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New Revenue Recognition Standard

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Meet the Presenters…

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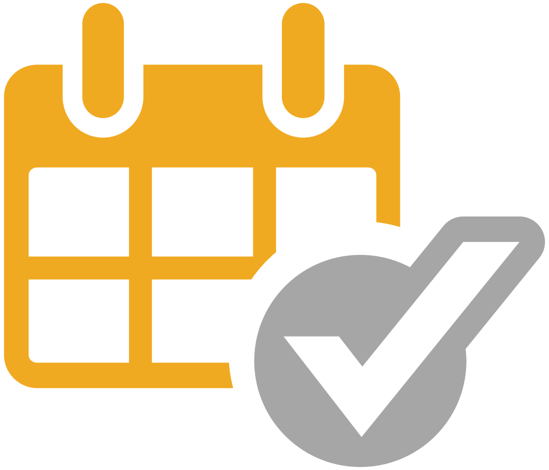
Agenda

- Background and scope
- Effective dates and transition requirements
- Overview of the new standard
- Specialized topics
  - Licenses of intellectual property
  - Variable consideration
- Implementation framework
- Questions



Background and scope

Background

- Provides accounting guidance for all revenue arising from contracts with customers and affects all entities that enter into contracts to provide goods or services to their customers.
- Issued by FASB and IASB in May 2014.
- New standard will supersede virtually all revenue recognition guidance in US GAAP and IFRS.
- Benefits of the new standard.

Scope

- The new standard outlines the principles an entity must apply to measure and recognize revenue and the related cash flows.
  - The core principle is that an entity will recognize revenue at an amount that reflects the consideration to which the entity expects to be entitled in exchange for transferring goods or services to a customer.

- The principles in the new standards will be applied using the following five steps
  1. Identify the contracts(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

Effective dates and transition requirements

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Effective dates

- Public entities - fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.
- Nonpublic - fiscal years beginning after December 15, 2018, interim periods beginning after December 15, 2019.
- Early application permitted for all U.S. entities for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years.

Transition

- Full retrospective application
- Modified retrospective application

Overview of the new standard

The five steps of revenue recognition

1 • Identify the contract(s) with the customer.

2 • Identify the separate performance obligations in the contract(s).

3 • Determine the transaction price.

4 • Allocate the transaction price to the performance obligations in the contract(s).

5 • Recognize revenue when (or as) the entity satisfies a performance obligation.

Step 1: Identify the contract(s) with the customer

- To apply the model, an entity must first identify the contract, or contracts, to provide goods and services to customers.
- Any contracts that create enforceable rights and obligations fall within the scope of the new guidance.
- Such contracts may be written, oral or implied by the entity’s customary business practice.
- For example, an entity’s past business practices may influence its determination of when an arrangement meets the definition of a contract with a customer. An entity that has an established practice of starting performance based on oral agreements with its customers may determine that such oral agreements meet the definition of a contract.

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Step 2: Identify the performance obligations in the contract

- To apply the new guidance, an entity must identify the promised goods and services within the contract and determine which of those goods and services are separate, or distinct, performance obligations (i.e., the unit of accounting for purposes of applying the standard).

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Promised goods and services

- Promised goods or services in a contract may be identified explicitly in the contract
- Or, they may be implied by the entity's customary business practices (e.g. "free" handsets provided by telecommunication entities)

Separate, or distinct, performance obligations

- Two step process to determine whether a promised good and service (or bundle of goods and services) is distinct: (1) consider the level of the individual good or service (i.e., the goods or services are capable of being distinct) and (2) consider whether the good or service is separable from other promises in the contract (i.e., the good or service is distinct within the context of the contract).

Step 3: Determine the transaction price

- The transaction price is based on the amount to which the entity expects to be "entitled."

- This amount is meant to reflect the amount that the entity has rights to under the present contract.

- The transaction price does not include the following:
  - Estimates of consideration from future change orders for additional goods and services.
  - Amounts collected on behalf of another party, such as sales taxes.

- The transaction price is readily determinable because the entity receives payment when it transfers promised goods or services and the price is fixed (e.g., the sale of goods in a retail store).
  - In other situations, determining the transaction price is more variable when payment is received at a different time from when the entity provides goods or services, or when payment is in a form other than cash.

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Step 4: Allocate the transaction price to the performance obligations in the contract

- Once the separate performance obligations are identified and the transaction price has been determined, the standard requires an entity to allocate the transaction price to the performance obligations.

- Generally, this is done in proportion to their standalone selling prices (i.e., on a relative standalone selling price basis).

- As a result, any discount within the contract generally is allocated proportionally to all of the separate performance obligations in the contract.

- There are some exceptions:
  - An entity could allocate variable consideration to a single performance obligation in some situations.
  - Also, an entity could allocate any discount in a contract to only certain performance obligations, if specified criteria are met.

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Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation

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- An entity recognizes revenue only when it satisfies an identified performance obligation by transferring a promised good or service to a customer.

- A good or service is considered to be transferred when the customer obtains control.
  - Recognizing revenue upon a transfer of control is a different approach from the "risks and rewards" model that currently exists in today's guidance.

- Control of an asset refers to the ability to direct the use of and obtain substantially all of the remaining benefits from the asset.

- Control also means the ability to prevent other entities from directing the use of, and receiving the benefit from, a good or service.

- An entity must determine at contract inception whether it will transfer control of a promised good or service over time.
  - If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.

Specialized topics

Licenses of intellectual property

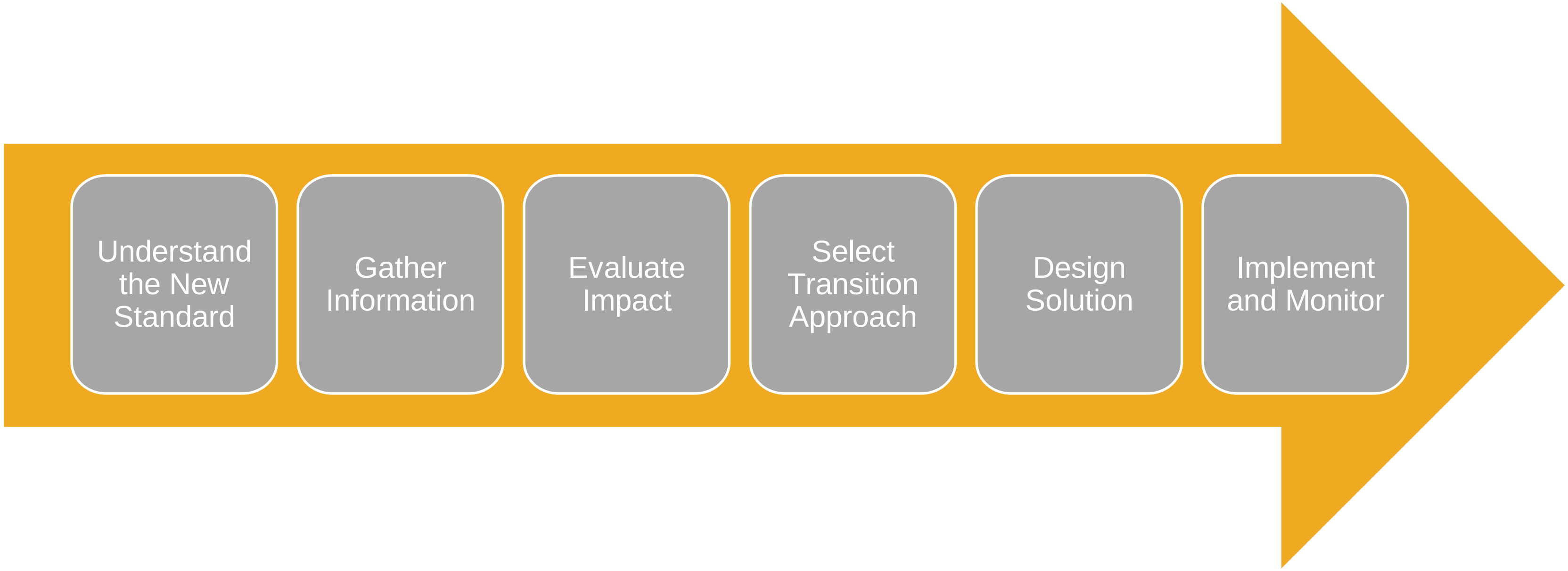
- Within step two: Identify each performance obligation in the contract
  - Licenses of intellectual property.
    - **Distinct license:** The customer can benefit from the license on its own or with readily available resources, and it is separately identifiable from the other goods or services in the contract.
    - **Non-distinct license:** the customer can benefit from the license only with another good or service that is promised (explicitly or implicitly) in the contract.

Variable consideration

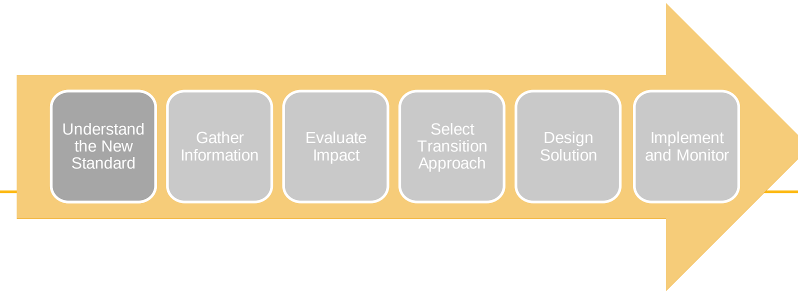
- Within step three: Determine the transaction price
  - Variable consideration relates to contracts where a portion of the transaction price could vary because of the contract terms may include items such as discounts, rebates, price concessions, or implied price concessions.
    - **Current guidance:** If a vendor concludes the arrangement fee is not fixed or determinable, revenue is recognized as payments from the customer become due or as rights of returns lapse.
    - **New standard:** The transaction price is based on an amount to which the entity expects to be entitled. As such, entities will be required to estimate variable consideration and include amounts in the allocable transaction price. Entities may recognized revenue earlier under the new standard.

Implementation framework

Implementation framework



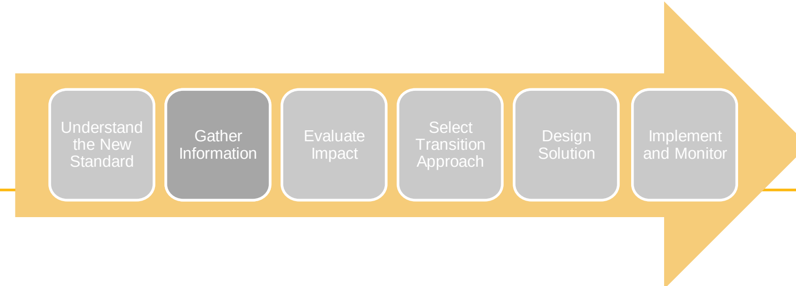
Understand the new standard



- Resources to help you:
  - **Crowe Horwath Revenue Recognition Resource Center**: includes our guidance including industry specific guidance: http://www.crowehorwath.com/revenue-recognition/
  - **AICPA Revenue Recognition Task Forces**: The AICPA has formed sixteen industry task forces to help develop a new Accounting Guide on Revenue Recognition that will provide illustrative examples for how to apply the new Revenue Recognition Standard. http://www.aicpa.org/InterestAreas/FRC/AccountingFinancialReporting/RevenueRecognition/Pages/RevenueRecognition.aspx
  - The industries involved with this project are:

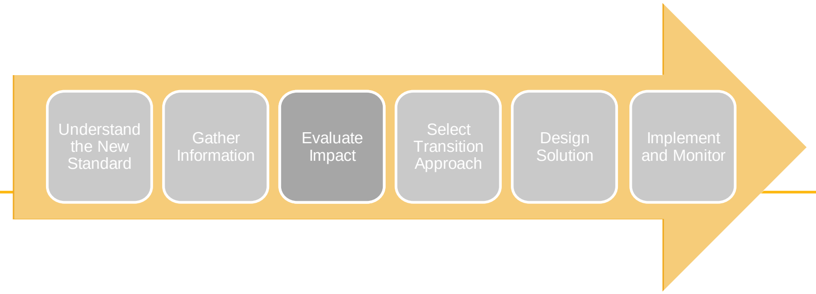
Aerospace and Defense
Airlines
Asset Management
Broker-Dealers
Construction
Contractors
Depository Institutions
Gaming
Health Care
Hospitality
Insurance
Not-for-Profit
Oil and Gas
Power and Utility
Software
Telecommunications
Timeshare

Gather information



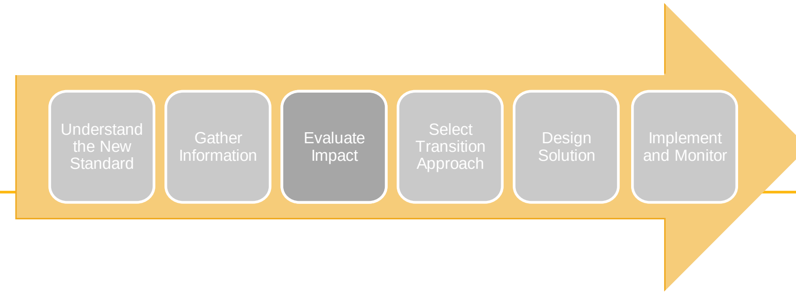
- Gather relevant information to understand impact of standard:
  - Identify types of customer agreements
  - Gather examples of customer agreements for each type
  - Pricing information:
    - Transaction price if available for separate and distinct performance obligations
    - Pricing structure
    - Rebates and other incentives
    - Any other instances of variable consideration
  - Data needed for estimates:
    - Returns
    - Rebates
    - Transaction price
  - Current policies, process and control documentation
  - Compensation plans
  - IT system configurations

Evaluate impact



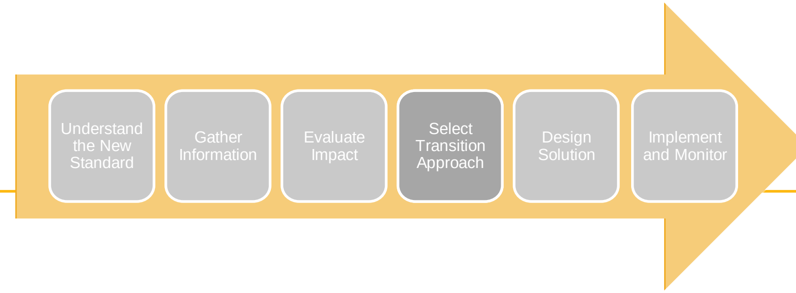
- Establish cross-functional team:
  - Accounting, tax, compensation and benefits, IT, legal, sales
- Evaluate impact of new standard and review customer agreements and identify differences
  - Some areas to consider:
    - Arrangements with customers that are subject to transaction- or industry-specific revenue guidance that is being superseded;
      - Software: PCS and elimination of VSOE
      - Technology: warranties, volume discounts, rebates and returns
    - Customer contracts with unique revenue recognition considerations or terms and conditions;
    - The degree of variation in the contracts with customers, including the nature and type of goods or services being offered;
    - Different business lines or multiple geographies that could involve different implicit promises through differences in customary business practices;
    - The degree to which contracts include multiple performance obligations, variable consideration, or licenses of intellectual property;
- Document conclusions and ensure you involve your auditors early in the process.

Evaluate impact (cont.)



- Systems impact
  - If new performance obligations are identified, asses ability of current systems to capture separate performance obligations and recognize revenue when performance is satisfied
- Data used in estimates
  - Identify any new data required to determine transaction price and make other estimates
- Tax impact
  - Need to involve tax professionals
  - May impact timing of when revenue is recognized, leading to temporary differences and also impact sales and use taxes
- Compensation
  - Timing of revenue may impact sales commissions, bonuses, and other employee incentive plans
  - May need to revise incentive plans
- Business practices and strategies (e.g., pricing, marketing, and contracting)
  - May need to be revised

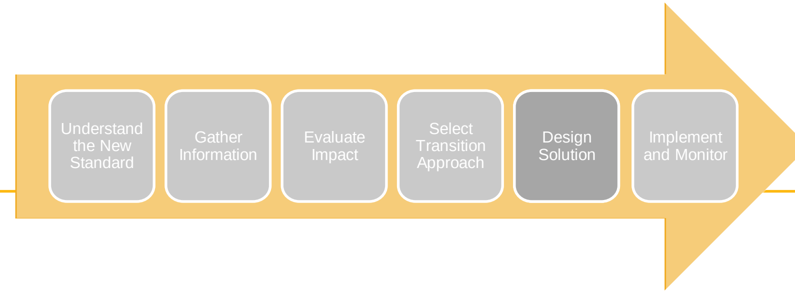
Implement transition approach



The standard provides two methods to apply the changes resulting from the application of the new rules. Significant planning should go into the method to be used in order to achieve organization goals

- **Retrospective**
  - When using this application option, the organization can elect practical expedients in the area of completed contracts within a reporting period, use of contract price at date of completion rather than use of an estimate, and for all periods before initial application an entity is not required to disclose amounts of transaction price allocated to remaining performance obligations.
- **Cumulative effect**
  - Comparative periods presented would not have to be restated. Under this option, the new rules would be applied only to contracts that are uncompleted at the date of initial application.

Design solution

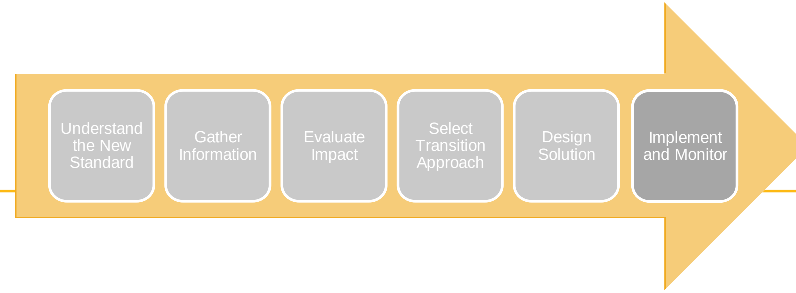


- Design solution is based on the impact evaluation:
  - Transition approach determined
  - Nature and extent of changes in revenue recognition identified:
    - Performance obligations identified
    - Transaction Price identified
    - New information required identified
  - Nature and extent of changes needed in other areas identified:

- Develop project plan and timeline
  - Consider need for project manager and steering committee
  - Identify resources needed

- Communicate plan and gain consensus
  - Ensure alignment with independent and internal audit

Implement and monitor



- Implementation varies based on degree of change and impact to the organization
- Depending on complexity, may need steering committee and PMO
- Keep all stakeholders informed
- Establish monitoring process
  - Validate that changes have been implemented and are operating
  - Key controls are in place and operating effectively

Questions

For additional resources, including industry specific information, visit the **Crowe Horwath LLP Revenue Recognition Resource Center:**

http://www.crowehorwath.com/rr-technology

Thank you

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