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WHITE PAPER

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Are You Ready for "New GAAP" Revenue Recognition?

SEC Disclosure Considerations

Public companies are running out of time to disclose how the new GAAP revenue recognition standards—ASC 606, *Revenue from Contracts with Customers*—will impact previously reported, and/or comparative period, top-line revenue and related income statement line items. The new standards apply to most U.S. public companies and must be adopted for annual reporting periods beginning after December 15, 2017. Companies are encouraged to augment their disclosures to investors in the upcoming Form 10-Q for the quarter ending September 30, 2017, particularly with regard to the progress of ASC 606 implementation and to the qualitative and quantitative impact of the new standards.

To assist companies with preparations, internal and outside counsel should refer to guidance previously provided by SEC staff.

"NEW GAAP" REVENUE RECOGNITION

In 2014, the U.S. Financial Accounting Standards Board ("FASB") issued new revenue standards under Accounting Standards Codification ("ASC") 606, *Revenue from Contracts with Customers* (Accounting Standards Update ("ASU") 2014-09), which essentially replaced existing revenue recognition requirements under U.S. generally accepted accounting principles.[1] Following several amendments to ASC 606 in 2015 and 2016, the final standards, referred to as "New GAAP revenue recognition," must be adopted by most U.S. public companies (other than those choosing early adoption) for the annual reporting periods (and subsequent interim reporting periods) beginning after December 15, 2017. As a result, the vast majority of U.S. public companies with a calendar year-end fiscal year will begin reporting under the New GAAP revenue recognition standards beginning in the first quarter of 2018.[2]

While the details of the application of the New GAAP revenue recognition standards are complex and beyond the scope of this *White Paper*, the result of their implementation will mean that public companies must choose to disclose the changes to their financial statements as a result of the standards in future periodic reports filed with the U.S. Securities and Exchange Commission ("SEC") using either the *full retrospective method*, which involves recasting prior periods revenue and expenses to reflect the effects of the new standards, or the *modified retrospective method*, which will apply the new standard to all contracts entered into after the adoption date and involve an opening balance sheet adjustment for the period for prior contracts with remaining obligations. While each method has pros and cons that are likely to be company specific, both methods could significantly impact previously reported and/or comparative period top-line revenue and related income statement line items in public companies' future annual and interim reports following the effective date.

SEC EMPHASIS ON TRANSITION DISCLOSURES UNDER SAB 74

Many in-house lawyers may view this as principally an accounting matter left to the internal accounting and finance staff and outside auditors. While those groups may bear the bulk of the heavy lifting, the SEC staff has been clear that it sees this as a significant disclosure matter for companies in their SEC reports leading up to the effective date of the new standards. In multiple conferences and speeches since 2016, members of the SEC's Office of the Chief Accountant have publicly encouraged companies to provide transition disclosures to investors about the effects of the New GAAP revenue recognition standards under the standards of Staff Accounting Bulletin ("SAB") No. 74 (codified in SAB Topic 11.M).[3] Under SAB 74, when a recently issued accounting standard has not yet been adopted, a reporting company is required to discuss the potential effects of the future adoption in its interim and annual SEC filings. While most public companies have at least identified ASC 606 in the "recent accounting pronouncements" disclosures in their annual and interim reports for the current fiscal year, the level of disclosure to this point has varied significantly among companies. For example, in its disclosure for the quarterly period ended July 1, 2017, Apple Inc. simply stated:

> The new revenue standards may be applied retrospectively to each prior period presented or retrospectively with the cumulative effect recognized as of the date of adoption. The Company plans to adopt the new revenue standards in its first quarter of 2019 utilizing the full retrospective adoption method. The new revenue standards are not expected to have a material impact on the amount and timing of revenue recognized in the Company's consolidated financial statements.[4]

By contrast, Microsoft Corporation, in its most recent disclosure for its fiscal year ended June 30, 2017, included a more detailed qualitative and quantitative discussion:

> The most significant impact of the standard relates to our accounting for software license revenue. Specifically, for Windows 10, we will recognize revenue predominantly at the time of billing and delivery rather than ratably over the life of the related device. For certain multi-year commercial software subscriptions that include both distinct software licenses and Software Assurance, we will recognize license revenue at the time of contract execution rather than over the subscription period. Due to the complexity of certain of our commercial license subscription contracts, the actual revenue recognition treatment required under the standard will depend on contract-specific terms and in some instances may vary from recognition at

the time of billing. Revenue recognition related to our hardware, cloud offerings such as Office 365, LinkedIn, and professional services will remain substantially unchanged.

Adoption of the standard will result in the recognition of additional revenue of $6.6 billion and $5.8 billion for fiscal year 2017 and 2016, respectively, and an increase in the provision for income taxes of $2.5 billion and $2.1 billion, respectively, primarily due to the net change in Windows 10 revenue recognition. In addition, adoption of the standard will result in an increase in accounts receivable and other current and long-term assets of $2.7 billion and $4.2 billion, as of June 30, 2017 and 2016, respectively, driven by unbilled receivables from upfront recognition of revenue for certain multi-year commercial software subscriptions that include both distinct software licenses and Software Assurance; a reduction of unearned revenue of $17.8 billion and $11.7 billion as of June 30, 2017 and 2016, respectively, driven by the upfront recognition of license revenue from Windows 10 and certain multi-year commercial software subscriptions; and an increase in deferred income taxes of $5.2 billion and $4.8 billion as of June 30, 2017 and 2016, respectively, driven by the upfront recognition of revenue.[5]

Clearly the New GAAP revenue recognition standards may have widely varying degrees of impact among companies depending on their specific business practices, industry, and size, particularly with respect to the materiality of the potential impact. It is likely that these variations account for much of the variance thus far in these disclosures. A review of multiple recent filings, however, indicates that many companies have yet to disclose a selected methodology for the implementation of the standards, and many have simply stated that they are still reviewing the new standards as they relate to the company's existing contracts and cannot currently estimate the financial impact of the implementation of such standards.

LAST CALL FOR TRANSITION DISCLOSURE

For calendar year public companies, the upcoming Form 10-Q for the third quarter ending September 30, 2017, is the last chance before year-end to provide investors with some meaningful disclosure on their progress on implementation of ASC 606, as well as qualitative and quantitative disclosures on the anticipated impact of the new standards. The SEC staff has indicated that it expects SAB 74 disclosures to be more robust and descriptive as the mandatory implementation date draws closer. Accordingly, public companies are encouraged to revisit and enhance their disclosures in their upcoming quarterly report, as the preparation and analysis by internal and external accountants and consultants should be getting closer to completion.

In assisting such review and disclosure, internal and outside counsel should review again and consider the SEC staff's guidance in the following areas:

Description of the Standard and Implementation

SAB 74 states that the company shall briefly describe the new standard, the date that adoption is required, and the date that the company plans to adopt, if earlier. In addition, the company shall include a description of the methods of adoption allowed by the standard and the method expected to be utilized by the company, if determined (e.g., with respect to the New GAAP revenue recognition standards, whether the company will utilize a full retrospective method or modified retrospective method upon adoption).

Quantitative and Qualitative Disclosures

Under SAB 74, a company is required to describe the impact that adoption of the new standard is expected to have on the company's financial statements, unless not known or reasonably estimable. In the case where a company does not know, or cannot reasonably estimate the expected financial statement impact, that fact should be disclosed. In those cases, however, the SEC staff has indicated that it expects a qualitative description of the effect of the new accounting policies, and a comparison to the company's current accounting to assist investors' understanding of the impact.

Status of Implementation Process

The SEC staff has indicated that companies should also disclose the status of its implementation process for the new standard and significant implementation matters yet to be addressed.

Internal Control over Financial Reporting

An additional area the SEC staff has emphasized in recent remarks regarding the implementation of New GAAP revenue recognition standards, is the need to involve the audit committee in the process and to ensure that the SAB 74 disclosures are subject to effective internal control over financial reporting ("ICFR"). The SEC staff has stated that as management completes portions of its implementation plan for the New GAAP revenue recognition standards and assesses the anticipated impact of the new standards, effective internal controls should be in place to timely identify these transition disclosures. In assessing effectiveness of ICFR for the pre-adoption transition disclosure periods, management should ensure that the COSO or other appropriate framework properly identifies and addresses these additional implementation assessments and disclosures.

MATERIALITY AND NEW GAAP REVENUE RECOGNITION DISCLOSURES

As an additional consideration, companies should review again and consider their pretransition disclosures for New GAAP revenue recognition as it relates to materiality. Many companies have already indicated in previous filings that they do not expect the implementation of the New GAAP revenue recognition standards to have a "material" impact on their financial statements. While this assessment may be true in some or all of these circumstances, the SEC staff has expressed skepticism in this regard, noting that even if the extent of the changes on the balance sheet or income statement is not deemed material, the related disclosures may be material. Accordingly, companies are cautioned to consider the full scope of the New GAAP revenue recognition standard, which covers recognition, measurement, presentation, *and* disclosure.[6]

NEW GAAP REVENUE RECOGNITION AND REGISTRATION STATEMENTS

As a final consideration, U.S. public companies that are adopting New GAAP revenue recognition pursuant to the full retrospective method should be strategic about when they file new or amended registrations statements in 2018.

In particular, pursuant to Item 11(b)(ii) of Form S-3, if there is a change in accounting principles that requires a material retroactive restatement of financial statements and a company has filed financial statements for a historical period reflecting the change in accounting principles, then the company could be required to incorporate by reference or include retrospectively revised audited financial statements that also reflect the change in accounting principles into its Form S-3 registration statement.[7]

Consider a U.S. public company with a calendar year-end fiscal year adopting New GAAP revenue recognition as of January 1, 2018, pursuant to the full retrospective method. Once the company files its first quarter 2018 Form 10-Q reflecting the full retrospective method, and until it files its fiscal year 2018 Form 10-K in early 2019, the company could be required to incorporate by reference or include retrospectively revised financial statements for 2017, 2016, and 2015 into its Form S-3. The SEC staff has noted that such a company could seek to avoid retrospectively revising its financial statements for 2015 by relying upon the impracticable exception provided by Asc 250, *Accounting Changes and Error Corrections*. That said, the SEC staff encouraged, but did not mandate, a company in that circumstance to consult with the SEC staff regarding its specific fact pattern. Should the company wait to file its Form S-3 registration statement until after it files its fiscal year 2018 Form 10-K in early 2019, it would not need to retrospectively revise any prior period financial statements. Additionally, a company could avoid this analysis by filing its Form S-3 registration statement before filing its first quarter 2018 Form 10-Q reflecting the full retrospective method.[8]

The analysis is different for shelf takedowns. In a shelf takedown off of an effective registration statement, even one occurring after the company files its first quarter 2018 Form 10-Q reflecting the full retrospective method and before it files its fiscal year 2018 Form 10-K in early 2019, the company would only be required to incorporate by reference or include retrospectively revised financial statements if the adoption of New GAAP revenue recognition pursuant to the full retrospective method constituted a "fundamental change" under Section 512(a) of Regulation S-K. As acknowledged by the SEC staff, fundamental changes are rare and, absent a unique set of circumstances, we would not expect revisions to prior historical financial statements applying the full retrospective method to constitute a fundamental change.[9]

Similar issues may apply to other registration statements on other forms. While financial statements for which the requirements of Item 11(b)(ii) of Form S-3 would require restatement may not necessarily need to be restated for incorporation by reference into Form S-8,[10] the issues raised by New GAAP revenue recognition are complex, and companies should consider their future plans with respect to registration statements and consult with counsel.

* * *

While every public company, large and small, and from a vast array of industries, may have a significantly different experiences with the adoption and implementation of New GAAP revenue recognition standards, all will be impacted to some significant degree, and time is running out to ensure that your SAB 74 pre-adoption transition disclosures provide investors with a sufficient understanding of how you will look under New GAAP revenue recognition.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the other lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com/contactus/.

Bradley C. Brasser
Chicago
+1.312.269.4252
bcbrasser@jonesday.com

Joel T. May
Atlanta
+1.404.581.8967
jtmay@jonesday.com

Rory T. Hood
New York
+1.212.326.3814
rhood@jonesday.com

W. Stuart Ogg
Los Angeles
+1.213.243.2365
sogg@jonesday.com

Thomas L. Short, an associate in the Atlanta Office, assisted in the preparation of this White Paper.

NOTES

1 The International Accounting Standards Board also issued substantially similar new revenue standards under International Financial Reporting Standards 15, *Revenue from Contracts with Customers*.

2 Related new accounting standards for leases and financial instruments/credit losses are scheduled to go into effect in calendar years 2019 and 2020, respectively.

3 See, e.g., *Remarks before the 36th Annual SEC and Financial Reporting Institute Conference: "Advancing the Role of Credible Financial Reporting in the Capital Markets,"* June 8, 2017, Wesley R. Bricker, Chief Accountant (OCA); and *Remarks before the Bloomberg BNA Conference on Revenue Recognition*, May 8, 2017 by Sylvia E. Alicea, Professional Accounting Fellow (OCA).

4 See Apple's Form 10-Q for the fiscal quarter ended July 1, 2017.

5 See Microsoft's Form 10-K for the fiscal year ended June 30, 2017. Microsoft also included a detailed tabular disclosure of expected impact on the New GAAP revenue recognition standards on specific income statement and balance sheet line items.

6 See *Remarks before the Bloomberg BNA Conference on Revenue Recognition*, May 8, 2017 by Sylvia E. Alicea, Professional Accounting Fellow (OCA).

7 See Form S-3, Item 11(b)(ii) and Financial Reporting Manual, SEC Division of Corporation Finance, Section 13210.1 and .2 (Aug. 25, 2017).

8 See Financial Reporting Manual, SEC Division of Corporation Finance, Section 13210.2 (Aug. 25, 2017).

9 See PriceWaterhouseCoopers LLP, *2016 AICPA Conference: Highlights of the 2016 AICPA Conference on Current SEC and PCAOB Developments* 7 (Dec. 12, 2016).

10 See Financial Reporting Manual, SEC Division of Corporation Finance, Note to Section 13100 (Aug. 25, 2017).

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