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AN ALERT FROM THE BDO NATIONAL ASSURANCE PRACTICE

BDO **FLASH** REPORT
FASB

SUBJECT

NEW REVENUE RECOGNITION STANDARD: FREQUENTLY ASKED QUESTIONS

SUMMARY

On May 28, 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers. It takes effect in 2017 and establishes a comprehensive revenue recognition standard for virtually all industries in U.S. GAAP, including those that previously followed industry-specific guidance such as the real estate, construction and software industries. The new ASU is available here.

BDO developed these Frequently Asked Questions and Answers to facilitate discussions between management teams, audit committees, boards of directors, and auditors. A more detailed BDO Financial Reporting Letter will be issued this summer.

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CONTACT:

ADAM BROWN
National Assurance Partner
214-665-0673 / abrown@bdo.com

KENNETH GEE
National Assurance Partner
415-490-3230 / kgee@bdo.com

MICHAEL STEVENSON
National Assurance Partner
214-665-0707 / mstevenson@bdo.com

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FREQUENTLY ASKED QUESTIONS:

1. When does the standard become effective?

Public entities[1] will apply the new standard for annual periods beginning after December 15, 2016, including interim periods therein. Early adoption is prohibited. Therefore, a calendar year-end public entity would reflect the new standard in its March 31, 2017 first quarter, each subsequent quarter, and also in the year ending December 31, 2017.

Nonpublic entities have an additional year to adopt, i.e., the new standard applies for annual periods beginning after December 15, 2017. In addition, the new standard is effective for interim periods within annual periods that begin after December 15, 2018. Therefore, a calendar year-end nonpublic entity would first apply the new standard for the year ended December 31, 2018. If it also prepares interim financial statements, the new standard would first take affect for those interim periods in 2019.

However, nonpublic entities are allowed to early adopt the new standard as follows, if they choose to do so:
- The new requirements may be applied no earlier than an annual reporting period beginning after December 15, 2016, including interim reporting periods within that period. This would mirror the effective date for public entities.
- They may be applied for annual reporting periods beginning after December 15, 2016 and interim periods within annual periods beginning after December 15, 2017. In other words, calendar year-end nonpublic entities would apply the new standard for the year ended December 31, 2017. Interim periods would first reflect the new standard in the following year, e.g., the first quarter ended March 31, 2018.
- They may be applied for an annual reporting period beginning after December 15, 2017, including interim periods within that period. In this scenario, calendar year-end nonpublic entities would apply the new standard to the year ended December 31, 2018. Interim periods in that year would also reflect the new standard, e.g., the first quarter ended March 31, 2018.

2. What are the transition methods?

For ***both public and nonpublic entities***, three basic transition methods are available — full retrospective, retrospective with certain practical expedients, and a cumulative effect approach:

a. A full retrospective approach would apply the default method of adopting new accounting standards in Topic 250. Each prior period presented would follow the guidance in paragraphs 250-10-45-5 through 45-10.
b. Similarly, a retrospective approach can be used in conjunction with up to three forms of practical relief. That is, entities can choose to use one, two or all three of the following accommodations:
   i. Contracts that begin and end in the same annual reporting period would not need to be restated under the new revenue recognition standard.
   ii. Contracts that contain variable consideration can use hindsight. That is, entities are allowed to use the final transaction price at the date the contract was actually completed, rather than estimating the variable consideration at inception.
   iii. Entities are not required to disclose the amount of a contract’s transaction price that was allocated to the remaining performance obligations or an explanation of when those obligations are expected to be recognized as revenue for reporting periods presented before the date of adoption.
c. Under the third alternative—the cumulative effect approach—an entity would apply the new revenue standard only to contracts that are incomplete under legacy U.S. GAAP at the date of initial application (e.g., January 1, 2017 for a calendar year-end public company) and recognize the cumulative effect of the new standard as an adjustment to the opening balance of retained earnings. That is, prior years would not be restated. However, additional disclosures would be required to enable users of the financial statements to understand

[1] In this Flash Report, a “public entity” is one that meets the definition of a “public business entity” in the ASC Master Glossary, as defined in ASU 2013-12. Under ASU 2014-09, “not-for-profit” entities will apply the same effective date as public business entities. All other entities are considered “non-public” under the new revenue recognition standard, as well as this Flash Report.

the impact of adopting the new standard in the current year compared to prior years that are presented under legacy U.S. GAAP.

3. In a nutshell, what does the new standard require?

The revenue standard's core principle is built on the contract between a vendor and a customer for the provision of goods and services. It attempts to depict the exchange of rights and obligations between the parties in the pattern of revenue recognition based on the consideration to which the vendor is entitled. To accomplish this objective, the standard requires five basic steps: (i) identify the contract with the customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract, and (v) recognize revenue when (or as) the entity satisfies a performance obligation.

4. What are some of the more significant changes?

- Under existing U.S. GAAP, numerous requirements for particular industries sometimes resulted in different accounting for economically similar transactions. To facilitate comparability, the new standard eliminates previous industry-specific revenue recognition guidance. As such, software companies who have been unable to establish VSOE[2] under current U.S. GAAP will likely accelerate the timing of revenue recognition because the new standard will more frequently result in "unbundled" performance obligations in a multiple-element contract, such as one for the sale of software and support services. Similarly, the "continuing involvement" test in the real estate literature will be eliminated, which could lead to earlier revenue recognition assuming the parties to the contract are committed to performing.
- The new guidance requires identifying when a customer controls the good or service that the entity provides, which may occur at a single point in time (e.g., a point of sale transaction) or over a period of time (e.g., a long-term construction project). Specific guidance is provided for making the assessment in both cases. This could differ from existing U.S. GAAP, which may not provide for revenue recognition until risks and rewards have been transferred or the earnings process has been completed.
- Contract costs may be capitalized more frequently than under current U.S. GAAP. The ASU provides specific guidance for capitalizing contract acquisition costs, such as a sales commission, assuming the costs are recoverable. As an alternative, acquisition costs may be expensed immediately if they would otherwise be fully amortized within one year. In addition, contract fulfillment costs would be capitalized if they relate directly to a specific contract, generate or enhance resources that will be used to satisfy performance obligations, and are recoverable. This assumes such costs are not addressed by other applicable literature, such as that related to inventory.
- Variable (contingent) consideration, if any, must be estimated throughout the life of a contract, whereas contingent revenue was generally excluded from the allocation of revenue under current U.S. GAAP in a multiple-element arrangement. The new standard requires the estimate of variable consideration to be allocated to performance obligations and recognized as the obligations are satisfied. This may result in some entities changing from the "sell-through" method to the "sell-in" method for the timing of revenue recognition. The estimate of variable consideration can be developed using a probability-weighted approach addressing a range of possible scenarios, or by estimating the single most likely amount, such as whether an entity either achieves a bonus or does not. However, the amount included in the transaction price is subject to a constraint, such that it includes only those amounts for which it is probable that a significant reversal of revenue will not occur when the uncertainty is resolved. Further, variable consideration related to a license of intellectual property (e.g., royalties) will not be estimated at all. That is, the Board decided such amounts should not be recognized until the licensee's subsequent sales or usages occur.
- Aside from industry-specific guidance for software and certain entertainment arrangements, current U.S. GAAP is unclear as to when revenue for other intellectual property licenses (IP) should be recognized—either at a point in time or over time. Under the new standard, revenue from license transactions should be recognized over time if an entity is determined to be providing access to its IP as it exists throughout the license period, for example, a franchise right that exists for several years. Conversely, license revenue should be recognized at a point in time if

[2] Vendor-specific objective evidence of fair value

the entity is providing its customer with the right to use its IP as it exists at the time the license is granted, for example, the right to use a recording of a classical symphony performed by a noted orchestra many years ago. In short, the franchise right is dynamic over its term, while the symphony recording is static in nature.

- The new standard requires extensive disclosures that will highlight the significant judgments and estimates required of management to determine the amount of revenue to recognize. Historically, disclosures about revenue were limited, having been developed in a piece-meal fashion over time. The new disclosures have been designed to complement the new five-step model for recognizing revenue and should standardize the information that users of the financial statement receive.

5. How is this going to affect us?

The following areas may be significantly impacted:

- **Judgments and estimates** – in some situations, management will be required to make more estimates and use more judgment than under current guidance, such as estimates related to variable consideration discussed above. Those matters will be highlighted for users through increased disclosure requirements.
- **Compensation based on revenue-related metrics** – management may consider possible changes to compensation arrangements that are driven by revenue, if the timing or pattern of the entity's revenue recognition changes under the new guidance.
- **Covenants** – management may need to discuss similar changes with lenders to revise debt covenants that are impacted by revenue, such as EBITDA and times-interest earned ratios.
- **Contract terms** – management may consider possible changes to its standard contracts. For example, a vendor may decide to provide a right to future products that have not yet been released.
- **Income tax effects** – the changes in timing of revenue recognition may result in changes in current taxable income since many entities use U.S. GAAP to determine revenue recognition for income tax purposes. The new standard may also impact an entity's deferred taxes. Since an entity's income tax accounting depends on specific facts and circumstances, consultation with a tax advisor may be useful.
- **Internal controls** – management, particularly of public companies, will likely need to revise documented processes and controls to ensure they are sufficient to prevent or detect misstatements under the new guidance. Further, public entities must report changes in the entity's internal controls in the period they occur.[3]
- **Communications with stakeholders** – management and boards will need to anticipate the effect on earnings in order to set expectations for investors, lenders, analysts, and other stakeholders.

6. What should we be doing now?

Initial considerations include:

- Management should familiarize itself with the new standard and begin evaluating its potential impact on each specific revenue stream of the entity, such as the sale of goods vs. the provision of services.
- Additional investments in training for financial reporting professionals may be necessary.
- Monitor the activities of the AICPA and the Transition Resource Group, as discussed below. This may be particularly relevant for matters involving a high degree of judgment, where previous U.S. GAAP may have been more prescriptive.
- Management should begin considering the available transition methods. Conversations with the company's financial statement users and also peer companies may be useful for this purpose. Further, the SEC staff is expected to address how transition under the new standard will affect the five-year selected financial data table for SEC registrants.
- Public entities will need to begin drafting SAB 74[4] disclosures about the anticipated effect of the new pronouncement. While these disclosures will become more specific over time, the SEC staff has informally indicated it expects entities to disclose their chosen method of transition in the period that a decision is reached, which will vary across entities.

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[3] See Item 308(c) of Regulation S-K.

[4] Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period

- Likewise, SEC registrants should remain alert for any changes to SAB 104[5], including a possible rescission. The SEC staff has not yet indicated what its plans are on this point.

7. What resources are available to help us with implementation?

- FASB/IASB Joint Transition Resource Group – The TRG was designed to discuss emerging issues and to inform the Boards about interpretive questions that are likely to arise as implementation efforts commence. Interested parties are encouraged to monitor the resource group's deliberations. Initially, four to six meetings a year are anticipated, which will be available on the FASB and IASB websites via webcast for those unable to attend in person. BDO will be represented on the TRG by Andrew Buchannan, who is the Global Head of IFRS at BDO IFRS Advisory Limited in London.
- The AICPA has established industry-based task forces that have already begun initial discussions about the new standard's impact with a view to providing white papers before and after the standard's effective date. The white papers will not be authoritative U.S. GAAP, but rather are designed to provide emerging best practices. The task forces consist primarily of industry professionals and auditors, including multiple BDO assurance partners.
- BDO will issue an in-depth publication this summer on the new standard.
- Additional training events are also planned for clients and contacts through the BDO Knowledge program.

Stay tuned for further BDO webinar programming and thought leadership in this area.

[5] Revenue Recognition

Material discussed in this report is meant to provide general information and should not be acted on without professional advice tailored to your firm's individual needs.

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