

Practical matters

for the c-suite

Revenue recognition project: second time's a charm?

Revised model would still change current practice

The FASB and IASB have revised their June 2010 proposal on revenue recognition. While some of the complexity has been stripped from the proposal, complying with the proposed new guidance would still require significant effort and management judgment.

Here's what the revised proposal would mean to you:

- ▶ The new proposed revenue model is closer to current US GAAP than the previous proposal, but would require companies to make more estimates and use more judgment than under current practice.
- ▶ Key metrics, including gross margins, would change due to differences in the timing of recognition and presentation of revenue and certain expenses.
- ▶ Employees and stakeholders would need to be educated on how the changes impact the company.
- ▶ More disclosures surrounding management judgments would be required in the financial statements.
- ▶ Key processes and controls that support the company's internal control structure would need to be updated.
- ▶ IT systems and manual processes that support the accumulation and reporting of data would need to be developed.
- ▶ Tax-planning strategies, transfer pricing and tax filings might be affected.
- ▶ Financial statements would need to be restated retrospectively.

How has the revenue recognition model changed?

In November 2011, the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) (collectively, the Boards) issued a revised joint exposure draft (ED) for revenue recognition. The revised proposal considers input received from nearly a thousand comment letters and other outreach efforts. The ED simplifies some of the 2010 proposal's concepts and provides additional application guidance. However, the basic revenue recognition principle and model have not changed from the original proposal – that is, a company should recognize revenue when it transfers promised goods and services to the customer, and the amount recognized should be the consideration to which the company expects to be entitled. Under present practice, US GAAP and international standards on revenue recognition differ. Under the revised ED, they would essentially converge.

Companies would apply a five-step revenue recognition framework, which is the same as in the 2010 ED. How certain aspects of these steps would be applied has changed. While the basic principles of the revised ED are straightforward, especially when applied to simple revenue transactions, increased use of management judgment and estimates could prove challenging. In addition, particular industries, such as software and construction that have specific guidance existing for recognizing revenue, may find that the new ED changes the timing and amount of revenue recognition for certain transactions.

Five-step revenue recognition proposed model

Step 1: Identify the contract

Step 2: Identify the separate performance obligations

Step 3: Determine the transaction price

Step 4: Allocate the transaction price to separate performance obligations

Step 5: Recognize revenue as performance obligations are satisfied

Proposal snapshot – What are the basic elements of the proposed model?

- ▶ The proposed model would apply to all contracts with customers except leases, insurance, financial instruments, guarantees and certain nonmonetary exchanges.
- ▶ It also would apply to the sale of nonfinancial assets, such as property, plant and equipment, or intangible assets.
- ▶ Revenue would be recognized when, or as, the customer obtains control of the good or service. The Boards acknowledged that control of a good or service may transfer continuously, and have developed criteria to help companies assess whether control transfers at a point in time or continuously over time.
- ▶ When either party to a contract has performed, a contract asset or contract liability will be recorded on the balance sheet.
- ▶ All uncollectible amounts will now be recognized in the income statement in a separate line item that is presented next to revenue.
- ▶ A company will recognize a liability and expense on onerous performance obligations satisfied over a period of greater than one year even if the overall contract will not result in a loss.
- ▶ Variable consideration would be allocated to the performance obligations and recognized when the estimated amounts are “reasonably assured,” which could change the current timing of revenue recognition.
- ▶ Significantly more disclosures would be required.
- ▶ Companies would apply the standard retrospectively, although some practical relief from full retrospective application would be permitted.

While the Boards noted that retrospective application could be burdensome for some companies, particularly those with a large number of long-term arrangements, they ultimately rejected a prospective or limited retrospective basis of adoption. The Boards believe preparers would have the time and flexibility to apply the proposed guidance retrospectively because of the relief provided in the revised ED and the long lead-time between the issuance of a final standard and its effective date (which the Boards have stated would be no sooner than 1 January 2015).

How has the revenue recognition model changed?

The sections that follow illustrate how the Boards' proposal on revenue has changed from the original June 2010 version, and highlight certain changes from current US GAAP. The discussion focuses on areas that will truly affect your business.

Goods and services as a single performance obligation

One of the key requirements of the proposal is the identification of separate performance obligations in the contract with a customer. Many respondents to the June 2010 ED expressed concern that it would require the identification of a large number of individual performance obligations. The Boards' revised proposal specifies that a company would account for a bundle of goods and services as one performance obligation if those bundled goods and services are highly interrelated, and providing them requires significant integration and modification by the company. For instance, consider a software development firm that is contracted to provide a suite of software products including installation and licenses to support an online ordering process. The company could consider the installation, licenses and software to be a single performance obligation if significant integration and customization of the software packages is required in order to fulfill the customer's needs.

Performance obligations satisfied over time

The revised proposal acknowledges that a performance obligation can be satisfied continuously (i.e., services) and provides several criteria for determining when continuous revenue recognition is appropriate. The proposal's criteria for determining when revenue can be recognized are different from current guidance. The revised ED says a performance obligation is satisfied continuously if (1) the company's performance creates or enhances an asset that the customer controls as the asset is being created or (2) the company's performance does not create an asset with alternative use to the company and certain additional conditions are met. A company may not have an alternative use for the good or service if the contract precludes the entity from transferring the good or service to another customer.

In many situations, determining whether a performance obligation is satisfied over time would be easy. For example, a contract to provide legal services would be satisfied over time if the law firm has a right to payment for performance to date.

However, recognizing revenue in contracts involving the construction of complex goods, or a combination of goods and services, could be more difficult. A company would be required to exercise significant judgment for each type of contract it enters into to determine if the performance obligation is satisfied continuously. If certain criteria, such as creating an asset with "alternative use," have not been satisfied, revenue would then need to be deferred until completion.

Onerous performance obligations

The revised ED modified the scope of the onerous test to include performance obligations that a company satisfies over a period of greater than one year. Performance obligations satisfied at a point in

time or satisfied over a period of less than one year would not be subject to the test. The original ED did not have this scope limitation. Once the company has recorded a liability and corresponding expense for an onerous performance obligation, the proposed guidance would require that the measurement of the obligation be updated at each financial reporting date to include changes in assumptions or new information.

This provision would significantly change practice for most transactions satisfied over time other than construction and production-type contracts. Under current US GAAP, many companies do not recognize losses on executory contracts unless there is a specific requirement to do so. And when they do, it is at the contract level, rather than at the performance obligation level.

Variable consideration

A portion of the transaction price in a contract can vary in amount and timing. Examples of variable consideration include discounts, rebates, refunds, credits, incentives, performance bonuses, penalties, contingencies, price concessions or other similar items. In a significant change from current US GAAP, the revised ED would require variable consideration to be estimated and allocated to the performance obligations, and ultimately recognized as revenue, prior to resolving all uncertainty (limited by certain criteria). The revised ED proposes that variable consideration be estimated based on the expected value (the expected value is the sum of probability-weighted amounts in a range of possible consideration amounts) or the amount most likely to be received, whichever best predicts the consideration to be received. The estimate would need to be updated at each reporting period. The original ED would have required use of an expected value approach.

For a number of companies, the treatment of variable consideration under the revised model would represent a significant change from current practice. Most current US GAAP limits the amount of revenue allocable to identified performance obligations to the amount that is not contingent on the future satisfaction of performance obligations. The revised model would allow variable consideration to be allocated to performance obligations and provides a restriction only on recognizing variable amounts that are not reasonably assured. As a result, entities may recognize revenue for variable amounts sooner.

Product warranties

The proposed accounting for warranties has been scaled back significantly from the 2010 ED and would now be similar to current practice. Warranties that provide the customer with assurance that the delivered product is as specified in the contract would not affect the recognition of revenue. Warranties that provide a service to a customer that is in addition to that assurance would be treated as

separate performance obligations. Revenue allocated to these warranties would be deferred, but the amounts would be measured differently from current practice.

Presentation of bad debt expense

The revised ED would require a company to recognize the estimated transaction price as gross revenue. A customer's credit risk (i.e., collectibility) would not be taken into consideration when measuring the recognized gross revenue. This represents a major change from the original ED, which would have required revenue to be reduced by any potentially uncollectible amounts. Under the revised proposal, the expected uncollectible amount (including both the initial estimates and subsequent adjustments) would be presented as a separate income statement line item adjacent to gross revenue.

This change will have a significant effect on a company's income statement presentation and gross margins. For most contracts, gross revenue would be greater than the amount of revenue recognized currently because, unlike present standards, the proposed model does not require an assessment of collectibility in order for revenue to be recognized.

Investors and stakeholders could potentially be confused by these new presentation requirements. They also may give more attention to uncollectible amounts since they would be presented more prominently on the income statement. Communicating the new presentation requirements and the company's policy on accounting for bad debts would be important, especially in the early periods after adoption.

How will the company's business be affected?

As described above, some of the Boards' changes have reduced the burden of the original proposal and brought them closer to current guidance, although differences would still exist. We discuss below significant implementation considerations that would result from the revised proposal.

Management estimates and judgments

Even though the Boards have attempted to simplify the original proposal, management estimates and judgments would still be an important part of implementing the proposed standard. The model's use of broader principles, rather than more detailed prescriptive guidance, would require companies to make more estimates and use more judgment than under today's guidance.

Identifying separate performance obligations

As discussed above, identifying separate performance obligations would be one of the more challenging aspects of the revised ED. A company would have to evaluate all the facts and circumstances of an arrangement and ultimately use significant judgment to determine whether to account for promised goods and services as one or more performance obligations. Consider a contract that contains hardware, software hosting and professional services. Applying the proposed model could lead to three separate

Contract costs

The proposed method of accounting for contract costs would be significantly different from current practice. Whereas many companies today currently expense contract acquisition costs, such as sales commissions, the proposal would require capitalization of incremental costs of obtaining a contract longer than one year (long-term contracts).

The ED also proposes that costs incurred to fulfill a contract (e.g., setup costs) that are not otherwise capitalized under other standards (e.g., inventory, property and equipment) would be recognized in the statement of operations consistent with the pattern of transfer of the related good or service. When the cost of producing products varies based on changes in the cost of raw materials, learning curves with initial products or other variable input costs, the proposal would preclude the current practice of recognizing costs to units delivered in equal amounts. This would be a change in practice for many companies that now apply construction-type and production-type contracts guidance.

Increased disclosures

To increase transparency, the proposal would call for several new disclosures that would require collecting more data than is required under current practice. For example, the proposal would call for additional disaggregated disclosures of revenue (such as by type of good or service, geography, or contract duration), rollforwards of certain asset and liability account balances within the notes to the financial statements and the disclosure of key estimates. Companies will also need to disclose their judgments that significantly affect the amount and the timing of revenue recognition.

performance obligations or any number of combinations. If a company determines that the hardware is always sold with the professional services, it would account for them as a single obligation, with the hosting services accounted for as a separate performance obligation. This judgment to determine the appropriate combination of goods and services may result in a combination different from current guidance. Under current GAAP, if the hardware was not separable, it would always be combined with the last deliverable in the bundle (the hosting services).

Allocating the transaction price

A company generally would allocate the transaction price to the performance obligations based on their relative standalone selling prices. This would require a company to estimate the standalone selling price if it is not otherwise observable.

Allocating the transaction price based on standalone selling prices could potentially have a big impact on certain industries. For instance,

telecommunication companies often provide customers with free or deeply discounted equipment. Currently, little or no revenue may be allocated to this equipment because the related revenue is contingent on the delivery of the ongoing monthly services. Under the revised ED, companies would allocate the relative selling price of the equipment to this separate performance obligation and recognize the allocated amount upon delivery of the equipment (i.e., more revenue recorded upfront and less over the service period).

A company would be able to use a residual approach in estimating the standalone selling price of a good or service if the price at which a good or service is sold is highly variable or uncertain. Whether the standalone selling price of a good or service is highly variable or uncertain will require significant judgment. Companies may need to develop policies to ensure they are applying the guidance and exercising judgment consistently for similar transactions.

Estimating the standalone selling prices would be particularly difficult when the price is not currently observable, or when goods or services are offered as incentives for the customer to purchase more from the seller. For instance, determining a standalone selling price on free periods of maintenance may not be observable and difficult to estimate.

Transfer of control

As noted above, under the revised ED, revenue would be recognized upon satisfaction of performance obligations. Performance obligations are satisfied when a company transfers a good or service to a customer, which is evidenced by the customer obtaining control of the good or service. The proposal provides several indicators of transfer of control (including evaluating who has title to the asset, present right to payment, and physical possession of an asset). Determining who controls a good or service in a contract will require judgment. As discussed in the previous section, determining when the customer obtains control is not always straightforward for contracts that provide for the transfer of goods and services continuously over a period of time. Adding to the complexity, the ED further requires a company to select a single revenue recognition model (i.e., the output or input method) for those contracts in which the transfer of goods and services is deemed to occur continuously.

Variable consideration

The revised ED would allow two separate approaches to recognize variable consideration – a probability-weighted estimate or a “most likely” approach. Upon transition to the new standard, a company would need to assess, based on its business model and sources of revenue, whether probability weighting or the most likely amount to be received would better predict the amount of consideration to which it will be entitled. That method would have to be applied consistently throughout the contract.

Onerous contracts

If the cost to fulfill a performance obligation exceeds the portion of the transaction price allocated to that performance obligation, a company would record a liability and corresponding expense for that

amount (even if the overall contract will not result in a loss). Estimating the cost to fulfill a performance obligation, especially performance obligations that are expected to be satisfied over several years, could be difficult and require significant assumptions. Furthermore, continuously assessing if a contract's individual performance obligations are onerous will be operationally challenging.

Product warranties

If a company provides more assurance than a normal warranty, it would be accounted for as a separate performance obligation and the revenue allocated to those warranties would be deferred. Increased judgment would be required to determine if the warranty provides more assurance than a standard product warranty and the period of time over which revenue should be recognized for such warranties.

Processes and controls

Additional data will be needed to comply with the expanded revenue disclosure requirements. These enhanced information requirements may call for significant modifications to existing internal data-gathering efforts and processes. Companies with decentralized operations will be especially affected in view of the need to accumulate information from multiple locations.

Furthermore, companies may need to challenge their IT systems and related general ledger and reporting software to determine whether they are able to track, compile and report information in accordance with the proposed revenue model.

In addition to data accumulation and IT changes, internal reporting processes and controls will most likely also require revision. These revisions will be especially important because they affect compliance with Section 404 of the Sarbanes-Oxley Act, as well as the company's Sections 302 and 906 management certifications. Companies need to take steps to determine that their internal control processes remain effective in the face of the significant change in the accumulation and reporting of financial information.

Financial statement metrics and communications

Many companies are measured and evaluated based on revenue. And while revenue is itself a key metric, it also directly affects other significant measures, such as earnings per share, EBITDA and gross margins, among others. Under the new revenue recognition model, revenue and its related metrics may change. Companies need to think through how such changes will be presented and discussed on analyst calls, in earnings releases and in other shareholder communications.

Financial measures driven by revenue also could affect loan covenants, financing agreements and regulatory requirements. Companies that base bonuses, share-based vesting provisions and other compensation plans on such measures may need to reassess the arrangements and whether they would continue to be an appropriate performance measure. By performing an initial impact assessment, a company will be able to identify the effects of the proposal early on so it can begin to develop meaningful communication with stakeholders.

Contract terms

The proposed standard could affect the timing and amount of a company's revenue, particularly for companies with longer-term contracts or those with multiple performance obligations. When a contract involves the construction of an asset over time, the company will need to demonstrate that control of a portion of the asset has passed to the customer in order to recognize revenue prior to the asset's completion. Factors to consider include the customer's present obligation to pay, the passing of legal title, physical possession of the asset and customer acceptance. Accounting should not drive a company's business, but the company should

understand the effect that certain contract terms could have on its ability to recognize revenue at points prior to completion of the asset, and be mindful of those terms as it negotiates contracts with customers.

Tax issues

The tax determination of revenue differs, in many instances, from the accounting requirements for revenue recognition under the proposed new model. As companies potentially modify existing revenue arrangements to address the accounting treatment under the proposed new standard, the existing tax treatment will also need to be analyzed to determine that favorable tax positions have not been jeopardized and that tax risks have been appropriately managed.

Assessing tax treatments early will help companies reduce tax exposures, identify book versus tax differences presented by the proposal and develop the most advantageous tax strategies possible. In addition, there are significant synergies to be gained by analyzing tax treatments and financial accounting impacts simultaneously, because much of the underlying financial information is the same.

What can you do now?

Although the Boards have not yet finalized an effective date, companies should begin preparing for the revised proposal by identifying potential implementation issues. Preparing to adopt a new accounting standard as pervasive as the revenue recognition project is a large undertaking for any organization. Although still in the proposal stage, there are key differences in current practice that will likely remain upon finalization. Early planning is the key to a smart transition. A measured and thoughtful approach to transition is the best way to reduce cost and ensure a successful implementation. Some actions that companies should consider now:

- ▶ Understand the magnitude of the changes to your company from both a financial statement and business perspective.
- ▶ Establish a project management plan for adoption of the proposed standard.
- ▶ Determine training requirements for individuals responsible for the key judgments and estimates.
- ▶ Identify common transactions and potential implementation issues.
- ▶ Establish a process for gathering appropriate data to comply with the proposal.
- ▶ Voice your views on the proposal through the comment letter process.
- ▶ Continue to monitor the Boards' deliberations.

For a more complete technical discussion about the ED and the latest proposed changes, refer to the following publications available through Ernst & Young's Accounting Link, www.ey.com/us/accountinglink:

- ▶ *Technical Line: Double-exposure: the revised revenue recognition proposal (12 December 2011, SCORE number BB2231)*
 - ▶ *To the Point: A new proposal for revenue recognition (14 November 2011, SCORE number BB2210)*
-

For more information, please contact:

Ken Marshall

Financial Accounting Advisory Services Leader – Americas

+1 212 773 2279

kenneth.marshall@ey.com

How Ernst & Young may be able to help

Ernst & Young can bring its multidisciplinary team of accounting, tax, systems and IT professionals to your company to assist in assessing what the revised revenue recognition proposal means to you. In the chart below, we outline issues and steps you should consider related to the proposal and indicate how Ernst & Young may be able to help you from initial assessment through adoption.

Issues and steps	How Ernst & Young may be able to help
Gain a general understanding of the proposal	<ul style="list-style-type: none"> ▶ Design and deliver training sessions for company personnel ▶ Share insights and views of the FASB, IASB and SEC ▶ Provide input into the company's comment letter on the ED
Perform a preliminary assessment of the impact of the proposal on the company's financial statements	<p>Advise and provide input into:</p> <ul style="list-style-type: none"> ▶ Gathering necessary information needed to adopt the proposed standard ▶ Summarizing customer contracts ▶ Interpreting the proposed rules and application to customer contracts (e.g., performance obligation, when control is obtained, the impact of rights to return, and warranties and other key contractual terms) ▶ Developing a consistent methodology around judgmental areas such as variable consideration, contract costs, warranties, onerous contracts or selecting a revenue recognition model that best depicts the continuous transfer of goods and services ▶ Calculating the income statement impact of adopting the proposed standard ▶ Assessing the impact on key financial ratios and performance, such as gross margins ▶ Identification of shortfalls in available information to adopt the proposed standard, especially considering the proposed ED's additional disclosures ▶ Developing a process for monitoring performance obligations, costs incurred and the impact to the financial statements
Benchmark the company against peers and others in the industry	<ul style="list-style-type: none"> ▶ Provide observations of how others are approaching the proposal, problems they encountered and solutions developed ▶ Assist in the evaluation of peers, competitors and industry disclosures and expected impact on their financial reporting
Access processes for data collection, internal controls, IT systems	<ul style="list-style-type: none"> ▶ Provide observations and insights based on leading practices on ways the company could design its business process, IT systems and internal controls in response to the new requirements
Assess tax positions relating to the proposal	<ul style="list-style-type: none"> ▶ Assist in analyzing tax positions arising from adopting the new proposal, reducing tax exposure and determining tax effects of the new revenue recognition model
Plan for ultimate adoption of the proposed standard	<ul style="list-style-type: none"> ▶ Advise regarding your project management and planning, including timeline, tasks and resource allocation
Update accounting manuals and accounting policies	<ul style="list-style-type: none"> ▶ Review and provide input into accounting manuals and policies selected by management and help draft policies in anticipation of the final standard
Communicate effect of adoption to stakeholders – analysts, regulators, shareholders	<ul style="list-style-type: none"> ▶ Advise on developing a communication plan ▶ Advise on drafting communications ▶ Provide an analysis of the information that will be available under the new proposal

Ernst & Young
Assurance | Tax | Transactions | Advisory

© 2011 Ernst & Young LLP.
All Rights Reserved.

BSC No. 1111-1305598

SCORE No. BB2244

About Ernst & Young

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 152,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit www.ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

This publication has been carefully prepared but it necessarily contains information in summary form and is therefore intended for general guidance only; it is not intended to be a substitute for detailed research or the exercise of professional judgment. The information presented in this publication should not be construed as legal, tax, accounting, or any other professional advice or service. Ernst & Young LLP can accept no responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. You should consult with Ernst & Young LLP or other professional advisors familiar with your particular factual situation for advice concerning specific audit, tax or other matters before making any decision.