Revenue Recognition: Understanding the New Standard

January 14, 2015
IIA Meeting
San Diego, CA

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- Global organization with global talent and best practices, serving local markets.
- Practice areas: Finance & Accounting, Information Management, Governance, Risk & Compliance, Supply Chain, Legal & Regulatory, Corporate Advisory & Restructuring, Strategic Communications

We partner with business leaders and their teams to plan and execute initiatives as well as support day-to-day operations. Working collaboratively with our clients, we provide:

- **ADVISORY**
  - Project scoping, approach, management and execution
- **PROJECT**
  - Subject matter or functional expertise for specific projects
- **INTERIM**
  - Management level expertise for daily operations

$567 M REVENUE IN FISCAL YEAR 2014  
3,100 PROFESSIONALS SERVING CLIENTS IN OVER 70 COUNTRIES

10-20 YEARS AVERAGE EXPERIENCE FOR OUR PROFESSIONALS  
87 OF THE FORTUNE 100 HAVE BEEN OUR CLIENTS

55% OF THE FORTUNE GLOBAL 50 HAVE BEEN OUR CLIENTS  
OUR TOP 50 CLIENTS HAVE REMAINED SO YEAR AFTER YEAR
Agenda

- Overview
- Changes to Revenue Recognition
- Implementation
- Control Considerations
Overview

ASU 2014-09 & IFRS 15

The New Revenue Recognition Standard was issued May 28, 2014

Joint FASB and IASB project to issue a converged standard since 2002

Eliminates all industry-specific guidance, replacing it with one standard

Most companies will be affected – those following industry-specific accounting may have the most difficulty with implementation

IN SCOPE: All companies that enter into contracts with customers to transfer goods, services or nonfinancial assets

63+ Examples

700+ pages long

Effective 2017 – 2 transition methods

4 ½ pages of disclosure requirements
Overview - Applying the Standard...It’s Complicated


Combination of contracts. Extended warranties. Bill & Hold.

Time value of money.

Constraints. Free or discounted goods.

Variable consideration.

Disclosures. VSOE.

Licenses.

Is there a contract?

Multiple element arrangements.

Input/output methods.

Customary business practices.

Collectability.

Recognition over time or point in time. Cost capitalization.

Discount allocation to performance obligations. Units of Delivery / POC

Five Step Process
1. Identify customer’s contracts
2. Identify separate performance obligations in contracts
3. Determine transaction price
4. Allocate transaction price to separate performance obligations
5. Recognize revenue when entity meets performance obligation
Revenue Recognition - Overview

- Objective is to converge standards and provide a single, high-quality standard to recognize revenue consistently across entities and jurisdictions
- Focus is on the Contract with the Customer and transfer of control

**WHAT does the CUSTOMER receive and WHEN?**

**Effective Date:**

- **US Public Companies:** Annual periods beginning after Dec. 15, 2016 and interim periods within that period – early adoption NOT permitted
- **IFRS:** Annual periods beginning after Jan. 1, 2017 – early adoption IS permitted
- **US Nonpublic Companies:** Annual periods beginning after Dec. 15, 2017 and interim periods beginning the following year – early adoption IS permitted, but not before public companies

**Possibility of a Delay?**
Selecting a Transition Method

Although the Effective Date for Public Companies is Jan. 1, 2017, implementation should begin NOW to capture necessary data.

- **Full Retrospective**
  - 2015: Current GAAP
  - 2016: Current GAAP
  - 2017: New GAAP
  - Cumulative Effect: 1/1/2015

- **Modified Retrospective**
  - 2015: Current GAAP
  - 2016: Current GAAP
  - 2017: New GAAP

- **New GAAP**
  - 2015: (restated)
  - 2016: New GAAP
  - 2017: New GAAP

- **Effective Date**
  - 1/1/2017

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* Practical expedients available

** SEC will allow companies to present additional years in the Selected Data Tables in Current GAAP as long as this is disclosed
- **Modified Retrospective approach will likely be less work**
  - Peers – investor expectations
  - Meaningful information in financials/MD&A (trends)
  - System limitations (dual reporting capability)
  - Contract characteristics (duration, nonstandard terms, volume, location, modifications)
  - Availability of historical data
  - Impact on other contracts (“orphan” revenue; expense doubling)
  - Controls / availability of resources
  - Equity-method investments; Emerging Growth Companies (EGCs)
STEP 1: Identify the contract with the customer

Written, oral or implied

Contract exists if (all of the following criteria):

- Commercial substance (changes in cash flows expected)
- Approval & commitment to perform from both parties
- Rights & responsibilities of parties are identified
- Payment terms identified
- Probable that the entity will collect the consideration

Enforceable by LAW

No contract = liability for cash received or work performed

Combining contracts

Contract Modifications
STEP 2: Identify the separate performance obligations in the contract:

New Unit of Account (no longer the contract)

Identify as a performance obligation each promise to transfer a good or service to a customer that is either:

1. A good or service (or bundle) that is DISTINCT:
   a) customer can use the good or service either on its own or together with resources that are readily available to the customer. **AND**
   b) Distinct within the context of the contract because the good or service is not highly dependent on or highly interrelated with others promised in the contract

2. A series of G&S that are substantially the same and have the same pattern of transfer to the customer

Bundled goods or services: *If the risks are inseparable, account for the bundle as a single performance obligation (combine until you have a distinct bundle).*

Consider customary business practices

Material rights

Customer Loyalty Programs

Warranties
STEP 3: Determine the transaction price

Transaction price is the consideration an entity receives, or expects to receive, in exchange for transferring goods or services to a customer, excluding amounts collected on behalf of third parties.

- Variable consideration must be estimated – most likely amount or expected value
  - Constraint: should be probable [IFRS: highly probable] it’s not subject to risk of significant reversal
    - Qualitative Assessment – consider factors:
      - Factors outside entity’s control
      - Time before uncertainty resolved
      - Experience with similar contracts
      - Practice of providing concessions
  - Exception: sales or usage-based royalties from licenses of intellectual property recognized at later of (1) subsequent sale or usage or (2) satisfaction of performance obligation
  - Update quarterly
STEP 3: Determine the transaction price (con’t)

- Time Value of Money (< one year practical expedient); discount rate implicit in the contract or considering arm’s length
- Non-cash consideration (Fair Value or standalone selling price) – EX 31: Common Stock received for services
- Consideration payable to customer (as a reduction of the transaction price) – Collectability: Transaction price is what the entity is entitled to, but must be probable to recognize revenue – recognized as expense (consider in Steps 1 & 3)
STEP 4: Allocate the transaction price to the separate performance obligations

Allocate to each separate performance obligation the amount of consideration the entity expects to receive in exchange for satisfying that performance obligation.

- Allocate on a relative stand alone selling price basis (estimate but maximize observable inputs – using adjusted market assessment or expected cost + margin)
- If highly variable, consider a residual technique by reference to the total transaction price less the standalone selling price of other goods or services in the contract (different from today)

Criteria are specified for allocating discounts and variable consideration entirely to one (or more) performance obligations

Allocate discount first if using residual approach & sufficient observable evidence exists to allocate discount to less than all performance obligations
STEP 5: Recognize revenue as performance obligations are satisfied

Generally when the good or service is transferred to the customer

Customer has control when they have the ability to direct the use of and receive the benefit from the good or service

- Over Time if at least one of these is met:
  - Customer simultaneously receives and consumes benefits provided as the entity performs (EX 13 – payroll processing)
  - Entity’s performance creates or enhances an asset that the customer controls as the asset is created or enhanced (EX 15 – building a satellite)
  - Entity’s performance does not create an asset with an alternative use AND the entity has an enforceable right to payment for performance completed to date (EX 14 – consulting)
  - If over time, select an appropriate measure of progress in a manner that best depicts the transfer of goods or services to the customer
    - If not possible, recognize revenue to the extent of costs incurred
STEP 5: Recognize revenue as performance obligations are satisfied (cont.)

- At a Point in Time -- Control indicators
  - Not necessary to meet all the indicators
    - No single indicator is determinative
    - Consider all facts and circumstances - Some provisions (reseller agreements, cancellation privileges, fiscal funding clauses) may preclude revenue recognition if reasonably assured indicators are not present.

- Goods
  - Customer has an unconditional obligation to pay
  - Customer has legal title
  - Customer has physical possession
  - Customer has the risks and rewards of ownership
  - Customer has accepted

- Right of Return – consider when control passes
  - Recognize Revenue in amount expected to be entitled (fixed & variable)
  - Recognize Liability for refunds/credits to be provided & asset for product recovery
Licenses

1. Is the license Distinct (Step 2)?
2. Does it provide the customer with:
   - A right to use intellectual property (IP) at a point in time
   - Access to IP over time
     - Licensor will undertake activities that significantly affect the IP;
     - License directly exposes the customer to any effects of the licensor’s activities that affect the IP, and
     - Those activities do not transfer a good or service to the customer as those activities occur
**Contract Costs – Overview**

- **Acquisition costs** – capitalize incremental costs of obtaining a contract that the entity expects to recover as a separate asset. Asset would subsequently be measured on a systematic basis consistent with the pattern of transfer of the related goods and services.
  - Practical Expedient

- **Fulfillment costs** (e.g., precontract or setup costs) are capitalized if they:
  - Relate directly to a specific anticipated contract
  - Generate or enhance resources that will be used to satisfy future performance obligations
  - Are expected to be recovered

- **Impairment**

- **Amortization**
Disclosures

• Disaggregated information about revenue recognized from contracts with customers, including a breakout of revenue into appropriate categories detailing how revenue and cash flows are affected by economic factors and the relationship to segment disclosures;

• Contract balances, including the opening and closing balances of receivables, contract assets, and contract liabilities;

• Qualitative and quantitative information about costs capitalized as assets;

• Performance obligations remaining at period-end, including allocated transaction price and quantitative or qualitative discussion of when amounts will be recognized as revenue (i.e. back-log); and

• Significant judgments, and changes in judgments, made in applying the requirements to those contracts.
TRANSITION RESOURCE GROUP

July 18, 2014 Meeting:
1. Determining Whether an Entity Offering Internet-Related Intangible Goods and Service Arrangements Is a Principal or an Agent
2. Determining Whether Certain Amounts Billed to Customers Should Be Presented as Revenue or a Reduction of Costs
3. Sales and Usage-Based Royalties in Contracts With Licenses and Goods or Services Other Than Licenses
4. Inclusion of Renewal Periods for Impairment Testing of Capitalized Contract Costs

October 31, 2014 Meeting:
5. Summary of Issues Discussed and Next Steps
6. Customer Options for Additional Goods and Services and Nonrefundable Upfront Fees
7. Determining the Nature of a License of Intellectual Property
8. Presentation of a Contract as a Contract Asset or a Contractual Liability
9. Distinct in the Context of the Contract
10. Contract Enforceability and Termination Clauses
Deferral of Effective Date

- At the October TRG meeting the FASB Vice Chairman announced that the FASB is currently evaluating whether there is a need to defer effective date.
- FASB to perform site visits in Q4 2014 and Q1 2015 to assess stakeholder progress with implementation and assess challenges faced.
- FASB plans to reach final decision about whether to delay effective date no later than Q2 2015.
- Delay in starting not a good fact pattern to support deferral.
- IASB did not comment on a potential delay in the effective date.
AICPA INDUSTRY GROUPS

Industry Task Forces

The AICPA has formed sixteen industry task forces to help develop a new Accounting Guide on Revenue Recognition that will provide helpful hints and illustrative examples for how to apply the new Revenue Recognition Standard. The industries involved with this project are:

- Aerospace and Defense
- Airlines
- Broker- Dealers
- Construction Contractors
- Depository Institutions
- Gaming
- Health Care
- Hospitality
- Insurance
- Investment Companies
- Not-for-Profit
- Oil and Gas
- Power and Utility
- Software
- Telecommunications
- Timeshare

Conference Learning

The AICPA conducts conferences around the country. The following conferences will have dedicated sessions surrounding revenue recognition:

- AICPA Conference on Credit Unions (October 2014)
- AICPA National Governmental and Not-for-Profit Training Program
- AICPA Auto Dealership Conference (October 2014)
- AICPA National Tax Conference (November 2014)
- AICPA Real Estate Conference (November 2014)
- AICPA Healthcare Industry Conference (November 2014)
- AICPA Controllers Conference (November 2014)
- AICPA & PDI National Oil & Gas Conference (November 2014)
- 2014 AICPA National Construction Industry Conference (December 2014)
Not just a finance & accounting initiative – Cross-functional teams and understanding needed
Why It’s Not Just a Finance & Accounting Project (con’t)

Systems
- Accounting for separate performance obligations
- Additional information necessary for disclosure?
- Ability to run parallel under the old and new model for 2017 (modified retro), or 2015 & 2016 if full retrospective presentation
- Automate to ease reassessment burden
- Data management & integrity

Training
- Across all levels and departments of the organization
- Financial reporting, treasury, tax, FP&A, sales & marketing, IT, investor relations, HR/compensation, and legal.

Communication
- Changes in other metrics (net income, EBITDA, EPS)
- Communicated externally and internally to management and the Board.
- Revenue may be recognized earlier for many companies
Contracts
• Contracts with thresholds for revenue or other metrics may be affected, such as bonus and commission structures, stock compensation plans, earnouts, debt covenants or even sales contracts.
• May need to be modified to maintain the original intent – accounting impact?
• Provisions in sales contracts specific for revenue recognition

Forecasting
• Update internal FP&A models.

Staffing
• Time-consuming and complex

Incentives
• Fresh look at compensation policies and sales contracts, ensuring incentive plans don’t encourage bad business practices like channel-stuffing.
Processes and controls
• Dual reporting requirements (one yr. min.) – auditable (SOX) processes and controls.
• More estimates and judgment (e.g. whether a contract exists, quantifying variable consideration, separating performance obligations, stand-alone selling price, and measuring progress over time).
• Technical accounting position papers to support areas where management has choices in the application of the new rules.
• IT controls: additional risks with potential short-term (EXCEL?) solution
• PCAOB focus on Revenue (new audit alert)
• Completeness of data
• Increased risk of fraud
Implementation Approach

Assessment
*Gap Analysis and Roadmap Development*

Design & Build
*Define & create solution*

Rollout
*Apply & integrate change*

Phased approach is necessary due to tight timeline
Assessment – Deliverables & Tools

Deliverables

- Assessment project plan
- Technical accounting training
- Customized global survey
- Data gaps

- Issue summary
  - Accounting & Tax
  - System/data
  - Process/control
  - Operations

- Business case analysis
  - Transition method
  - System
  - Next steps

- Roadmap/workplans
  - Timeline
  - Resources/cost requirements
  - Communication/training plan

Example tools & templates

- Transition method roadmap
- Global assessment survey (online)
- Contract documentation framework
- Project plan
Get the right people involved early – Executives, Business Units & PMO

Communicate progress – Dashboard

Standardize information gathering and analysis templates

Keep in touch with your industry group and peers – watch the technical interpretation activity

Use the exercise of contract identification to improve controls over contract existence (and approval) and implement a good contract management system

Consider whether standardization of contracts may benefit the organization

Work closely with sales/marketing to optimize contract provisions

Consider other activities of the entity (finance transformation, acquisitions & dispositions, changes in leadership, planned system implementations)
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