recognized in profit or loss.

For financial assets classified as FVTPL, all changes in fair value are recognized in profit or loss.

For equity investments classified as FVTOCI, changes in fair value are recognized in OCI. Realized gains and losses are not recognized in profit or loss even if the equity investment is subsequently sold. Instead, gains and losses are permanently deferred in equity except to the extent of any dividends received, which are recognized in profit or loss.

### Impairment (Credit Losses)

Under the IASB's approach, financial assets in the amortized cost category (e.g., many loans, receivables, and investments in debt securities) have to be assessed in each period for credit impairments. Unlike the FASB, the IASB has tentatively concluded that it will propose an "expected loss" approach that incorporates expectations about future credit

losses over the life of the financial asset. Under this approach, an entity determines the amortized cost carrying amount of a financial asset or portfolio of financial assets on the basis of the present value of future expected cash flows in considering expectations about future credit losses.

In each period, management reestimates the future expected cash flows. An impairment loss is recognized if there is an adverse change in expected cash flows, and a reversal of impairment losses is recognized if there is a favorable change in expected cash flows. A key feature of the IASB's expected-loss approach is the effective interest rate used to discount the cash flows and calculate interest revenue and the amortized cost carrying amount. Unlike approaches under existing accounting requirements, the effective interest rate used in the IASB's expected-loss approach is adjusted by deducting a margin for future credit losses expected upon initial recognition.

**Editor's Note:** The IASB's expected-loss approach is based on the manner in which a lender would price a loan upon origination. That is, if the lender seeks to realize a certain yield after credit losses for a portfolio of loans, it will seek a margin for future expected credit losses in the pricing of the loan. Despite its label, the IASB's expected-loss approach typically does not result in up-front recognition of expected losses in profit or loss upon initial recognition of a financial asset. Instead, the effective interest rate and reported net interest revenue are lower than under current accounting requirements. Under the expected-loss approach, no impairment loss is recognized if actual credit losses materialize unless there is an adverse change in cash flows.

For example, for a portfolio of fixed-interest rate loans for which the amounts lent equal the principal amounts to be repaid at maturity, a portion of cash interest received in each period is set aside as a cushion against future expected credit losses in the portfolio of loans. If the fixed interest received in each period is \$10,000, the lender might expect that \$1,000 of that amount reflects future expected credit losses. In this example, in the absence of any changes in cash flow expectations, only \$9,000 would be recognized as net interest revenue in the income statement and the remaining \$1,000 of cash interest received would reduce the net carrying amount of the loan to reflect the expectation of future credit losses in the portfolio of loans. Under this approach, if actual future credit losses equals originally expected credit losses, no impairment is recognized.

If the IASB proceeds with its expected-loss approach, implementation will be a significant undertaking for many banks and other entities with lending activities. In particular, entities will need to collect data and develop systems that satisfy the operational requirements of the approach, including the derivation of cash flow estimates over the life of financial assets and application of the effective interest rate method (or other allocation mechanisms for credit costs) over the life of a financial asset. The IASB is establishing an expert advisory panel to advise it on operational issues related to the implementation of its expected-loss approach.

If the IASB proceeds with its expected-loss approach, implementation will be a significant undertaking for many banks and other entities with lending activities.

## Hedge Accounting

The IASB has decided to propose replacing the current approach to accounting for fair value hedging relationships (i.e., the recognition of changes in the fair value of the hedging instrument and the hedged item attributable to the hedged risk in profit or loss). Instead, fair value hedge accounting relationships would be accounted for under an approach similar to cash flow hedge accounting. Thus, gains and losses on hedging instruments in hedging relationships that are currently accounted for as fair value hedges would instead be recognized outside of earnings in OCI, with subsequent reclassification to profit or loss (as with cash flow hedges), and the measurement of the hedged item would not be adjusted.

On October 26, 2009, the FASB and IASB held a joint Board meeting to discuss the financial instruments project, focusing on financial statement presentation issues, core principles for convergence, their draft work plan on the joint project, and their respective approaches to credit impairments.

## Effective Date and Transition

The IASB has decided that the effective date for the new IFRS on classification and measurement of financial assets will be January 1, 2013, with early adoption permitted. Therefore, a calendar-year entity could elect to adopt the new requirements already for its 2009 year-end financial statements.

The IASB has indicated that it will consider providing a transitional option for an insurer to change the classification of financial assets when the insurer adopts the anticipated future IFRS on insurance contracts.

The new IFRS on impairments of financial assets is expected to become effective about three years after the date of issuance of final requirements on impairments. The IASB has not yet debated the effective date for the new IFRS on hedge accounting.

## Joint Board Meeting Discussion on October 26, 2009

On October 26, 2009, the FASB and IASB held a joint Board meeting to discuss the financial instruments project, focusing on financial statement presentation issues, core principles for convergence, their draft work plan on the joint project, and their respective approaches to credit impairments.

### Presentation

The boards discussed whether both fair value and amortized cost information should be prominently disclosed on the face of the financial statements (e.g., through parenthetical disclosure or reconciling information on the face of the financial statements). One benefit of such disclosure is that it would allow investors to more easily compare financial statements prepared under the FASB's and IASB's respective approaches. In addition, it was noted that some investors are looking for both fair value and amortized cost information in a timely manner. Some questioned whether providing both fair value and amortized cost on the face of the statement of financial position would be confusing to readers of financial statements.

A majority of the IASB members present indicated that they would not necessarily object to requiring entities to provide both fair value and amortized cost information on the face of the statement of financial position for financial instruments that are classified as amortized cost under the IASB's approach. The IASB agreed to consider this issue further at a future Board meeting along with whether to require prominent disclosure of changes in fair value in separate pro forma statements to illustrate the impact on accumulated other comprehensive income and shareholders' equity. (The FASB has previously agreed to propose prominent disclosure in the financial statements of both fair value and amortized cost information for financial instruments that are classified as FVTOCI under the FASB's approach.)

### Core Principles

The two boards tentatively agreed on the following core principles for converging their approaches to accounting for financial instruments:

1. The new requirements should enhance comparability for the benefit of investors.
2. The new requirements should provide transparency of risk exposures in management business strategies.
3. Prominent and timely fair value information is relevant for financial instruments with highly variable cash flows or held-for-trading purposes.
4. Both amortized cost and fair value information is relevant for financial instruments with principal amounts held for collection or payment of the contractual cash flows rather than for sale to or settlement with a third party.
5. The new requirements should be less complex to implement.
6. The impairment approach for financial assets held for collection of contractual cash flows should be consistent.

Regarding the fourth principle, some Board members expressed concern about the relevance of fair value information for financial liabilities because of the impact of an entity's own credit risk on fair value measurements of liabilities.

### **Work Plan for Convergence**

The FASB technical director informed the boards that the FASB expects to issue an exposure draft on the financial instruments project in the first quarter of 2010. In addition, the technical director identified the following work plan:

- Both boards will jointly deliberate improvements to hedge accounting in November and December.
- The IASB's expert advisory panel will focus on both the IASB's and the FASB's proposed impairment models.
- One of the boards' objectives is to understand differences and identify specific financial instruments that will be affected by the classification and measurement model they are developing.
- The boards will jointly deliberate issues related to credit risk in liability measurement.
- The final standard is expected to be issued in late 2010.

### **Impairment**

The boards exchanged questions about their respective approaches to credit impairment. IASB members asked whether the FASB's approach could result in the recognition of a loss on initial recognition of a portfolio of loans if credit losses are expected in the portfolio. FASB members indicated that they had not yet deliberated the details of its approach. They emphasized that an entity should not consider possible future changes in estimating cash flows. No decisions were made.

## Appendix A

The table below summarizes the tentative decisions reached by the FASB regarding its project on accounting for financial instruments through October 26, 2009. Note that the FASB has not yet made any final decisions.

### Recognition and Measurement Model

Subject	FASB's Tentative Decisions
Scope	<p>All financial instruments (as defined in the master glossary of the Accounting Standards Codification), except for the following:</p> <ul style="list-style-type: none"> <li>• Employers' and plans' obligations for pension benefits; other postretirement benefits, including health care and life insurance benefits, postemployment benefits, and employee stock option and stock purchase plans and other forms of deferred compensation arrangements in ASCs 712,<sup>7</sup> 715,<sup>8</sup> and 960.<sup>9</sup></li> <li>• Insurance contracts within the scope of ASC 944,<sup>10</sup> except for deposit-type and investment contracts issued by insurance entities, as defined in ASC 944.</li> <li>• Noncontrolling interests in consolidated subsidiaries.</li> <li>• Equity investments in consolidated subsidiaries.</li> <li>• Equity instruments issued by the entity and classified in stockholders' equity. This exception would not apply to financial instruments with equity-like features that are classified as liabilities.</li> <li>• Interests in a variable interest entity that is consolidated by the enterprise.</li> <li>• Lease assets and liabilities accounted for under ASC 840.<sup>11</sup></li> </ul> <p>The Board has yet to determine whether equity method investments will be within the scope of the exposure draft.</p>
Categories of financial assets and financial liabilities	<p>Effectively, three categories:</p> <ol style="list-style-type: none"> <li>1. Fair value through earnings.</li> <li>2. Fair value through other comprehensive income (FVTOCI).</li> <li>3. Amortized cost.</li> </ol> <p>All financial assets and financial liabilities (within the scope) would be measured at fair value on the balance sheet, with an optional exception for certain types of an entity's own debt, which may be recorded at amortized cost if it meets certain criteria.</p> <p>This would eliminate the available-for-sale and held-to-maturity categories in ASC 320<sup>12</sup> (formerly Statement 115<sup>13</sup>) and the held-for-sale and held-for-investment categories of loans under ASC 948<sup>14</sup> (formerly Statement 65<sup>15</sup>) and ASC 310<sup>16</sup> (formerly SOP 01-6<sup>17</sup>).</p>
Criteria for amortized cost measurement	<p>An entity has the option to elect to carry certain types of its own debt at amortized cost if this debt meets the criteria for classification as FVTOCI and such designation addresses an accounting mismatch.</p>
Criterion for FVTOCI classification	<p>An entity has the option to classify a financial asset or financial liability as fair value, with certain changes in fair value recorded in OCI, if it meets the following (business-model and instrument-type) criterion:</p> <p><b>Business strategy</b> is to hold a debt instrument with principal amount for <b>collection or payment of contractual cash flows</b> rather than to sell or settle the debt instrument.</p>
Recycling of accumulated OCI to net income	<p>Amounts in accumulated OCI are recycled to net income upon sale, settlement, or impairment.</p>
Equity investments	<p>All measured at fair value through earnings. Unlike current U.S. GAAP, the FASB's tentative decisions do not allow an exception for nonmarketable equity securities.</p>
Embedded derivatives in hybrid financial contracts	<p>Hybrid financial contracts with an embedded derivative, which currently must be bifurcated under ASC 815<sup>18</sup> (formerly Statement 133<sup>19</sup>), would instead be classified in their entirety as fair value through earnings.</p>

<sup>7</sup> FASB Accounting Standards Codification Topic 712, *Compensation — Nonretirement Postemployment Benefits*.

<sup>8</sup> FASB Accounting Standards Codification Topic 715, *Compensation — Retirement Benefits*.

<sup>9</sup> FASB Accounting Standards Codification Topic 960, *Plan Accounting — Defined Benefit Pension Plans*.

<sup>10</sup> FASB Accounting Standards Codification Topic 944, *Financial Services — Insurance*.

<sup>11</sup> FASB Accounting Standards Codification Topic 840, *Leases*.

<sup>12</sup> FASB Accounting Standards Codification Topic 320, *Investments — Debt and Equity Securities*.

<sup>13</sup> FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

<sup>14</sup> FASB Accounting Standards Codification Topic 948, *Financial Services — Mortgage Banking*.

<sup>15</sup> FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*.

<sup>16</sup> FASB Accounting Standards Codification Topic 310, *Receivables*.

<sup>17</sup> AICPA Statement of Position 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*.

<sup>18</sup> FASB Accounting Standards Codification Topic 815, *Derivatives and Hedging*.

<sup>19</sup> FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

Subject	FASB's Tentative Decisions
Embedded credit derivatives in securitizations	<p>This will depend on what the FASB concludes in its deliberations on the proposed ASU <i>Scope Exception Related to Embedded Credit Derivatives</i>.<sup>20</sup> If an embedded credit feature would have been subject to bifurcation under ASC 815 (formerly Statement 133), the hybrid instrument would be recorded at fair value through earnings. If, however, the instrument would not meet the criteria for bifurcation, the hybrid instrument may be eligible for classification as FVTOCI.</p> <p>The proposed ASU clarifies that an embedded credit derivative that arises in a securitization structure that redistributes credit risk between tranches solely through subordination meets the embedded derivative scope exception. However, other embedded credit derivatives in the securitization structure that are not only in the form of subordination (e.g., credit default swaps) still would be subject to bifurcation analysis.</p>
Reclassification	Not permitted.

## Impairment and Hedging Models

Subject	FASB's Tentative Decisions
Credit impairment model for financial assets recorded in the FVTOCI category	<p>An impairment loss is measured (in each reporting period) as the present value of management's current estimate of cash flows that are not expected to be collected.</p> <p>In determining the expected cash flows, an entity would consider all available information relating to past events and existing conditions that are relevant to the collectibility of the financial asset(s), such as the remaining payment terms, the financial condition of the issuer, expected defaults, and collateral values, as well as existing environmental factors such as industry, geographical, economic, and political data indicating that some contractual cash flows are not expected to be collected. An entity would not consider possible future events.</p> <p>The Board will deliberate interest income recognition on impaired financial assets at a later date.</p>
Hedge accounting	Not yet deliberated.

## Financial Statement Presentation

Classification Category	Balance Sheet	Income Statement
Fair value through earnings	<p>An entity would be required to present on the face of the balance sheet:</p> <ul style="list-style-type: none"> <li>Fair value.</li> <li>Amortized cost (for the entity's own debt classified as fair value through earnings).</li> </ul>	<p>Separate line item on the face of the income statement for:</p> <ul style="list-style-type: none"> <li>Realized and unrealized gains and losses (in the aggregate).</li> </ul>
FVTOCI	<p>Separate line items on the face of the balance sheet for:</p> <ul style="list-style-type: none"> <li>Amortized cost.</li> <li>Cumulative credit losses.</li> <li>Adjustment to arrive at fair value.</li> <li>Fair value.</li> </ul>	<p>Separate line items on the face of the income statement for:</p> <ul style="list-style-type: none"> <li>Interest income.</li> <li>Interest expense.</li> <li>Credit losses.</li> <li>Realized gains and losses.</li> </ul>
Amortized cost	<p>Amortized cost would be shown on the face of the balance sheet.</p>	<p>Separate line items on the face of the income statement for:</p> <ul style="list-style-type: none"> <li>Interest expense.</li> <li>Realized gains and losses.</li> </ul>
Other tentative decisions	<ul style="list-style-type: none"> <li>One performance statement would be required, with a total for comprehensive income and a subtotal for net income.</li> <li>An entity would continue to be required to present basic and diluted earnings per share on the basis of net income.</li> </ul>	

<sup>20</sup> The proposed ASU was issued for public comment on October 13, 2009. The comment deadline is November 12, 2009.

## Appendix B

The following table summarizes the IASB's July 2009 exposure draft (ED) on classification and measurement of financial instruments and compares it with subsequent tentative decisions reached by the IASB through October 26, 2009. Note that the IASB may change its decision before issuing final guidance.

### Classification and Measurement Model

Subject	IASB's Exposure Draft, July 2009	Subsequent IASB Tentative Decisions
Scope	Same as IAS 39.	At the <b>October 21, 2009</b> , Board meeting, the IASB tentatively agreed to exclude all financial liabilities from the scope of the final IFRS. The existing requirements of IAS 39 would continue to apply to all financial liabilities.
Categories of financial assets and financial liabilities	Effectively, three categories of financial assets and financial liabilities: <ol style="list-style-type: none"> <li>1. Fair value through profit or loss (FVTPL).</li> <li>2. Amortized cost.</li> <li>3. Fair value through other comprehensive income (FVTOCI).</li> </ol> <p>The available-for-sale and held-to-maturity categories in IAS 39 would be eliminated.</p>	Same as the ED, except that the categories now apply to financial assets only (see above).
Criteria for amortized cost measurement	A financial asset or financial liability generally must be measured at amortized cost if it meets both of the following criteria: <ol style="list-style-type: none"> <li>1. It has only basic loan features: for example, its interest is either fixed or market interest or a combination of the two, it is not leveraged, it is prepayable, it has no variability other than nonpayment (i.e., default).</li> <li>2. It is managed on a contractual yield basis (based on management's focus on the cash flows under the instrument, not on cash flows arising from sale).</li> </ol> <p>There is an exception for items that qualify for and are designated under the fair value option (see below).</p>	Same as the ED, except that at the <b>September 29, 2009</b> , Board meeting, the IASB tentatively agreed to reword the "managed on a contractual yield basis" criterion. The final IFRS may describe this criterion as follows: <p>The objective of an entity's business model is to hold the instrument to collect (or pay) contractual cash flows rather than to sell (or settle) the instruments before its contractual maturity to realize changes in fair value.</p>
Criterion for FVTOCI	An entity has the option to elect to carry designated equity investments at FVTOCI. For this category, dividend income and realized gains and losses are also recorded in OCI.	No change to the ED, except that dividend income is recognized in profit or loss for these investments.
Recycling of accumulated OCI to profit or loss	Amounts in OCI are permanently deferred in equity, except if distributed as dividends.	No change to the ED.
Equity investments	All measured at fair value. Unlike the current IAS 39, the ED does not contain an exception for unquoted equity investments that do not have a reliably determinable fair value.	No change to the ED. However, at the October 15, 2009, Board meeting, the IASB tentatively agreed to provide additional measurement guidance on measuring the fair value of unquoted equity instruments in the final IFRS.
Embedded derivatives in hybrid financial contracts	Embedded derivative guidance is eliminated for hybrid financial contracts. Typically, hybrid financial contracts with embedded derivatives, which currently must be bifurcated, would not possess basic loan features, so the ED would require an entity to measure the hybrid contract at FVTPL.	No change to the ED, except that the embedded derivative guidance in IAS 39 would continue to apply to host contracts that are financial liabilities (see "Scope" above).

Subject	IASB's Exposure Draft, July 2009	Subsequent IASB Tentative Decisions
Embedded credit derivatives in securitizations	If instruments are issued by an entity in tranches that carve up the credit risk between tranches, generally only the most senior tranche can be considered to contain basic loan features. All more junior tranches would be at FVTPL since they are deemed to have written credit protection to the more senior tranches.	At the October 6, 2009, Board meeting, the IASB tentatively agreed that the holder of contractually linked instruments (tranches) must use a "look through" approach to assess the characteristics of the underlying instruments and the individual instrument's exposure to credit risk relative to the pool of underlying investments. If it is impracticable to look through, the instrument must be measured at FVTPL.
Financial assets acquired at a discount that reflects incurred credit losses	Does not meet "managed on a contractual yield basis" criterion.	At the <b>October 16, 2009</b> , Board meeting, the IASB tentatively agreed that financial assets acquired at a discount that reflects incurred credit losses are not precluded from meeting the amortized cost criteria.
Fair value option	Retained when a fair value designation eliminates an accounting mismatch.	Same as ED, except that the revised fair value option in the ED would apply to financial assets only (see "Scope" above). The existing IAS 39 fair value option would continue to apply to financial liabilities designated at FVTPL.
Reclassification	Not permitted.	At the <b>October 15, 2009</b> , Board meeting, the IASB tentatively decided to require reclassifications if an entity's business model changes. However, a change in business model is expected to be infrequent.

## Impairment Model

Subject	IASB's Tentative Decisions
Credit impairment model for financial assets at amortized cost	An expected-loss approach. A key difference to the currently used incurred-loss model in IAS 39 is that the expected-loss approach incorporates expectations about expected future credit losses over the life of the financial asset or group of financial assets and is not limited by the incurred-loss threshold.
Initial recognition	Recognition of a loss on initial recognition is prohibited if the interest rate on the financial asset (e.g., loan) is sufficient to cover credit losses expected over the life of the financial asset at initial recognition.
Interest recognition	Interest revenue is determined on the basis of estimated future cash flows adjusted for estimated future credit losses. That is, at initial recognition, the effective interest rate is adjusted to exclude the margin for expected future credit losses. Therefore, net interest revenue recognized under the expected-loss approach will be lower than it is under current accounting requirements, which assume that future cash flows will be received in full.
Impairment recognition	Entities would continually reassess credit loss expectations in each reporting period. An impairment loss (or reversal) would be recognized in earnings in each reporting period as the difference between the previous carrying amount of the financial asset and the present value of the revised expected cash flows discounted by using the effective interest rate.
Other	The IASB agreed to establish an expert advisory panel to address implementation issues.

## Hedge Accounting

Subject	IASB's Tentative Decisions
Fair value hedge accounting	<p>Fair value hedge accounting would be replaced with a model similar to cash flow hedge accounting. This would result in:</p> <ul style="list-style-type: none"><li>• Recognition outside profit or loss of any gains or losses on the hedging instrument to the extent the hedge is effective.</li><li>• No fair value adjustments to the carrying amount of the hedged item.</li><li>• The "lower of test" will not apply to fair value hedges. Therefore, ineffectiveness resulting from both underhedges and overhedges is recognized in profit or loss. Unlike cash flow hedges, therefore, fair value changes arising on the hedged item in excess of fair value changes arising on the hedging instrument would be recognized in profit or loss.</li></ul> <p>The IASB will continue to deliberate the hedge accounting model and other aspects of cash flow hedge accounting in an effort to simplify their application.</p>
Financial instruments measured at amortized cost	Eligible as hedged items in a fair value hedge if the instrument is managed on a contractual cash flow basis.

## Appendix C

The following table summarizes the similarities and differences between the IASB's ED, including subsequent tentative decisions reached by the IASB through October 26, 2009, and the FASB's tentative decisions reached through October 26, 2009. Note that neither the IASB nor the FASB has made any final decisions.

### Classification and Measurement Model

Subject	IASB's Tentative Decisions	FASB's Tentative Decisions
Scope	Applies to <b>financial assets</b> within scope of IAS 39.	Applies to all <b>financial assets</b> and <b>financial liabilities</b> (see <a href="#">Appendix A</a> for scope exceptions).
Categories of financial assets and financial liabilities	Effectively, three categories of <b>financial assets</b> : <ol style="list-style-type: none"> <li>1. Fair value through profit or loss (FVTPL).</li> <li>2. Amortized cost.</li> <li>3. Fair value through other comprehensive income (FVTOCI).</li> </ol> The available-for-sale and held-to-maturity categories in IAS 39 would be eliminated.	Effectively, three categories: <ol style="list-style-type: none"> <li>1. Fair value through earnings.</li> <li>2. FVTOCI.</li> <li>3. Amortized cost.</li> </ol> All financial assets and financial liabilities (within the project's scope) would be measured at fair value on the balance sheet, with an optional exception for certain types of an entity's own debt, which may be recorded at amortized cost if it meets certain criteria.  The available-for-sale and held-to-maturity categories in ASC 320 (formerly Statement 115) and the held-for-sale and held-for-investment categories of loans under ASC 948 (formerly Statement 65) and ASC 310 (formerly SOP 01-6) would be eliminated.
Criteria for amortized cost measurement	A financial asset generally must be measured at amortized cost if it meets the following (business model and contractual cash flow characteristics of the instrument) criteria: <ul style="list-style-type: none"> <li>• The entity's business model is to hold the instruments to collect (or pay) the contractual cash flows.</li> <li>• The instrument's contractual cash flows represent payment of principal and interest ("basic loan features").</li> </ul> There is an exception for items that qualify for and are designated under the fair value option (see below).	An entity has the option to elect to carry its own debt at amortized cost if this debt meets the criteria for classification as FVTOCI (see below) and such designation addresses an accounting mismatch.
Criterion for FVTOCI classification	An entity has the option to elect to carry designated equity investments at FVTOCI. For this category, realized gains and losses are recorded in OCI and dividend income is recorded in profit or loss.	An entity has the option to classify a financial asset or financial liability as fair value, with certain changes in fair value recorded in OCI, if it meets the following (business-model and instrument-type) criterion:  <b>Business strategy</b> is to hold a debt instrument with principal amount for <b>collection or payment of contractual cash flows</b> rather than to sell or settle the debt instrument.
Recycling of accumulated OCI to net income	Amounts in OCI are permanently deferred in equity except if distributed as dividends.	Amounts in accumulated OCI are recycled to net income upon sale, settlement, or impairment.
Equity investments	All measured at FVTPL unless FVTOCI option is elected. Unlike the current IAS 39, the ED does not contain an exception for unquoted equity investments that do not have a reliably determinable fair value. The final IFRS will provide additional measurement guidance on measuring fair value of unquoted equity instruments.	All measured at fair value through earnings. Unlike current U.S. GAAP, the FASB's tentative decisions do not allow an exception for nonmarketable equity securities.

Subject	IASB's Tentative Decisions	FASB's Tentative Decisions
Embedded derivatives in hybrid financial contracts	Embedded derivative guidance is eliminated for hybrid financial assets. Typically, hybrid financial assets with embedded derivatives, which currently must be bifurcated, would not possess basic loan features, so an entity will be required to measure the hybrid contract at FVTPL.	Hybrid financial contracts with an embedded derivative, which currently must be bifurcated under ASC 815 (formerly Statement 133), would instead be classified in their entirety as fair value through earnings.
Embedded credit derivatives in securitizations	The holder of contractually linked instruments (tranches) must use a "look through" approach to assess the characteristics of the underlying instruments and the individual instrument's exposure to credit risk relative to the pool of underlying investments. If it is impracticable to look through, the instrument must be measured at FVTPL.	This will depend on what the FASB concludes in its deliberations on the proposed ASU <i>Scope Exception Related to Embedded Credit Derivatives</i> . If an embedded credit feature would have been subject to bifurcation under ASC 815 (formerly Statement 133), the hybrid instrument would be recorded at fair value through earnings. If, however, the instrument would not meet the criteria for bifurcation, the hybrid instrument may be eligible for classification as FVTOCI.  The proposed ASU clarifies that an embedded credit derivative that arises in a securitization structure that redistributes credit risk between tranches solely through subordination meets the embedded derivative scope exception. However, other embedded credit derivatives in the securitization structure that are not only in the form of subordination (e.g., credit default swaps) still would be subject to bifurcation analysis.
Fair value option	Retained when a fair value designation eliminates an accounting mismatch (financial assets only).	No explicit fair value option.
Reclassification	Required if the business model changes; however, changes in the business model are expected to be infrequent).	Not permitted.

## Impairment Model

Subject	IASB's Tentative Decisions	FASB's Tentative Decisions
Credit impairment model	An expected-loss model. Based on expected future cash flows (not limited by the incurred-loss threshold); this model takes into consideration future credit losses expected throughout the life of the asset or portfolio.	Based on expected future cash flows; all available information relating to past events and existing conditions is considered. An entity would not consider possible future events.
Initial recognition	Recognition of a loss on initial recognition is generally prohibited.	Not yet deliberated.
Interest recognition	Interest revenue is determined on the basis of estimated future cash flows adjusted for estimated future credit losses. That is, at initial recognition, the effective interest rate is adjusted to exclude the margin for expected future credit losses.	Not yet deliberated.
Impairment recognition	Continual reassessment.  Will result in recognition of credit loss (or reversal) in earnings.	Continual reassessment.  Will result in recognition of credit loss (or reversal) in earnings.

## Hedge Accounting

Subject	IASB's Tentative Decisions	FASB's Tentative Decisions
Cash flow hedge accounting	Assessment and measurement requirements would be simplified.	Not yet deliberated.
Fair value hedge accounting	Fair value hedge accounting would be replaced with a model similar to cash flow hedge accounting. This would result in: <ul data-bbox="565 365 1024 741" style="list-style-type: none"><li>• Recognition outside of profit or loss of any gains or losses on the hedging instrument to the extent the hedge is effective.</li><li>• No fair value adjustments to the carrying amount of the hedged item.</li><li>• The "lower of test" will not apply to fair value hedges. Therefore, ineffectiveness resulting from both underhedges and overhedges is recognized in profit or loss. Unlike cash flow hedges, therefore, fair value changes arising on the hedged item in excess of fair value changes arising on the hedging instrument would be recognized in profit or loss.</li></ul>	Not yet deliberated.

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