REVENUE RECOGNITION PART II: DECONSTRUCTING BUSINESS JUDGEMENTS

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AGENDA

- Build the right team
- Analyze your contracts
- Develop a list of criteria for evaluation process
- Additional contracts to review
- Taxes

BUILD A TEAM

Finance

- Will affect the entire organization, so include people at a high level

Legal

- Will affect contract interpretations
- Terms of art are changing – it's all about 'control'

Sales

- Will impact sales negotiations

IT

- Will probably impact systems

FIRST THINGS FIRST: ANALYZE YOUR CONTRACTS

Develop a list of criteria for your evaluation process:

- To combine, or not to combine
  - Is this several contracts, or just one?
- Identify the obligations
  - VSOE is dead; long live performance obligations
- Consider consideration
  - Milestone payments may now be considered variable
- Consider the past
  - Have you historically granted concessions?
- Consider the future
  - Contract modifications, wording in new contracts

WHAT ELSE?

Sales = related contracts

- Warranties
- Rebates and incentives
- Advance payments

Other contracts

- Compensation agreements
  - Bonuses or other compensation based on revenue
- Debt agreements
  - Covenants may be affected
- Leases
  - Scoped out, but you may have contingent rents based on revenue

ONE OF THE TWO CERTAINTIES IN LIFE…

Taxes

- Will likely change your temporary differences
- Will probably need new policies and procedures for tax accounting
- Could affect your sales tax process if you're recharacterizing revenue between sales and services
- Outside investment in foreign subsidiaries – will likely change outside basis, need to reevaluate your indefinite investment criteria
- TRANSFER PRICING

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Curtis Matthews, Moss Adams LLP

AGENDA

- Fundamental controls impact of the new requirements
- PCAOB Staff Audit Practice Alert No. 12
- Audit firms' reactions to PCAOB reported deficiencies
- Revenue recognition controls impacted
- Five revenue recognition process steps
  and compliance risk areas

FUNDAMENTAL CONTROLS IMPACT OF THE NEW REQUIREMENTS

An entity will need clearly defined controls to recognize revenue with the transfer of promised goods or services to customers for an amount that reflects the consideration expected to be owed for those goods and services.

PCAOB STAFF AUDIT PRACTICE ALERT NO. 12

Audit revenue recognition performance issues were reported on Sept. 9, 2014:

- Understanding of arrangements and verification of revenue recognition alignment with contracts was not sufficient
- Failure to recognize when the audit client was a principal seller or an agent
- Testing of revenue cutoff was insufficient
- Revenue disclosure information was sufficient
- Insufficient procedures around the detection of revenue reporting fraud

AUDIT FIRMS' REACTIONS TO PCAOB REPORTED DEFICIENCIES

- Auditors have expanded their work scope
- Number of required controls has often increased
- More evidence is required to prove control performance
- Basis for management decisions is regularly questioned
- Audit of controls is more intense and no longer permits:
  - Inquiry and observation of no change in controls
  - Reliance on substantive procedures as controls evidence
  - Relying on prior year audit knowledge and experience
- Extrapolation of sample location testing now requires proof of consistent system and controls at all locations
- An extremely high level of assurance is required

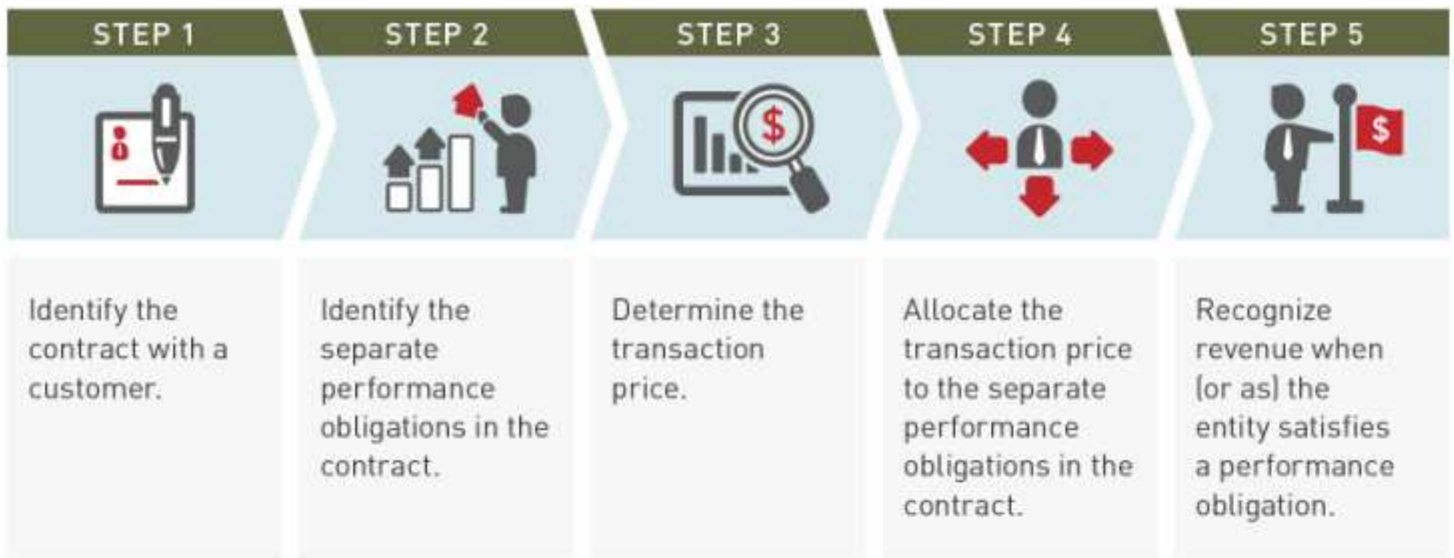
REVENUE RECOGNITION CONTROLS IMPACTED – MANAGEMENT REVIEW CONTROLS

- Revenue recognition's Management Review Controls (MRC) must be identified and evaluated for completeness and relevance
- Revenue cognition criteria must be defined in controls
- Control information sources must be validated
- Revenue recognition control precision must be identified
- Reliance on revenue recognition MRCs can be challenging

REVENUE RECOGNITION CONTROLS IMPACTED – SYSTEM GENERATED DATA AND REPORTS

- All relevant data and elements used in the performance of revenue recognition controls must be identified
- Risks related to the use of system generated data and revenue control reports must be identified
- Management should identify controls covering the completeness and accuracy of each data element used determining revenue recognition amounts
- IT General Controls (ITGCs) must be in place and functioning properly for each revenue recognition key control

FIVE REVENUE RECOGNITION PROCESS STEPS AND COMPLIANCE RISK AREAS



COMPLIANCE RISK AREAS
1. ENFORCEABLE RIGHTS AND OBLIGATIONS

- We must prove our customer arrangements create enforceable rights and obligations
- Risks:
  - Do we completely apply and document approval and commitment controls to parties across all agreements?
  - Are our rights and payment terms clearly defined?
  - How do we prove transactions have commercial substance to our auditors?
  - What documented evidence can we produce to show collectability is ***probable*** at the inception of our deals?

COMPLIANCE RISK AREAS (cont.)

2. OBLIGATION TO TRANSFER GOODS OR SERVICE

- We must demonstrate a contractual obligation to transfer goods or services
- Risks:
  - How will our controls address obligations to transfer goods or services in sales that do not involve contracts?
  - What precision will we apply in our controls to distinguish distinct goods or services when assessing specific obligations under an agreement?

COMPLIANCE RISK AREAS (cont.)

3. DETERMINING TRANSACTION PRICE

- Proof of transaction price must be evident to show agreed upon consideration for exchange for transferring goods or services
- Risks:
  - How is variable consideration measured for controlling amounts to be recognized?
  - What method of estimation do we use for claims and liquidated damages reporting controls?
  - How is probability of variable consideration measured?

COMPLIANCE RISK AREAS (cont.)

4. ALLOCATE THE TRANSACTION PRICE

- Our controls must ensure accurate transaction price allocation, for multiple obligation agreements, using ***stand alone selling prices***
- Risks:
  - What criteria do we use to distinguish standalone obligations across all of our contracts?
  - How do we determine standalone selling prices for contract price allocations controls?

COMPLIANCE RISK AREAS (cont.)

5. WHEN TO RECOGNIZE REVENUE

- We must ensure revenue is recognized when (or as) the entity satisfies a performance obligation by transferring the goods or services to a customer
- Risks:
  - How do our controls measure when the customer obtains control of the asset or service?
  - What criteria do we apply to measure revenue earned when we create or enhance an asset the customer controls?

QUESTIONS

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