How Deltek Vision Helps Project-based Businesses Prepare for ASC Topic 606 and IFRS 15

Revenue from Contracts with Clients

Contents

Starting January 1, 2018 ASC 606 and IFRS 15 will take effect regulating companies that recognize revenue from contracts with clients. Both standards detail that revenue is recognized when an entity satisfies a performance obligation by transferring a good or service to a client and the client has received control of that good/service.

Understanding these new principle-based frameworks will require companies to look closely at how several steps in the contracting process affect revenue recognition. It is important to note that these standards affect not only the accounting or financial departments within a company, but also other departments such as marketing, business development, and project management who interact with client contracts.

The effective dates are as follows:

Public companies and certain not for profits — reporting periods begin after 12/15/2017 for ASC 606 only.* IFRS 15 begins on or after 1/1/2018.

Non-public companies — reporting periods begin after 12/15/2018 (ASC 606 only; IFRS 15 on or after 1/1/18).

As companies move towards adoption of these new standards, there are two transition or adoption methods available, both of which will require a detailed review of contracts to determine the cumulative adjustment to revenue.

1. Full retrospective adoption requires 3 years of financial statement comparison, including 2 prior years. No restatement of contracts that begin and end within the same company fiscal year.

2. Modified retrospective application is the cumulative effect of applying the new standard as an adjustment to the opening balance of retained earnings at the date of initial application for contracts that are still ongoing at the date of adoption.

With the release of this Revenue Recognition Standard, companies now have a five-step model for recognizing revenue:

1. Identify the Contract with the Client
2. Identify the Separate Performance Obligations
3. Determine the Transaction Price
4. Allocate the Transaction Price to the Performance Obligations
5. Recognize Revenue as Each Performance Obligation is Satisfied

Step 1: Identify the Contract with the Client

There must be a promise to deliver goods or services with a high probability that the company will be able to collect the amounts owed from the client.

» Under the new standards, companies may need to combine or separate contracts, based on the contract language. It is very important to review all contracts.

» Companies may need to restructure the language and provisions of contracts going forward, to facilitate identifying payment terms. Processing new contracts with existing clients may need a process step to evaluate how "separate" the new contract actually is from ongoing work with the client. In particular, modifications or add-on work needs to be assessed, since they can sometimes require a detailed review of contracts to determine the cumulative adjustments to revenue.

There are two methods to adopt the new standards to existing contracts:

1. Full retrospective application: Requires 3 years of financial statement comparison, including 2 prior years. No restatement of contracts that begin and end within the same company fiscal year.

2. Modified retrospective application: The cumulative effect of applying the new standard as an adjustment to the opening balance of retained earnings at the date of initial application for contracts that are still ongoing as the date of adoption.

» Companies may need their financial and audit advisors to help them choose which option is best for them.

Deltek Vision provides Opportunity and Contract Management tools to collect and control both new and add-on contract negotiations. Compensation values for revenue recognition can be synchronized to match contracts. In addition, several agreements can be combined into a single tracked "contract," or a single agreement can be split among work structures and tracked as a single "contract."

Review of any contract templates will lead to clear pre-payment, retainer and retainage clauses. Standardizing contract language can be effective to identify each party's rights. Using Vision's template features, standardization of these components will lead to smoother revenue recognition.

Once a contracting process has been designed, Vision's Contract Workflows can be tailored to the company's specific needs, providing oversight, guidance and consistency in identifying the contract.

Step 2: Identify the Separate Performance Obligations

A performance obligation is defined as a bundle of goods or services from which the client can benefit. Goods and/or services may need to be combined into a single performance obligation or broken apart into separate performance obligations, based on whether the good or service is distinct and has a value on its own.

» Marketing and proposal materials, as well as specific contract language, can be helpful to create a deliberate integration of services. This can have an impact on how revenue can be recognized over time for a large deliverable, particularly when the deliverable is unique to the client.

» Performance obligations are met when control of the good or service passes to the client. The company needs to assess certain activities like set-up activities or pre-planning to determine the character of the client's control. These activities might not provide any revenue as they may have in the past.

» Identifying performance obligations requires significant judgment, but consistency in identifying deliverables can be helpful to making distinctions. Integrating Vision's Proposal module can control representations made during negotiations. Proposal template materials can provide substantiation of "customary business practices." All of which is important in defining a performance obligation.

Deltek Vision offers separate revenue recognition on each piece of flexible work breakdown structure, to match performance obligations. Vision's Revenue Groups feature is just one way to have several work breakdown structures match to a single performance obligation.

Step 3: Determine the Transaction Price

The transaction price is the amount of consideration a company expects to receive from the client in exchange for transferring promised goods and services. This transaction price is determined at contract inception, but needs to be reassessed for each reporting period. Therefore, the company's process for modification, write-off, or changes to agreements needs to be monitored for easy review.

» Transaction price has two components—fixed amounts and variable consideration:

- Variable consideration may change the amount received from the client. Examples include: discounts, financing, incentive fees/award fees, performance penalties, etc.

- If a contract includes variable consideration, the company will estimate the amount of variable consideration based on expected value (appropriate if large number of contracts with similar characteristics) or most likely value (appropriate if contract has two possible outcomes).
- Payment terms can also affect the transaction price, since the contract is considered to contain a financing component if the payment by the client occurs significantly before or after the performance obligation has been satisfied. Explicit or implicit interest income or expense resulting from the financing component should be presented separately on the financial statements.

Vision helps maintain transaction prices via the Service Profiles of Fee Estimates and user-defined Contract Types in Contract Management. Multiple posting accounts can be utilized for separating the financing, or other variable consideration by utilizing a sophisticated Accounts Receivable Configuration model in Vision.

Step 4: Allocate the Transaction Price to the Performance Obligations

The transaction price allocated to each performance obligation is what the client agrees to pay for delivery of the goods and services.

» If there is more than one performance obligation for the delivery of goods and services, the transaction price is allocated to each based on the relative standalone selling price.

- For example, if a company is charging for one item, and a separate item is shown in the contract as "no cost," a standalone price will need to be allocated to that "no cost" item if the company sells that good or service separately for a similar type of contract.

» Next determine whether the variable consideration should apply (and be allocated) to the entire contract or to a specific performance obligation.

For a long-term contract, standalone prices can change and even the contract's performance obligations may change over time. Using Vision's user-defined reporting capability, more detailed review of long-term contracts can be simplified.

With Vision, allocate pricing to performance obligations using work breakdown structure can provide the revenue breakout needed. By utilizing the Contract Management feature with the synchronization to Compensation amounts, revenue recognition can use the most current allocation of transaction price.

Step 5: Recognize Revenue as Each Performance Obligation is Satisfied

Revenue can be recognized once a performance obligation is satisfied and control of goods and services passes to the client.

» Control passes to the client either 'Over Time' or 'Point in Time'

- Control passes to the client 'Over Time' when:
  - ✓ Client benefits as work is performed, and/or
  - ✓ Client controls the asset as work is performed (work in process), and/or
  - ✓ There is no alternative use for asset created
- Control passes to client as 'Point in Time' when:
  - ✓ Client obtains control or gets benefit from transfer and all terms of the performance obligation are met.

Using Vision Planning can greatly assist in providing the clear, measurable progress on performance obligations. By constantly looking at the estimate to complete, the progress is properly revalued and can be utilized by Vision's automatic revenue recognition.

Vision's automated revenue recognition process allows separate calculations for each section of work breakdown structure and, as mentioned, utilizes the Vision Planning components to assess progress. Using Vision's Revenue Categories, the company can have different calculations on parts of even a single work piece. By disconnecting the revenue recognition process from the invoicing process, Vision provides an integrated, and real-time, look at work in process, unbilled services, and billings in excess of revenue.

Disclosures and Financial Reporting

The objective of the financial disclosures is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, and uncertainty of revenue of the company. Since the standard is more judgment-based and uses less industry-specific guidance, the disclosure requirements have increased.

Disclosures include quantitative and qualitative information. Utilizing the powerful revenue generation features that allow Revenue Categories, Accounts Receivable configuration, and override of revenue accounts at posting can provide better transparency on financial statements of the nature the revenue, with a disaggregation by type of contract, product line, geographic region or many other characteristics.

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In addition, the involvement of many people outside the finance department can be recorded and reported using updates and notations in Opportunity stages, Contract Management, and progress on plans. This leads to better understanding of contracts' life cycle, changes over time, and the impact of the five steps described here.

Stay Compliant with Deltek Vision

Deltek Vision provides a variety of tools and features to deal with revenue recognition and these new standards. Revenue can be recognized at cost or selling price based on the recording of time against a work piece, invoice creation or percentage of progress on a work piece. Revenue Categories allow separation and exposure of variable consideration and other judgments on a contract.

Deltek Vision helps companies meet the requirements of these new revenue standards. However, the new revenue standard is very complex and it is between a company and their auditors to determine whether they are compliant and what, if any changes are needed to their business processes to be compliant.

Companies must be able to do revenue analysis and comparisons of different calculations by project. They must also be able to do comparative reporting of revenue and financial statements based on differences, at least quarterly, in order to provide the reports required by the new standard and, in the case of public companies, the SEC and its European counterparts.

Most important for the new requirements, Vision enables companies to efficiently apply the five steps of the new revenue recognition standards. Consolidating and presenting the entire project and contract life cycle is a key principle of Vision's design.

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Notes:

*Not for IFRS 15
**The revenue standard is very complex and it is between a company and their auditors to determine whether they are compliant and what, if any changes need to be made to become compliant.

References:

» Morgan Franklin Consulting – ASC Topic 606, Revenue from Contracts with Customers

» PWC – Revenue from contracts with customers – 2014 global accounting and financial reporting guide.