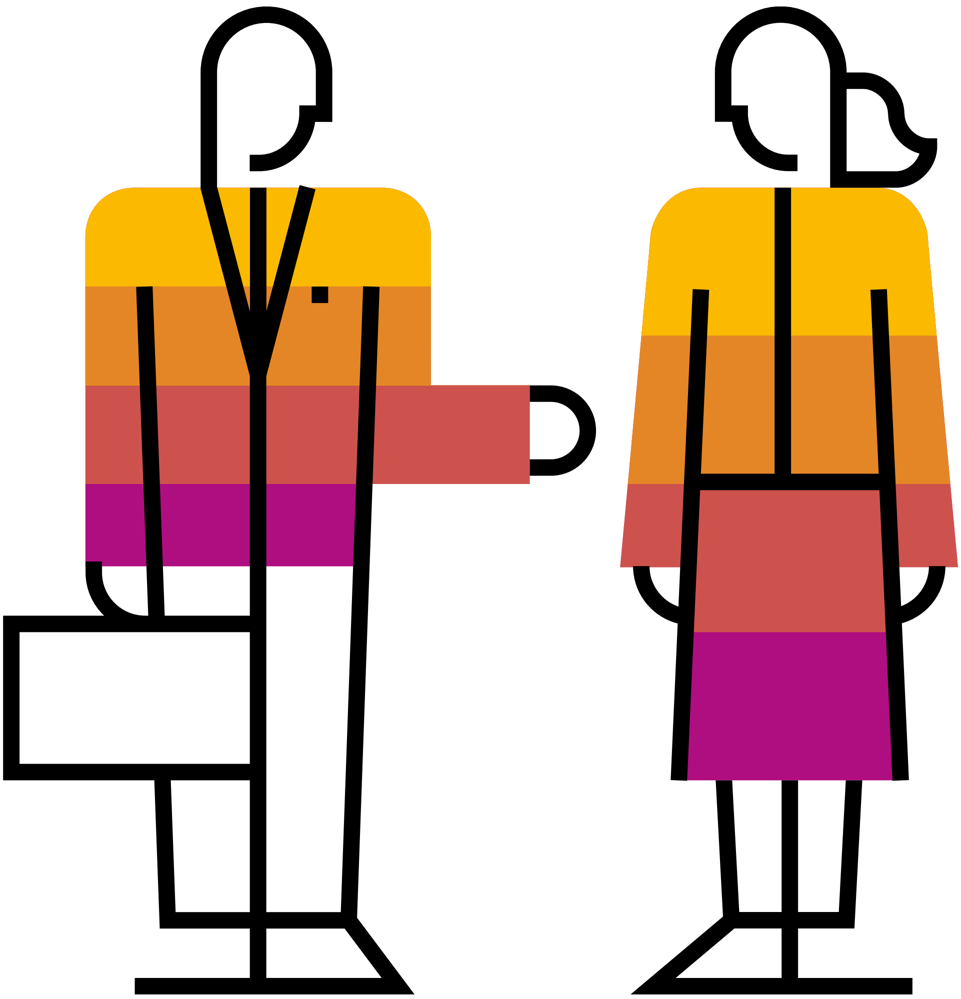
SAP Thought Leadership Paper
Revenue Recognition and Lease Accounting

Getting Smart About Revenue Recognition and Lease Accounting

What the Rule Changes Mean for Your Business



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With new regulatory changes coming into effect for revenue recognition and lease accounting, now is the time to take the action needed to ensure compliance with the new regulations.

You must analyze the new rules, determine how they impact your business, and then make the changes to processes and systems that will enable you to operate in compliance while maintaining business efficiency and effectiveness. Read on to learn more about these regulatory changes, how your company can prepare, and why you should start today.

New Rules Will Be in Effect Sooner than You Might Think

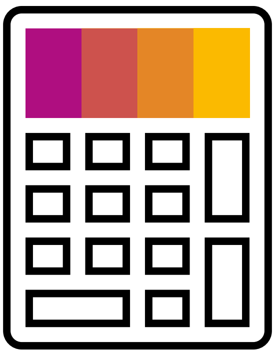
The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) recently issued a converged standard on recognition of revenue from contracts with customers. The goal is to introduce uniformity and predictability to revenue recognition practices. In addition, the FASB and IASB have also issued a new standard for leases that provides new guidance on lease accounting. The upshot is that most leases will have to be reported on each company's balance sheet in the future.

The new revenue recognition standard takes effect for most companies in 2018, but for companies choosing the full retrospective adoption approach, the comparative period has already begun. The new lease accounting standard was released in 2016 and takes effect for most companies in 2019. However, for companies that choose the full retrospective adoption approach, the transition period will start in 2018.

While these dates may seem far away, the reality is that your organization will need time to put in place new financial processes and the technology to support them. This paper will review the changes these new regulations will bring and examine the impact they will have on your financial reporting processes.

REVENUE RECOGNITION

New guidance from the FASB and IASB provides details on how companies should recognize revenue in financial statements under both U.S. Generally Accepted Accounting Principles (U.S. GAAP) and International Financial Reporting Standards (IFRS). Companies that sell products and services in a bundle, or those engaged in projects that extend over long periods of time – in industries such as telecommunications, software, engineering, construction, and real estate – could see significant changes to the timing of revenue recognition. According to the FASB chairman, Russell Golden, the new regulation will "eliminate a major source of inconsistency in GAAP, which currently consists of numerous disparate, industry-specific pieces of revenue recognition guidance."[1]



Companies that sell products and services in a bundle could see **significant changes** to the timing of revenue recognition.

1. FASB news release, "IASB and FASB Issue Converged Standard on Revenue Recognition," May 28, 2014, www.fasb.org/jsp/FASB/FASBContent_C/NewsPage&cid=1176164075286&pf=true.

Start dates for companies to comply with these regulations will vary:
- Public companies using U.S. GAAP will be required to apply the standard for annual reporting periods beginning after December 15, 2017.
- U.S. private companies and organizations are required to apply the revenue standard for annual reporting periods beginning after December 15, 2018.
- Companies using IFRS will be required to apply the revenue standard for reporting periods beginning on or after January 1, 2018.

Under the new standard, companies will be required to follow this five-step process:
1. **Identify the contract with the customer.** While this may sound simple enough, it is important to remember that the revenue accounting process can combine items from different operational contracts and applications in a single contract. Clearly associating the right customers and projects with the right contracts lays the foundation for subsequent steps in the process.
2. **Identify the separate performance obligations in the contract.** This step defines the distinct goods and services within a contract, along with the selling price, where the price is allocated, and how fulfillment is determined. While a performance obligation typically corresponds to a specific item in an operational contract, it can also comprise a combination of several items – such as various line items on a bill of materials (BOM) or implicit obligations to provide software upgrades to customers in the future.
3. **Determine the transaction price.** The transaction price is determined from the pricing conditions of the operational items. The transaction price is the amount of consideration, fixed or variable, to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer.
4. **Allocate the transaction price to the separate performance obligations in the contract.** The transaction price is then allocated to the various performance obligations to identify the revenue amount that will be recognized when the performance obligation is satisfied. Guidance is provided for cases in which the transaction price changes during the life of the contract.
5. **Recognize revenue when (or as) the business satisfies a performance obligation.** According to the "transfer of control" principle, this final step allows revenue to be recognized when control over a good or service is transferred to the customer and the corresponding performance obligation is satisfied.

Many companies will continue to use methods that are comparable to either the percentage-of-completion or proportional performance accounting models under these new rules. But they will still need to reassess whether revenue is recognized over time or at a point in time for each performance obligation. Changes may also be made to how the percentage-of-completion or proportional performance model is applied – particularly for those using units of production or delivery.

Companies will need to reassess whether revenue is recognized over time or at a point in time for **each performance obligation**.

Your company may feel the impact of these rule changes in a variety of ways. First and foremost, you should analyze your revenue contract portfolio to evaluate which contracts may need to be combined and which may entail new performance obligations under the new rules.

All of the impacts and implications of the new revenue regulations can be more effectively forecasted and managed by carefully capturing the critical contract data, tagging the contract terms, and enabling collaboration among stakeholders through contract sharing, discussions, and notifications. This is necessary to support the wide range of new estimates, judgments, and disclosures required.

LEASE ACCOUNTING

For a wide range of strategic financial reasons, companies everywhere use leases as an alternative to purchasing assets. However, the standard accounting practice for operating leases – namely, reporting them off balance sheet so that debt is not shown and disclosing them in the notes of financial statements – lacks the transparency investors need. The current standards (FAS-13 for FASB and IAS 17 for IFRS) present challenges in comparing the financial position and operating results of companies that purchase assets with those of companies that lease similar assets. And the exclusion of lease liabilities from the balance sheet leads to an incomplete picture of the financial position of a company for the investor and financial statement reader. Many stakeholders with an interest in greater financial transparency also want an accounting model that reports future lease commitments on the company's balance sheet.

The FASB and IASB have issued new rules that meet the demand for improved transparency. Companies are now required to record lease assets and liabilities on the balance sheet. In the case of lease assets with values of less than US$5,000 or a lease term of 12 months or less, IASB (IFRS 16) has a lessee recognition and measurement exemption. Leases are now "capitalized" by recognizing the present value of the minimum lease payments and showing them as right-of-use assets on the balance sheet. If lease payments are made over time, the lessee also recognizes a financial liability representing its obligation to make future lease payments.

Therefore, a lessee is required to recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in the statement of financial position. The most significant effect of the new requirements will be an increase in lease assets and financial liabilities. Accordingly, for companies with a lot of off-balance-sheet leases, there will be a change to key financial metrics derived from the company's assets and liabilities (for example, debt-to-equity ratio).

Another significant effect of the new standard is the separation of lease and service components, as leases may be embedded in service arrangements or provided alongside other goods or services. Lessees are required to separate lease components and service components of a contract and allocate payments to those separate components based on the observable standalone price of the components involved. Therefore, an accounting assessment is required by the lessee before recognizing the lease asset and liability in the balance sheet.

Since the implications of such changes may ripple through your business, your company should determine which parts of the business need to be aware of the potential changes and educate the relevant business leaders. In addition to your corporate accounting and finance groups, support may be needed from various other groups including IT, HR, tax, procurement, treasury, and investor relations.

The chief challenge with regard to these new rules is the lack of visibility into the current lease portfolio. If your company is like most, lease data is dispersed across the entire organization, both geographically and in various formats (paper and electronic). Within the organization, different departments or groups collect data using diverse processes and mechanisms, leading to significant variation in the quality, integrity, and relevance of lease data across information sources. Poor documentation and limited transparency into the assumptions used for lease classification cause confusion. In addition, as lease portfolios increase in diversity and spread across regions globally, these challenges multiply exponentially. The end result is increased risk of regulatory noncompliance and inaccurate reporting.

In order to prepare for compliance with the new leasing regulations, these issues can be addressed head-on by:

- Centralizing the lease data
- Identifying and tagging the important terms for quick access in the future
- Enabling collaboration among stakeholders through contract sharing, discussions, and notifications
- Building a portfolio of leases for easier visibility of current obligations and analysis of future obligations

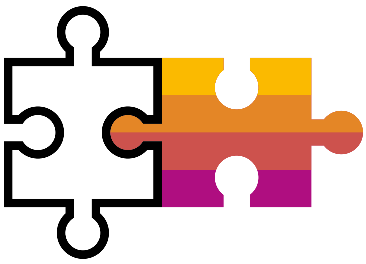
With clear visibility into your lease exposure by any critical dimension (region, business unit, and time horizon), you can make much better business decisions faster.

Implications for Processes and Technology

To comply effectively with the new revenue recognition rules, as a critical first step, your company will need to develop processes to assess the current revenue accounting contracts in light of the new regulations. This accounting assessment process will require your organization to capture key information from many revenue accounting contracts in order to document the judgments of management (executive management, sales, legal, operations, marketing, and business development) about the contracts at the source. The output of the accounting assessment should be a comprehensive accounting strategy and technical accounting recommendations for implementing the new revenue recognition rules for your company. Ideally, your company could then incorporate these judgments and accounting recommendations in an automated fashion into your accounting process and related IT systems. Revenue recognition, however, can be extremely fluid, especially as contract terms are amended or new performance obligations are added. Judgments and estimates will require periodic updating. All of this, in turn, will require IT investments in order to centralize all contracts and help improve collaboration on revenue recognition activities and judgments across various stakeholders.

For lease accounting, the objective is to build a comprehensive lease portfolio by centralizing lease data into a single repository. This approach gives you excellent access, visibility, and traceability regarding critical issues such as lease composition, key lifecycle dates, the value of leased assets, and responsible organizational units. The alternative is manually intensive one-off data aggregation and cleansing on a yearly basis to prepare for reporting. To avoid this, you need mass importing and field-mapping functionality to quickly import and integrate data from thousands of contracts across a wide range of sources. You will also need abilities to track changes and who made them from start to finish. Finally, powerful collaboration tools are essential so that stakeholders can validate contracts for leased assets and better understand all the associated legal, financial, and business implications.

For both revenue recognition and lease accounting, it is important to start activities now. Implementing fundamental process changes of the kind implied by the new regulations will take time; strategic planning and agreement are required across multiple functional groups and at the executive board level, as well as coordination with IT teams to implement the appropriate technology by the desired compliance dates. Companies that start today are more likely to succeed at a lower cost: by getting ahead of the curve they can avoid the kind of costly disruptions that can derail critical business processes and operations and risk costly noncompliance events.



Integration with other SAP solutions allows you to use data already in your SAP software environment, reducing data entry time and improving data consistency.

How SAP Can Help

SAP offers solutions to help customers comply with current and new regulations for revenue recognition and lease accounting, including the SAP® Revenue Accounting and Reporting application and the SAP Lease Administration application by Nakisa.

With the new five-step accounting process for recognizing revenue, companies face challenges with assessing their contracts. SAP Revenue Accounting and Reporting is built from the ground up to handle revenue accounting regulation and to simplify and automate revenue accounting activities.

SAP Lease Administration is complementary to SAP Revenue Accounting and Reporting and allows users to abstract, analyze, evaluate, and assess their revenue contract data. Technical accounting assessments can be challenging and tedious. This tool helps customers reduce the time and cost to perform the assessments by providing end-user productivity tools, enterprise collaboration tools, and complete audit trails for all activities. The resulting record of activities and decisions associated with revenue contracts demonstrates compliance and helps ensure accurate reporting. By generating contract summaries, users get a snapshot of all information that is relevant for reviews and audits, including a potential revenue forecast and a summary of performance obligations that are accessible to all stakeholders.

SAP Lease Administration collects and unifies contractual lease data throughout the enterprise into one comprehensive database (see the figure). This global view of lease contracts provides stakeholders with insight into contractual data and allows users to analyze their contract portfolio, including the impact on financial statements. The application helps ensure traceability for compliant reporting and offers complete visibility into the changes and decisions made during the entire data collection process.

Delivering an end-to-end lease management process, SAP Lease Administration is designed to handle a large volume of contracts, assets, and associated operations and events. The unified contract repository enables customers to onboard contracts and extracts relevant information to efficiently support accounting, regulatory, and operational processes. Rich data collection, collaboration, tracking, and reporting capabilities enable accelerated compliance with the new lease standard.

SAP Lease Administration is also designed to support current and new lease accounting standards so that companies can start early and prepare for compliance. It allows for the management of asset events such as asset casualties, replacement, and retirement to help ensure proper tracking and accounting as these events happen.

The application's robust integration with other SAP solutions allows you to use data already in your SAP software environment, reducing data entry time and improving data consistency. SAP Lease Administration is designed to handle gradual onboarding and activation of assets in batches to streamline accounting during the onboarding process. The alerts and notification capabilities provide visibility into key contract and asset events, which makes timely action possible when lease contracts are up for renewals or termination.

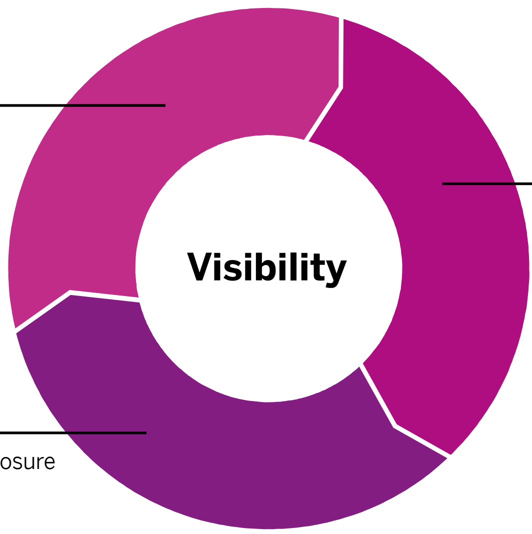
SAP Lease Administration enables customers to meet reporting and compliance requirements with greater ease and efficiency. Information-rich dashboards empower organizations with a clear view of their overall lease exposure. By conducting what-if scenarios, management teams are equipped to analyze financial implications and make informed business decisions including lease-versus-buy assessments, as well as determine the best approach to the changing landscape of lease accounting rules and regulations.

SAP Lease Administration is designed to **support current and new lease accounting standards** so that customers can start early and prepare for compliance.

Figure: End-to-End Coverage for Revenue Recognition and Lease Accounting

Validation and traceability

Validation of true and useful data
Efficient traceability for compliance
Readiness for reporting compliance



Collaboration

Open collaboration framework, engaging and aligning business decision makers
Simulation capabilities, for analyzing the best response to business changes
Efficient evaluation for lease or buy scenarios

Collection and unification

Visibility into lease and revenue contract exposure
Automated and effective data collection
Unified data in a single repository

LEARN MORE

To learn more about how SAP can help you manage change in the area of revenue recognition and lease accounting, contact your SAP representative today or visit us online at http://www.sap.com/product/financial-mgmt/nakisa-lease-administration.html.

KEY HIGHLIGHTS OF SAP® SOLUTIONS

A single source of truth for all your revenue and leasing contracts:

- Single or mass importing of contract information
- Role- and permission-based user management for secure access and the right level of visibility
- Collaboration through contract sharing, discussions, and notifications
- Associated data collected with contract terms through contract tagging
- Support for the SAP HANA® platform and SAP HANA Enterprise Cloud service
- Flexible deployment model – cloud or on premise
- Traceability of all modifications and entries in the contract implemented through a change log

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Revenue recognition capabilities:

- Optimization for revenue contract abstraction and analysis
- Support for data collection compliant with the new five-step model under the new revenue recognition standard
- Performance obligations management during the contract abstraction phase
- Maintenance of company-specific accounting policy, regulations, and a technical line for specific contracts
- Contract summary generated to facilitate review and audits
- Capabilities in the SAP® Lease Administration application by Nakisa complementary to the SAP Revenue Accounting and Reporting application

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Lease accounting capabilities:

- Support for true end-to-end operating and financial lease management including robust integration with asset accounting, general ledger, accounts payable, materials management, and plant maintenance functionality in SAP software; allows for changes to contract data to be committed back to SAP
- Optimization for lease contract abstraction and analysis
- Support for current and new lease accounting standards
- Audit trail maintained of changes and decisions made throughout the data collection process to help ensure traceability for compliance and reporting
- Support for complex lease terms, conditions, and payment schedules
- Ability to upload contracts and easily highlight and tag important areas of lease contracts
- Quick reference dashboards and reports to assess overall lease exposure and asset portfolio

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