FEI - Boston's 2016 Accounting & Auditing update

Boston, MA

16 December 2016

EY
Building a better working world

Agenda

	Revenue recognition update
	New leasing standard

Revenue recognition update

Building a better
working world

Revenue agenda

- SEC focus
- Implementation groups and activities
- Principal versus agent
- Identifying performance obligations
- Licenses of intellectual property
- Narrow scope improvements
- Other standard-setting
- Transition approach and considerations
- Key areas of implementation focus
- Next steps

Revenue recognition
SEC focus

- SEC staff is monitoring implementation of converged standard
  - Consistent application is an area of focus
    - Staff has stated that similar facts should result in consistent outcomes
  - Staff expects companies to follow conclusions reached by the TRG even though they are non-authoritative
    - Staff strongly encourages registrants that want to use accounting that differs from TRG discussions to discuss accounting with the SEC staff
- Staff Accounting Bulletin (SAB) Topic 11.M (SAB 74) disclosures about potential effects of adoption remain applicable and should evolve as adoption nears
  - The volume and specificity of disclosure are expected to increase as adoption nears
  - If effects are unknown, disclose when the assessment is expected to be completed

> "… the implementation of the [new revenue] standard in the United States in a timely and consistent manner will continue to be a priority for me and my staff."
>
> – SEC Chief Accountant James Schnurr

Revenue recognition
Implementation groups and activities

Joint Transition Resource Group

- TRG has discussed 46 topics in 7 meetings
  - Meeting minutes and FASB/IASB staff papers available on FASB website

AICPA Industry Task Forces

- 16 industry task forces are helping develop a new accounting guide on revenue recognition that will provide illustrative examples.
- AICPA's Financial Reporting Executive Committee (FinREC) has issued several working drafts addressing accounting issues entities may encounter when implementing the standard.

Revenue recognition
Principal versus agent (ASU 2016-08)

Principal (gross)	Agent (net)
Controls good or service before transferring to customer	Arranges for another entity to provide good or service

- Identify unit of account (i.e., specified good or service)
- Determine whether entity controls the specified good or service prior to transfer to the customer
  - May be difficult for service contracts
- Consider indicators of being a principal:
  - Primarily responsible for fulfillment and acceptability
  - Inventory risk before or after transfer to customer
  - Discretion in setting the price

Revenue recognition
Identifying performance obligations (ASU 2016-10)

- Allows entities to disregard immaterial promises in the context of a contract when identifying promised goods and services
- Clarifies when promises are distinct within the context of the contract
  - Principle: Do multiple promised goods or services work together to deliver a combined output?
  - Indicators that promises are not separately identifiable
    - Significant integration, significant modification or customization, highly interdependent or interrelated
- Permits, as an accounting policy election, the accounting for shipping and handling costs performed after control of a good has been transferred to customer as either fulfillment cost (expense) or performance obligation (allocate consideration and recognize as revenue)

Revenue recognition
Licenses of intellectual property (ASU 2016-10)

Functional	Symbolic
▸ Intellectual property (IP) has significant stand-alone functionality ▸ Licensor does not support or maintain IP ▸ Examples – completed media content (film, TV show), software	▸ IP does not have significant stand-alone functionality ▸ Utility derived from licensor's ongoing or past activities ▸ Examples – brands, logos, trade names
Recognize revenue at a point in time*	Recognize revenue over time

*Unless (1) the functionality of the IP is expected to substantially change as a result of activities performed by the entity that do not transfer a good or service and (2) the customer is contractually or practically required to use the updated IP.

Revenue recognition
Narrow scope improvements (ASU 2016-12)

Transition – completed contracts

- A contract is complete if all (or substantially all) revenue was recognized under legacy GAAP

Transition – contract modifications

- Practical expedient for contracts modified prior to the earliest period presented under the new standard

Identify the contract – collectibility criterion

- Consider probability of collecting substantially all of the consideration in exchange for goods or services that will be transferred
  - May be different than total consideration promised for all goods or services

Revenue recognition
Narrow scope improvements (ASU 2016-12) (continued)

Recognizing consideration when a contract does not exist

- Recognize nonrefundable consideration when any of three events has occurred

Determine the transaction price – noncash consideration

- Measure fair value (FV) at contract inception
- Constraint applied to noncash consideration that varies due to reasons other than the form (e.g., performance conditions that affect the amount of noncash consideration)

Determine the transaction price – sales taxes

- Accounting policy to exclude from revenue (present net) sales and other similar taxes collected from a customer

Revenue recognition
Other standard-setting

- Rescission of SEC guidance (ASU 2016-11)
  - Rescinds certain SEC observer comments upon the adoption of ASC 606
- Proposed technical corrections and improvements
  - Nine narrow-scope issues
  - Proposes practical expedient (if criteria are met) to omit disclosure of variable consideration allocated to remaining performance obligations for:
    - Sales- or usage-based royalties on licenses of IP
    - Variable consideration allocated entirely to a wholly unsatisfied performance obligation or promise to transfer a distinct good or service in a series
  - Would require alternative qualitative disclosures if practical expedient is used

Full Retrospective provides more robust comparative data but there is substantially more effort and cost to implement

Factors impacting choice of adoption method	Full retrospective (**)	Pro/ con	Modified retrospective (**)	Pro/ con
Business model and systems changes	Reduced time to address business process changes and to have systems ready for 2016 contracts	X	More time to address changes from business perspective and to prepare new systems	✓
Trend benefit & Investor Relations	Yes – shows 3 years of financial data which may be preferable to investors.	✓	No – 2016 and 2017 are old GAAP and 2018 will be under new GAAP which provides less trending data for investors.	X
Lost Revenue	Record beginning of 2016 (in 2018 FS) as adjustment to R/E	✓	Recorded beginning of 2018 as adjustment to R/E	X
# Contracts to review	Contracts open at beginning of 2016 and multi-year contracts for 2016,17 and 18, including all modifications from 1/1/16	X	Contracts open at the beginning of 2018. All contracts executed in 2018 and modifications from 1/1/18	✓
Financial Reporting	Revise 2016 and 2017 annual periods, and 2017 quarterly periods	X	No need to revise prior years (but 2018 disclosure under Old GAAP will add to the period close effort)	✓
Pressure during close	More time to close books to report new GAAP numbers for 2016 and 2017	✓	Increased pressure during close in 2018 quarter-ends (dual reporting)	X
Audit costs	Audit recast 2016, 2017 revenue; review 2017 quarters	X	Not required to re-audit 2018 (audit disclosures under old GAAP for 2018)	✓
Registration Statements	Fourth year (2015) can be trapped by 2018 registration statements	X	No such concern under modified retrospective adoption	✓

**Assumes public company with calendar year end

Revenue recognition

SEC focus – considerations for full retrospective adoption

- New or initial registration statements filed in 2018 after adoption is presented in 2018 interim periods
  - If material, recast all comparative periods in prior annual financial statements
  - SEC staff said a registrant may consider, based on its facts and circumstances, whether recasting all periods (i.e., 2015 to 2017) required in Form S-3 is impracticable under GAAP
- SEC staff updated Financial Reporting Manual for reporting issues and other guidance related to adoption of the standard:
  - Selected financial data and earnings to fixed charges tables – no requirement to recast earliest two years
  - Investee significance for S-X Rule 3-09 when filing 2018 Form 10-K – SEC staff will not require reassessing significance for prior periods

Revenue recognition
Other key areas of implementation focus

- Variable compensation capitalized
  - All variable costs related to contract signings (bonuses, commissions, etc…)
  - Incremental costs (no longer direct AND incremental)
  - Recognized over estimated customer life, unless commensurate variable costs paid upon renewal/incremental orders
    - Commensurate defined as costs as percentage of contract value
- Significant financing component
    - Multi-year prepaid services
  - Timing of recording a receivable (maybe earlier)
    - Unconditional right to payment
    - Passage of time required before payment due
    - Services provided in the near future

Revenue recognition
Implementation and next steps

- Prepare transition disclosures and update them as adoption nears
  - The effects the new standard will have when it is adopted
  - The transition method as soon as it is known
- Evaluate the potential effects
  - Identify key revenue streams, review current accounting policies and compare those polices with requirements of the new standard
    - Identify the contracts within the scope of the new standard and apply new guidance to select contracts within each revenue stream to evaluate the potential effect
  - Continue communications with stakeholders
  - Monitor external implementation activities
- Use time prior to adoption to prepare
  - Design and execute a detailed project plan of activities to be performed across the company
  - Document business and IT process changes and create/enhance controls corresponding with the changes

New leasing standard update

Building a better working world

Leasing agenda

- Leases – where are we going?
- Questions audit committees should consider
- Overview
- Scope and definition of a lease
- Identifying and separating lease and non-lease components of contracts
- Disclosure
- Practical considerations
- Transition to the new standard

Leases
Where are we going?

Balance sheet

- Majority of today's operating leases will be coming onto the balance sheet

Income statement

- US generally accepted accounting principles (GAAP) pattern of rent expense recognition should not change materially
- For statutory reports filed under International Financial Reporting Standards (IFRS) dual accounting will be required, as US and IFRS standards not fully converged

Operations

- The opportunity exists to centralize and systemize lease procurement and administration
- Resulting improved governance over and management of lease activity may drive cost savings

Role of systems enablement

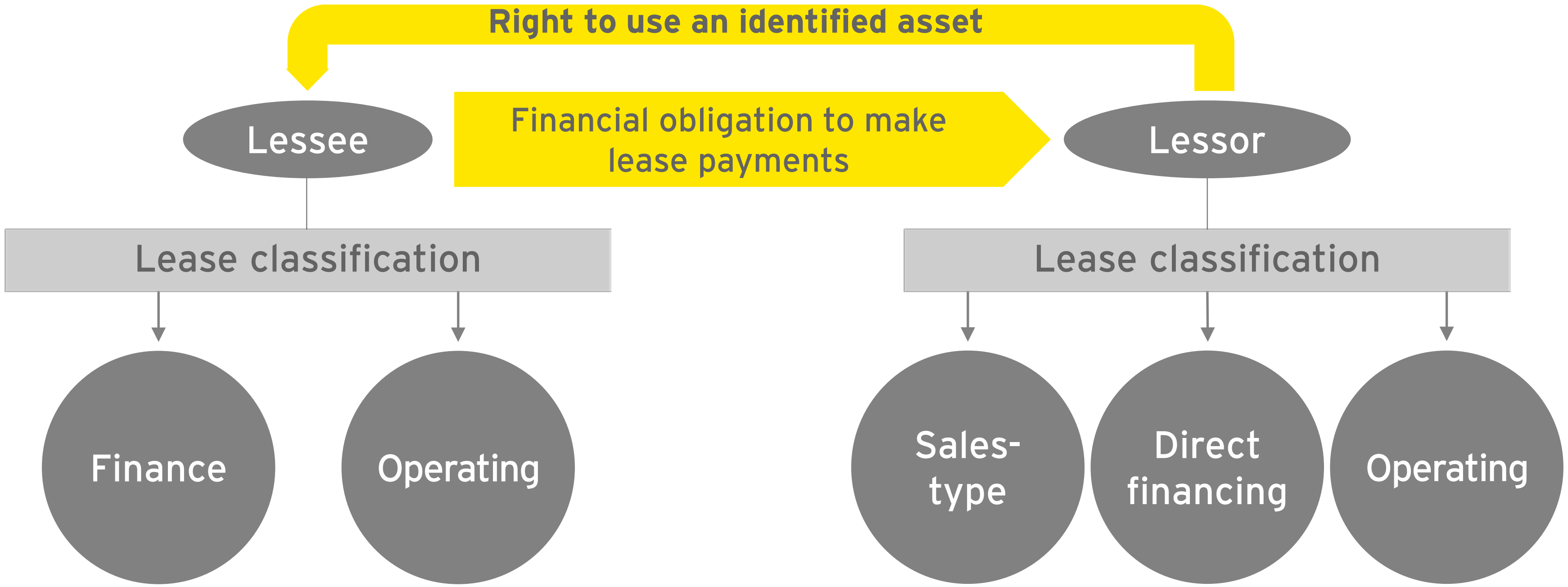
- May benefit financial reporting, disclosure, lease administration and payment processing
- Many different options are available
- Implementation plans need to consider completeness and accuracy of lease data elements

Effective in first quarter of 2019

Leases
Questions audit committees should consider

- What is the status of implementation of the standards?
- Does management have a detailed implementation plan that includes key action steps and timing?
- Has management made a preliminary assessment of the new standards' effect on the company?
- What is the anticipated effect on the company's businesses, processes and financial reporting?
- How do the company's preliminary assessment and plans benchmark against its peers?
- Does the company have sufficient resources for an effective implementation?

Overview
Right-of-use model

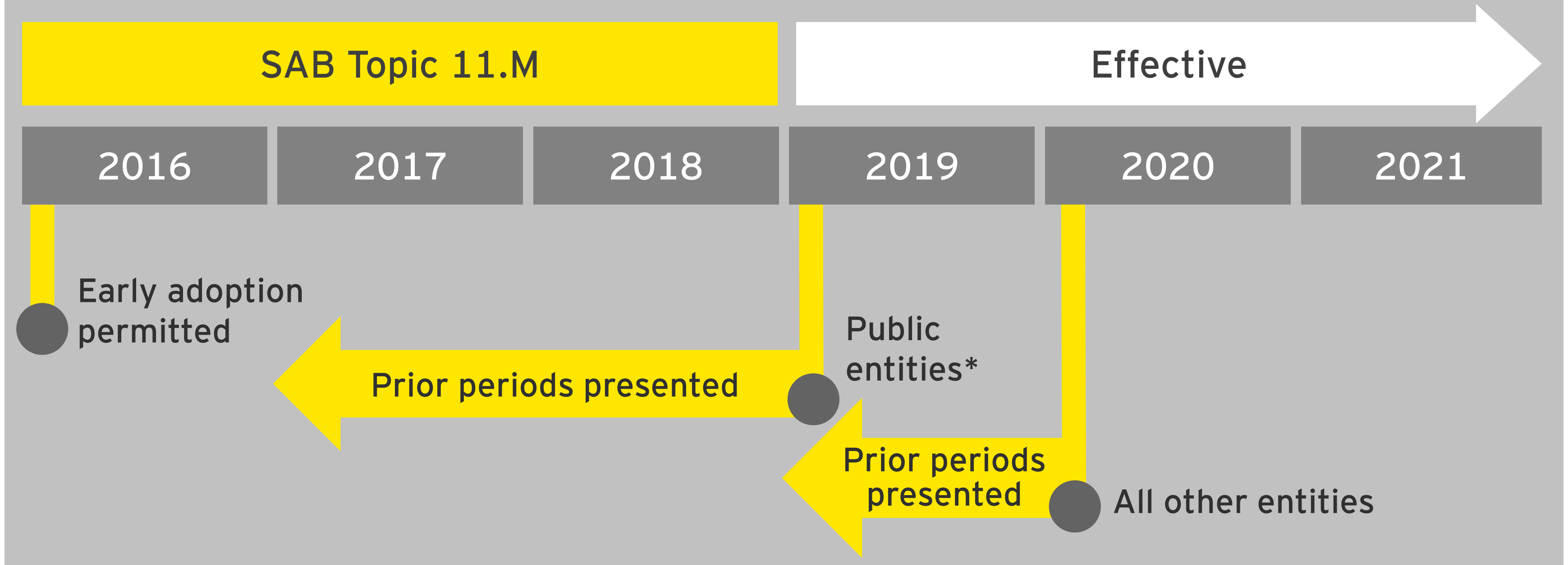


- Recognize right-of-use (ROU) assets and lease liabilities for most leases
- Recognize expense similar to legacy GAAP

- Similar to legacy GAAP with some changes
- Leveraged lease accounting eliminated prospectively

Overview
Effective date and transition

- The transition provisions are applied using a modified retrospective approach
  - Full retrospective adoption is prohibited



* Public entities include public business entities and certain not-for-profit entities and employee benefit plans.

Scope and definition of a lease
Applying the definition of a lease — what is changing?

Legacy GAAP	The new leases standard
An asset is identified explicitly or implicitly	
► Guidance does not address substitution rights	► Guidance says that there is no identified asset if the supplier has a substantive substitution right
The customer has the right to control the use of the identified asset	
► **Any one** of the following criteria is met: ► The customer operates the PP&E ► The customer controls physical access to the PP&E ► It is remote that other parties will take more than a minor amount of the output, and certain pricing criteria are met	► The customer has **both:** ► The right to **substantially all** the economic benefits from the use of the identified asset throughout the period of use ► The right to **direct how and for what purpose** the asset is used throughout the period of use

Scope and definition of a lease
Practical considerations

Entities need internal processes, controls and systems in place to …

… **verify** the completeness of their portfolio of leases	► Does the entity use a standard lease/service contract, or do the form and content vary? ► Does the entity operate in a decentralized or centralized environment?
… **evaluate** whether a contract is or contains a lease	► What type of arrangements does an entity have that could be affected by the revised definition of a lease? ► How does an entity plan to identify any necessary changes? ► Will management be required to make more judgments when evaluating contracts?

Identifying and separating lease and non-lease components of contracts

- The right to use each asset is considered a separate lease component if **both** of the following criteria are met:

1. The lessee can benefit from the right of use either on its own or together with other resources that are readily available

2. The right of use is neither highly dependent on, nor highly interrelated with, the other right(s) to use underlying assets in the contract

- The right to use land is generally accounted for as a separate lease component
- Non-lease components (e.g., services) are identified and accounted for separately from the lease component under other US GAAP
- ***Practical expedient*** – lessees

Identifying and separating lease and non-lease components of contracts

Insurance, taxes and maintenance
(including common area maintenance)

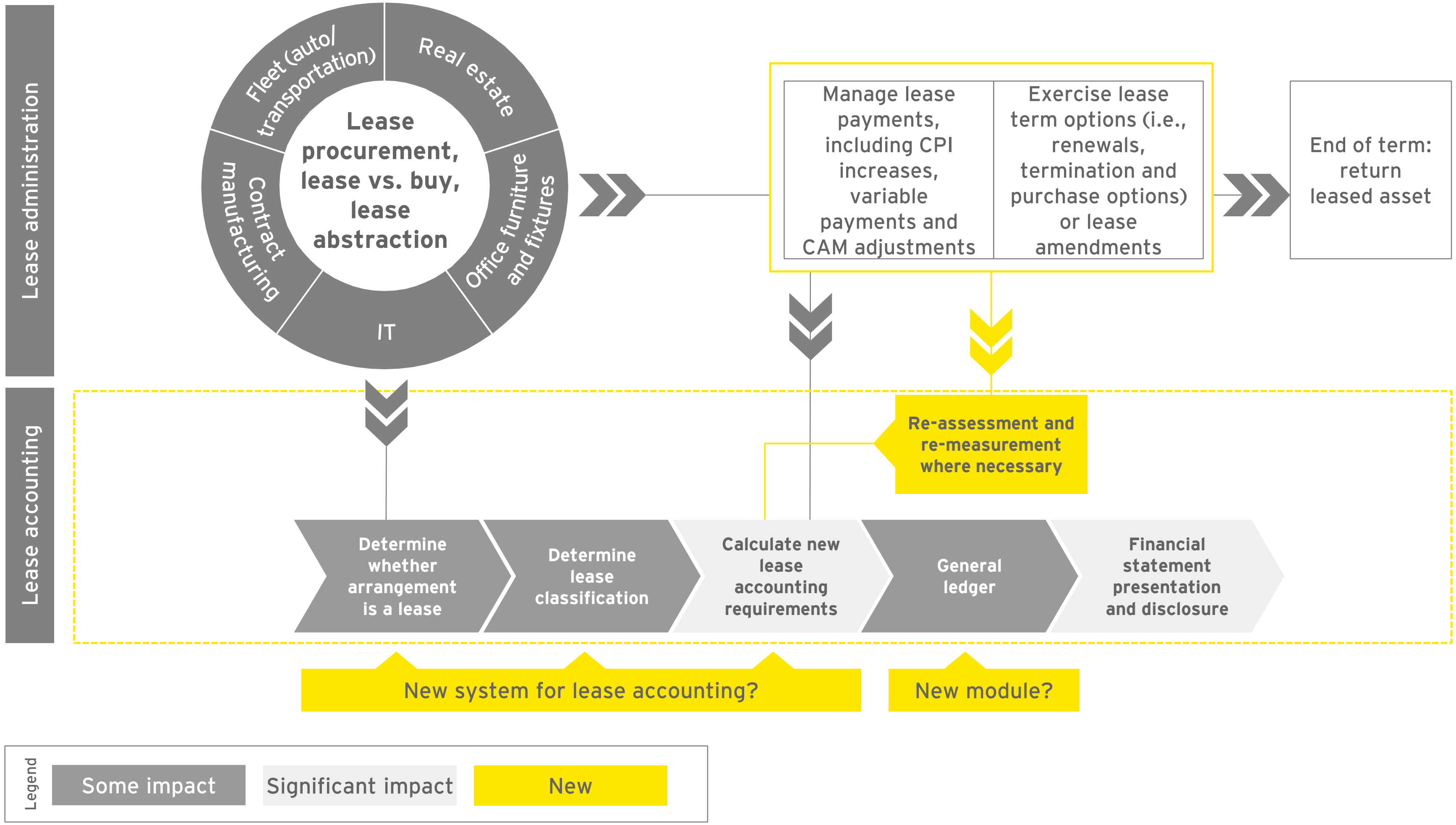
Legacy GAAP	The new leases standard
▶ Payments for insurance, maintenance and taxes (executory costs), and any profit thereon, are part of the lease component but excluded from minimum lease payments ▶ If not specified in the agreement, such costs are estimated	▶ The term "executory costs" is eliminated ▶ Payments for maintenance activities are non-lease components ▶ Payments for insurance that protects the lessor's interest in the asset and taxes related to the asset are not separate components

Disclosure

- New disclosures for lessees include the following:
  - Maturity analyses, including a reconciliation of undiscounted cash flows to the lease liability,
    as of the reporting date
  - Lease expense, by type (e.g., finance, operating, short-term)
  - Weighted average remaining lease term, by lease type
- New disclosures for lessors include the following:
  - Information about how they manage risks related to residual values of leased assets
  - For sales-type and direct financing leases, explanations of significant changes in the balance of unguaranteed residual assets
  - Table of lease income recognized during each annual and interim reporting period

The new standard requires more disclosures for lessees and lessors.

Practical considerations
Lease administration and lease accounting



Transition to the new standard
Practical expedients

- Lessees and lessors are permitted to make an election to apply the package of practical expedients **and/or** the hindsight practical expedient.

Package of expedients	Hindsight expedient
► Do not reassess: ► Whether contracts are or contain leases ► Lease classification ► Whether initial direct costs qualify for capitalization	► Use hindsight when determining the lease term and assessing impairment of ROU assets (lessees only)

- If elected, practical expedients must be applied to all leases

Transition to the new standard
What makes it complex?

1	**Modified retrospective transition** – There are many specific transition requirements and practical expedients to consider.
2	**IT systems, processes and controls** – Implementation will likely require new IT applications, process and controls.
3	**Resource allocation** – Management will want to make sure it has sufficient resources for implementation.
4	**Judgments and estimates** – The new standard will likely require more judgments and estimates.
5	**Interaction with other guidance** – Understanding the interaction of the new leases standard with the new revenue recognition standard will be key to successful implementation for lessors.

Transition to the new standard
Requires organizational change and alignment

2 weeks	3-4 months	3-4 weeks	9-12 months	9-12 months
1. Understand current state	2. Identify changes resulting from the new lease standard	3. Design solution for accounting change	4. Implement	5. Transition

Current state → **Transition** → **Future state**

Lease environment

Lease contracts

Electronic data

- SLIM, Lucernex and other lease applications
- Excel files
- Procurement and cost center databases

Agree lease arrangement scope

Identify key contract terms required for both administration and financial reporting

Additional abstraction and/or electronic data transfer

Management assumptions supporting financial reporting (by pool of similar leases where possible)

IT enablement

One or more of Lucernex or other

Analyze and decide, find, abstract, cleanse, transform, measure

Cross-organizational participation

Finance and accounting	Corporate real estate	Procurement	Business development	Treasury	Business operations	Legal	Information technology	Investor relations

Geographic consideration

North America	South America	Europe	Asia	Africa	Australia

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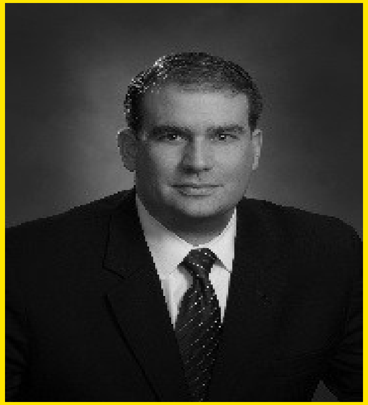
Questions & comments



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Thank you!

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