The revenue recognition transition:

A primer for the transition to ASC 606 Revenue from Contracts with Customers

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Agenda

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1) Overview: ASU 2014-09, (Topic 606) *Revenue from contracts with customers*
2) Applying the Five Elements
3) Contract costs
4) Disclosures
5) Effective dates and transition
6) The current status on guidance
7) Key considerations for transition
8) How to get started
9) Questions

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OVERVIEW:
ASU 2014-09, (Topic 606)
Revenue from contracts with customers

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Revenue from contracts with customers was issued in May 2014 by both

— FASB (as ASU 2014-09, Topic 606) and

— IASB (as IFRS 15)

Effective dates are

1) periods beginning after **December 15, 2017** for **public** entities, and
2) periods beginning after **December 15, 2018** for **all other** entities.

Overview: History

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The project was taken up for several reasons:

1

Revenue is important! Probably the most important line item in an entity's financial statements.

2

Recognition practices diverged across industries due to lack of a comprehensive standard.

3

The standard would improve comparability and transparency as to how entities recognize revenue.

4

International convergence would be beneficial for capital markets.

Historically, significant differences between US / international standards

US

- Revenue recognition was based on hundreds of pages of industry specific guidance
- Sometimes resulting in differences, depending on the industry, for transactions that had the same basic economics

IFRS

- Principles based
- Difficult to apply due to the lack of any guidance

Overview: History

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01/2002
Project started with goal of improving revenue recognition.

The Boards reviewed hundreds of comment letters and conducted extensive outreach before concluding on the final standard.

Issuance of invitation to comment (ITC).

06/24/10
Issuance of first exposure draft.

11/04/11
Re-exposure of first exposure draft.

01/04/12
Issuance of second exposure draft.

05/28/14
Converged standards released.
Substantially identical, minor differences.

Overview: Scope

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Scope

All entities which report in accordance with GAAP or IFRS

Out of scope

Specific types of contracts including:

- Leases
- Insurance contracts
- Financial instruments
- Nonmonetary exchanges to facilitate sales to customers
- Certain guarantees

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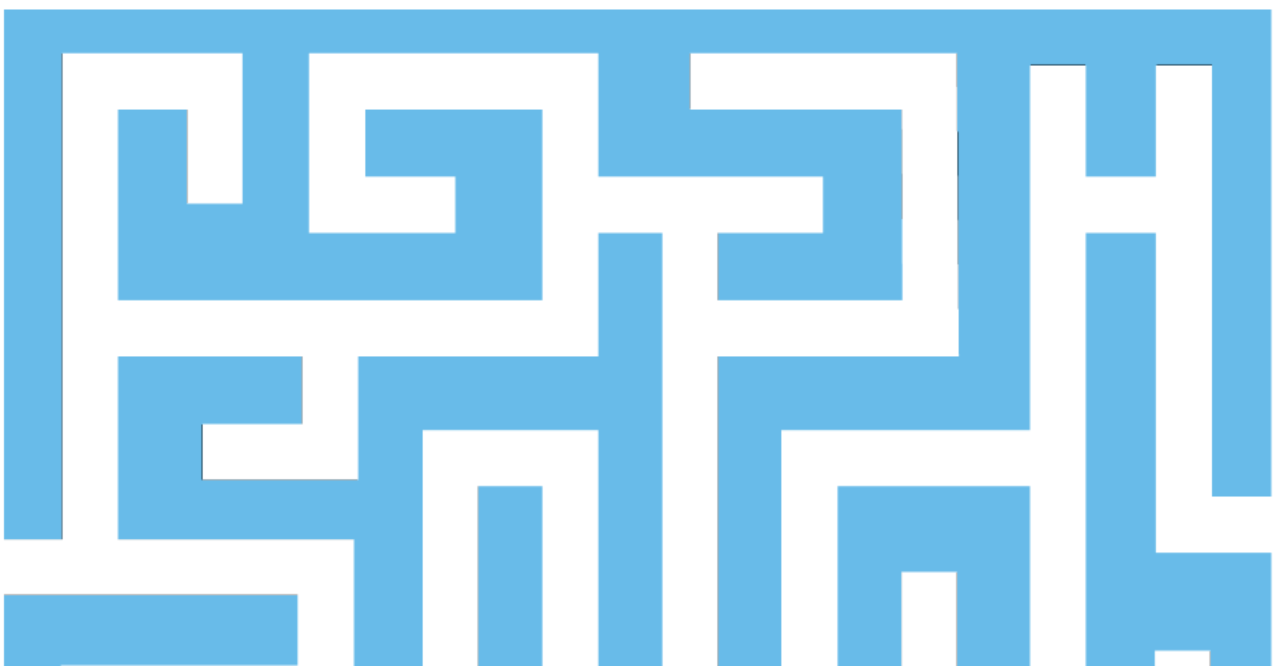
Applying the five elements



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For each revenue transaction the entity must address five specific elements (or steps):

1. Identify the contract with the customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to each performance obligation
5. Recognize revenue as the entity satisfies the performance obligation

1) Identify the contract with the customer

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KEY CONCEPTS		
	I	An agreement with enforceable rights and obligations; written, oral or standard business practice
	II	Parties have approved
	III	Goods and/or services can be identified
	IV	Payment can be identified
	V	Commercial substance
	VI	Collectability is probable

Additional considerations

1) Collectability: Based on customer's ability and intent to pay, considering only credit risk

2) How and when to combining contracts

3) How and when to account for contract modifications; separate contract or adjustment to original contract

2) Identify separate performance obligations

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KEY CONCEPTS

I	A promise to transfer goods or services
II	Services can be discreet or a series of services which are the same
III	Explicit or implicit promises
IV	Determining whether a promise is distinct

2) Identify separate performance obligations

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Distinct promises

1) Customer can benefit from the good or service on its own with readily available resources

2) Separately identifiable, in the context of the contract
   - Promise does not significantly modify other promises
   - The good or service is not highly interrelated with other promises

3) Determine the transaction price

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KEY CONCEPTS		
	I	Amount of consideration an entity expects to receive in exchange for the good or service
	II	Variable consideration: must be estimated at contract inception
	III	Variability as a result of: discounts, rebates, refunds, incentives, performance bonuses, etc.
	IV	Significant financing component

3) Determine the transaction price

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Variable consideration

1) Must be estimated either using a probability weighted approach, expected value, or estimated as the most likely amount
   - This is not a policy choice, rather the estimation is driven by the facts and circumstances of the contract
2) Constraint: the actual amount should be recognized only if it is probably that there will not be a significant revenue reversal in the future
3) The initial estimate is revisited each reporting period

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Significant financing component

Entities may need to consider the time value of money for contracts where payment is expected to take over one year.

- Factors to consider:
  - Time between delivery of promises and when payment is received
  - Whether consideration would be different if customer paid cash
  - Interest rates implicit in the contact and prevailing interest rates
- Prepayments may be subject to interest expense recognition

4) Allocate the transaction price to the separate performance obligations

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KEY CONCEPTS

I	Allocation based on relative standalone selling price
II	Made at inception with no future adjustments for changes in the selling prices

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Determining standalone selling prices

Observable price of good or service when entity sells each separately

- If unavailable an estimation must be made:
  - Expected cost plus margin
  - Assessment of market for similar items
  - Residual approach (limited use)

Allocating a discount (sum of standalone prices is less than contract price)

1) Generally allocated proportionally

2) May be allocated to individual performance obligations directly under certain circumstances

5) Recognize revenue when (or as) each performance obligation is satisfied

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KEY CONCEPTS

- **I** Recognize as goods or services are transferred to customer **control**
- **II** Control: An entity's ability to direct the use and obtain all of the remaining benefits of transferred items
- **III** Recognition at a point in time or over time

5) Recognize revenue when (or as) each performance obligation is satisfied

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Over time

1) Customer concurrently receives and consumes the benefits provided; or

2) Entity's performance creates or enhances a customer controlled asset; or

3) Entity's performance does not create an asset with alternative use and the entity has the right to payment for progress to date

5) Recognize revenue when (or as) each performance obligation is satisfied

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Point in time

Control transfers to the customer, indicators:

1) Entity has present right to payment
2) Legal title has been transferred to customer
3) Physical possession has been transferred to customer
4) Risks and reward have been transferred to customer
5) Customer has accepted the asset

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Contract costs

Key concepts

An entity should capitalize incremental costs of obtaining a contract and amortize over the life of the contract

- Relate directly to a contract that can be identified
- Enhances the entity's ability to complete the contract
- Are expected to be recovered

Contract costs

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Costs to fulfill a contract should be capitalized in accordance with guidance on:

> inventories
> PP&E
> internal-use software
> costs of software to be sold

In general, if the costs directly relate to the contract, will be used in the performance, and are expected to be recovered.

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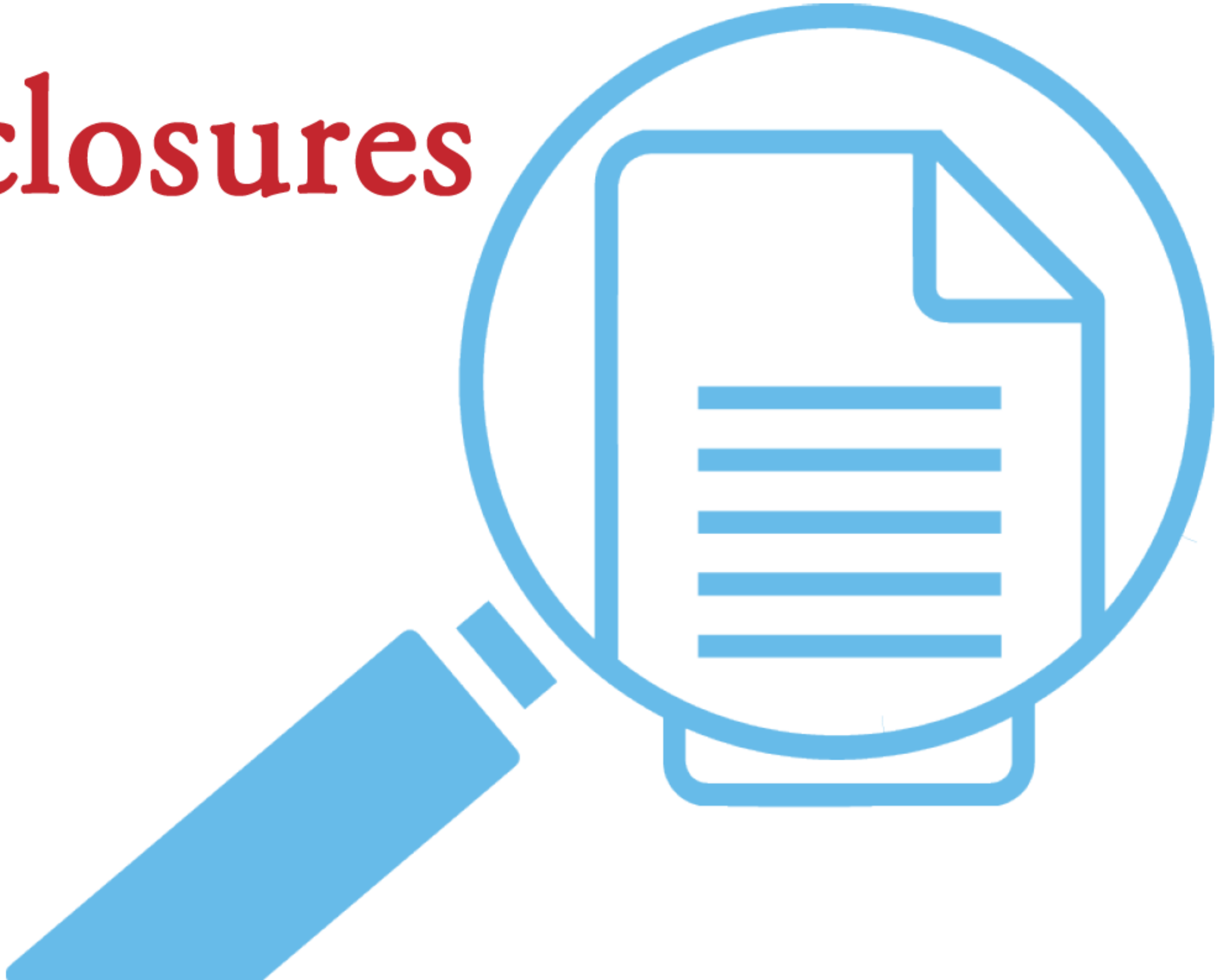
Disclosures



Required for public entities

1) Disaggregation of revenue
2) Reconciliation of contract balances
3) Information about performance obligations
4) Remaining performance obligations
5) Costs to obtain contracts
6) Qualitative disclosures

Effective dates and transition

Effective dates and transition

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2017

For **public** entities (including conduit debt obligors): Periods beginning after **December 15, 2017**

2018

For **all other** entities: Periods beginning after **December 15, 2018**

Early adoption is permitted for all entities as of periods beginning after December 15, 2016 (the original effective date).

Transition

Full retrospective

- Restate all periods presented
- For accelerated filers: 2016 and 2017
- For all others: 2017

Simplified method

- Cumulative effect change through equity in year of change with prior period presented without change
- Disclosure required to state the amount of change in each line of item of financial statements as if presented under prior accounting

Effective dates and transition: ASC 606 v. IFRS 15

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Collectability threshold

US GAAP

> Probable = “likely to occur” = 75-80% probability

IFRS

> Probable = “more likely than not” = 50%+

Effective date

IFRS: No one year deferral for non-issuers

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Impairment loss reversal

IFRS

> Permits reversal for impaired contract costs under certain circumstances

US GAAP

> Does not permit

Effective dates and transition: ASC 606 v. IFRS 15

Relief for non-issuers

US GAAP

> Provides some disclosure relief for non-issuers

IFRS

> Does not provide

Early adoption

IFRS

> Permits adoption before periods beginning after December 15, 2016

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The current status on guidance

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Transition Resource Group (TRG)

Created by FASB and the IASB to filter questions that come up in attempting to apply the ASU.

> This process as led, so far, to the following additional proposed guidance:

1) Principal v. agent considerations
2) Narrow scope improvements and practical expedients
   i. Collectability
   ii. Presentation of sales taxes
   iii. Noncash consideration
   iv. Transition issues

TRG pending issues

Identifying performance obligations and licenses

> Under consideration:

i. Restocking fees
ii. Credit cards
iii. Consideration payable to a customer
iv. Measuring progress toward satisfaction of a performance obligation

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What is the Financial Reporting Executive Committee (FinREC) doing?

Industry task forces

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

The current status on guidance

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Process

1) **Task forces surface industry relevant issues**
    - Submit to rev rec oversight committee for clearance
    - Cleared items go to the full FinRec for consideration

2) **Guidance is approved or sent back for revisions, or if no consensus, goes to TRG**

3) **Final step before guidance is included is "blessing," from SEC and FASB staff**

The current status on guidance

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Goal

AICPA Guide to Revenue from Contracts with Customers

> Overview chapter(s)
> Industry specific guidance

This is a slow process – do not expect guidance for at least a year.

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Industries with the most change

Healthcare	Real estate	Contractors
Gaming		Pharma
Some manufacturing	Service industries	Software

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Key considerations for transition

Key considerations for transition

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Concepts that will be difficult to apply

- Identifying performance obligations
- Allocating consideration (including variable)
- Variable consideration: How much? Dealing with the constraint
- Recognizing completion of a performance obligation: at a point in time or over time
- Applying the collectability concept when determining whether there is a contract

Key considerations for transition

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Business model

Investors and other stakeholders will want to understand the impact on your business

Contracts revisions

Existing contracts may need to be analyzed — some contracts may need to be combined and some may contain additional performance obligations

Key considerations for transition

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Tax impact

Timing and amounts of revenue and expenses may require adjustments to tax accounting and planning or prompt changes in tax accounting methods

ICFR impact

Processes and controls may need to be developed to capture and monitor management's judgments and any subsequent changes on a timely basis

Key considerations for transition

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IT impact

ERM may need to be updated or upgraded to capture data for the additional judgments, estimates, and disclosures; **required data may reside outside of accounting departments** and the entity's internal control structure

Compensation

Staff bonuses, incentive plans, and executive compensation may need to be reconsidered

Key considerations for transition

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Disclosures

Significant additional **disclosure regarding qualitative and quantitative assumptions used** (i.e., disaggregation of revenue below the segment level), disclosure of performance obligations and timing of when these amounts will be recognized, **disclosure of transaction price and allocation to performance obligation**

What to do next

What to do next?

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Public companies

- Need to start soon on transition
- SEC expects to see more robust SAB 74 disclosures beginning in 2016
- Choosing a transition method soon
- How to run parallel systems currently for support in 2018

What to do next?

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I — **Establish a cross functional internal team to manage the process**

II — **Assess the need for external advisors**

- Accounting experts
- IT specialists
- ICFR specialists

III — **Begin to understand the revenue streams in your business**

IV — **Perform pro-forma analysis of the impact**

Disclosure

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