Preparing for Changes in Standards—Revenue Recognition
Module 1:
Course introduction
Agenda

Preparing for Changes in Standards material to be covered today:

• Fair value measurement
• Financial instruments
• Revenue recognition
• Leasing
Objectives

• Discuss key decisions and principles that have been agreed or that are planned by the FASB and IASB.

• Describe key provisions of the projects and identify potential changes to current accounting standards.

• Anticipate and prepare for initial conversations with entities regarding information to gather and actions to take in anticipation of the upcoming new standards.

• Identify areas that may require increased use of professional judgment related to the upcoming new standards.

• Discuss audit, documentation, crucial conversations, and industry implications, as applicable, that may result due to the upcoming new standards.
Module 2: Revenue recognition
Revenue recognition overview

One-size fits all, principles-based revenue recognition model
Revenue recognition project objective

Clarify principles
Develop a common revenue standard
Current timeline

Effective date TBD (no earlier than 1/1/2015)

- Summarize comment letter responses and affirm redeliberation plan
- Segment a contract, identify separate performance obligations
- Determine the transfer of control for goods and services

- Cost of obtaining a contract, warranties, breakage, and prepayments
- Measuring progress, contract combining, modifications, and onerous test
- Time value of money, collectibility, and uncertain consideration

- Determine and allocate transaction price, licenses, and rights to use, fulfillment costs, sales and repurchase agreements
- Disclosures and fulfillment costs

- Redeliberations completed
- Certain industry specific considerations, transition, re-expose

Revised exposure draft with 120-day comment period

Finalize standard (Q2 or Q3?)

2011 Jan Feb Mar Apr May Jun Jul Aug Sep

2012 Jun Jul Aug Sep Oct
Transition methods

Full retrospective application

Retrospective application with optional transition reliefs
Discussion question #5

Which of the following statements are true?  
(Hint: More than one may be correct.)

a) The revenue recognition project will supersede most current accounting guidance in U.S. GAAP and IFRS on revenue recognition and will impact any entity that has revenue, unless specifically scoped out (e.g., insurance, leases, financial instruments).

b) The revised exposure draft proposes that the final standard will be effective no earlier than annual reporting periods beginning on or after January 1, 2015.

c) All entities will be required to apply the standard on a full retrospective basis with certain optional transition reliefs.

d) Public and nonpublic entities will have the same transition requirements.
Summary of key provisions
Core principle and steps in the model

**Core principle**: Recognize revenue to depict the *transfer of goods or services* in an amount that reflects *the consideration the entity expects to receive* in exchange for those goods or services.

**Step 1**: Identify contracts with the customer.

**Step 2**: Identify the separate performance obligations.

**Step 3**: Determine the transaction price.

**Step 4**: Allocate the transaction price to the separate performance obligations.

**Step 5**: Recognize revenue when performance obligations are satisfied.
What are several situations in which entities:

• Make significant judgments or estimates as it relates to revenue

• Apply industry specific guidance or common practices

• Have variable or contingent revenues
Step 1: Identify the contracts with the customer

<table>
<thead>
<tr>
<th>The model does not apply to scoped out topics</th>
<th>The model does provide guidance on</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Lease contracts (ASC 840)</td>
<td>• When one or more contracts should be combined into a single analysis for accounting purposes</td>
</tr>
<tr>
<td>• Insurance contracts (ASC 944)</td>
<td>• How to deal with contract modifications</td>
</tr>
<tr>
<td>• Certain contractual rights or obligations</td>
<td></td>
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<tr>
<td>• Guarantees (other than product warranties)</td>
<td></td>
</tr>
<tr>
<td>• Non-monetary exchanges whose purpose is to facilitate a sale to another party</td>
<td></td>
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</tbody>
</table>
Step 2: Identify performance obligations in the contract

Is the entity integrating a bundle of highly interrelated goods or services?

- No → Do the promised goods or services transfer at the same time?
  - No → Does the good or service have a distinct function?
    - No → Combine performance obligations until two or more performance obligations are distinct
    - Yes → Account for distinct performance obligations separately
  - Yes → Treat as a single performance obligation

A good or service has a distinct function (similar to “stand-alone value of EITF 08-1) if it either:

1. Is regularly sold separately by the entity or
2. Can be used on its own or together with resources that are readily available to the customer
Discussion question #6

Step 2, identify the performance obligations in the contract, provides a decision tree that an entity must follow to determine how to separate its goods or services into separate performance obligations (i.e., separate units of accounting). Which of the following is the first question in the decision tree that an entity must consider?

a) Do the promised goods or services transfer at the same time?

b) Is the entity integrating a bundle of highly interrelated goods or services?

c) Does the good or service have a distinct function?

d) Is the good or service sold separately by the entity?
Step 3: Determine the transaction price

Transaction price

- Consideration often varies due to discounts, rebates, refunds, credits, incentives, performance bonus/penalty, contingencies, price concessions, or similar items.
- Probability-weighted or most likely amount of consideration that the entity is entitled to from the customer, depending on which method is the most predictive of the amount of consideration the entity will be entitled.

Time value of money

Transaction price adjusted for time value of money if contract includes a significant financing component (variance in amounts, payment timing lag, explicit/implicit interest rate), subject to a one year practical expedient (mandatory when is greater than one year).
Step 3: Determine the transaction price

<table>
<thead>
<tr>
<th>Collectibility</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial and subsequent assessments of collectibility presented separately from revenue (one line item immediately following revenue)</td>
<td></td>
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</tbody>
</table>

**Initial recognition**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>10,000,000</td>
</tr>
<tr>
<td>Collectibility adjustments</td>
<td>(300,000)</td>
</tr>
<tr>
<td>Net revenue</td>
<td>9,700,000</td>
</tr>
</tbody>
</table>

**Subsequent measurement**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>10,000,000</td>
</tr>
<tr>
<td>Collectibility adjustments</td>
<td>(200,000)</td>
</tr>
<tr>
<td>Net revenue</td>
<td>9,800,000</td>
</tr>
</tbody>
</table>

Note that collectibility being reasonably assured is no longer a specific revenue recognition criteria.
Step 4: Allocate transaction price to separate performance obligations

- Allocate transaction price on a relative stand-alone selling price basis (estimate stand-alone selling price if not observable).
  - Expected cost-plus margin, adjusted market assessment, or residual (when price is highly variable) methods are acceptable.

- Allocate changes in the transaction price to all performance obligations (based on initial allocation) unless portion of (or changes in) transaction price relate entirely to one (or more) obligations, which is the case in the following instances:
  - Contingent terms relate specifically to a certain obligation.
  - Amount allocated is reasonable relative to entire contract.

- Do not reallocate for changes in stand-alone selling prices.
Step 5: Recognize revenue when performance obligations are satisfied

• Recognize revenue when promised good or service is transferred to the customer, which occurs when the customer obtains control of that good or service (in the amount that the entity is reasonably assured to be entitled to)

• Indicators of control (point-in-time): if the customer has:
  ○ An unconditional obligation to pay
  ○ Legal title
  ○ Physical possession
  ○ Risks and rewards of ownership

• If continuous transfer of goods or services, select one revenue recognition method for each separate performance obligation.
  ○ Select a method that best depicts the transfer of the goods or services (input, output, or passage of time).
Step 5: Recognize revenue when performance obligations are satisfied

• An entity satisfies a performance obligation continuously if its performance:
  ○ Creates or enhances a customer controlled asset (vgr: painting a house) or
  ○ Does not create an asset with an alternative use and at least one of the following:
    ▪ The customer receives a benefit as the entity performs each task. (vgr: a third party payment processor)
    ▪ Another entity would not need to reperform the tasks performed to date if it were to fulfill the remaining obligation to the customer. (vgr: a rail entity or cargo carrier)
    ▪ The entity has a right to payment for performance to date even if the customer could cancel the contract for convenience. (vgr: Professional services)
Step 5: Recognize revenue when performance obligations are satisfied

• Entities shall recognize revenue from satisfying performance obligations only if the transaction price is **reasonably assured**.

• An entity can conclude on whether the amount is “reasonably assured” when the following criteria are met:
  
  ○ Entity has experience with similar types of contracts (or other persuasive evidence).
  
  ○ Such experience is predictive of the outcome (factors to consider are judgment of third parties and risk of obsolescence).
  
  ○ Additional consideration can be avoided without breaching the contract (e.g., certain royalties).
Discussion question #7

The proposed guidance provides three criteria that indicate when revenue cannot be recognized because it is not reasonably assured for an entity to be entitled to that consideration. Which of the below answers is NOT one of those three criteria?

a) Additional consideration can be avoided without breaching the contract (e.g., certain royalties).

b) There is significant uncertainty regarding collectibility.

c) Entity has experience, but experience is not predictive (susceptible to external factors, judgment of third parties, and risk of obsolescence).

d) Entity has no experience with similar types of contracts (or other persuasive evidence).
Key provisions

- Objective to disclose quantitative and qualitative information about:
  - Contracts with customers
  - Significant judgments and changes in judgments
  - Specific disclosure requirements for:
    - Disaggregation of revenue
    - Reconciliation of contract balances
    - Onerous performance obligations
    - Performance obligations
    - Expenses from contract acquisition and fulfillment costs
- The amount of revenue recognition related disclosures required by entities will increase.
- Entities may need to track, analyze, and disclose revenue data in further detail when compared to today. Entities should clearly evaluate the required disclosures and ensure that they put processes in place to capture all of the necessary data to comply with the enhanced disclosure requirements. This data collection may be more difficult for entities that do not have a robust contract management database. This may require changes to their current systems.
- Nonpublic entities have reduced disclosure requirements.
- Disclosures will also be part of the retrospective adoption requirements.

### Onerous Contracts
- Onerous test is limited to contracts with performance obligations that an entity satisfies over an extended period of time (e.g., long-term service contracts).
- Recognize a separate liability and a corresponding expense for expected losses on satisfying remaining obligations in a contract.
- Liability is measured as different between allocated transaction price and either:
  - Direct costs to satisfy remaining performance obligations
  - Amount required to pay to cancel contract
- Entities may need to exercise judgment to determine if a contract is in the scope of this test.
- If in scope, entities will need to develop processes and procedures to evaluate these contracts at each reporting period.
Revenue project: summary of key provisions

Disclosure objective

• Disclose qualitative and quantitative information regarding the following:
  ○ Contracts with customers
  ○ Significant judgments, of changes to such, in applying the revenue recognition guidance

• Information shall be aggregated or disaggregated in the following instance:
  ○ “So that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have different characteristics.”

• Certain disclosure exceptions are provided for nonpublic entities.
Revenue project: summary of key provisions

Onerous obligations

• Onerous test is limited to contracts with performance obligations that an entity satisfies over an extended period of time (e.g., long-term service contracts).

• Recognize a separate liability and a corresponding expense for expected losses on satisfying remaining obligations.

• Measure liability based on difference between the allocated transaction price, in addition to one of the following:
  ○ Amount of direct costs (costs related directly to the contract) to satisfy the performance obligation
  ○ Amounts the entity would have to pay to cancel the contract

• Update the measurement of the liability at each subsequent reporting date (changes recognized as a reduction of expense).
Potential implementation questions to consider

<table>
<thead>
<tr>
<th>Question</th>
<th>Notes</th>
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<tbody>
<tr>
<td>What industries do you think will be most impacted by this new guidance? Why?</td>
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<tr>
<td>What are your entities the most interested in?</td>
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<tr>
<td>What steps should entities be taking now to start thinking about the potential implications of the new standard and potential changes needed in internal processes and systems?</td>
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<tr>
<td>Do companies anticipate that the timing or amount of revenue recognition represent significant change for any of its goods or services provided to customers?</td>
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<tr>
<td>Will the timing or the manner in which the sales force is compensated need to change?</td>
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<tr>
<td>How will entities capture the data necessary to provide for the extensive disclosures being proposed in the new revenue standard?</td>
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<tr>
<td>For entities required to apply the onerous test, what processes and controls will be required to ensure compliance with the new requirement at each reporting period?</td>
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<tr>
<td>Are entity's accounting systems able to capture all of the relevant data needed to:</td>
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<tr>
<td>• Estimate selling price</td>
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<tr>
<td>• Measure progress toward completion</td>
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<tr>
<td>• Perform and update a transaction price that is predictive of the consideration to which an entity will be entitled?</td>
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<tr>
<td>• Expand disclosures?</td>
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<tr>
<td>• Will processes around the income tax provision and income tax compliance need to be adjusted to account for changes to the information systems?</td>
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<tr>
<td>Are there potential impacts to the way in which service contracts are designed and written?</td>
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Questions?
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