Revenue Recognition Standard: Navigating the New Landscape

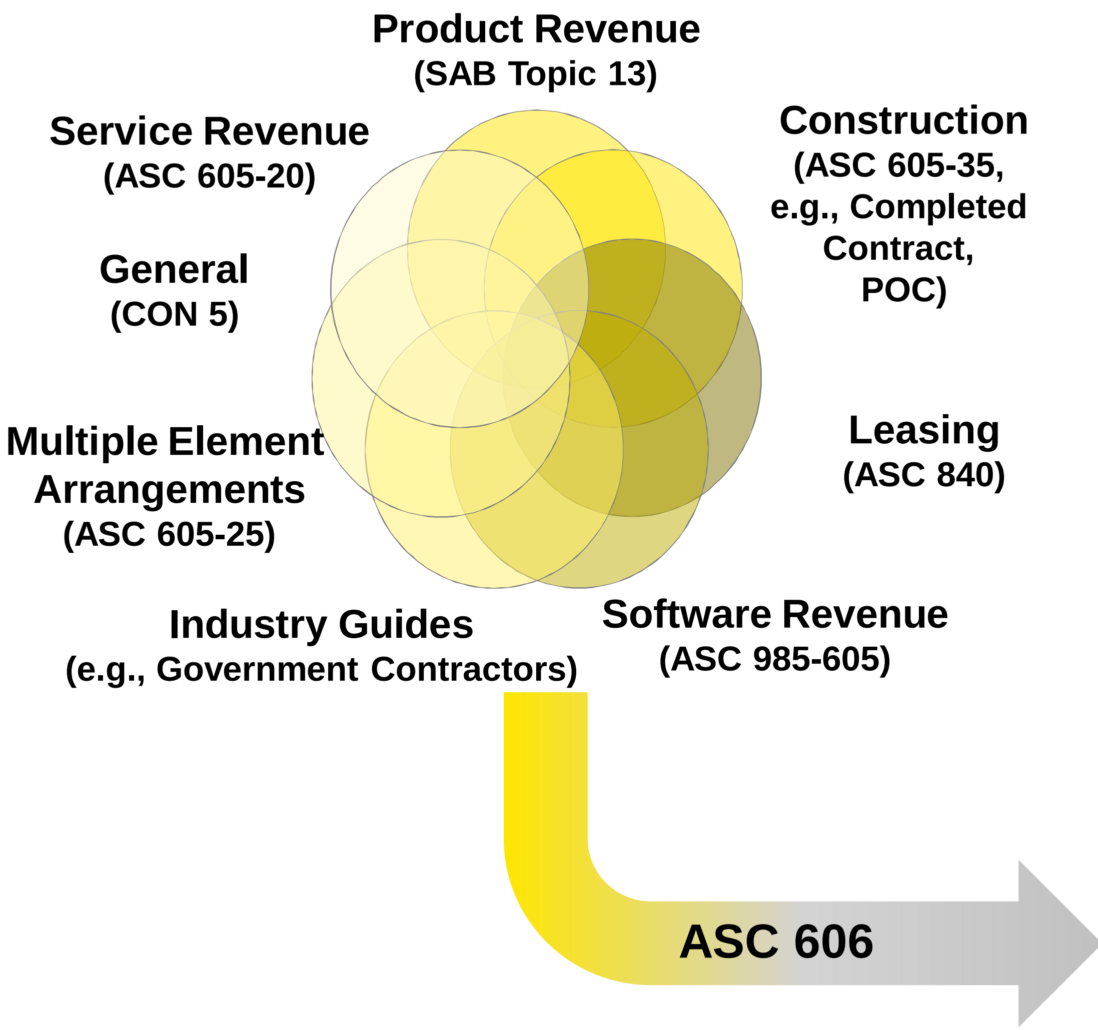
August 11, 2016

Building a better working world

Agenda

- Welcome and objectives
- New Revenue Recognition Standard
  - **Overview**
  - Five step model
  - Disclosures requirements
  - Effective date and transition
  - Subsequent changes

Overview
What's the change?



"Transfer of control"

- Single, global revenue standard for all transactions
- More "principles" than prescriptive, anti-abuse-oriented rules
- Potential changes:
  - More performance obligations (identify, track, allocate revenue)
  - Disconnect between billing and revenue recognition
  - More estimates included in revenue
  - Change in revenue patterns
  - "Lost" revenue upon transition

Overview
Drivers of complexity

Less complex | **More complex**

Less complex	More complex
Shorter revenue cycle	Long-term contracts
Single line of business	Multiple, diverse businesses
Domestic operations only	Global operations
Highly centralized	Decentralized
Well-controlled process currently provides revenue estimates	More and more complex estimates and judgments required by new revenue recognition standard
No change to existing performance obligations	Additional performance obligations under new model
One global ERP	Multiple, disparate IT systems
Strong organizational change management	Organization struggles to implement change

Overview
Summary of the model

Core principle – Recognize revenue to depict the transfer of 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

Step 1:	Identify the contract(s) with the customer
Step 2:	Identify the separate performance obligation(s) in the contract
Step 3:	Determine the transaction price
Step 4:	Allocate the transaction price to the separate performance obligation(s)
Step 5:	Recognize revenue as each performance obligation is satisfied

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

- Contract defined as an agreement between two or more parties that creates enforceable rights and obligations
  - Can be written, oral or implied
  - Does not exist if both parties have not performed and can cancel without penalty
- Arrangement must meet these criteria to be within scope of standard:
  - Parties have agreed to terms and are committed to perform
  - Each party's rights and payment terms can be identified
  - Contract has commercial substance
  - Collection is probable
- Contracts entered into at the same time with the same customer should be combined if certain criteria are met

Five Step Model
Step 1: Identify the contract(s) with the customer (cont.)

- Before applying the model in the standard to a contract, it must be *probable* that the entity will collect the consideration to which it is entitled (collectibility threshold) in exchange for the goods and services that will be transferred to the customer

- Collectibility assessment relates to the transaction price
  - The transaction price may be less than the stated contract price, for example, if the entity intends to offer a price concession

- It may be difficult in some cases to distinguish between price concession, bad debt and a lack of sufficient commercial substance to be considered a contract

Five Step Model
Step 2: Identify the performance obligation(s)

- A performance obligation is a promise (explicit or implicit) to transfer a good or service to a customer
  - Performance obligations are accounted for separately if they are distinct

- Two-step process to identify if a good or service is distinct:
  - Step 1 – Determine if the good or service is capable of being distinct
  - Step 2 – Determine if the good or service is distinct within the context of the contract

- Performance obligations are identified at contract inception and determined based on:
  - Contractual terms
  - Customary business practice

Five Step Model

Step 2: Identify the performance obligation(s) (cont.)

Two-step model to identify which goods or services are distinct

Step 1 - Focus on whether the good or service is ***capable of being distinct***	Step 2 - Focus on whether the good or service is ***distinct in the context of the contract***
Customer can benefit from the individual good or service on its own **OR** Customer can use good or service with other readily available resources	The good or service is not highly dependent on, or highly interrelated with, other promised goods or services in the contract

Five Step Model
Example: Identify performance obligations

- Entity enters into a contract to manufacture and install customized equipment and provide maintenance services for a five-year period
- Installation services include the integration of multiple pieces of equipment at the customer's facility in order for the equipment to operate as a single unit
- Equipment cannot operate without installation
- Entity sells equipment and installation services together, does not sell installation separately
- Other vendors can provide the installation services
- The maintenance services are sold separately

Five Step Model

Example: Identify performance obligations (cont.)

	Step 1 – Capable of being distinct?	Step 2 – Distinct in the context of the contract?
Equipment	Good cannot be used without installation, but customer can obtain installation from another source. Good is distinct. Move to Step 2.	Equipment and installation are highly interrelated. Significant customization is required during installation. Good isn't distinct on its own because it must be combined with installation.
Installation	Installation can be provided by multiple vendors, so service is distinct. Move to Step 2.	See discussion above. Equipment and installation are not distinct from one another.
Maintenance	Services have a distinct function because they are sold separately. Move to Step 2.	Services are not highly interrelated. No integration, modification or customization required. Services are distinct.

- In this example, there would be two performance obligations: (1) the equipment and installation because they are not distinct; (2) maintenance services because they are distinct services in the contract.

Five Step Model

Step 2: Identify the performance obligation(s) (cont.)

- Determining whether an entity acts as a principal or an agent in a contract affects the amount of revenue recognized (gross versus net recognition)
  - Appropriately identifying the entity's performance obligation is fundamental to the principal or agent determination
- Entity is a principal if it controls a promised good or service before its transfer to a customer
- Entity is an agent if its performance obligation is to arrange for the provision of goods or services by another party

What's changing?

- The new standard contains an overarching consideration for who controls the goods or services transferred to a customer and eliminates the weighting of the indicators. This area will continue to be challenging and require significant judgment.

Five Step Model
Step 3: Determine the transaction price

- Transaction price is defined as the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer
- Transaction price includes the effects of the following:
  - Variable consideration
    - Includes application of the constraint (i.e. only if it is “probable” a significant revenue reversal will not occur when uncertainties are resolved)
  - Significant financing component
  - Consideration paid to a customer
  - Noncash consideration
- Variable consideration is estimated using an “expected value” or a “most likely amount” approach

Five Step Model

Step 3: Determine the transaction price (cont.)

- Transaction price may vary because of items such as bonuses, discounts, rebates, refunds, credits, price concessions or incentives
- The transaction price is estimated using the technique that better predicts the amount the company will receive

Expected value	Most likely amount
► Sum of the probability-weighted amounts in a range of possible outcomes ► Most predictive when the transaction has a large number of possible outcomes ► Can be based on a limited number of discrete outcomes and probabilities	► The single most likely amount in a range of possible outcomes ► Most predictive when the transaction will produce few outcomes

EY

Five Step Model

Step 3: Determine the transaction price (cont.)

- Entities are required to evaluate whether to “constrain” amounts of variable consideration included in transaction price
- Objective of the constraint – include variable consideration in the transaction price only to the extent it is “probable” that a significant revenue reversal will not occur when uncertainty is subsequently resolved
- “Significant” is relative to cumulative revenue recognized for the contract considering variable and fixed consideration
- An entity should update its estimate of the transaction price that includes variable consideration at each reporting date

Five Step Model
Step 3: Determine the transaction price (cont.)

Significant financing component

- The time value of money is considered when significant
  - Evaluation not required if customer is expected to pay within one year of when control of the goods or services is transferred

Noncash consideration

- Measured at the fair value of the consideration received or promised

Consideration payable to a customer

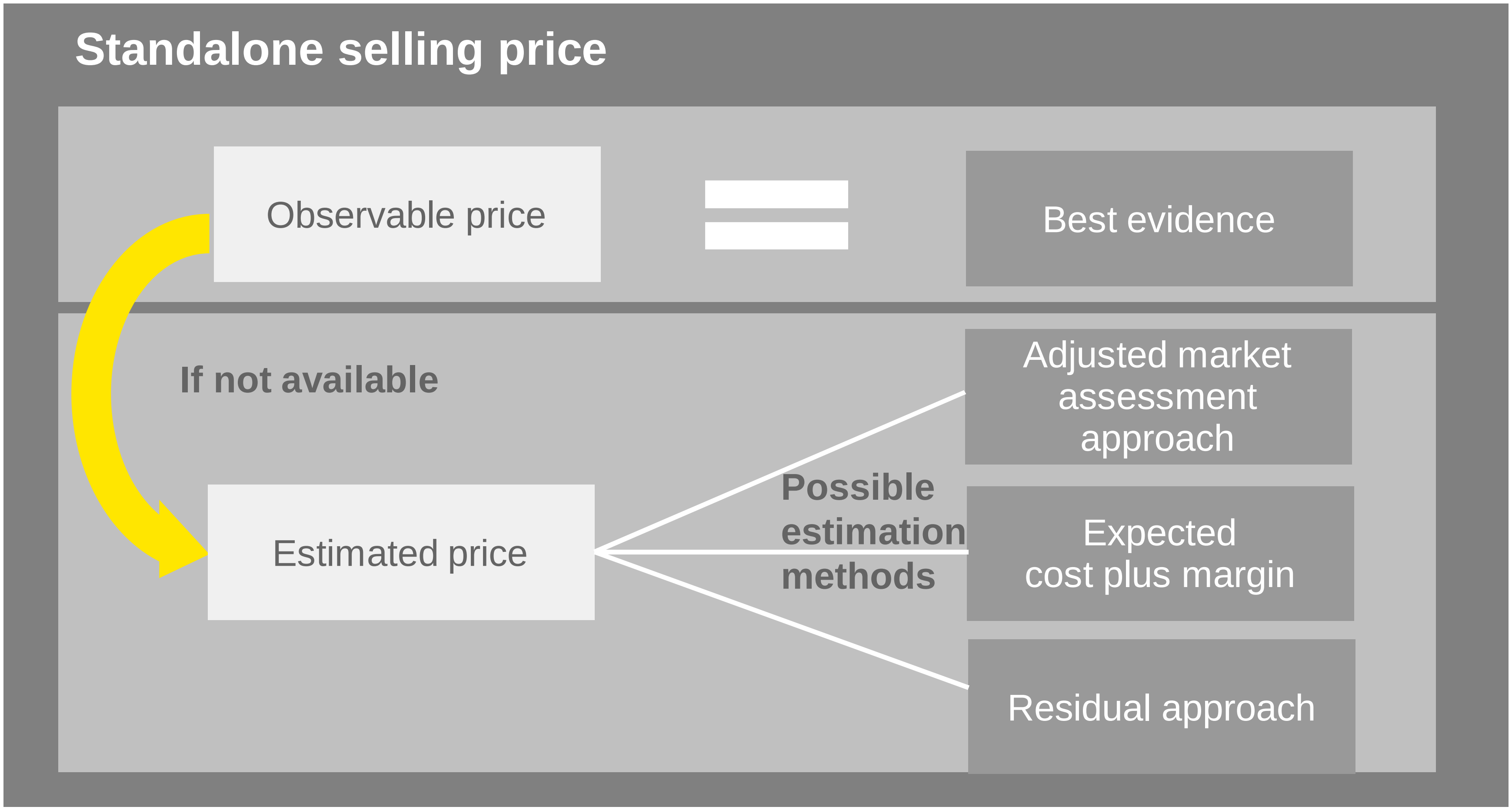
- Determine whether amounts paid or payable to the customer are:
  - A reduction of the transaction price and revenue
  - A payment for <u>distinct</u> goods and services
  - A combination of the two

EY

Five Step Model
Step 4: Allocate the transaction price

- Transaction price is generally allocated to each separate performance obligation on a relative standalone selling price basis
  - Model provides two possible exceptions relating to the allocation of variable consideration and discounts, if certain criteria are met
- When a standalone selling price is not observable, an entity is required to estimate it
  - Maximize the use of observable inputs
  - Apply estimation methods consistently in similar circumstances
  - Standard describes three estimation methods, but others are permitted (and a combination of estimation methods is allowed)
- Standalone selling prices used to perform the initial allocation <u>should not be updated</u> after contract inception

Five Step Model
Step 4: Allocate the transaction price (cont.)



Five Step Model
Step 5: Recognize revenue

- Revenue recognized upon satisfaction of a performance obligation by transferring ***control*** of a good or service to a customer

- Control is transferred either *over time* or at *a point in time*. Default is at a point in time unless specific criteria are met to transfer control over time.

Five Step Model

Step 5: Recognize revenue (cont.)

Control of goods and services is transferred ***over time***
if **one** of the following three criteria is met:

The entity creates or enhances an asset that the customer controls as it is created or enhanced

The entity's performance does not create an asset with alternative use, and the entity has a right to payment for performance completed to date

The customer simultaneously receives and consumes the benefits of the entity's performance as the entity performs

"Pure service" contracts

Another entity would not have to re-perform work completed to date

(1) Disregard potential limitations that would prevent the transfer of a remaining PO to another entity

(2) Assume another entity fulfilling the remaining PO would not have the benefit of any asset the entity controls

If none of the criteria are met, control transfers at a point in time

Five Step Model
Step 5: Recognize revenue (cont.)

When is control transferred?

Over time	At a point in time
Select a measure of progress	**Evaluate indicators of control**
▶ Input method (e.g., cost incurred) ▶ Output method (e.g., units delivered)	▶ Right to payment ▶ Transfer of legal title ▶ Physical possession ▶ Risks and rewards of ownership ▶ Customer acceptance

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Disclosure Requirements
Summary

Category	Subcategory	Information Type	Frequency
Contracts with customers	Disaggregation of revenue	Quantitative	Interim/annual
	Contract balances	Quantitative	Interim/annual
		Qualitative	Annual
	Performance obligations	Quantitative	Interim/annual
		Qualitative	Annual
Significant judgments	N/A	Qualitative	Annual
Contract costs	N/A	Quantitative	Annual
		Qualitative	
Other	Practical expedients	Qualitative	Annual
	Transition	Quantitative	Interim/annual
		Qualitative	
	SEC requirements	Quantitative	Interim/annual
		Qualitative	

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Effective Date

- ASU No. 2015-14 (August 2015) – Deferral of Effective Date
  - One year deferral of effective date for application by public and nonpublic entities

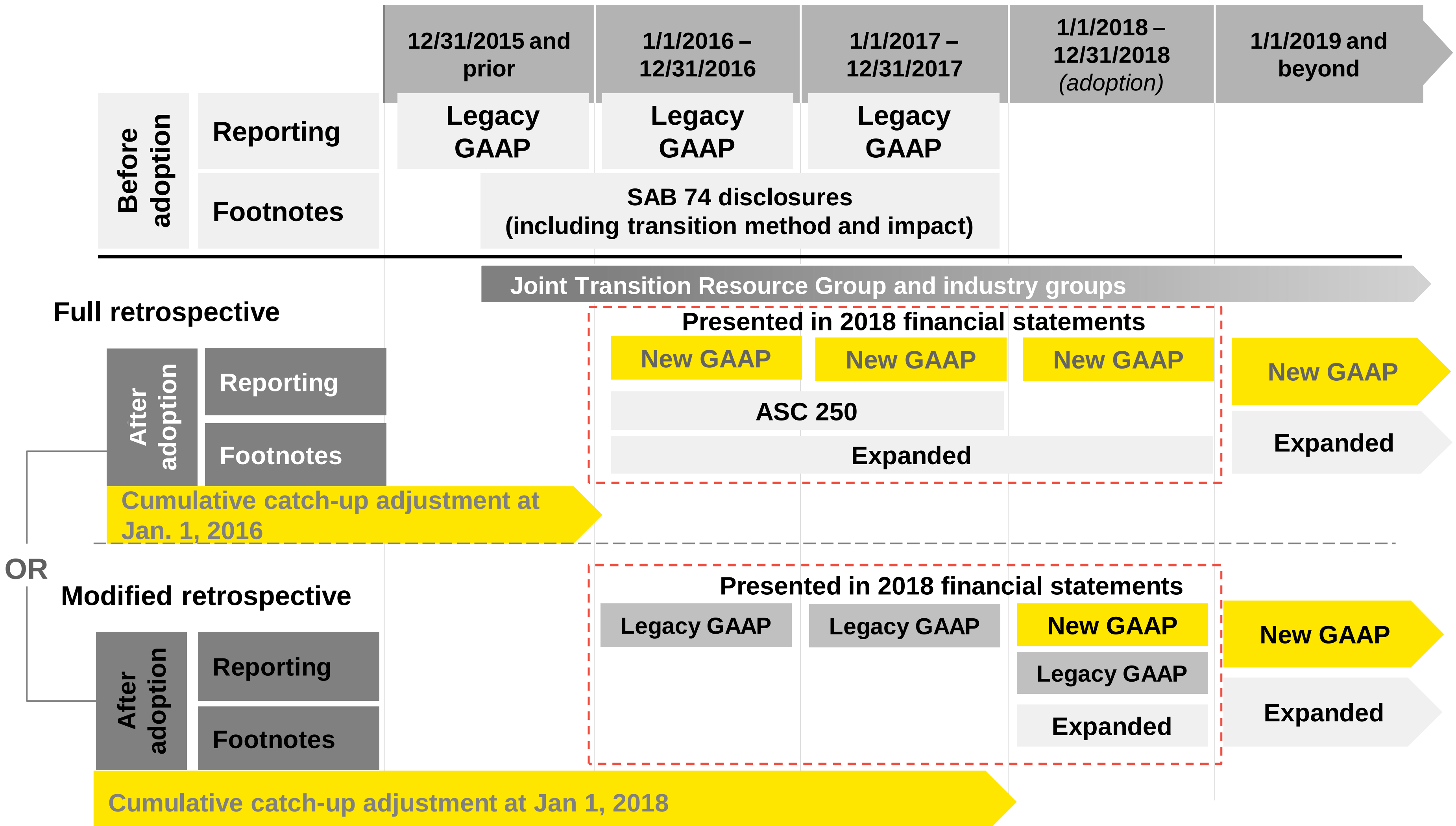
Effective date for calendar-year companies		
Public business entities and certain other entities*	**All other entities**	**Early adoption?**
2018 and interim periods within that year	2019 and interim periods in 2021	No**

* Public business entities, not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed, or quoted on an exchange or an-over-the-counter market, and employee benefit plans that file or furnish financial statements with or to the SEC.

** Public business entities and nonpublic entities are permitted to adopt the standard as early as the original public entity effective date (i.e. annual reporting periods beginning after December 15, 2016 and interim periods therein). Early adoption prior to that date is not permitted.

Transition

You have a choice in transition methods



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Subsequent Changes

- ASU No. 2015-14 (August 2015) – Deferral of Effective Date
  - One year deferral of effective date for application by public and nonpublic entities
- ASU No. 2016-08 (March 2016) – Principal versus Agent Considerations (Reporting Revenue Gross versus Net)
  - Amendments to clarify principal versus agent guidance on how to apply the control principal to certain types of arrangements and indicators to focus on evidence that an entity is acting as a principal rather than as an agent.
- ASU No. 2016-10 (April 2016) – Identifying Performance Obligations and Licensing
  - Amendments to clarify how an entity should evaluate the nature of its promise in granting a license of IP, when a promised good or service is separately identifiable, and allow entities to disregard items that are immaterial in the context of a contract.
- ASU No. 2016-12 (May 2016) – Narrow-Scope Improvements and Practical Expedients
  - Amendments on transition, collectibility, noncash consideration and the presentation of sales and other similar taxes and nine technical corrections and improvements on narrow aspects of the guidance

Thank you!

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