



## In This Issue

- [Background](#)
- [What Is Double Materiality?](#)
- [The Double Materiality Assessment](#)
- [Interplay With the SEC Climate Rule and International Sustainability Standards Board Standards](#)
- [Contacts](#)

# #DeloitteESGNow — Unpacking the Double Materiality Assessment Under the E.U. Corporate Sustainability Reporting Directive

## Background

On July 31, 2023, the European Commission adopted a delegated regulation on the [European Sustainability Reporting Standards](#) (ESRS or “the standards”), which detail the requirements for companies within the scope of the [E.U. Corporate Sustainability Reporting Directive \(EU\) 2022/2464](#) (CSRD or “the directive”).<sup>1</sup>

The CSRD and ESRS introduce a “double materiality” concept that consists of impact materiality and financial materiality; assessing double materiality is a critical step in entities’ determination of the disclosures required for sustainability reporting. To assess materiality under the CSRD, entities identify information about material impacts, risks, and opportunities (IROs) related to their business activities and relevant sustainability matters. This publication discusses possible approaches to performing a double materiality assessment under the CSRD and various factors that entities may want to consider.<sup>2</sup> For further information, see Deloitte’s August 17, 2023 (updated February 23, 2024), [Heads Up](#) on the application of the CSRD to companies based in the United States.

<sup>1</sup> “Directive (EU) 2022/2464 of the European Parliament and of the Council.”

<sup>2</sup> For additional considerations, see the European Financial Reporting Advisory Group (EFRAG) publication [IG 1: Materiality Assessment Implementation Guidance](#), which discusses one possible approach to performing the double materiality assessment and includes examples of IROs arising from sustainability matters.

## What Is Double Materiality?

The CSRD explains that entities should disclose information that is material from either an impact perspective or a financial perspective, or from both perspectives. The directive establishes the “double materiality” terminology to describe this concept, and the ESRS expand and clarify the approach and required disclosures.

Sustainability matters that are material from an impact or financial perspective, or both, have associated material IROs. [ESRS 1](#) describes these terms as follows:

- *Impacts* — “[P]ositive and negative sustainability-related impacts that are connected with the undertaking’s business, as identified through an **impact materiality** assessment” (paragraph 14(a)).
- *Risks and opportunities* — An “undertaking’s sustainability-related financial risks and opportunities, including those deriving from dependencies on natural, human and social resources, as identified through a **financial materiality** assessment” (paragraph 14(b)).

## The Double Materiality Assessment

There are four general steps that an entity may consider when developing its double materiality assessment process and related internal controls. While the ESRS include certain elements that are required within the double materiality assessment, the guidance does not prescribe exactly how the assessment should be conducted. Therefore, judgment is required to design a process that (1) is in compliance with the standards and (2) reflects the entity’s specific facts and circumstances. Furthermore, an entity should consider how its double materiality assessment process may be affected by both the [IG 1: Materiality Assessment Implementation Guidance](#) and forthcoming implementation guidance related to the ESRS.<sup>3</sup>

An entity may consider the following steps in its double materiality assessment process:

- *Step 1* — Identify business activities, including those in the value chain.<sup>4</sup>
- *Step 2* — Identify IROs.
- *Step 3* — Determine which IROs are material.
- *Step 4* — Conclude and prepare documentation.

### Step 1 — Identify Business Activities, Including Those in the Value Chain

An entity may find it helpful to first identify the nature and extent of its business activities and operations, including those in its value chain, related to sustainability matters. The scope of this analysis should align with the ESRS reporting level at which the entity has determined it should report (e.g., subsidiary level or parent company level). To capture all of an entity’s activities that may be related to a sustainability topic (including activities of the entity’s value chain partners), the entity may consider the following factors:

- Information included on the entity’s Web site or other external materials.
- The entity’s legal and regulatory environment.
- Media reports and publications about the entity and its industry.
- Peer reports and sector-specific benchmarks.
- Publications on sustainability trends and scientific findings.

<sup>3</sup> See the Web sites of [EFRAG](#) and the [European Commission](#) for information on the additional guidance that is expected to be released.

<sup>4</sup> ESRS Annex II defines value chain, in part, as “the full range of activities, resources and relationships related to the undertaking’s business model and the external environment in which it operates.” For further information, see the EFRAG publication [IG 2: Value Chain Implementation Guidance](#).

By using the information gathered, the entity can identify its own business activities — including upstream and downstream value chain activities and the related dependencies, resources, business relationships, geographical footprint, and affected stakeholders.

**Upon completion of step 1, entities should have an inventory of all activities to be included in the double materiality assessment.**

## Step 2 — Identify IROs

The process of identifying IROs may be challenging, and it is likely to involve activities such as those discussed below.

### *Engaging Stakeholders*

Soliciting balanced and meaningful feedback from both internal and external stakeholders is a critical part of the double materiality assessment. While engagement with affected stakeholders or their representatives is central to the process of identifying IROs, the method of engagement can vary with respect to both the timing and manner of engagement. For instance, an entity may obtain information from external stakeholders before assessing double materiality to guide its identification of IROs or it may obtain information after the assessment to corroborate the results, or both. With regard to the manner of engagement, the entity may obtain feedback in different ways, including through proxy conversations, surveys, or interviews.

**While included in step 2 for illustrative purposes, engagement with affected stakeholders should not be a one-time activity but rather a part of an entity's ongoing due diligence process.**

### *Identifying Sustainability Matters*

ESRS 1, AR<sup>5</sup> 16, provides a list of sustainability matters that may be relevant in the context of an entity's business activities and value chain. However, while the list of topics in AR 16 provides the starting point for this analysis, sector-specific and entity-specific matters must also be considered. Additional considerations that may inform this part of the process could include (1) matters reported by the entity's peers or competitors, (2) matters raised by financial analysts, (3) relevant regulations or sector standards (e.g., Sustainability Accounting Standards Board [SASB], Global Reporting Initiative [GRI]), (4) matters that are prevalent in the industry, (5) previously or voluntarily reported information, or (6) other matters identified in the entity's ongoing due diligence process.

#### **Example 1**

Entity Z is a distributor of furniture and uses its fleet of diesel-engine trucks to deliver inventory to retailers. In addition to assessing the list of matters in ESRS 1, AR 16, Z determines whether there are any sector-specific or entity-specific matters that are not included in the list. As one example, Z evaluates the regulations that it is subject to and identifies vehicle maintenance standards and driving standards as potentially relevant matters because they are related to the well-being of both the employee drivers and other drivers on the roadways.

Note that the discussion in this example is for illustrative purposes only and therefore is limited to specific items and does not contemplate all potentially relevant matters.

<sup>5</sup> "AR" refers to the "Application Requirements" section in ESRS 1, Appendix A.

## Determining Which Sustainability Matters Are Relevant

Once an entity has identified all (1) the “topics, sub-topics and sub-sub-topics (collectively ‘**sustainability matters**’)” from the list in ESRS 1, AR 16, and (2) the sector-specific and entity-specific sustainability matters that it believes *could* be relevant as described in the previous section, it determines which of those matters *are* relevant and refines the list to include only such matters. To do so, the entity may consider the following questions about each sustainability matter:

- Is the matter regulated, or is disclosure of the matter required by a regulatory body?
- Is disclosure of the matter required by relevant industry SASB standards or GRI sector standards?
- Was the matter identified in a previous double materiality assessment?
- Has the matter been identified in any research conducted (by ESG analysts, peers, etc.)?
- Is the matter related to the entity’s (1) business activities or relationships or (2) value chain dependencies or resources, or is it in the financial, regulatory, geopolitical, or regulatory environments in which the entity operates?

Note that an entity is required to consider the list of sustainability matters in ESRS 1, AR 16, as well as sector-specific and entity-specific matters, and to then identify the material IROs. We expect that, in practice, this will be an iterative process. Therefore, in step 2, an entity may identify the sustainability matters that are relevant to its business and value chain and may later determine whether the specific sustainability matter is material on the basis of the materiality determination of the associated IROs identified (see [step 3](#)). In addition, an entity may identify IROs that prompt it to revisit its preliminary conclusions regarding the relevance of particular sustainability matters.

### Example 2

Entity Z assesses the “topics,” “sub-topics,” and “sub-sub-topics” listed in ESRS 1, AR 16, as well as sector-specific and entity-specific matters, and narrows down the list to include only relevant matters. As part of that determination, Z considers that its fleet of vehicles has diesel engines that emit pollutants into the air and concludes that these emissions are an inherent consequence of its core business. Entity Z notes that other distributors in similar industries provide air pollution metrics and, therefore, believes that its stakeholders and sustainability statement users would expect it to provide the same type of information. Therefore, Z determines that the subtopic “Pollution of air” is relevant.

In addition, the subtopic “Pollution of water” may also be relevant since trucking can cause water pollution via runoff from roadways (i.e., if rain washes harmful pollutants into bodies of water). While Z does not transport toxic chemicals that could pollute the roadways, its trucking activities can cause other types of pollutants (oil, grease, fluid leakage), and therefore Z determines that “Pollution of water” is a relevant subtopic.

As part of this step, Z also eliminates matters that are clearly *not* relevant. For example, Z determines that the subtopic “Communities’ civil and political rights” in ESRS 1, AR 16, is not relevant because its business is not associated with or involved in any community’s “freedom of expression” or “freedom of assembly,” nor does it have any “impact on human rights defenders.”

Note that the discussion in this example is for illustrative purposes only and therefore is limited to specific items and does not contemplate all potentially relevant matters.

## Determining the IROs

After identifying the relevant sustainability matters, an entity should analyze such matters to determine the associated IROs. Input from stakeholders, qualitative information, and information from other sources should be evaluated. An entity may seek to identify all sustainability IROs first and then refine the list to include only material IROs in a later step (see [step 3](#)).

## Impacts

ESRS 1, Section 3.4, describes impacts as “actual or potential, positive or negative **impacts** on people or the environment.” The specific impacts associated with each sustainability matter are disaggregated and defined in this step. For example, if an entity identifies “substances of concern” as a relevant subtopic (see ESRS 1, AR 16), it would then identify each individual substance of concern and obtain information about each instance, such as the location, the associated business activity, the quantity produced or procured, and the environmental impact.

## Financial Risks and Opportunities

In terms of financial risks and opportunities, ESRS 1, paragraph 49, notes that a “sustainability matter is material from a financial perspective if it triggers or could reasonably be expected to trigger material **financial effects** on the undertaking.” Specifically, a matter may be material from a financial perspective if it materially affects or is expected to materially affect an “undertaking’s development, financial position, financial performance, cash flows, access to finance or cost of capital.” An entity should consider events and circumstances that may give rise to a financial effect, either currently or in the future.

## Impacts That May Generate Financial Risks and Opportunities

ESRS 1, paragraph 38, states that “[i]mpact materiality and **financial materiality** assessments are inter-related” and requires an entity to consider the “interdependencies between these two dimensions.” Thus, in addition to identifying sustainability matters that generate a financial risk or opportunity directly, the entity must also consider whether its sustainability impacts have an indirect financial effect. As stated in paragraph 91 of EFRAG’s *IG 1: Materiality Assessment Implementation Guidance*, “most impacts give rise to financial risks and opportunities.”

An entity may consider the following factors when identifying risks and opportunities related to each sustainability impact:

- Whether there are expected operational changes.
- Its ability to meet strategic goals.
- Its ability to adhere to regulations.
- The reputational effects of its environmental or social impacts.
- Decreased operating expenses resulting from investments in energy-efficient technologies.
- Increased capital expenditures associated with facility upgrades or modifications.
- New access to capital with more favorable terms and lower interest rates.
- Modifications made to assets because of changing weather patterns such as increased flood risks.
- Accelerated decommissioning of assets as a result of commitments or loss of financial viability.
- Incurrence of costs associated with stranded assets and associated redundancies.
- Increased training costs to upskill workforce for new products or services.
- A reduction in revenues linked to certain products or services.
- Increased insurance premiums or legal liabilities as a result of noncompliance with regulations, settlements, fines, or legal fees.



### Example 3

Entity Z considers all the impacts associated with air pollution that could result from its trucking activities and compiles a list specifying (1) each type of gas pollutant associated with each vehicle type in its fleet and (2) the nature of the environmental or social harm, or both, that each pollutant may cause (i.e., impacts). Entity Z also identifies sources of financial risks; it (1) determines which of the jurisdictions in which it operates imposes fines for exceeding emissions limits and (2) considers that reputational damage related to its pollutant emissions could result in a shift in consumer demand for furniture delivered by trucks with diesel engines (financial risks).

Similarly, Z takes inventory of all its IROs related to water pollution.

Note that the discussion in this example is for illustrative purposes only and does not provide an exhaustive list of matters and IROs. In addition to the topical standard “Pollution” in ESRS E2, air pollution related to greenhouse gases is also covered in the ESRS E1 topical standard “Climate change,” which Z evaluates separately.

**Upon completion of step 2, entities should have identified the IROs that need to be assessed for materiality.**

### Step 3 — Determine Which IROs Are Material

In this step, an entity assesses the materiality of each IRO identified in step 2. To do so, the entity may choose to use stakeholder input, qualitative information, and information from its ongoing due diligence to develop IRO scoring criteria. IRO scoring is an approach that management may use to assign standardized ratings to each IRO for each of the prescribed criteria on the basis of the specific characteristics of each IRO. Although an entity will need to apply judgment when developing the scoring criteria, it is also required to apply the appropriate thresholds under ESRS 1. A leading practice is to ensure consistent scoring of IROs, which in turn provides a sound foundation for the entity’s internal control framework. Furthermore, a systematic and consistently applied rating approach supports consistent execution of the steps, conclusions, and related documentation needed to prepare for obtaining assurance for both compliance and the double materiality assessment process.

The indicators and thresholds used in a materiality assessment under ESRS 1 may consist of quantitative information, qualitative information, or both. The table below shows the criteria that ESRS 1 prescribes, depending on the type of IRO.

		Actual Negative Impacts	Potential Negative Impacts <sup>6</sup>	Actual Positive Impacts	Potential Positive Impacts	Risks	Opportunities
Severity	Scale	✓	✓	✓	✓		
	Scope	✓	✓	✓	✓		
	Irremediable Character	✓	✓				
Likelihood			✓		✓	✓	✓
Magnitude						✓	✓

<sup>6</sup> ESRS 1, paragraph 45, specifies that “[i]n the case of a potential negative human rights impact, the severity of the impact takes precedence over its likelihood.”

As indicated in ESRS 1, AR 10, the “severity” of an IRO depends on its “scale,” “scope,” and “irremediable character.” ESRS 1, AR 11, states that “[a]ny of the three characteristics . . . can make a negative impact severe.” When evaluating each IRO, an entity may want to consider factors such as the following, as shown in the table above:

- *Scale* — How intense the negative or positive impacts are or potentially would be for people or the environment (e.g., substantial, major, moderate, minimal).
- *Scope* — How widespread or broad the negative or positive impacts are or potentially would be (e.g., high, moderate, low).<sup>7</sup>
- *Irremediable character* — How difficult it would be to remediate or reverse any actual damage (e.g., impossible, challenging, moderately difficult, easy).
- *Likelihood* — How probable it is that the potential impact will occur or that the risk or opportunity will materialize (e.g., almost certain, likely, possible, unlikely).
- *Magnitude* — How significant the financial effect would be if this risk or opportunity were to materialize (e.g., above or below the threshold).

The scoring of each criterion should be aggregated on the basis of the approach and thresholds determined by the entity.

#### Example 4

Entity Z assesses each of the impacts and risks identified in step 2 in accordance with the relevant criteria outlined above and considers the information gathered about each IRO, including input and feedback from stakeholders. In its analysis, Z determines that the potential impacts of air pollutants are material on the basis of the nature of the harm (scale), the quantity emitted (scope), and the irremediable character of the damage. Entity Z also aggregates the potential regulatory fines from all jurisdictions. While it assesses the likelihood of being subject to fines as moderate (likely), Z determines that the magnitude of such fines would be low (below the threshold); therefore, it concludes that the total financial risk related to fines is not material to users of the general-purpose financial statements and does not need to be disclosed. However, Z determines that there are material financial risks related to reduced consumer demand resulting from potential reputational damage associated with the air pollution.

In addition, Z assesses the severity and likelihood of the impacts related to water pollution caused by its trucking activities. Since Z does not transport chemicals, the only sources of pollutants are minor leaks from the trucks’ engines, which are mitigated by regular inspection and maintenance to help prevent the leakage of harmful chemicals. Entity Z concludes that both the scale and likelihood of the IROs associated with water pollution are low (minimal and unlikely, respectively) in the short, medium, and long term. On the basis of its materiality assessment, Z determines that IROs related to water pollution are not material.

Note that the discussion in this example is for illustrative purposes only and does not contemplate all IROs or factors that would be considered in the scoring of the IROs.



#### Assurance Note

To facilitate compliance with ESRS 2 IRO-1 and IRO-2 and for assurance purposes, entities should maintain documentation of management’s decisions and outcomes for each IRO as part of their detailed documentation of the materiality assessment. For example, entities should describe how thresholds were determined and where management used judgment in applying the thresholds.

**Upon completion of step 3, entities should have identified the IROs that are material.**

<sup>7</sup> As noted in ESRS 1, AR 10, “[i]n the case of environmental impacts, the scope may be understood as the extent of environmental damage or a geographical perimeter. In the case of impacts on people, the scope may be understood as the number of people adversely affected.”

## Step 4 — Conclude and Prepare Documentation

After an entity has evaluated each IRO and reached a preliminary conclusion about whether it is material in relation to the thresholds defined by management, the entity may want to reengage external stakeholders to corroborate the double materiality assessment and gather additional stakeholder feedback.

To prepare its sustainability disclosures, an entity may find it helpful to map material IROs to related ESRS disclosure requirements and data points within the relevant topical standard to determine the information to be disclosed. If industry- and entity-specific IROs are determined to be material, entity-specific disclosures<sup>8</sup> must be provided to enable users to understand IROs.



### Assurance Note

FAQ 12 of EFRAG's *IG 1: Materiality Assessment Implementation Guidance* notes that "it is reasonable to expect a certain level of documentation to be needed for internal purposes" and to "help assurance providers to perform their work." Entities should consider and anticipate the information that assurance providers will need to render assurance reports. In addition, information about the double materiality assessment process, including management's use of thresholds, is required to be disclosed in accordance with ESRS 2 IRO-1 and IRO-2. Therefore, a key step in obtaining assurance over an entity's CSRD compliance is to capture management's judgments and conclusions in writing throughout the double materiality process. The documentation should also provide evidence of the entity's ongoing due diligence activities to ensure that all material IROs that exist during the reporting period are identified, even if not reflected in the initial assessment. Entities should maintain records of management's decisions and outcomes for each IRO as part of their detailed documentation of the materiality assessment. For example, entities should describe how thresholds were determined and applied.

**At the end of this step, the entity will have a completed double materiality assessment that identifies all material IROs and records the documentation of the double materiality assessment process.**

## Interplay With the SEC Climate Rule and International Sustainability Standards Board Standards

### SEC Climate Rule

Entities with reporting obligations under ESRS may also have reporting obligations with the SEC. In March 2024, the SEC issued a [final rule](#)<sup>9</sup> regarding climate matters that has been stayed pending judicial review. While it is uncertain whether the rule will be issued as written, modified, or not issued at all, entities should prepare to comply with the new rule as well as with existing SEC rules regarding MD&A, legal proceedings, and risk factors (which may capture other material sustainability matters beyond climate). As a result, SEC registrants may need to include disclosures about material sustainability matters. In doing so, registrants must apply the definition of "material" established in U.S. Supreme Court rulings, which states that "a matter is material if there is a substantial likelihood that a reasonable investor would consider it important when determining whether to buy or sell securities or how to vote or such a reasonable investor would view omission of the disclosure as having significantly altered the total mix of information made available."

<sup>8</sup> See ESRS 1, AR 1 through AR 5, for information about the application requirements for entity-specific disclosures.

<sup>9</sup> SEC Final Rule Release No. 33-11275, *The Enhancement and Standardization of Climate-Related Disclosures for Investors*.



While the guidance on financial materiality in ESRS and in the SEC's definition of materiality are different, many of the underlying concepts are generally similar and, in many cases, overlapping. However, the double materiality approach under ESRS further requires companies to disclose matters that may be material from an impact perspective. For example, if a U.S. multinational registrant provides a consolidated sustainability report in accordance with ESRS at the enterprise level to satisfy the requirements of its E.U. subsidiaries in the scope of the CSRD, the reporting entity for both the CSRD/ESRS report and its SEC filing will be the same. In such a case, the more prescriptive requirements for identifying material matters under ESRS may lead a registrant to reassess the matters to be disclosed for SEC reporting purposes, except for matters that are only deemed to be material from an impact perspective. We believe, however, that matters that are preliminarily determined to only be material from an impact perspective under ESRS could potentially lead to financial risks that may have a material impact on a registrant's future operations, such as through legal liabilities or reputational harm.

Because of the number of ESG topics covered by ESRS and the related ESRS disclosure requirements and datapoints, we believe that U.S. companies may evaluate the population of sustainability matters in their double materiality assessment at a more granular level than has previously been applied in practice. In addition, as a result of the ongoing sustainability due diligence process required by the ESRS, which informs the materiality assessment process, registrants may identify more activities that may be considered for SEC disclosure purposes than are currently addressed as sustainability matters in SEC registrants' disclosures. Companies should further implement the appropriate processes and controls for collecting sufficient information to conduct a thorough materiality assessment and document both quantitative and qualitative considerations. Such matters may include (1) their conclusions regarding which matters must be disclosed under each regulation and (2) their rationale and support for any differences in the matters disclosed under different regulations (e.g., matters may be material for disclosure in CSRD/ESRS reports but not for disclosure in SEC reports).

## **ISSB Guidance**

On May 2, 2024, EFRAG and the International Sustainability Standards Board (ISSB) jointly published [interoperability guidance](#). According to the press release, the guidance is intended to "reduce complexity, fragmentation and duplication for companies applying both the ISSB Standards and ESRS." The guidance states:

The financial materiality assessment in ESRS 1 corresponds to the identification of information that is material for primary users of general purpose financial reports in making decisions relating to providing resources to the entity (see paragraph 48 of ESRS 1 and paragraph 18 of IFRS S1). The definition of information that is considered material for users of general purpose financial reports is therefore aligned between the two sets of standards.

This alignment means that in assessing whether a particular disclosure is considered material in applying ISSB Standards, that assessment is aligned with the assessment of whether that disclosure is financially material in accordance with ESRS, and conversely.

Although EFRAG and the ISSB noted that their guidance is aligned in terms of financial materiality, the double materiality approach under ESRS requires companies to disclose additional matters that may be material from an impact perspective. In addition, ESRS require companies to evaluate sustainability matters that are incremental to those currently covered in IFRS S1 and S2. Lastly, the interoperability guidance must be considered in conjunction with the ESRS and ISSB standards, and entities will need to comply with all the requirements of both standards to claim they are reporting in accordance with either one.

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