

Heads Up

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IASB Issues Exposure Draft and FASB Initiates Deliberations on New Classification and Measurement Requirements for Financial Assets and Financial Liabilities.

by Magnus Orrell, Shahid Shah, and Ana Zelic, Deloitte & Touche LLP, and Andrew Spooner, Deloitte LLP (UK)

Background

The accounting for financial assets and financial liabilities, including investments in debt and equity securities, nonmarketable equity investments, loan receivables, and own debt could soon change. In response to the global financial crisis and recommendations received from their constituents, the FASB and the IASB announced in March 2009 that they will fast-track their efforts to reduce complexity in the accounting for financial instruments by replacing existing requirements with a simplified and improved approach. Although this is a joint project, each Board has decided to separately deliberate the issues and subsequently seek to reconcile any differences in its tentative decisions.

The IASB is further ahead in its deliberations. On July 14, 2009, the IASB issued an Exposure Draft (ED), *Financial Instruments: Classification and Measurement*, which proposes a new classification and measurement model for financial assets and financial liabilities. Comments on the ED are due by September 14, 2009. This ED is part of a project to replace IAS 39¹ with an entirely new International Financial Reporting Standard (IFRS) for financial instruments that is expected to be mandatory for IFRS reporting entities no earlier than January 2012. The IASB intends to perform this replacement in stages. The other parts of the replacement include an ED on derecognition that was issued in March 2009 and EDs on impairment and hedge accounting that are expected to be issued in the fourth quarter of 2009. The IASB expects to finalize the new classification and measurement model in time for entities to voluntarily adopt it for 2009 year-end financial statements. The finalization of the remaining parts is expected in 2010.

Concurrently with the issuance of the IASB's ED, the FASB met on July 15, 2009, to begin its deliberations on the project. The tentative decisions reached by the FASB at its July 15 meeting suggest that the FASB ED is likely to significantly differ from the IASB ED. For example, the FASB's tentative approach would require that more financial instruments be measured at fair value. While the IASB expects to issue a separate ED on impairments,

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¹ IAS 39, *Financial Instruments: Recognition and Measurement*.

the FASB has noted that it intends to issue a comprehensive ED, which would address classification and measurements, impairments, and hedge accounting, later this year. (Note also that in late August, the FASB intends to post preliminary views on the project to its Web site and solicit feedback from constituents.)

This *Heads Up* summarizes the key provisions of the IASB's ED and the tentative decisions reached by the FASB at its July 15 Board meeting. It also includes three appendixes: Appendix A contains a flowchart depicting the classification and measurement model in the IASB's ED, Appendix B compares the IASB's ED and the FASB's tentative decisions, and Appendix C summarizes how some common financial assets and financial liabilities would be classified and measured in accordance with the IASB's ED and the FASB's tentative decisions.

IASB's Proposed Approach

Under the IASB's ED, all recognized financial assets and financial liabilities that are currently within the scope of IAS 39 (including investments in debt and equity securities, receivables, payables, loan assets, issued debt, and other financial assets and financial liabilities that are not specifically excluded) would be measured at either amortized cost or fair value.² The current available-for-sale, loans and receivables, and held-to-maturity classification categories in IAS 39 (including the associated tainting rules) would be removed.

An entity would be required to measure a financial asset or financial liability that has only *basic loan features* and that is *managed on a contractual yield basis* at amortized cost, unless it is designated as at fair value through profit or loss (FVTPL). A financial asset or financial liability that otherwise qualifies for measurement at amortized cost can be designated as at FVTPL only on initial recognition and only if such designation would eliminate or significantly reduce an accounting mismatch that would exist had the instrument been measured at amortized cost (this option is equivalent to the current IAS 39 fair value option for an accounting mismatch).

The ED would require an entity to measure all other financial assets and financial liabilities, including debt instruments that do not meet the above criteria and all equity investments, at fair value. For all financial instruments measured at fair value, except certain equity instruments, changes in fair value are recognized in earnings (i.e., FVTPL). Investments in equity investments that are not held for trading may be designated irrevocably as at fair value through other comprehensive income (FVTOCI) upon initial recognition. The ED would no longer permit an investment in an unquoted equity investment to be measured at cost less impairment when fair value cannot be reliably measured.

If an equity instrument is designated as at FVTOCI, all gains and losses, including realized gains and losses and dividends, and transaction costs are recognized directly in equity without any reclassifications to profit or loss. The ED's notion of FVTOCI removes the current requirement in IAS 39 that an entity perform an assessment of impairment and reclassify the cumulative fair value gain or loss on disposal for equity investments designated as at FVTOCI, since all changes in fair value remain permanently in equity.

The ED would not permit reclassifications out of or into amortized cost, FVTPL, or FVTOCI after initial recognition.

The ED would amend IAS 1³ to require that if a financial asset or financial liability measured at amortized cost is derecognized, the gain or loss on disposal must be separately disclosed in the statement of comprehensive income. In addition, the ED amends IFRS 7⁴ to require "a reconciliation of the gain or loss recognised in the statement of comprehensive income arising from the derecognition of financial assets and financial liabilities measured at amortised cost." In addition, IFRS 7 would be amended to include

² The proposals do not change the requirement in IAS 32, *Financial Instruments: Presentation*, to separate a financial liability and equity component of a compound instrument. The measurement of certain financial guarantee contracts, loan commitments, and liabilities arising from failed derecognition is unaffected by the proposals.

³ IAS 1, *Presentation of Financial Statements*.

⁴ IFRS 7, *Financial Instruments: Disclosures*.

Under the IASB's ED, all recognized financial assets and financial liabilities that are currently within the scope of IAS 39 would be measured at either amortized cost or fair value.

(1) extensive disclosures about investments in equity instruments designated as at FVTOCI, including why an entity has chosen to designate these instruments as at FVTOCI; (2) the fair value of each investment at the end of the reporting period; and (3) details of investments sold during the reporting period.

Basic Loan Features

The ED introduces the concept of basic loan features as “contractual terms that give rise on specified dates to cash flows that are payments of principal and interest on the principal outstanding.” The IASB adapted this concept from a similar approach applied in its recently issued *IFRS for Small and Medium-sized Entities*. Examples of basic loan features include:

- A return to the holder that is (1) a fixed amount, (2) fixed over the instrument’s life, (3) variable over the instrument’s life because of changes in a single referenced quoted or observable interest rate, or (4) a combination of a fixed and variable return (e.g., LIBOR plus a fixed spread).
- Terms that limit the variability (e.g., caps and floors) or that permit the issuer to prepay or the holder to put the instrument, as long as the option to prepay or put is not contingent on future events⁵ and the amount that is prepaid substantially represents unpaid interest and principal.
- Terms in which the contractual cash flows of a financial instrument vary because of changes in the instrument’s credit quality. When a debt instrument’s claim against an entity is more subordinate than other claims, the entity must use care in assessing whether the instrument has basic loan features.

The ED notes that “if the issuer’s non-payment is a breach of contract and the holder has a contractual right to unpaid amounts of principal and interest even in the event of the issuer’s bankruptcy,” the instrument may have basic loan features. However, when the holder has an interest in an entity that involves multiple contractually subordinated interests (i.e., tranches), “[a]ny tranche that provides credit protection to other tranches in any situation does not have basic loan features.” In practice, this would mean that generally only the most senior tranche of an entity securitizing financial assets can be measured at amortized cost, while subordinated tranches would not qualify for such classification.

Managed on a Contractual Yield Basis

The ED introduces a new concept of managing on a contractual yield basis. This concept is derived from the entity’s business model and, therefore, is most likely to be determined at a business unit, not an individual financial instrument, level. The concept is based on whether key management personnel’s focus is on the cash flows generated from (or payable on) the instrument, rather than the cash flows that may be realized from sale of the asset (or used to repurchase the liability).

The ED acknowledges that an entity may have different business units that are managed differently. For example, an entity may have a retail banking business managed on a contractual yield basis and an investment banking business managed on another basis. In this case, financial instruments with basic loan features in the retail banking business would qualify for amortized cost measurement even if similar financial instruments in the investment banking business do not.

All instruments that would meet the existing definition of held for trading would continue to be measured at FVTPL since they are not managed on a contractual yield basis. The ED also notes that a financial asset acquired at a discount that reflects incurred credit losses cannot be deemed to be managed on a contractual yield basis.

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⁵ Terms that protect the lender from credit deterioration of the borrower in cases of defaults, credit downgrades, and loan covenant violations, as well as terms relating to possible future changes in taxation, law, and similar factors that protect the lender, are not considered contingent on future events.

The ED's impact will depend on what financial instruments an entity has, how it has classified them previously, and what choices it makes under the revised classification model.

Embedded Derivatives

The ED would eliminate the existing separation requirements for embedded derivatives in circumstances in which the host contract is within the scope of IAS 39 (i.e., a financial host). Instead, an entity would evaluate the entire hybrid financial instrument under the classification criteria to determine whether it should be measured in its entirety at fair value or at amortized cost. The separation requirements for non-closely-related embedded derivatives continue to apply to contracts outside the scope of IAS 39 (e.g., insurance contracts, lease contracts, and purchase and sale contracts).

Impact of ED's Revised Model

The ED will sometimes result in more, and sometimes fewer, fair value measurements for entities applying IFRSs. The ED's impact will depend on what financial instruments an entity has, how it has classified them previously, and what choices it makes under the revised classification model.

One of the most significant changes under the ED would be the ability to measure many investments in government and corporate bonds with basic loan features at amortized cost. Under IAS 39, these investments are often classified as available for sale and measured at fair value if they are quoted in an active market and the entity does not assert its intent and ability to hold the asset until maturity. Other instruments, such as investments in asset-backed securities (e.g., some cash-credit default obligations), which may have been measured entirely at amortized cost or at fair value as an available-for-sale asset, would more likely be measured at FVTPL since they may not contain basic loan features. Hybrid instruments with separated embedded derivatives (e.g., synthetic-credit default obligations) would usually be measured at FVTPL in their entirety.

Assets that are currently classified as held to maturity typically would continue to be measured at amortized cost because they often contain only basic loan features and are managed on a contractual yield basis. However, the current tainting rules that apply to held-to-maturity assets would be removed. Bank borrowings, issued debt, and trade receivables and payables would most likely continue to be measured at amortized cost; however, their classification could change depending on the terms of the instruments and whether the entity manages them on a contractual yield basis.

The elimination of the available-for-sale category and the requirement that all investments in equity instruments be measured at fair value effectively removes the multiple impairment methods under IAS 39. The ED would only require impairment assessment for financial assets measured at amortized cost. The rules on impairing amortized cost assets remain unchanged, but will be reconsidered in the IASB's impairment ED that is expected to be issued in the fourth quarter of 2009.

Upon adoption of this ED, an instrument that qualifies for amortized cost measurement may be classified as such. This would allow qualifying instruments that were designated as at FVTPL under the fair value option in IAS 39 to be reclassified to an amortized cost measure.

Effective Date and Transition

The effective date is not yet determined. However, the IASB's objective is to issue the new classification and measurement standard in the fourth quarter of 2009 to allow entities with a December 2009 year-end to early adopt. Entities would not be required to adopt the standard until at least January 2012.

Entities that choose to early adopt the ED would be required to disclose, in accordance with the ED's amendments to IFRS 7, a comparison of the classification and carrying amounts of financial instruments by class under the old and new standard.

The ED must be applied retrospectively. However, an entity must assess whether instruments are managed on a contractual yield basis as of the date of initial application. Also, designation as at FVTPL or FVTOCI, or de-designation of financial instruments that were previously designated as at FVTPL, is made on the basis of the facts and circumstances that existed as of the date of initial application.

The FASB's Tentative Approach⁶

Concurrently with the issuance of the IASB's ED, on July 15, 2009, the FASB began deliberations on its project to improve the accounting for financial instruments. The FASB will continue to deliberate various issues and expects to issue its own ED on classification and measurement (including impairment and hedge accounting) later this year.

Measurement Model

Departing from the IASB's ED measurement model, the FASB tentatively decided to require that all financial instruments be measured at fair value; entities would, however, be permitted to elect to record their own long-term debt at amortized cost if certain classification criteria are met. Changes in fair value of financial instruments would generally be recorded in earnings; however, changes in fair value of certain financial instruments would be recorded in other comprehensive income (OCI) if certain classification criteria are met.

Classification

The FASB agreed that the default classification for changes in fair value of financial instruments would be through earnings. However, if the following two criteria are met, an entity would be permitted to record changes in fair value through OCI (classification of financial instruments will be determined at inception and reclassifications would be prohibited):

- *Management intent/business model* — The financial instruments in a portfolio of financial instruments are predominantly held for collection or payment of the contractual cash flows, and it is more likely than not that management will not be required to sell or repurchase the instruments before their maturity. The FASB concluded that to apply this criterion, an entity would need to classify individual securities into portfolios and then assess management's intent for the portfolio.
- *Cash flow variability* — The financial instrument (1) has a stated maturity date, (2) cannot be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its initial investment, and (3) is not a derivative, a hybrid instrument containing an embedded derivative that requires bifurcation under ASC Topic 815 (formerly Statement 133⁷), or an equity security.

For financial instruments for which fair value changes are recognized in OCI, amortized cost would be displayed on the balance sheet along with the adjustment made in arriving at fair value. Further, the FASB agreed that (1) interest income and expense, (2) realized gains and losses, and (3) credit-related impairments would be recognized in earnings for financial instruments for which changes in fair value are recognized in OCI.

Fair Value Measurement Exception

Although all financial instruments within the scope of the project are measured at fair value, the FASB agreed to allow entities to elect to record at amortized cost their own long-term debt if (1) the two above classification criteria for measuring financial instruments at FVTOCI are met and (2) recording their own debt at amortized cost would address an accounting mismatch (e.g., the debt is used to fund nonfinancial assets measured at amortized cost). An entity may still elect to record its own debt at FVTOCI if the classification criteria are met. The Board requested the staff to conduct further research and define long-term debt at future meetings. Further, the FASB did not reach a decision regarding deposit liabilities and any financial instruments that potentially would be outside the scope of the new classification and measurement approach. The FASB expects to discuss the measurement model for deposit liabilities and scope issues at future meetings.

The FASB tentatively decided to require that all financial instruments be measured at fair value; entities would, however, be permitted to elect to record their own long-term debt at amortized cost if certain classification criteria are met.

⁶ The following summary of the FASB's approach is based on preliminary and unofficial notes taken by Deloitte observers at the FASB's Board meeting.

⁷ FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

Presentation of Comprehensive Income

The FASB tentatively agreed to amend ASC Topic 220 (formerly Statement 130) to require presentation of one statement of financial performance; the components of OCI would be displayed below the total for net income. Further, the FASB agreed not to require a separate earnings-per-share computation for comprehensive income.

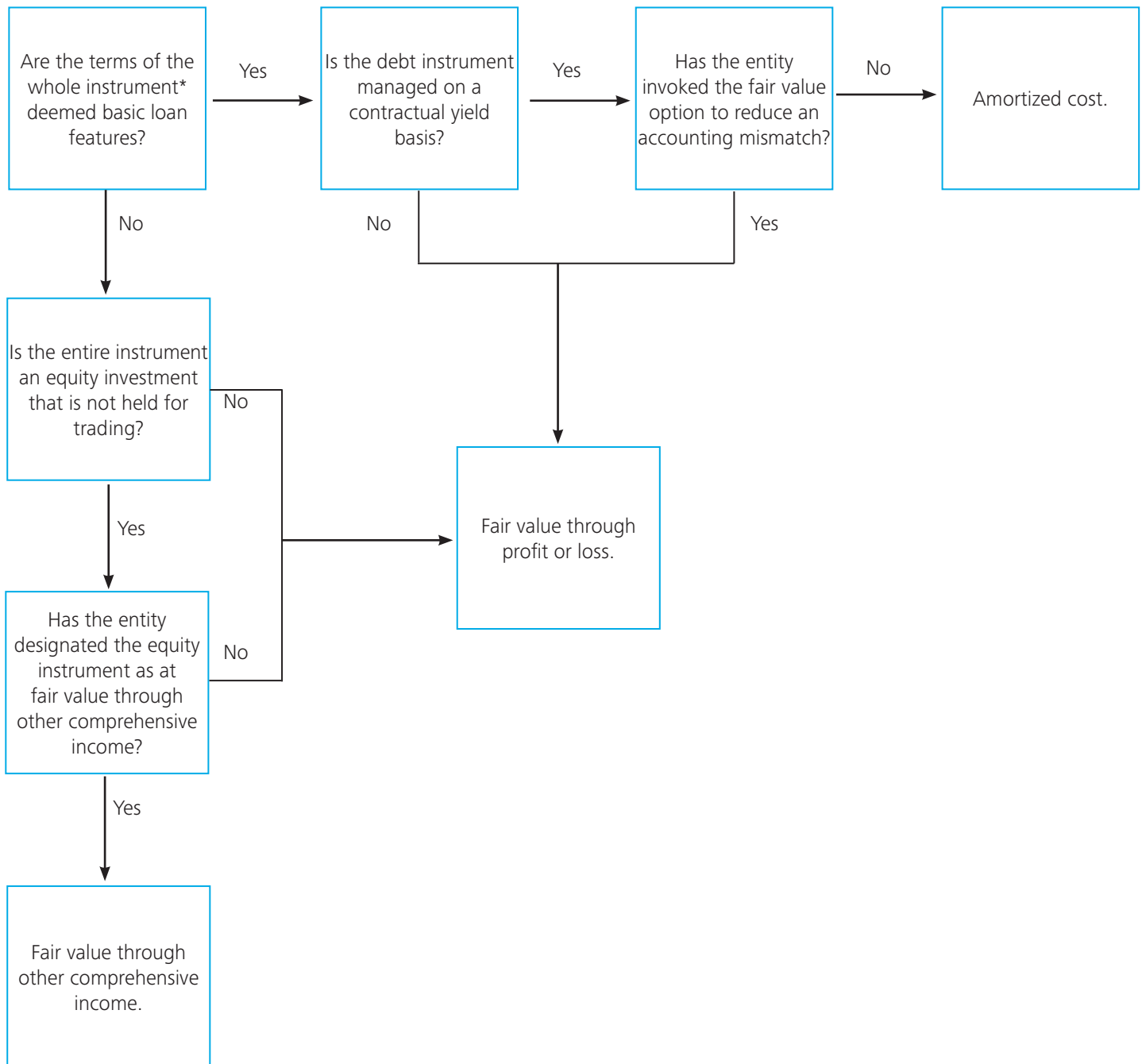
Other Issues

Although the FASB did not discuss impairment models, it did agree that only one impairment model should be required. The FASB instructed the staff to continue its research on (1) an expected loss model and (2) a measurement model for deposit liabilities, which will be discussed at future Board meetings. The FASB also plans to address scope, disclosure requirements, effective date, and transition requirements before issuing an ED.

⁸ FASB Statement No. 130, *Reporting Comprehensive Income*.

Appendix A

This flowchart illustrates the application of the financial instrument classification and measurement model in the IASB's ED.



* For a compound instrument for which the equity component is recognized in equity under IAS 32, the whole instrument for this purpose is the liability component.

Appendix B

The following table summarizes the similarities and differences between the IASB's ED and the FASB's tentative decisions reached at the July 15, 2009, Board meeting. Note that neither the IASB nor the FASB has made any final decisions and that the description of the FASB's tentative decisions is based on preliminary and unofficial notes taken by Deloitte observers of the FASB's deliberations.

Subject	IASB's Exposure Draft, July 2009	FASB's Tentative Decisions, July 2009
Categories of financial assets and financial liabilities	<p>Effectively, three categories:</p> <ol style="list-style-type: none"> 1. Fair value through profit or loss (FVTPL). 2. Amortized cost (two criteria). 3. Fair value through other comprehensive income (FVTOCI) (option for equities). <p>The available-for-sale, loans and receivables, and held-to-maturity categories in IAS 39 would be eliminated.</p>	<p>Effectively, three categories:</p> <ol style="list-style-type: none"> 1. FVTPL. 2. FVTOCI (two criteria). 3. Amortized cost (option for own debt). <p>All financial assets and financial liabilities would be measured at fair value on the balance sheet, with an optional exception for own long-term debt, which may be recorded at amortized cost if it meets certain criteria. For instruments designated as at FVTOCI, amortized cost will be displayed on the balance sheet in addition to the adjustment made in arriving at fair value.</p> <p>This would eliminate the available-for-sale and held-to-maturity categories in ASC Topic 320 (formerly Statement 115⁹) and the held-for-sale and held-for-investment categories of loans under ASC Topic 948 (formerly Statement 65¹⁰) and ASC Topic 310 (formerly SOP 01-6¹¹).</p>
Criteria for amortized cost measurement	<p>A financial asset or financial liability generally must be measured at amortized cost if it meets the following two criteria:</p> <ol style="list-style-type: none"> 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). 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). <p>There is an exception for items that qualify and are designated under the fair value option (see below).</p>	<p>An entity has the option to elect to carry its own long-term debt at amortized cost if it meets the criteria for financial instruments at FVTOCI and such designation addresses an accounting mismatch.</p>
Criteria for FVTOCI	<p>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.</p>	<p>A financial asset or financial liability is permitted to be measured at fair value, with changes in fair value recorded in OCI, if it meets the following two criteria:</p> <ol style="list-style-type: none"> 1. There is "no or little" cash flow variability (the financial instrument (1) has a stated maturity date, (2) cannot be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its initial investment, and (3) is not a derivative, a hybrid instrument containing embedded derivatives that requires bifurcation under ASC Topic 815 (formerly Statement 133), or an equity security). 2. Management intent/business model (the financial instruments in a portfolio of financial instruments are predominantly held for collection or payment of the contractual cash flows, and it is more likely than not that management will not be required to sell or repurchase the instruments before their maturity).
Recycling of accumulated OCI to net income	<p>No. Amounts in OCI are permanently deferred in equity.</p>	<p>Yes, amounts in accumulated OCI are recycled to net income upon realization or impairment.</p>

⁹ FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

¹⁰ FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*.

¹¹ AICPA Statement of Position 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*.

Subject	IASB's Exposure Draft, July 2009	FASB's Tentative Decisions, July 2009
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.	All measured at fair value. Unlike current U.S. GAAP, the FASB's tentative decisions do not allow an exception for nonmarketable equity securities.
Embedded derivatives in financial hybrid 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 fair value.	Hybrid financial contracts with an embedded derivative, which currently must be bifurcated under ASC Topic 815 (formerly Statement 133), would instead be measured at fair value in their entirety.
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.	This will depend on what the FASB concludes in its deliberations on Implementation Issue C22. ¹² If an embedded credit feature would have been subject to bifurcation under ASC Topic 815 (formerly Statement 133), the hybrid instrument would be recorded at fair value through net income. If, however, the instrument would not meet the criteria for bifurcation, the hybrid instrument may be at FVTOCI.
Fair value option	Retained when a fair value designation eliminates an accounting mismatch.	No explicit fair value option.
Reclassification	Not permitted.	Not permitted.

¹² Proposed Statement 133 Implementation Issue No. C22, "Scope Exceptions: Exception Related to Embedded Credit Derivatives."

Appendix C

The table below summarizes the likely classification and measurement of some common financial instruments in accordance with the IASB's ED and the FASB's tentative decisions. Classification and measurement for a particular instrument will depend on specific facts and circumstances. In addition, note that neither the IASB nor the FASB has made any final decisions and that the description of the FASB's tentative decisions is based on preliminary and unofficial notes taken by Deloitte observers at the FASB's Board meeting.

Instrument	IASB's ED	FASB's Tentative Decision
Derivatives not in a qualifying hedge accounting relationship and derivatives in a qualifying fair value hedge accounting relationship	FVTPL	FVTPL
Derivatives in a qualifying cash flow or net investment hedging relationship (effective portion)	FVTOCI with reclassification to income (hedge accounting to be discussed in a later phase of the project)	FVTOCI with reclassification to income (hedge accounting to be discussed in a later phase of the project)
Financial instruments held for trading	FVTPL	FVTPL
Marketable equity securities not held for trading	FVTPL (default category) or FVTOCI (option) without reclassification to income	FVTPL
Nonmarketable equity securities not held for trading	FVTPL (default category) or FVTOCI (option) without reclassification to income	FVTPL
Loan receivables (not held for sale, not subject to fair value option)	Amortized cost	FVTPL or FVTOCI (option) with reclassification to income
Debt instruments managed on a fair value basis	FVTPL	FVTPL
Investments in debt securities (not structured, not held for trading, not held for sale, not subject to fair value option)	Amortized cost	FVTPL or FVTOCI (option) with reclassification to income
Issued debt instruments (not structured, not subject to fair value option)	Amortized cost	FVTPL, FVTOCI (option) with reclassification to income or amortized cost (option)
Structured notes	FVTPL	FVTPL
Investments in convertible debt	FVTPL	FVTPL

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