SAB 74 Disclosures Related to ASC 606 (IFRS 15) by Large US Public Companies

Methods, Dates, and Anticipated Impact

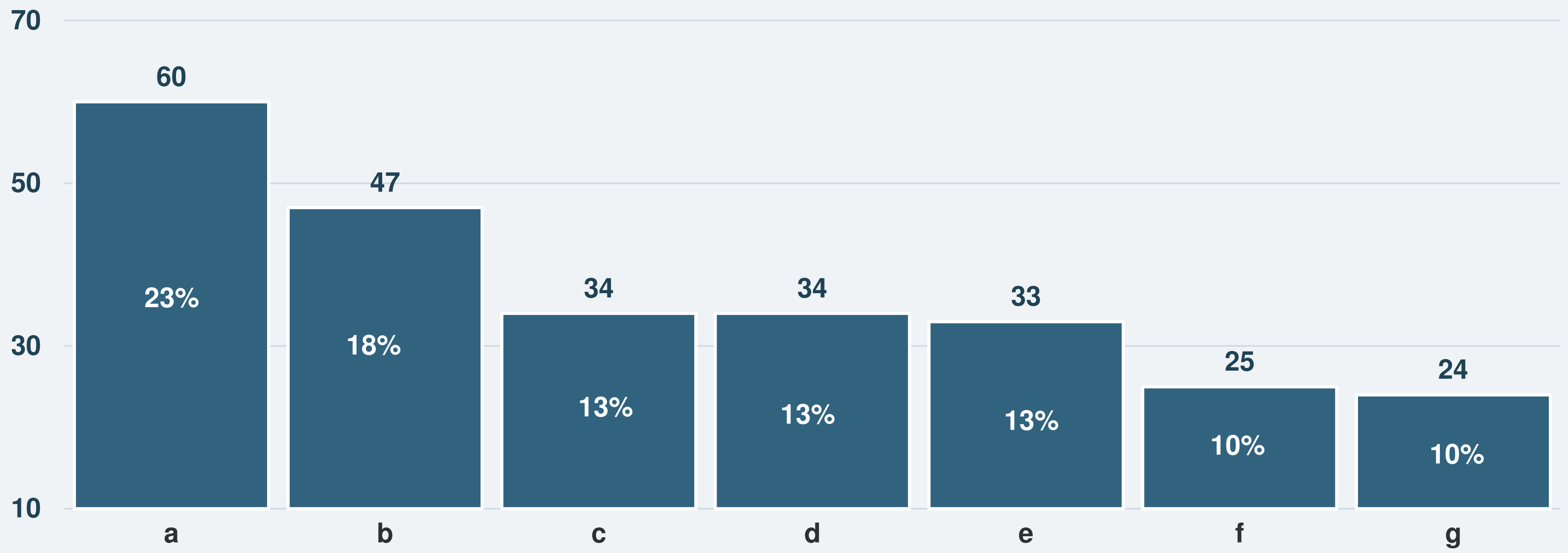
November 2016

CONNOR GROUP

Executive Summary

- This study was performed by Connor Group to provide an overview of current disclosures made by large US public companies regarding the upcoming adoption of ASC 606 *Revenue from Contracts with Customers* (or its IFRS equivalent, IFRS 15). This is our second disclosure study on the topic. The initial study was completed in July 2016.
- This study was conducted in November 2016 based on disclosures in SEC filings of 257 companies (237 companies filing using US GAAP, and 20 using IFRS). This population was determined via a search within the SEC database based on the following criteria:
    - Companies with market capitalization over $10 billion
    - A Form 10-Q, 10-K, 20-F or 6-K was filed from August 15, 2016 and November 10, 2016.
    - Disclosure language includes “revenue from contracts with customers” or “new revenue standards”.
    - All industries except finance, insurance, real estate, oil and gas, and mining
- A summary of the findings is presented below:
    - a) Overall, approximately 90% of the companies are still evaluating the new standard and are yet to select an adoption method and to determine the magnitude of the potential impact. This percentage has not improved since our last study.
    - b) A few companies have provided an anticipated assessment completion timeline while others have shared certain areas where changes in the companies’ revenue practices might potentially arise upon adoption.
    - c) Only a handful of companies have discussed the potential internal control implications from the new standard implementation.
- The study includes illustrative disclosures from several companies.

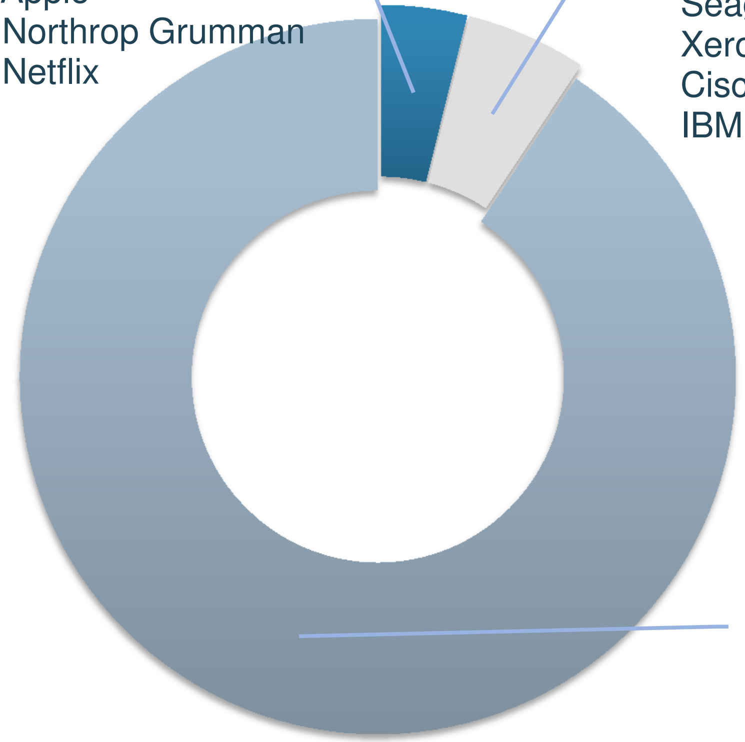
Sampled Companies by Industry



From left to right:

a. Technology
b. Industrial products, chemicals, and manufacturing
c. Transportation and utilities
d. Wholesale, retail, services and other
e. Life sciences (biotechnology, pharmaceuticals, medical devices)
f. Consumer products
g. Entertainment, media and communications

Anticipated Adoption Method



Full Retrospective: 4% (10/257 companies)

Notable companies:
Lockheed Martin
Apple
Northrop Grumman
Netflix

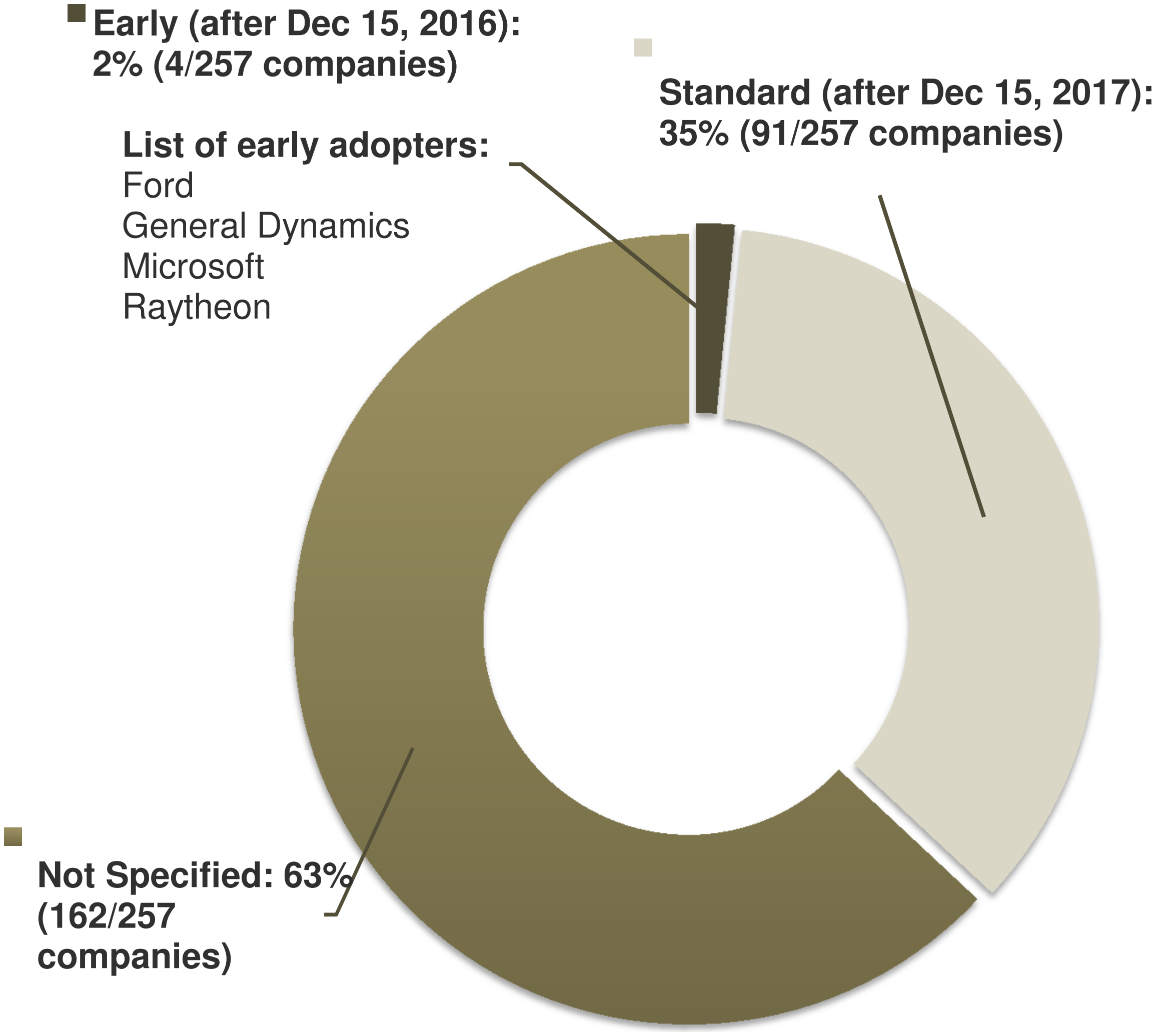
Modified Retrospective: 5% (14/257 companies)

Notable companies:
Seagate Technology
Xerox
Cisco
IBM

Still Assessing: 91% (233/257 companies)

- ☐ Full Retrospective ≡ recast all comparative periods presented in the post-adoption financial statements
- ☐ Modified Retrospective ≡ cumulative-effect adjustment to retained earnings in the period of adoption for prior periods' effects
- ☐ Over 90% of the companies reviewed are yet to decide on the adoption method.
- ☐ None of the companies which have elected the modified retrospective method expect ASC 606 to have a material impact on their financial statements. Out of those 14 companies, 7 represent technology industry, with the remaining ones spread among other industries.
- ☐ Out of 10 companies which have elected the full retrospective method, 3 have indicated that ASC 606 will have a material impact, another 3 expect an immaterial impact, while the remaining ones are yet to determine the impact. 4 companies each represent technology and industrial products, chemicals, and manufacturing industry groups.

Anticipated Adoption Date



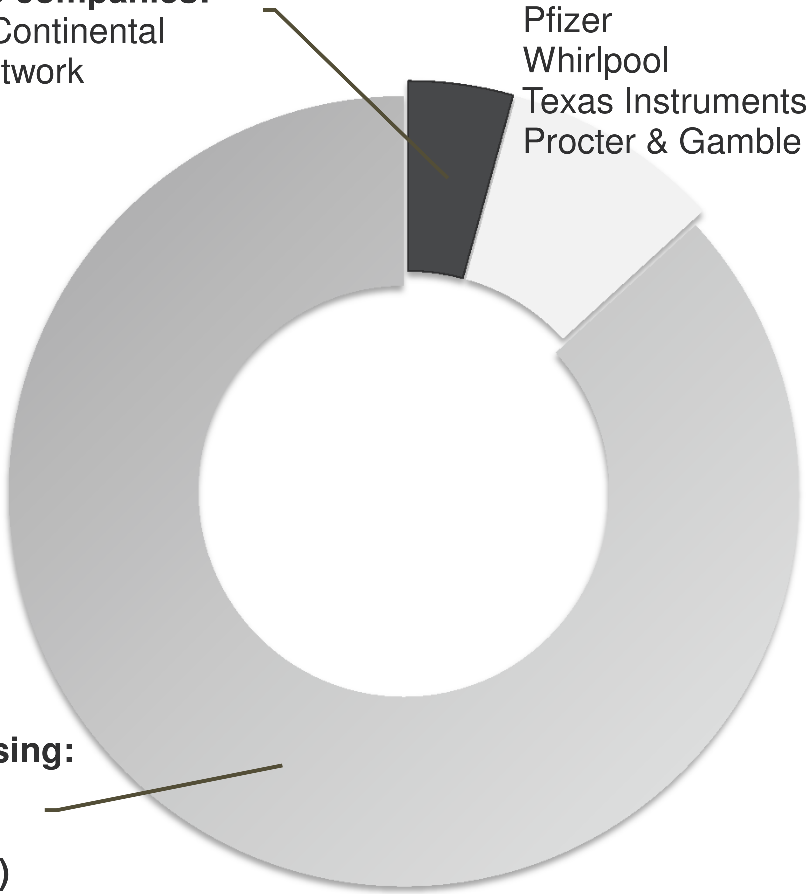
List of early adopters:
Ford
General Dynamics
Microsoft
Raytheon

- Companies who have elected to early adopt the standard have also disclosed their elected adoption method (Ford elected modified retrospective and the others elected full retrospective) and the anticipated adoption impact (General Dynamics and Microsoft expect a material impact upon adoption, while the other two do not).

- For companies who have decided not to early adopt, over 80% have yet to determine the potential adoption impact.

- Overall, 63% of the companies have not specified the adoption timing. This group of companies will likely be adopting at a standard adoption date.

Anticipated Adoption Impact



■ **Material:**
4% (11/257 companies)

Notable companies:
United Continental
Dish Network
GE
Sprint

□ **Immaterial: 9%**
(23/257 companies)

Notable companies:
Pfizer
Whirlpool
Texas Instruments
Procter & Gamble

▨ **Still Assessing:**
87%
(223/257
companies)

- ☐ The percentage of companies that are yet to determine the potential adoption impact is more or less aligned with that for the adoption method.
- ☐ Among others, material changes disclosed include accounting for mileage programs for the airline industry that are currently accounted for under the incremental cost approach, delay in recognition for long-term arrangements without continuous transfer of control that are currently under contract accounting, acceleration of revenue from software licenses that are currently deferred due to lack of VSOE on other elements, and acceleration of distributor revenue compared with the current sell-through recognition model.
- ☐ Companies that anticipate material changes and have also decided on the adoption method usually select the full retrospective method.

Top 15 Technology Companies

Adoption Method

	Not Specified	Immaterial	☐ Material
Full Retrospective		☐ Apple ☐ Oracle ☐ Netflix	☐ Microsoft (*Early adopt*)
Modified Retrospective	☐ Cisco ☐ IBM ☐ Accenture		
Not Specified	☐ Facebook ☐ Alphabet ☐ Intel ☐ MasterCard ☐ Qualcomm ☐ Salesforce ☐ PayPal	☐ Texas Instrument	

Adoption Impact

- *Top 15 technology companies were selected based on market capitalization at the time of their SEC filings.*
- *Other than Microsoft, companies selected have either chosen to adopt on a standard adoption date or not specified the adoption timing.*

Top 15 Life Sciences Companies

Adoption Method

Full Retrospective			
Modified Retrospective			
Not Specified	☐ Johnson & Johnson ☐ Zimmer Biomet ☐ Merck ☐ Gilead Sciences ☐ Shire ☐ Amgen ☐ Medtronic ☐ AbbVie ☐ Celgene ☐ Lilly Eli ☐ Biogen ☐ Abbott Laboratories ☐ Thermo Fisher Scientific ☐ McKesson	☐ Pfizer	
	Not Specified	**Immaterial**	☐ **Material**

Adoption Impact

- *Top 15 life science companies are selected based on market capitalization at the time of their SEC filings.*
- *None of the companies selected have indicated that they will early adopt.*

Example disclosure

(no adoption method or date elected, evaluation in progress, impact from lack of VSOE under current standard)

Electronic Arts Inc.

"……
While we are currently evaluating the method of adoption and the impact of the new revenue standard, as amended, on our Consolidated Financial Statements and related disclosures, we believe the adoption of the new standard will have a significant impact on the accounting for certain transactions with multiple elements or "bundled" arrangements (for example, sales of online-enabled games for which we do not have vendor-specific objective evidence of fair value ("VSOE") for unspecified future updates) because the requirement to have VSOE for undelivered elements under current accounting standards is eliminated under the new standard. Accordingly, we may be required to recognize as revenue a portion of the sales price upon delivery of the software, as compared to the current requirement of recognizing the entire sales price ratably over an estimated offering period. In addition, based upon what we expect to be our performance obligations under the new standard, as amended, we believe that upon adoption, a larger portion of our bundled arrangements will be presented as service revenue instead of product revenue in our Consolidated Statements of Operations."

Example disclosure

(no adoption method or date elected, evaluation in progress, impact from current sale-through model for distributor sales)

Microchip Technology Inc.

"……
As described in the Company's significant accounting policies, the Company defers the revenue and cost of sales on shipments to distributors until the distributor sells the product to their end customer. Upon adoption of ASU 2014-09, ASU 2015-14, ASU 2016-08, ASU 2016-10 and ASU 2016-12, the Company will no longer defer revenue until sale by the distributor to the end customer, but rather, will be required to estimate the effects of returns and allowances provided to distributors and record revenue at the time of sale to the distributor. The Company is currently evaluating the impact that the adoption of the standards will have on its condensed consolidated financial statements. The Company has not yet elected a transition method."

Example disclosure

(full retrospective, early adoption,
detailed disclosure of impact on FY15 and control framework)

General Dynamics Corporation

"……

We anticipate that the adoption of ASU 2014-09 will have primarily two impacts on our portfolio of contracts and our Consolidated Financial Statements. The majority of our long-term contracts will continue to recognize revenue and earnings over time as the work progresses because of the continuous transfer of control to the customer, generally using an input measure (e.g., costs incurred) to reflect progress. However, we will be precluded from using the reallocation method of recognizing adjustments in estimated profit on contracts discussed previously. The total impact of an adjustment in estimated profit recorded to date on a contract will be recognized in the period it is identified (cumulative catch-up method), rather than recognizing the impact of an adjustment prospectively over the remaining contract term. As a result, adjustments in contract estimates may be larger and likely more variable from period to period, particularly on our contracts of greater value and longer performance period (for example, in our Marine Systems group), and may introduce an element of variability to our operating results that we have not experienced using the reallocation method. Despite this variability, a contract's cash flows and overall profitability at completion are the same under the cumulative catch-up method versus our current method of prospectively recognizing adjustments in estimate. Anticipated losses on contracts will continue to be recognized in the quarter they are identified.

For our contracts for the manufacture of business-jet aircraft in the Aerospace group, we currently record revenue at two contractual milestones, green and outfitted aircraft delivery. Under ASU 2014-09, we will record revenue when control is transferred to the customer, generally when the customer accepts the fully outfitted aircraft. ASU 2014-09 will not change the total revenue or operating earnings recognized on our new aircraft contracts, only the timing of when those amounts are recognized.

Numerous other contracts in our portfolio will be impacted by ASU 2014-09, due primarily to the identification of multiple performance obligations within a single contract. However, we do not anticipate that these impacts will be material to our Consolidated Financial Statements.

Example disclosure (Continued)

(full retrospective, early adoption,
detailed disclosure of impact on FY15 and control framework)

General Dynamics Corporation (Continued)

We have assessed our 2015 operating results under ASU 2014-09. In our three defense groups, the assessment under ASU 2014-09 did not have a material impact on our results of operations. Our defense groups' revenue and operating margin for 2015 were essentially unchanged. In our Aerospace group, the assessment under ASU 2014-09 increased revenue and operating margin by 4 percent and 40 basis points, respectively, as compared to 2015 operating results under existing GAAP. The increase in revenue and operating margin compared to as-reported 2015 operating results is due to the relationship between green and outfitted aircraft deliveries and the timing and mix of those aircraft deliveries. Because we delivered more outfitted aircraft than green aircraft in 2015, revenue and operating earnings were higher in 2015 under ASU 2014-09 versus under existing GAAP.

The impact of ASU 2014-09 on our 2015 operating results may or may not be representative of the impact on subsequent years' results. As noted above, aircraft manufacturing revenue in our Aerospace group will be recognized when control is transferred to the customer, generally when the customer accepts the fully outfitted aircraft, which will depend on annual delivery rates. Moreover, as described above in our defense groups, use of the cumulative catch-up method of recognizing adjustments in estimated profits on our long-term contracts will require us to recognize the total impact of an adjustment in the period it is identified rather than prospectively over the remaining contract term as we have in the past.

On our Consolidated Balance Sheet, long-term contracts will continue to be reported in a net asset (contracts in process) or liability (customer advances and deposits) position on a contract-by-contract basis at the end of each reporting period. Business-jet components in our Aerospace group will be reported in inventory until control of the aircraft transfers to the customer. The assessment of our December 31, 2015, Consolidated Balance Sheet under ASU 2014-09 resulted in some reclassifications among financial statement accounts, but these reclassifications did not materially change the total amount of net assets as of December 31, 2015.

Once we adopt ASU 2014-09, we do not anticipate that our internal control framework will materially change, but rather that existing internal controls will be modified and augmented, as necessary, to consider our new revenue recognition policy effective January 1, 2017. As we implement the new standard, we have developed internal controls to ensure that we adequately evaluate our portfolio of contracts under the five-step model and accurately restate our prior-period operating results under ASU 2014-09."

Example disclosure

(no adoption method elected, standard adoption date, potential impact on cost)

AT&T Inc.

"…… These standards replace existing revenue recognition rules with a comprehensive revenue measurement and recognition standard and expanded disclosure requirements. ASU 2014-09, as amended, becomes effective for annual reporting periods beginning after December 15, 2017, at which point we plan to adopt the standard.

The FASB allows two adoption methods under ASU 2014-09. Under one method, a company will apply the rules to contracts in all reporting periods presented, subject to certain allowable exceptions. Under the other method, a company will apply the rules to all contracts existing as of January 1, 2018, recognizing in beginning retained earnings an adjustment for the cumulative effect of the change and providing additional disclosures comparing results to previous rules ("modified retrospective method"). We continue to evaluate the available adoption methods.

Upon initial evaluation, we believe the key changes in the standard that impact our revenue recognition relate to the allocation of contract revenues between various services and equipment, and the timing of when those revenues are recognized. We are still in the process of evaluating these impacts. As a result of our accounting policy change for customer set-up and installation costs made in 2015, we believe that the requirement to defer such costs under the new standard will not result in a significant change to our results. However, the requirement to defer incremental contract acquisition costs and recognize them over the contract period or expected customer life will result in the recognition of a deferred charge on our balance sheets. We cannot currently estimate the impact of this change upon adoption, as the industry continues to undergo changes in how devices and services are sold to customers."

Example disclosure

(full retrospective, early adoption, material impact)

Microsoft

"……
The new standard will be effective for us beginning July 1, 2018, and adoption as of the original effective date of July 1, 2017 is permitted. We currently anticipate early adoption of the new standard effective July 1, 2017. Our ability to early adopt using the full retrospective method is dependent on system readiness, including software procured from third-party providers, and the completion of our analysis of information necessary to restate prior period financial statements.

We anticipate this standard will have a material impact on our consolidated financial statements. While we are continuing to assess all potential impacts of the standard, we currently believe the most significant impact relates to our accounting for software license revenue. We expect revenue related to hardware, cloud offerings, and professional services to remain substantially unchanged. Specifically, under the new standard we expect to recognize Windows 10 revenue predominantly at the time of billing rather than ratably over the life of the related device. We also expect to recognize license revenue at the time of billing rather than over the subscription period from certain multi-year commercial software subscriptions that include both software licenses and Software Assurance. Due to the complexity of certain of our commercial license subscription contracts, the actual revenue recognition treatment required under the standard will be dependent on contract-specific terms, and may vary in some instances from recognition at the time of billing.

We currently believe that the net change in Windows 10 revenue from period to period is indicative of the net change in revenue we expect from the adoption of the new standard."