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New Revenue Recognition Rules and ERP Systems: Implications for Engineering and Construction Companies

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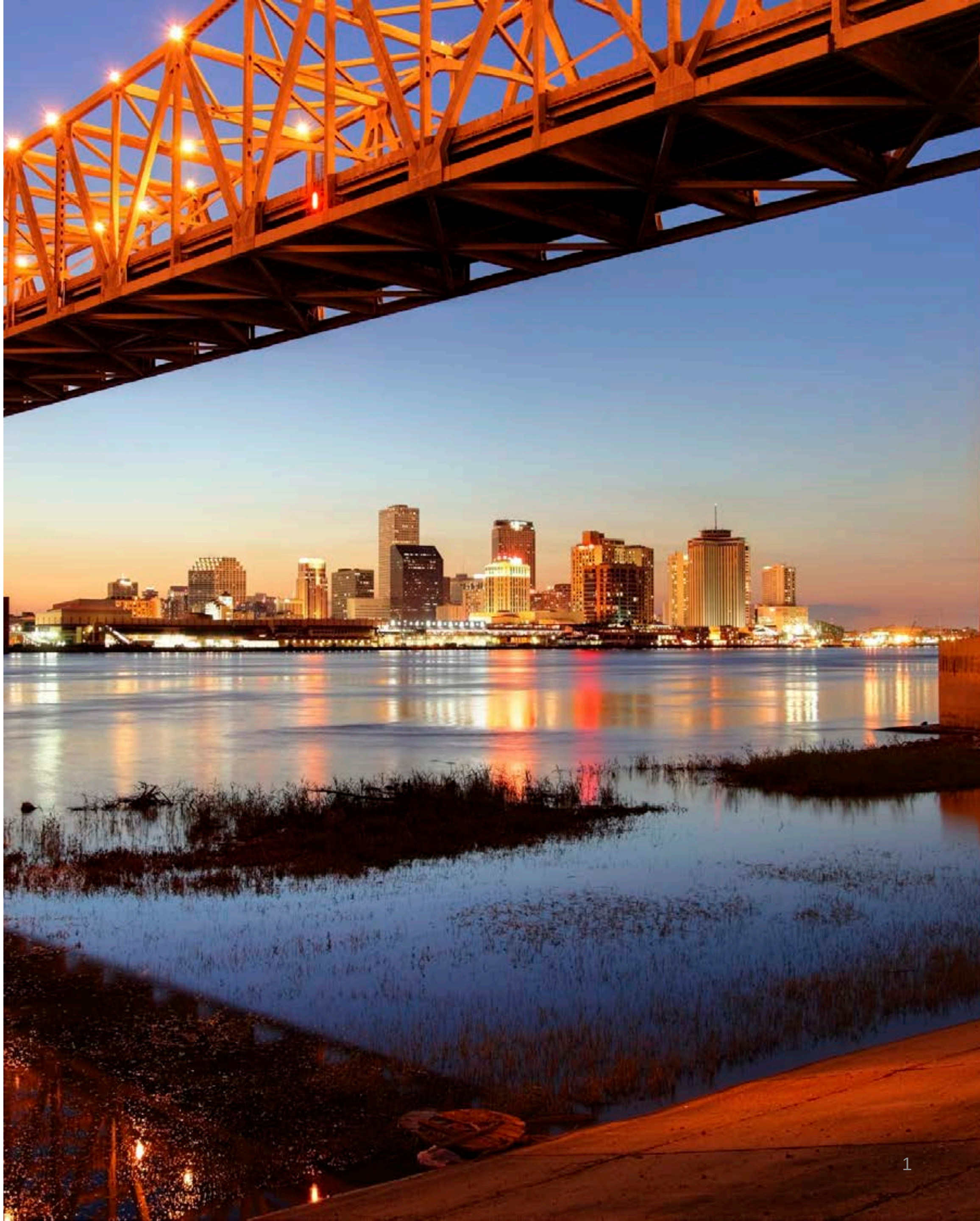


Agenda

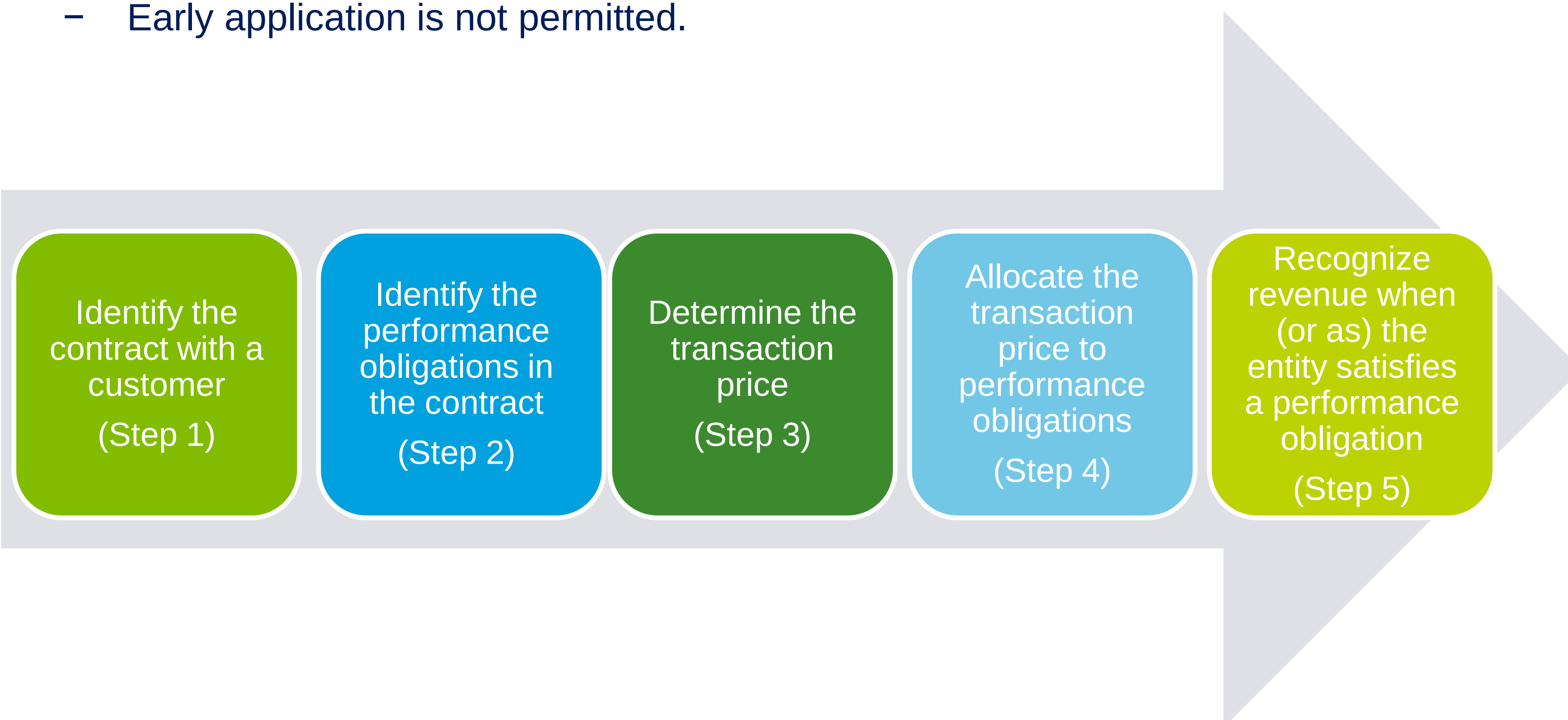
- Introduction
- Overview
- Accounting Implications for E&C Entities
- Systems Implications and Potential Solutions
- Tax Implications
- Q&A

Overview

Final Revenue Recognition Standard Issued

On May 28, 2014, Accounting Standards Update No. 2014-09 (the "ASU"), *Revenue from Contracts with Customers (Topic 606)* was issued:

- Applies to contracts with customers.
- Effective for annual reporting periods beginning after December 15, 2016 (subject to proposed deferral by a year), including interim reporting periods therein.
- Early application is not permitted.



Scope

ASU 2014-09 outlines a single comprehensive model for entities overriding certain industry-specific guidance, with the following scope exceptions:

ASC#	Topic Excluded from the scope of ASU 2014-09
310	*Receivables*
320	*Investments—Debt and Equity Securities*
323	***Investments—Equity Method and Joint Ventures***
325	*Investments—Other*
405	*Liabilities 6*
460	*Guarantees (other than product or service warranties)*
470	*Debt*
815	*Derivatives and Hedging*
825	*Financial Instruments*
840	***Leases***
845	*Nonmonetary transactions between entities in the same line of business to facilitate sales to customers or potential customers*
860	*Transfers and Servicing*
944	*Financial Services— Insurance*

Effective Date and Transition Method

An effective date of 2017 was established for public companies with alternative transition methods:

Retrospective restatement

- Reflect the impact of the new guidance in each year presented in the 2017 financial statements (2015-2017)
- Recognize the cumulative effect as of the beginning of the earliest year presented (January 1, 2015 for a calendar year-end), through an adjustment to retained earnings
- Certain limited practical expedients

Cumulative effect adjustment with certain practical expedients

- Revenue guidance 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 the amount by which each financial statement line item is affected by the new guidance in the period of adoption
- Provide an explanation of the significant changes between applying the new guidance and prior/legacy guidance

Accounting Implications for E&C Entities

Potential accounting implications

Issue	Description
Identification of Contracts w/ Customers *(new contracts and modifications)*	• Mandates application of <u>"probable" threshold on collectability</u> • Requires an assessment of relationship between parties to the contract (i.e., supplier-customer vs. other relationship, such as a partnership)
Contract Combinations	• Combination <u>mandated</u> if contracts involve: i. Package negotiations (around the same time with the same customer); ii. Single commercial objective; iii. Pricing/performance interdependencies; and iv. Common performance obligation(s)

Potential accounting implications (cont'd)

Issue	Description
Contract Modification, Claims & Unapproved Change Orders	• Limits revenue recognition to client-approved amendments/change orders whereby vendor is entitled to enforceable rights to consideration • Assessment of nature & extent of amendment required for categorization of amendment as: i. A separate contract (i.e., no impact on existing contract); ii. Modification of existing contract (i.e., update to transaction price and POC resulting in cumulative catch up adj. on existing contract); or iii. Termination of existing contract and generation of new contract (i.e., allocation of non-recognized consideration to new contract) • Unpriced Change Orders – Recognize when change is expected to be approved and there is not an expectation that the estimate will have a significant reversal in the future • Claims – Recognize when there is not an expectation that the estimate will have a significant reversal in the future

Potential accounting implications (cont'd)

Issue	Description
Performance obligation (PO) Segregation	• Identification of "distinct" goods/services separable within the context of the contract requires consideration of: − Activity integrating multiple deliverables − Commonalities in pattern of transfer − Interdependencies in performance, delivery, pricing or utilization of deliverables • Emphasis on consistency of approach across contract portfolio / business unit for PO segregation and determination of stand-alone selling prices
PO satisfaction pattern: over time vs. at a point in time	• Focus on transfer of control → deemed to be transferred over time if any of the following criteria are met: − Asset created has no alternative use to the vendor and vendor has enforceable rights to payment for progress to date − Customer simultaneously receives & consumes benefits from the asset or has control over the asset as vendor is in the process of developing the assets • Proportionate method may no longer be supportable

Potential accounting implications (cont'd)

Issue	Description
Progress measurement for POs satisfied over time	• Completed-contract method not allowed • Where input method is used, specific adjustments mandated around costs that do not contribute to progress on a proportionate basis (e.g., material or labor cost overruns due to inefficiencies)
Determination of transaction price	• Prescribes a new threshold, "probable" for recognition of variable consideration • Retroactive adjustments required in certain instances
Significant financing component	• Consideration to be adjusted for time value of money if contract has significant financing component and expands over one year
Warranties	• Distinction between: − Basic warranty for fulfillment of agreed-upon specifications (subject to cost-accrual model); vs. − Advanced warranty (separate PO with revenue allocation)

Potential accounting implications (cont'd)

Issue	Description
Allocation of revenue	• Transaction price to be allocated to POs based on relative stand-alone selling value • Exceptions may apply for: discounts, variable consideration, changes in transaction price
Contract costs	• Incremental costs directly attributable to a contract (including those incurred to generate or enhance resources of entity that will be used in satisfying POs) required to be capitalized • Amortization of such costs into income in a consistent manner as related revenue recognition methodology
Disclosures and other	• New disclosure requirements, including tabular reconciliation of contract balances, forecasted "rollout" of performance obligations over time • See next slide for additional details

Disclosures

The revenue standard requires the following quantitative and qualitative disclosures:

Required annual disclosures	Quantitative	Qualitative	Required on an interim basis?	Key Decisions and Considerations
1. Disaggregation of revenue	✓	✓	✓	• Determination of disaggregation categories • Choice between quantitative or qualitative reconciliation to segment revenue
2. Contract asset/liability balances	✓	✓	✓	• Determination of whether the reporting requirement for receivables is already met elsewhere
3. Nature of POs		✓		
4. Amount and recognition timing of transaction price allocated to the remaining PO	✓		✓	• Preferred breakdown of remaining POs • Quantitative or qualitative presentation
5. Significant judgments used in determining the transaction price and satisfying POs		✓		• Determination of whether there should be a specific list of judgments to reference when preparing the disclosure or whether the disclosure should be open-ended
6. Assets recognized from the costs to obtain or fulfill a contract	✓	✓		
7. Election of practical expedients		✓		• Capability to capture the use of practical expedients and apply practical expedients consistently

Systems Implications & Potential Solutions

Topic 606 and IFRS 15 Requirements & Software Objective

- Accounting Standard Timeline
- Performance Obligations replace Deferred Revenue
- The Core Principle in Five Steps
  - Identify the contract(s) with the customer
  - Identify the separate performance obligations
  - Determine the transaction price
  - Allocate the transaction price
  - Recognize revenue when a performance obligation is satisfied
- How are the software companies helping
  - Oracle EBS - Fusion Revenue Management Cloud Service
  - JDE Profit and Revenue Recognition – Performance Obligation tracking
  - Peoplesoft - Change in applications
  - SAP – Revenue Accounting and Reporting 1.0

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Identify the contract with a customer (Step 1)	Identify the performance obligations in the contract (Step 2)	Determine the transaction price (Step 3)	Allocate the transaction price to performance obligations (Step 4)	Recognize revenue when (or as) the entity satisfies a performance obligation (Step 5)
If you do not have a defined system contract, time to start considering.	Determine how your Work Breakdown Structure aligns with your contract	Understand the mapping between your WBS and Billing Pay Items	Align billing system to support invoicing by performance obligation	Test the system completely with existing contracts and projects

What’s New in Oracle EBS 12

Fusion Revenue Management (FRM) Footprint and Features

- EBS Order Management
- EBS Service Contracts
- EBS Projects
- EBS Accounts Receivable

Fusion Revenue Management → EBS General Ledger

- Co-existence from Cloud to On-Premise Integration to EBS
- Automated extraction of contract information
- Automated processing for revenue recognition
- Helps identify performance obligations as part of a contract with a customer
- Generates accounting entries
- Central reporting platform for all revenue processing

What's New in Oracle PeopleSoft 9.2

- New Revenue Recognition Requirements
  - Impacts all organization with revenue from customers
  - Biggest impact for multiple products and services, bundled products, variable prices, and finished products
  - Comprehensive transition and comparative reporting requirements
  - New accounts in GL and additional schedules at Qtr/Yr end
  - Documentation and audit

- Planned New Capabilities
  - New attributes to identify bundled products and services, not really aligned with the E&C industry
  - Streamlined allocation of contract price
  - Flexibility to maintain prices for revenue separately from billing
  - Price determination for revenue
  - Management of contract obligations, reports, and support of price audits

What's New in Oracle JDE 9.x

- Contracts and Job Cost Revenue Recognition
  - Ability to manage multiple performance obligations in a single project/job
  - Additional capabilities to tie detailed project costs to contract performance obligations
  - Flexibility to track contract change orders and existing performance obligations in different ways
  - More control of invoicing that affect revenue recognition

What’s New in Oracle JDE 9.x

- Contracts
  - Additional flexibility of tying work to specific performance obligations
  - Flexibility to track how change orders affect existing performance obligations
  - Simplify the control of how invoicing affects GL date revenue recognition adjustments

- Accounts Receivable
  - Ability to Recognize Revenue for invoices generated from Accounts Receivable, Sales, Contract and Service Billing, and other methods without the need to purchase and use the Contracts module
  - Ability to research prices to determine the “stand alone price”
  - Ability to make the Revenue Recognition process transparent to current users to the Accounts Receivable Invoice process

What's New in Oracle JDE 9.x

Additional changes to allow compliance:

- Job Cost
  - Identify multiple performance obligations within a single project/job
  - Ability to make adjustments (revenue, cost, and % complete) by performance obligation
  - Ability to run Profit Recognition process by performance obligation
- Ability to summarize Unit Price and Lump Sum contract billing transactions by subledger
- Ability to enter change requests for Time & Material and Fee billing lines
- Reporting changes
  - Track contract amounts (e.g. Schedule of Values) related to change orders
  - Detailed revenue recognition posting report
  - Performance Liability Account amounts visible in Contract Status Inquiry application
- Upgrade to the 9.x to get enhancements

What's New in SAP

- SAP Revenue Accounting and Reporting 1.0 addresses requirements derived from this new accounting standard
- This new solution is now in ramp-up
- SAP ERP Financials customers with current maintenance agreements will have access to the solution
- The main requirement of the new ruling is tackled using "Multiple Element Arrangements" (aka performance obligations)
- Revenue can be recorded at the time of billing, between specific sets of dates in equal proportions, and on the basis of specific events
- Revenue can be recorded on the basis of the criteria which have been established for the contract, it can be recognized before, during and after billing
- Real time updates of revenue information to the general ledger and accounts receivable sub-ledger
- The solution supports the accounting for multiple element arrangements by leveraging the flexible rules framework

Tax Implications

Revenue Recognition for Tax - Generally

- **Long Term Construction Contracts**
  - Tax methods of "percentage of completion" differ from GAAP
    - Expenses for tax generally lag GAAP (compensation accruals, reserves, etc.)
    - Results in deferral for tax purposes
    - Analysis to determine expense allocation method on project by project basis.

- **Non-Long Term Construction Contracts** (i.e. pure engineering)
  - Revenue is recognized for tax purposes when substantially "all events" have occurred to earn the revenue
  - Opportunities to defer revenue for tax purposes:
    - Retainage
    - Award Fees
    - Holdback

Potential Tax Impact of the new Standard

Considerations

- Identification of a contract – may be required to “sever or aggregate” a contract for tax differently than GAAP
- Different distinctions for change orders
- Performance obligation - satisfaction at a point in time vs. over a period of time
- Bid and proposal costs

Book / Tax Differences and Deferreds

- Timing of revenue recognition will differ for GAAP causing a shift in deferred taxes

Accounting Method Changes

- Required method for book purposes may not be available for tax
- A change in GAAP revenue recognition may require advance consent to change for tax purposes

Identifying Contracts - Tax

The tax rules for severing or aggregating contracts rely on three factors – Treasury Regulation 1.460-1(e)

- Independent pricing of terms
- Separate delivery or acceptance
- Reasonable business person:
  - would not have entered into one of the agreements for the terms agreed upon without also entering into the other agreement(s) or
  - would not have entered into separate agreements containing terms allocable to each severed contract.

Applies to contracts and change orders

Other Tax Considerations

- Simplified cost to cost method
- Year of substantial completion – 95%
- 10% method
- Look back calculation

Revenue Recognition – NEW TWIST for Non-Construction

- **Billings in Excess of Cost (pre-bill)**
  - Not includible in taxable income until earned BUT
  - MUST be included in taxable income no later than subsequent tax year per Revenue Ruling 2004-34
    - May result in accelerated revenue recognition for tax purposes compared to GAAP
- **Interplay with Retainage / Award Fees / Holdback**
  - Revenues cannot be deferred if they are not yet included in income
  - Accounting method considerations
  - Contract by contract analysis for those which have BOTH a pre-bill component AND retainage, award fees, holdback, etc.

Question and answer

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