

Executive Accounting Update

New Revenue Recognition Standard

Overview of the New Revenue Recognition Standard*

Why was the new standard developed?

Streamline and simplify. To provide a single framework that replaces existing industry- and transaction-specific U.S. GAAP.

Global and cross-industry consistency and comparability. To enable financial statements users and preparers to compare companies in different industries regardless of whether the companies apply U.S. GAAP or IFRS.

Transparency. To provide users of financial statements with more extensive disclosures.

How could it impact your business?

Key financial measures and ratios may change, affecting analyst expectations, earnouts, bonuses, budgeting, and compliance with contractual covenants.

IT systems may need to be upgraded or modified for revised requirements to capture additional data necessary to support the accounting and disclosures.

Sales and contracting processes may need to be reconsidered.

Accounting processes and internal controls may need to be revised for the new standard, which requires significant judgment and use of estimates. There also may be a need to maintain parallel records during transition.



When is it effective?

Public business entities and certain not-for-profit entities for fiscal years beginning after December 15, 2016, and interim periods within those years (early adoption prohibited).

All other entities for fiscal years beginning after December 15, 2017, and interim periods thereafter (early adoption allowed, but not earlier than public business entities).

Companies can elect to transition to the new standard either retrospectively or as a cumulative-effect adjustment as of the date of adoption.

* **The FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers*, in May 2014.**

DISCUSSION TOPICS

1 A single accounting model for revenue recognition

2 Implementation considerations and disclosure requirements

3 Examples of transactions that may be significantly affected

1 A single accounting model for revenue recognition

The model requires more judgment than many current U.S. GAAP requirements

Companies will need to develop processes to capture and document management's judgments at the source (e.g., executive management, sales, legal, operations, marketing, and business development) and incorporate those into their accounting process.

Judgments and estimates will require periodic updating—this may increase the number of adjustments to the financial statements for changes in estimates in periods after the sale.

More judgments and estimates required

For **variable or contingent consideration**, companies will generally need to estimate the amount to which they expect to be entitled. Amounts are included in the transaction price only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is subsequently resolved. Under current U.S. GAAP, revenue from variable or contingent consideration may have been deferred due to the price not being fixed or determinable. The new standard may accelerate revenue for some transactions.

An exception applies to distinct licenses of intellectual property with a **sales- or usage-based royalty**. For those transactions, revenue is recognized at the later of when the subsequent sale or usage occurs or at the satisfaction or partial satisfaction of the performance obligation to which the royalty relates.

For sales of **bundled goods or services**, the separation criteria changes and will be applied to all contracts. Judgment will be required to determine whether a promised good or service in a bundle of promised goods or services is distinct. A promised good or service is distinct if the customer can benefit from the good or service either on its own or with other readily available resources and the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract. Each promised good or service is either distinct or grouped into a bundle of goods or services that is distinct. The application of the separation guidance may result in either more units of account or fewer compared to current U.S. GAAP.

Criteria to recognize revenue over time

Under the new standard revenue is recognized when a good or service transfers to the customer, which may be over time or at a point in time. Criteria are provided to determine when revenue is recognized **over time**. If none of the criteria are met, then revenue is recognized at a **point in time**. Although many, but not all, companies currently using percentage-of-completion or proportional performance accounting will continue to do so under the new model, they will first need to reassess whether revenue is recognized over time or at a point in time. There also may be changes in how the percentage-of-completion or proportional performance model is applied, particularly for those using units of production or delivery. Conversely, some companies currently using point-in-time recognition may need to change to over time recognition.

Significant financing component

The new standard introduces a requirement to impute interest for contracts when there is a significant financing component in the contract, which may arise when payment is received significantly before or after the transfer of goods or services.

Cost capitalization

The new standard requires capitalization of costs incurred to obtain contracts, which may be a change for many entities. A practical expedient applies when the amortization period is one year or less.

2 Implementation considerations and disclosure requirements

Impact of implementation may be felt across the entire company

- Existing contracts may need to be analyzed—some contracts may need to be combined and some may contain additional performance obligations
- A gap analysis of accounting policies may need to be performed
- Changes in the timing and amounts of revenue and expenses may require adjustments to tax accounting and planning
- Processes and controls may need to be developed to capture and monitor management’s judgments and any subsequent changes on a timely basis
- Systems may need to be updated or upgraded to capture data for the additional judgments, estimates, and disclosures
- Staff bonuses and incentive plans may need to be reconsidered
- Investors and other stakeholders will want to understand the impact on your business

Disclosures

The new standard contains expanded interim and annual disclosures to help financial statement users understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers including:

- Disaggregation of revenue
- Significant changes in contract assets and contract liabilities
- When performance obligations are typically satisfied and significant payment terms. Amounts allocated to remaining performance obligations and when these amounts are expected to be recognized as revenue
- Significant judgments and changes in judgments including how the transaction price was determined and allocated to performance obligations
- Costs capitalized in obtaining or fulfilling contracts
- Practical expedients elected

Accommodations for some entities

Entities that are not public business entities or certain not-for-profit entities are exempted from most of the quantitative disclosures and from any revenue-specific disclosures for interim periods.

Recommended actions

Form a cross-functional project team including resources from areas such as accounting, legal, sales operations, information technology, financial planning and analysis, human resources, internal audit, and tax to start assessing the new standard’s potential impact on your company and to spearhead implementation efforts.

Reach out to your KPMG contact for a more detailed discussion about the impacts of the new revenue recognition standard on your business and to find out how we can help.

3 Examples of transactions that may be significantly affected



Construction-type and production-type contracts.

Recognition of contract revenue and contract costs may be decoupled; smooth margins may only result if a company determines that a cost-to-cost method most appropriately measures progress towards satisfaction of the performance obligation.



Bill-and-hold arrangements. There are fewer bill-and-hold criteria in the new standard compared with the criteria in current SEC guidance. It's unknown whether the SEC will revise or rescind its bill-and-hold criteria.



Performance-based incentive fees (e.g., asset management fees).

These fees may not be recognized until the end of a measurement period, depending on the risk of a significant revenue reversal. Amounts may be recognized prior to the end of a measurement period if the fees are commensurate with performance, and if it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur.



Software arrangements. The vendor-specific objective evidence (VSOE) requirement is eliminated, resulting in the acceleration of revenue for many licenses that is currently deferred due to lack of VSOE for undelivered elements. Specified future upgrades or additional product rights or other vendor obligations that currently cause revenue deferral due to lack of VSOE may not delay revenue recognition under the new standard.



Licenses of intellectual property.

Guidance is provided to determine whether a distinct license arrangement represents a right to use the underlying intellectual property as it exists at the point in time at which the license is granted (point in time) or access to the entity's intellectual property as it exists throughout the license period (over time). The new standard may result in changes from current guidance. For example, franchisors may conclude that up-front franchisee fees are recognized over time.



Telecommunications/cable contracts.

Current practice of recognizing revenue only to the extent that cash is received is replaced by a requirement to estimate a stand-alone selling price for free or discounted goods or services (e.g., wireless handset or free premium channel services for a limited time). Additional amounts may be allocated to these goods or services and the allocation may require significant IT changes for tracking and calculating revenue, with revenue decoupled from customer billings.



Sales of real estate.

The new standard eliminates the specific requirements for profit recognition on sales of real estate under current U.S. GAAP, which may result in the acceleration of revenue (or gains).



Contract manufacturing arrangements.

Companies that manufacture large volumes of customized homogeneous goods with short production cycles may be required to recognize revenue using the transfer over time model (versus upon delivery of the final product to the customer).

The descriptive and summary statements in this newsletter are not intended to be a substitute for the requirements of the standard or any other potential or applicable requirements of the accounting literature or SEC regulations. Companies applying U.S. GAAP or filing with the SEC should apply the texts of the relevant laws, regulations, and accounting requirements, consider their particular circumstances, and consult their accounting and legal advisors.

This information is current as of May 2014.