

# Functional currency determination

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## Introduction

Before a reporting entity can apply the provisions of the Financial Accounting Standards Board's (FASB) Accounting Standards Codification (ASC) Topic 830, Foreign Currency Matters, to determine the amounts of transaction gains or losses arising from transactions denominated in foreign currencies or to translate the financial statements of foreign entities for preparation of consolidated financial statements, it must first determine the functional currency for each distinct and separable operation. The ASC Master Glossary defines functional currency as "the currency of the primary economic environment in which the entity operates; normally, that is the currency of the environment in which an entity primarily generates and expends cash." (See the Appendix for additional definitions of terms used throughout this white paper.)

This white paper addresses the (1) identification of distinct and separable operations, (2) relevant factors to consider in determining the functional currency for each distinct and separable operation included within the consolidated financial statements being presented, and (3) situations in which a change in the functional currency may be appropriate.

## Identifying distinct and separable operations

Under ASC 830, the assets, liabilities and operations of a foreign entity are measured using the functional currency of that entity. A foreign entity is any operation whose financial statements are (1) prepared in a currency other than the reporting currency of the reporting entity and (2) combined, consolidated or accounted for on the equity basis in the reporting entity's financial statements. However, a foreign entity

may be comprised of more than one distinct and separable operation, such as a division or branch, in which case each operation may be considered a separate entity. These foreign entities or operations can include any branches, sales offices or subsidiaries with their own identifiable assets, liabilities, and operations. If those operations are conducted in different economic environments, they might have different functional currencies.

**ASC 830-10-55-6** In some instances, a foreign entity might have more than one distinct and separable operation. For example, a foreign entity might have one operation that sells parent-entity-produced products and another operation that manufactures and sells foreign-entity-produced products. If they are conducted in different economic environments, those two operations might have different functional currencies. Similarly, a single subsidiary of a financial institution might have relatively self-contained and integrated operations in each of several different countries. In those circumstances, each operation may be considered to be an entity as that term is used in this Subtopic, and, based on the facts and circumstances, each operation might have a different functional currency.

The functional currency determination is not necessarily made on a legal entity basis. In cases where a company's economic factors indicate that a foreign entity conducts its operations in more than one economic environment, each operation may be considered a "foreign entity" with a different functional currency for purposes of applying ASC 830.

**Example 1: Foreign entity composed of more than one distinct and separable operation**

Parent, a U.S. company, has a subsidiary that operates in a foreign country. The subsidiary consists of two separate foreign operations in the same country.

- Branch BC is a sales outlet for the parent's products. Cost of its sales are in the local country and its net cash flows are remitted exclusively to the parent.
- Division DEF manufactures and distributes its own products. Its manufacturing and distribution costs, as well as cash generated by those operations, are primarily in the local currency and have little, if any, direct effect on the parent's cash flows.

While there is only one legal entity operating in the foreign country, if each operation has its own segregated assets, liabilities, revenues and expenses, as well as goods and services that are managed separately, it would be appropriate for the reporting entity to conclude there are two separate and distinct operations, each with its own functional currency.

An operation that is distinct and separable has characteristics such as assets, liabilities, revenues and expenses that are segregated from those of other operations, as well as goods and services that the operation provides to its own customers that are managed separately from other goods and services. In theory, a formal business plan exists for the operation and a separate management team is in place to conduct its business. In addition, management should be capable of producing standalone financial statements for the operation. In other words, the entity should have the appropriate record-keeping and financial reporting systems and processes so that it could prepare financial statements.

While the notion of a distinct and separable operation is included in ASC 830, it is not defined. Factors to consider in determining if an operation represents a distinct and separable operation include, but are not necessarily limited to, the following:

- Does the operation have separately identifiable assets and liabilities, or are they commingled with the assets and liabilities of other operations?
- Does the operation hold the assets and liabilities relevant to the type of business it purports to represent? An operation generally would not be considered distinct and separable if it holds only some of the assets and liabilities or incurs only some of the costs and expenses necessary to conduct the purported business.

- Are the activities of the operation managed separately from the rest of the entity as an integrated operation (i.e., integration of people, processes, disciplines, IT, etc.) and are the activities distinguished from others within the entity considering the factors for determining the functional currency under ASC 830-10-55-5?
- Is management capable of producing standalone financial statements for the operation? In other words, the operation should have appropriate record-keeping and financial reporting systems and processes so that management could prepare a full set of articulated financial statements that reflect the financial position, operating results and cash flows of the operation.

While ASC 830 provides that a foreign entity may be comprised of more than one distinct and separable operation and that those operations might have different functional currencies, there is no requirement that a foreign entity maintain disaggregated accounting records. Accordingly, if the activities and assets or liabilities of an operation are not distinguished and accounted for separately from the rest of the entity, then the operation likely is not a distinct and separable operation under ASC 830 and the functional currency determination should be made based on the entity's integrated operations.

## Determining an entity's functional currency

Once each separate and distinct foreign operation has been identified, the specific facts and circumstances pertaining to each separate and distinct foreign operation must be assessed in determining the functional currency. It is not appropriate to just assume that an entity's functional currency is that of the parent company or the currency in which the entity maintains its books.

Determining an entity's functional currency is important because it serves as the basis for identifying foreign currency transactions that are subject to the remeasurement and translation provisions of ASC 830.

In some circumstances, the functional currency determination may be relatively straightforward and the foreign operations may fall within two broad classes of foreign operations; (1) a foreign operation that is clearly self-contained and integrated within a particular country or economic environment for which the foreign currency is the functional currency, or (2) a foreign operation that is essentially an extension of the parent entity's operations for which the functional currency is that of the parent. ASC 830-10-45-4 describes these two broad classes of foreign operations:

**ASC 830-10-45-4** Multinational reporting entities may consist of entities operating in a number of economic environments and dealing in a number of foreign currencies. All foreign operations are not alike. To fulfill the objectives in paragraph 830-10-10-2, it is necessary to recognize at least two broad classes of foreign operations:

- a. In the first class are foreign operations that are relatively self-contained and integrated within a particular country or economic environment. The day-to-day operations are not dependent on the economic environment of the parent's functional currency; the foreign operation primarily generates and expends foreign currency. The foreign currency net cash flows that it generates may be reinvested or converted and distributed to the parent. For this class, the foreign currency is the functional currency.
- b. In the second class are foreign operations that are primarily a direct and integral component or extension of the parent entity's operations. Significant assets may be acquired from the parent entity or otherwise by expending dollars and, similarly, the sale of assets may generate dollars that are available to the parent. Financing is primarily by the parent or otherwise from dollar sources. In other words, the day-to-day operations are dependent on the economic environment of the parent's currency, and the changes in the foreign entity's individual assets and liabilities impact directly on the cash flows of the parent entity in the parent's currency. For this class, the dollar is the functional currency.

### RSM Commentary

Large multinational companies may have complex organizational structures that include multiple entities and layers in their consolidated financial statements, including several entities that are upstream from the foreign entity. However, for the purpose of determining the functional currency, any references to the parent of the foreign entity should be assumed to refer to the direct parent of that entity and not the reporting entity or other entity within the organizational structure.

The functional currency of an entity is, in principle, a matter of fact. Sometimes the facts will clearly identify the entity's functional currency. However, if a foreign entity conducts significant amounts of business in two or more currencies, the functional currency might not be clearly identifiable. In those instances, management's judgment will be required to determine the functional currency in which financial results and relationships are measured with the greatest degree of relevance and reliability.

### RSM Commentary

As the facts become more varied and complex, determining the functional currency becomes increasingly difficult. ASC 830-10-55-4 states that “[m]anagement is in the best position to obtain the pertinent facts and weigh their relative importance in determining the functional currency for each operation. It is important to recognize that management's judgment is essential and paramount in this determination, provided only that it is not contradicted by the facts [emphasis added].”

ASC 830-10-55-5 provides a list of economic factors to be considered both individually and collectively when determining the functional currency. It may also be appropriate to consider additional factors. ASC 830 does not indicate that any one factor should be given more or less weight than any other. Accordingly, management must reach its own conclusions as to how much weight to give each factor based on its importance to a given foreign operation.

**ASC 830-10-55-5** The following salient economic factors, and possibly others, should be considered both individually and collectively when determining the functional currency:

a. Cash flow indicators, for example:

1. Foreign currency. Cash flows related to the foreign entity's individual assets and liabilities are primarily in the foreign currency and do not directly affect the parent entity's cash flows.
2. Parent's currency. Cash flows related to the foreign entity's individual assets and liabilities directly affect the parent's cash flows currently and are readily available for remittance to the parent entity.

### RSM Commentary

Examples of cash flows that directly affect the parent's cash flows include (but are not limited to):

- Purchases from or sales to the parent
- Borrowing proceeds from and repayments to the parent
- Other income and expense items with the parent or other entities under common control
- Capital contributions from the parent
- Remittances of profits to the parent

## b. Sales price indicators, for example:

1. Foreign currency. Sales prices for the foreign entity's products are not primarily responsive on a short-term basis to changes in exchange rates but are determined more by local competition or local government regulation.
2. Parent's currency. Sales prices for the foreign entity's products are primarily responsive on a short-term basis to changes in exchange rates; for example, sales prices are determined more by worldwide competition or by international prices.

**RSM Commentary**

In evaluating the sales price factor, consideration should be given to how prices are set by the foreign entity, including whether the entity sets the prices by itself and the extent to which the parent has any input into the pricing decisions.

## c. Sales market indicators, for example:

1. Foreign currency. There is an active local sales market for the foreign entity's products, although there also might be significant amounts of exports.
2. Parent's currency. The sales market is mostly in the parent's country or sales contracts are denominated in the parent's currency.

## d. Expense indicators, for example:

1. Foreign currency. Labor, materials, and other costs for the foreign entity's products or services are primarily local costs, even though there also might be imports from other countries.
2. Parent's currency. Labor, materials, and other costs for the foreign entity's products or services continually are primarily costs for components obtained from the country in which the parent entity is located.

## e. Financing indicators, for example:

1. Foreign currency. Financing is primarily denominated in foreign currency, and funds generated by the foreign entity's operations are sufficient to service existing and normally expected debt obligations.
2. Parent's Currency—Financing is primarily from the parent or other dollar-denominated obligations, or funds generated by the foreign entity's operations are not sufficient to service existing and normally expected debt obligations without the infusion of additional funds from the parent entity. Infusion of additional funds from the parent entity for expansion is not a factor, provided funds generated by the foreign entity's expanded operations are expected to be sufficient to service that additional financing.

**RSM Commentary**

Consider the sources of financing, including amounts payable to the parent and to all affiliates when determining the functional currency. If the subsidiary's operations are dependent on borrowings from the parent, this would be a strong indicator of parent dependent status. If, however, financing is primarily denominated in a foreign currency, that indication would not change if the parent supplies additional financing for expansion, as long as the expanded foreign operation is expected to service the additional financing.

## f. Intra-entity transactions and arrangements indicators, for example:

1. Foreign currency. There is a low volume of intra-entity transactions and there is not an extensive interrelationship between the operations of the foreign entity and the parent entity.

However, the foreign entity's operations may rely on the parent's or affiliates' competitive advantages, such as patents and trademarks.

2. Parent's currency. There is a high volume of intra-entity transactions and there is an extensive interrelationship between the operations of the foreign entity and the parent entity. Additionally, the parent's currency generally would be the functional currency if the foreign entity is a device or shell corporation for holding investments, obligations, intangible assets, and so forth, that could readily be carried on the parent's or an affiliate's books.

### RSM Commentary

The functional currency of an intermediate holding company is most often the same functional currency as its parent because it typically serves as an extension of the parent's operations and does not function in any role in which its parent could not function. The fact that the intermediary holding company may exist to achieve certain tax and or asset protection purposes that the parent entity could not otherwise achieve on its own does not change the functional currency determination.

When evaluating the economic factors described in ASC 830-10-55-5, consider that the ultimate determination of the entity's functional currency is not necessarily binary. In other words, if the functional currency of the foreign entity is not the local currency, that does not necessarily mean that the functional currency is that of the parent. The facts and circumstances might lead to a determination that the functional currency is that of a different economy rather than the local currency or the functional currency of the parent. The following example illustrates this point.

#### **Example 2: Functional currency may be currency other than local currency or functional currency of parent**

A U.K. subsidiary of a U.S. company manufactures its own products in the U.K. that are then sold to third-party customers throughout Europe. The foreign entity is self-contained and does not rely upon its parent for funding. 75% of the cost of sales incurred by the U.K. subsidiary are in the local currency, GBP. The subsidiary also has a note from a local bank denominated in GBP. 90% of the subsidiary's sales are denominated in EUR and the management team sets pricing based on local competition in EUR. In this situation, the functional currency of the foreign entity may not be the functional currency of the parent or the local currency. Rather, the reporting entity will need to evaluate whether the GBP or the EUR is the functional currency of the U.K. subsidiary by appropriately weighting the importance of these factors (and any other relevant factors) to the foreign operation.

ASC 830-10-45-7 states that “[o]nce the functional currency for a foreign entity is determined, that determination should be used consistently unless significant changes in economic facts and circumstances indicate clearly that the functional currency has changed.” However, except for functional currency changes resulting from a foreign entity operating in a highly inflationary economy (discussed below), ASC 830 does not provide guidance or examples for identifying those significant changes. As a result, significant judgment and careful consideration of the factors described in ASC 830-10-55-5 are needed to make a proper determination. Also, because an entity's functional currency is not expected to change once established, long-term considerations are more important than short-term considerations when making that determination. For example, a newly formed foreign entity may not initially be self-sufficient. However, if the long-term plan and expectation is for the entity to operate as a self-contained fully integrated operation in a foreign economy capable of generating sufficient revenues to support its own operations, consideration should be given to those facts.

## Illustrations: Functional currency determination

The following examples are intended to illustrate the application of the preceding guidance on the functional currency determination. These examples are not intended to be comprehensive and may not include all relevant factors; any conclusions reached will depend upon the facts and circumstances specific to a foreign entity.

### Example 3: Foreign entity is self-contained and integrated in local economy

A Spanish subsidiary of a U.S. corporation has a relatively self-contained and integrated operation in Spain. The sales prices of its products largely are determined by local competition and generally are sold in Spain. The products are manufactured in Spain using raw materials that are predominantly purchased from Spanish vendors.

*What is the foreign entity's functional currency?*

The functional currency for the foreign subsidiary would be its local currency, the euro. This example demonstrates the first class of foreign operations previously described, that is, an entity with operations that are relatively self-contained and integrated within a particular country or economic environment.

### Example 4: Foreign entity is an extension of the parent company

A Spanish subsidiary of a U.S. company takes orders for the U.S. company's merchandise, bills and collects for the sale of merchandise, and has a local warehouse to facilitate timely delivery of the U.S. company's merchandise. The Spanish subsidiary is financed by the U.S. parent, and immediately remits to the parent all cash flows that it generates.

*What is the foreign entity's functional currency?*

The U.S. dollar would be its functional currency. This example represents the second class of foreign operations previously described, that is, an entity with operations that are primarily a direct and integral component or extension of the parent entity's operations.

### Example 5: Germany subsidiary sells parent product

A German subsidiary imports a product manufactured by its parent at a price denominated in U.S. dollars. The product is sold in the local market at a sales price denominated in the local currency that is determined primarily by competition with similar locally produced products. Selling expenses are incurred locally and represent 20% of sales price. The operation's long-term financing is primarily in the form of U.S. dollar loans from its parent.

*What is the German subsidiary's functional currency?*

The preponderance of the evidence indicates that the functional currency of the German subsidiary is the U.S. dollar.

The factors supporting the U.S. dollar as the functional currency include the following:

1. The German subsidiary imports its product from its parent at a price denominated in U.S. dollars (see expense indicator, example 2 of ASC 830-10-55-5(d));

- 2. The German subsidiary's long-term financing is denominated in U.S. dollars obtained from the parent (see financing indicator, example 2 of ASC 830-10-55-5(e)); and
- 3. There is a high volume of intercompany transactions (see intra-entity transactions and arrangement indicator, example 2 of ASC 830-10-55-5(f)).

On the other hand, the factors supporting the local currency as the functional currency include the following:

- 1. The German subsidiary's product is sold in the local market at a price set by local competition (see sales price indicator, example 2 of ASC 830-10-55-5(b)); and
- 2. The German subsidiary generates and expends local currency (see sales market indicator, example 2 of ASC 830-10-55-5(c)).

While there are factors supporting both the local currency and the U.S. dollar as the functional currency, the factors must be considered individually and collectively, and the importance of those factors weighted to determine the appropriate functional currency. In this example, outside of its relationship with the parent, the subsidiary has no clear business purpose and likely would not exist. The entity is basically operating as an extension of the parent's operations.

#### **Example 6: Germany subsidiary sells products imported from nonaffiliated entities**

A German subsidiary imports a product manufactured in the U.S. by nonaffiliated parties at a price denominated in U.S. dollars. The product is sold in the local market at a price denominated in the local currency that is determined primarily by competition with similar locally produced products. Selling expenses are incurred locally and represent 20% of sales price. The operation's long-term financing is from nonaffiliated lenders and is denominated in the local currency, and the entity is expected to be able to service its debt with internally generated funds.

*What is the German subsidiary's functional currency?*

The preponderance of the evidence indicates that the functional currency of the German subsidiary is the local currency. In this example, as compared to Example 5, *Germany subsidiary sells parent product*, the following differences are evident:

- 1. The product is imported from nonaffiliated parties;
- 2. The entity's long-term financing is denominated in the local currency and was obtained from nonaffiliated lenders; and
- 3. There is a low volume of intercompany transactions.

The operations described above indicate a foreign entity that is relatively self-contained and integrated within the local economy. Again, no particular factor alone determines the entity's functional currency; rather, the factors must be considered individually and collectively, and the importance of those factors weighted to determine the appropriate functional currency.

#### **Highly inflationary economies**

If a foreign entity operates in a highly inflationary economy, its financial statements must be remeasured (as described in ASC 830-10-45-17) as if its functional currency is the reporting currency. For purposes of applying this requirement, a highly inflationary economy is one that has cumulative inflation of

approximately 100% or more over a three-year period. Under ASC 830, the determination of a highly inflationary economy begins by calculating the cumulative inflation rate for the three years that precede the beginning of the reporting period, including interim reporting periods. If that calculation results in a cumulative inflation rate in excess of 100%, the economy should be considered highly inflationary in all instances; projections cannot be used to overcome the presumption that an economy is highly inflationary if the three-year cumulative rate exceeds 100%. However, if that calculation results in the cumulative rate being less than 100%, historical inflation rate trends and other pertinent economic factors should be considered to determine whether such information suggests that classification of the economy as highly inflationary is appropriate. Additional implementation guidance and illustrative examples can be found at ASC 830-10-55-23 to 55-26.

In some instances, the trend of inflation might be as important as the absolute rate. Accordingly, the determination of whether a country's economy meets the definition of a highly inflationary economy can require significant professional judgment. In an effort to facilitate greater consistency, the Center for Audit Quality's International Practices Task Force (IPTF) has developed a framework for compiling inflation data to assist reporting entities in monitoring inflation statistics in connection with the determination of the inflationary status of countries in which they have operations. The discussions documented in the *IPTF Documents for Discussion: Monitoring Inflation in Certain Countries* available on the Center for Audit Quality website (<https://www.thecaq.org/>) can be used by entities, in conjunction with their internal controls over financial reporting, in determining which country's economy should be considered highly inflationary.

### RSM Commentary

Entities that utilize the IPTF's discussion documents to assist with their application of ASC 830 requirements should be mindful that there may be other countries with cumulative inflation rates of 100% or more that are not captured in the IPTF's analysis because the sources used by the IPTF do not include inflation data for all countries. Consequently, entities should closely monitor the inflation rates in economies in which they operate and not be solely dependent on the inflation analyses published by the IPTF.

### Change in functional currency

ASC 830-10-45-17 provides that once the functional currency for a foreign entity is determined, it should not change unless there are significant changes in facts and circumstances upon which the functional currency determination is based. ASC 830 does not provide further guidance on what constitutes a significant change in facts and circumstances. However, we would expect such changes to represent a long-term and ongoing change to the foreign entity's operations rather than specific discrete events (such as an acquisition), which may not necessarily represent a permanent change in operations. For example, a foreign entity may have initially been considered to be an extension of a U.S. parent. However, over time the operations have shifted, and the foreign entity is now a self-contained operation that acquires a majority of its product from third-party vendors and generates a majority of its sales from third-party customers. Such a change would constitute a significant change in facts in circumstances that would warrant a reassessment of the functional currency. On the other hand, a foreign entity may have a significant acquisition funded by a U.S. parent that expands but does not change the foreign entity's operations. While the acquisition may temporarily increase the volume of intercompany transactions denominated in the parent's functional currency, it would not, on its own, indicate a shift in the foreign entity's operations constituting a significant change in facts and circumstances.

In situations in which a change in the functional currency is appropriate because significant changes in facts and circumstances have occurred, previously issued financial statements are not restated for the

change. Rather, an entity should refer to the guidance in ASC 250-10-45-1 on a change in accounting principle.

In situations in which the functional currency changes from the reporting currency to a foreign currency, ASC 830-10-45-9 requires that the adjustment attributable to current-rate translation of nonmonetary assets as of the date of the change should be reported in other comprehensive income.

If instead the functional currency changes from a foreign currency to the reporting currency, translation adjustments for prior periods are not removed from equity. Rather, in accordance with ASC 830-10-45-10, the translated amounts for nonmonetary assets at the end of the prior period become the accounting basis for those assets in the period of the change and subsequent periods. The same treatment is also appropriate when accounting for a change in functional currency from the foreign currency to the reporting currency when an economy becomes highly inflationary. Additional guidance on the accounting for changes in inflationary economies can be found in ASC 830-10-45-15 and 45-16.

## Appendix: Definitions

Following is a list of certain key terms used in this white paper and their corresponding definitions in the Master Glossary of the ASC.

Term	Definition
Exchange rate	The ratio between a unit of one currency and the amount of another currency for which that unit can be exchanged at a particular time.
Foreign currency	A currency other than the functional currency of the entity being referred to (for example, the dollar could be a foreign currency for a foreign entity). Composites of currencies, such as the Special Drawing Rights, used to set prices or denominate amounts of loans, and so forth, have the characteristics of foreign currency.
Foreign currency transactions	Transactions whose terms are denominated in a currency other than the entity's functional currency. Foreign currency transactions arise when a reporting entity does any of the following: <ol style="list-style-type: none"> <li>Buys or sells on credit goods or services whose prices are denominated in foreign currency</li> <li>Borrows or lends funds and the amounts payable or receivable are denominated in foreign currency</li> <li>Is a party to an unperformed forward exchange contract</li> <li>For other reasons, acquires or disposes of assets, or incurs or settles liabilities denominated in foreign currency.</li> </ol>
Foreign currency translation	The process of expressing in the reporting currency of the reporting entity those amounts that are denominated or measured in a different currency.
Foreign entity	An operation (for example, subsidiary, division, branch, joint venture, and so forth) whose financial statements are both: <ol style="list-style-type: none"> <li>Prepared in a currency other than the reporting currency of the reporting entity</li> <li>Combined or consolidated with or accounted for on the equity basis in the financial statements of the reporting entity.</li> </ol>
Functional currency	An entity's functional currency is the currency of the primary economic environment in which the entity operates; normally, that is the currency of the environment in which an entity primarily generates and expends cash.
Local currency	The currency of a particular country being referred to.
Reporting currency	The currency in which a reporting entity prepares its financial statements.

Term	Definition
Reporting entity	<p>An entity or group whose financial statements are being referred to. Those financial statements reflect any of the following:</p> <ul style="list-style-type: none"><li>a. The financial statements of one or more foreign operations by combination, consolidation, or equity accounting</li><li>b. Foreign currency transactions.</li></ul>

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