

# Investment Management Spotlight

## Navigating the New Revenue Standard

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## The Bottom Line

- On May 28, 2014, the FASB and IASB issued their final standard on revenue from contracts with customers. The standard, issued by the FASB as [ASU 2014-09](#),<sup>1</sup> 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.
- Asset managers will need to evaluate their revenue arrangements (including performance-based fees and up-front fees) under the revised requirements to determine how to recognize revenue related to their services.
- Accounting for performance-based fees (especially those subject to future market performance) may be affected by the requirement under the new standard to recognize revenue only when it is probable that the amount recognized will not be subject to significant future reversals.
- If an asset manager receives up-front distribution fees that are unrelated to a distinct performance obligation (i.e., do not result in the transfer of a promised service), it would defer recognizing those fees as revenue.
- The new standard requires significantly more extensive disclosures than current revenue standards. Therefore, asset managers may need to modify their systems and processes to gather information that is not otherwise readily available.

### Deloitte Dash

#### Revenue Recognition — Navigating the New Revenue Standard

Listen to a brief discussion about accounting issues that investment managers will need to consider under the new revenue standard.



<sup>1</sup> FASB Accounting Standards Update No. 2014-09, *Revenue From Contracts With Customers*.

# Beyond the Bottom Line

This *Investment Management Spotlight* discusses the framework of the new revenue model and highlights key accounting issues and potential challenges for asset managers that account for revenue under U.S. GAAP or IFRSs. For additional information about the new standard, see Deloitte's May 28, 2014, *Heads Up*.

## Thinking It Through

The ASU includes a scope exception for sales of financial instruments that are within the scope of ASC 860.<sup>2</sup> Accordingly, asset managers would continue to apply ASC 860 to disposals of financial instruments.

## Background

The goal of the revenue recognition project is to clarify and converge the revenue recognition principles under U.S. GAAP and IFRSs and to develop guidance that would streamline and enhance revenue recognition requirements while also providing "a more robust framework for addressing revenue issues." The boards believe that the standard will improve the consistency of requirements, comparability of revenue recognition practices, and usefulness of disclosures.

The ASU retains the overall model originally proposed, which outlines five sequential steps to recognizing revenue:

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

The ASU states that the core principle of the new revenue recognition guidance 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."

## Thinking It Through

As a result of the ASU, entities will need to reassess their current revenue accounting and determine whether accounting 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

### Performance-Based Fees

Asset manager fee arrangements may include performance-based fees that are calculated on the basis of the performance of the underlying assets being managed. Sometimes the performance of the underlying assets is evaluated against external factors such as a market index, and the fee arrangements may include complexities such as a high watermark or performance hurdles. Performance-based fees include carried interests and incentive fees.

The FASB and IASB believe that the new revenue standard will improve the consistency of requirements, comparability of revenue recognition practices, and usefulness of disclosures.

<sup>2</sup> For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

If a contract's variable consideration is highly susceptible to factors outside the entity's influence (including volatility in a market), the consideration could be subject to significant future reversal.

In each reporting period, there may be uncertainty about the amount the asset manager will ultimately receive in performance-based fees until the fees are finalized or close to being finalized. In addition, performance-based fees paid to an asset manager may be subject to clawback provisions for underperformance in future periods. These clawback provisions may exist until the underlying assets are liquidated (which could be several years after the payment).

The SEC staff guidance in EITF D-96<sup>3</sup> (codified in ASC 605-20-S99-1) provides two alternatives for recognizing performance-based management fees. Accordingly, an asset manager elects an accounting policy to do either of the following:

- Defer recognizing performance-based fee revenue until the end of the contract ("Method 1").
- Recognize revenue as of an interim date on which it is considered realizable because of termination provisions in the arrangement ("Method 2").

While the ASU does not supersede the guidance in EITF D-96, it provides specific requirements for contracts that include variable consideration (including arrangements whose consideration fluctuates depending on changes in the underlying assets managed by an asset manager). Specifically, it indicates that the estimated variable consideration (or a portion thereof) is included in the transaction price (and therefore eligible for recognition) only to the extent that it is probable that the cumulative amount of revenue recognized will not be subject to significant reversal. This concept is commonly referred to as the "constraint." Entities may use judgment in determining whether to include variable consideration in the transaction price; however, the ASU notes that if the variable consideration is highly susceptible to factors outside the entity's influence (including volatility in a market), the consideration could be subject to significant future reversal.

Since an asset manager's performance-based fees may be affected by the future performance of the underlying assets it manages, it is difficult to accurately predict how much of the performance-based revenue payable to the asset manager is not subject to future reversal until the fees are finalized or close to being finalized. Accordingly, for asset managers that currently apply Method 2, the timing of revenue recognition for these fees may be significantly delayed by the ASU's constraint on the amount of revenue that may be recognized as of a reporting date.

#### Thinking It Through

The SEC has indicated that it plans to review and update its revenue recognition guidance after the ASU is issued. The extent to which the ASU's guidance will affect a public entity will depend on how the SEC amends its guidance in EITF D-96 to be consistent with the new revenue standard.

Although the ASU could delay the recognition of these fees as revenue, the new guidance does not modify how asset managers should account for the associated costs (typically, compensation paid to employees). That is, although the revenue may be deferred until long after cash has been received by the asset manager, amounts distributed to employees may need to be recognized as an expense in the period in which the amounts are incurred since they represent costs associated with fulfilling the contract.

#### Thinking It Through

While the ASU includes a scope exception for financial instruments that are within the scope of other ASC topics, it does not address whether performance-based fees in the form of carried interests are (1) revenue contracts within the scope of the ASU or (2) financial instruments that should be accounted for as equity-method investments. This issue may be addressed by the AICPA implementation group.

<sup>3</sup> EITF Topic No. D-96, "Accounting for Management Fees Based on a Formula."

The example below, which is adapted from the ASU,<sup>4</sup> illustrates how an entity would apply the new revenue recognition requirements to a management arrangement that includes performance-based fees. Although the boards discussed whether termination provisions should affect the revenue recognition analysis, the ASU does not indicate whether the arrangement in the example includes any termination provisions that would allow the asset manager to terminate the contract and still receive all or part of its performance-based fees.

The ASU does not indicate whether the arrangement in its example of management fees that are subject to the constraint includes any termination provisions that would allow the asset manager to terminate the contract and still receive all or part of its performance-based fees.

#### Example

On January 1, 20X8, an entity enters into a contract with a client to provide asset management services for five years. The entity receives a 2 percent quarterly management fee based on the client's assets under management at the end of each quarter. In addition, the entity receives a performance-based incentive fee of 20 percent of the fund's return in excess of the return of an observable index over the five-year period. Consequently, both the management fee and the performance fee in the contract are variable consideration.

The entity accounts for the services as a single performance obligation in accordance with ASC 606-10-25-14(b), because it is providing a series of distinct services that are substantially the same and have the same pattern of transfer (the services transfer to the customer over time and use the same method to measure progress — i.e., a time-based measure of progress).

At contract inception, the entity considers the guidance in ASC 606-10-32-5 through 32-9 on estimating variable consideration and the guidance in ASC 606-10-32-11 through 32-13 on constraining estimates of variable consideration, including the factors in ASC 606-10-32-12. The entity observes that the promised consideration depends on the market and, thus, is highly susceptible to factors outside the entity's influence. In addition, the incentive fee has a large number and a broad range of possible consideration amounts. The entity also observes that although it has experience with similar contracts, that experience is of little predictive value in the determination of future market performance. Therefore, at contract inception, the entity cannot conclude that it is probable that a significant reversal in the cumulative amount of revenue recognized would not occur if the entity included its estimate of the management fee or the incentive fee in the transaction price.

As of each reporting date, the entity updates its estimate of the transaction price. Consequently, at the end of each quarter, the entity concludes that it can include in the transaction price the actual amount of the quarterly management fee because the uncertainty is resolved. However, the entity concludes that it cannot include its estimate of the incentive fee in the transaction price as of those dates. This is because there has not been a change in its assessment from contract inception — the variability of the fee based on the market index indicates that the entity cannot conclude that it is probable that a significant reversal in the cumulative amount of revenue recognized would not occur if the entity included its estimate of the incentive fee in the transaction price. As of March 31, 20X8, the client's assets under management total \$100 million. Therefore, the resulting quarterly management fee and the transaction price are valued at \$2 million.

At the end of each quarter, the entity allocates the quarterly management fee to the distinct services provided during the quarter in accordance with ASC 606-10-32-39(b) and ASC 606-10-32-40. This is because the fee is specifically related to the entity's efforts to transfer the services for that quarter, which are distinct from the services provided in other quarters, and the resulting allocation will be consistent with the allocation objective in ASC 606-10-32-28. Consequently, the entity recognizes \$2 million as revenue for the quarter ended March 31, 20X8.

<sup>4</sup> ASC 606-10-55-221 through 55-225.

Since the ASU's contract combination requirement may change what asset managers previously regarded as a unit of accounting, each arrangement should be carefully evaluated.

## Contract Combinations

Asset managers may contemporaneously enter into multiple arrangements with a fund to provide various services, including advisory, custodian, administrative, marketing, and distribution services. These contracts may be with different consolidated subsidiaries of the asset manager. 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."

Although entities are permitted by current U.S. GAAP to combine contracts under certain circumstances, the ASU will require contract combination when one or more of the criteria listed above are met. Since the contract combination requirement may change what asset managers previously regarded as a unit of accounting, each arrangement should be carefully evaluated.

### Thinking It Through

To determine whether contracts should not be combined, an asset manager should consider whether each of the contracted services could be performed by a separate third-party provider under similar terms and conditions. The ability to perform these services separately under similar terms and conditions may indicate that the services were not negotiated as a package with a single commercial objective and that the consideration paid for each contract does not depend on the price or performance of the other services. Asset managers should consider all facts and circumstances when making this evaluation.

## Up-Front Distribution Fees Received

Asset managers may use an in-house broker that distributes their sponsored products. In arrangements that include front-end load distribution fees, an investor will pay the in-house broker a fee upon subscribing to the fund. Under current U.S. GAAP, these distribution fees are generally recognized by the asset manager as revenue when received. Under the new standard, entities would apply the guidance on up-front fees to determine whether such fees are related to the transfer of a promised service (a "distinct" performance obligation). If the up-front fees are related to the transfer of a separate promised service, the entity should recognize an **allocated** portion of the total consideration as revenue at the time it transfers the related service to the customer. However, if the activities associated with the fee are not related to a separate performance obligation, revenue recognition would be deferred.

To be considered a separate performance obligation, the service needs to be distinct. A service is considered distinct (and therefore a performance obligation) if both of the following criteria are met:

- *Capable of being distinct* — "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."
- *Distinct within the context of the contract* — "The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract" (the ASU provides specific indicators of this criterion).

For example, an affiliate of an asset manager may enter into a distribution agreement that contains both distribution services and ongoing marketing activities. If the distribution services do not represent a separate performance obligation, any up-front distribution fees would be considered an advance payment for future services and would be recognized as revenue when those future services are provided. Given the significant difference in the accounting, asset managers should focus on identifying the promises made to the customer and whether those promised services represent distinct services (i.e., a performance obligation).

### Thinking It Through

When an up-front fee is considered an advance payment for future services, an asset manager would also need to consider the guidance on determining whether a contract with a customer has a financing component. Under that guidance, interest expense would be recognized for the effects of the time value of money if the timing of payments specified in the contract gives the asset manager a significant benefit for financing the services.

The ASU retains the cost guidance in ASC 946-605-25-8 that requires an entity to defer and amortize incremental direct costs associated with distributing a mutual fund's shares if the entity is compensated for these costs.

### Third-Party Distribution Fees Paid

An asset manager or its affiliates may pay fees to a third-party broker for distributing the asset manager's sponsored products and may be compensated for these costs through distribution fees charged to investors, including contingent deferred sales commissions (CDSCs) and 12b-1 fees. The ASU retains the cost guidance in ASC 946-605-25-8<sup>5</sup> that requires an entity that receives CDSC fees and 12b-1 fees (or fees similar to, or substantially the same as, CDSC fees and 12b-1 fees<sup>6</sup>) to (1) defer and amortize incremental direct costs associated with distributing a mutual fund's shares and (2) expense indirect distribution costs when such costs are incurred.

However, the ASU supersedes the guidance in ASC 946-605-25-8 on when to recognize as revenue the fees received from investors to compensate the entity for these costs (i.e., the current requirement that these fees should be recognized as revenue when received). Accordingly, such fees would be subject to the overall revenue recognition model.

### Thinking It Through

The IASB decided not to include any specific guidance on how asset managers or their affiliates should account for the fees they pay third-party brokers for distributing their products. Accordingly, entities that apply IFRSs would be required to evaluate such costs in accordance with the guidance in IFRS 15<sup>7</sup> on contract costs to determine whether the fees should be capitalized or expensed.

### Transfer of Rights to Certain Future Distribution Fees

Some distributors may receive a lump-sum cash payment from a third party for the distributor's right to future cash flows related to distribution fees (CDSCs and 12b-1 fees) for shares previously sold. The ASU supersedes the industry-specific guidance in ASC 946-605,<sup>8</sup> which requires immediate revenue recognition for the sale of rights to cash flows from future distribution fees if certain criteria are met. Since these arrangements may include provisions that protect the purchasers of such rights if certain events occur (e.g., termination of the 12b-1 plan by the fund's independent board of directors), entities will need to carefully assess whether such arrangements should be

<sup>5</sup> Formerly EITF Issue No. 85-24, "Distribution Fees by Distributors of Mutual Funds That Do Not Have a Front-End Sales Charge."

<sup>6</sup> The ASU retains the guidance in ASC 946-605-25-2 and 25-3 (formerly EITF Topic No. D-76, "Accounting by Advisors for Offering Costs Paid on Behalf of Funds, When the Advisor Does Not Receive Both 12b-1 Fees and Contingent Deferred Sales Charges").

<sup>7</sup> IFRS 15, *Revenue From Contracts With Customers*.

<sup>8</sup> Formerly FASB Staff Position (FSP) No. EITF 85-24-1, "Application of EITF Issue No. 85-24, 'Distribution Fees by Distributors of Mutual Funds That Do Not Have a Front-End Sales Charge,' When Cash for the Right to Future Distribution Fees for Shares Previously Sold Is Received From Third Parties."

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.”

accounted for as a borrowing in accordance with ASC 470<sup>9</sup> or evaluated as sales under the revenue standard. Entities that have applied ASC 946-605 and recognized as revenue the consideration received in these transactions will need to reassess their accounting for these arrangements.

## Gross Versus Net Presentation

Often, an asset manager or its affiliates involve third parties to provide services it has agreed to perform. In this situation, the asset manager must determine whether “the nature of its promise is a performance obligation to provide the specified goods or services itself (that is, the entity is a principal) or to arrange for the other party to provide those goods or services (that is, the entity is an agent).” The ASU provides indicators and other implementation guidance to help an entity determine whether it is acting as a principal (with revenue recognized on a gross basis) or as an agent (with revenue recognized on a net basis).

### Thinking It Through

While the ASU’s indicators for determining whether an entity is acting as a principal or as an agent in an arrangement are similar to those in ASC 605-45,<sup>10</sup> the ASU’s guidance on making this determination differs slightly from that of current U.S. GAAP by applying an overall principle based on the “control” notion and replacing the examples in the current guidance with more limited examples. In general, however, the principal-versus-agent concept under the ASU seems consistent with current U.S. GAAP. Therefore, significant changes to this aspect of current accounting policies are not expected.

## 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.

<sup>9</sup> Formerly EITF Issue No. 88-18, “Sales of Future Revenues.”

<sup>10</sup> Formerly EITF Issue No. 99-19, “Reporting Revenue Gross as a Principal Versus Net as an Agent.”

Since the ASU allows entities to apply the standard retrospectively and use certain optional practical expedients at their discretion, asset managers may need to assess contracts that commenced several years before the ASU's effective date.

### 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 to determine the transition approach that is practical to apply and most beneficial to financial statement users.

## Challenges for Asset Managers

### 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 asset managers 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 allows entities to apply the standard retrospectively and use certain optional practical expedients at their discretion. As a result, asset managers may need to assess contracts that commenced several years before the ASU's effective date. In addition, asset managers will most likely be required to perform dual tracking of revenue balances during the retrospective period given the potential difficulty of retroactively recalculating revenue balances when the ASU becomes effective.

### Systems, Processes, and Controls

To comply with the ASU's new practice and disclosure requirements, asset managers 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. Asset managers 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 asset managers 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.



Data, systems, processes, and controls that do not currently exist may be needed to support the implementation of the standard.

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

Even though the ASU is not effective until December 15, 2016 (with a maximum deferral of one year for nonpublic entities that apply U.S. GAAP), asset managers 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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