

## Heads Up

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## PCAOB Approves Auditing Standard on Communications With Audit Committees

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On August 15, 2012, the PCAOB approved [AS 16](#),<sup>1</sup> which would supersede PCAOB AU Sections 310<sup>2</sup> and 380.<sup>3</sup> If approved by the SEC, AS 16 will be effective for audits of fiscal years beginning on or after December 15, 2012.

AS 16 is the result of modifications made to a proposal originally issued by the PCAOB on March 29, 2010, and [reproposed](#) on December 20, 2011. The revisions to the original proposal were based on feedback in comment letters and at a roundtable session held in September 2011.

The PCAOB's primary objectives in issuing a new standard on audit committee communications are to (1) enhance communications between auditors and audit committees and (2) improve audits by fostering constructive dialogue between the auditor and the audit committee.

This *Heads Up* gives an overview of AS 16 and highlights the significant ways it differs from current standards and from the December 2011 reproposal. For additional information on the original proposal and the reproposal, see Deloitte's [April 19, 2010](#), and [February 10, 2012](#), *Heads Up* newsletters.

### Themes Related to the New Communication Requirements

Overall, the PCAOB seeks to improve auditors' communications with audit committees by expanding on and adding to existing required communications, including those related to significant accounting policies and practices, significant unusual transactions, and the auditor's evaluation of the quality of the company's financial reporting. AS 16 carries forward substantially all of the communication requirements of current standards and, in certain circumstances, requires auditors to provide additional communications. The table in the [appendix](#) of this *Heads Up* lists the communications required under AS 16 as well as communications required by other PCAOB standards and rules, and identifies communications that are new or expanded (relative to current requirements). Note that although many auditors already communicate with audit committees about some or all of the matters that are the subject of new or expanded requirements, they may not necessarily be doing so consistently throughout the profession.

<sup>1</sup> PCAOB Release No. 2012-004, *Auditing Standard No. 16, Communications With Audit Committees*.

<sup>2</sup> PCAOB AU Section 310, *Appointment of the Independent Auditor*.

<sup>3</sup> PCAOB AU Section 380, *Communication With Audit Committees*.

The PCAOB made minor modifications to the reposed standard before approving it.

The PCAOB made minor modifications to the reposed standard before approving it, including the following:

- Modifying the language describing the required communications for going-concern matters.
- Removing the text that referred to communicating with the “full” audit committee before the release of the auditor’s report to give auditors flexibility in communicating with the audit committee when a quorum is present.
- Clarifying that if management communicates matters regarding significant unusual transactions to the audit committee, the auditor is not required to repeat such information if certain requirements are met (see discussion below).

AS 16 does not prescribe required communications in connection with PCAOB inspection findings. However, on August 1, 2012, the PCAOB issued Release 2012-003<sup>4</sup> to inform audit committees of public companies about the PCAOB inspections process and to help such committees engage in discussions with PCAOB-registered audit firms about the results of inspections. For additional information about Release 2012-003, see Deloitte’s August 30, 2012, *Heads Up*.

## Overview of AS 16

AS 16 states that the objectives of the auditor are to:

- a. Communicate to the audit committee the responsibilities of the auditor in relation to the audit and establish an understanding of the terms of the audit engagement with the audit committee;
- b. Obtain information from the audit committee relevant to the audit;
- c. Communicate to the audit committee an overview of the overall audit strategy and timing of the audit; and
- d. Provide the audit committee with timely observations arising from the audit that are significant to the financial reporting process.

Requirements under AS 16 that would fulfill these objectives are outlined in the standard and discussed below.

**Editor’s Note:** These objectives are unchanged from the reproposal. Although the objectives are consistent with concepts under existing PCAOB standards, such standards do not contain explicit auditor objectives.

## Appointment and Retention

### *Significant Issues Discussed With Management*

AS 16 reiterates the existing requirement for auditors to communicate to the audit committee any significant issues discussed with management in connection with the auditor’s initial appointment or retention.

**Editor’s Note:** This provision is substantively unchanged from current requirements and from the reproposal.

### *Establishing an Understanding of the Terms of the Audit*

Under AS 16, the auditor should establish annually an understanding of the terms of the engagement. The auditor is required to achieve this by recording such understanding in a written engagement letter and providing such engagement letter to the appropriate party or parties (as identified by the company) each year. Among other things, the letter should describe the objective of an audit, the auditor’s responsibilities, and the responsibilities of management. If the appropriate party is neither the audit committee nor its chair, the auditor should determine that the audit committee acknowledges and agrees to the terms of the engagement. This acknowledgment need not be in writing.

<sup>4</sup> PCAOB Release No. 2012-003, *Information for Audit Committees About the PCAOB Inspection Process*.

AS 16 requires the auditor to ask the audit committee whether it is aware of matters relevant to the audit, including but not limited to knowledge of violations or possible violations of laws.

**Editor’s Note:** Current PCAOB auditing standards for public companies were written before the Sarbanes-Oxley Act of 2002; therefore, they do not specifically require that an understanding of the terms of an engagement be reached with the audit committee nor do they require documentation of the terms of the engagement in an annual engagement letter. However, it is common practice for auditors to use written engagement letters and to execute such letters with audit committees; accordingly, this provision of AS 16 substantively retains current practice. However, under AS 16 the auditor is now specifically required to establish annually a mutual understanding with the appropriate party or parties and, if the appropriate party is not the audit committee, to determine that the audit committee acknowledges and agrees to the terms of the engagement.

## Obtaining Information and Communicating the Audit Strategy

### *Obtaining Information Relevant to the Audit*

AS 16 requires the auditor to ask the audit committee whether it is aware of matters relevant to the audit, including but not limited to knowledge of violations or possible violations of laws. This aspect of AS 16 complements requirements in AS 12<sup>5</sup> to inquire of the audit committee regarding risks of material misstatement, including fraud risks (e.g., tips or complaints regarding the company’s financial reporting received through the audit committee’s internal whistleblower program).<sup>6</sup>

**Editor’s Note:** AS 16 slightly modified the reproposal’s language regarding audit committee inquiries about “knowledge of violations or possible violations of laws or regulations” to no longer refer to “complaints or concerns received by the audit committee regarding financial reporting matters” because the requirement for such inquiries by the auditor was already in AS 12. Although discussions regarding violations of laws or regulations already typically take place between auditors and audit committees, such discussions are not specifically required under existing standards.

### *Overview of the Audit Strategy, Timing of the Audit, and Significant Risks*

Under AS 16, the auditor should summarize for the audit committee the overall audit strategy. Such summary should include a discussion of the timing of the audit and of the significant risks identified during the auditor’s risk assessment procedures. The summary should also specify:

- The nature and extent of specialized skill or knowledge needed in the performance of the planned procedures and evaluation of the results.
- The consideration and planned use by the auditor of the work of internal auditors and similar persons.
- The names, roles, responsibilities, locations, and scope of work of the firms participating in the audit (includes firms that perform audit procedures in the current-period audit regardless of whether they otherwise have any relationship with the auditor).
- The basis for the auditor’s determination that he or she can serve as the principal auditor if significant parts of the audit will be performed by other auditors.

In addition, AS 16 requires the auditor to timely communicate to the audit committee significant audit strategy changes or changes to the significant risks.

<sup>5</sup> PCAOB Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

<sup>6</sup> See paragraphs 54–56 of AS 12.

**Editor’s Note:** This provision is substantively unchanged from the reproposal. Although these types of discussions already typically take place, they are not specifically required under existing standards.

## Results of the Audit

AS 16 substantively carries forward existing auditor communication requirements regarding:

- The “initial selection of, or changes in, significant accounting policies or the application of such policies.”
- “The [methods] management used to account for significant unusual transactions.”
- “The effect on financial statements or disclosures of significant accounting policies.”

AS 16 also creates new requirements, which are discussed below.

### *Significant Accounting Policies and Practices*

AS 16 differentiates between “significant” accounting policies and practices and “critical” accounting policies and practices (as did the reproposal) and includes separate communication requirements for each category. As used in AS 16, the term “significant accounting policies” aligns with the FASB’s and IASB’s definitions<sup>7</sup> and is consistent with the definition in PCAOB AU Section 380 (which, as noted above, would be superseded by AS 16).

AS 16 carries forward existing requirements to communicate to the audit committee about the following:

- Management’s initial selection of, or changes in, significant accounting policies or the application of such policies in the current period; and
- The effect on financial statements or disclosures of significant accounting policies in (i) controversial areas or (ii) areas for which there is a lack of authoritative guidance or consensus, or diversity in practice.

### *Critical Accounting Policies and Practices*

The definition of the term “critical accounting policies and practices” in AS 16 is based on the SEC’s definition<sup>8</sup> and states that critical accounting policies and practices are those “that are both most important to the portrayal of the company’s financial [position] and require management’s most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effects of matters that are inherently uncertain.” As discussed in the release accompanying AS 16, the “selection of significant accounting policies and practices involves a broader range of [matters] over time, while the selection of critical accounting policies and practices is tailored to specific events in the current year.”<sup>9</sup> Thus, critical accounting policies and practices would be a subset of significant accounting policies and practices.

The requirements under AS 16 related to critical accounting policies and practices are consistent with those in SEC Regulation S-X, Rule 2-07,<sup>10</sup> that state that the auditor should communicate all critical accounting policies and practices directly to the audit committee.

In addition, AS 16 outlines new communication requirements related to the following:

- The “reasons certain policies and practices are considered critical.”
- “How current and anticipated future events might affect the determination of [what is] considered critical.”

<sup>7</sup> See FASB Accounting Standards Codification Topic 235, *Notes to Financial Statements*, and IAS 1, *Presentation of Financial Statements*.

<sup>8</sup> See SEC Final Rule Release 33-8183, *Strengthening the Commission’s Requirements Regarding Auditor Independence*.

<sup>9</sup> See PCAOB Release 2012-004, page A4-17.

<sup>10</sup> SEC Regulation S-X, Rule 2-07, “Communication With Audit Committees.”

AS 16 differentiates between “significant” accounting policies and practices and “critical” accounting policies and practices (as did the reproposal) and includes separate communication requirements for each category.

AS 16 requires the auditor to communicate its understanding of the business rationale for significant unusual transactions as part of its communications about the quality of financial reporting.

### ***Critical Accounting Estimates***

The definition of “critical accounting estimate” in AS 16 is aligned with the SEC’s definition<sup>11</sup> and states that such an estimate is one in which “(a) the nature of the estimate is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change and (b) the impact of the estimate on financial condition or operating performance is material.”

AS 16 carries forward the existing requirements for auditors to communicate to the audit committee:

- “A description of the process management used to develop critical accounting estimates.”
- The “significant assumptions used in [such] estimates that have a high degree of subjectivity.”
- “The basis for the auditor’s conclusions regarding the reasonableness of the critical accounting estimates.”

AS 16 also outlines new communication requirements related to the following:

- Any “significant changes management made to the processes used to develop critical accounting estimates, . . . management’s reasons for the changes, and the effects of the changes on the financial statements.”

### ***Significant Unusual Transactions***

AS 16 requires auditors to communicate to the audit committee:

- “[S]ignificant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature.”
- The “policies and practices management used to account for significant unusual transactions.”

In addition, AS 16 requires the auditor to communicate its understanding of the business rationale for such transactions as part of its communications about the quality of financial reporting (see discussion below).

**Editor’s Note:** PCAOB AU Section 380 contains a provision under which an auditor is required to determine that the audit committee is informed about the methods used to account for significant unusual transactions. As a result of AS 16, the auditor would also be required to communicate about additional aspects of such significant unusual transactions (including the auditor’s understanding of the business rationale for them) and not just the company’s methods of accounting for them.

### ***Consideration of Management Communications***

AS 16 includes a caveat that if management communicates to the audit committee about (1) significant accounting policies and practices, (2) critical accounting policies and practices, (3) critical accounting estimates, or (4) significant unusual transactions, the auditor does not need to use the same level of detail to communicate the same matters as long as the auditor:

- “[P]articipated in management’s discussion with the audit committee.”
- “[A]ffirmatively confirmed to the audit committee that management has adequately communicated [the required] matters.”
- “[I]dentified for the audit committee those accounting policies and practices that the auditor considers critical.”

<sup>11</sup> See SEC Interpretation 33-8350, *Commission Guidance Regarding Management’s Discussion and Analysis of Financial Condition and Results of Operations*.

With the exception of communications about uncorrected and corrected misstatements, which are discussed below, this caveat does not apply to the other required communications under AS 16.

**Editor’s Note:** The PCAOB modified the reproposal to incorporate significant unusual transactions among items that may be discussed by management with the audit committee. Accordingly, if the auditor meets the above requirements, communications to the audit committee by the auditor about such matters do not need to be as detailed as they might need to be for other matters.

### ***Auditor’s Evaluation of the Quality of Financial Reporting***

Current standards require that the auditor’s evaluation of the quality of the company’s financial reporting be communicated to the audit committee. AS 16 expands on these requirements, including requiring the auditor to communicate:

- “The results of the auditor’s evaluation of, and conclusions about, the qualitative aspects of the company’s significant accounting policies and practices, including situations in which the auditor identified bias in management’s judgments about the amounts and disclosures in the financial statements.”
- “The results of the auditor’s evaluation of the differences between (i) estimates best supported by the audit evidence and (ii) estimates included in the financial statements which are individually reasonable, that indicate a possible bias on the part of the company’s management.”
- “The auditor’s assessment of management’s disclosures related to the critical accounting policies and practices, along with any significant modifications to the disclosures . . . proposed by the auditor that management did not make.”
- “The basis for the auditor’s conclusions regarding the reasonableness of the critical accounting [policies].”
- “The auditor’s understanding of the business rationale for significant unusual transactions.”
- The “auditor’s evaluation of whether the presentation of the financial statements and the related disclosures are in conformity with the applicable financial reporting framework including the auditor’s consideration of the form, arrangement, and content of the financial statements.”
- “Situations in which the auditor identified a concern regarding management’s anticipated application of accounting pronouncements that have been issued but are not yet effective and might have a significant effect on future financial reporting.”

In addition, AS 16 carries forward communication requirements (contained in SEC Regulation S-X, Rule 2-07) regarding “[a]lternative accounting treatments . . . for policies and practices related to material items that have been discussed with management.”

**Editor’s Note:** We believe that some of the above provisions are similar to and appear to replace current audit committee communication requirements regarding the auditor’s judgments about the quality, and not just the acceptability, of the company’s accounting principles. The provisions are substantively unchanged from the reproposal.

Current standards require that the auditor’s evaluation of the quality of the company’s financial reporting be communicated to the audit committee. AS 16 expands on these requirements.

AS 16 modified the language in the reproposal so that the auditor's threshold for communication to the audit committee is when the auditor "believes there is substantial doubt about the company's ability to continue as a going concern."

## Difficult or Contentious Matters About Which the Auditor Consulted

AS 16 contains new communication requirements related to "matters that are difficult or contentious for which the auditor consulted outside the engagement team [and] that the auditor reasonably determined are relevant to the audit committee's oversight." (Note that the original proposal contained an exception regarding consultations with the engagement quality reviewer; AS 16 does not retain this exception.)

**Editor's Note:** This provision is not currently required under PCAOB standards and is unchanged from the reproposal.

## Management's Consultation With Other Accountants About Significant Matters

AS 16 carries forward the current requirement to communicate management's consultations with other accountants about significant auditing or accounting matters, including the auditor's views about such matters; however, unlike the current standard, the approved standard states that such communications should only be related to those matters about which the auditor has identified a concern.

**Editor's Note:** This provision is unchanged from the reproposal.

## Going-Concern Matters

Although auditors typically communicate going-concern matters to the audit committee when applicable, they are not required to do so under current PCAOB standards. AS 16 requires the auditor to communicate the following:

- a. If the auditor believes there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time, the conditions and events that the auditor identified that, when considered in the aggregate, indicate that there is substantial doubt;
- b. If the auditor concludes, after consideration of management's plans, that substantial doubt about the company's ability to continue as a going concern is alleviated, the basis for the auditor's conclusion, including elements the auditor identified within management's plans that are significant to overcoming the adverse effects of the conditions and events;
- c. If the auditor concludes, after consideration of management's plans, that substantial doubt about the company's ability to continue as a going concern for a reasonable period of time remains:
  - (1) The effects, if any, on the financial statements and the adequacy of the related disclosure; and
  - (2) The effects on the auditor's report. [Footnotes omitted]

**Editor's Note:** AS 16 modified the language in the reproposal so that the auditor's threshold for communication to the audit committee is when the auditor "believes there **is substantial doubt** about the company's ability to continue as a going concern" (emphasis added). The reproposal required communications when there are "conditions and events the auditor identified that, when considered in the aggregate, indicate there **could be substantial doubt** about the company's ability to continue as a going concern for a reasonable period of time." The PCAOB modified this language so that it is more consistent with the remainder of the language in paragraph 17 of AS 16.

The FASB has on its agenda a related project on the liquidation basis of accounting and going concern (formerly, its project on disclosures about risks and uncertainties). See Deloitte's July 5, 2012, [Heads Up](#) for additional information about the project.

AS 16 requires the auditor to inform the audit committee if the auditor expects to modify an opinion or add an explanatory paragraph in the auditor's report and, if so, to explain the reasons why.

### ***Uncorrected and Corrected Misstatements***

AS 16 reiterates the existing requirements for auditors to communicate corrected and uncorrected misstatements to the audit committee, emphasizing that auditors should include misstatements related to disclosures when communicating misstatements. In addition, it requires the auditor to:

- “[D]iscuss with the audit committee, or determine that management has adequately discussed with the audit committee, the basis for the determination that the uncorrected misstatements [are] immaterial, including the qualitative factors considered.”
- “[C]ommunicate that uncorrected misstatements or matters underlying those uncorrected misstatements could potentially cause future-period financial statements to be materially misstated.”

**Editor’s Note:** This provision of AS 16 and the discussion in the accompanying release clarify that such misstatements refer only to those identified in the audit process.<sup>12</sup> This provision is substantively unchanged from the reproposal.

### **Material Written Communications**

The reproposal carries forward communication requirements (contained in SEC Regulation S-X, Rule 2-07) regarding “material written communications between the auditor and management.”

**Editor’s Note:** This provision is unchanged from the reproposal.

### ***Departure From the Auditor’s Standard Report***

AS 16 requires the auditor to inform the audit committee if the auditor expects to modify an opinion or add an explanatory paragraph in the auditor’s report and, if so, to explain the reasons why.

**Editor’s Note:** This provision is unchanged from the reproposal. Although current standards do not contain a similar requirement, it is common practice for such discussions to take place between the auditor and the audit committee in the circumstances described in this requirement.

### ***Other Information, Disagreements With Management, and Difficulties Encountered in the Audit***

AS 16 includes communication requirements, largely taken from existing standards and rules, that address the auditor’s responsibility in connection with information in documents containing audited financial statements, disagreements with management, and difficulties encountered in performing the audit.

**Editor’s Note:** The provisions of AS 16 related to these requirements are substantively unchanged from the reproposal.

### ***Other Matters***

Under AS 16, the auditor should communicate matters that have arisen during the audit that are significant to the oversight of the financial reporting process. Such matters include situations in which the auditor is aware of concerns having been raised about auditing or accounting and the results of the auditor’s procedures regarding such concerns.

**Editor’s Note:** This provision is substantively unchanged from the reproposal and is consistent with current practice.

<sup>12</sup> See PCAOB Release 2012-004, page A4-38.



AS 16 specifies that all required communications should take place before the issuance of the auditor's report.

## Form and Documentation of Communications

AS 16 allows the auditor to communicate to the audit committee, either orally or in writing, unless a written communication is required by the standard (e.g., the terms of engagement are required to be documented in an engagement letter and the auditor is required to provide the audit committee with "a schedule of uncorrected misstatements"). In practice, auditors often use various forms of a written document (e.g., a letter or slide presentation) to communicate matters to the audit committee. Regardless of whether the auditor communicates in writing or orally, the auditor is specifically required to document such communications in the workpapers and to indicate whether they were oral or written.

Under existing standards, any written communication is restricted to the use of the audit committee, the board of directors, or management. AS 16 does not contain this requirement explicitly, although, in accordance with the PCAOB's standards,<sup>13</sup> auditors may continue to restrict the use of written communications by specifying the intended users.

**Editor's Note:** This provision is substantively unchanged from the reproposal.

## Timing of Communications

Currently, communications with audit committees are not specifically required to occur before the date of the auditor's report, or before the issuance of the auditor's report, although in practice they typically take place before the report is issued and before the related filing of the annual financial statements. The PCAOB has explained its view that communications are considered an integral part of the audit and not incidental to the process. AS 16 therefore specifically requires the communications to be made in a timely manner, stating that the "appropriate timing of a particular communication to the audit committee depends on factors such as the significance of the matters to be communicated and corrective or follow-up action needed, unless other timing requirements are specified by PCAOB rules or standards or the securities laws." This language allows the auditor to determine when to make the required communications. AS 16 also specifies that all required communications should take place before the issuance of the auditor's report. For practical purposes, certain matters (e.g., those related to overall audit strategy and timing of the audit) are likely to be communicated much earlier in the process.

**Editor's Note:** The PCAOB modified the reproposal to remove the reference to the "full" audit committee to allow the auditor to communicate to the audit committee when a quorum is present.

## Application of AS 16 to Audits of Broker-Dealers

AS 16 is intended to apply to all audits of broker-dealers once such broker-dealer audits are required to be performed under PCAOB standards. The Dodd-Frank Wall Street Reform and Consumer Protection Act gave the PCAOB authority to oversee the audits of broker-dealers registered with the SEC. The SEC has stated in [interpretive guidance](#) that for transitional purposes, auditors should continue to conduct audits of broker-dealers in accordance with the standards of the AICPA until it reconsiders its rules related to such audits.

Currently, although AICPA standards on audit committee communications apply to audits of broker-dealers, the PCAOB's interim standard on audit committee communications, PCAOB AU Section 380, does not apply to audits of broker-dealers that do not have an audit committee.

<sup>13</sup> See paragraphs .07-.11 of PCAOB AU Section 532, *Restricting the Use of an Auditor's Report*.

Thus, if the SEC updates its rules to make PCAOB standards applicable to audits of broker-dealers before the SEC approves AS 16, there could be a timing gap in PCAOB requirements for audit committee communications in connection with audits of broker-dealers. Accordingly, the PCAOB has adopted a transitional amendment that would make the communication requirements in PCAOB AU Section 380 applicable to audits of broker-dealers (once the SEC approves rules that make PCAOB standards applicable to audits of broker-dealers) until AS 16 is approved by the SEC and is effective.

## **Next Steps**

PCAOB standards are not effective until the SEC approves them. As part of its approval process, the SEC has issued AS 16 for additional public comments. We encourage audit committees to study AS 16 and to submit comments to the SEC if they believe there are concerns the SEC should address during its review of the standard. Comments should be sent by October 8, 2012, to the Office of the Secretary, SEC, 100 F Street, NE, Washington, DC 20549-1090.

## Appendix

The table below (1) lists the communications to audit committees required by (a) the approved standard and (b) other PCAOB standards and rules and (2) indicates whether communications required by the approved standard are new requirements or expand on current requirements.

Communications Required by AS 16	New or Expanded Requirement
Significant issues discussed with management before the auditor's appointment or retention.	
Establishing an understanding of the terms of the audit.	Expanded requirement
Obtaining information relevant to the audit.	Expanded requirement
Overview of the audit strategy, timing of the audit, and significant risks.	New requirement
Results of the audit including: Significant accounting policies and practices. Critical accounting policies and practices. Critical accounting estimates. Significant unusual transactions.	Expanded requirement
Auditor's evaluation of the quality of the company's financial reporting.	Expanded requirement
Other information in documents containing audited financial statements.	
Difficult or contentious matters about which the auditor consulted.	New requirement
Management consultations with other accountants.	
Going-concern matters.	New requirement
Uncorrected and corrected misstatements.	
Material written communications.	
Departure from the auditor's standard report.	New requirement
Disagreements with management.	
Difficulties encountered in performing the audit.	
Other matters.	New requirement
Communications Required by Other PCAOB Standards or Rules	
Material weaknesses and significant deficiencies in internal control.	
Representations of management.	
Fraud and illegal acts.	
Communications in connection with interim reviews.	
Preapproval of services.	
Independence matters.	

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