Revenue Recognition

The new Revenue Standard is finally upon us, but was it worth the wait?

March 2014

Topic

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Compliance
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Concerns
Lessons Learned
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Regulation
Cost
Reporting Risk
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JGAAP
Preparation
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Convergence
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Agenda

Overview of the Requirements

- Preparing for the Changes
- Selected Key Challenges and Adoption Issues
- Preparer Perspective – SAP

System and Process Challenges

- System Adaptation Perspective – SAP

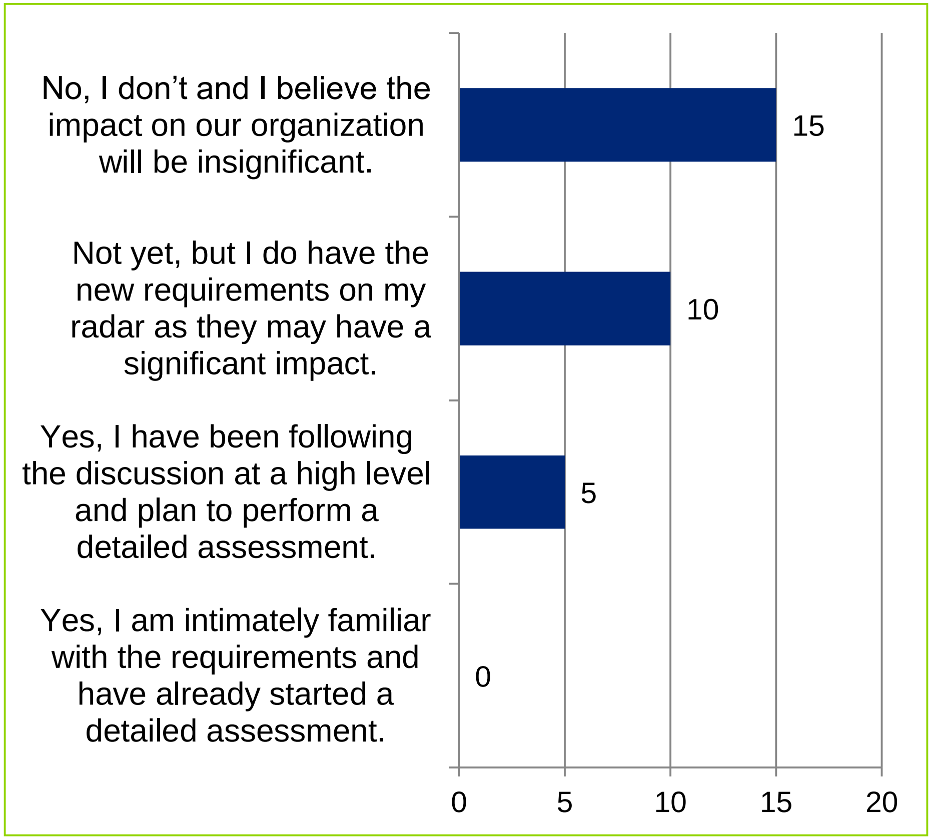
Implementation Strategies

Conclusion

Overview of the Requirements: Preparing for the Changes

Polling Question 1:
Overview of the Requirements – Understanding and Impact

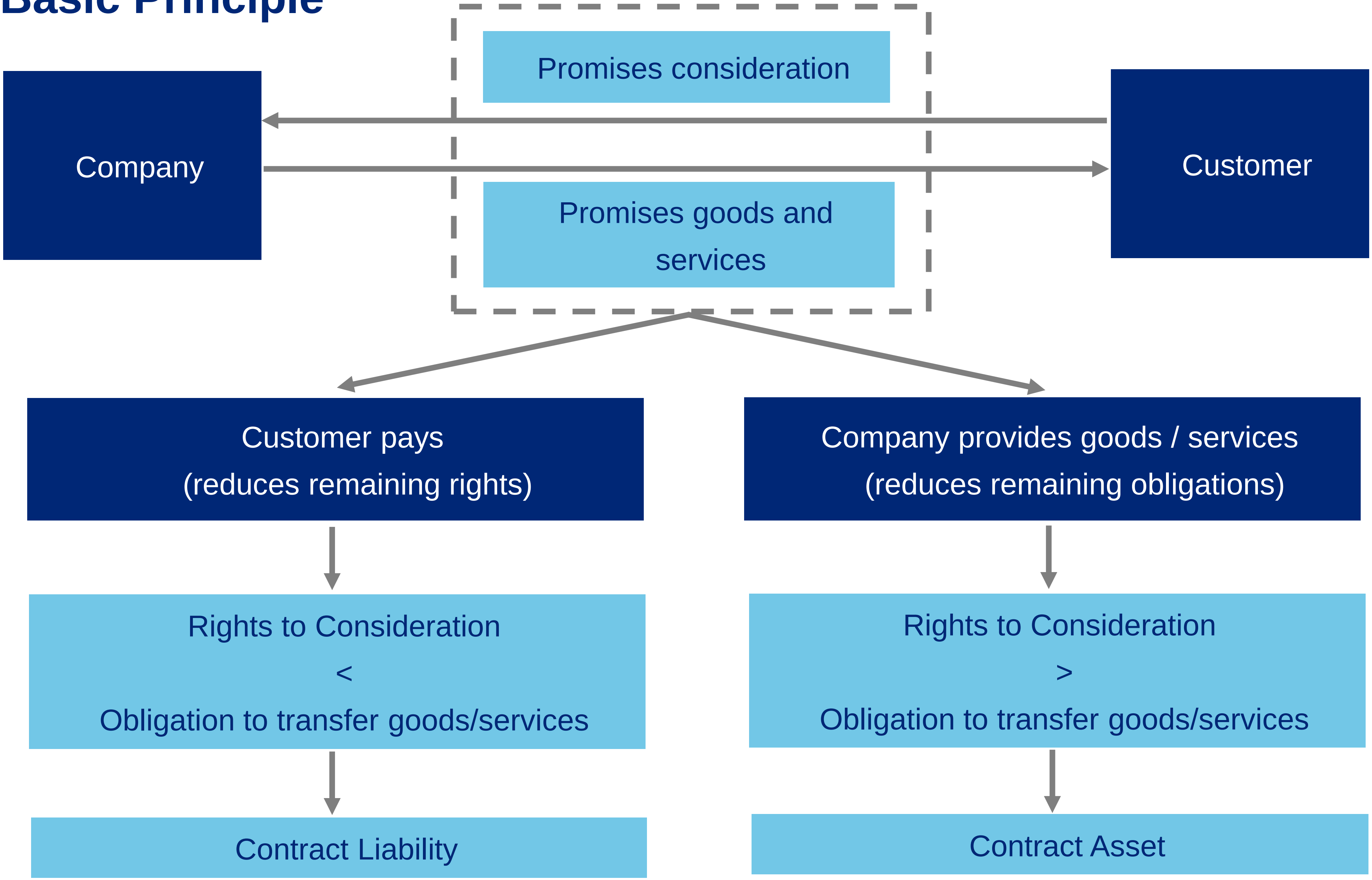
Do you have a broad understanding of the new revenue recognition requirements and what they mean for your organization?



- Most CFOs attending had no or limited knowledge of the new revenue recognition requirements
- About half of the CFOs believe the new standard will have a significant impact on their company and have already performed an assessment or have this on their radar
- It appears no company represented at the roundtable discussions has yet performed an assessment to the level of detail comparable to SAP's

Source: Session polling of 27 CFOs. Since multiple answers have been registered by several CFOs, the number of answers does not add up to 27

Basic Principle



New Model – Five Step Approach

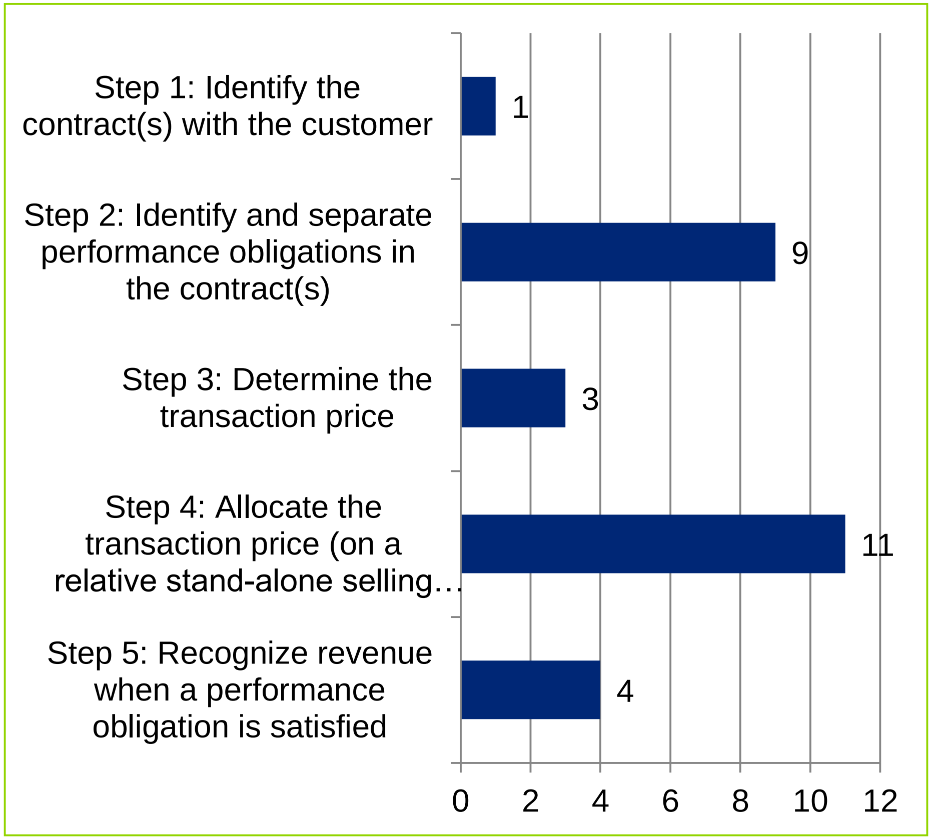
1. Identify the contract(s) with the customer
2. Identify and separate performance obligations in the contract(s)
3. Determine the transaction price
4. Allocate the transaction price (on a relative stand-alone selling price basis)
5. Recognize revenue when a performance obligation is satisfied

Overall approach

Step 1: Identify contract(s)	Step 2: Identify separate performance obligations	Step 3: Determine transaction price / Step 4: Allocate transaction price	Step 5: Recognize revenue on transfer to customer
Contract with X	Deliver equipment	CU 60	When delivered
	Provide training services	CU 30	When performed
	Deliver accessories	CU 5	When delivered
	Provide ongoing support	CU 3	When provided
	Provide warranty	CU 2	When provided

Polling Question 2
Overview of the Requirements – Implementation Challenges

In which step do you expect the most significant implementation challenges?



- The critical steps will differ by industries and the nature of the business and products/services
- CFOs selling products/services with several deliverables tend to find identifying and separating performance obligations in the contracts (Step 2) the most challenging
- CFOs that have to deal with frequent contract modifications or variable pricing (from discounts, incentives, etc.) identified allocating the transaction price as a major challenge (Step 4)

Source: Session polling of 27 CFOs. Since multiple answers have been registered by several CFOs, the number of answers does not add up to 27

Preparing for the Changes

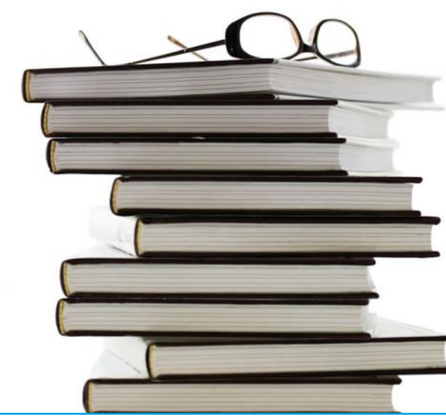
- The following summarizes some important near-term actions and decisions that companies will likely need to undertake:

Near-term actions

- Analyze impact of standard on business units and revenue streams
- Develop project plan and roadmap
- Analyze effect on financial statements
- Determine and resolve specific accounting and tax issues
- Design system solutions, where needed
- Evaluate impact on periodic financial processes

Important decisions

- Transition method (US GAAP only)
- Contract vs. portfolio approach
- System solutions
- Accounting policy choices



Transition methods

- The following table summarizes the requirements on permitted adoption approaches:

Retrospective Restatement (IFRS mandatory)	Cumulative Catch-up Adjustment (US GAAP only)
▪ Restate each prior year presented (2015-2016) ▪ Present 2017 under the proposed guidance ▪ Recognize the beginning contract asset at January 1, 2015, through an adjustment to 2015 beginning retained earnings	▪ New guidance would be applied for new and existing contracts at January 1, 2017 ▪ Cumulative effect adjustment included in the income statement in 2017 ▪ Prior/legacy revenue recognition rules applied to 2015 and 2016 financial statements (these would not be restated) ▪ Disclose all 2017 revenue line items required under prior/legacy revenue recognition rules (dual rep. required)

Selecting a transition method (US GAAP only)

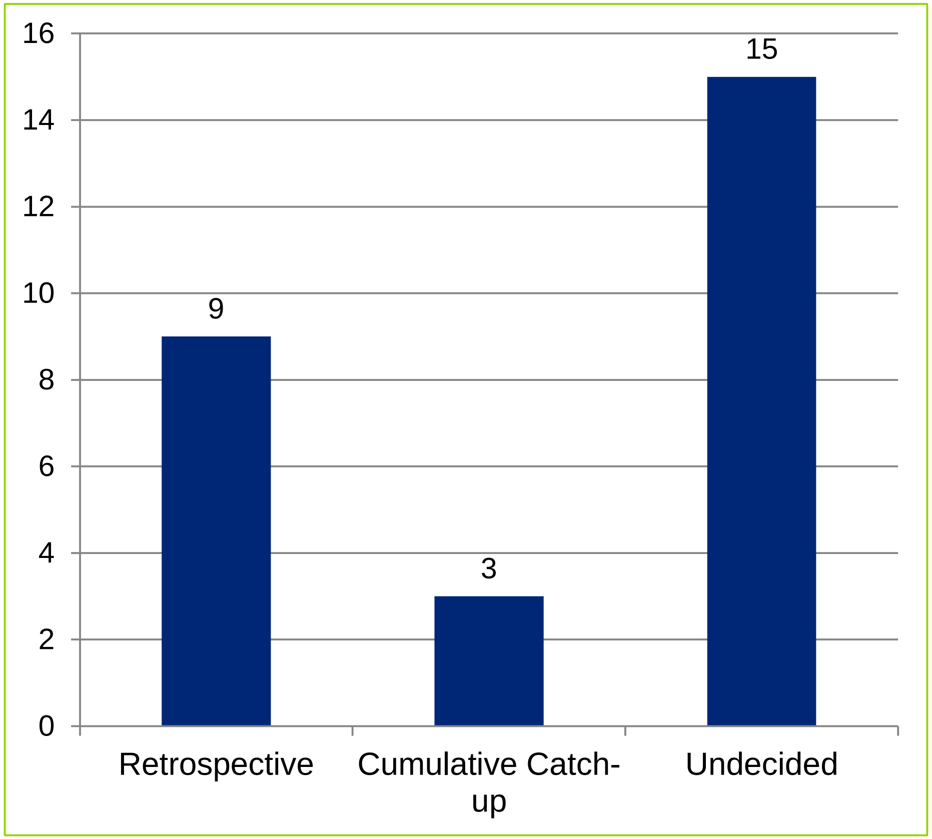
In determining whether to follow Retrospective Restatement or Cumulative Catch-up Adjustment, it may be helpful to consider the following:

- High level illustrative impact of each alternative approach
- Impact on level and trend of key metrics
- Timeline required to develop system changes
- Readiness to gather additional required data
- Analyst and investor expectations

This analysis can assist in evaluating the impact of adoption, in addition to the underlying timeline requirements related to the method chosen

Polling Question 3
Preparing for the Changes – Transition Preference

Which transition method do you consider preferable for your organization?



- More than half of the CFOs find it difficult to indicate their transition method preference
- They indicated they need a better understanding of the new requirements and potential impacts, particularly for their balance sheet and income statement, before making a decision
- More CFOs preferred the retrospective approach to the cumulative catch-up because they thought it was the “cleaner” method or they did not have a choice as IFRS filers

Source: Session polling of 27 CFOs

Contract Level vs. Portfolio – Key Attributes

- Key attributes of the contract level and portfolio approaches are as follows:

Contract level approach attributes	Portfolio-based approach attributes
▪ Revenue allocations performed at the contract level ▪ Computational requirements for the revenue recognition standard performed systematically ▪ Internal controls likely to be automated ▪ Detailed audit trail available at the contract level ▪ Disclosure information available at the detailed contract level	▪ Establishment and maintenance of portfolios of contracts with similar features ▪ Maintenance of average stand-alone selling price for each portfolio ▪ Application of computational requirements of the revenue recognition standard applied to each portfolio, either through an automated tool, a spreadsheet or manually ▪ Accommodation of contract modification and discount activities required

Portfolio-based Approach

The level of precision with the portfolios will be impacted principally by the following factors:

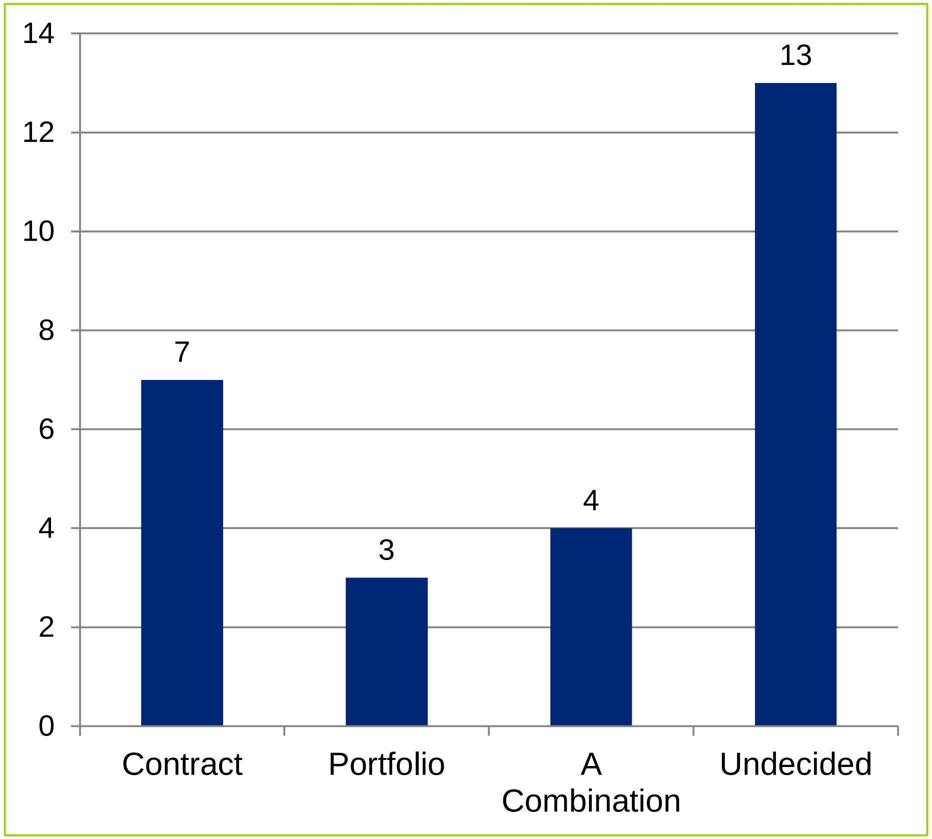
- Number of portfolios used to reflect differences in pricing structure, discounts, modifications and other factors
- Frequency with which averages from the portfolios are updated to apply to new transactions, and the relative ongoing accuracy of these key averages (stand-alone selling price, average monthly recurring charge (MRC), etc.)

The establishment of portfolios will need to comprehend the following key factors, in terms of contract segregation:

Contract Attributes	Modification Types	Tax Issues
▪ Pricing structure ▪ Contract dates ▪ Discount applicability ▪ Pre-sale and post-sale incentives	▪ Pricing changes ▪ Changes in incentives ▪ New or modified terms/products	▪ Transaction tax jurisdiction ▪ Legal entity information

Polling Question 4
Preparing for the Changes – Implementation Approach

Will you use the contract or the portfolio approach when implementing the new standard?



- Almost half of the CFOs have not yet decided on whether to track revenue recognition at the contract or at the portfolio level as they felt they first need to perform some internal research to determine opportunities for combining contracts into portfolios for revenue recognition purposes
- CFOs with a limited number of contracts tended to favor the "by contract" approach
- CFOs from the Automotive industry and from other industries with a high number of contracts tend to choose the portfolio approach where their business is relatively homogeneous
- Some CFOs indicated for some business units they may seek to define portfolios while for other business units they may go for "by contract" tracking where the number and standardization of contracts differs by BUs

Source: Session polling of 27 CFOs

Overview of the Requirements: Selected Key Challenges and Adoption Issues

Selected Key Challenges and Adoption Issues

- The following summarizes potential key issues related to revenue recognition, which may impact companies in many industries, and have significant process and system implications:

Issue	Description
1 Bundled goods and services	▪ Identification of distinct products and services within a contract (e.g., certain warranties, maintenance, accessories, etc.) ▪ Determination of criteria for stand-alone selling prices
2 Variable pricing	▪ Variable transaction price (e.g., pre-sale and post-sale incentives, rebates, etc.) requires estimation and potentially retroactive adjustment ▪ Tiered discounts and anticipated concessions must also be addressed
3 Contract combination and modification requirements	▪ Contracts with the same customer entered at or near same time, with pricing dependencies, will need to be combined ▪ Certain contract modifications will give rise to retrospective adjustments ▪ Long-term contract nature may drive “over-time” recognition for contracts where no alternative use exists
4 Disclosures	▪ Disaggregation of revenue ▪ Maturity of anticipated fulfillment of outstanding performance obligations

1 Bundled goods / services – Implementation considerations

Challenges	Considerations
▪ Identification of other products or services in the contract that transfer at a different pace ▪ Determination (and maintenance) of the stand-alone selling price information for these various components, and allocation of the transaction price ▪ Tracking and adjustment of allocated revenue which could differ from billed revenue ▪ Reconciliation and control of a contract asset or liability ▪ Transition from VSOE to alternative and more flexible measures	▪ Evaluation of contracts and revenue arrangements, to determine whether and where separate performance obligations may exist ▪ Development of accounting policy to review with external auditors on the existence and materiality of such performance obligations ▪ Development of a repository and process to maintain the stand-alone selling price information, where needed ▪ Development of allocation and calculation logic to systematically allocate the transaction price, where relevant

2 Variable pricing – Implementation considerations

Challenges	Considerations
▪ Application of variable pricing guidance to contracts which include discount based pricing ▪ Determination of contract asset or liability on pricing contracts where variable pricing must be recognized ▪ Periodic reconciliation and control over contract asset or liability balances ▪ Process to capture/estimate other variable pricing mechanisms ▪ Segregation and accounting for a significant financing component, if/when this exists on certain contracts	▪ Analysis of contracts and pricing mechanisms ▪ Development of accounting policy related to pricing mechanisms, and review/clearance with auditors ▪ Implementation of process and controls over the identification and analysis of variable priced contracts ▪ Documentation of transaction requirements & business requirements for needed system changes ▪ Development of criteria or guidance to determine when a significant financing component exists, and how it should be adjusted

3 Contract modifications – Implementation considerations

Challenges	Considerations
▪ Segregation and identification of contract modifications falling under separate requirements ▪ Determination of catch-up adjustments on modifications where no distinct goods or services are added (e.g., adjustments to supplier contracts) ▪ Process, controls and calculation logic to help determine if modifications are accounted for appropriately ▪ Need to forecast and analyze potential modifications to consider revenue impact (during negotiations)	▪ Analysis of contracts and pricing of typical modifications ▪ Documentation of typical modification scenarios ▪ Development of accounting policy and controls related to modifications, and review with external auditors ▪ Documentation and analysis of business requirements for system changes

4 Disclosures – Disaggregated revenue

- Revenue for contracts with customers must be disaggregated to show the nature, timing, amount and uncertainty of revenues and cash flows

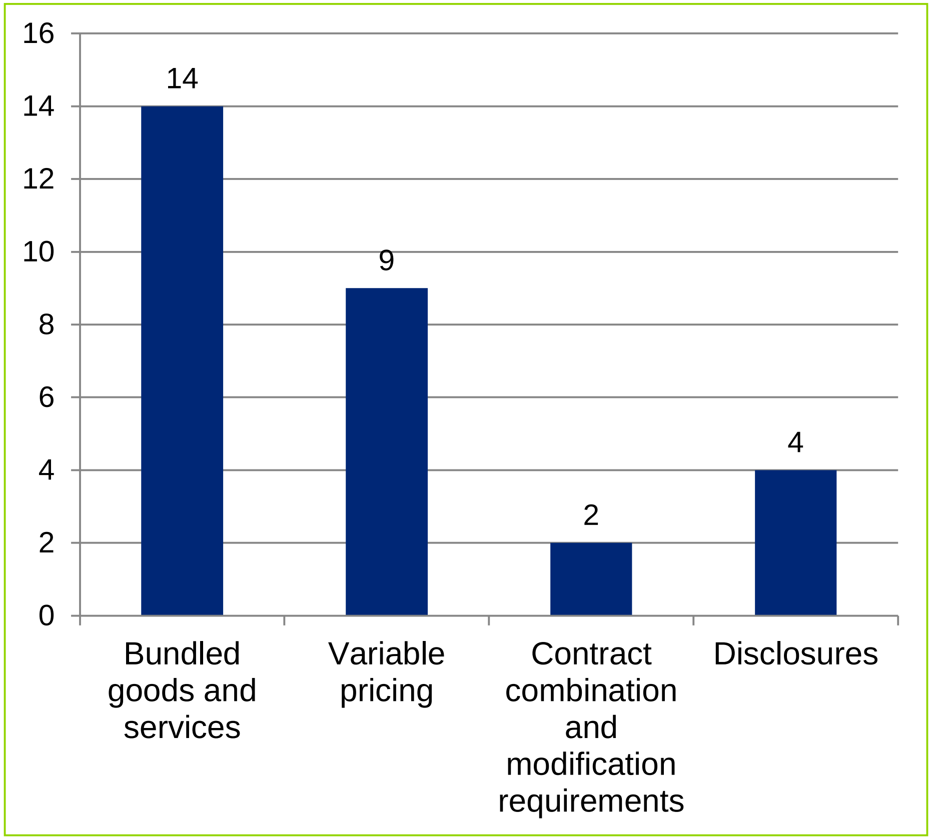
- The number of types of disaggregation could be one or more than one, based on judgment of company:
  - Disclosures outside the financial statements
  - Information reviewed by chief operating decisions maker
  - Other information used by the entity or users of the entities’ financial statements

- Examples of types of disaggregation include type of good/service, geographies, customer-type, contract duration, sales channels, or continuous vs. point-in-time transfer

- Such disclosures will be required on an interim basis

Polling Question 5
Selected Key Challenges and Adoption Issues

Which of the selected key challenges we discussed do you expect to be most significant for your organization? The ones related to:



- In line with the responses in which steps of the revenue recognition model CFOs expect the most significant implementation effort, they expect key challenges for bundled goods and services and for variable pricing
- These challenges would be attributable to determining which promises qualify as performance obligations and which contract terms cause pricing variability that needs to be accounted for
- Some CFOs also indicated they are concerned about additional disclosures required under the new standard

Source: Session polling of 27 CFOs. Since multiple answers have been registered by several CFOs, the number of answers does not add up to 27

Overview of the Requirements: Preparer Perspective – SAP

Preparer Perspective – SAP (1/5)

SAP is under a very tight revenue recognition regime … this may change

Under SAP's Current Policies	Under IFRS 14
Allocation of transaction fee to individual performance obligations based on Vendor Specific Objective Evidence of Fair Value (VSOE)	Allocation of transaction fee to individual performance obligations based on Estimated Standalone Sales Prices (ESP)
Frequent pricing changes over time may be a significant issue	Frequent pricing changes over time are less of an issue
Low pricing flexibility	High pricing flexibility

Source: Speech by Christopher Hütten, SAP CAO, Amsterdam 27 June 2013

Preparer Perspective – SAP (2/5)

SAP is under a very tight revenue recognition regime … this may change

Under SAP's Current Policies	Under IFRS 14
Strict residual method due to lacking VSOE for software: Allocate amounts equaling VSOE to all elements other than software and residual to software	Full allocation of a discount to the triggering performance obligation may be appropriate even under residual approach
All discounts run against software revenue	Discounts triggered by a specific performance obligation may not affect "the residual"

Source: Speech by Christopher Hütten, SAP CAO, Amsterdam 27 June 2013

Preparer Perspective – SAP (3/5)

SAP uses revenue recognition to steer the business … this may need to change

Under SAP's Current Policies	Under IFRS 14
Allocation of transaction fee to individual performance obligations based on VSOE High pricing consistency required to establish VSOE	Allocation of transaction fee to individual performance obligations based on Estimated Standalone Sales Prices (ESP) ESP deemed determinable even if pricing consistency is low
Strong incentive to focus on pricing consistency and to limit discounting on services	Weaker incentive to focus on pricing consistency because discounting of non-software deliverables has less of an impact

Source: Speech by Christopher Hütten, SAP CAO, Amsterdam 27 June 2013

Preparer Perspective – SAP (4/5)

SAP uses revenue recognition to steer the business … this may need to change

Under SAP's Current Policies	Under IFRS 14
Due to lacking VSOE for software all revenue of a transaction is deferred if a future functionality is committed to the customer in a multi element arrangement	Only amounts equal to the ESP of the future functionality are deferred if a future functionality qualifying as a separate performance obligation is committed to the customer in a multi element arrangement
Strong incentive to refrain from committing future functionalities	Weaker incentive to refrain from committing future functionalities

Source: Speech by Christopher Hütten, SAP CAO, Amsterdam 27 June 2013

Preparer Perspective – SAP (5/5)

SAP is under a very tight revenue recognition regime … this may change

Under SAP's Current Policies	Under IFRS 14
All revenue from transactions may need to be deferred if significant customer payments are long overdue (rebuttable presumption that long overdue fees indicate high collectability risk)	Collectability risks are considered in expense rather than revenue
↓	↓
Incentive for the sales force to support collection efforts	No incentive for sales force to support collection efforts (unless compensation framework is changed)

Source: Speech by Christopher Hütten, SAP CAO, Amsterdam 27 June 2013

System and Process Challenges:
System Adaptation Perspective – SAP

System and Process Challenges

Issue	Description
Bundled goods and services	▪ Rules engine, data repository or revenue sub-ledger needed to allocate revenue between products and services ▪ Suppliers may need to allocate revenue between related engineering contracts and supply arrangements with same customer, if contracts combined ▪ Dual reporting capability to track multiple reporting bases potentially during transition period (US GAAP only)
Variable pricing	▪ System functionality to estimate or track applicable discounts or tiered pricing on longer term contracts ▪ System capability to estimate price variations and concessions by suppliers over long-term supply contracts, to achieve appropriate “over-time” revenue recognition
Contract modification and combinations	▪ Capability within contract management systems to flag contract modifications and identify potential contracts for combination
Disclosures	▪ Additional functionality within consolidation systems to identify required disaggregated revenue disclosures, anticipated maturity of performance obligation fulfillment on long-term contracts, and other disclosures

System Adaptation Perspective – SAP

Impact Assessment

“This standard will impact many industries. SAP customers will seek solutions that enable them to automate accounting entries. When using current solutions for automated recognition of revenue without modification, they will **not** in every case **comply** with the new standard.”

Implications

“Consequently, SAP customers will seek modified solutions that **enable** them to automate the accounting for their contracts with customers to a high degree. Since this standard addresses the core business of all entities, it will have far reaching impact not limited to accounting and controlling departments.”

Source: SAP Comment Letter to the IASB, 2011

Cost Impact?

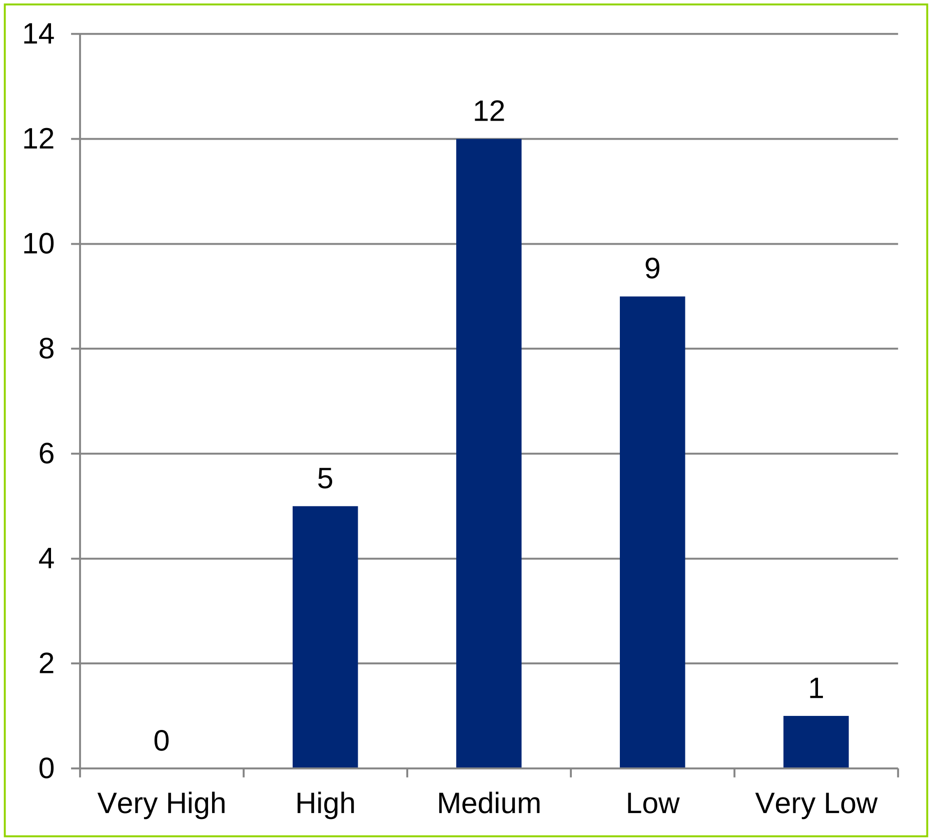
As Preparer
"Significant impact on the whole organization, impacting all employees, analysts, etc. Consequently, the cost will be significant. We will also have to review legal agreements with resellers and third parties, since the changes to revenue recognition might impact their remuneration and our cash flows. Additional cost result from the requirement to apply the standard retrospectively."

As Software Developer
"The standard may impact SAP's solutions for certain industries. The final standard will have to be discussed internally and with customers to understand how business processes would change and what supporting solutions or customizations would be required. SAP would also have to understand what retrospective application would mean to customers and affected industries and how this could be best supported."

Source: SAP Comment Letter to the IASB, 2011

Polling Question 6
System and Process Challenges

How do you assess the anticipated impact of the new revenue recognition guidelines on your systems and process infrastructure for financial reporting?



- Almost half of the CFOs expected a medium level impact on systems
- CFOs with relatively simple business models expected a lower level impact while CFOs with a high level of customization in their products and services expected more significant process and system challenges

Source: Session polling of 27 CFOs

Implementation Strategies

Implementation

Key activities	Key issues	Work products
▪ Evaluate significant revenue streams ▪ Identify, evaluate and summarize key contract types ▪ Capture and define key accounting and tax issues and new policy requirements ▪ Identify key data gaps and process requirements ▪ Assess other potential system impacts ▪ Analyze and determine additional disclosure requirements ▪ Model the impact at a high level on the financial statements and key metrics ▪ Determine long-term training requirements	▪ Performance obligation evaluation ▪ Transaction price determination ▪ Contract combination and modification requirements ▪ Disclosures	▪ Implementation roadmap and work plan ▪ Accounting and tax issue summary ▪ Revenue landscape ▪ Data gaps identification ▪ Operational issues and process changes

Case Study
Lessons Learned in the U.S. Automotive Industry

Project organization and analysis

- Need to perform analysis of applicability of issues by business unit
- Peeling the onion – broader scope of changes than initially anticipated, particularly regarding variable pricing and contract modifications
- Pro forma-type financial statements helpful in making decisions regarding transition method under US GAAP (particularly given revenue impact on many key metrics)
- Will want a significant contingency period to test new/dual accounting

Process and systems

- Breaking of existing process/system interface between billing and revenue recognition will cause system adjustments, which could become project bottleneck
- Focus on data retention for new data elements needed for calculations (e.g., stand-alone selling price, discounts, etc.)
- Challenges from maintenance of portfolios
- May provide opportunity for enhanced automation, improved controls and reduced manual adjustments for current accounting

Scope of Assessment

Adoption Approach of CFO and Finance Department

Need for business partnering with

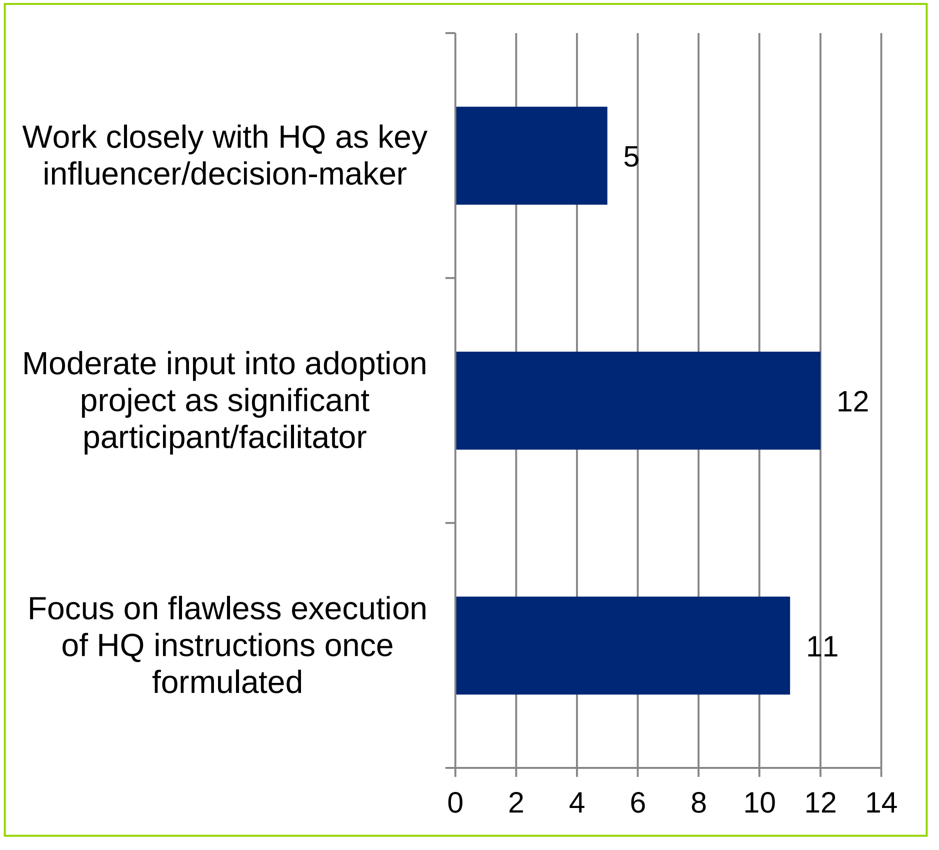
- Sales
- Legal
- Business Planning
- HR
- Investor Relations

Coordinate between group and regional CFOs

- Some parts of the assessment relevant across the group while others specific to entity or region can be dealt with autonomously (driven by company structure)

Polling Question 7
Implementation

How would you describe your role and level of involvement in adopting the new revenue standard?



- There was a relatively even divide between CFOs who see their role as a significant participant or facilitator in the adoption project and CFOs who indicated their role would be limited to execute HQ instructions
- CFOs who indicated they will work closely with HQ in making adoption decisions tended to either have a significant presence in Japan compared to the overall size of their organization or had an HQ function in Japan

Source: Session polling of 27 CFOs. Since multiple answers have been registered by several CFOs, the number of answers does not add up to 27

Implications for Statutory Reporting?

How will the changes in IFRS/US GAAP reporting impact your statutory JGAAP reporting?

Expected Impact

- JGAAP has no single standard on revenue
- Realization principles stated in various standards
- Revenue recognition criteria: “completion of transfer of goods or rendering of services” and “receipt of consideration in the form of cash or receivables”
- Interpretation of principles towards detailed application matters has evolved in practice

  - ► As JGAAP guidance is very principles-based in the area of revenue, provisions in the new IFRS/US GAAP guidelines may or may not be considered acceptable
  - ► Consider joining discussion forums to grasp local to group reconciliation implications (e.g. Financial Reporting Committee at the EBC)

Conclusion

Conclusion

The key to a successful adoption of the new revenue standard is involving the entire organization in a structured and timely manner:

- **Timeliness:** “Prepare well in advance of the effective date, understanding the lead time required for what might be the greatest accounting change in the last 20 years”
- **Perspective:** “Analyze, design and execute across the many dimensions of impact”
- **Partnering:** “Employ partnering internally with other business functions and externally with industry or topical discussion groups”

Contacts

Deloitte.

Dirk Hermans
Global Services
Director

Deloitte Touche Tohmatsu LLC
PCPM Building
1-11-1 Marunouchi
Chiyoda-ku, Tokyo 100-6211
Japan

Mobile +81(0) 90 8569 2646
dirk.hermans@tohmatsu.co.jp

Deloitte.

Michael M. Laurer
The CFO Program | Japan
Manager

Deloitte Tohmatsu Consulting Co. Ltd.
Marunouchi Building
2-4-1 Marunouchi
Chiyoda-ku, Tokyo 100-6390
Japan

Mobile: +81(0) 80 4363 4814
mlaurer@tohmatsu.co.jp
http://www.tohmatsu.com/jp/cfo/en

Deloitte. トーマツ.