Navigating the New Revenue Recognition Standard

Revenue Recognition: At a glance

What is the new revenue recognition standard?

- ASC 606, the newly implemented revenue recognition standard, could significantly change how and when entities recognize revenue.
- The new standard is also a global standard – US GAAP and IFRS guidance are now substantially similar.

What are the most significant features of the new standard?

- The new standard uses a five-step model for revenue recognition and is contract oriented rather than product oriented. Further, revenue recognition and cash collection are delinked to a greater degree than under previous rules.
- The new standard also expands the number of required annul and interim disclosures.

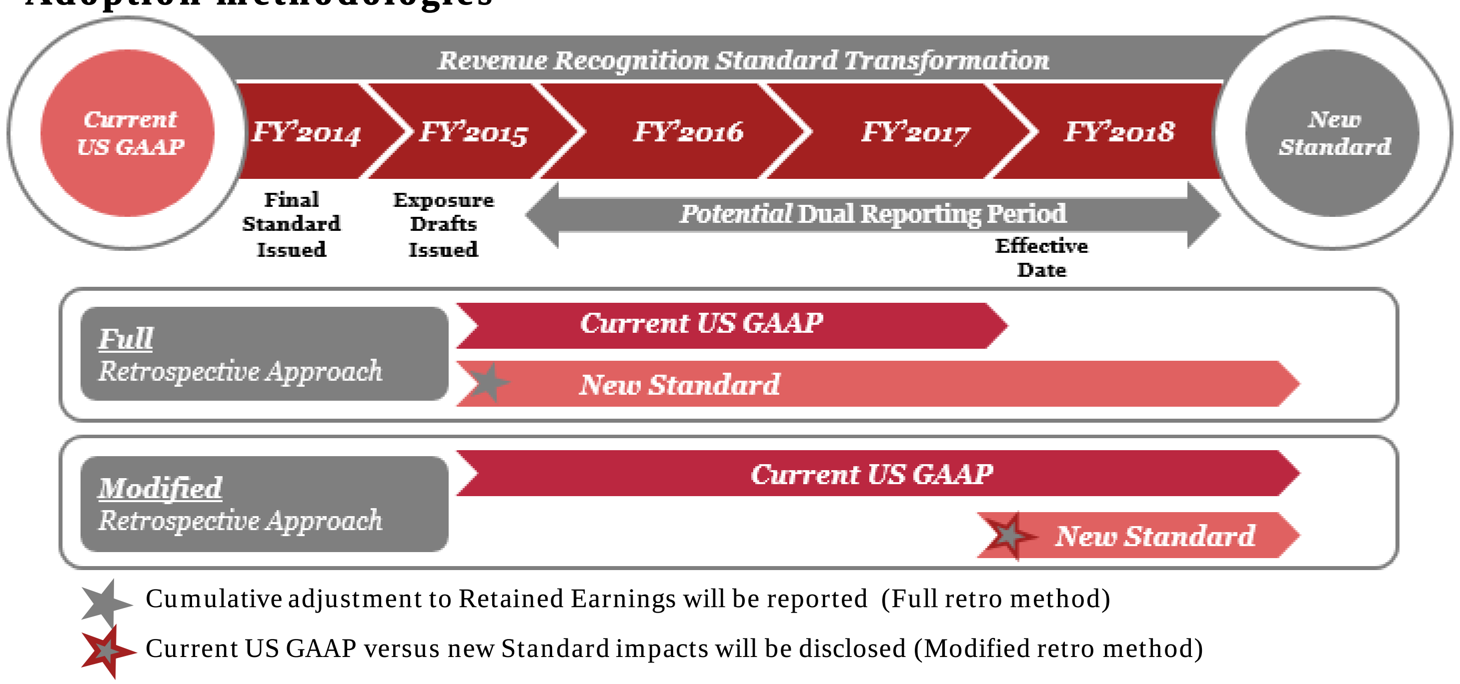
What are key impact areas companies should be aware of?

- There are two transition alternatives: retrospective and modified retrospective.
- There are various significant impacts beyond the financial statements, as the accounting change effects data, processes, systems, and people. In effect, resource and system constraints are significantly impacting many companies as they adopt the new standard.

Far-reaching impact of the new standard

- ***Finance***
  - Changes to accounting methods and estimates
  - Impact on financial statements
- ***Sales***
  - Impact on pricing
- ***IT***
  - Reconfiguring or implementing new ERP/other systems
- ***Legal***
  - Changes to contract terms
- ***Compliance***
  - Impact on FAR/CAS compliance
  - New controls and processes
- ***HR***
  - Changes to bonus plan metrics and hiring needs

Adoption methodologies



Note 1 - Above timeline assumes a public, calendar year-end, without election of the option to adopt at the original effective date.

Note 2 – If a company elects full retro and has to file a Form s-3 or similar registration statements, it might need to recast FY 2015 financial statements as well.

Implementation Challenges

Accounting Judgments	Process Implications	System Complexities
Generally units of delivery no longer permissible	Increased use of judgment required	IT Impact *(planning, ERP, consolidation)*
Increased focus on timing of cost recognition	Increasing quarterly requirements	Data collection & new accounting treatments
Increased complexity in service based arrangements	FP&A impacts	Enhanced disclosures
Identifying performance obligations remains challenging	Cross functional training & internal controls	Critical IT decisions

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Key Compliance Challenges for Government Contractors (process and technology)

Accounting

- **Sales recognition:**
  - For certain contracts, sales recognition is changed from units-of-delivery methodology to cost-to-cost methodology.
  - Because certain expenses are allocated based on sales, a change in the revenue recognition may affect the allocation of expenses to contracts.
- **Disclosure of Unfulfilled Performance Obligations:**
  - Adoption of the new standard will require a one-time adjustment to align backlog with the GAAP concept of an unfulfilled performance obligation.
  - For cost accounting purposes, the one-time backlog adjustment may result in future sales that differ from the sales that would have been recorded without the backlog adjustment.
  - Because certain expenses are allocated based on sales, a change in the revenue recognition methodology may impact the allocation of expenses to contracts, thereby affecting contract prices.
- **Contract Asset:**
  - A contract asset account will be used when recognizing revenue on a cost-to-cost basis instead of inventory for work in process (WIP) purposes (e.g., unbilled receivables).
  - Because certain expenses are allocated using the CAS 403 three factor formula, this change may affect allocation of expenses to contracts (because of a different inventory balance).
- **G&A Allocation:**
  - G&A may be allocated based on cost as incurred (input method), not upon completion of deliverables (cost of sales output method).
  - As a result, G&A could potentially be allocated to contracts in an earlier cost accounting period, resulting in different cost allocations and different contract prices.

Regulatory Compliance

- **CAS Implications and Disclosure Statement (if applicable):**
  - Consistency in treatment and allocation of costs is required.
  - Any changes in cost accounting practices have to be reported 60 days prior to implementation and a cost impact is needed.
  - A change may be required, voluntary or desirable (as defined in 48 CFR 9903.201-6 and FAR 30.603).
  - Adopting this standard could potentially lead to a shift of costs between commercial and government contracts, depending on contract portfolio and existing revenue recognition practices (CAS 403 impact)
  - *Critical question: will adopting this new standard constitute a change in cost accounting practice?*
    - Disclosure Statements may need to be updated to reflect new accounting policies.
    - DCAA has been silent on this issue to-date.
- **FAR and TCoPD (i.e. *TINA*) Disclosures:**
  - Management decisions and other facts
  - Changes in accounting and estimating
- **DFARS Implications:**
  - Changes in internal control structure and activities
  - Accounting System – indirect cost allocation (G&A)
  - Estimating System – impact to cost data used to support proposal activity

ERP/Accounting Systems

- **Capability to carry out the five-step revenue recognition model:**
  - Identify existing contracts with customers
  - Identify distinct performance obligations in contracts
  - Determine the transaction price
  - Allocate the transaction price across all distinct performance obligations
  - Recognize revenue as each performance obligation is satisfied
- **Capability to aggregate information for required disclosures:**
  - Revenue from contracts with customers by type of contract, product line, and geographic region
  - Satisfaction and timing of performance obligations
  - Documentation of the process to evaluate contracts to determine which contracts may have changes under the new standard
  - Management judgements used in determining transaction price and allocation to performance obligations
- **Accounting and disclosure requirements specific to transition method adopted (full vs. modified):**
  - The following items are treated differently depending on the transition method adopted:
    - Pertinent standard – new or existing -- for previous two fiscal years' contracts in year of adoption of new standard
    - Pertinent standard for new and uncompleted contracts in current fiscal year
    - Cumulative adjustment to retained earnings
    - Use of practical expedients
    - Various disclosures, such as use of practical expedients, qualitative assessments, and changes to financial statement line items

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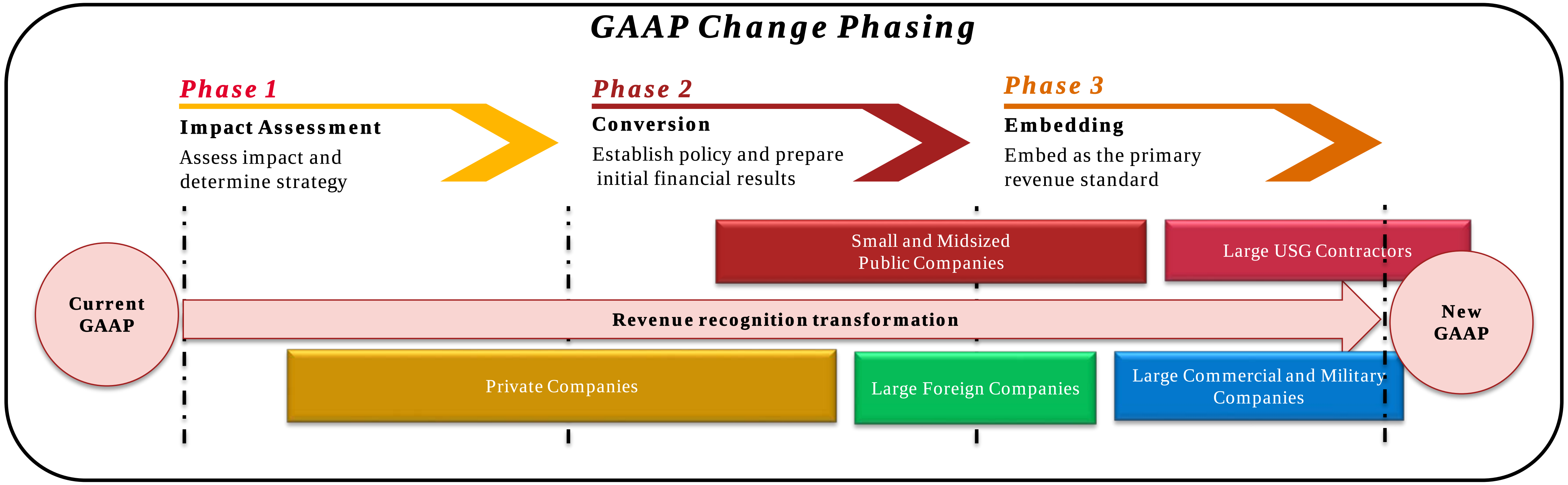
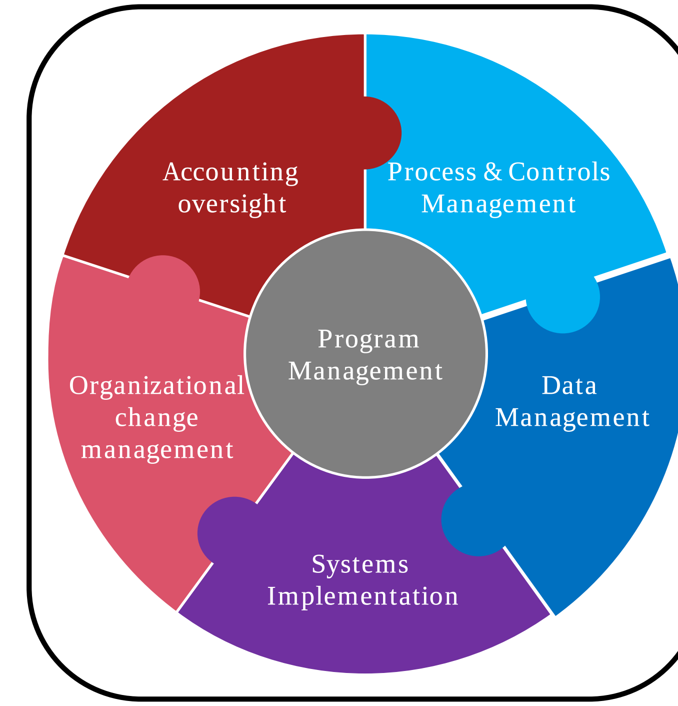
Looking Forward: Successfully Implementing the New Revenue Recognition Standard





Revenue Recognition Adoption Survey

- Over 50% of the respondents believe that establishing new accounting policies, business processes, internal controls and IT system changes will each have a moderate or high impact on their organization
- Only 5% of companies have hired additional full time resources to support GAAP change with 20%+ currently hiring outside consultants
- The use of outside consultants and additional hires may be limited as 65% of companies do not believe the standard will mater iality impact their P&L while 20% remain unsure
- Nonetheless, over 34% of companies are investing over 4 equivalent FTEs to their project with 11% of companies devoting at le ast 9 FTEs

SEC Comment Letter Trends

- General Dynamics, Ford and Alphabet have all received SEC comment letters on ASC606 adoption
- SEC commentary pointed at completeness & accuracy of FS disclosures, including requests to examine Company's internal documentation when statements were made that impacts were 'immaterial'.
- SEC also examined other Company specific public information and reconciled those statements to current revenue disclosures, asking questions where gaps were perceived

Success factors

- Importance to starting now, to determine how the standard affects the Company's financial picture, its investors, and the way it does business
- Develop an approach that effectively leverages the transition period–measured approach
- Establish robust governance structure
- Agree on project management and change management protocol
- Document as you go –maintain and maintain an audit trail
- Don't forget about disclosures!

Contact information

Phil Koos	John May	Paul Whiteman	Gregg Pilotte	Jeffrey M. Griffiths
Partner, PwC Government Contracts Practice	Partner, PwC Government Contracts Practice	Partner, LexellBlue Consulting	Director, PwC Government Contracts Practice	Director, PwC Capital Markets and Accounting Advisory Services
(646) 818-7171	(617) 530-5340	(571) 214-9613	(617) 530-4514	(617) 406-2497
phil.koos@pwc.com	john.m.may@pwc.com	paulwhiteman@ lexellblue.com	gregg.s.pilotte @pwc.com	jeffrey.m.griffiths @pwc.com

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