

## Power & Utilities Spotlight

### Shedding Light on the Proposed Leases Standard

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## The Bottom Line

The proposed lease guidance could significantly affect P&U companies, since they would need to reassess their contracts, including power purchase agreements and those related to transportation and storage, to determine whether such contracts contain a lease.

- On May 16, 2013, the FASB and IASB jointly issued a [revised exposure draft](#) (ED) on lease accounting. Under the proposal, lessees would record most leases, including those currently treated as operating leases, on their balance sheet by recognizing a right-of-use (ROU) asset and a corresponding lease liability.
- The proposed lease guidance could significantly affect power and utilities (P&U) companies, since they would need to reassess their contracts, including power purchase agreements and those related to transportation and storage, to determine whether such contracts contain a lease. For companies with a large number of contracts in their portfolio, doing so could take considerable time and effort.
- The ED defines a lease as a “contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.” To determine whether a given contract meets this definition, companies would need to assess whether the contract is based on an identified asset and whether the lessee obtains the right to control the use of the asset for a particular period.
- Under the ED, a lease is classified as one of two types on the basis of (1) whether the underlying asset is considered “property” (defined as “[l]and or a building, or part of a building, or both”) and (2) the terms of the lease. Although lessees would record most leases on their balance sheet, the ED’s effect on the income statement would depend on the lease classification.
- Comments on the ED are due by September 13, 2013.

# Beyond the Bottom Line

This *Power & Utilities Spotlight* provides insight into select aspects of the ED that are relevant to lessees and lessors in the P&U industry. For a comprehensive overview of the ED, including illustrative examples, see Deloitte's May 17, 2013, [Heads Up](#).

## Overview of the Proposed Standard

### Background

The proposed changes would significantly affect entities in the P&U industry because of their extensive use of fixed assets under contracts that may qualify as leases under the ED. Agreements for the use of such assets are frequently customized and include other services and components that are important to the contract. While under current guidance the accounting for operating leases is often similar to that for service contracts, this would no longer be the case under the proposal. Accordingly, entities would need to reevaluate their contracts to determine the appropriate accounting.

### Identifying a Lease

The ED defines a lease as “a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.” When determining whether a contract contains a lease under the ED, entities should assess whether (1) the contract is based on an identified asset and (2) the lessee obtains the right to control the use of the asset for a particular period.

The ED's concept of identifying the asset is consistent with that in current U.S. GAAP. Under the proposal, a leased asset must be specifically identifiable either explicitly (e.g., by a named generating facility) or implicitly (e.g., the asset is the only one available to meet the requirements of the lease contract). The evaluation should take into account any substantive rights of the lessor to substitute the underlying asset. Substitution rights would be considered substantive if the lessor can substitute the leased asset without the customer's consent and no barriers would prevent substitution (e.g., high costs or the unavailability of alternative assets). The ED also notes that a specified asset could be a physically distinct portion of a larger asset (e.g., one floor of a building). However, a capacity portion of a larger asset that is not physically distinct (e.g., a percentage of a natural gas pipeline or storage facility) would generally not be a specified asset under the proposal.

The ED would align the assessment of whether a contract gives the lessee the right to control the specified asset with the concept of control developed as part of the FASB's and IASB's joint project on revenue recognition. Accordingly, a contract would be deemed to convey the right to control the use of an identified asset if the customer has the ability to direct, and derive benefits from, the use of that asset. The ability to direct the use of the specified asset would include the determination of when and how the asset is used. Benefits from use would include direct and indirect economic gain stemming from use of the asset (e.g., renewable energy credits and secondary physical output).

Under the ED, a contract would be deemed to convey the right to control the use of an identified asset if the customer has the ability to direct, and derive benefits from, the use of that asset.

Under the ED, a customer that can specify the output from the use of the asset but is unable to make decisions about the processes that result in that output generally will not have the ability to direct the use of the asset. The determination of whether the customer possesses that ability is likely to affect whether gas supply contracts and power purchase arrangements constitute leases. See [Implications for P&U Companies](#) below for additional details.

The ED’s proposed accounting model for lessees is based on an ROU approach under which lessees would generally recognize (1) an asset for the right to use the underlying asset (ROU asset) and (2) a liability to make lease payments.

### Lessee Accounting

The ED’s proposed accounting model for lessees is based on an ROU approach under which lessees would generally recognize (1) an asset for the right to use the underlying asset (ROU asset) and (2) a liability to make lease payments. Both would initially be measured at the present value of the future lease payments. Under the ED, lease arrangements would be classified as one of two types: a financing lease (Type A lease) or a straight-line lease (Type B lease). The subsequent accounting would depend on this classification.

To determine the lease classification, a lessee would consider the nature of the asset being leased as well as the terms and conditions of the lease, as explained in the following table:

Lease of an Asset Other Than Property	Lease of Property
<p>A lessee will classify a lease of an asset other than property as Type A (financing approach) unless:*</p> <ol style="list-style-type: none"> <li>1. “The lease term is for an insignificant part of the <b>total economic life</b> of the underlying asset” (emphasis added); or</li> <li>2. “The present value of the lease payments is insignificant relative to the fair value of the underlying asset.”</li> </ol> <p>* If a lessee has a significant economic incentive to exercise an option to purchase the underlying asset, the lease would be classified as Type A regardless of whether it meets the exceptions.</p>	<p>A lessee will classify a lease of property as Type B (straight-line approach) unless:</p> <ol style="list-style-type: none"> <li>1. “The lease term is for the major part of the <b>remaining economic life</b> of the underlying asset” (emphasis added); or</li> <li>2. “The present value of the lease payments accounts for substantially all of the fair value of the underlying asset”; or</li> <li>3. The “lessee has a significant economic incentive to exercise an option to purchase the underlying asset.”</li> </ol>

For leases accounted for under the financing approach, the ROU asset would be amortized in the same manner as other nonfinancial assets. For leases accounted for under the straight-line approach, the ROU asset would be amortized in a way that ensures a straight-line total lease expense (including the interest expense related to the lease liability). Such straight-line lease expense would be presented as a rental expense rather than depreciation and interest costs.

It is expected that many current operating leases for properties would qualify for the straight-line lease expense approach under the ED (although companies would now recognize the lease obligation and ROU asset). However, leases that begin within the latter portion of the total estimated life of the property would more likely be accounted for under the financing approach because the ED, unlike current U.S. GAAP, does not propose exemptions for evaluating the classification of a lease whose term begins during the last 25 percent of the asset’s total economic life.

The proposed lease guidance would require a lessee to record all leases (other than those deemed short-term) on the balance sheet. This requirement could significantly affect the balance sheet of a P&U company that has a large number of leases in its portfolio. Further, the two-model approach is expected to have a far greater impact on the statement of operations and cash flows for current operating leases of assets other than property. It is expected that only shorter-term leases of assets other than property would qualify for the straight-line approach.

## Lessor Accounting

Under the proposal, a lessor would classify a lease as a receivable-and-residual lease (Type A lease) or an operating lease (Type B lease) on the basis of the nature of the asset being leased as well as the terms and conditions of the lease, as explained in the following table:

Lease of an Asset Other Than Property	Lease of Property
<p>A lessor will classify the lease of an asset other than property as a Type A lease (receivable-and-residual approach) unless:</p> <ol style="list-style-type: none"> <li>1. "The lease term is for an insignificant part of the <b>total economic life</b> of the underlying asset" (emphasis added); or</li> <li>2. "The present value of the lease payments is insignificant relative to the fair value of the underlying asset."</li> </ol> <p>* If a lessee has a significant economic incentive to exercise an option to purchase the underlying asset, the lease would be classified as Type A regardless of whether it meets the exceptions.</p>	<p>A lessor will classify the lease of property as a Type B lease (operating lease approach) unless:</p> <ol style="list-style-type: none"> <li>1. "The lease term is for the major part of the <b>remaining economic life</b> of the underlying asset" (emphasis added); or</li> <li>2. "The present value of the lease payments accounts for substantially all of the fair value of the underlying asset"; or</li> <li>3. The "lessee has a significant economic incentive to exercise an option to purchase the underlying asset."</li> </ol>

Under the proposal, a lessor would classify a lease as a receivable-and-residual lease (Type A lease) or an operating lease (Type B lease) on the basis of the nature of the asset being leased as well as the terms and conditions of the lease.

If the lessor concludes that it should account for the lease by using the receivable-and-residual approach, it would derecognize the carrying amount of the underlying asset and recognize:

- A lease receivable representing the right to receive lease payments throughout the lease term. This is measured as the present value of the lease payments discounted at the rate the lessor charges the lessee.
- A residual asset representing the lessor's claim to the residual value of the leased asset at the end of the lease term. This is measured as the present value of the residual asset less the deferred profit (if any). In subsequent periods, the accretion of the residual asset would be recognized as interest income.
- A gain or loss on the effective "sale" of a portion of the underlying asset. This is measured as the difference between the lease receivable and an allocated amount of the previous carrying value of the underlying asset.

The receivable-and-residual approach is generally consistent with the sales-type lease accounting approach that lessors apply under current U.S. GAAP; however, the portion of the profit related to the residual asset would be deferred. Accordingly, a lessor would recognize up-front profit or loss on the "sale" and then recognize interest income on the receivable (as well as the residual asset) over the lease term. Lease-related income would be front-loaded under the receivable-and-residual approach as a result of the recognition of both the "sale" at inception and higher interest income in the earlier portion of the lease.

The ED requires lessors to present the "sale" in their income statement by using a method that is consistent with their business model. That is, the gain or loss might be recognized on either a gross or a net basis.

If a lessor determines that the lease should be accounted for under the operating lease approach, it would account for the lease contract by using an approach similar to that for operating leases under current U.S. GAAP. That is, at lease commencement, the lessor would continue to recognize the leased asset in its statement of financial position and, in subsequent periods, would recognize (1) lease income by using a straight-line approach or another systematic basis and (2) depreciation expense for the leased asset by using an appropriate method of depreciation.

The ED's proposed guidance could significantly affect when a lessor recognizes lease income. Leases of assets other than property that lessors currently treat as operating leases would generally be accounted for by using the receivable-and-residual approach, given the expectation that only shorter-term leases of such assets would qualify for the operating lease approach. Specifically, recognition of income on a straight-line basis over the lease term would be replaced with recognition of up-front profit (if any), followed by recognition of a decreasing amount of interest income in each subsequent period.

## Implications for P&U Companies

Agreements that P&U companies enter into are frequently customized and include services and other components critical to completing the contract. While the proposed definition of a lease is similar to the definition now in use in some respects, it is different in others. In particular, the concept of right of use or control has been modified to achieve consistency with the proposed revenue guidance being developed jointly by the boards. Accordingly, P&U companies would need to assess their contracts under the proposed leases guidance to determine whether such agreements meet, or have components that meet, the definition of a lease under the proposed guidance. Under the proposal, when determining whether a contract contains a lease, they would assess whether (1) the contract is based on an identified asset and (2) the lessee obtains the right to control the use of the asset for a particular period.

P&U companies will have to determine whether a PPA gives the off-taker control of an identified generating facility because the off-taker has the ability to direct the use, and derive the benefits from the use, of the facility.

### Power Purchase Agreements

Under current guidance, a power purchase agreement (PPA) is accounted for as a lease if the off-taker (1) agrees to buy all, or substantially all, of the output(s) of a specified generating facility and (2) pays for the output(s) under pricing terms that are neither fixed per unit nor indexed to market prices. However, the proposed definition of a lease focuses on whether the off-taker has control of the specified generating facility. That is, an arrangement would not be considered a lease solely on the basis of the pricing and the extent of outputs purchased under the contract. P&U companies will have to determine whether a PPA gives the off-taker control of an identified generating facility because the off-taker has the ability to direct the use, and derive the benefits from the use, of the facility.

#### *Ability to Direct the Use of the Facility*

The degree to which an off-taker can direct the use of a specified generating facility will depend on the terms of the PPA. Traditional "vanilla" PPAs that provide an off-taker with dispatch rights and require that the operator follow prudent utility operating practices in running the facility are unlikely to enable the off-taker to direct the use of the generating facility under the proposed definition of control. Dispatch rights may give an off-taker the ability to direct and specify the timing of a facility's outputs, but not the ability to dictate how the facility is used to produce those outputs.

Similarly, an agreement that conveys control over both inputs and outputs but does not convey operating control will most likely not meet the definition of a lease under the ED. For example, terms in a standard tolling arrangement that require the off-taker to provide the fuel used by a specified generating facility and entitle the off-taker to all of the output would not be sufficient in and of themselves to demonstrate the off-taker's ability to direct the use of the facility under the proposal.

However, other rights that a PPA or tolling arrangement grants an off-taker could affect the off-taker's control assessment, including but not limited to:

- The off-taker's right to determine the facility's operator.
- The off-taker's right to determine specific operating procedures, outside those requiring the operator to follow prudent utility operating practices, by which the operator must strictly abide.
- The off-taker's involvement in the design of the generating facility.

In each scenario, the off-taker would need to evaluate on the basis of the specific facts and circumstances whether it has the ability to direct the use of the facility and whether the arrangement would be considered a lease under the proposal. Judgment will be required in this evaluation.

The ED indicates that a customer that is involved in the design of a specified asset may have the ability to direct the asset's use, given that the customer may be predetermining, before lease commencement, how the asset is to operate and run in order to derive economic benefits from the use of the asset. However, the ED does not indicate how involved in the asset's design the customer would need to be to demonstrate that it has the ability to direct the asset's use, or how to consider the customer's involvement in design together with other ongoing decisions in a PPA or other off-take agreement. Considerations related to the role of design involvement in connection with variable interest entity consolidation analyses may be informative in this regard. Companies may wish to request further clarity on the implications of design involvement during the comment process.

If a single lease contract or component of a lease contract gives a P&U company the right to use more than one asset, the entity would have to determine the primary asset in the arrangement, which would dictate the lease classification and income statement profile.

### ***Ability to Derive the Benefits From the Use of the Facility***

For an arrangement to be considered a lease, the off-taker must also have the right to obtain substantially all of the benefits from directing the generating facility's use during the contract term. Although the ED does not explicitly define "benefits," the proposal explains that the term encompasses all potential benefits, including those that may be realized indirectly through a subsequent transaction with a third party. Therefore, an off-taker would conclude that certain other utility provided in a PPA (e.g., capacity, renewable energy credits, or steam) constitutes benefits. An off-taker would have to consider whether the receipt or nonreceipt of such additional utility from the use of a facility affects the accounting for a particular contract or contractual component as a lease. It is important to note that certain tax attributes relating to the ownership of the asset would not be considered a benefit.

### **Transportation and Storage Contracts**

Existing contracts to transport or store gas or other fuel products would need to be evaluated under the proposed definition of a lease. Currently, a contract for a portion of a pipeline transport or storage capacity is not necessarily precluded from being a lease. Under the proposed lease standard, however, a capacity portion of a larger asset would have to be physically distinct or substantially all of the larger asset's capacity to be considered a specified asset. Given that pipeline and storage contracts vary significantly in structure (e.g., in terms of contracting for the rights to a percentage of an asset's capacity or benefits), P&U companies would need to evaluate their contracts to determine whether they should account for them under the guidance on leases, revenue recognition, or derivatives.

P&U companies currently may structure agreements for electricity off-take, or to satisfy commodity transportation and storage needs, in order to avoid on-balance-sheet accounting under either derivative or capital lease guidance. Those structures may not offer the same accounting benefits once the proposed lease model is in effect.

### **Other Accounting and Measurement Considerations**

For a lease or a contract that contains lease components, there are several other accounting and measurement considerations under the proposed guidance that could especially affect entities in the P&U industry.

#### ***Lease Classification***

If a single lease contract or component of a lease contract gives a P&U company the right to use more than one asset, the entity would have to determine the primary asset in the arrangement. That determination would dictate the lease classification and income statement profile.

Regulated P&U companies that currently apply ASC 980-840 to lease contracts would need to evaluate such contracts under the proposed lease guidance and may not have the benefit of a regulatory accounting overlay.

#### Example

A PPA accounted for as a lease provides for the off-take from a combined-cycle power plant and gives a party the right to use a natural gas-powered turbine (equipment) and the building housing the turbine (property). The primary purpose of the agreement is to lease the turbine generating the power, an asset other than property. Therefore, the primary asset in the PPA would be considered other than property and the lease would be accounted for as a Type A lease with a front-loaded statement of operations profile. Under the proposed guidance, today's notion of "integral equipment" would not be relevant in distinguishing between property and nonproperty.

#### ***In-Substance Fixed Lease Payments***

The proposed guidance would also modify the definition of lease payments. Under the proposal, companies would need to include in-substance fixed lease payments structured as variable or contingent payments in measuring the lease liability (for lessees) or receivable (for lessors). Accordingly, P&U companies would need to evaluate their contracts to determine whether those agreements include in-substance fixed lease payments.

PPAs for the output of a wind farm may include a price that is fixed per unit of energy delivered. The wind farm developer may undertake an engineering production case to support the wind farm's expected annual energy output at a particular level (e.g., 95 percent probability, or P95 production level). Although the off-taker from the wind farm may consider the expected P95 production to indicate a relatively fixed or minimum amount of annual delivered energy, that expected amount is contingent (i.e., if the wind does not blow, payment will be zero). Therefore, the expected amount would not constitute an in-substance fixed lease payment.

Given the varying views among the FASB members on how variable lease payments should be accounted for and dissent by several Board members over the ED's measurement provisions, P&U companies should continue to focus on the Board's redeliberations related to such payments.

#### ***EITF 01-8 Grandfathering***

P&U companies may have PPAs, other off-take agreements, or fixed-asset leases that were executed before May 2003. Companies were not required to reassess those contracts when the guidance in EITF 01-8<sup>1</sup> (currently ASC 840-10-15<sup>2</sup>) on determining whether an arrangement contains a lease became effective. However, under the ED, all outstanding contracts would need to be evaluated in light of the proposed new definition of a lease. That is, there would be no grandfathering under the proposed guidance, even for contracts entered into before May 2003.

#### ***Consideration of Other U.S. GAAP***

The guidance in U.S. GAAP on leases of regulated entities (ASC 980-840) would be superseded by the proposed guidance. It is unclear whether the removal of ASC 980-840 would eliminate the benefit of the regulatory accounting overlay provided by ASC 980. Specifically, regulated P&U companies that currently apply ASC 980-840 to lease contracts would need to evaluate such contracts under the proposed lease guidance and may not have the benefit of a regulatory accounting overlay. This could affect the timing of expense recognition for financial reporting purposes. Lease expense that is currently recognized on a straight-line basis in accordance with the accounting requirements in ASC 980-840 (i.e., consistent with the approach used for rate-making purposes) regardless of the lease classification requirements in ASC 840 may need to be recorded in accordance with the general lease classification requirements of the ED.

<sup>1</sup> EITF Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease."

<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*."

While it is expected that fewer arrangements in the industry will meet the definition of a lease under the ED, this change could have a significant impact on the financial reporting of regulated P&U companies. P&U entities that want to provide comments to the FASB on the proposed elimination of ASC 980-840 should submit comments no later than September 13, 2013.

In addition, in a manner consistent with current lease accounting, P&U companies would need to consider the interaction of certain lease contract terms with other U.S. GAAP accounting requirements. For example, P&U companies would have to determine whether an obligation to decommission a leased asset or a leasehold improvement should be considered a “lease payment” within the context of the proposed lease guidance or an asset retirement obligation under other U.S. GAAP. This determination could result in significantly different initial and subsequent measurement considerations.

## Operational Challenges

### Information Technology Systems, Applications, and Processes

Companies may face challenges associated with changes to their information technology (IT) systems, applications, and processes that may be necessary for applying the proposed guidance:

- *Changes to systems, processes, and controls* — Companies will most likely need to make several changes to systems, processes, and controls to collect and store key data, perform calculations, and process accounting entries in a controlled and secure environment on an ongoing basis. To allow for potentially lengthy lead times, companies would need to implement these changes long before adopting the standard.
- *Data requirements* — Some companies have numerous lease agreements across multiple decentralized locations in different business and operating units. It may be time-consuming for such companies to gather data, particularly when the information is located in multiple systems or maintained manually.
- *Data repository considerations* — Companies often have limited systems capability to track and record the additional lease information they need to apply the new guidance. In addition, because many lease agreements involve decentralized locations, companies may find a centralized information repository helpful when developing a complete inventory of leases.
- *IT systems* — Companies must consider whether to develop functionality within an existing enterprise resource planning system or whether to implement new modules to comply with the proposed lease standard. In addition, companies may need to establish new processes for identifying and assigning value to embedded service and lease components in service arrangements that will now contain a lease under the proposed standard. Because systems initiatives entail long lead times, interim solutions may also be required.

### Implementation Considerations

P&U companies should also consider potential implementation challenges presented by the proposed guidance, including those related to:

- *Increased judgment* — Given the replacement of bright-line rules with a principles-based approach, companies will often have to use judgment in applying the new guidance (e.g., when determining whether an arrangement is a lease, choosing the appropriate lease classification, and measuring lease payments and lease term). These judgments should be consistent throughout the organization.

To allow for potentially lengthy lead times, companies would need to implement changes to systems, processes, and controls long before adopting the standard.

- *Periodic evaluation* — Companies would have to revisit their lease portfolios periodically, on an individual-lease basis, to reevaluate whether they need to change any assumption (e.g., the lease term) on the basis of new facts or circumstances. The process may be labor-intensive for companies that have entered into a large number of lease arrangements.
- *Impact on the financial statements* — For leases accounted for under the financing approach, the proposed standard would result in lessees' recording higher lease expenses at the beginning of the lease that diminish toward the end of the lease period. In addition, the proposed guidance could have reporting implications for the statutory reporting of subsidiaries because it would significantly affect the accounting for intercompany leasing activities.
- *Taxes* — Tax departments would need to evaluate how the accounting changes will affect the overall tax analysis, including cash taxes paid (i.e., financial statement changes may affect transfer pricing, state apportionment, or non-U.S. taxes) and changes in deferred taxes related to book/tax differences in the accounting for leases.
- *Contractual terms tied to financial metrics* — The proposed accounting changes could affect many key financial statement measures tied to the balance sheet (e.g., leverage ratios) and income statement (e.g., EBITDA). P&U companies should proactively assess the impact of the accounting changes on contracts with terms linked to financial metrics, such as debt arrangements, earn-outs, and compensation arrangements.

## Thinking Ahead

The FASB and IASB have requested feedback on many of the core elements of the ED. P&U companies are encouraged to continue their active role in the standard-setting process. Comments on the ED are due by September 13, 2013.

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