Deloitte.



# Value Reporting – Revenue Recognition Update

## How will the new Revenue Recognition Guidelines impact your KPIs

**April 2013**

# Agenda

| | |
|---|---|
| 0 | Fundamentals of Value, KPIs, P/E & P/B ratios |
| 1 | Purpose-driven accounting policy election & use of estimates |
| 2 | Structuring transactions to avoid undesired results/surprises |
| 3 | Time of opportunity in a volatile regulatory environment: Revenue recognition |
| 4 | Characteristics of thorough impact analysis to prepare for adoption of new revenue guidelines |
| 5 | Dealing with financial reporting effects in valuation models based on a thorough impact analysis |

# THE DAILY NEWS

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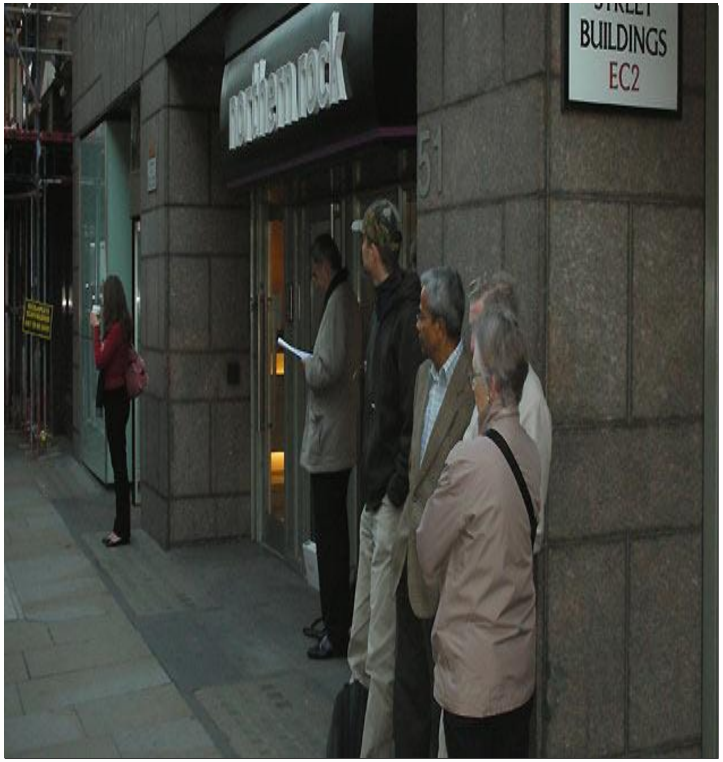
# Northern Rock hit by accounting change




**Northern Rock** Northern Rock's full-year results show it weathering the housing downturn but the mortgage bank shocks investors with news that a change in accounting rules will cut 2004 earnings per share by up to 12%.

Northern Rock (NRK) shares slipped by 21.5p, or 2.7%, to 776.5p despite news of a 24.9% increase in assets under management to £64.9 billion and record pre-tax profits of £431.2 million, up 13% on a like-for-like basis.

Northern more than held its own as mortgage demand has waned, increasing its net market share for the year from 7.8% to 11.2%, taking more than 14% in the second half.

2005 begins with a new business pipeline of £5.1 billion, up 32% on the last year.

Less welcome was news of the effect of the new International Financial Reporting Standards (IFRS). These reduce the amount of income the bank can recognize in the first year of a new loan, although this is offset by increase amount of revenue recognition later in a loan's term. Changing the shape of the accounting treatment of loan revenue will see 2004's earnings per share of 74.1p revised down by 10%-12%.

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# What is Value ?

| Value Attributes |
| --- |
| ▪ Varies by industry and organization<br>▪ Captured in set of Key Performance Indicators (KPIs)<br>▪ KPIs as means of internal performance assessment and communication tool to market through analysts as intermediaries |

# What are KPIs ?

## KPI Attributes

**Liquidity**

- e.g. cash-flow/liabilities

**Capital structure**

- e.g. (long-term debt + equity)/long-lived assets

**Profitability**

- e.g. pre-tax earnings/revenue

**Efficiency**

- e.g. revenue/inventories + trade receivables

**Analysts' #1 focus**

- (current + future) Earnings

  → Multiples valuation

# Common Multiples - P/E and P/B Ratios

**P/E & P/B Attributes**

- Market price/cost of an asset **relative to value related parameter**
- Examples for parameter:
  - Earnings
  - EBIT
  - Book Value of Equity
- Commonly used by analysts
  - P/E ratio
  - P/B ratio (fundamental investors only)
- Ratios **measure relative cost** of an investment
- Investments could be internal or external

**Benjamin Graham**

'Price is what you pay; **value** is **what you get** !'

# Why are Financial Statement Adjustments necessary ?

## Adjustment Approach

- Financial statements as basis for KPIs
- Oftentimes elimination of perceived accounting anomalies
- Examples:
  - Eliminate **goodwill** against equity
  - Change from LIFO to alternative **inventory costing**
  - Bring all **leases** on balance sheet
  - Show related party balances & **transactions** separately
  - Separate **operational** from **financial** results
  - Isolate unusual or **nonrecurring items**

## Adjustment Variation

- Perspective
  - Management vs. analyst
  - Reclassifications lead to **“reformulated”** or **“structural” financial statements**

# Why are KPIs important ?

## KPI Application

- Impact **resource allocation** to business units
- Trigger **share price** movements through analyst research reports
- Impact **cost of debt financing** through credit ratings or bank covenants
- Shape **corporate image** through reports in the financial press
- Starting point for **valuations** of **businesses** bought or sold

## KPI as a Tool

- Not just analysis of **past** performance
- Drive **future** revenues, costs, resources!

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# What Purposes could Drive Accounting?

## Drivers of Accounting

- Potential Objectives
  - Earnings **smoothing**
  - Create **buffers** for tough times
  - Tell a steady **growth story**
  - Demonstrate **conservatism**
  - Be aggressive for **short-time success**

## Implications of Accounting Drivers

- Ensure purposes driving accounting are aligned with management's **strategic objectives** !
- Key characteristic: purposes **evolve over time** as market conditions & company performance change
- Purpose **variation**: group performance assessment vs. acquisitions/disposals
- Limitation: requirement for **consistent application**

# Accounting Policies and Estimates

## Attributes of Accounting Policies

- Explicit recognition, measurement, and presentation **alternatives**
- Absence of applicable **guidelines** creates de facto options
- Uncertainty and subjectivity create **ranges** of acceptable measurement/recognition
- Alternative **transition scenarios** in adoption of new standards/interpretations

## Key Characteristic of Accounting Policies

- Elections or estimates based on **present facts** & **circumstances**

# Explicit & De Facto Options/Leeway

| Examples |
|---|
| ▪ Explicit<br>▪ **PP&E** at cost or fair value<br>▪ **Investment property** at cost of fair value<br>▪ De Facto<br>▪ **Development cost** capitalization<br>▪ **Deferred taxes** on tax loss carryforwards<br>▪ **Financial instrument** classification<br>▪ **Fair value** measurement<br>▪ **Impairment** testing<br>▪ **Inventory** write-downs<br>▪ **Inventory** costing<br>▪ Revenue recognition timing for **long-term contracts**<br>▪ Revenue recognition deferral due to **uncertainties** |

# KPI Impacts from Accounting

## Dependence on Investment Growth

- No growth scenario: **P/E ratio** unaffected but **P/B ratio** increases
- Conservative (liberal) accounting triggers above (below) normal P/E ratios due to lower (higher) earnings with positive (negative) investment growth
- Implications of growth for **RNOA**, **residual operating income**, and other indicators vary

## Note Reversal Property of Accounting

- Earnings induced by **accounting reverse** in the future but growth (rather than replacement) investments overlay reversals
- Exceptions: accounting drives **permanent book/tax differences** or off-B/S items

# Deficiencies in Policy Setting

| Potential Patterns of Deficiencies |
|---|
| ▪ Unawareness of alternatives<br>▪ Elections unaligned with management objectives<br>▪ Adverse KPI impacts not known until after the effect<br>▪ KPI sensitivities not well understood<br>▪ Inconsistencies across group companies<br>▪ Lack of attention to changing guidelines<br>▪ SALY syndrome |

# Alignment with Communications

**Corporate Communication**

- HQ may perceive wrong messages from BUs
- KPIs may miss desired impact if misaligned with MD&A, earnings releases, etc.
- Semiotic analysis of investor communications increasingly used

→ Focus on

✓**Synchronized use** of accounting policies & estimates, KPI framework

✓**Corporate communications** !

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# Structuring Transactions

| Attributes of Transaction Approach |
| --- |

- **Substance/form** of transactions or events may be flexible
- Establish desired outcomes in **KPI terms** and work backwards
- Consider shaping substance/form to achieve **desired effects**
- Weight **costs/benefits** of **desired KPI** impacts against potential operational, **adverse effects**
- Obtain **'HQ buy-in'** before proceeding at BU level

| Key Characteristic of Transaction Approach |
| --- |

- Underlying **facts & circumstances** need to change to achieve desired outcome

# Interdependencies

| Checklist |
| --- |
| ❑ Green light per cost/benefit analysis |
| ❑ Alignment with management's strategic objectives |
| ❑ Congruence with applicable accounting policy decisions already made (unless changes justified) |
| ❑ Appropriate disclosures in the financial statements where applicable |
| ❑ Adequate messaging in internal or investor communications (potentially highly sensitive !) |

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# Regulatory Environment: A Time of Change in Financial Reporting Areas

**Expect entirely new Accounting Models:**

- **Revenue recognition**
- Leases
- Financial instruments
- Insurance accounting

**New guidelines for Accounting**

- Present **opportunities for**:
  - **Policy** setting
  - **Different** use of **estimates**
  - **Structuring** where prior requirements changed

# Coming up: New Revenue Recognition Guidelines

**Joint IASB/FASB Project**

- Exposure **draft** issued on **November 14, 2011**
- Result of **re-exposure**
- Currently in process of **finalizing deliberations**
- New standard expected to be **issued** in **Q2 of 2013**
- Effective for **annual reporting** periods beginning on or **after January 1, 2015 or 2016**
- **Early adoption** likely permitted under **IFRS only**

# Project Objectives and Core Principle

***One Model***

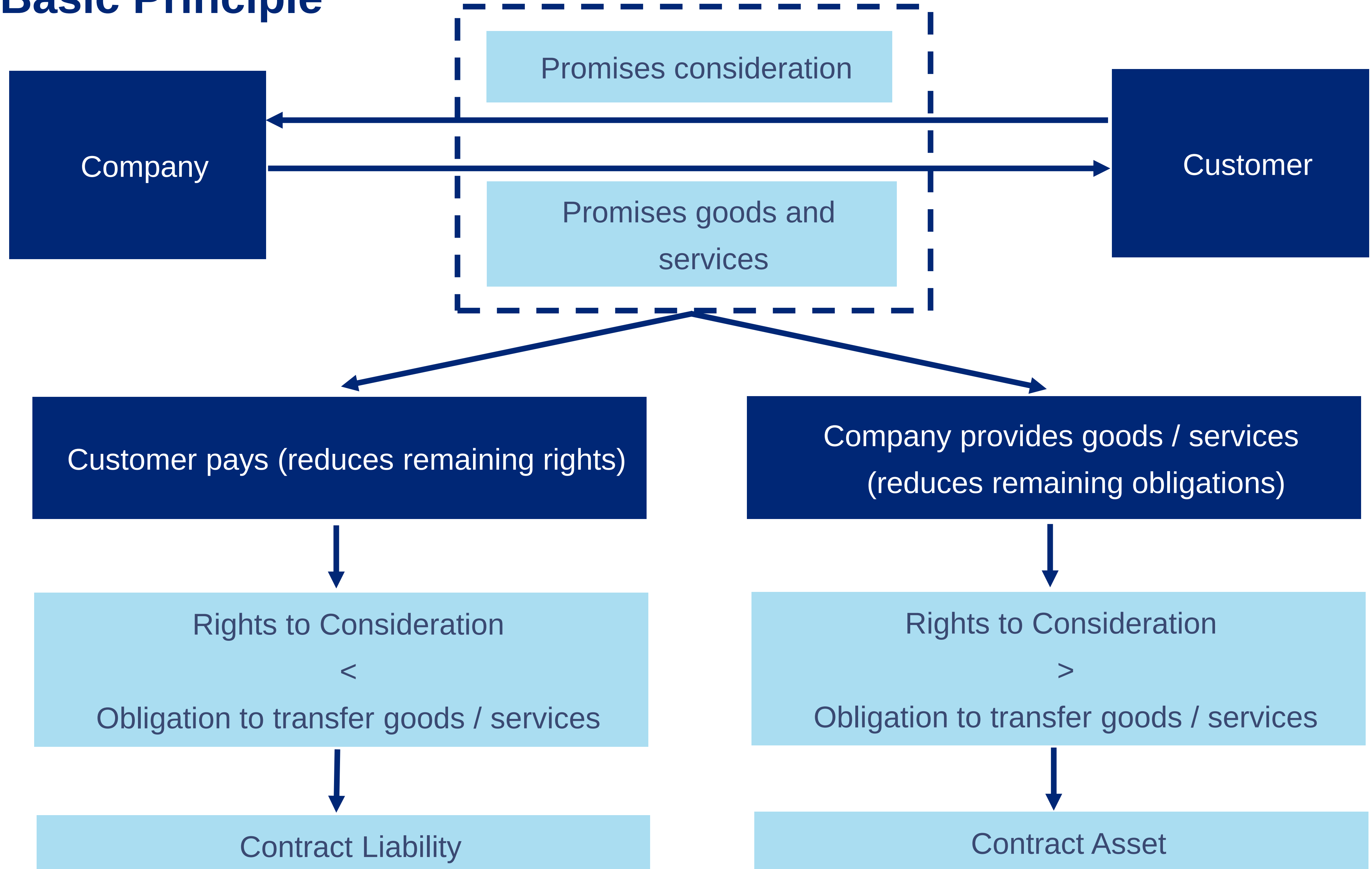
A single, joint revenue standard to be applied across all industries and capital markets

| | | | |
|---|---|---|---|
| ***Enhanced disclosures*** | ***Robust framework*** | ***Clear principles*** | ***Comparability across industries*** |

Core principle:

Recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services

# Basic Principle



# Proposed Model – Five Step Approach

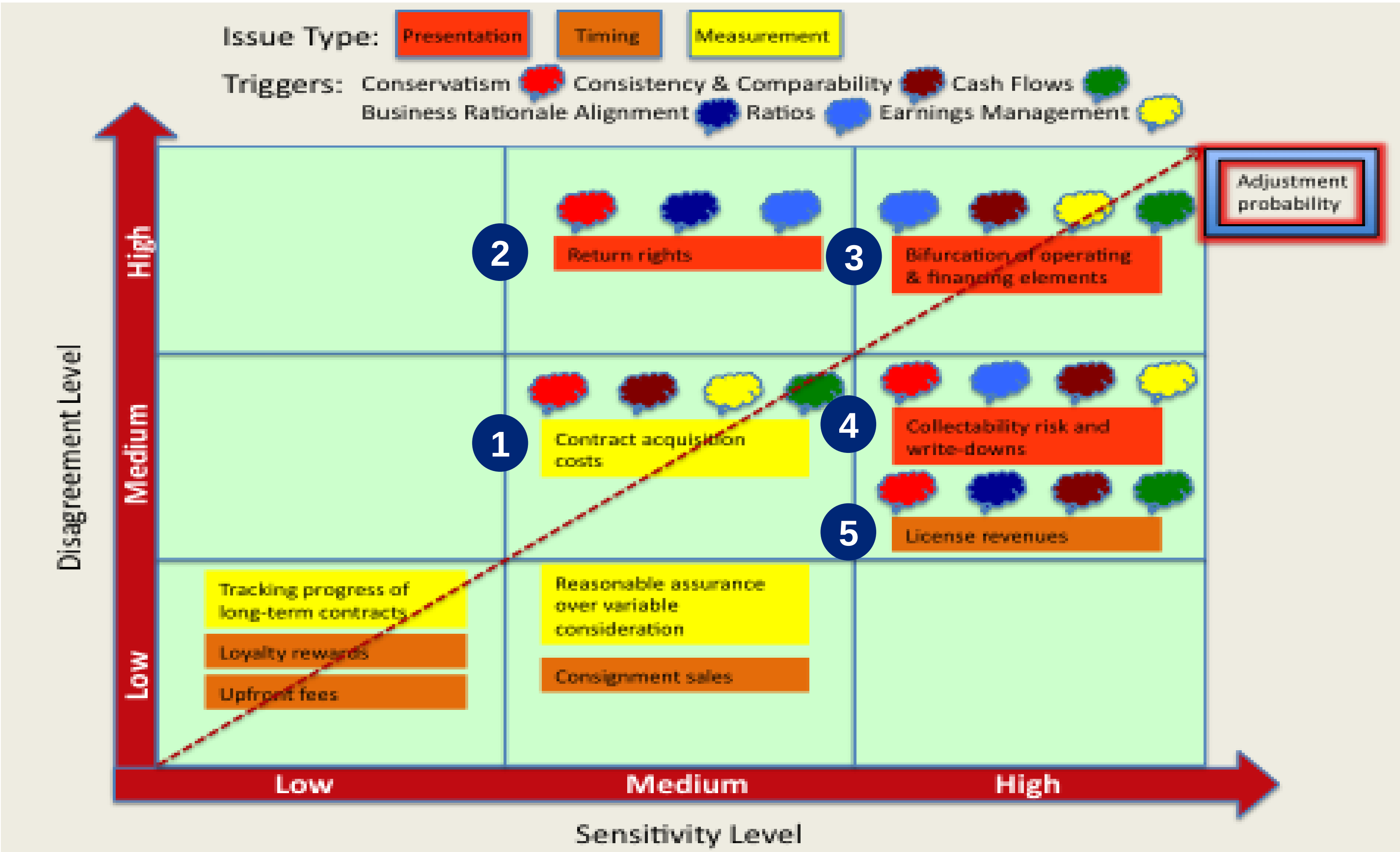
1. Identify the contract(s) with the customer
2. Identify and separate performance obligations in the contract(s)
3. Determine the transaction price
4. Allocate the transaction price (on a relative stand-alone selling price basis)
5. Recognize revenue when a performance obligation is satisfied

# Reactions to Proposals

| Revenue recognized when realized / earned (US GAAP) or risks & rewards transferred to buyer (IFRS) | → | Revenue recognized when performance obligations satisfied |
|---|---|---|
| ▪ Alignment with **operations management** | | X |
| ▪ Clear & unambiguous **principle** | | X |
| ▪ Consistent **triggers across industries** | | X |

No reference to customer commitment to pay → revenue
Limited reference to reduction of uncertainty → profit

# Analyst Views (1/6)







Source: Implications of Proposed New Revenue Guidelines for Quality of Earnings Analyses (Hermans, D., 2012)

# Analyst Views (2/6)

1

## Contract Acquisition Costs

- Recognize incremental costs as asset if expected to be recovered; not required to recognize as asset if contract period is < 1 year
- Incremental – costs not incurred had the contract not been obtained
- Subject to periodic amortization and impairment testing
- Similar to current practice in insurance industry
- Change from current IFRS and US GAAP practice for other companies
- **KPI Impacts:** capital structure and efficiency KPIs

# Analyst Views (3/6)

2

## Return Rights

- Derecognize full value of inventory
- Recognize asset representing the right to recover goods
- Record liability for the refund obligation
- Monitor if impairment needed on asset recorded for goods recovery
- Asset recognition represents change from prior IFRS and US GAAP requirements
- **KPI Impacts:** capital structure and efficiency KPIs

# Analyst Views (4/6)

3

## Bifurcation of Operating & Financing Elements

- Separate the impact of discounting from recognition of long-term receivables for non-financial services businesses
- Record the discount below the gross profit line in financing
- Inconsistent application in practice likely as operating vs. financing distinction depends on business model
- Disincentive to grant generous payment terms as timing of payment drives amount of discount recognized as financing
- **KPI Impacts:** capital structure, efficiency, and liquidity KPIs

# Analyst Views (5/6)

4

## Collectability Risk & Write-Downs

- Collectability risk no longer prevents revenue recognition
- Instead, such risk is reflected in measurement of the receivable
- Record subsequent period adjustments to collectability risk as a separate line item adjacent to revenue
- Could lead to frequent and significant gross profit swings with changes in credit conditions (think Euro crisis)
- Direct link to orders and cash inflows
- **KPI Impacts:** capital structure, efficiency, and profitability KPIs

# Analyst Views (6/6)

5

## License Revenues

- Recognize license revenues when control over the use of the license has passed to the licensee
- Subject to “reasonably assured” constraint
- Continue to spread usage-based fees over license period
- Application to term-based licenses currently unclear
- Upfront recognition would represent departure from current practice under IFRS and US GAAP
- **KPI Impacts:** capital structure, efficiency, and profitability KPIs

# Implications for Revenue Deferrals?

**How will application of the new revenue model impact Apple's iPhone and Apple TV revenues?**

- Delivery of products such as iPhone and Apple TV and the promise to later provide free upgrades & features would be considered distinct **performance obligations**
- **Fair values** would be attributed to performance obligations based on standalone prices
- Recognize **product revenues** on delivery
- Defer revenues from **upgrades & features** until provided
- Significant **tax implications** from timing of revenues

→ Adoption **impact** will depend on **fair value allocated** to upgrades & features

# Implications for Statutory Reporting?

**How will the changes in your secondary GAAP impact your statutory reporting under JGAAP?**

- **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**, many provisions in the **new IFRS/US GAAP guidelines** may be considered **acceptable**

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# What should I do now?

## 1 — 2013 – Assess impact and determine strategy

- Perform a **high-level assessment** to determine significant impacts on major BUs
- Inventory standard **transaction types** and prioritize
- Educate key stakeholders, including investor relations, the board and audit committee

## 2 — 2014 – Establish policies and prepare financial results

- Perform **quantitative assessment**
- Consider impact on strategic business initiatives such as changes in bundling, pricing, go-to-market strategy, new product and service offerings
- Understand **KPI effects** when analyzing and **defining policies** under new rules
- Assess what data will need to be collected and analyzed prior to adoption to allow for comparative presentation
- **Assess how** such **data** will **be collected** and to what extent **processes & systems** require **modification**
- Establish a **training** and **communication plan**

## 3 — 2015 – Embed the new standard

- Go live and **business as usual**

# Why Using a Phased Approach?

| Requirements of new Model Application |
| --- |
| ▪ Comprehensive **understanding** and inventory of **current practice** before detailed impact assessment can be performed |
| ▪ Necessary for identification of **performance obligations** |
| ▪ Enables harmonization of **application across the group** |
| ▪ Focuses assessment on **key revenue streams** and typical contracts |
| ▪ Considers **qualitative** before **quantitative** aspects with operational impact factors included in **assessment** |

# Bridging Quantitative & Qualitative Aspects

**Checklist: link up direct financial reporting impacts with indirect operational impacts**

- ❑ Identify additional data requirements
- ❑ Plan process updates
- ❑ Check IT compatibility
- ❑ Consider legal aspects from contract modifications
- ❑ Assess KPI impacts through sensitivity analysis
- ❑ Analyze interdependencies with sales and marketing strategies
- ❑ Consider effects on business planning
- ❑ Identify related HR issues, such as compensation schemes
- ❑ Define communication plan for investor relations

# Scope of Analysis

**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)

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# Use of Modeling in Analysis of Financial Reporting Effects

**Modeling Application**

**Modeling can be employed to support decision making**

- Design of **KPI metrics**
- **Sensitivity analysis** for accounting policy elections and use of estimates with respect to KPIs
- Sensitivity analysis to support **structuring alternatives**
- Anticipate KPI impacts from adoption of new accounting guidelines such as revenue recognition
- Capture accounting impacts in **business valuations** to distinguish them from value drivers (acquisitions/disposals)

**KPI analysis cannot manage accounting distortions but comprehensive valuation models can … how?**

# Achieving Accounting Irrelevance in Valuation

| Valuation Approach |
|---|
| **Isolate accounting effects to challenge prices**<br><br>**Consider book value and residual operating income growth in valuation formula**<br>▪ Book value as anchor<br>▪ Focus on **operating component**<br>▪ Reflect that operating income needs to exceed the required return to add value<br>▪ Employ modeling to determine **accounting-induced growth** (from thorough analysis of options or changes)<br>▪ Distinguish between accounting-induced growth and **"real" anticipated growth** to focus on the latter<br><br>**Technique not generally applied in internal performance assessments or by analysts or other 3rd parties (!)** |

# Conclusion

## Implications

- Prices include **growth from the accounting** that does not add value
- Isolation of accounting-induced growth allows you to scrutinize **“real” anticipated growth**
- “**Componentization**” of prices facilitates assessment of value at risk

## Advice

Benjamin Graham: **Beware of paying too much for growth !**

# Summary of Key Takeaways

✓ **Regulatory** and **de facto options** in accounting policy setting impact KPIs

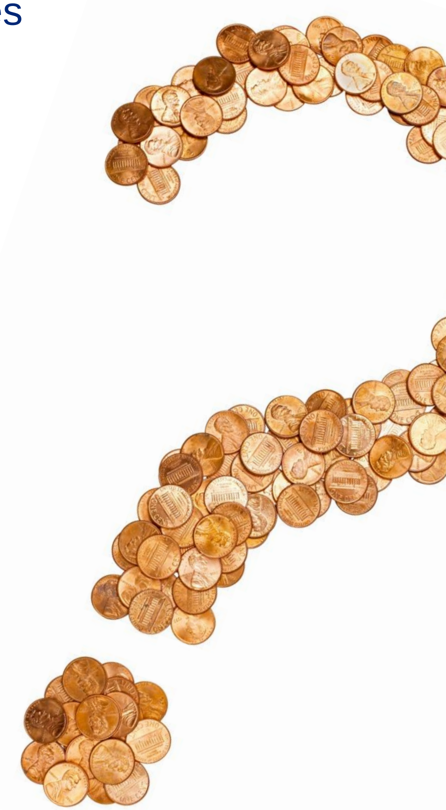
✓ **Sensitivity analysis** can be employed to identify and manage interdependencies

✓ **Financial statements** may be adjusted or reformulated to “purify” KPI analysis

✓ **Transactions** may be structured to avoid undesired accounting consequences

✓ **Proposed new revenue guidelines** will have extensive impacts on KPIs
→ impact analysis should start early

✓ **Modeling** allows isolation of known accounting impacts to distinguish between accounting-induced and “real” growth to challenge prices



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