August 2014

Automotive Spotlight

New Revenue Recognition Model Reaches the Finish Line!

In This Issue:

The ASU outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance.

The Bottom Line

- On May 28, 2014, the FASB and IASB issued their final standard on revenue from contracts with customers. The standard, issued as ASU 2014-09[1] by the FASB and as IFRS 15[2] by the IASB, outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance.
- The new standard requires management to use judgment to (1) determine whether contracts with one customer (or related parties) should be combined and treated as a single contract, (2) identify the number of performance obligations in a contract, and (3) determine the transaction price.
- Revenue from contracts for customized parts that an entity creates by providing a "service" to a customer (i.e., the parts have no alternative use to the entity and the entity has a right to payment for performance to date) will need to be recognized over time as the parts are constructed.
- Entities will need to determine whether contract costs should be capitalized and amortized as goods and services are transferred to the customer or whether such costs should be expensed as incurred.
- Entities will need to evaluate the appropriate accounting when a contract with a customer contains a repurchase right (e.g., an option that allows the customer to "put" the product back to the entity may represent a lease or a sale with a right of return).
- The new standard requires significantly more extensive disclosures than current guidance; therefore, automotive entities may need to modify their systems and processes to gather information about contracts with customers that is not otherwise readily available.

[1] FASB Accounting Standards Update No. 2014-09, *Revenue From Contracts With Customers.*
[2] IFRS 15, *Revenue From Contracts With Customers.*

Beyond the Bottom Line

This *Automotive Spotlight* discusses the new revenue model and highlights key accounting issues and potential challenges for automotive entities that recognize revenue under U.S. GAAP or IFRSs. For additional information about the new standard, see Deloitte's May 28, 2014, *Heads Up*.

Background

The goals of the ASU are to clarify and converge the revenue recognition principles under U.S. GAAP and IFRSs while (1) streamlining, and removing inconsistencies from, revenue recognition requirements; (2) providing "a more robust framework for addressing revenue issues"; (3) making revenue recognition practices more comparable; and (4) increasing the usefulness of disclosures. The ASU states that the core principle for revenue recognition is that an "entity shall recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services."

Under the ASU, entities must perform the following five steps in recognizing revenue:

- "Identify the contract(s) with a customer" (step 1).
- "Identify the performance obligations in the contract" (step 2).
- "Determine the transaction price" (step 3).
- "Allocate the transaction price to the performance obligations in the contract" (step 4).
- "Recognize revenue when (or as) the entity satisfies a performance obligation" (step 5).

Entities must reassess their current revenue accounting and determine whether changes are necessary.

Entities must also reassess their current revenue accounting and determine whether changes are necessary. In addition, the ASU requires significantly expanded disclosures about revenue recognition, including both quantitative and qualitative information about (1) the amount, timing, and uncertainty of revenue (and related cash flows) from contracts with customers; (2) the judgment, and changes in judgment, exercised in applying the revenue model; and (3) the assets recognized from costs to obtain or fulfill a contract with a customer.

Key Accounting Issues

Certain automotive entities (including suppliers, original equipment manufacturers, and dealers) may encounter accounting and operational challenges in applying the ASU. Some of these key accounting issues are discussed below.

Identifying the Contracts With Customers (Step 1)

In evaluating whether a contract with a customer exists, an entity would analyze the specific terms and conditions of an arrangement to determine whether the parties to the arrangement have a supplier-customer relationship or some other relationship (e.g., as collaborators or partners that are outside the ASU's scope). The entity would consider all relevant facts and circumstances in assessing whether the counterparty to a contract meets the ASU's definition of a customer and whether the contract is within the scope of the ASU (or another Codification topic). Contracts with customers may be written, oral, or implied and must create enforceable rights and obligations between two or more parties. Further, for a contract to exist, management must conclude that it is probable that the entity will collect the consideration to which it expects to be entitled.

If a contract with a customer does not meet the criteria to be accounted for under the ASU, the entity would recognize consideration received under the contract as revenue only when (1) the entity has no remaining obligations to transfer goods or services to the customer (because of complete fulfillment or cancellation of the contract), (2) the entity has collected all promised consideration, and (3) the consideration received is nonrefundable.

Further, when assessing the contractual period to apply the ASU's guidance (e.g., to each outstanding purchase order or over a three-year master services agreement), entities will need to evaluate the contract to determine the period in which the parties to the contract have "present enforceable rights and obligations."

Contract Combination

Entities must also assess whether to account for multiple contracts as a single contract. The ASU requires entities to combine contracts entered into at or around the same time with the same customer (or parties related to the customer) if one or more of the following criteria are met:

- "The contracts are negotiated as a package with a single commercial objective."
- "The amount of consideration to be paid in one contract depends on the price or performance of the other contract."
- "The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation."

Thinking It Through

Unlike current U.S. GAAP, under which entities may consider combining contracts in certain circumstances, the ASU **requires** contract combination when the above criteria are met. Automotive entities (especially suppliers) often enter into multiple contracts with the same customer around the same time but may not specifically evaluate whether those contracts are interdependent. After establishing controls to ensure that this evaluation is performed, automotive entities may need to use judgment to determine whether the ASU's contract-combination criteria are met. A conclusion that the criteria are met could significantly affect (1) how performance obligations are identified, (2) how consideration is allocated to those obligations, or (3) when revenue is ultimately recognized. Note that contracts with different customers (that are not related parties) would not be combined.

The ASU requires entities to evaluate the goods and services promised in a contract to identify "performance obligations."

Example
In March 20X4, Entity A, an automotive supplier located in the United States, enters into two separate contracts with Entity B to supply parts: one with Entity B's U.S. subsidiary and one with its Chinese subsidiary. Because the contracts are with the same customer, Entity A would be required to assess whether the contract-combination criteria are met. Specifically, if the pricing in one contract depends on the price or performance of the other contract, Entity A may be required to account for the two contracts as a single contract.

Identification of Performance Obligations (Step 2)

The ASU requires entities to evaluate the goods and services promised in a contract to identify "performance obligations." Specifically, the ASU requires an entity to account for a "distinct" good or service (or bundle of goods or services) or a series of distinct goods or services (if they are substantially the same and have the same pattern of transfer) as a performance obligation (i.e., a separate unit of account). The ASU defines a distinct good or service as one that meets both of the following criteria:

- "The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct)."
- "The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the good or service is distinct within the context of the contract)."

A good or service that does not meet these criteria would be combined with other goods or services in the contract until the criteria are met. While the first criterion is generally consistent with the current guidance in ASC 605-25[3] on determining whether a good or service has "stand-alone value," the second criterion is a new concept. The ASU provides the following indicators for evaluating whether a promised good or service is separable from other promises in a contract:

- "The entity does not provide a significant service of integrating the good or service with other goods or services promised in the contract . . . . In other words, the entity is not using the good or service as an input to produce or deliver the combined output specified by the customer."
- "The good or service does not significantly modify or customize another good or service promised in the contract."
- "The good or service is not highly dependent on, or highly interrelated with, other goods or services promised in the contract. For example, the fact that a customer could decide to not purchase the good or service without significantly affecting the other promised goods or services."

Thinking It Through

Automotive entities often provide multiple goods or services to their customers in a single contract. For example, in contracts to supply parts to an original equipment manufacturer (OEM), automotive suppliers may provide for engineering services or development of tooling. On the other hand, OEMs and dealers may offer free services and other incentives to their customers along with the purchase of a vehicle. Under current U.S. GAAP, entities may conclude that certain deliverables are inconsequential or perfunctory obligations or that they constitute "marketing" or "financing" deliverables. However, the new revenue standard does not have an exception for inconsequential or perfunctory obligations or for obligations that constitute marketing deliverables. An entity may need to use significant judgment in identifying all the goods or services in contracts with a customer and applying the above criteria to determine each performance obligation (especially when considering the new concept of "distinct within the context of the contract").

Warranties

The boards retained the current cost accrual model related to accounting for warranty obligations (in accordance with ASC 460), but only for warranties that ensure that a product complies with agreed-upon specifications. To the extent that a warranty constitutes any other service, it would be accounted for as a performance obligation (consideration would be allocated to this obligation and recognized as it is satisfied). The warranty would also be accounted for as a performance obligation if the customer has the option of purchasing it separately.

Automotive entities will need to carefully evaluate their warranties to identify any services or provisions that have an additional purpose besides ensuring the product's specifications. For example, the sale of a vehicle may include a warranty under which routine maintenance services are provided free of charge for a specified period and do more than ensure that the vehicle operates as specified. Entities may also need to consider the length of the warranty coverage and the nature of the product under warranty to ensure that the warranty period does not extend beyond the expected life of the product (which may indicate that the warranty constitutes a service). In assessing whether aspects of a warranty represent a performance obligation, an entity may need to use significant judgment.

Automotive entities will need to carefully evaluate their warranties to identify any services or provisions that have an additional purpose besides ensuring the product's specifications.

[3] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

While automotive entities' accounting for variable compensation under the ASU may ultimately be consistent with their current accounting under U.S. GAAP, entities will need to evaluate their contracts under the ASU to assess whether their current accounting remains appropriate.

Determination of the Transaction Price (Step 3)

Under the ASU, entities must determine the transaction price[4] by estimating any variable consideration (including potentially contingent consideration). Estimates of variable consideration are only included in the transaction price to the extent that it is probable that the amount of cumulative revenue recognized would not be subject to a significant future revenue reversal when such estimates are revised.

Thinking It Through

Automotive entities may have contracts that include variable elements (e.g., incentive bonuses, penalties, or varying contract prices). Consideration payable to the customer (e.g., cash rebates, credits, or discounts) may also be variable. Such variable consideration would be estimated by taking into account available information (e.g., past history or projected sales) and would be included in the transaction price to the extent that it is probable that its inclusion would not result in a significant future revenue reversal. While automotive entities' accounting for variable compensation under the ASU may ultimately be consistent with their current accounting under U.S. GAAP, entities will need to evaluate their contracts under the ASU to assess whether their current accounting remains appropriate.

Adjustments for the Time Value of Money

The ASU requires entities to adjust the transaction price for the time value of money when a significant financing component exists (and provides guidance on determining when such a financing exists). The objective of this requirement is to adjust the promised amount of consideration to reflect what the selling price would have been if the customer had paid cash for the goods or services at the time (or over the period during which) such goods or services were transferred to the customer. As a practical expedient, an entity is not required to account for a significant financing component in a contract if, at contract inception, the expected time between payment and the transfer of the promised goods and services is one year or less. In addition, a significant financing component would not exist if the difference between the promised consideration and the cash selling price of the good or service arises "for reasons other than the provision of finance . . . and the difference between those amounts is proportional to the reason for the difference."[5] Therefore, to the extent that an automotive entity receives an up-front payment for which the related revenue will be recognized over several years or the customer is not required to pay for a certain period after a good or service is provided, the transaction price may need to be adjusted for the time value of money (as if a hypothetical loan was provided to one of the parties in the contract). For example, if a separately priced extended warranty is sold to a customer (in which case the related revenue would be deferred) for an up-front payment, the entity will most likely need to adjust the transaction price for the time value of money as if the entity received a loan from the customer. In such circumstances, the amount of revenue recognized would increase and interest expense would increase by the same amount.

[4] The transaction price is defined as the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer (excluding amounts collected on behalf of third parties) and consists of both fixed and variable consideration.

[5] ASC 606-10-55-244 through 55-246 provide an example of factors to consider in the assessment of whether the payment terms in a contract were structured primarily for reasons other than the provision of finance to the entity.

Recognizing Revenue

Under the ASU, entities recognize revenue as "control" of the goods or services underlying a performance obligation is transferred to the customer.[6] This control-based model differs from the risks-and-rewards model generally applied under current U.S. GAAP. Entities must first determine whether control is transferred over time. If not, it is transferred at a point in time. Under the ASU, control is transferred over time if any of the following criteria are met:

- "The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs."
- "The entity's performance creates or enhances an asset . . . that the customer controls as the asset is created or enhanced."
- "The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date."

After carefully evaluating whether revenue should be recognized over time (as production occurs) or at a point in time (most likely when the customer obtains the goods or service), automotive entities will need to determine how to measure progress toward satisfying the performance obligation over time or the point at which control has been transferred to the customer.

If none of these criteria are met, an entity would determine the point in time at which the customer obtains control of the good or service. Factors indicating that control has been transferred at a point in time include, but are not limited to, the following:[7]

- "The entity has a present right to payment for the asset."
- "The customer has legal title to the asset."
- "The entity has transferred physical possession of the asset."
- "The customer has the significant risks and rewards of ownership of the asset."
- "The customer has accepted the asset."

After carefully evaluating whether revenue should be recognized over time (as production occurs) or at a point in time (most likely when the customer obtains the goods or service), automotive entities will need to determine how to measure progress toward satisfying the performance obligation over time or the point at which control has been transferred to the customer.

Thinking It Through

An automotive supplier may manufacture a customized part for an OEM that will have no alternative use to the supplier (e.g., a steering wheel that is customized to fit one of the OEM's vehicles). Depending on the payment terms (in accordance with the ASU, the supplier will have to determine whether it has an enforceable right to payment for performance completed to date throughout production), the supplier may be required to recognize revenue over time (as production occurs). If the supplier recognizes revenue at a point in time, it will have to use judgment in evaluating the indicators for determining when "delivery" has occurred. This provision differs from the prescriptive guidance on this topic in current U.S. GAAP.

Contract Modification

The ASU requires entities to account for contract modifications as separate contracts if such modifications result in (1) the addition of "distinct" performance obligations and (2) an increase in the price of the contract by an amount of consideration that reflects the entity's stand-alone selling price for the separate performance obligations. For a contract modification that does not meet the criteria to be accounted for as a separate contract, an entity must determine whether it should be accounted for (1) as a termination of the original contract and the creation of a new contract (i.e., the amount of consideration not yet recognized would be allocated to the remaining performance obligations) or (2) as if it

[6] Control of an asset refers to the ability to direct the use of and obtain substantially all of the remaining benefits from the asset as well as the ability to prevent other entities from directing the use of and obtaining the benefits from the asset.

[7] The individual indicators listed below are not definitive in and of themselves. An entity would consider all relevant facts and circumstances when determining the point in time at which control is transferred to the customer.

were part of the original contract (i.e., the entity would update the transaction price and the measure of progress toward complete satisfaction of the performance obligation and would record a cumulative catch-up adjustment to revenue). The ASU provides specific guidance on making this determination. Depending on how revenue is recognized (i.e., over time or at a point in time) and the terms of a contract modification, the amount of current and ongoing revenue recognized can dramatically differ.

Example
Entity A, an automotive parts manufacturer, enters into a contract to sell customized chrome hubcaps to a customer. Because the hubcaps are customized, Entity A cannot rework them and sell them to another customer without incurring a substantial cost (i.e., there is no alternative use for the hubcaps). The contract requires Entity A to deliver 800,000 customized hubcaps to the OEM at a cost of $200 per unit. The contract terms specify that if the OEM cancels the contract, Entity A is entitled to receive its cost to date plus a reasonable margin (enforceable right to payment). Entity A therefore concludes that its performance obligation (deliver 800,000 units) is satisfied over time. After Entity A has transferred control of 600,000 units, the OEM requests that the remaining units and an additional 400,000 units be rush-delivered because of higher-than-expected demand. The parties agree to modify the contract to require Entity A to deliver the 200,000 remaining units at the original price and 400,000 additional units at a cost of $275 per unit on a rush basis. Because the remaining 600,000 units to be provided under the modified contract are distinct from the goods transferred on or before the date of the contract modification, the entity accounts for the modification as a termination of the original contract and the creation of a new contract. The entity would recognize the remaining consideration of $150 million (200,000 units at $200 per unit + 400,000 units at $275 per unit = $150 million) as the 600,000 remaining units are produced over time.

The ASU requires capitalization of the recoverable incremental costs of obtaining a contract. This new requirement could represent a significant change for automotive entities that currently expense such costs.

Contract Costs

The ASU requires capitalization of the recoverable incremental costs of obtaining a contract (e.g., sales commissions).[8] This new requirement could represent a significant change for automotive entities that currently expense such costs.

In addition, if the following criteria are met, an entity must capitalize the costs of fulfilling a contact that are not within the scope of other Codification topics:

- "The costs relate directly to a contract" (or a specific anticipated contract).
- "The costs generate or enhance resources of the entity that will be used in satisfying . . . performance obligations in the future."
- "The costs are expected to be recovered."

Nevertheless, costs related to satisfied (or partially satisfied) performance obligations must be expensed as incurred. In the automotive industry, many of the costs incurred in fulfilling a customer contract are likely to be accounted for in accordance with the inventory guidance in ASC 330. Such guidance would continue to apply to performance obligations satisfied at a point in time. However, if a performance obligation is satisfied over time, the costs would most likely be related to a partially satisfied performance obligation and would therefore need to be expensed as incurred (as noted above).

Costs capitalized under the ASU would be amortized in a manner consistent with the pattern of transfer of the goods or services to which the asset is related (i.e., as the related revenue is recognized). In certain circumstances, the amortization period may extend beyond the original contract term (e.g., when future anticipated contracts or expected renewal periods exist). All capitalized-cost assets would be subject to impairment testing if any impairment indicators exist.

[8] As a practical expedient, the ASU allows an entity to elect to expense costs of obtaining a contract when incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less.

Repurchase Agreements

The ASU provides specific guidance on accounting for sales with repurchase agreements. Under the ASU, if an entity is required (a forward), or a customer has the option of requiring an entity, to repurchase the asset (a put option) at a price lower than the original selling price, the entity will need to consider at contract inception whether the customer has a significant economic incentive to exercise its option. If the customer has such an incentive, the contract should be treated as a lease. Otherwise, the transaction should be accounted for as a sale with a right of return.

Thinking It Through

Automotive entities that have an obligation to (1) repurchase the asset (i.e., a forward) or (2) repurchase the asset at the customer's request (i.e., a put option) at a price that is lower than the original selling price of the asset will need to carefully evaluate the ASU's provisions to ensure that they recognize revenue appropriately.

The ASU requires entities to disclose both quantitative and qualitative information that enables "users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers."

Required Disclosures

The ASU requires entities to disclose both quantitative and qualitative information that enables "users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers." The ASU's disclosure requirements are significantly more comprehensive than those in existing revenue standards. For additional information about the new disclosure requirements, see Deloitte's May 28, 2014, *Heads Up*.

Effective Date and Transition

The ASU is effective for annual reporting periods (including interim reporting periods within those periods) beginning after December 15, 2016, for public entities. Early application is not permitted (however, early adoption is optional for entities reporting under IFRSs). Nonpublic entities can use the same effective date as public entities (regardless of whether interim periods are included) or postpone adoption for one year from the effective date for public entities.

Entities have the option of using either a full retrospective or a modified approach to adopt the guidance in the ASU. Retrospective application would take into account the requirements in ASC 250 (with certain practical expedients). Under the modified approach, an entity recognizes "the cumulative effect of initially applying [the ASU] as an adjustment to the opening balance of retained earnings . . . of the annual reporting period that includes the date of initial application" (revenue in periods presented in the financial statements before that date is reported under guidance in effect before the change). Under the modified approach, the guidance in the ASU is only applied to existing contracts (those for which the entity has remaining performance obligations) as of, and new contracts after, the date of initial application. The ASU is not applied to contracts that were completed before the effective date (i.e., an entity has no remaining performance obligations to fulfill). Entities that elect the modified approach must disclose an explanation of the impact of adopting the ASU, including the financial statement line items and respective amounts directly affected by the standard's application.

Thinking It Through

The modified transition approach provides entities relief from having to restate and present comparable prior-year financial statement information; however, entities will still need to evaluate existing contracts as of the date of initial adoption under the ASU to determine whether a cumulative adjustment is necessary. Therefore, entities may want to begin considering the typical nature and duration of their contracts to understand the impact of applying the ASU and determine the transition approach that is practical to apply and most beneficial to financial statement users.

Challenges for Automotive Entities

Increased Use of Judgment

Management will need to exercise significant judgment in applying certain of the ASU's requirements, including those related to the identification of performance obligations and allocation of revenue to each performance obligation. It is important for automotive entities to consider how the standard specifically applies to them so that they can prepare for any changes in revenue recognition patterns.

Retrospective Application

The ASU proposes retrospective application, with certain optional practical expedients available to entities at their discretion. Because of the long-term nature of many contracts in the automotive industry, this aspect of the proposal may require entities to gather data and assess contracts that commenced several years before the effective date of the ASU. In addition, automotive entities will most likely be required to perform dual tracking of revenue balances during this retrospective period, given the potential difficulty associated with retroactively recalculating revenue balances when the new standard becomes effective.

To comply with the ASU's new accounting and disclosure requirements, automotive entities will have to gather and track information that they may not have previously monitored.

Systems, Processes, and Controls

To comply with the ASU's new accounting and disclosure requirements, automotive entities will have to gather and track information that they may not have previously monitored. The systems and processes associated with such information may need to be modified to support the capture of additional data elements that may not currently be supported by legacy systems. Further, to ensure the effectiveness of internal controls over financial reporting, management will want to assess whether it should implement additional controls. Automotive entities may also need to begin aggregating essential data from new and existing contracts since many of these contracts will most likely be subject to the ASU.

Note that the above are only a few examples of changes automotive entities may need to make to their systems, processes, and controls; such entities should evaluate all aspects of the ASU's requirements to determine whether any other modifications may be necessary.

Income Taxes

Federal income tax law provides both general and specific rules for recognizing revenue on certain types of transactions (e.g., long-term contracts and arrangements that include advance payments for goods and services). These rules are often similar to the method a taxpayer uses for financial reporting purposes and, if so, the taxpayer employs the revenue recognition method it applies in maintaining its books and records (e.g., cash basis, U.S. GAAP, IFRSs). Although the Internal Revenue Code (IRC) does not require entities to use any particular underlying financial accounting method to determine their taxable income (such as U.S. GAAP), entities must make appropriate adjustments (on Schedule M) to their financial accounting pretax income to determine taxable income under the IRC.

The ASU may change the timing of revenue recognition and, in some cases, the amount of revenue recognized for entities that maintain their books and records under U.S. GAAP or IFRSs. These changes may also affect taxable income. Thus, it will be important for tax professionals to understand the detailed financial reporting implications of the standard so that they can analyze the tax ramifications and facilitate the selection of any alternative tax accounting methods that may be available. If a change in a tax accounting method is advantageous or expedient (including circumstances in which the book method has historically been used), the taxpayer will most likely be required to obtain approval from the relevant tax authorities to use the new method. Similar requirements may arise in foreign jurisdictions that maintain statutory accounting records under U.S. GAAP or IFRSs. Additional record keeping will also be required when entities are not permitted to use the standard's revenue recognition method for tax purposes.

Thinking Ahead

Although the ASU is not effective until December 15, 2016 (with a maximum deferral of one year for nonpublic entities that apply U.S. GAAP), automotive entities should start carefully examining the ASU and assessing the impact it may have on their current accounting policies, procedures, systems, and processes.

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