PROFESSIONAL ACCOUNTING
UPDATE

Revenue Recognition, *We're in the Homestretch!*

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INTRODUCTION

As companies implement the new revenue recognition standard, there has been a significant increase in the specificity of the information being disclosed about the anticipated adoption effects.

The new revenue standard, ASC 606, *Revenue from Contracts with Customers,* issued by the Financial Account Standards Board (FASB), supersedes virtually all US GAAP guidance on revenue recognition. The new standard provides a comprehensive revenue recognition model intended to remove inconsistencies, weakness and complexities inherent in today's guidance, while also increasing financial statement comparability and providing more useful information through enhanced disclosure requirements. The standard is effective for all public entities for annual periods beginning after December 15, 2017 (January 1, 2018, for calendar year-end public entities).

Since its original issuance in May 2014, companies have focused on efforts to assess and implement the new standard's requirements. For public entities, this also includes considering how to address SEC requirements around transition. SEC Staff Accounting Bulletin (SAB) Topic 11.M (issued as SAB 74) requires an SEC registrant to disclose the potential effects, if known, of recently issued accounting standards on the registrant's financial statements when adopted in a future period. The SEC staff has closely monitored registrants' SAB 74 disclosures and has consistently communicated that these transition disclosures should be comprehensive and provide transparency into a registrant's implementation efforts[1].

The effective date of the new revenue standard for calendar year-end entities is approximately one month away. At this stage, SAB 74 disclosures included in the Q3 2017 10-Qs of calendar year-end entities should be robust, with specific information about the anticipated effects of the new standard and the status of implementation efforts. The observations included in this study provide a preview of the financial statement impact that can be expected when many public companies adopt the standard on January 1, 2018.

[1] https://www.financialexecutives.org/getattachment/Influence/Committees/Corporate-Reporting/News/Lessons-Learned-From-SEC-Comment-Letters-on-The-Ne/FEI-Professional-Accounting-Update-SEC-Comment-Letter-on-New-Revenue-Standard.pdf.aspx?lang=en-US

OVERVIEW OF STUDY

In June 2017, FEI conducted research to understand what companies were disclosing about the anticipated effects of adopting ASC 606[2]. With just a few months remaining before calendar year-end, many companies are preparing to issue their first quarterly filings under the new standard. As part of our update, we revisited our June 2017 study to see how disclosures have progressed since Q1 2017 and to compile trends from the information disclosed thus far. We updated the original study to include Q2 2017 and Q3 2017 disclosures, and expanded the population from the largest 100 SEC filers (by revenue) to include the Fortune 500 companies[3]. We used the GICS code assigned to each company to categorize observations by industry. Excluded from this analysis were six early adopters[4].

On an overall basis, as well as by industry, we reviewed the SAB 74 disclosures for the following information:

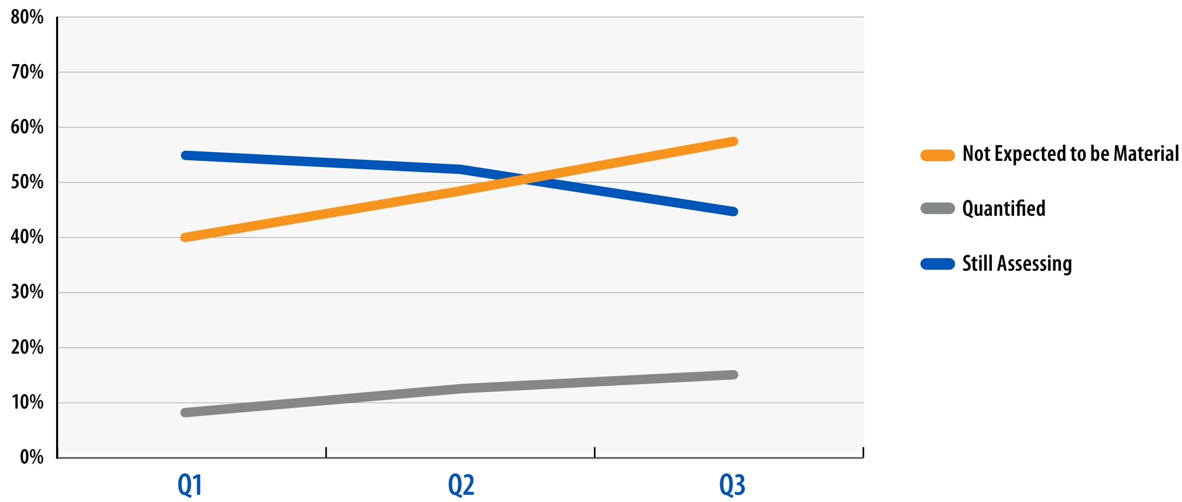
- Statements disclosing the selected adoption method (i.e., full retrospective or modified retrospective),
- Inclusion of the estimated quantitative impact of adopting the new standard,
- Indication of whether or not the impact is expected to be material,
- Discussion of the degree and/or nature of any anticipated effects from:
  - a) Expanded disclosure requirements,
  - b) Internal controls over financial reporting (ICFR) and/or,
  - c) Income tax accounting,
- Statements communicating that the company is continuing to assess the impact,
- Commonality across industries regarding the nature of the changes.

In June 2017 speech before the FEI San Diego chapter, Deputy Chief Accountant in the SEC's Office of the Chief Accountant Sagar Teotia stated the commission's expectation for SAB 74 disclosures to become more informative to financial statement users as the effective date nears. Teotia also emphasized the need to consider the expanded disclosure requirements in the SAB 74 disclosure, stating, "The assessment of the materiality of the new revenue standard must include consideration of the new required disclosures."

> "The assessment of the materiality of the new revenue standard must include consideration of the new required disclosures. In addition, as we approach the fourth quarter of 2017, it is critical for the transition disclosures to be as informative as possible to the users of the financial statements."
>
> – Sagar Teotia, Deputy Chief Accountant, SEC

In reviewing the SAB 74 disclosures included in this study, we observed an increase in the specificity of information included in company's SAB 74 disclosures related to the anticipated effects of adopting ASC 606. For example, we observed that 14% of companies in the study disclosed expected quantitative impacts from adoption, compared to just one company as of Q1 2017. Additionally, 41% described the expected impact of the expanded disclosure requirements, 23% addressed the expected impact to ICFR, and two companies addressed the expected impact to income tax accounts. Further, we identified the following trends in disclosures over the three-quarter period.

ASC 606 SAB 74 Trends for F500 Over 3-Quarter Period



[2]https://www.financialexecutives.org/getattachment/3e5ed0d1-ca66-4ea4-8c73-33924de66c95/Professional-Accounting-Update_Revenue-Recognition-Disclosures_6-02-17_Final01.pdf.aspx

[3]As of the date of this study, roughly 30 companies have not yet filed their latest quarterly filing.

[4]Early adopters included: Alphabet, Ford Motor Co., General Dynamics, Microsoft, Raytheon, and UnitedHealthcare. Q3 trends do not include companies that have not filed as of November 19, 2017. This study refers to Q3 2017 as all filings from July through August 2017, irrespective of the company's calendar year. Additionally, companies that made no disclosure in reference to ASC 606 and without contracts in scope of the standard were excluded from this study.

Q3 2017 SNAPSHOT

For many, the Q3 2017 filing represents a pivotal point in the communication about the revenue standard. Companies should be entering the final stretch of their implementation projects and their progress should be reflected in their Q3 disclosures. While the final SAB 74 revenue disclosures will appear in the 2017 10-Ks of calendar year-end registrants, Q3 2017 is the last opportunity to communicate the standard's impact before they begin operating under ASC 606.

Below is a summary of key observations compiled from the information disclosed as of Q3 2017 by the registrants included in this study.

We also noted that while some included a quantitative estimate and/or a statement regarding the expected materiality of the impact, these companies often stated they are continuing to assess the effect of adoption. Meanwhile approximately 45% of companies stated they are continuing to assess the impact, but disclosed no specific information regarding an estimated amount. That said, many of these companies did contain qualitative discussion about specific anticipated impacts, including changes to: the timing of recognition, the treatment of incremental costs to obtain a contract, the transaction price as a result of estimating variable consideration and changes to disclosures.

15% disclosed their decision to use the full retrospective transition method

71% disclosed their decision to use the modified retrospective transition method

14% of companies did not disclose a selected transition method

Broader Implications

The new revenue standard will have implications beyond the income statement. In addition to the expanded disclosure requirements outlined in the standard itself, companies must also consider the impacts to ICFR and income tax accounting as part of their SAB 74 disclosures. We observed that companies addressed these areas in a variety of ways. For example, some explicitly connected the significance of the impact of adopting the standard to their additional disclosure requirements. Meanwhile, others made more general statements to indicate that updates to disclosures, or to processes and internal controls, is a significant focus of implementation efforts[5].

Disclosures

As discussed above, the SEC has communicated on multiple occasions the expectation that the new disclosure requirements should be considered when determining whether the impact to the financial statements is material.

In Q3, 41% of companies made reference to an assessment of the new disclosure requirements as part of their implementation efforts, and/or an explicit statement regarding the significance of the impact of the new disclosure requirements.

ICFR

In Teotia's June 2017 San Diego speech, he also discussed the likely impact that new GAAP standards, including ASC 606, will have on a company's ICFR. Based on the nature and extent of new or modified controls and processes, registrants will need to consider whether these changes are material and thus require disclosure under Item 308(c) of Regulation S-K. Efforts to this end would be an indicator of the need to disclose such information in the context of the SAB 74 discussion on the expected impacts of adopting ASC 606.

In Q3, approximately 23% of companies made reference to an assessment of ICFR[6] as part of their implementation efforts, and/or an explicit statement that ICFR will be impacted as a result of adopting the new standard.

Tax

If companies identify differences between the timing of revenue recognition under ASC 606 and revenue recognized for tax purposes, they would need to recognize and measure any related temporary differences in accordance with ASC 740, *Income Taxes*. Further, changes to existing deferred tax assets or liabilities that result from the initial adoption of the standard should be included in the cumulative-effect adjustment recorded as of the date of initial application. The nature and amount (if known) of any such effect should be disclosed as it also represents information that would assist in communicating the significance of the standard's impact on the financial statements.

14% disclosed an estimated quantitative impact in Q3

58% indicated the standard is expected to have an immaterial impact

45% indicated that they are continuing to assess the impact of adopting the standard

These assessments are not mutually exclusive of one another

A significant number of companies addressed their anticipated accounting policy election regarding the presentation of certain types of taxes[7]. However, of the companies reviewed, we identified only two that addressed the expected impact ASC 606 will have on their income tax accounting.

[5] We excluded these instances from the results below.

[6] For purposes of collecting the related data for this study result, the disclosure may not have necessarily used the specific words or acronym of "internal control over financial reporting" or "ICFR", but at a minimum, "processes" and "internal controls" were referenced.

[7] In May 2016, the FASB issued ASU 2016-12, allowing an entity to make an accounting policy election to exclude from the transaction price certain types of taxes (i.e. sales, use, value-added and some excise taxes) collected from a customer.

KEY FINDINGS: ACROSS INDUSTRIES

Transition Method: Uncertainty, Findings and Trends

Companies may elect to adopt the new revenue recognition standard using one of two transition methods. The "full retrospective" method requires the new standard to be applied to each prior reporting period presented in the financial statements, with the cumulative effect of initial application recorded to the opening balance of retained earnings as of January 1, 2016. The "modified retrospective" method requires the standard to be applied only to the most current year presented in the financial statements, with the cumulative effect of initially applying the standard recognized at the date of initial application (i.e., January 1, 2018), with the cumulative effect of initial application recorded to the opening balance of retained earnings as of January 1, 2018.

For most companies, a significant amount of work and evaluation is needed to make the selection of which transition method to apply. This often involves weighing a company's preference for a method against what can feasibly be achieved given the allotted time and availability of resources. As such, we observed that many companies did not disclose their intended method of adoption until later quarters of 2017. However, there were others that chose to change methods, with about 10 companies communicating a different method than they initially disclosed in a previous quarter. Of these companies, all but one switched from the full retrospective method to the modified retrospective method.

As of Q3 2017,
70% of companies disclosed the use of the
MODIFIED RETROSPECTIVE METHOD

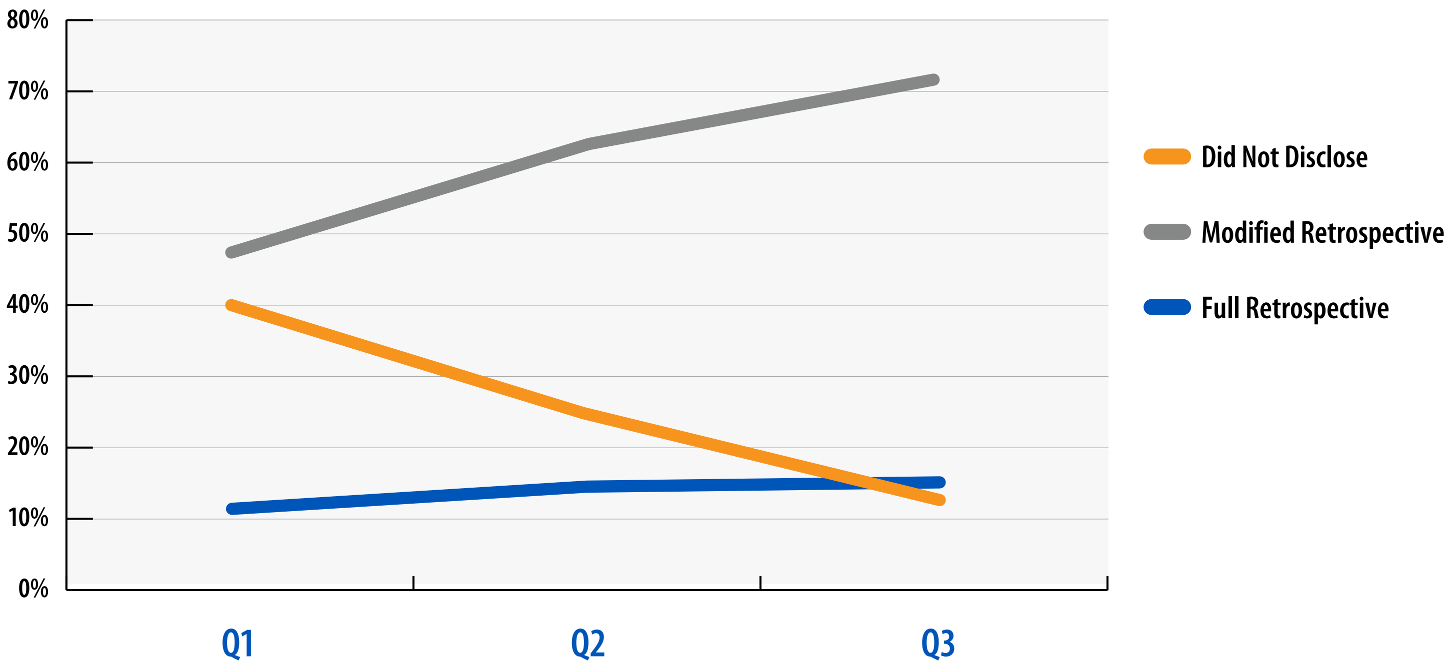
As of Q3 2017,
15% of companies disclosed the use of the
FULL RETROSPECTIVE METHOD

15% of companies did not disclose a transition method in Q3 2017

25% of companies did not disclose a transition method in Q2 2017

40% of companies did not disclose a transition method in Q1 2017

ASC 606 Transition Method Trends



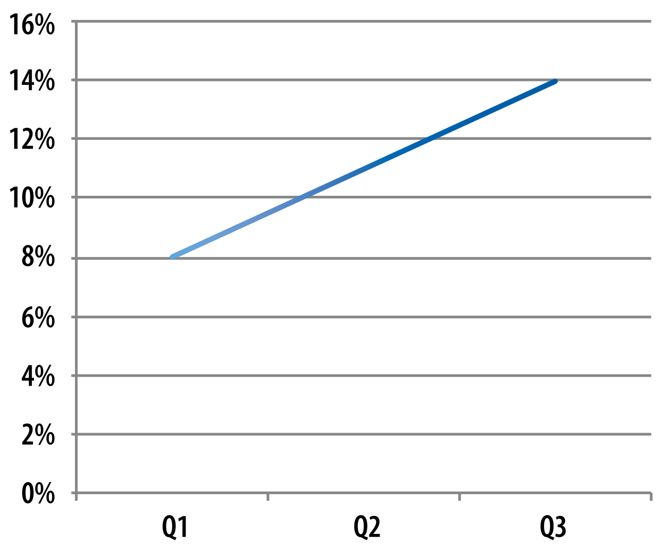
Slow to Quantify

The SEC has consistently communicated that companies should disclose the anticipated quantitative impact of adopting the standard, even if that impact is a preliminary estimate or is only available within a range. This reflects the expectation that the disclosure should provide transparency on the progress of implementation efforts, a significant part of which is identifying a numerical impact to the financial statements.

In fact, the SEC issued comment letters to several companies that were a year away from the effective date of ASC 606 but had yet disclose an estimate of the quantitative impact[8]. While the number of companies that disclosed quantitative information increased significantly since Q1 2017, many companies still have not done so, despite encouragement from the SEC.

Of the companies that did communicate an estimated quantitative impact, a handful disclosed an anticipated effect to costs rather than to revenue. Under the original ASU 2014-09, the FASB also added ASC 340-40, Other Assets and Deferred Costs – Contracts with Customers, to codify the guidance on other assets and deferred costs relating to contracts with customers. Many companies identified the new guidance in ASC 340-40 as a source of accounting change, and for some, the only numerical amount disclosed in their SAB 74 disclosures represents the impact to the treatment of contract costs upon adoption of the new standard.

Overall Quantitative Impact Disclosed



14% disclosed an estimated quantitative impact in Q3

11% disclosed an estimated quantitative impact in Q2

8% disclosed an estimated quantitative impact in Q1

The number of companies that included an estimated quantitative disclosure increased six percentage points from Q1 to Q3 2017. Although objectively a small percentage is disclosing the impact, the trend information is telling.

[8]https://www.financialexecutives.org/getattachment/Influence/Committees/Corporate-Reporting/News/Lessons-Learned-From-SEC-Comment-Letters-on-The-Ne/FEI-Professional-Accounting-Update-SEC-Comment-Letter-on-New-Revenue-Standard.pdf.aspx?lang=en-US

SAB 74 DISCLOSURES: FINDINGS AND TRENDS BY INDUSTRY

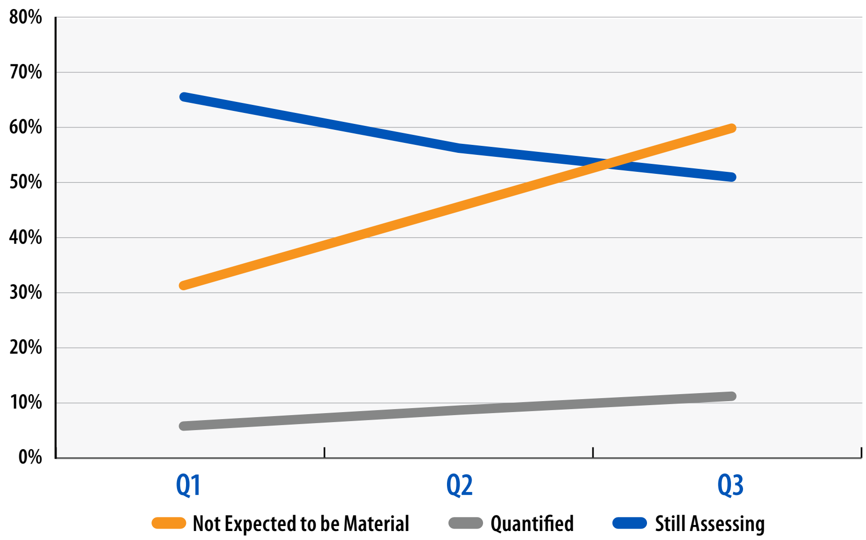
General Industry Overview

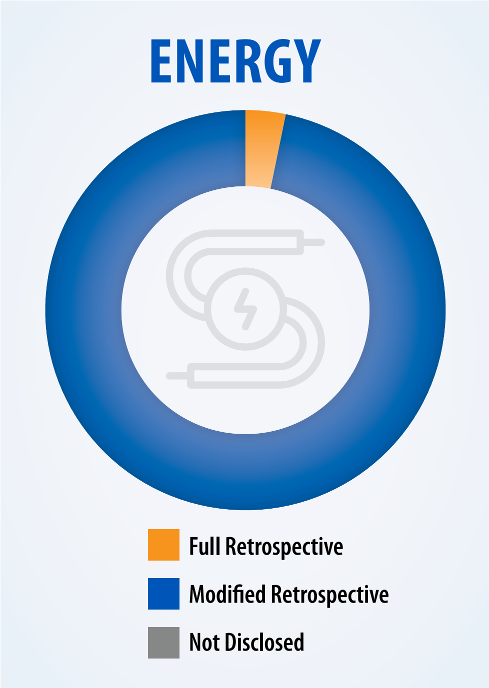
The following is a summary of trends and information on transition method selection, quantitative estimates, anticipated degree of materiality, and other anticipated impacts of adopting the new revenue standard.

We also included highlights of some of the most commonly disclosed qualitative impacts or themes by industry as of Q3 2017. Throughout the implementation process, various issues have arisen when applying ASC 606 to industry-specific facts and circumstances. Some industries are affected by more issues than others, and the degree by which an industry may be challenged by such issues may also vary. With this in mind, the summaries below address the common impacts that have been disclosed to date by companies and therefore do not reflect the entire breadth of issues the respective industries may be facing.

Energy (including Oil & Gas)

Summary of key industry findings:



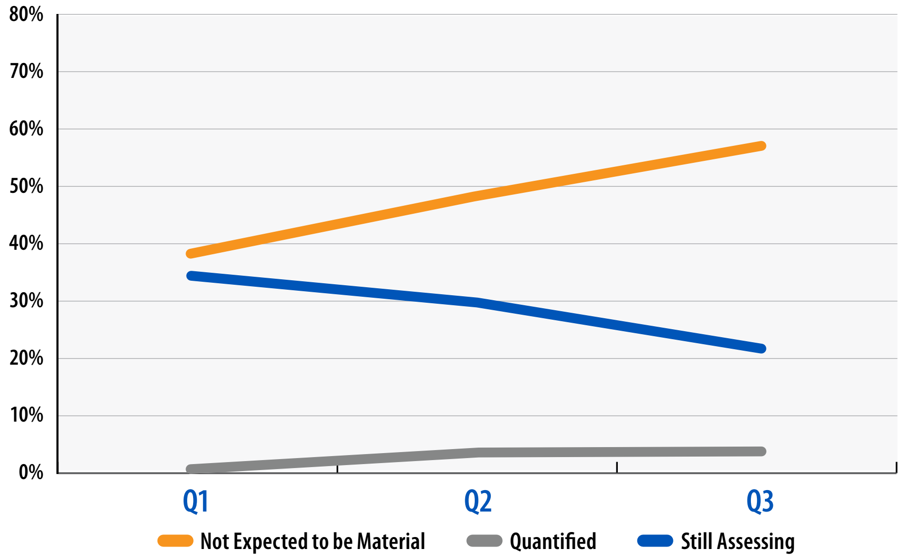


Summary of common qualitative impacts and/or themes included in Q3 2017 disclosures:

- A majority of companies have included detailed discussion of their implementation plans, including creation of a project team, identification of specific activities performed, etc., but say the overall expectation is that adoption will result in minimal impact to the company.
- Though generally expected to be immaterial, many disclosed that the only change, or most significant change, is related to their decision on the standard's policy election to exclude sales-based taxes (often including excise taxes on products sold) collected on behalf of third parties.
- A handful of companies included statements to affirm their derivative contracts or embedded derivatives were scoped out of their ASC 606 analysis.

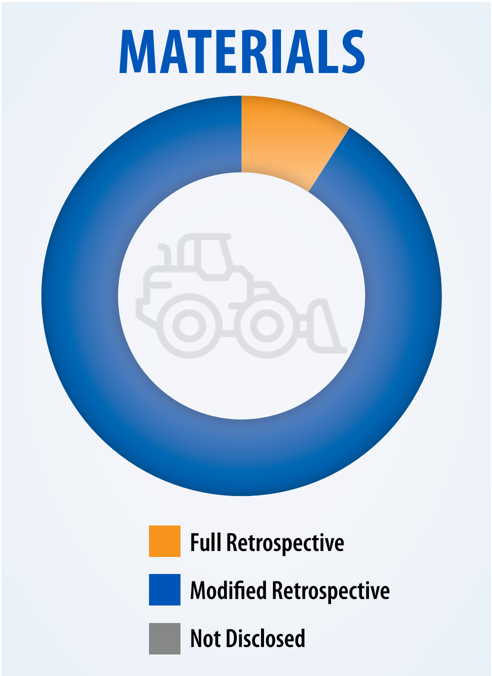
Materials (including Mining & Metals and Chemicals)

Summary of key industry findings:



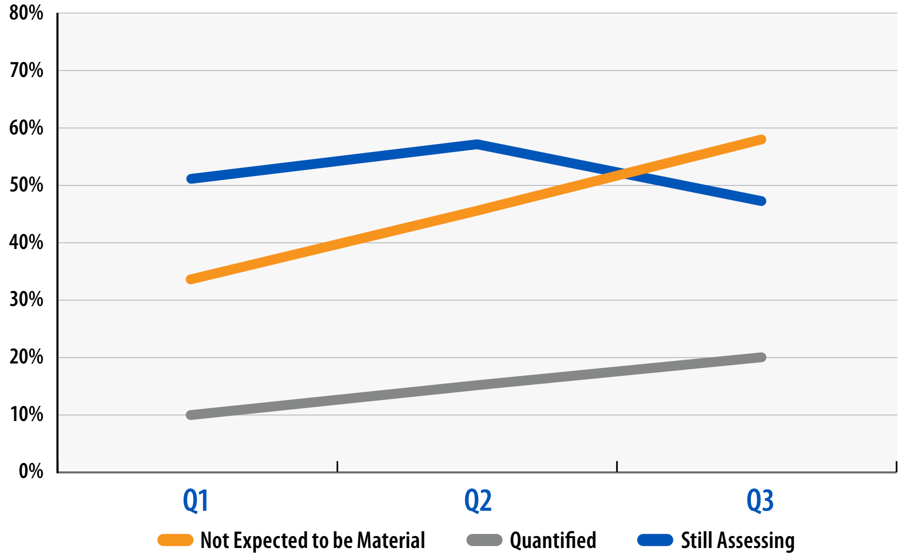
Summary of common qualitative impacts and/or themes included in Q3 2017 disclosures:

- Many compared the risk-of-loss criteria for revenue recognition included in today's revenue recognition guidance to the concept of the transfer of control under ASC 606. Some identified an expected acceleration of revenue under ASC 606, while others disclosed that they expect the timing of revenue to remain relatively consistent.
- The majority of filers indicated that the impact was expected to be immaterial.



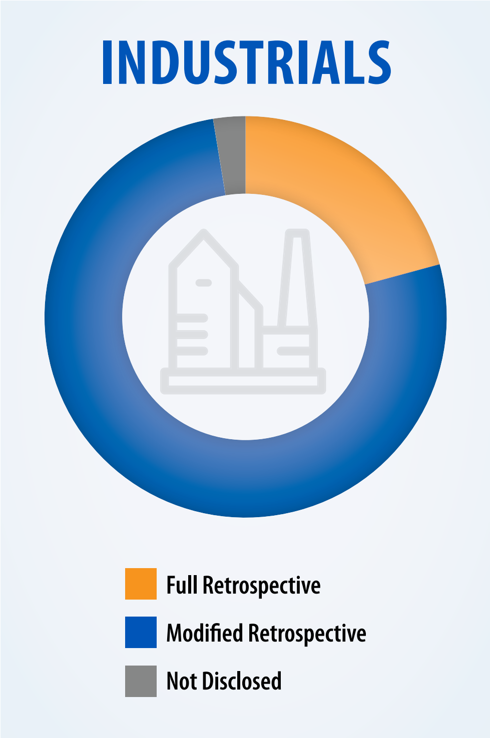
Industrials (including Diversified Industrial Products and Aerospace & Defense, Airlines and Transportation)

Summary of key industry findings:



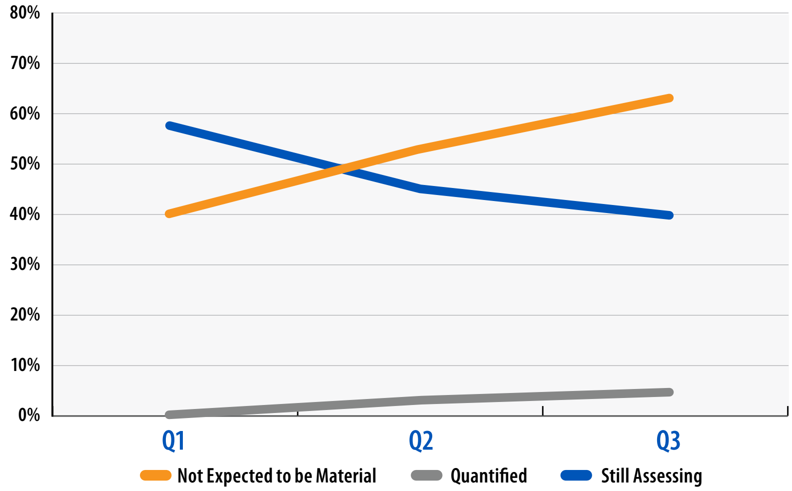
Summary of common qualitative impacts and/or themes included in Q3 2017 disclosures:

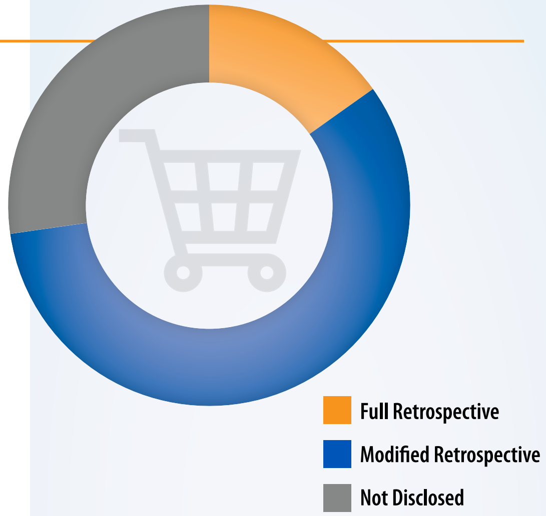
- As a whole, companies within this industry prepared some of the most robust SAB 74 disclosures, providing significant detail about the efforts performed and specific assessments around areas of their business, regardless of the extent of impact.
- Many disclosed their determination that they meet one of the three criteria under ASC 606 for recognizing revenue over a period of time and therefore expect their pattern of recognition to change from the point-in-time recognition followed today. Meanwhile, for some that are already recognizing revenue over time, a change is expected in how they measure revenue over the specified time period because the standard generally requires these companies to transition from an output method of measurement (e.g., units of delivery) to an input method (e.g., cost-to-cost).



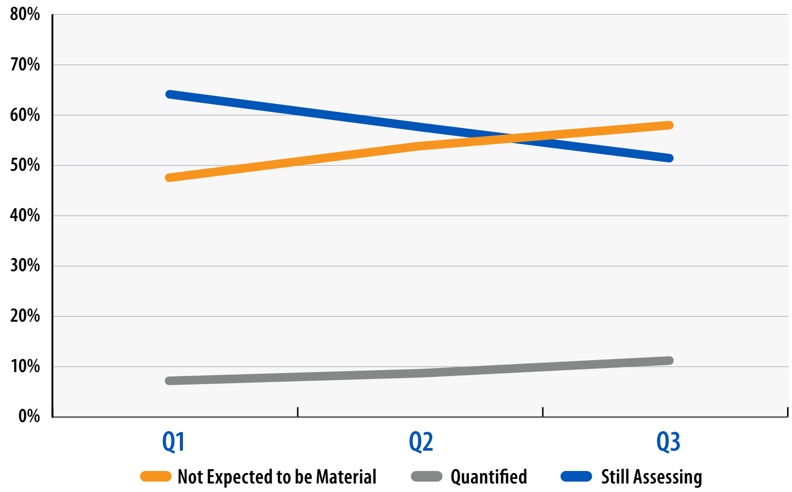
Consumer Staples and Consumer Discretionary (including Automotive, Media and Entertainment and Retail & Consumer Products) ***Summary of key industry findings:***

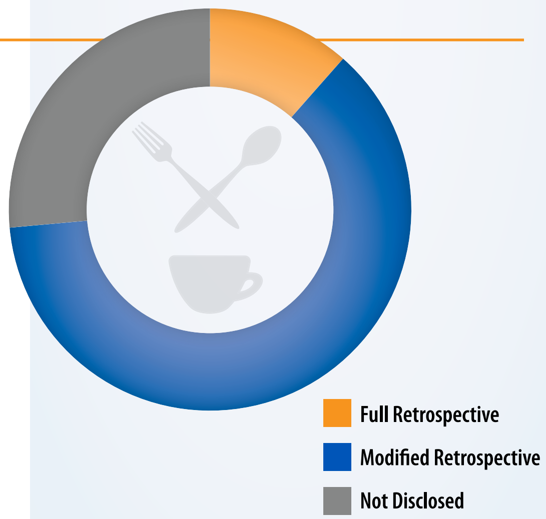
CONSUMER STAPLES





CONSUMER DISCRETIONARY



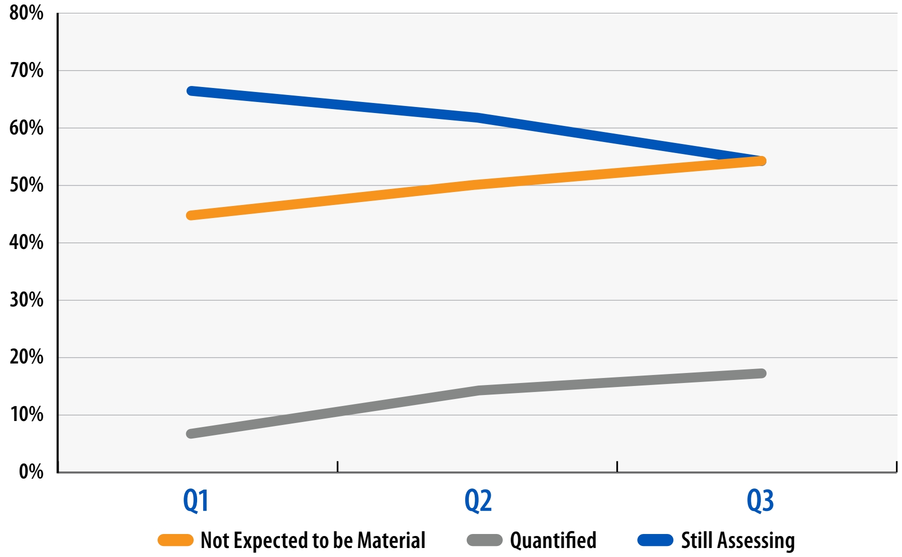


Summary of common qualitative impacts and/or themes included in Q3 2017 disclosures:

- Though often not expected to be material, many disclosed an expected acceleration of revenue related to the unredeemed portion of gift cards. This results from recognition of the revenue over the expected redemption period of the gift card rather than waiting to recognize it until the likelihood of redemption becomes remote or when the gift card expires. Similarly, many disclosed that they expect to defer revenue related to loyalty programs. Many currently accrue the incremental cost of loyalty points awarded, whereas the new standard will require in many cases for the customer loyalty program to be accounted for as revenue, resulting in a deferral of a portion of the revenue from the product or service sale to the loyalty program.
- Certain automotive companies disclosed that after considering the new guidance and related interpretations, they do not expect the accounting treatment of their reimbursable pre-production costs to change, and therefore will continue to account for them as reduction to costs.
- Many media and entertainment companies disclosed expected changes to the timing of recognition due to the treatment of renewals or extensions to licensing agreements under the new standard. Under ASC 606, they will recognize revenue once the customer begins to use and benefit from the license, rather than when the agreement is extended or renewed.

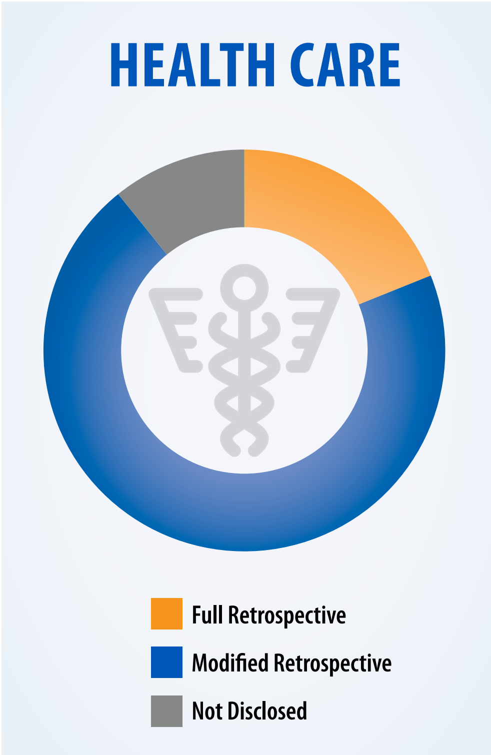
Health Care (including Life Sciences and Insurance)

Summary of key industry findings:



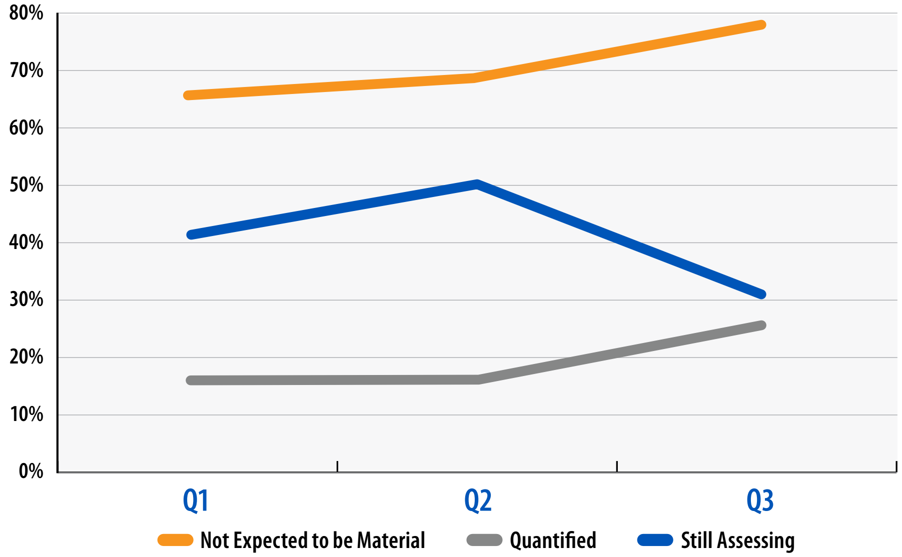
Summary of common qualitative impacts and/or themes included in Q3 2017 disclosures:

- Many companies disclosed information regarding the effects of including estimates of variable consideration and judgments around the assessment of collectability in the transaction price. Specifically:
  - A portion of the transaction price that was previously included as a component of the bad debt allowance will be reflected as an implicit price concession in the transaction price.
  - Variable consideration from various sources, including discounts and third-party settlement payments arising from reimbursement programs, will result in recognition of revenue prior to the occurrence or resolution of the related contingent event, thus leading to an acceleration of revenue.
  - Indication by one company that it will require new internal controls related to judgments made in connection to variable consideration and applying the constraint.



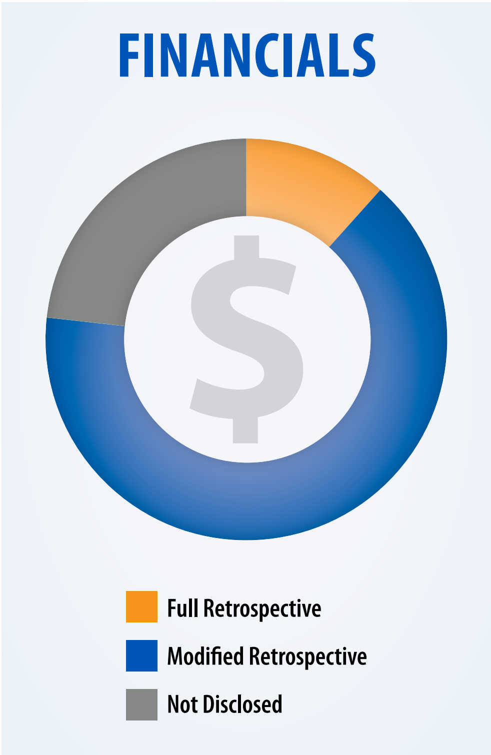
Financials (including Banking & Capital Markets, Broker Dealers and Wealth Management)

Summary of key industry findings:



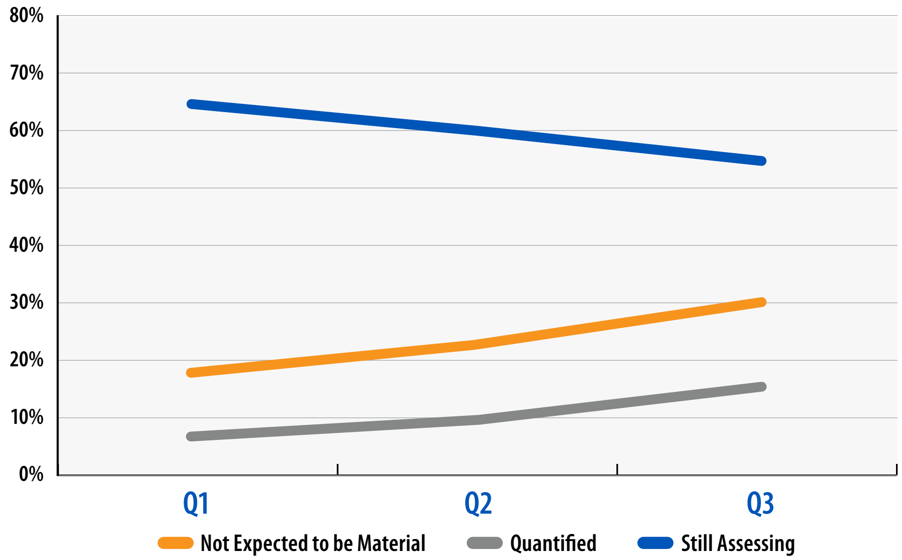
Summary of common qualitative impacts and/or themes included in Q3 2017 disclosures:

- A significant number of companies made explicit statements affirming what is out of scope of ASC 606, such as financial instruments and derivatives.
- Many companies disclosed expected changes to the presentation of certain costs, primarily related to underwriting and/or distribution activities. Reflective of the change in the factors and how they are used in the gross vs. net (i.e., principal vs. agent) analysis, many companies identified transactions in which they are considered the principal under ASC 606, resulting in an expected gross-up of annual revenues and expenses.

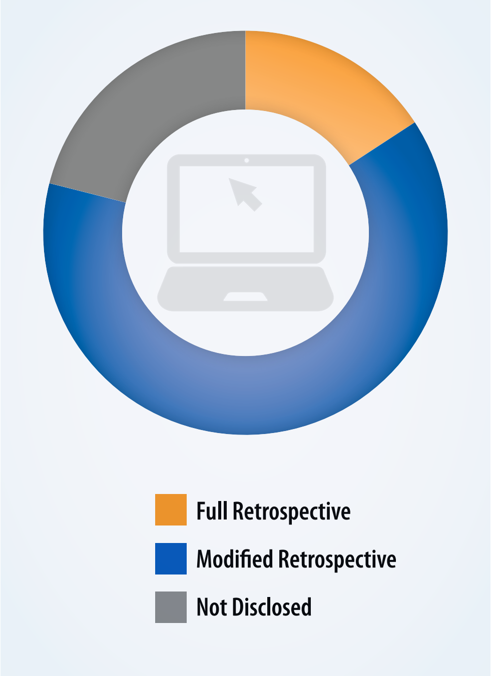


Information Technology and Telecommunication Services (including Software)

Summary of key industry findings:



INFORMATION TECHNOLOGY AND TELECOMMUNICATION SERVICES

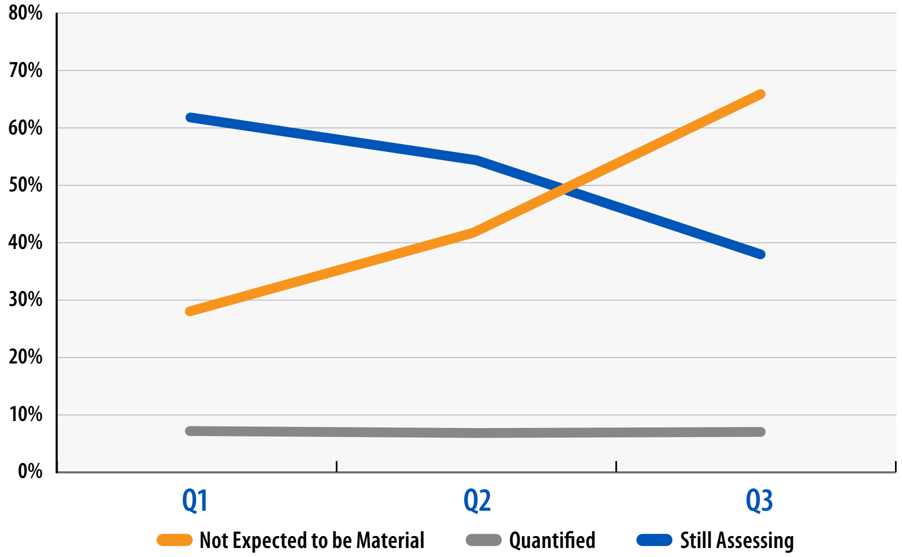


Summary of common qualitative impacts and/or themes included in Q3 2017 disclosures:

- Many companies indicated in their disclosures that they expect the timing of revenue recognition to change for certain licensing arrangements, though the change is largely expected to be immaterial. More significant impacts are anticipated if consideration is provided in the form of a sales-based royalty (variable consideration).
- Others disclosed that the treatment of certain in-scope contract costs, most commonly incremental sales commissions, will result an accounting change requiring a significant number of companies to change from expensing such costs today to deferring and amortizing them upon adoption of the new standard.

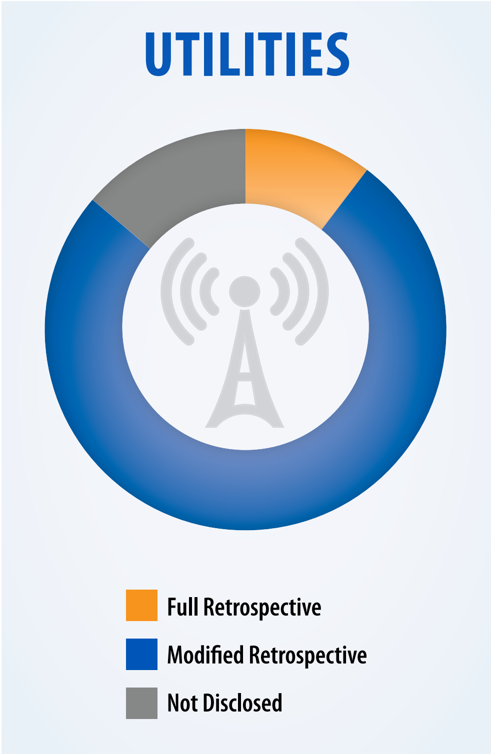
Utilities

Summary of key industry findings:



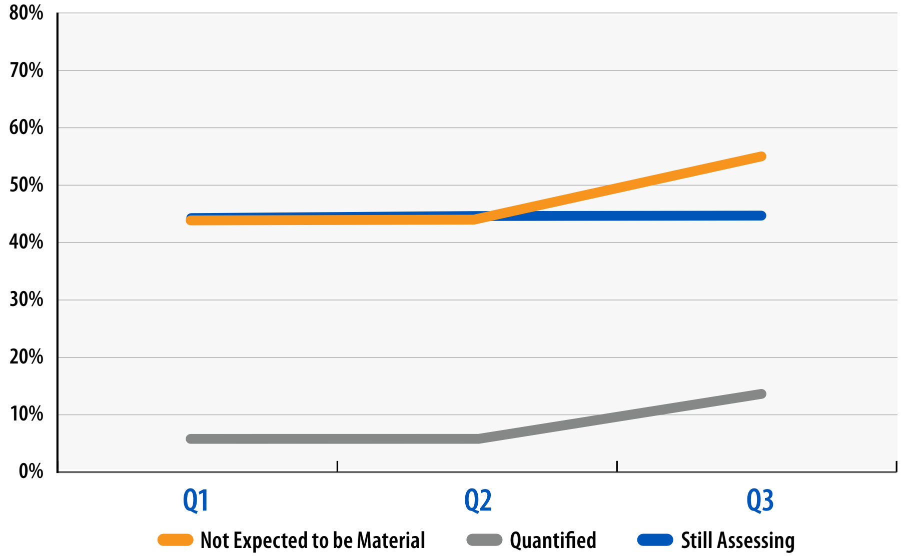
Summary of common qualitative impacts and/or themes included in Q3 2017 disclosures:

- A significant number of companies included statements to affirm that a regulated utility's tariff-based sales are within the scope of ASC 606 and are not expected to be impacted upon adoption.
- Many companies within the industry disclosed their election of the practical expedient that allows an entity to recognize revenue in an amount equal to the amount it has the right to invoice, provided that amount corresponds directly with the value transferred to the customer.



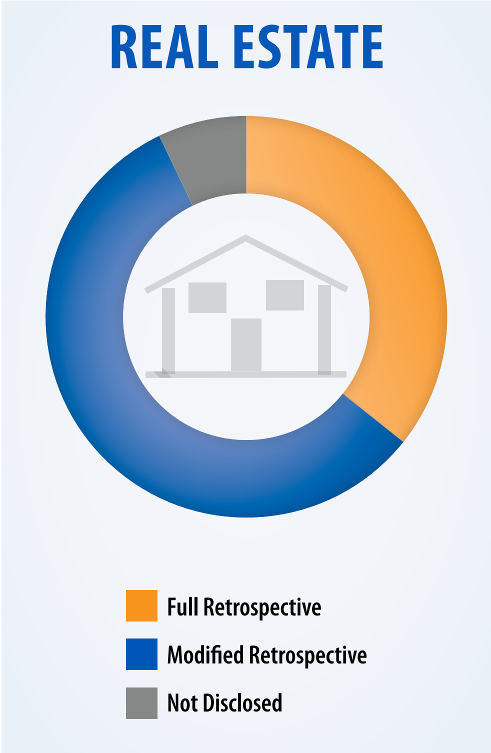
Real Estate

Summary of key industry findings:



Summary of common qualitative impacts and/or themes included in Q3 2017 disclosures:

- Many disclosed that revenue related to franchise fees is expected to be deferred and recognized over the term of the franchise agreement. This reflects the impact of the assessment of performance obligations under the new standard, and the determination that the initial franchise services and the continuing services offered during the term of the franchise agreement are a single performance obligation.
- Some disclosed an expected impact to the presentation of revenue from services contracts, changing from a net presentation to a gross presentation. Some companies explained this change is due to the absence of certain factors that exist under ASC 606.
- Revenue from loyalty programs was identified as an area of expected change, relating to the period over which the revenue is expected to be deferred and recognized and/or related to the presentation of the revenue on a net basis (i.e., the net amount of consideration the company is entitled to for arranging for the redemption award).



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