Crowe Horwath.

Smart decisions. Lasting value.™

New revenue recognition standard

IIA Super Conference

Dallas Chapter

October 28, 2016

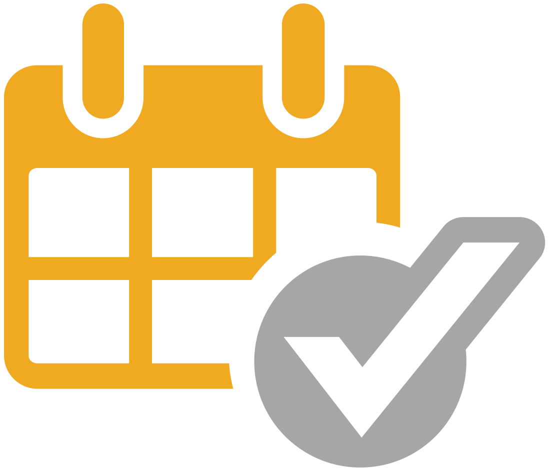
Meet the presenter

Jim Hannan

- Risk Consulting
- Chicago, Illinois

Agenda

- Background and scope
- Effective dates and transition requirements
- Overview of the new standard
- Industry Specific Considerations
- Implementation framework
- What Should Internal Audit Do?
- 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.

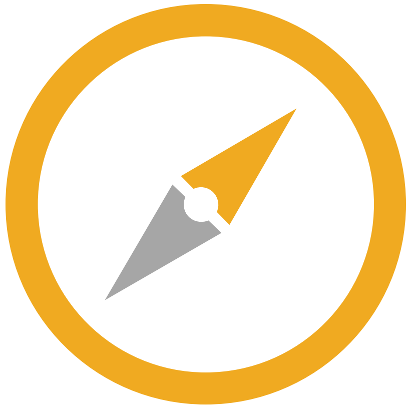
- Issued by FASB and IASB in May 2014.

- 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

Scope Exceptions

a. Lease contracts within the scope of Topic 840, Leases.

b. Insurance contracts within the scope of Topic 944, Financial Services—Insurance.

c. Financial instruments and other contractual rights or obligations within the scope of the following Topics:

- 1. Topic 310, Receivables
- 2. Topic 320, Investments—Debt and Equity Securities
- 3. Topic 323, Investments—Equity Method and Joint Ventures
- 4. Topic 325, Investments—Other
- 5. Topic 405, Liabilities
- 6. Topic 470, Debt
- 7. Topic 815, Derivatives and Hedging
- 8. Topic 825, Financial Instruments
- 9. Topic 860, Transfers and Servicing.

d. Guarantees (other than product or service warranties) within the scope of Topic 460, Guarantees.

e. Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers.

f,. Arrangements with partners and collaborators

Effective dates and transition requirements

Effective dates and transition requirements

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.

1

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).

2

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.

3

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

4

- 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.

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

5

- 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.

Industry Specific Considerations

Considerations for M&D Companies

- **Satisfaction of a Performance Obligation**
- An entity recognizes revenue only when it satisfies an identified performance obligation by transferring a promised good or service to a customer. This is satisfied in most cases by shipping or delivery, and FOB terms still apply.
- **Warranties: Assurance-Type or Service-Type?**
  - Assurance-type warranties provide a customer with assurance that the related product will function as the parties intended because the product complies with agreed-upon specifications and are not a distinct performance obligation.
  - Service-type warranties (type of warranty customer can purchase separately) provide the customer with a service in addition to the assurance that the product complies with agreed-upon specifications and are a distinct performance obligation.
- **Performance obligations satisfied over time**
- In certain circumstances where a customized product is developed and created for a customer, revenue would be recognized over time, i.e. as the asset is in the process of development and manufacture if thee asset has no alternative use and there is an enforceable right to payment for performance completed to date.
- **Bill and Hold Arrangements:** guidance is similar to existing guidance
- **Volume discounts and rebates**: variable consideration needs to be estimated
- **Returns Accruals:** Variable consideration that needs to be estimated; record a refund liability and an asset for goods expected to be returned

Considerations for Software and Technology Companies

- **Elimination of “vendor-specific objective evidence” criteria**
  - Promised goods or services represent separate performance obligations if they are distinct. Companies can employ a number of methods (i.e. relative stand-alone selling price) to estimate the transaction price, not required to use VSOE.
- **Post Contract Support**
  - While PCS is defined as a single element of the arrangement under current guidance, PCS is not a unique service defined in the new standard and entities must evaluate whether the individual PCS services (bug fixes, upgrades, support) will be separate performance obligations under the new standard.

Life Sciences Company Considerations -License Agreements and Royalties

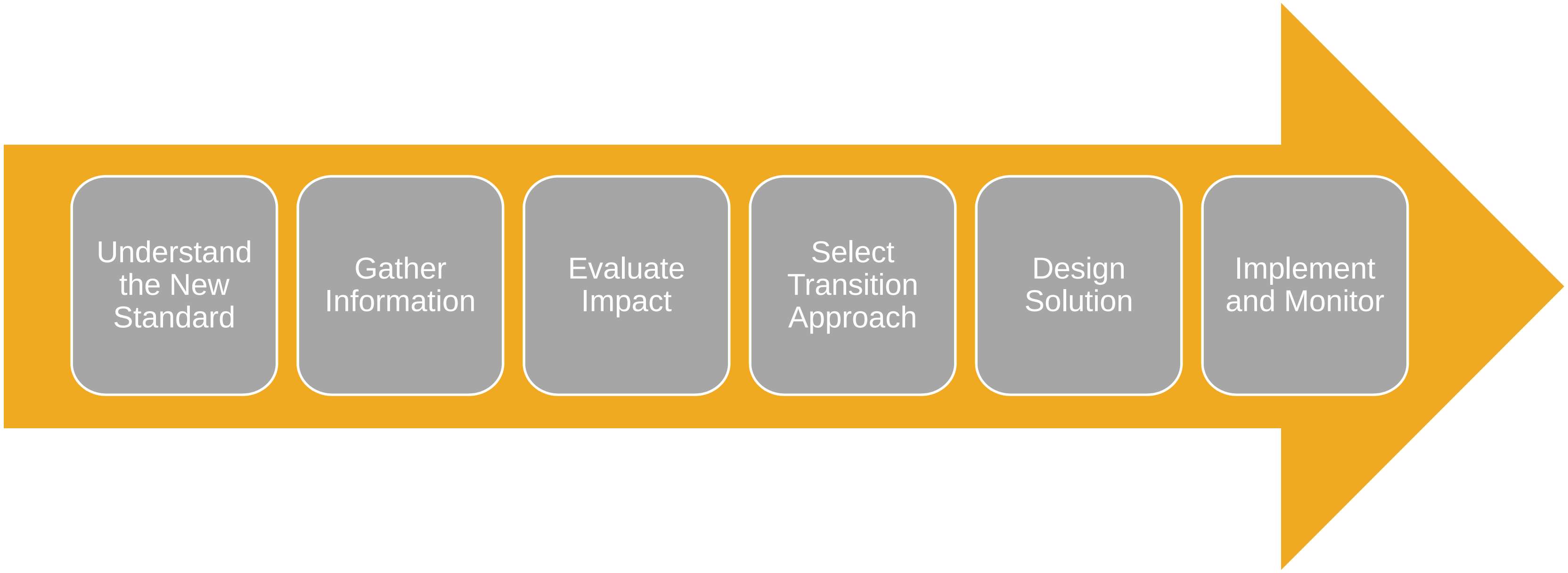
- Types of Intellectual Property Licenses: There are now two types of intellectual property:
    - **Functional intellectual property –** IP that has significant standalone functionality. Functional intellectual property derives a substantial portion of its utility (that is, its ability to provide benefit or value) from its significant standalone functionality.
    - **Symbolic intellectual property –** IP that is not functional intellectual property (that is, intellectual property that does not have significant standalone functionality). Because symbolic intellectual property does not have significant standalone functionality, substantially all of the utility of symbolic intellectual property is derived from its association wit the entity's past or ongoing activities, including its ordinary business activities.
- **When to recognize Intellectual Property Revenue:**
    - **Right to access – over time:** the customer can benefit from the license only with another good or service that is promised (explicitly or implicitly) in the contract. Revenue for the right to access a license of intellectual property is recognized over time as the entity fulfills its promise to both grant the customer rights to use and benefit from the entity's intellectual property and support or maintain the intellectual property.
- **Right to use – a point in time:** Company provides a right to use the company's intellectual property as that intellectual property exists at the time the license is granted and is satisfied at the point in time the customer is able to use and benefit from the license.
- **Royalties**: A Company should recognize revenue for a sales-based or usage-based royalty promised in exchange for a license of intellectual property only when (or as) the later of the subsequent sale or usage occurs or the performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).

Considerations for Consumer Products and Retail Companies

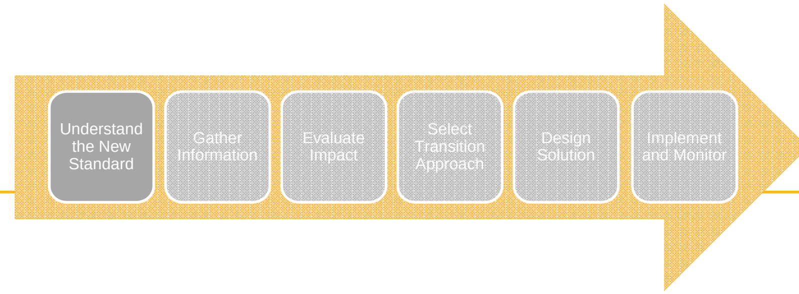
- **Coupons:** Companies must consider whether coupon issuance provides a material right that gives rise to a separate performance obligation. The Company must then allocate the transaction price between the goods or services delivered and the coupon.
- **Customer Loyalty Programs**: If the customer receives a material right they would not have received without entering into the contract, a separate performance obligation is created.
  - Transaction price is allocated between the product and the loyalty reward performance obligations based upon relative stand-alone selling price. The loyalty reward is recognized as a contract liability and revenue is recorded when the award is redeemed or expires. Entities currently using the incremental cost model may recognize revenue later under the new standard.
- **Gift Cards**: Gift Cards are a separate and distinct performance obligation.
  - A Gift card contract liability to be recorded.
  - Breakage – variable consideration recognized at point of sale if it can be reliably estimated
- **Sales Tax**: The transaction price definition excludes amounts "collected on behalf of third parties." As a result, companies will need to consider on a jurisdiction-by-jurisdiction basis which amounts should be reported gross and which should be reported net based upon principal versus agent guidance.

Implementation framework

Implementation framework



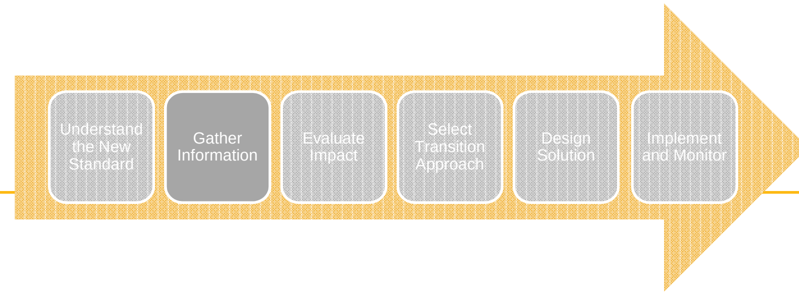
Understand the new standard



- Resources to help you:
  - **Crowe Horwath Revenue Recognition Resource Center**: includes our 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	Gaming	Software
Airlines	Health Care	Telecommunications
Asset Management	Hospitality	Timeshare
Broker-Dealers	Insurance	
Construction	Not-for-Profit	
Contractors	Oil and Gas	
Depository Institutions	Power and Utility	

Gather information



Customer Agreements

- Identify revenue streams
- Identify types of customer agreements in each revenue stream
- Gather examples of customer agreements for each type

Pricing information:

- Pricing structure
- Sales incentives
- Any other instances of variable consideration

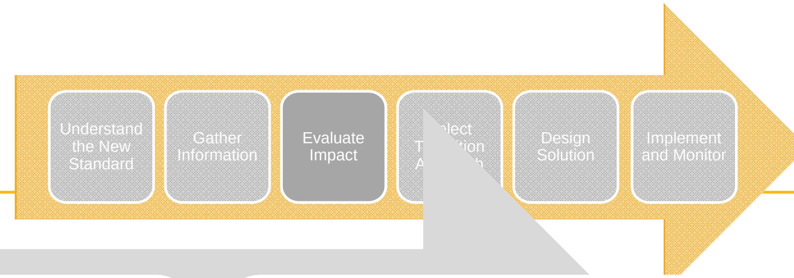
Data used in estimates

- Rebates, sales returns and other variable pricing
- Warranties
- Allowance for doubtful accounts

Other Information

- Current policies, process and control documentation
- Compensation plans
- IT system configurations
- Debt agreements

Evaluate impact



Establish cross-functional team

Accounting, tax, compensation and benefits, IT, legal, sales

Review customer agreements and identify differences

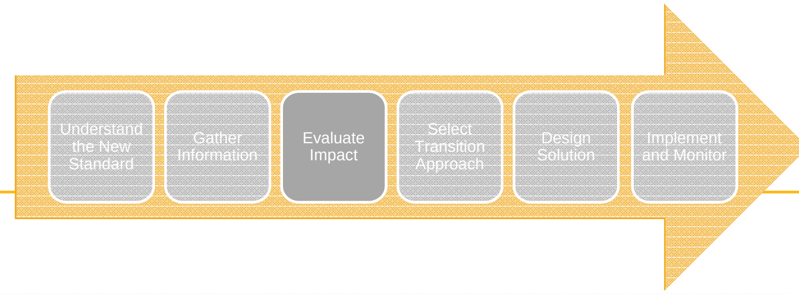
Things to look for:

- Transaction- or industry-specific revenue guidance that is being superseded;
- Unique revenue recognition considerations or terms and conditions;
- The degree of variation in the contracts
- Differences by business lines or multiple geographies
- Multiple performance obligations, variable consideration, or licenses of intellectual property;

Document conclusions

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

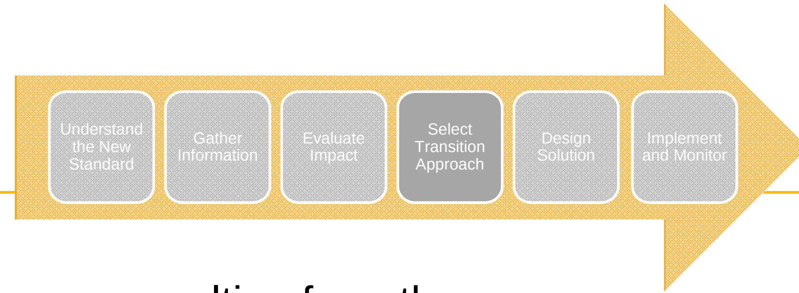
Compensation

- Timing of revenue may impact sales commissions, bonuses, and other employee incentive plans
- May need to revise incentive plans

Business practices and strategies

- For example, pricing, marketing, and contracting may need to be revised

Select 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

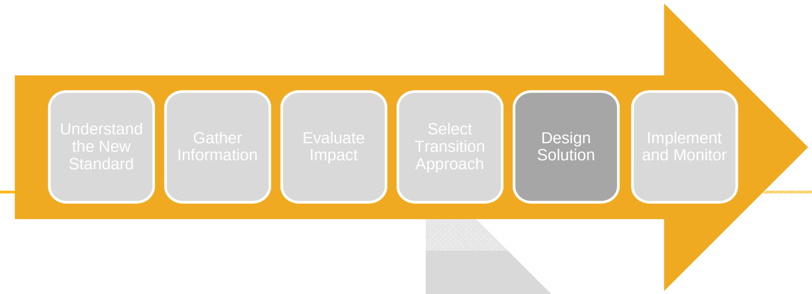
Retrospective

- 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



Solution Design 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

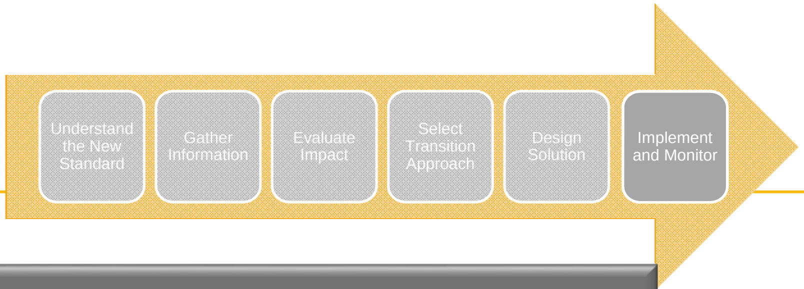
Develop project plan and timeline

- 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

What Should Internal Audit Do?

Areas for Internal Audit To Consider

- Understand the standard
- What is the status of the implementation?
  - Has an impact assessment been completed?
  - If yes:
    - Have accounting memos been produced documenting the company's accounting under ASC 606?
    - Have the accounting policies been reviewed and approved by CAO, Controller or other appropriate level of management?
    - Has the company's auditors reviewed these memos? What is their feedback?
  - If no, when will this be completed?
    - Does the accounting team ned assistance?
  - Has the impact assessment looked at, or will it look at:
    - IT systems
    - Business processes
    - Internal controls
    - Taxes
    - Incentive compensation plans
- Consider performing a pre and post implementation review
- Consider the impact on internal controls
- What has management told the audit committee?
- SEC is looking for impact assessment in he company's 10-k

Questions

Thank you

Jim Hannan
Risk Consulting
Direct 312.899.5303 | Mobile 312.563.0560
Jim.Hannan@crowehorwath.com